

CREDIT OPINION

12 September 2024

Update



RATINGS

Faroe Islands, Government of

Domicile	Denmark
Long Term Rating	Aa2
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 (Denmark)

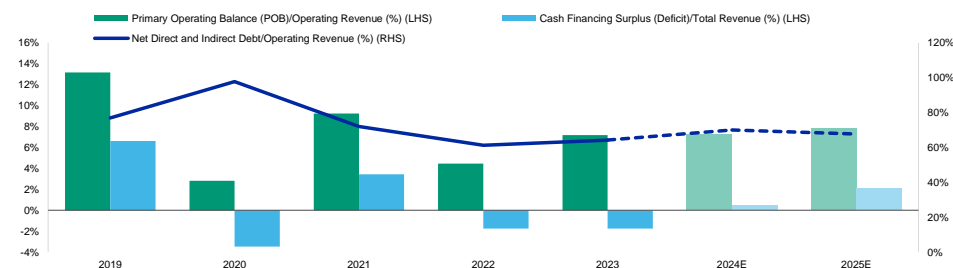
Update following rating affirmation

Summary

The credit profile of the [Government of Faroe Islands](#) (Faroe Islands, Aa2 stable) reflects its fiscal autonomy, providing a high level of financial flexibility, combined with a track record of prudent financial management resulting in sound operating balances. The credit profile is underpinned by the Faroese strong liquidity position, which allows the government to respond to shocks. Faroese institutions are robust and proactively responsive to any risks. Faroe Islands' rating remains constrained by the narrow and less diversified economy and high investment needs and population growth. We also take into account a strong likelihood that the [Government of Denmark](#) (Aaa stable) will provide support if the Faroe Islands were to face acute liquidity stress.

Exhibit 1

Faroe Islands' financial performance will remain sound in 2024-2025



E - Moody's estimate.

Source: Landsbankin Foroya (Faroe Islands Governmental Bank) and Moody's Ratings

Credit strengths

- » Strong institutional framework with long-established fiscal autonomy
- » Continuous sound budgetary results and strong liquidity buffers to address economic shocks
- » Declining and moderate debt levels

Credit challenges

- » Narrow economy relying on fishing and fish farming
- » Growing population and sub-sea tunnels driving high investment needs

Rating outlook

The stable outlook reflects our expectation that Faroe Islands' economic policies will continue to support macroeconomic stability which, along with a continuation of strong

institutions and effective policy making, will result in strong financial health. The stable outlook also reflects the expectation that liquidity will remain robust.

Factors that could lead to an upgrade

Upward pressure on the rating might develop if the Faroese government were able to alleviate the constraints that its small and undiversified economy poses to the credit profile. Continuation of sound financial results alongside further buildup of liquidity buffers to address economic shocks, and maintenance of the moderate debt ratio could also result in a positive rating action.

Factors that could lead to a downgrade

Downward pressure on the rating could emerge if the debt burden rises significantly higher than the current levels along with sustained financial deficits. A weakening in the relationship with Denmark could also have negative rating implications. Given the high reliance of revenues from fishing and fish farming, any unexpected adverse shock affecting the Faroese fishing industry could also lead to downward rating pressure.

Key indicators

Exhibit 2

Government of Faroe Islands

Faroe Islands, Government of	2019	2020	2021	2022	2023	2024E	2025E
Cash and cash equivalents as % of operating revenues	43.4	59.4	43.9	39.6	42.4	43.0	44.5
Primary operating balance (POB) as % of operating revenues	13.2	2.8	9.3	4.5	7.2	7.2	7.8
Interest payments as % of operating revenues	0.7	0.6	0.5	0.5	1.7	0.9	1.2
Capital expenses (Capex) as % of total expenses	6.6	8.1	6.0	6.1	7.6	7.3	5.4
Financing result (surplus or deficit) as % of total revenues	6.6	-3.5	3.4	-1.8	-1.8	0.5	2.1
Net direct and indirect debt (NDID) as % of operating revenues	76.9	97.7	72.0	61.2	64.2	70.0	67.7

E - Moody's estimate.

Source: Landsbankin Foroya and Moody's Ratings

Detailed credit considerations

On 6 September 2024, Moody's affirmed the Faroe Islands' Aa2 rating and maintained the stable outlook. At the same time, Moody's upgraded the Faroe Islands' Baseline Credit Assessment (BCA) to aa3 from a1 reflecting the Faroe Islands' track record of sound operating margins, balanced (or near-balanced) fiscal outcomes and robust liquidity, which increase the idiosyncratic capacity of the Faroe Islands to adjust to unexpected shocks.

The affirmation of the Aa2 issuer ratings reflects the strong institutions and a history of macroeconomic policy consensus contributing to high income levels, as well as a moderate debt burden and very strong liquidity.

The credit profile of the Faroe Islands, as expressed in an Aa2 stable rating, combines (1) a Baseline Credit Assessment (BCA) of aa3, and (2) a strong likelihood of extraordinary support from the government of Denmark in the event the entity faces acute liquidity stress.

Baseline credit assessment

Strong institutional framework with long-established fiscal autonomy

The Faroe Islands' credit profile is underpinned by the strong institutions and a history of macroeconomic policy consensus contributing to stable and high growth, high income levels and economic resilience despite the economy's small size.

The Faroe Islands consist of 18 islands located in the Atlantic Ocean, between Scotland and Iceland, with a growing population, with around 54 thousand inhabitants. While part of the Kingdom of Denmark, the Faroe Islands are governed by the Home Rule Act, which gives the Faroese government full power and flexibility to set its tax rates and fees. This broad control over revenue supports the Faroese government's financial flexibility; around 92% of the Faroese government's operating revenue is derived from sources under its control. The Kingdom of Denmark provided an annual general purpose grant of DKK661 million, which accounted for close to 7% of the

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Faroe Islands' operating revenue in 2023. This grant is for "Joint Matters" that have not been transferred to the Faroese government's control. The grant is intended and indeed spent on social welfare, schools and health sectors, though the Faroese government does have freedom over how the grant is used.

The islands' 29 municipalities vary widely in terms of size, from fewer than 50 inhabitants to around 24,000. Municipalities vary also widely in terms of financial strength, with stronger ones including Klaksvik and Tórshavn.

The Faroese relationship with Denmark is stable. In 1948, the Faroe Islands were granted Home Rule, and, in 2005, it gained further authority over certain matters. The Faroese government controls special matters that cover the economy, finances (independence to raise taxes), industry, foreign trade, mineral rights and the education system.¹ "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 the Danish and Faroese authorities jointly. Currently, matters under the Danish realm comprise the foreign policy, 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 its own finances. In addition, the Faroe Islands have two seats in the Danish parliament, which had some influence in Danish politics historically, particularly in parliaments with thin majorities.

Continuous sound budgetary results and strong liquidity buffers to address economic shocks

Faroe Islands has a consistent track record of sound budgetary results. Because of its strong economic fundamentals, Faroe Islands has historically generated solid operating revenue, which, along with effective spending-control mechanisms, has led to sound operating results.

In 2023, Faroe Islands' operating performance remained strong, with a primary operating balance (POB) of 7% of operating revenue. The performance was primarily driven by the growing collections of tax revenues, representing around 70% of operating revenue, that move in line with the nominal GDP thus providing a natural hedge against inflation. Direct taxes (income and corporate taxes) and indirect taxes (value added tax) contributed 39% and 30% to the operating revenues in 2023, respectively. The overall tax revenues growth of 5.4% in 2023 is expected to slow down to 2.8% in 2024, which nonetheless is expected to result in a similar POB again at solid 7% of operating revenue.

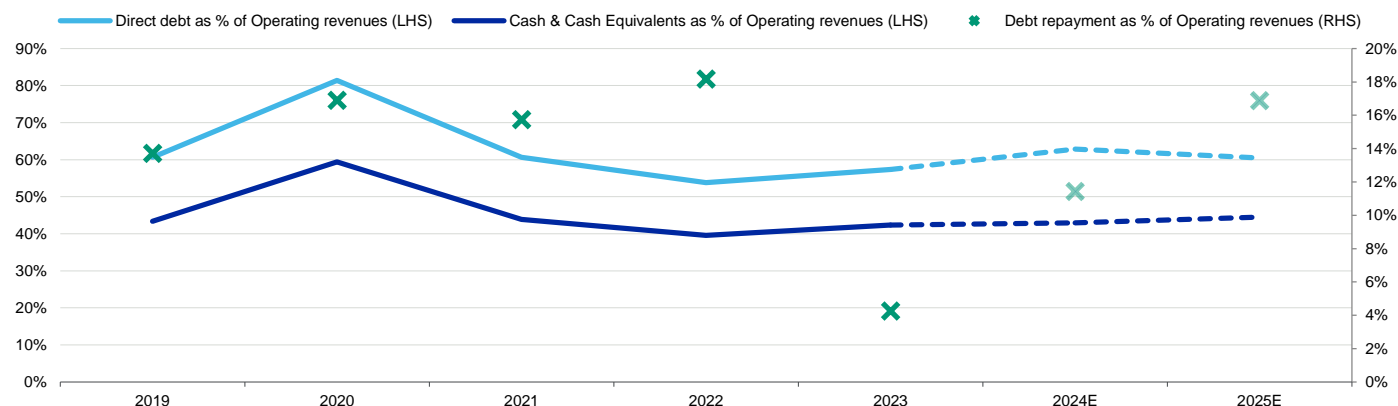
The Faroe Islands' have a large liquidity buffer, which helps mitigates the negative shocks. Faroese liquidity reserves amounted to DKK4.1 billion as of year-end 2023 representing over 40% of operating revenue and it was well above the internal minimum liquidity threshold of DKK3.4 billion based upon 15% of GDP and will remain above the threshold in 2024. According to the guidelines, this reserve is only to be used during times of heightened market stress — if the reserve is drawn upon and drops below 15% of the GDP, it is expected to be addressed and to again reach internal limits during the next borrowing round.

Faroese liquidity reserve represented nearly 74.5% of its outstanding direct debt at the end of 2023. The reserve amount exceeds necessary borrowing requirements in any single year, and this mitigates the refinancing risk significantly. The liquidity pool is sufficient to cover scheduled debt repayments for the next three years with liquidity coverage ratio of 4.7x at year-end 2023 (Exhibit 3). The liquidity reserve fund is invested in a portfolio of highly rated securities, with investments spread across various asset classes with defined limits to maximise the returns. Around two thirds of the total liquidity pool is invested in Aaa-rated securities.

Declining and moderate debt levels

The Faroe Islands' net direct and indirect debt (NDID) represented a moderate 64% of operating revenue in 2023 from 98% in 2020. At year-end 2023, the NDID was consisted of direct debt of DKK5.5 billion and another DKK0.7 billion as indirect debt, represented by the Faroese government guaranteed unfunded pension liability under Foroya Livstrygging (LIV). With the issuance of DKK1.1 billion, used for repayment of the maturing debt of equal amount due in June 2024, and new 15-year loan of DKK900 million contracted in July 2024, we expect the Faroese's debt to reach 70% of operating revenue this year before it decline again next year when DKK1,645 billion is due with debt levels expected between 67-68% of operating revenue.

Exhibit 3

Manageable debt levels; strong liquidity coverage

E - Moody's Estimate.

Sources: Landsbankin Foroya and Moody's Ratings

In addition, the government is responsible for the pensions of its civil servants. Such obligations are partly unfunded and could strain future budgets. However, the government has flexibility to manage its obligation, which we consider a contingent liability for the government.

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

The Faroese government has some off-balance-sheet activities and is exposed to public companies' debt amounting DKK2.7 billion at year-end 2023. Overall, the company in charge of the tunnels is assessed as self-supporting, so we do not include their debt into the government's NDID ratio. The most noteworthy of these activities is a state-owned project company executing the construction of two tunnel projects (Eysturoy and Sandoyar). The Faroese government has provided a minimum traffic revenue guarantee of DKK47 million in 2023 down from DKK54 million in 2022 for the benefit of the company. In 2024, the Faroese government will provide DKK40 million. The tunnel project company is 100%-owned by the government, and we consider its debt as a contingent liability.

Narrow economy relying on the fishing industry but supported by high wealth levels

The Faroese economy continues to rely on the fishery and fish farming, which account for around 20% of national gross value-added product and more than 90% of the total export value of goods. This high exposure introduces economic volatility as the economy is susceptible to external factors, such as fluctuations in fish and oil prices (Faroese fishing fleet is very oil dependent), and the risks of stock depletion, natural events, which would have a direct impact on the Faroese economy.

Despite these vulnerabilities, the Faroes have benefited considerably in the recent years due to high global demand for fish and low oil prices. Moreover, Faroe Islands have shifted considerably its export dependency to Russia from 23.2% share in total export in 2021 to 9.5% in 2023 opening new or expanding current markets globally.

To reduce dependencies, the Faroe Islands have also increased trade with non-EU countries 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 frictions.

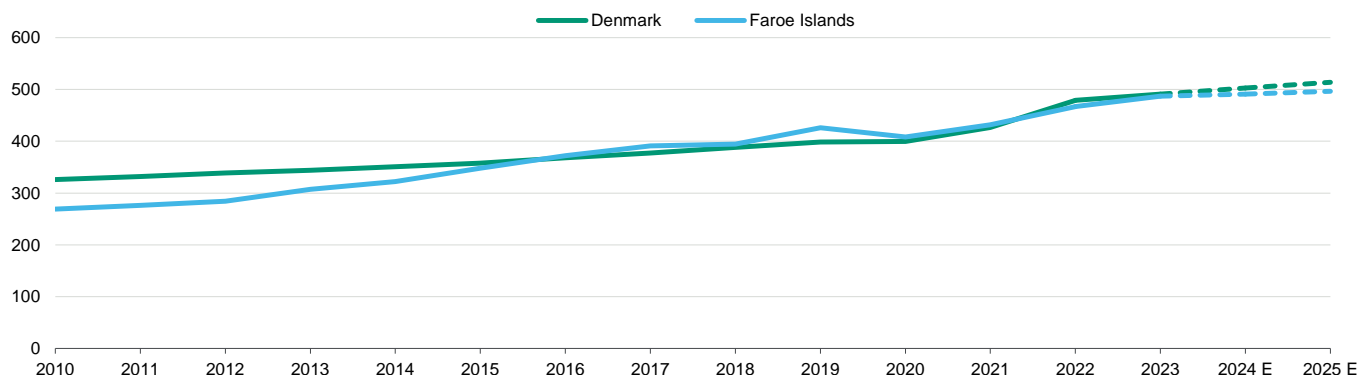
The Faroe Islands' high income levels and prudent policy making balances its susceptibility to shocks and the concentration of economic activity in fisheries sector, mitigating challenges related to small size and narrow economy related shocks.

With a nominal GDP of around DKK25.6 billion (€3,430 billion) in 2023, the Faroe Islands' economy is quite small compared to its similarly rated counterparts. However, this small size is counterbalanced by historically consistent growth rates (excluding a minor downturn in 2020) and extremely high wealth levels, with a GDP per capita of DKK487,000 (€65,300) in 2023 and on par with Danish levels (DKK 475,000 in 2023), enhancing the economy's resilience to shocks (Exhibit 4).

Exhibit 4

Faroese GDP per capita remains strong and in line with Danish GDP per capita

Nominal GDP per capita in DKK thousands, by year



E - Estimate

Sources: Landsbankin Foroya, Statistics Denmark and Moody's Ratings

Following the strong economic recovery from the pandemic, the unemployment rate decreased to the very low level of 1.1% in July 2024 even with the phasing out of employment support measures, introduced as an aid-package in connection with the Covid-19 pandemic.

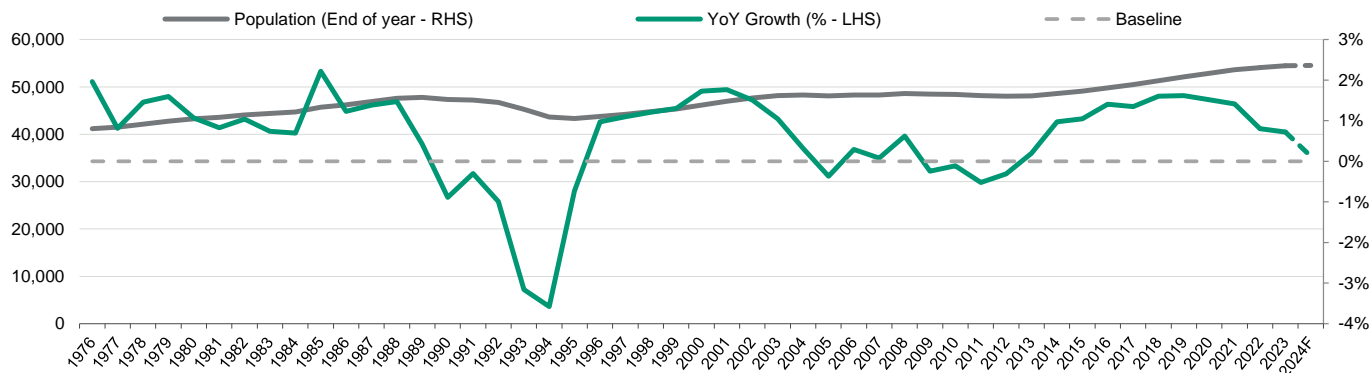
Growing population and sub-sea tunnels driving high investments needs

The Faroese population is steadily growing by about a couple of hundred new inhabitants per year (Exhibit 5). Such population growth put pressure on the government's operations especially with regards to capital investments. The government would need to invest in areas such as new schools, health and social service, culture and infrastructure projects.

The government envisages its capital investments to reach around DKK600 million annually over the next 5 years, including the IT infrastructure projects, ring roads in Torshavn and Runavik. In addition, government companies, like electricity company SEV, are also planning to invest to address infrastructure needs.

The most noteworthy of these activities is a state-owned project company executing the construction of two sub-sea tunnels, one to Eysturoy and one to Sandoy, with an estimated total cost of around DKK2.7 billion. The Eysturoy tunnel was open for traffic in 2020, and the Sandoy tunnel, the Faroe Islands' main infrastructure project over the last few years, was opened at the end of 2023, reducing materially the associated construction risk. The completion of this 10.8 kilometers long sub-sea tunnel (the longest in the Faroe Islands) marks a significant milestone connecting the islands of Streymoy and Sandoy, thus providing improved connectivity to over 90% of the Faroese population. The construction on two additional tunnels in Bordoy with an estimated cost of around 520 million has started in 2021 and is expected to be completed in 2025.

Exhibit 5
The Faroe Islands has seen strong population growth over the past decade
 Population (LHS) and year-on-year growth (%) (RHS)



F - Forecast.
 Sources: Landsbankin Foroya and Moody's Ratings

Extraordinary support considerations

We consider Faroe Islands to have a strong likelihood of extraordinary support from the Government of Denmark. This reflects our assessment that the current relationship with the Government of Denmark is unlikely to change in the medium term. We also take into consideration the intensive extraordinary support provided to the islands in response to the financial crisis of the 1990s.

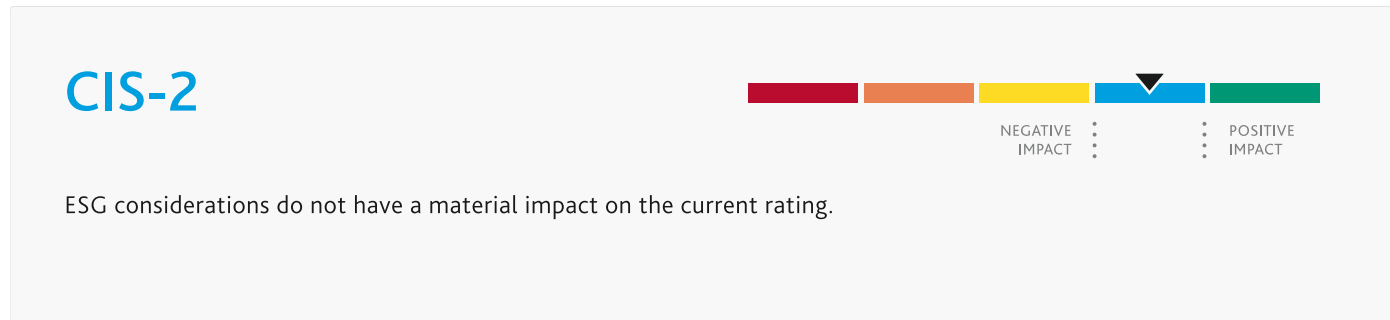
While Denmark has no formal obligation to provide extraordinary support to the Faroe Islands, it has historically supported the Faroese government on a number of occasions. In the 1990s, the Faroese government borrowed — largely from Denmark, given the scale of the crisis — to fund the nationalisation of Føroya Banki and Sjøvinnubankin 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's responsibility 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.

ESG considerations

Faroe Islands' ESG credit impact score is CIS-2

Exhibit 6

ESG credit impact score



Source: Moody's Ratings

Faroe Islands' ESG Credit Impact Score is neutral-to-low (**CIS-2**), reflecting moderate exposure to environmental and low exposure to social risks, and strong governance and capacity to respond to shocks.

Exhibit 7

ESG issuer profile scores



Source: Moody's Ratings

Environmental

Faroe Islands' exposure to environmental risks (**E-3**) stems from physical climate risks, including rising sea levels because of rising temperatures, which would affect its important fishing industry. Sharing responsibilities with the Government of Denmark, which would provide support to the Faroese government in the event of natural disasters, helps to mitigate the potential financial impact of these risks for the Faroe Islands. With 18 islands, the Faroe Islands are also exposed to moderate water management risks. To become completely non-dependent on fossil fuels for power production, the government is aiming to reach a 100% renewable electricity system by 2030.

Social

The (**S-2**) score assigned to Faroe Islands reflects its limited exposure to social risks primarily mirroring demographic pressures stemming from ageing population, declining labour supply and higher pension and social costs. However, Faroe Islands are benefiting from immigration at substantial growth rates, reflecting the attraction to live and work on the islands. In addition, we view the long-term economic and fiscal pressures as comparatively limited, given the labour market and pension reforms. Faroese health and safety risk and access to basic services are in line with those in the advanced economies.

Governance

Governance is **G-1**. This is underpinned by the government's high credibility, transparency and consensus on key economic policy goals. Coupled with exceptionally high wealth levels and financial strength, these support a high degree of resilience.

ESG Issuer Profile Scores and Credit Impact Scores for the rated entity/transaction are available on Moodys.com. In order to view the latest scores, please click [here](#) to go to the landing page for the entity/transaction on MDC and view the ESG Scores section.

Rating methodology and scorecard factors

The assigned baseline credit assessment (BCA) of aa3 is close to the BCA scorecard-indicated outcome of aa2.

For details about our rating approach, please refer to Rating Methodology: [Regional and Local Governments](#), 28 May 2024.

Exhibit 8

Faroe Islands, Government of Regional & Local Governments

Baseline Credit Assessment – Scorecard	Score	Value	Sub-factor Weighting	Sub-factor Score	Factor Weighting	Total
Factor 1: Economy					25%	1.22
Regional Income [1]	1.12	74396.66	15%	0.17		
Economic Growth	9.00	baa	5%	0.45		
Economic Diversification	12.00	ba	5%	0.60		
Factor 2: Institutional Framework and Governance					30%	0.60
Institutional Framework	1.00	aaa	15%	0.15		
Governance	3.00	aa	15%	0.45		
Factor 3: Financial Performance					20%	1.09
Operating Margin [2]	9.19	7.18%	10%	0.92		
Liquidity Ratio [3]	0.50	42.36%	5%	0.03		
Ease of Access to Funding	3.00	aa	5%	0.15		
Factor 4: Leverage					25%	0.86
Debt Burden [4]	4.75	64.23%	15%	0.71		
Interest Burden [5]	1.46	0.48%	10%	0.15		
Preliminary BCA Scorecard-Indicated Outcome (SIO)						(3.77) aa3
Idiosyncratic Notching						0.0
Preliminary BCA SIO After Idiosyncratic Notching						(3.77) aa3
Sovereign Rating Threshold						Aaa
Operating Environment Notching						1.0
BCA Scorecard-Indicated Outcome						(2.77) aa2
Assigned BCA						a1

[1] Regional GDP per capita in terms of purchasing power parity (PPP) terms, in international dollars

[2] Primary Operating Balance / Operating Revenue

[3] Cash and Cash Equivalents / Operating Revenue

[4] Net Direct and Indirect Debt / Operating Revenue

[5] Interest Payments / Operating Revenue

Source: Moody's Ratings; Fiscal 2023.

Ratings

Exhibit 9

Category	Moody's Rating
FAROE ISLANDS, GOVERNMENT OF	
Outlook	Stable
Baseline Credit Assessment	aa3
Issuer Rating	Aa2

Source: Moody's Ratings

Endnotes

1 For more information on the division of tasks, see [Delivery of Faroe Islands' Fiscal Plan Supports Creditworthiness](#), published July 2015

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