Credit Opinion: Faroe Islands, Government of

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Ratings

Category	Moody's Rating
Outlook	Stable
Government Bonds -Fgn Curr	Aa2
Government Bonds -Dom Curr	NR

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Key Indicators

Faroe Islands, Government of

	2003	2004	2005	2006	2007	2008B
Interest Payments/Operating Revenue (%)	4.0	3.3	3.0	1.0	1.5	1.8
Accrual Financing Surplus(Requirement)/Total Revenue (%)	-0.3	-3.8	-5.4	11.6	20.4	0.8
Gross Operating Balance/Operating Revenue (%)	5.6	1.6	-0.5	8.0	6.8	5.0
Net Direct and Indirect Debt / Operating Revenue (%)	95.0	91.0	95.6	69.0	65.4	63.4
Short-term Gross Direct Debt/Gross Direct Debt (%)	10.1	7.5	7.9	9.6	10.5	10.5
Intergovernmental Transfers / Operating Revenues (%)	13.9	14.5	14.3	12.9	12.2	13.0
Real GDP Growth (%)	-4.0	-0.1	0.4	8.1	--	--

Opinion

SUMMARY RATING RATIONALE

The Aa2 foreign currency rating with stable outlook for the Faroe Islands reflects a Baseline Credit Assessment (BCA) of 5 (on a scale of 1 to 21, where 1 represents the lowest credit risk) and a high likelihood that the Kingdom of Denmark (Aaa, stable) would act to prevent a default by the islands.

The Faroe Islands' BCA of 5 reflects a number of factors, including their economic strength and increasing diversification. The BCA also reflects the government's powers to raise revenues through taxation and fees and to control spending as well as the strong financial results achieved since 1995. The Faroese government maintains ample reserves, while the debt level is moderate and decreasing and the interest burden falling. The BCA takes into account the islands' relationship within the Kingdom of Denmark and the subsidies it receives for joint matters, which it administers in conjunction with the Kingdom of Denmark. The support (see below) also take into account the establishment of the settled relationship the Faroese have with Denmark in the consideration of further autonomy and potential independence.

Credit Strengths

Credit strengths for the Faroe Islands include:

Its development as a wealthy industrialised country, based on the growth of fishing and fish-related industries

Autonomous powers to set tax rates and fees, control spending and set the level of reserves

Good financial results across recent economic expansions and recessions

Moderate and decreasing debt levels

Stable relationship within the Kingdom of Denmark and the orderly process in the consideration of further autonomy and potential independence

Large reserves to address the historical volatility of the economy and government revenues, and to provide for the future costs of an ageing population

Credit Challenges

Credit Challenges for the Faroe Islands include:

Volatility of the fishing industry, which is exposed to boom and bust on price and volume, as well as substantial challenges in the management of commercial exploitation of its fishing grounds; these effects are somewhat mitigated by increasing diversification in the fish-related industries and in the economy at large

The trade balance has moved sharply negative and would be further weakened by any decline in fishing, which makes up almost all of exports

Governmental accounting standards, including the monitoring and control of municipal governments within the Faroe Islands are not as comprehensive as those of other Nordic countries

Potential independence has at times been a politically volatile issue; if poorly managed this could put substantial subsidies from the Kingdom of Denmark at risk

Ageing population and partly unfunded pension system

Rating Outlook

The outlook on the Faroe Islands' Aa2 rating is stable, reflecting its stable economic and financial management of Home Rule responsibilities and the orderly process being conducted with Denmark in the consideration of further autonomy and potential independence.

What Could Change the Rating - Up

Greater diversification of the economy, which would increase the stability of GDP and government revenues, could lead to an upgrade. However, Moody's does not expect significant diversification to occur in the near future, unless substantial petroleum reserves are exploited and their proceeds managed with a view to the long term.

What Could Change the Rating - Down

The rating could come under pressure if the Faroese government relaxes its financial management or if there is a substantial economic downturn, particularly one caused by environmental or structural changes in the fishing industry. Precipitous political actions taken by either the Faroe Islands or the Kingdom of Denmark could have a significant impact on the resources of the Faroese government, although such actions are deemed unlikely.

Recent Results and Developments

In August, the parties in the governing coalition, which had been in power only since January, lost its majority in parliament due to internal disagreements. A new coalition with a new prime minister was negotiated. Moody's does not foresee any significant change to the policies that produced the sound economic and financial results achieved since 1995.

In 2007, nominal GDP grew by approximately 5% but the consumer price index showed a similar increase.

The budget for 2008 has projected a slowdown in the economy and resulting tax collections, and is expected to come close to projections with a Gross operating balance of approximately 5%.

DETAILED RATING CONSIDERATIONS

The ratings assigned to the Faroe Islands reflect the application of Moody's Joint-Default Analysis (JDA) rating methodology for regional and local governments (RLGs). In accordance with this methodology, Moody's first establishes the BCA for the jurisdiction and then considers the likelihood of support coming from the national government to avoid a default by the jurisdiction, should this extreme situation ever occur.

Baseline Credit Assessment

Financial Position and Performance - Some 87% of the Faroese government's revenues come from sources under its control, such as income and company taxes, VAT, import duties, sales of products and services, and other sources. The Kingdom of Denmark provides 13% of operating revenue with grants for governmental services that, by agreement, it administer in conjunction with the Faroe Islands. Denmark and The Faroe Islands have fixed the level of grant in bilateral agreements and, over the medium- to-long term, these subsidies are set to decrease as more responsibilities are passed to the full control of the Faroe Islands.

The Faroese government has almost complete control over all its spending and it is not constrained by service levels or an inflexible cost base. Municipal governments make up a substantial part of public spending, but are not included as part of the budget of the Faroese government.

The gross operating balance (GOB) has been highly variable in recent years, although current budgeting practice has tended to keep it positive, sometimes strongly so. In 2007, GOB was 6.8%. The strong financing surplus in 2006 and 2007 was mainly due to the sell of assets in Atlantic Airways and one of the major Faroese banks.

Debt Profile - The debt level of the Faroese government is relatively low, decreasing from over 260% of total revenues in 1995 to approximately 55% as of 2007. Debt is currently issued in Danish Kroner. Whilst active debt management could allow large portions to be paid down with annual surpluses or reserves, the relatively short tenors of outstanding maturities make refinancing likely.

A liquidity fund has been established to provide for immediate shortfalls, debt repayments and to serve as a stabilisation fund to bridge any period of structural change within long-term budgets. As of year-end 2007, the fund held DKK1.5 billion, equal to approximately 30% of operating annual expenses in the budget. In addition to this fund, as of mid year 2008 the government had placed an additional DKK650 million in reserves.

Due to the high need for investment, an investment fund and build-operate-transfer financing are used for large-scale infrastructure projects; these amounts are not on the balance sheet of the Faroese Government. Government guarantees are limited to the debt of the Faroese municipalities, and on a downward trend as a matter of policy.

Governance and Management Factors - As its autonomy has increased, the Faroe Islands have built up its institutional capacity for fiscal and economic management, with particular emphasis on the regulation of fishing and fishing-related industries. In order to accommodate volatility in economically related tax and fee revenues, government budgets target surpluses. Debt practices are conservative, with gradual reductions in amounts outstanding and moderate amounts of refinancing. Successive governing coalitions have maintained reserves at ample proportions of government budgets and GDP. The reserves are invested in highly rated liquid assets outside the Faroese economy.

Transparency and disclosure are sufficient for the government to manage its finances, although they have yet to reach the level of detail seen in sub-sovereigns across Scandinavia or the UK. The auditing system is tied to an open, democratically driven process. Internal systems to incorporate real-time accrual of revenues and expenditures are adequate and being improved to facilitate the more timely incorporation of the Faroese municipal governments into the control of total governmental finances.

Economic Fundamentals - The economy depends on fishing, which in turn depends on finely balanced regulation of domestic and international commercial interests, environmental factors and renewable - potentially fragile - resources. Increases in prices for fish and fish products, which currently make up over 20% of wages and 94% of exports, have driven recent booms - underpinning the long-term growth of the economy. As Faroese waters provide 60-65% of the total value of the catch, international prices and management of resources beyond Faroese control can have profound impacts on the economy.

Over the past two decades, the fishing industry and the economy in general have become more diversified. Potential petroleum reserves within Faroese territorial waters continue to offer a possible step-change in the islands' wealth and security, but exploration has not produced accessible resources to date. The balance of trade has turned sharply negative in recent years, and any decline in fishing revenues, which directly contribute to the balance, could have a significant negative impact on the economy.

Operating Environment - The operating environment of the Faroe Islands - as part of the Kingdom of Denmark - is typical of advanced industrial economies and reflected in the high GDP per capita, low GDP volatility and a high ranking on the World Bank's Government Effectiveness Index. These characteristics suggest a low level of systemic risk. Nevertheless, the economy of the Faroe Islands itself has much higher volatility, which must be considered in the rating given the islands' path to increasing autonomy and potential independence.

Institutional Framework - The institutional framework was forged following the crisis of the 1990s to handle increasing autonomy while promoting prudent financial management and decreasing moral hazard. The powers of the Faroe Islands are set by agreements with Denmark over the allocation of responsibilities, with the respective roles of the Kingdom and the Faroe Islands being clear. The government of the Faroe Islands has full powers to set its tax rates and fees, and to set levels of spending on the services it provides. Levels of essential services may be adjusted at the discretion of the Faroese, and the government has historically implemented substantial cuts in spending when required, e.g. in the crisis of the 1990s.

The Faroe Islands has independent powers of borrowing, although in the past these have been circumscribed in agreements with Denmark to address the fiscal crisis. The Faroese government has repaid all interest-bearing debt to Denmark undertaken under these agreements.

Municipal governments account for almost 20% of total government spending and have wide latitude in spending, particularly for capital investments. They can maintain substantial balances of debt. The municipalities vary widely in size, from fewer than 50 inhabitants to approximately 20,000, making reform an ongoing and still-unresolved political question.

Extraordinary Support Considerations

Moody's rating of Aa2 reflects the BCA of 5 and an assessment of a high likelihood that the Kingdom of Denmark would act to prevent a default by the Faroe Islands. This level of support reflects the current relationship with the Kingdom of Denmark, unlikely changes to this relationship in the medium term and the period of intensive extraordinary support in response to the financial crisis of the 1990s.

Moody's rating committee also assigns a low level of default dependence, reflecting the significant differences between the economies of the Kingdom of Denmark and the Faroe Islands, due to the importance of fishing to the Faroese economy.

Output of the Baseline Credit Assessment Scorecard

In the case of the Faroe Islands, the BCA scorecard (presented below) generates an estimated BCA of 2, three notches higher than the BCA assigned by the rating committee. This differential is largely due to the volatility of the economy of the Faroe Islands and the challenges of managing the key fishing and fishing-related industries. The differential is also motivated by the unique features of the Faroe Islands, primarily its special legal status, which ensures wide autonomy within the Kingdom of Denmark.

The BCA scorecard, which generates estimated baseline credit assessments from a set of qualitative and quantitative credit metrics, is a tool used by the rating committee in assessing regional and local government credit quality. The credit metrics captured by the scorecard provide a good statistical gauge of stand-alone credit strength; however, the estimated BCAs generated by the scorecard do not substitute for rating committee judgments regarding individual baseline credit assessments, nor is the scorecard a matrix for automatically assigning or changing these assessments. Concomitantly, scorecard results have limitations in that they are backward-looking, using historical data, while the assessments are forward-looking opinions of credit strength. Moreover, the limited number of variables included in the scorecard cannot fully capture the breadth and depth of our analysis. Nevertheless, the performance statistics captured in the scorecard are important and, in general, higher ratings can be expected among issuers with the highest rankings from the scorecard.

ABOUT MOODY'S SUB-SOVEREIGN RATINGS

National and Global Scale Ratings

Moody's assigns national scale ratings in certain local capital markets in which investors have found the global rating scale provides inadequate differentiation among credits or is inconsistent with a rating scale already in common use in the country. Moody's National Scale Ratings are opinions of the relative creditworthiness of issuers and issues within a particular country. While loss expectation will be an important differentiating factor in the ultimate rating assignment, it should be noted that loss expectation associated with National Scale Ratings can be expected to be significantly higher than apparently similar rating levels on Moody's global scale. Moody's National Scale Ratings rank issuers and issues in order of relative creditworthiness: higher ratings are associated with lower expected credit loss.

National Scale Ratings can be understood as a relative ranking of creditworthiness (including relevant external support) within a particular country. National Scale Ratings are not designed to be compared among countries; rather, they address relative credit risk within a given country. Use of National Scale Ratings by investors is only appropriate within that portion of a portfolio that is exposed to a given country's local market, taking into consideration the various risks implied by that country's foreign and local currency ratings. The Moody's Global Scale rating for issuers and issues in local currency allows investors to compare the issuer's/issue's creditworthiness to all others in the world, rather than merely in one country. It incorporates all risks relating to that country, including the potential volatility of the national economy.

Moody's assigns a ceiling for foreign-currency bonds and notes to every country (or separate monetary area) in which there are rated obligors. The ceiling generally indicates the highest rating that can be assigned to a foreign-currency denominated security issued by an entity subject to the monetary sovereignty of that country or area. In most cases, the ceiling will be equivalent to the rating that is (or would be) assigned to foreign-currency denominated bonds of the government. Ratings that pierce the country ceiling may be permitted, however, for foreign-currency denominated securities benefiting from special characteristics that are judged to give them a lower risk of default than is indicated by the ceiling. Such characteristics may be intrinsic to the issuer and/or related to Moody's view regarding the government's likely policy actions during a foreign currency crisis.

Baseline Credit Assessment

Moody's baseline credit assessment incorporates the government's intrinsic credit strength and accounts for ongoing operating subsidies and transfers from the supporting government. In effect, the baseline credit assessment reflects the likelihood that a local government would require extraordinary support.

Extraordinary Support

Extraordinary support is defined as action taken by a supporting government to prevent a default by a regional or local government (RLG) and could take different forms, ranging from a formal guarantee to direct cash infusions to facilitating negotiations with lenders to enhance access to needed financing. Extraordinary support is described as either low (0% - 30%), moderate (31% - 50%) high (51% - 70%), very high (71% - 95%) or fully supported (96% - 100%).

Default Dependence

Default dependence reflects the likelihood that the credit profiles of two obligors may be imperfectly correlated. Such imperfect correlation, if present, has important diversifying effects, which can materially change the joint-default outcome. Intuitively, if two obligors' default risks are imperfectly correlated, the risk that they would simultaneously default is smaller than the risk of either defaulting on its own.

In the application of joint-default analysis to RLGs, default dependence reflects the tendency of the RLG and the supporting government to be jointly susceptible to adverse circumstances leading to defaults. Since the capacity of the higher-tier government to provide extraordinary support and prevent a default by an RLG is conditional on the solvency of both entities, the more highly dependent -- or correlated -- the two obligors' baseline default risks, the lower the benefits achieved from joint support. In most cases, the close economic links and/or overlapping tax bases and/or close intergovernmental fiscal arrangements between different levels of government result in a moderate to very high degree of default dependence.

Default dependence is described as either low (0% - 30%), moderate (31% - 50%), high (51% - 70%), very high (71% - 100%).

Rating Factors

BCA Scorecard 2007

Rating Factors

Faroe Islands, Government of

Baseline Credit Assessment Scorecard - 2007	**Value**	**Score**	**Sub-Factor Weighting**	**Sub-Factor Total**	**Factor Weighting**	**Total**
Factor 1: Operating Environment						
National GDP per capita (PPP basis, $US)	35,986	1	50.0%			
National GDP Volatility (%)	2.0	1	25.0%	1.00	50.0%	0.50
National Govt Effectiveness Index (World Bank)	2.29	1	25.0%			
Factor 2: Institutional Framework						
Predictability, Stability, Responsiveness	1	1	50.0%			
Fiscal Flexibility (A): Own-Source Revenues	1	1	16.7%	1.00	10.0%	0.10
Fiscal Flexibility (B): Spending	1	1	16.7%			
Fiscal Flexibility (C): Extent of Borrowing	1	1	16.6%			
Factor 3: Financial Position & Performance						
Interest Payments/Operating Revenue (%)	1.6	1	25.0%			
Accrual Financing Surplus(Req)/Total Revenue (%)	14.2	1	25.0%	3.50	10.0%	0.35
Gross Operating Balance/Operating Revenue (%)	6.1	9	25.0%			
Net Working Capital/Total Expenditures	16.6	3	25.0%			
Factor 4: Debt Profile						
Net Direct and Indirect Debt/Operating Revenue	62.6	3	50.0%			
				3.25	10.0%	0.33

Short-Term Direct Debt/Direct Debt (%)	21.3	6	25.0%			
Net Debt/Operating Revenue Trend	-16.4	1	25.0%			
Factor 5: Governance & Management						
Fiscal Management	7.5	7.5	40.0%	5.55	10.0%	0.56
Investment & Debt Management	1	1	20.0%			
Transparency & Disclosure (A)	7.5	7.5	15.0%			
Transparency & Disclosure (B)	7.5	7.5	15.0%			
Institutional Capacity	1	1	10.0%			
Factor 6: Economic Fundamentals						
Regional or Local GDP pc PPP - estimated ($US)	26,687	3	100.0%	3.00	10.0%	0.30
Estimated BCA						**2**