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CREDIT OPINION
21 February 2018

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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

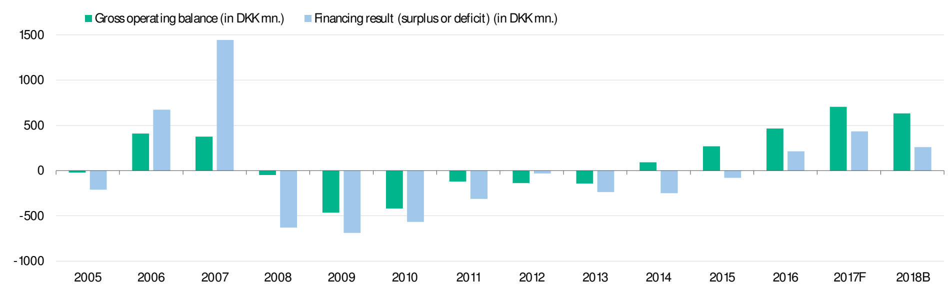
Summary

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 relatively high, also due to an infrastructure project, the construction of two sub-sea tunnels.

Exhibit 1

Financial surplus expected to be reported

Gross operating balance and financing surplus (or deficit) in DKK million, by year



Note: 2017 shows latest government forecast; 2018 is budget.
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

» High debt levels expected to remain due to a current major infrastructure project

» 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:

» Return to long-term structurally balanced budgets

» Steady reduction in debt to pre-recession levels

» 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:

» Weakening of the Faroe Islands' relationship with Denmark

» Adverse shock impacting the Faroese fishing industry

» Materially increased debt levels or guarantees above current projections

» Unexpected materialisation of construction risk from the current infrastructure project

Key Indicators

Exhibit 2

Faroe Islands, Government of

	2011	2012	2013	2014	2015	2016
Interest Payments/Operating Revenue (%)	3.0	3.0	2.3	1.8	1.6	0.9
Accrual Financing Surplus(Requirement)/Total Revenue (%)	-5.3	-5.6	-3.8	-3.8	-1.2	2.8
Gross Operating Balance/Operating Revenue (%)	-2.0	-2.4	-2.4	1.4	4.1	6.4
Net Direct and Guaranteed Debt/Operating Revenue (%)	104.6	106.3	109.8	104.6	107.2	99.8
Short-term Gross Direct Debt/Gross Direct Debt (%)	34.4	30.8	19.9	40.2	29.7	37.6
Intergovernmental Transfers/Operating Revenue (%)	13.6	13.5	13.9	12.7	14.0	14.5
Real GDP growth (%)*	0.1	0.9	8.2	8.6	7.5	7.1

* 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 growth
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

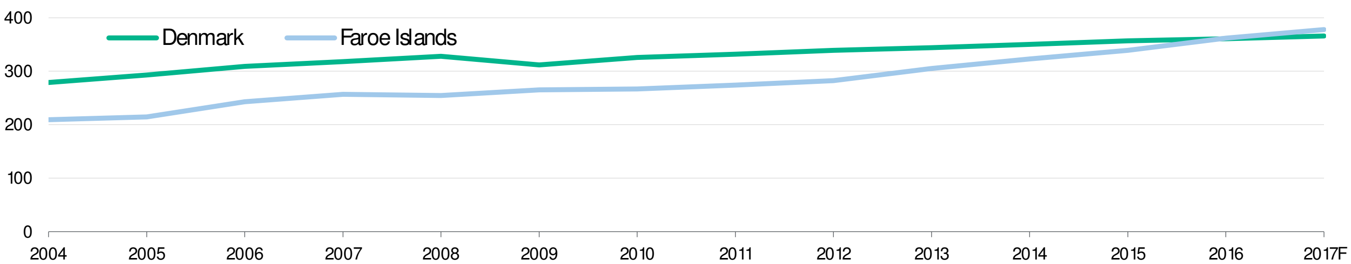
Fiscal autonomy and flexibility allow for reform implementation

The Faroe Islands consist of 18 islands located in the Atlantic Ocean, between Scotland and Iceland with a population of slightly above 50,000 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 Faroese government has in the past implemented substantial cuts in spending when required. During the banking crisis of the early 1990s, the government demonstrated its 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 its autonomy and opted for a loose fiscal policy. This policy choice resulted in a period of fiscal deficits (see Exhibit 1), but allowed to mitigate economic shock. Unemployment in the Faroe Islands is currently very low at around 2%, edging below the Danish national average since the end of 2013. This 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 7% in 2016, GDP per capita has improved substantially and has surpassed the Danish GDP per capita in 2016 and is expected to do so in 2017 (see Exhibit 3).

Exhibit 3

Faroese GDP per capita has surpassed Danish GDP per capita in 2016

Nominal GDP per capita in DKK thousands, by year



GDP per capita for the Faroe Islands for 2014-2017 are estimates, Danish GDP per capita in 2017 is an estimate

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. We understand that an important element of the reform (Act on Fishing Fee) is currently still in parliamentary discussion. We expect with full implementation of legislation, the new market-based auction system could generate double the amount (DKK213 mn. in 2016) of (fishing fee) revenues for the government in the near future.

In addition, pension reforms aim to control public pension liabilities in the medium and long run. All citizens have to pay in at least 3% of their income into a pension scheme starting in 2017. Contributions will increase every year by 1% until 2029. This means that by 2029, all citizens will pay at least 15% of their income into a pension scheme[2], helping reduce the public pension liability. The government's pension reform work is ongoing and potentially includes an increase to the retirement age (up to 68 by 2030) as well (currently at 67 years).

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 has been a referendum announced to be held, we do not expect a material change in the relationship with Denmark. The referendum aims to write down constitutionally the right to self-determination of a potential - but currently not envisaged - change of the status. We understand, that currently bill is going through parliamentary process, with such legislation needed as prerequirement, before any referendum can be set.

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 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 government's finances but now represent 10% of operating revenue. 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.

Despite the plan for a referendum on defining constitutional right to self-determination, the debate over independence has received less attention in recent years. The general elections held in September 2015 resulted in a Social Democrat led coalition, which sees the link with Denmark as favourable. We 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.

Financing surpluses and large liquidity buffer

According to recent data, the Faroe Islands forecast an increase of its reported gross operating surplus at DKK704 million in 2017 following DKK466 in 2016, which would result again in a favorable financing surplus (see Exhibit 1). This operating balance amounts to around 9% relative to operating revenues, a positive development of results and considerable improvement from a few years earlier. Publication of final actual results is expected for spring 2018.

The rapid improvement of financial performance was the result of an 18% increase in operating revenue between 2011 and 2016, driven by direct tax growth, while operating costs only increased by 7% over the same time frame. Meanwhile, the government seeks to cut capital expenditures, following the end of its 2011-2016 fiscal deficit reduction programme. The improvement in gross operating balance, coupled with decreasing net capital expenditures, is expected to generate another, potentially significantly higher, financing surplus in 2017, following 2016's DKK214 million surplus, the first realised surplus since 2007 (see Exhibit 1).

The Faroe Islands have a large liquidity reserve, amounting to DKK3.4 billion (41% of operating revenues) in December 2017, which is well above the internal minimum liquidity threshold of DKK2.7 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 2017 liquidity reserve represented around 18% 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 "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's dependence on fishing and fish farming sector

The Faroese economy continues to rely on the fishing industry with fishing accounting for nearly 20% of national GDP and for an estimated 96% of total exports in 2016. 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.

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.

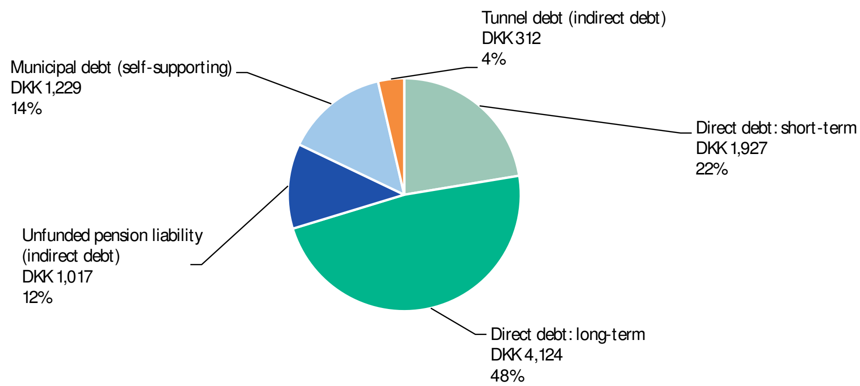
Increased debt levels expected to remain due to a current infrastructure project

The Faroese government's expansionary fiscal policy following the global financial crisis has resulted in increased debt levels. The government largely issued debt to finance large scale infrastructure projects, spending an average of DKK269 million per year on fixed capital construction between 2012-2016, 50% higher than the pre-crisis average annual spend of DKK179 million between 2003-2007. As a result of ongoing financing deficits since 2007, net direct and indirect debt as a percentage of operating revenue was above 100% of operating revenues since 2011, compared to 62% in 2007.

With the introduction of a guarantee on a major infrastructure project our projection of indirect debt has been negatively affected, as we attempt to capture the underlying construction risk that the Faroese government has underwritten.

Exhibit 4

The Faroese government's total (direct and indirect) debt portfolio of DKK8.4 billion is made up primarily by direct debt
Total direct and indirect debt in DKK million, 2016



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%. 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 some decades to be depleted. 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 still 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 generate income from oil production). With the cancelation of this debt during 2018, the Faroe Island's debt ratio would potentially decline, a credit positive.

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)

Taking into account the risk of this project during the construction phase, our debt projections remain at current level over the next five years, a trend we had otherwise expected to reverse over the coming years. We treat the net debt associated with the tunnel as indirect debt given the wholly-owned 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 have refinanced a maturing DKK1 billion loan with long-term new loans[5], which we consider 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 some refinancing risk. However, this has allowed the Faroe Islands to benefit from the low interest rate environment in the recent past. For example, in 2017, around DKK1 billion of maturing debt has been refinanced at very low interest rate (below 1% on average). Current interest rates are still very low, although rates are on a slightly upward trend. Mitigating the refinancing risk is the Faroe Islands' liquidity buffer currently at DKK3.4 billion or 18% of GDP, which could cover the scheduled repayments coming due over the next few years.

Extraordinary Support Considerations

We consider Faroe Islands to have 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 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. 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

The assigned baseline credit assessment (BCA) of a2 deviates from the scorecard generated BCA of aa3. 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 for Denmark (Aaa stable). The two notch differential reflects a number of factors that the scorecard does not capture. These include the Faroese industry's concentration on the fishing sector, refinancing risk and the islands' small population size limiting revenue generation.

Exhibit 5

Government of Faroe Islands

Regional and Local Governments

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	5	98.39	70%	6.2	20%	1.24
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 (%)	3	5.03	12.5%	4	30%	1.20
Interest payments / operating revenues (%)	3	1.24	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	5	99.79	25%			
Short-term direct debt / total direct debt (%)	7	37.63	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						**4.14(4)**
Systemic Risk Assessment						**Aaa**
Suggested BCA						**aa3**

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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