MOODY'S
PUBLIC SECTOR EUROPE

ISSUER IN-DEPTH
September 1, 2015

Faroe Islands

Delivery of Faroe Islands' Fiscal Plan Supports Creditworthiness

RATINGS

Faroe Islands, Government of

Rating	Aa3, Stable

Source: Moody's

KEY METRICS

	2013	2014	2015B	2016F
Accrual Financing Surplus(Requirement)/Total Revenue (%)	-3.8	-3.8	-2.1	0.9
Gross Operating Balance/Operating Revenue (%)	-2.4	1.4	2.2	5.0
Net Direct and Guaranteed Debt/Operating Revenue (%)	109	104	110	102
GDP Growth	7.5%	4.1%	2.5%	2.2%
Unemployment rate (%)	4.5	3.8	3.5	3.5

Source: Moody's.

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The credit quality of the Faroe Islands (Aa3, Stable) is supported by its credible long-term deficit reduction plan. The island will progress towards a balanced budget by fiscal year 2016. Faroe Islands' key credit strengths include:

» **A strong track record of delivering against their budget**. A history of prudent budgeting builds confidence in the succesful delivery of a long-term fiscal plan.

» **A high level of revenue and expenditure flexibility**. Broad control of revenues and expenditures enables budgetary flexibility providing a wide range of contingencies that allow the Faroe Islands to adapt to changing circumstances.

» **Low pre-crisis debt levels providing scope for additional borrowing.** A strong balance sheet position and initial low debt levels has provided room for additional borrowing. The deficit reduction plan anticipates that debt will peak in 2015 before starting to trend downward.

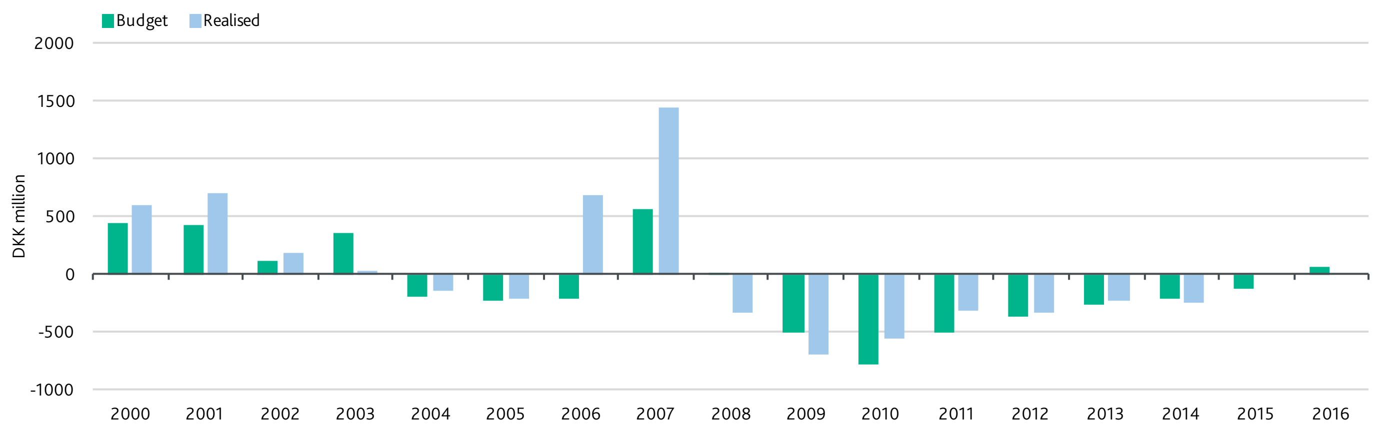
» **Stronger than expected economic growth.** The Faroe Islands has experienced strong economic growth forecasts in recent years, supporting its ability to reduce its deficit.

A strong track record of delivering against their budget

The Faroe Islands expects its first budget surplus since 2007.

Since the onset of the financial crisis, the central government has reported a succession of fiscal deficits. Over the last seven years, spending has been raised to aid an economic recovery and the introduction of the 2011-2016 deficit plan led to a rating downgrade from Aa3, Stable to Aa2, Negative back in 2011. However, over the last 15 years the Faroe Islands has tended to outperform budget expectations (see Exhibit 1) and this has remained true over the course of the five year reduction plan. Over the four years since the introduction of the deficit reduction plan in 2011, the Faroe Islands deficit totalled DKK1.13 billion, DKK 220 million (16%) less than the DDK 1.35 billion projected. The deficit has been falling steadily since 2009 and will reach a surplus by fiscal year 2016, largely driven by stronger revenue growth.

EXHIBIT 1
Faroe Islands' track record on delivering against budget provides credibility on 2016 projected surplus
Consolidated Surplus/Deficit



Source: Gjaldstova Føroya (Faroese statistical office)

The Faroe Islands track record of delivering on their budget builds confidence that they will be able to deliver their forecasted 2016 surplus of DKK56 million. The Faroe Islands does not however present specific and detailed disaggregated forecasts and this was a cause for concern when the deficit reduction plan was initially presented in 2011.

Excellent financial reporting, controls and monitoring ensuring budgetary delivery

The Faroe Islands' tight level of financial control and supervision allows them to meet its budget targets and to adjust quickly should they observe any deviations. The National Accounting Office ensures that all spending is tracked and stays within budget directives via a live tracking system. The central government has updated its online accounting systems to include the consolidation of municipal accounts into the national system. The finances of the government and of key industries are also monitored by the Danish National Bank. Separately, the Auditor General may review the accounts of the government, entities owned by the government and those entities receiving financial support from the government.

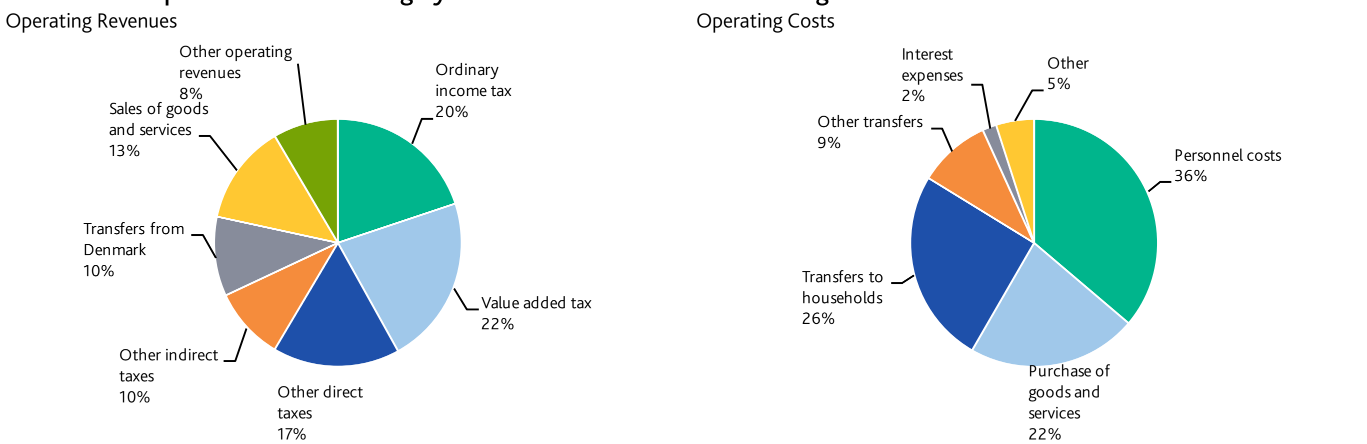
Revenue and expenditure flexibility provides levers to ensure deficit plan remains on track

Strong control of revenues and expenditures allows the Faroe Islands to make budgetary corrections as and when required. This flexibility provides for a wide range of contingencies. While part of the Kingdom of Denmark, the Faroe Islands is 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. In 1948, the Faroes were granted Home Rule and by 2005 controlled all matters except independence (For more details please see appendix).

Operating revenues are derived from sources under its control, such as VAT, income tax, company taxes, import duties, sales of products and services etc. Exhibit 2 shows that in 2014, 90% of the Faroese government's operating revenues were derived from sources under its control, and only 10% from transfers from Denmark. The transfer from Denmark has historically represented a bigger proportion of the islands operating revenue, represented approximately 20% of revenues in 2001. The Faroese government has control over its spending. During the banking crisis of the early 90s, the government demonstrated their expenditure flexibility by reducing expenditure by 15% in just two years. The government implemented substantial expenditure cuts during the crisis, with spending cut by 5% in 1992 and 10% in 1993.

EXHIBIT 2

Revenue and expenditure remains largely under the control of the Faroese government



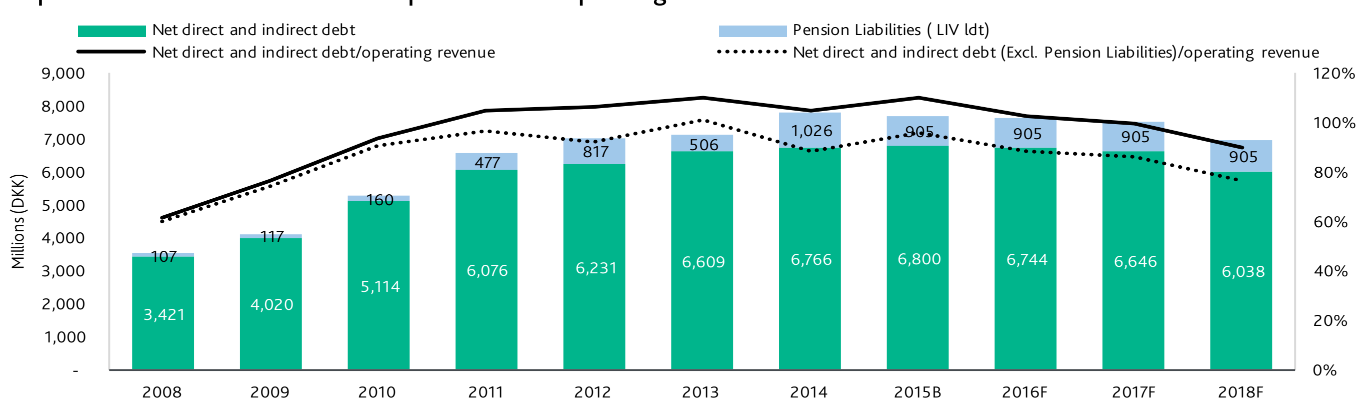
Source: Gjaldstova Føroya (Faroese statistical office)

Low pre-crisis debt levels providing scope for additional borrowing

In 2008, the Faroe Islands net direct and indirect debt (which includes unfunded LIV ltd pension liabilities) was DKK3.4 billion, representing 62% of operating revenues. This moderate level of debt enabled the government to mitigate the economic downturn with fiscal expansion and debt issuance rather than austerity. The island issued debt to finance large scale infrastructure projects, spending an average of DKK244 million per year between 2011-2015, 36% higher than the pre-crisis average annual spend of DKK179 million (between 2003-2007). This investment went mainly towards schools, hospital extensions and new tunnels. 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. Net direct and indirect also increased due to heightened pressures associated with unfunded pension liabilities. Debt increased significantly over the years, reaching 105% of revenues by 2011 and has remained high since. The Faroe Islands budgets that debt will peak in 2015 before trending downwards. The Faroes anticipate using future surpluses to repay debt with annual net debt falling moving forward.

EXHIBIT 3

Low pre-crisis debt levels afforded scope to increase spending levels



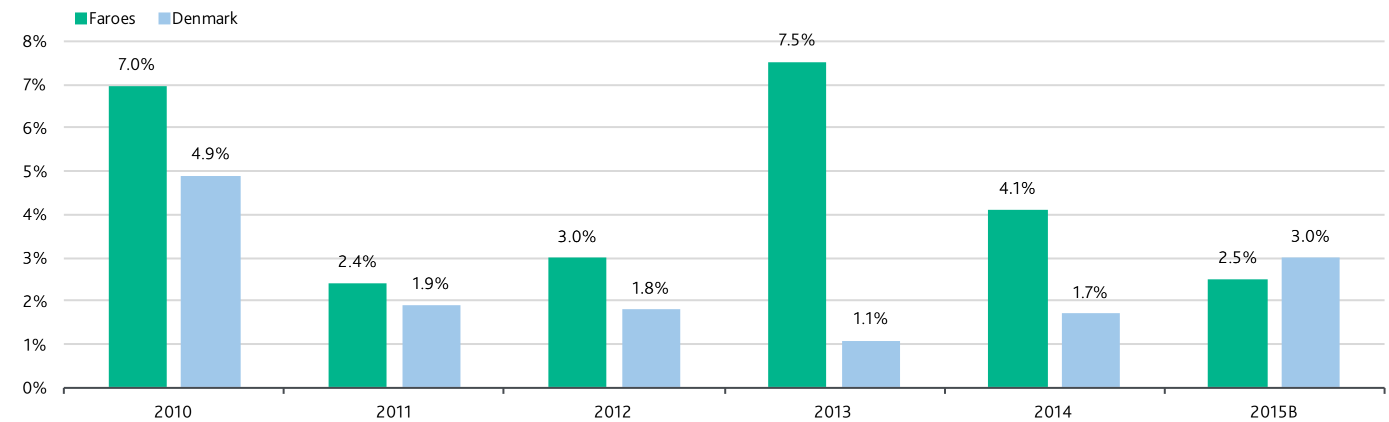
Source: Gjaldstova Føroya (Faroese statistical office)

Stronger than expected economic growth leading to stronger than expected operating revenues

In recent years, GDP growth in the Faroe islands has exceeded Denmark's GDP growth. Strong economic activity has translated into strong operating revenue growth enabling the Faroe Islands GDP/capita to catch up with Denmark. GDP per capita has been steadily rising and in 2015 was recorded at DKK313,000, representing approximately 90% of the level in Denmark. Nominal GDP growth has also averaged 4.8% per year between 2010 and 2014 and in the same time frame (Exhibit 4), the government's operating revenue has increased by 19%. Direct tax fuelled this growth, increasing by 23% over the same period. We anticipate continued economic growth to continue supporting revenues and the 2016 surplus.

EXHIBIT 4

Strong GDP growth supporting deficit plan



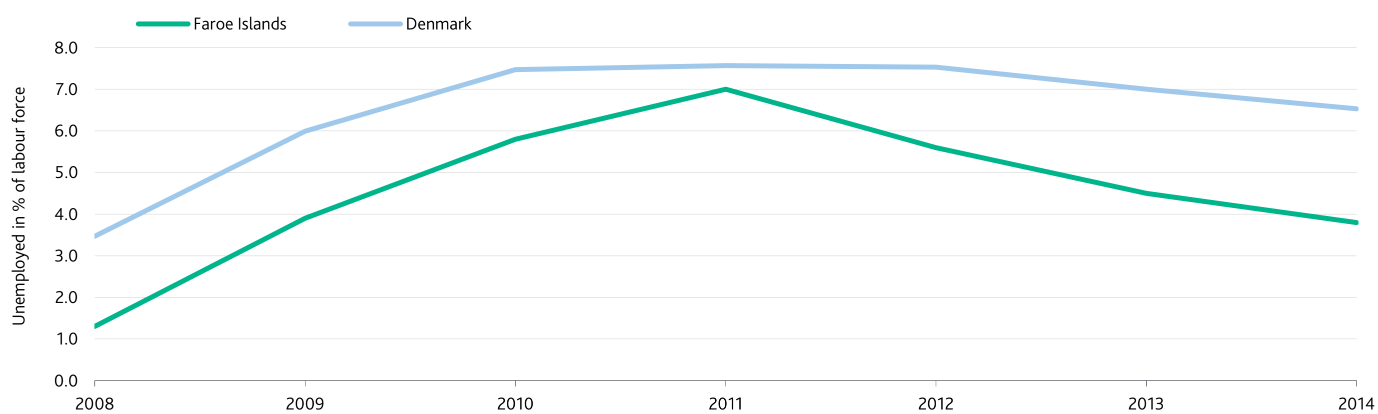
Source: Gjaldstova Føroya (Faroese statistical office)

Current environment of low unemployment is beneficial to budget surplus goal.

Exhibit 5 shows that unemployment in the Faroes has been decreasing since its peak in 2011 of 7%. Low unemployment levels support direct and indirect tax revenue growth. Similar to GDP growth, unemployment rates have compared favourably with Denmark over the same time period.

EXHIBIT 5

Unemployment has been decreasing, supporting operating revenue



Source: Gjaldstova Føroya (Faroese statistical office) and Eurostat

Political consensus around consolidation reinforces credibility of deficit plan

The Faroes will hold a general election on the 1st September 2015. The current government and the opposition parties share the goal of achieving a financing surplus by 2016. Regardless of the election's outcome, there appears to be consensus from all major parties in favour of the delivery of a long-term fiscal surplus. Broad political commitment towards a balanced budget is credit positive, though there remains disagreement between the political parties on how to best attain a surplus.

Appendix

Background: Faroe Islands (FI) consist of 18 islands, located in the Atlantic ocean, between Scotland and Iceland, with approx. 49,000 inhabitants. FI are an autonomy with "Home Rule", within Denmark and are responsible for their own finances, independently setting revenue and expenditure levels as well as issuing debt in capital markets. Denmark is an EU member state but FI is not. The Faroe Islands' decision to opt for a long-term deficit plan prompted a rating downgrade to Aa3 with a negative outlook in April 2011 from the initially assigned Aa2 in march 2008.

Division of responsibilities between the Faroe Islands and Denmark

The Faroese control "Special Matters" covering the economy, finances, industry, foreign trade, mineral rights, and the educational 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. For example, social welfare and health services are administered by the Faroes, while the legislative authority for these matters remains with the Danish Government.

Faroe Islands, Government of, Division of Responsibilities

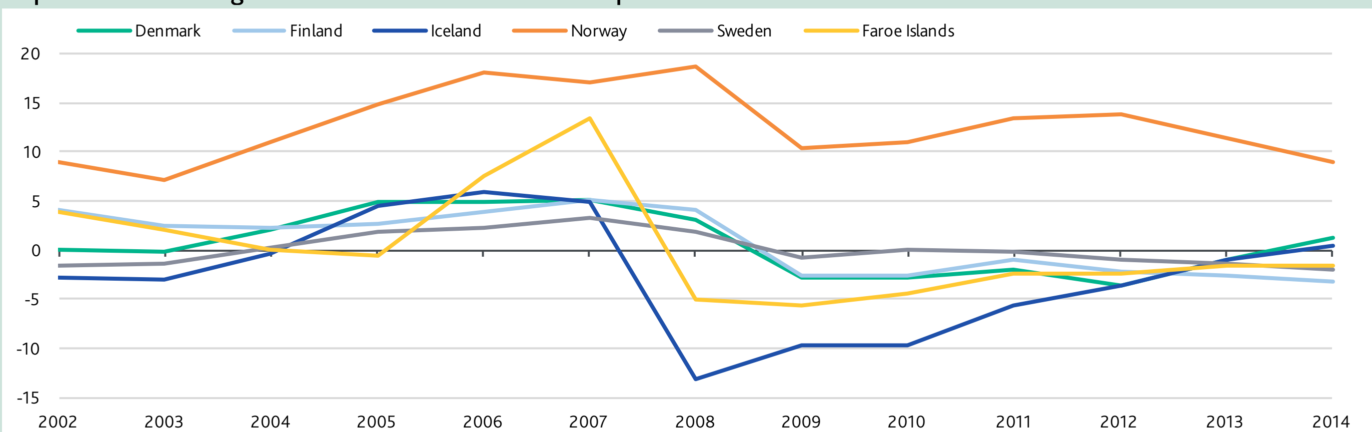
	Faroese Municipalities	Central Government Of Faroe Islands	Danish Government
Childcare	X		
Water & Sewage	X		
Waste management	X		
Planning and zoning	X		
School buildings (maintenance)	X		
Elderly Care	X		
Healthcare	X	X	
Road Maintenance	X	X	
Public Transport		X	
Education		X	
Social Security		X	
Police Force			X
Judicial system			X
Banking supervision			X

Source: 1948 Home Rule Act

Comparison with Nordic Countries. When comparing the Faroe Islands' surplus/deficit over time with that of Nordic countries [Denmark(Aaa, Stable) , Finland (Aaa, Negative), Iceland (Baa2, Stable), and Sweden (Aaa, Stable)], with the exception of Iceland, the deficits were more severe in the Faroe Islands. Like most Nordic countries, the Faroe Islands are working towards a balanced budget and the Faroese recovery pace has been greater, however. This demonstrates the Faroes budgetary discipline to deliver on their long-term deficit plan. Also favourably the FI have had very healthy surpluses leading up to the crisis which enabled them to build stronger buffers and low debt levels to face the 2008 downturn.

EXHIBIT 6

Surplus/deficit as %age of GDP in the Faroe Islands compared with other Nordic countries



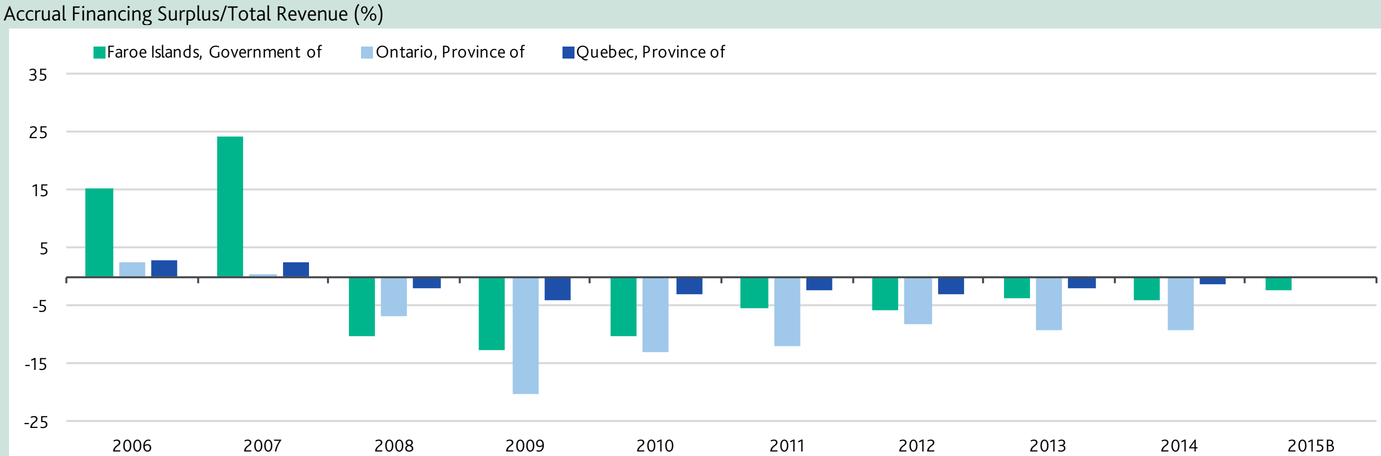
Source: Moody's

Comparison with Canadian Provinces. The Canadian Provinces of Quebec (Aa2, Stable) and Ontario (Aa2, Stable) have had a similar experience to the Faroes. The Faroes took a similar approach to the provinces in terms of running a long-term deficit. Ontario has run larger deficits than the Faroes over recent years, while Quebec has run smaller deficits. Moreover, unlike the Canadian provinces, the Faroes benefit from strong revenue and spending flexibility and from stronger than expected economic growth.

EXHIBIT 7

Canadian provinces record similar long-term deficits

Accrual Financing Surplus/Total Revenue (%)



Source: Moody's

Moody's Related Research

Credit Opinions:

» Faroe Islands, Government of

» Denmark, Government of

Issuer Comments:

» Faroe Islands Settlement of Fishing Dispute with European Union Is Credit Positive, June 2014 (172035)

» Denmark, Government of: Little risk to euro currency peg, but unconventional monetary policy creates distortions in mortgage market, February 2015 (1003015)

Rating Methodology:

» Regional and Local Governments, January 2013 (147779)

Credit Analysis:

» Faroe Islands, Government of, July 2012 (143824)

» Denmark, Government of, November 2014 (177586)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

» contacts continued from page 1

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