MOODY'S
PUBLIC SECTOR EUROPE

Credit Opinion: Faroe Islands, Government of

Global Credit Research - 07 Aug 2015

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating	Aa3

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Key Indicators

Faroe Islands, Government of

	2010	2011	2012	2013	2014	2015B
Interest Payments/Operating Revenue (%)	3.4	3.0	3.0	2.3	1.8	1.9
Accrual Financing Surplus(Requirement)/Total Revenue (%)	-10.1	-5.3	-5.6	-3.8	-3.8	-2.1
Gross Operating Balance/Operating Revenue (%)	-7.6	-2.0	-2.4	-2.4	1.4	2.2
Net Direct and Guarantees/Operating Revenue (%)	93.7	104.6	106.3	109.8	104.5	110.4
Short-term Gross Direct Debt/Gross Direct Debt (%)	15.5	34.4	30.8	19.9	29.8	37.0
Intergovernmental Transfers/Operating Revenue (%)	14.6	13.6	13.5	13.9	12.7	12.3
GDP growth (%)	7.0	2.4	3.0	7.5	4.1	2.5

Opinion

SUMMARY RATING RATIONALE

The Aa3 issuer rating with stable outlook for the Faroe Islands reflects its fiscal autonomy and revenue and expense flexibility with a track record of prudent budgeting. An additional strength includes the stable and historical relationship with the Kingdom of Denmark (Aaa, Stable), with joint matters clearly defined under the 1948 Home Rule Act, as well as the islands' strong liquidity buffer. The rating also takes into account the Faroese economy's dependence on the fishing industry and continued, albeit declining, accrual financing deficit and reliance on short-term borrowing.

Credit Strengths

Credit strengths for the Faroe Islands include:

- Fiscal autonomy allowing for greater revenue and expense flexibility

- Stable relationship with the Kingdom of Denmark (Aaa, Stable)

- The successful implementation of a long term deficit reduction plan

- A large liquidity buffer which mitigates refinancing risk

Credit Challenges

Credit challenges for the Faroe Islands include:

- Faroese economy dependence on the fishing sector

- High debt levels, albeit expected to peak and trend downwards

- Refinancing risk due to debt structure and reliance on short term borrowing

Rating Outlook

The stable outlook reflects the successful implementation of a long term deficit reduction plan (2008 to 2015).

What Could Change the Rating Up

A combination of the following could have positive rating implications: 1) a return to long term structurally balanced budgets; (2) steady debt reduction to pre-recession levels; (3) less reliance on short term borrowing could benefit the rating.

What Could Change the Rating Down

One or a combination of the following could have negative rating implications: 1) failure to implement their deficit reduction as planned; (2) materially increased debt levels above current levels; (3) a weakening of the Faroe Islands' relationship with Denmark; (4) an adverse shock impacting the Faroese fishing sector.

Issuer Profile

The Faroe Islands are an autonomy which forms part of the Kingdom of Denmark and consists of 18 islands located in the Atlantic Ocean, between Scotland and Iceland. The islands have a population of approximately 49,000.

DETAILED RATING CONSIDERATIONS

The rating assigned to the Faroe Islands combines (1) a baseline credit assessment (BCA) of a2 and (2) a strong likelihood of extraordinary support coming from the Danish government (Aaa stable).

Baseline Credit Assessment

FISCAL AUTONOMY ALLOWING FOR GREATER REVENUE AND EXPENSE FLEXIBILITY

While part of the Kingdom of Denmark, the Faroe Islands have been governed by the Home Rule Act, which gives the Faroese government full powers to set its tax rates and fees, and to set levels of spending on the services it provides. This broad control over revenue supports Faroese financial flexibility; 90% of the Faroese government's operating revenues are derived from sources under its control, such as income and company taxes, VAT, import duties, sales of products and services, and other internal sources. The Kingdom of Denmark provides an annual block grant which accounts for the remaining approximate 10% of the Faroes' operating revenues. This grant is for "Joint Matters" that have not been transferred to Faroese control (see below for relationship with Denmark).

Historically, the Faroese government has implemented substantial cuts in spending when required (e.g., during the crisis of the 1990s when the government cut spending by 5% in 1992 and 10% in 1993). However, following the global economic crisis in 2008-09, instead of spending cuts, the Faroes opted for a loose fiscal policy and subsequently increased debt. More recently, as the Faroese economy has entered a stage of recovery, the government is committed to revenue growth outpacing expenditure growth and reducing the existing debt level as part of its longer term deficit reduction plan.

STABLE RELATIONSHIP WITH THE KINGDOM OF DENMARK

The Faroes' relationship with Denmark (Aaa Stable) 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. "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 tight majorities. As previously mentioned, Denmark provides an annual block grant to the Faroe Islands. Historically this grant played a bigger role in the Faroese economy but now only represent 10% of Faroese operating revenue. The grant is intended and indeed spent on social welfare, schools and health sectors, the Faroese government does however maintain freedom over how the grant is used.

If the Faroe Islands were to separate from Denmark, a referendum would be assumed. The debate over independence has received less attention and political support in recent years. We do not expect any changes toward independence, and such a transition would be gradual. Although deemed unlikely, any push for separation from Denmark would exert downward pressure on the credit.

THE SUCCESSFUL IMPLEMENTATION OF A LONG TERM DEFICIT REDUCTION PLAN

The Faroe Islands reported a gross operating surplus of DKK91 million at year end 2014 which we recognize as a concrete step toward a positive financing surplus anticipated by 2016 and thereby the start of their debt reversal. The factors supporting positive gross operating balances in 2014 include a 10% increase in tax revenues coupled with a moderate 3.5% increase in operating expenditure.

Operating revenue increased by 19% between 2010 and 2014, while operating costs increased by 9% over the same time frame. Direct tax fuelled operating revenue, increasing by 23% over the same period. Plans to return to a balanced secondary budget position in 2016, will require added control on the expenditure side. While there appears to be a general political consensus towards a return to a secondary balance by 2016, there is political disagreement over how this is best achieved. Detailed plans on how spending will be reduced and deficit targets achieved are still to follow, presenting some implementation risks of achieving spending cuts envisioned, particularly as we are in an election year. Nevertheless, historical performance shows that Faroese budgets closely match and exceed actual performance. We will continue to monitor progress in achieving the fiscal plan and the return to a balanced budget position.

The Faroe Islands have reported primary and secondary deficits over the last seven years as the government increased spending to aid an economic recovery after the 2008 crisis. As a result of the deficits, net debt (including long and short term debt and guarantees to LIV) has increased significantly from around 62% of operating revenues in 2007 to an average of 104% from 2010-2014. Debt is forecasted to peak in 2015 at 110% and is expected to trend downwards from 2016 and beyond.

A LARGE LIQUIDITY BUFFER WHICH MITIGATES REFINANCING RISK

The Faroe Islands have a large liquidity reserve, amounting to DKK2.2 billion in May 2015. According to internal best practise, 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 before the government undertakes additional borrowing. The reserve amount exceeds necessary borrowing requirements in a single year and this mitigates the refinancing risk associated with their 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 and aims to maximize the return within clearly defined risk limits. Although the investment policies are being slightly modified in search for an improved return, in our view, despite a slight increase in risk appetite, the overall treasury policy remains prudent. We will continue to track any changes in risk appetite.

FAROESE ECONOMY'S DEPENDENCE ON THE FISHING SECTOR

The Faroese economy continues to rely on fishing and related industries. Fishing accounts for 97% of exports and almost 20% of GDP. This high exposure introduces economic volatility, largely driven by the variability of fish prices and for inputs such as oil prices, as well as the risks of stock depletion. Over the last years, a combination of high global demand and low oil prices has benefited the Faroese fishing sector, all leading to favourable tax receipts for the government. Since the 1990s, the Faroes' fishing industry has diversified to species other than cod and haddock and the Faroes have also diversified export markets to non-EU countries.

In recent years, the Faroe Islands and the European Union have engaged in several disputes over fishing quotas.

In March 2013, the Faroe Islands unilaterally increased their quota for herring and mackerel and EU member states responded in August 2013 by imposing trade sanctions on all herring and mackerel caught in Faroese waters. The sanctions came at a sensitive time for the Faroese economy, and any negative effect on the fishing sector was feared to exert pressure on the Faroese economy and put delivery pressure on the country's deficit reduction plan. In June 2014, the Faroe Islands and EU reached an agreement to end the sanctions. This was credit positive for the Faroese and evidence pointed towards a muted impact from the sanctions, however the imposition of sanctions further illustrates the volatility that the Faroe Islands operates under. Any future trade sanctions would exert additional credit pressure.

HIGH DEBT LEVELS, EXPECTED TO TREND DOWNWARDS

Net direct and indirect debt is recorded at 105% of operating revenues at year-end 2014, compared with 62% at year-end 2008, but down from 109% in 2013. The upward trend in debt levels over the years is a response to the financial crisis, and the central government favoring fiscal expansion above austerity. Whilst the debt level is expected to remain high in the near term, the debt burden is expected to reverse alongside the latter stage of islands' deficit reduction plan.

The Faroe Islands has independent borrowing powers, and currently has DKK5.74 billion of direct outstanding debt (at YE 2014), this represents 37.6% of 2014 GDP and represents a 6% reduction in absolute terms from year end 2013 direct debt levels (DKK6.1 billion). Although direct debt outstanding has reduced in 2014, the Faroe Islands' total direct and indirect debt levels have trended upwards in 2014. This increase is primarily due to heightened pressures associated with their unfunded pension liabilities. The Faroe islands have unfunded liabilities under the life insurance company, Foroya Livstrygging (LIV), which we include in the calculation of the government's total direct and indirect debt due to the direct guarantee. This pension scheme was fully self-funded until 2008 and until then did not generate any liabilities to taxpayers. However, since the onset of the financial crisis and the subsequent low interest rate environment, LIV's self-funding ratio has fallen below 100%. Unfunded liabilities increased at year end 2014 to DKK1,026 million, double the DKK506 million recorded in the previous year and offsetting the drop in direct debt. Although part of our debt calculation, it is important to note that the government will not be exposed to any LIV liabilities before LIV 's own assets are fully depleted - With a current asset base of DKK2.1billion we expect that this will be depleted in 20-25 years. We will continue to monitor the progress of this off balance sheet scheme, as it impacts the government's total debt burden over the long run.

Additionally, DKK992 million in municipal debt was recorded in 2014, and this is excluded from our net debt calculation as this is deemed self-supporting. The Ministry of Finance is responsible for the supervision of the financial strength of municipalities and they may only incur a total debt burden up to their level of total tax income in any one year. Additionally, the central government does not guarantee any of the municipal debt. Nonetheless, we appreciate that the local and regional government plays a crucial role and accounts for more than 20% (DKK1,506 million) of total government spending (DKK5,945 million). Municipalities continue to benefit from considerable flexibility in terms of spending, particularly for capital investments and have over the last year been better integrated into the national budgeting process. Reforms have brought their finances more in line with a national controlled system. However, some additional work is required to bring all municipalities to the same standards. The islands' 30 municipalities vary widely in terms of size, from fewer than 50 inhabitants to approximately 20,000. Recent reforms include moving responsibility for elderly care from central government to municipalities, which came into force on January 1, 2015..

REFINANCING RISK DUE TO DEBT STRUCTURE AND RELIANCE ON SHORT TERM BORROWING

The Faroe Islands' debt profile requires refinancing of approximately one billion DKK annually. At year end 2014, short-term gross direct debt as a percentage of gross direct debt stood at 29.8%, increasing from 19.9% in 2013. We consider this to be a high level of debt maturing in any single year and consider that this debt structure exposes the islands to market risk. Admittedly, it has allowed the Faroe Islands to benefit from the current low rate environment. Mitigating the refinancing risk is the Faroe Islands' liquidity buffer currently at DKK2.2 billion or 15% of GDP (for more details refer to the Strengths section in this report). A move towards longer dated debt could address this refinancing risk concern. Additionally, the debt is mainly bought by small and mid-sized Danish financial institutions which are less likely to receive a bail out from the central government under financial distress (Amagerbanken in 2010) and consequently .

Extraordinary Support Considerations

We assign 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 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.

Output of the Baseline Credit Assessment Scorecard

In the case of the Faroe Islands, the BCA matrix generates an estimated BCA of a1 compared to the assigned BCA of a2 by the rating committee. The matrix-generated BCA of a1 reflects (1) an idiosyncratic risk score of 5 (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 (Aaa stable). The one notch differential reflects a number of factors not captured in the scorecard including: 1) the Faroese industry's concentration on the fishing sector which we consider to be insufficiently captured in the scorecard; 2) Refinancing risk and the Faroe Islands' reliance on small and mid-sized Danish financial institutions for debt refinancing; 3) small population limiting revenue generation.

The idiosyncratic risk scorecard and BCA matrix, which generates estimated baseline credit assessments from a set of qualitative and quantitative credit metrics, are tools used by the rating committee in assessing regional and local government credit quality. The credit metrics captured by these tools provide a good statistical gauge of stand-alone credit strength and, in general, higher ratings can be expected among issuers with the highest scorecard-estimated BCAs. Nevertheless, the scorecard-estimated BCAs 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. Scorecard results have limitations in that they are backward-looking, using historical data, while the assessments are forward-looking opinions of credit strength. Concomitantly, the limited number of variables included in these tools cannot fully capture the breadth and depth of our credit analysis.

ABOUT MOODY'S SUB-SOVEREIGN RATINGS

National and Global Scale Ratings

Moody's National Scale Credit Ratings (NSRs) are intended as relative measures of creditworthiness among debt issues and issuers within a country, enabling market participants to better differentiate relative risks. NSRs differ from Moody's global scale credit ratings in that they are not globally comparable with the full universe of Moody's rated entities, but only with NSRs for other rated debt issues and issuers within the same country. NSRs are designated by a ".nn" country modifier signifying the relevant country, as in ".za" for South Africa. For further information on Moody's approach to national scale credit ratings, please refer to Moody's Credit rating Methodology published in June 2014 entitled "Mapping Moody's National Scale Ratings to Global Scale Ratings".

The Moody's Global Scale rating for issuers and issues 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.

Baseline Credit Assessment

Baseline credit assessments (BCAs) are opinions of entity's standalone intrinsic strength, absent any extraordinary support from a government. Contractual relationships and any expected ongoing annual subsidies from the government are incorporated in BCAs and, therefore, are considered intrinsic to an issuer's standalone financial strength.

BCAs are expressed on a lower-case alpha-numeric scale that corresponds to the alpha-numeric ratings of the global long-term rating scale.

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%), strong (51% - 70%), high (71% - 90%) or very high (91% - 100%).

Rating Factors

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	7	91.03	70%	7.6	20%	1.52
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 (%)	7	-0.22	12.5%	4.5	30%	1.35
Interest payments / operating revenues (%)	3	2.12	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	7	104.55	25%			
Short-term direct debt / total direct debt (%)	5	29.84	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						4.57(5)
Systemic Risk Assessment						Aaa
Suggested BCA						a1

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