

CREDIT OPINION

16 August 2023

Update

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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)

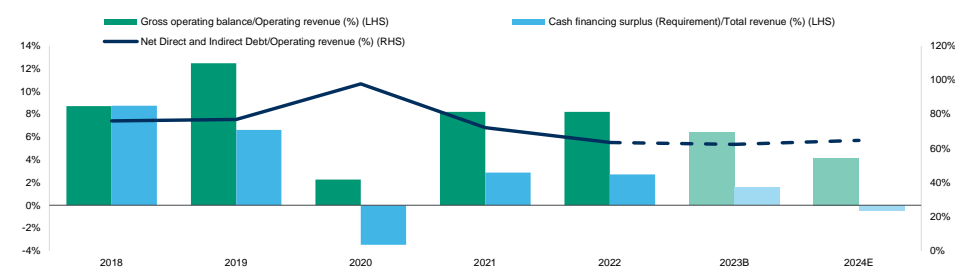
Update following rating affirmation

Summary

The credit profile of the [Government of Faroe Islands](#) (Faroe Islands, Aa2 stable) reflects the fiscal autonomy, providing a high level of financial flexibility, combined with a track record of prudent budgetary 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 driven by the construction of sub-sea tunnels 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 2023-24



B - Budget; E - Moody's estimate.
 Sources: Issuer and Moody's Investors Service

Credit strengths

- » Strong institutional framework with long-established fiscal autonomy
- » Track record of sound budgetary results and strong liquidity
- » Manageable and stable debt levels

Credit challenges

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

Rating outlook

The outlook of the Faroe Islands is stable. This reflects our view that Faroe Islands will preserve its sound financial performance and manageable debt levels, good macroeconomic metrics and a stable relationship with the government of Denmark.

Factors that could lead to an upgrade

An upgrade of the Faroe Islands' rating would require a significant reduction in debt ratios as well as a more diversified economic structure. A stronger support assumption could also have positive rating implications, which, however, is not expected because of its autonomous status.

Factors that could lead to a downgrade

One or a combination of the following could have negative rating implications: (1) a weakening in the Faroe Islands' relationship with Denmark; (2) significantly higher debt than the current levels or structural financial deficits over several years; and (3) any unexpected adverse shock affecting the Faroese fishing industry.

Key indicators

Exhibit 2

Government of Faroe Islands

	2018	2019	2020	2021	2022	2023B	2024E
Population (in '000)	50.5	51.3	52.9	53.6	54.0	54.3	54.5
Gross operating balance/Operating revenue (%)	8.7%	12.5%	2.3%	8.2%	8.2%	6.4%	4.1%
Intergovernmental transfers/Operating Revenue(%)	9.5%	8.7%	8.7%	8.0%	7.8%	7.5%	7.4%
Cash financing surplus (Requirement)/Total revenue (%)	8.7%	6.6%	-3.5%	2.9%	2.7%	1.6%	-0.5%
Net Direct and Indirect Debt/Operating revenue (%)	76.0%	76.9%	97.7%	72.0%	63.4%	62.3%	64.6%
Direct debt/Operating revenue (%)	62.4%	60.7%	81.4%	60.6%	56.2%	55.8%	58.7%
Debt service/Total revenue (%)	0.4%	14.4%	17.0%	15.8%	12.5%	6.4%	12.0%

B - Budget; E - Moody's estimate.

Sources: Landsbankin Foroya (Faroe Islands Governmental Bank) and Moody's Investors Service

Detailed credit considerations

On 11 August 2023, Moody's affirmed the Faroe Islands' Aa2 rating and maintained the stable outlook. The key drivers for the rating affirmation were track record of continued positive operating balances, consistently strong financial performance as well as prudent and sophisticated financial management. The rating also takes into account Faroe Islands' narrow and less diversified economic base relying on the fishing industry but partially offset by high wealth levels, providing greater shock-absorption capacity.

The credit profile of the Faroe Islands, as expressed in an Aa2 stable rating, combines (1) a Baseline Credit Assessment (BCA) of a1, 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 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 provides an annual block grant of DKK707 million, which accounted for close to 8% of the Faroe Islands' operating revenue in 2022. 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 Faroese government has, in the past, implemented substantial cuts in spending, when required.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the issuer/deal page on <https://ratings.moody.com> for the most updated credit rating action information and rating history.

The islands' 29 municipalities vary widely in terms of size, from fewer than 50 inhabitants to around 20,000. Municipalities vary also widely in terms of financial strength, with stronger ones including Klaksvík 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 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.

Track record of sound budgetary results and strong liquidity

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 2022, Faroe Islands' operating performance remained strong, with a gross operating balance (GOB) of 8% 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 38% and 34% to the operating revenues in 2022, respectively. The overall tax revenues growth of 6.3% in 2022 will slow down to 2.8% in 2023, which nonetheless result in a GOB projected at solid 6.4% of operating revenue.

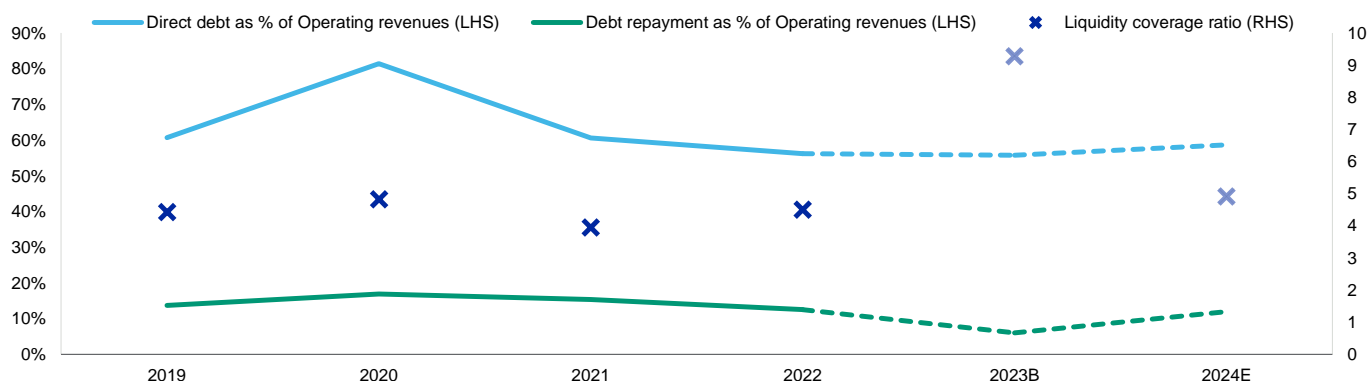
The Faroe Islands' have a large liquidity buffer, which helps mitigates the negative shocks. Faroese liquidity reserves amounted to DKK3.8 billion as of year-end 2022 representing over 40% of operating revenue and it was well above the internal minimum liquidity threshold of DKK3.4 billion based upon 15% of GDP and will remain above the threshold in 2023. 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 70% of its outstanding debt at the end of 2022. 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 4.7 at year-end 2022 (Exhibit 3). In June 2022, the government issued DKK1.1 billion fixed rate notes due in 2024 to finance the maturing debt of DKK1.3 billion. 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.

Manageable and stable debt levels

At year-end 2022, the net direct and indirect debt (NDID) consisted of direct debt of DKK5.1 billion and another DKK0.7 billion as indirect debt, represented by the Faroese government guaranteed unfunded pension liability under Foroya Livstrygging (LIV), translating into NDID of 65.7% of operating revenue. After the issuance of DKK900 million, partly used for repayment of the maturing debt of DKK550 million due in June 2023 and partly for liquidity purposes; and with an additional issuance of DKK1.1 billion in 2024 for refinancing purposes, we expect the NDID to represent around 65% of operating revenue projected in 2024.

Exhibit 3

Manageable debt levels; strong liquidity coverage

B - Budget; E - Moody's Estimate.

Sources: Issuer and Moody's Investors Service

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 2022. 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 DKK54 million in 2022 for the benefit of the company. The tunnel project company is 100%-owned by the government, and we consider it a contingent liability.

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

The Faroese economy continues to rely on the fishing industry, including fishing and fish farming, accounting for around 20% of national gross value-added product and 92% of the total export value of goods. 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 past few years, a combination of high global demand for fish and low oil prices has benefited the Faroese fishing sector, and indirectly government revenue.

After being hit hard during the pandemic, fishing exports (salmon and pelagic species) showed a strong recovery in 2021 and at year-end 2022 the results recorded the highest levels yet. Export of main demersal species (cod, haddock and saithe) was higher by DKK404 million in 2022 compared to the previous year; revenues from fish farming (salmon) similarly were up by DKK1.063 million; while lastly, the only group which showed less earning compared to 2021 was the fishing of herring, mackerel and blue whiting which were DKK23 million less.

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 coastal states, including UK, were unable to reach an agreement on mackerel quota last year and subsequently increased the quota on previous year. In 2022, the mackerel quota remains high although it was lowered at the same percentage that International Council for Exploration of Sea has lowered the total allowable catch on mackerel.

The effect of the Russian-Ukrainian military conflict can be seen on multiple areas: 1) in the increased level of commodity prices reflected in the consumer price inflation. The CPI has considerably increased from 0.3% in 2020, to 2.7% in 2021 and most recently 7.7% at year-end in 2022; 2) increase of oil prices which while not necessarily affecting the islands, it does have a heavy impact on the

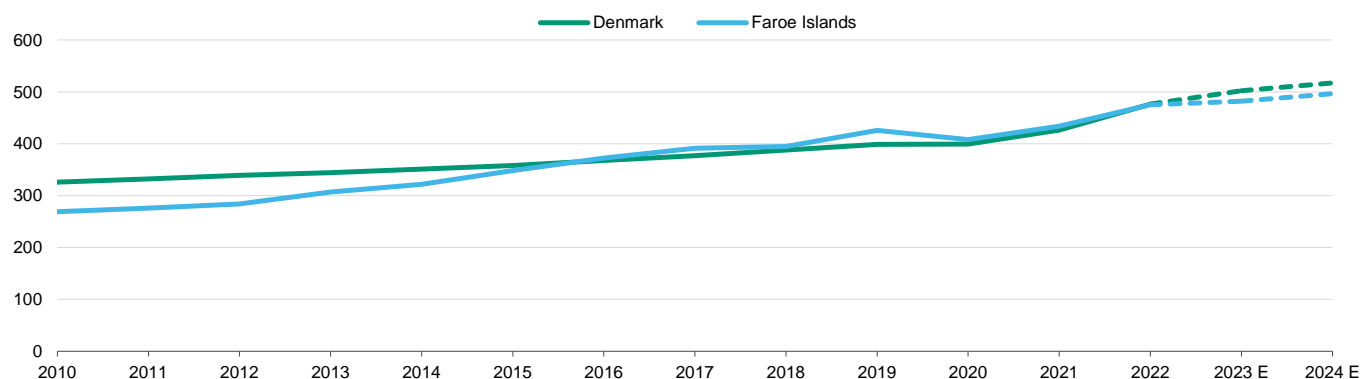
Faroese fishing sector which is very oil dependent; and 3) sanctions towards Russia with impact on fishing agreements and to a lesser degree due to a successful diversification, the exports of salmon, herring and mackerel. The demand for Faroese salmon and the catches by the pelagic fleet remains high and Faroese export companies have successfully diverted from Russian market to new countries.

At DKK25 billion in 2022 (forecast), Faroe Islands' nominal GDP is very small compared with that of similarly rated peers. However, the economy's small size is offset by historically stable growth rates (2020 is an exception when the economy had a small downturn) and very high wealth levels with GDP per capita at DKK475 million in 2022 (compared to Denmark's GDP per capita of DKK476 million), which provide greater shock-absorption capacity (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 Investors Service

Following the strong economic recovery from the pandemic, the unemployment rate decreased to the lowest level of 0.6% 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

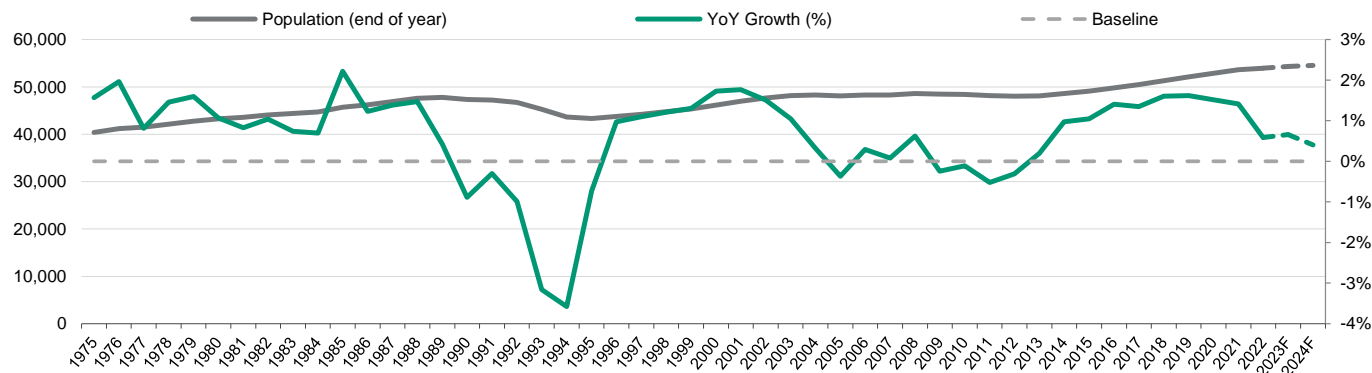
The Faroese population is steadily growing by about a couple of hundred new inhabitants per year (Exhibit 5). Such population growth put pressure on the government's operations especially with regards to capital investments. The government would need to invest in areas such as new schools, health and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

The government expects its capital investments to reach around DKK550 million annually over the coming years. In addition, government companies 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 is planned to be opened by the end of 2023. In 2021, the construction has started on two additional tunnels in Bordoy with an estimated cost of around 520 million.

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 Investors Service

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.

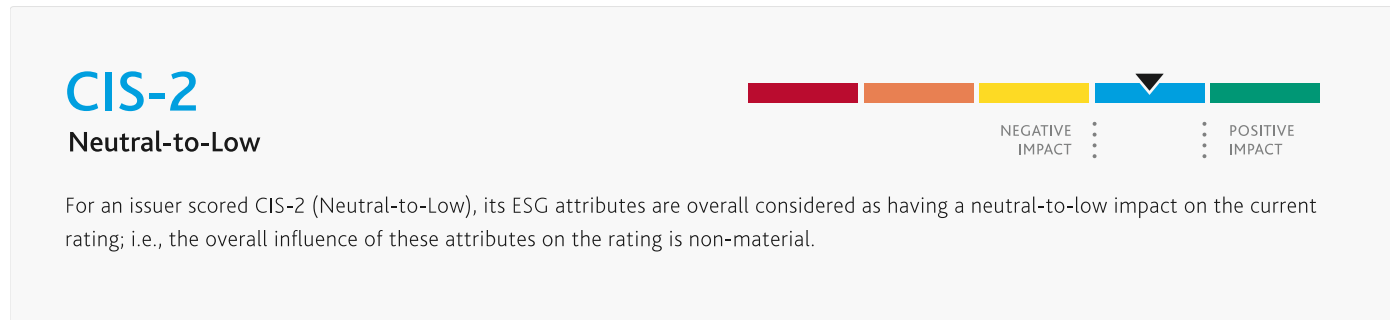
While Denmark has no formal obligation to provide extraordinary support to the Faroe Islands, it has historically supported the Faroese government on a number of occasions. In the 1990s, the Faroese government borrowed — largely from Denmark, given the scale of the crisis — to fund the nationalisation of Føroya Banki and Sjóvinnubankin 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 Finansiell 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 Neutral-to-Low CIS-2

Exhibit 6

ESG Credit Impact Score



Source: Moody's Investors Service

Faroe Islands' CIS-2 reflects exposure to environmental risks, which is mitigated by strong governance and capacity to respond to shocks.

Exhibit 7

ESG Issuer Profile Scores



Source: Moody's Investors Service

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.

Social

The Faroe Islands' exposure to social risks is neutral-to-low (S-2). The population of the Faroe Islands is ageing, resulting in declining labour supply and higher pension and social costs. Furthermore, the Faroes are benefiting from immigration at substantial growth rates, reflecting the attraction to live and work on the islands.

Governance

Governance is appropriate (G-2). 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. However, its small size and interest rate volatility represent constraints.

ESG Issuer Profile Scores and Credit Impact Scores for the rated entity/transaction are available on Moody's.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 a1 is close to the suggested BCA of aa3 generated by the scorecard. The suggested BCA of aa3 reflects (i) 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 (ii) a systemic risk score of Aaa, as reflected in the sovereign bond rating for Denmark (Aaa stable).

For details about our rating approach, please refer to Rating Methodology: [Regional and Local Governments](#), 16 Jan 2018.

Exhibit 8

Faroe Islands, Government of Regional & Local Governments

Baseline Credit Assessment – Scorecard	Score	Value	Sub-factor Weighting	Sub-factor Total	Factor Weighting	Total
Factor 1: Economic Fundamentals				6.20	20%	1.24
Economic Strength [1]	5	100.52%	70%			
Economic Volatility	9		30%			
Factor 2: Institutional Framework				1	20%	0.20
Legislative Background	1		50%			
Financial Flexibility	1		50%			
Factor 3: Financial Position				3.25	30%	0.98
Operating Margin [2]	3	7.36%	12.5%			
Interest Burden [3]	1	0.51%	12.5%			
Liquidity	1		25%			
Debt Burden [4]	3	63.36%	25%			
Debt Structure [5]	7	30.93%	25%			
Factor 4: Governance and Management				5	30%	1.50
Risk Controls and Financial Management	1					
Investment and Debt Management	5					
Transparency and Disclosure	1					
Idiosyncratic Risk Assessment						3.92 (4)
Systemic Risk Assessment						Aaa
Suggested BCA						aa3
Assigned BCA						a1

[1] Local GDP per capita as % of national GDP per capita

[2] Gross operating balance/operating revenues

[3] Interest payments/operating revenues

[4] Net direct and indirect debt/operating revenues

[5] Short-term direct debt/total direct debt

Source: Moody's Investors Service; Fiscal 2022.

Ratings

Exhibit 9

Category	Moody's Rating
FAROE ISLANDS, GOVERNMENT OF	
Outlook	Stable
Issuer Rating	Aa2

Source: Moody's Investors Service

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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