

MOODY'S

RATINGS

Rating Action: Moody's Ratings affirms Faroe Islands' Aa2 rating with stable outlook

06 Sep 2024

Frankfurt am Main, September 06, 2024 -- Moody's Ratings (Moody's) has today affirmed the Government of Faroe Islands' Aa2 long-term issuer rating and maintained the stable outlook. Concurrently, we have upgraded the Faroe Islands' Baseline Credit Assessment (BCA) to aa3 from a1.

RATINGS RATIONALE

The upgrade of the BCA to aa3 from a1 reflects our opinion that the Faroe Islands' track record of sound operating margins, balanced (or near-balanced) fiscal outcomes and robust liquidity increases the idiosyncratic capacity of the Faroe Islands to adjust to unexpected shocks. The completion of the Sandoy sub-sea tunnel in December 2023 and progress of the remaining tunnels further eases exposure to potential higher construction costs and liabilities associated with these projects.

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.

Faroe Islands' economy has rebounded strongly from the pandemic driven primarily by fishing and fish farming, and to lesser extent by tourism, and produced real GDP growth averaging 4.1% during 2021-2023. The small scale of the economy and concentration is counterbalanced by the very high GDP per capital (on par with that of Denmark) which helps support the government's revenue.

Prudent policy making balances the susceptibility to shocks stemming from a narrow economy concentrated in fishing and fish farming, which contributes to nearly 90% of the total export and around 20% of gross value added (GVA). Although the government closely monitors fishing activity to ensure sustainable operations, it is susceptible to external factors, such as fluctuations in fish and oil prices, weather-related events, and depletion of fish stocks.

The Faroese government has the authority to determine its own tax rates and

charges, with about 92% of its operating revenue generated from such self-regulated sources. The remaining 8% of the revenue represents a general grant from the Government of Denmark, which further supports the Faroese government to deliver a sound fiscal position over the next two years.

The Faroe Islands have demonstrated efficient budgetary management as evidenced by their positive operating results over the past several years (7.1% of operating revenue in 2023 and 4.5% in 2022) - a trend we anticipate will continue in 2024 and 2025 with operating margins at around 7% of projected operating revenue.

Furthermore, the Faroes have a substantial liquidity cushion of approximately DKK4.1 billion at year-end 2023, representing around 40% of operating revenue. This is significantly above the internal minimum limit based on 15% of GDP (around DKK3.7 billion forecasted for 2024). Additionally, the Faroese liquidity reserve accounts for about 70% of its outstanding debt.

Net direct and indirect debt (NDID) measured 64% of operating revenues in 2023, down from 98% in 2020 highlighting a long-term trend of debt reduction. We expect it will remain between 65%-70% in 2024 and 2025. Direct debt accounts for 89% of the total NDID, while the remaining debt is made up of indirect debt, which is a guaranteed unfunded pension liability.

Faroe Islands' Aa2 issuer rating incorporates the BCA of aa3 and our assessment of a strong likelihood of extraordinary support from the Government of Denmark (Aaa stable).

RATIONALE FOR THE STABLE 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.

ENVIRONMENTAL, SOCIAL, GOVERNANCE CONSIDERATIONS

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.

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.

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. Faroese health and safety risk and access to basic services are in line with those in the advanced economies.

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.

The specific economic indicators, as required by EU regulation, are not available for this entity. The following national economic indicators are relevant to the sovereign rating, which was used as an input to this credit rating action.

Sovereign Issuer: Denmark, Government of

GDP per capita (PPP basis, US\$): 74,457 (2023) (also known as Per Capita Income)

Real GDP growth (% change): 2.5% (2023) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 0.4% (2023)

Gen. Gov. Financial Balance/GDP: 3.3% (2023) (also known as Fiscal Balance)

Current Account Balance/GDP: 9.8% (2023) (also known as External Balance)

External debt/GDP: 134.6% (2023)

Economic resiliency: aa1

Default history: No default events (on bonds or loans) have been recorded since 1983.

SUMMARY OF MINUTES FROM RATING COMMITTEE

On 03 September 2024, a rating committee was called to discuss the rating of the Faroe Islands, Government of. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength, have not materially changed. The issuer's institutions and governance strength, have not materially changed. The issuer's fiscal or financial strength, including its debt profile, has not materially changed.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

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.

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.

PRINCIPAL METHODOLOGY

The principal methodology used in these ratings was Regional and Local Governments published in May 2024 and available at <https://ratings.moodys.com/rmc-documents/421891>. Alternatively, please see the Rating Methodologies page on <https://ratings.moodys.com> for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

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For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found on <https://ratings.moodys.com/rating-definitions>.

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