

CREDIT OPINION

20 August 2019

✓ Rate this Research

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

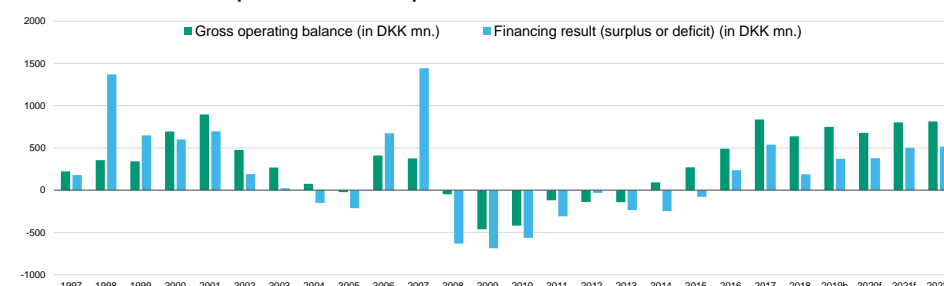
Update following upgrade to Aa2

Summary

The credit profile of the [Government of Faroe Islands \(the Faroe Islands, Aa2 stable\)](#) reflects the fiscal autonomy, resulting in a high level of revenue and expense flexibility, combined with a track record of prudent budgeting. The stable and historical relationship with the [Government of Denmark \(Aaa stable\)](#) is credit positive. While the Faroese economy has a high dependence on the fishing industry, this is somewhat offset by regular fish stock control and efforts to diversify the country's trade partners. The rating takes into account the government's very large liquidity buffer, which mitigates any refinancing risk. Debt metrics are on a moderate level and on a declining trend because of significant financial surpluses, which we expect to sustain. The rating also takes into account a strong likelihood of the government of Denmark providing support if the Faroe Islands were to face acute liquidity stress.

Exhibit 1

Financial results are expected to remain positive



2019b: budgeted data; 2020f-22f: forecast.

Sources: Issuer, Moody's Investors Service

Credit strengths

- » Fiscal autonomy and stable relationship with the Government of Denmark
- » Financing surpluses and large liquidity buffer
- » Declining debt indicators, with some off-balance-sheet activities

Credit challenges

- » Faroese economy is narrow and relatively exposed to the fishing industry
- » Faroe Islands' growing population requires infrastructure investments

Rating outlook

The outlook of the Faroe Islands is stable. This reflects its sustainable financial performance and debt-reduction trend, improved 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 further 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) a materially increased debt level or financial deficits over several years; and (3) an adverse shock affecting the Faroese fishing industry.

Key indicators

Exhibit 2

Government of Faroe Islands

Faroe Islands, Government of	2014	2015	2016	2017	2018	2019b
Population (in '000)	48.6	49.1	49.8	50.5	51.3	52.0
Gross Operating Balance/Operating Revenue (%)	1.5	4.3	7.2	11.4	8.6	9.9
Interest Payments/Operating Revenue (%)	1.9	1.7	0.9	1.1	0.3	0.6
Intergovernmental Transfers/Operating Revenue (%)	10.6	11.1	10.3	9.5	9.5	9.1
Cash Financing Surplus(Requirement)/Total Revenue (%)	-3.9	-1.2	3.4	7.3	2.5	4.9
Net Direct and Indirect Debt/Operating Revenue (%)	107.1	111.1	104.5	97.9	90.1	83.1
Short-term Direct Debt/Direct Debt (%)	14.3	15.3	15.2	16.1	18.2	12.5

2019: financial indicators show budget data and Moody's estimate, population indicator is an estimate.

Sources: Issuer, Moody's Investors Service

Detailed credit considerations

On 16 August 2019, we [upgraded the long-term issuer rating of the Faroe Islands to Aa2 from Aa3](#). The rating outlook remained stable.

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

Fiscal autonomy and a stable relationship with the Government of Denmark

The Faroe Islands consist of 18 islands located in the Atlantic Ocean, between Scotland and Iceland, with a growing population, with more than 51 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 90% of the Faroese government's operating revenue is derived from sources under its control. The Kingdom of Denmark provides an annual block grant of around DKK700 million, which accounts for about 10% of the Faroe Islands' operating revenue. 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.

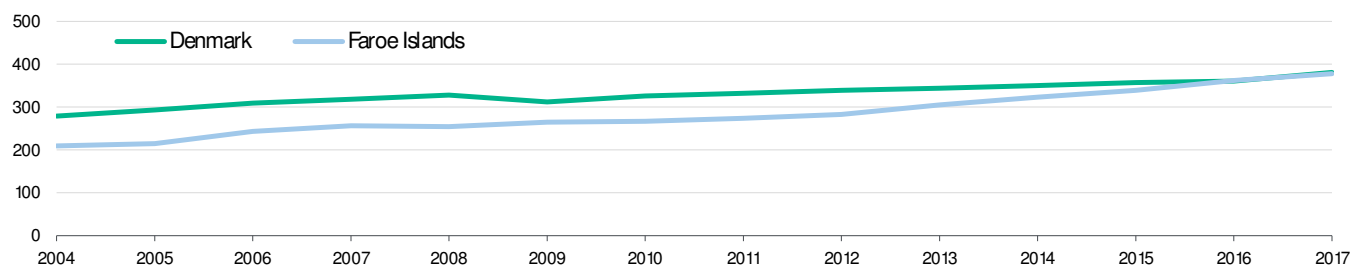
Economic indicators are very strong, with a gross domestic product (GDP) per capita at the Danish average (as Exhibit 3 shows). Real GDP growth rate was above the Danish average over the many years in the past. Unemployment rate is extremely low at below 2%.

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Exhibit 3

Faroese GDP per capita is now at the level of the Danish GDP per capita

Nominal GDP per capita in DKK thousands, by year



Estimates of GDP per capita for the Faroe Islands for 2014-17.

Sources: Statistics Denmark, Hagtova Foroya (Statistics Faroe Islands)

In recent years, the government has implemented certain reforms including fishing and pension reforms that will enhance and sustain the government's long-term public finances.

An important part of the fishing reform was recently implemented, with the Act on the Management of Marine Resources, which was approved by the parliament on 18 December 2017, aiming to foster sustainable management of fisheries, including legal and administrative frameworks, to promote equal rights and wider access to the fish stock while increasing government revenue (see also: [Fishing Policy Reform – Issuer In-Depth Report, published October 2018](#)). We understand that other elements of the fishing reform are still under discussion and will be implemented in the future.

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 Klaksvikar and Torshavnar.

Although there were discussions about a referendum, the current government of the Faroe Islands has not put this forward. We understand that based on what has been discussed so far, there is no concern about a significant change in the Faroese relationship with Denmark. The next general election will be held on 31 August 2019.

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.

Financing surpluses and large liquidity buffer

The Faroe Islands reported a favourable gross operating surplus of DKK636 million in 2018, compared with DKK835 million in 2017. This operating balance amounts to 8.6%, relative to the operating revenue, reflecting a positive development in results and considerable improvement from that five years earlier, when operating balance was still negative. We expect operating surpluses to sustain in the next five years. Given the strong operating performance, the government is now in a position to easily cover capital expenses and still report considerable financial surpluses. In 2018, Moody's-adjusted financing surplus was DKK188 million, which is DKK500 million lower than the government-reported surplus. This is explained by an adjustment made to capital expenses because of the write-off of a loan granted by the Danish government. The 2017 financing surplus was DKK539 million. According to the government budget, 2019 operating surplus and financing surplus will be higher than that in 2018 (as Exhibit 1 shows), which we deem realistic. In absence of any unexpected economic shock, such operating and financing surpluses are expected to continue to be reported over the coming years, which we also view as realistic.

The Faroe Islands have a large liquidity reserve, amounting to DKK3.7 billion as of the end of December 2018 (compared with DKK3.4 billion in December 2017), which is well above the internal minimum liquidity threshold of DKK2.8 billion. According to the guidelines,

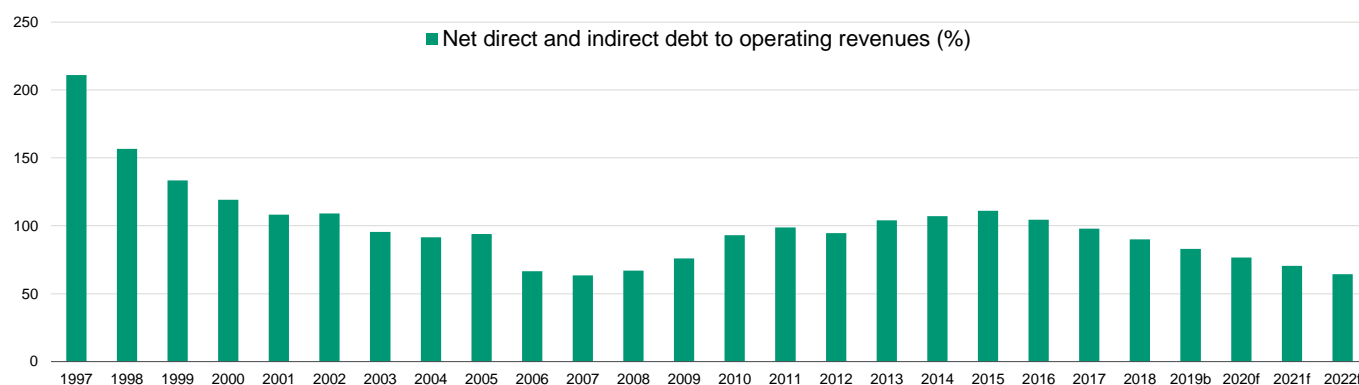
this reserve is only to be used during times of heightened market stress — if the reserve is drawn upon and drops below 15% of the GDP, it is expected to be addressed and to again reach internal limits during the next borrowing round. The 2018 liquidity reserve represented nearly 20% of the Faroese GDP or 65% of its outstanding direct debt. 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. In June 2019, the government used some of its excess liquidity (that is, above 15%-threshold) to pay down a part of its DKK1.1 billion maturing bond, while only DKK300 million has been refinanced. 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 third of the total liquidity pool is invested in Aaa-rated securities.

Declining debt indicators, with some off-balance-sheet activities

The Faroese government's expansionary fiscal policy following the global financial crisis (2008-09) had resulted in increased debt levels. However, the debt is on a declining trend, expecting to reach pre-crisis level in the near future (as Exhibit 4 shows).

Exhibit 4

Debt is trending down



2019b: budgeted data; 2020f-22f: forecast.

Sources: Issuer, Moody's Investors Service

The net direct and indirect debt (NDID) consists mainly of direct debt (DKK5.6 billion as of December 2018). We count another DKK1 billion as indirect debt, which is because of the fact that the Faroese government has guaranteed an unfunded pension liability under Foroya Livstrygging (LIV). Since the onset of the financial crisis and the subsequent low interest rate environment, LIV's self-funding ratio has fallen below 100%. We will continue to monitor the progress of this off-balance-sheet scheme, as it impacts the government's total debt metrics over the long run.

Our projections foresee that NDID (% of operating revenue) will reach a record low in the near future (as Exhibit 4 shows).

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 also has some off-balance-sheet activities and public companies. Overall, these are 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. The Faroese government has provided a minimum revenue guarantee for the benefit of the company. The infrastructure project exposes the government to construction and operational risk by underwriting the major infrastructure project that involves two subsea tunnels, Eysturoy and Sandoy. The tunnels represent the biggest infrastructure deal in the history of the Faroe Islands, with an expected cost of around DKK2.64 billion. (see: [FAQs About the Sub-Sea Tunnel Plans, Minimum Traffic Guarantee, published 6 March 2017](#)). We note that in June 2019, the islands' main infrastructure project (Eysturoy tunnel) has reached an important milestone with the breakthrough of the tunnel construction. The tunnel project

company is 100%-owned by the government, and we consider it a contingent liability, although with a low-risk profile. The progress of the construction and milestone achieved reduce the related construction risk significantly, which is credit positive.

Faroese economy is narrow and relatively exposed to fishing industry

The Faroese economy continues to rely on the fishing industry, including fishing and fish farming, accounting for around 20% of national GDP and 95% 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.

To reduce dependencies, the Faroe Islands have also increased trade with non-EU countries, from around one-third 10 years earlier 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.

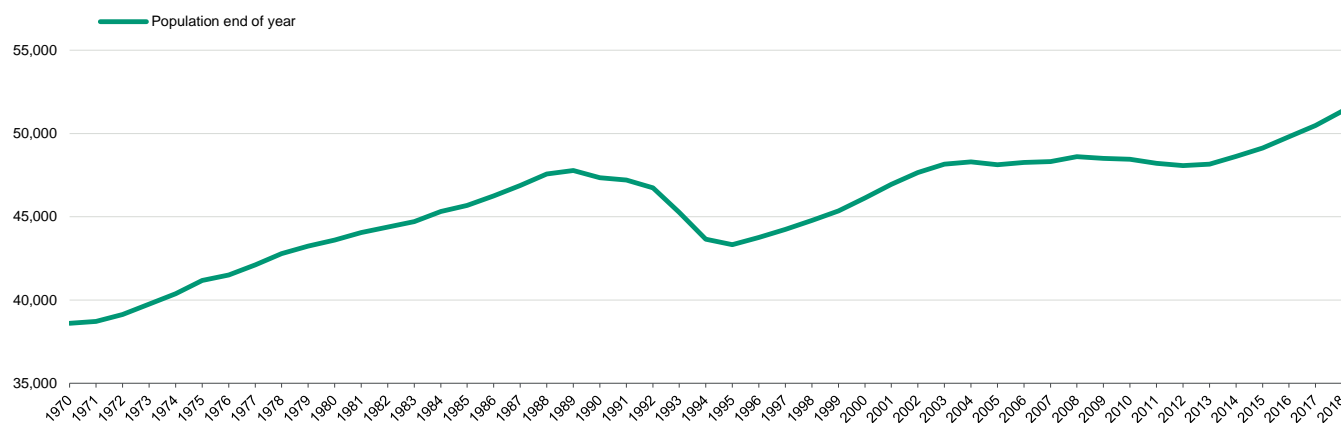
Faro Islands' growing population requires infrastructure investments

The Faroese population is steadily growing by about a couple of hundred new inhabitants per year (as Exhibit 5 shows). Such population growth strains the government's operating but mainly capital expenditures. 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 more than DKK400 million annually over the coming years. In addition, government companies are also planning to invest to address infrastructure needs.

Exhibit 5

Population growth over the last half century



Source: Statistics Faroe Islands

Extraordinary support considerations

We consider Faroe Islands to have a strong likelihood of extraordinary support from the Kingdom of Denmark. This reflects our assessment that the current relationship with the Kingdom 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.

Rating methodology and scorecard factors

The assigned Baseline Credit Assessment (BCA) of a1 is close to the scorecard indicated BCA of aa3. The matrix-generated BCA of aa3 reflects (1) 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 (2) a systemic risk score of Aaa, as reflected in the Denmark's Aaa stable sovereign bond rating.

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

Exhibit 6

Government of Faroe Islands

Baseline Credit Assessment	Score	Value	Sub-factor Weighting	Sub-factor Total	Factor Weighting	Total
Scorecard						
Factor 1: Economic Fundamentals						
Economic strength	5	99.13	70%	6.2	20%	1.24
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 (%)	3	9.23	12.5%	2.75	30%	0.83
Interest payments / operating revenues (%)	1	0.63	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	5	90.09	25%			
Short-term direct debt / total direct debt (%)	3	18.23	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						3.77(4)
Systemic Risk Assessment						Aaa
Suggested BCA						aa3

Based on 2018 data.

Source: Moody's Investors Service

Ratings

Exhibit 7

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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