

CREDIT OPINION

12 October 2022

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)

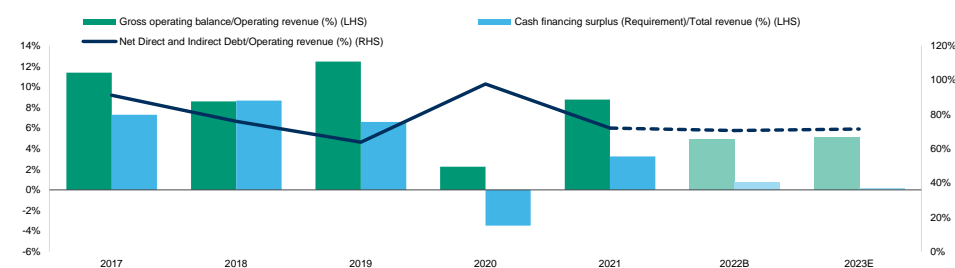
Update to credit analysis

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. 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 economy and high exposure to fish industry as well as relatively high debt stemming from the government's commitment to complete the sub-sea tunnels. 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 2022-23



B - Budget; E - Moody's estimate.
 Source: Issuer, Moody's Investors Service

Credit strengths

- » Long-established legislative and fiscal autonomy
- » Sound budgetary results and large liquidity buffer
- » Sustained debt levels in 2022-23

Credit challenges

- » Faroese economy is narrow and exposed to the fishing industry
- » Growing population and sub-sea tunnels drive high infrastructure investment

Rating outlook

The outlook of the Faroe Islands is stable. This reflects its sound financial performance and ability to contain 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 from the current crisis affecting the Faroese fishing industry.

Key indicators

Exhibit 2

Government of Faroe Islands

Faroe Islands, Government of	2017	2018	2019	2020	2021	2022B	2023E
Population (in '000)	50.1	50.5	51.3	52.9	53.6	54.0	54.3
Gross operating balance/Operating revenue (%)	11.4%	8.6%	12.5%	2.3%	8.8%	4.9%	5.1%
Intergovernmental transfers/Operating Revenue(%)	9.5%	9.5%	8.7%	8.8%	8.0%	8.2%	7.9%
Cash financing surplus (Requirement)/Total revenue (%)	7.3%	8.7%	6.6%	-3.5%	3.2%	0.7%	0.1%
Net Direct and Indirect Debt/Operating revenue (%)	91.2%	76.0%	76.9%	97.7%	72.0%	70.6%	71.5%
Direct debt/Operating revenue (%)	77.6%	62.4%	60.7%	81.4%	60.6%	58.7%	60.3%
Debt service/Total revenue (%)	14.5%	7.1%	10.6%	16.9%	14.7%	15.5%	6.5%

B - Budget; E - Moody's estimate.

Source: Landsbankin Foroya (Faroe Islands Governmental Bank), Moody's Investors Service

Detailed credit considerations

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

Long-established legislative and 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 DKK642 million, which accounted for close to 8% of the Faroe Islands' operating revenue in 2021. 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.

The main impact on the Faroese economy from the Russia-Ukraine military conflict comes from higher commodity prices which will feed through into already elevated consumer price inflation in Faroe Islands and limit growth by hitting households' disposable incomes. CPI inflation has accelerated strongly in recent months and surpassed 7.3% at the end of Q2 2022. We expect inflation to

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stay high reaching more than 7% on average in 2022 which is above the average inflation of 2.7% over 2021. In addition, the Faroese fishing fleet is very oil dependent, representing another risk for the fishing industry stemming from the increases of oil prices.

We expect the military conflict in Ukraine to have limited and temporary impact on Faroese fish export as 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.

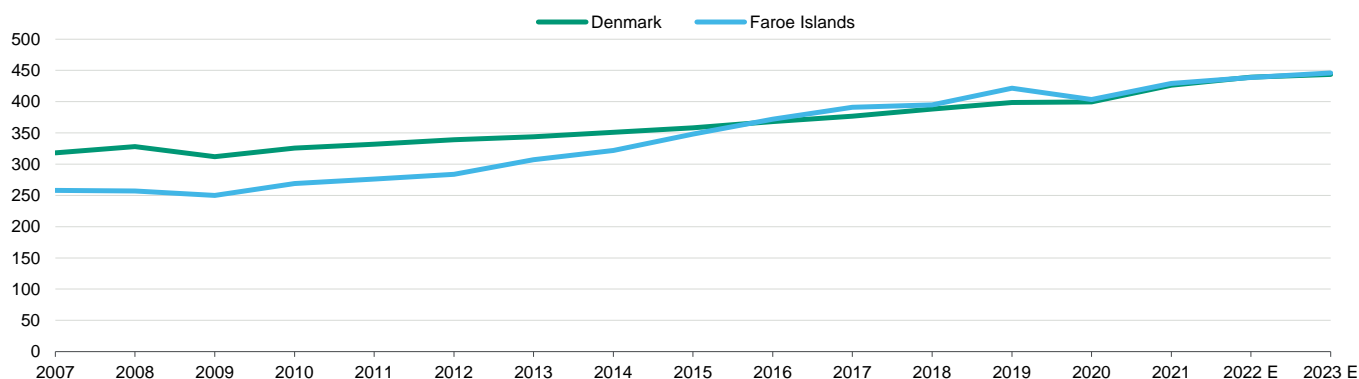
Faroe Islands entered 2022 with a very strong economic momentum as highlighted by the nominal GDP growth of 7.3% in the previous year. The quick recovery from the pandemic, when the Faroese economy only mildly contracted, combined with supportive fiscal and monetary support measures resulted in very limited scarring from the negative shocks with nominal GDP growth forecast of 11.2% in 2022.

Contrary to our forecast, Faroese GDP per capita has remained very strong and was at the Danish level in 2020 and 2021 and we expect this indicator to be close to the Danish average in 2022 and 2023 (Exhibit 3). Following the strong economic recovery from the pandemic, the unemployment rate decreased to the lowest level of around 1% even with the phasing out of employment support measures, introduced as an aid-package in connection with the Covid-19 pandemic (financed by state employment agency).

Exhibit 3

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.

Source: Landsbankin Foroya, Statistics Denmark, Moody's Investors Service

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.

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.

Sound budgetary results and large liquidity buffer

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 2021, Faroe Islands' operating performance improved, with a gross operating balance (GOB) of DKK770 million or sound 8.8% of operating revenue (2.3% in 2020). The improvement of 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 35% and 33% to the operating revenues in 2021, respectively. The overall tax revenues growth of 4.6% in 2021 will slow down to 1.8% in 2022, which will result in lower GOB projected at solid 5% of operating revenue.

Faroe islands reverted to a financing surplus of DKK303 million or 3.2% of total revenue in 2021 (deficit of 3.5% in 2020), in line with the pre-pandemic results. We expect Faroe Islands to keep posting positive financing surpluses of 1% in 2022 despite lower economic growth prospects.

This is attributable to the Faroe Islands' large liquidity buffer, which mitigates the negative shocks. Faroese liquidity reserves amounted to DKK3.8 billion as of year-end 2021 representing 43% of operating revenue. This liquidity level was lower when compared with DKK4.7 billion at year-end 2020, however, it was well above the internal minimum liquidity threshold of DKK3.3 billion based upon 15% of GDP and will remain above the threshold of DKK3.05 billion estimated for 2022. 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.

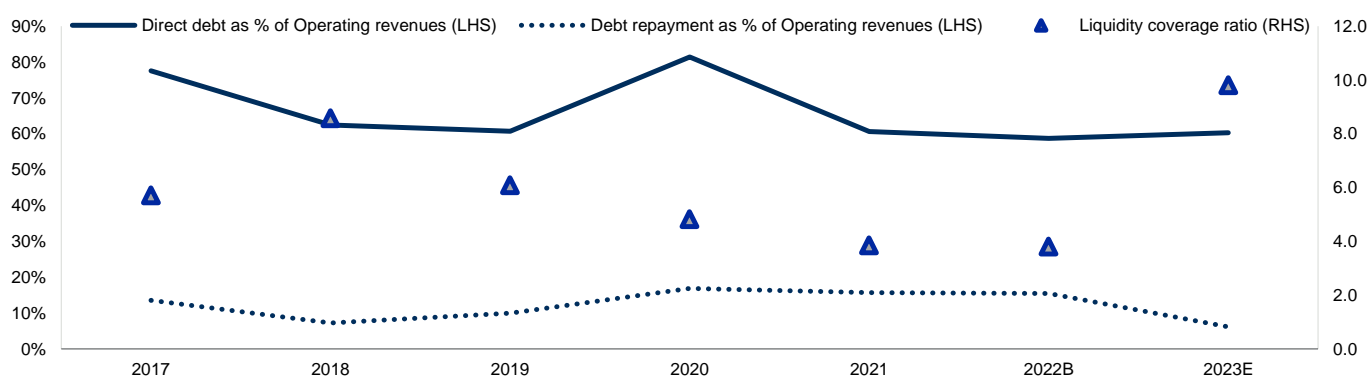
Faroese liquidity reserve represented 72.5% of its outstanding debt at the end of 2021. The reserve amount exceeds necessary borrowing requirements in any single year, and this mitigates the refinancing risk significantly. The liquidity pool is sufficient to cover scheduled debt repayments for the next three years with liquidity coverage ratio of 2.86 (Exhibit 4). In June 2022, the government issued DKK1.100 million fixed rate notes due in 2024 to finance the maturing debt of DKK1.300 million. 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.

Sustained debt levels in 2022-23

The net direct and indirect debt (NDID) consists of direct debt (DKK5.2 billion as of December 2021) and another DKK1.0 billion as indirect debt, represented by the Faroese government guaranteed unfunded pension liability under Foroya Livstrygging (LIV). This translates into NDID of 72% of operating revenue as of year-end 2021. After successful repayment of the maturing debt of DKK1.3 billion in June 2022 and no plans for new borrowing, we expect NDID to decline to DKK6.0 billion representing 71% of projected operating revenue this year. We forecast similar debt levels in 2023 as the Faroese government will refinance DKK550 million bond due in June 2023 and take on new debt to reach the liquidity threshold of DKK3.4 billion forecasted for next year.

Exhibit 4

Manageable debt levels; strong liquidity coverage



B - Budget; E - Moody's Estimate.

Source: Issuer, 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. 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 (Eysturoy and Sandoyar). The Faroese government has provided a minimum revenue guarantee estimated at 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.

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 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 already reaching their pre-pandemic levels in 2021. Subsequently, revenues from fish farming (salmon) and fishing (herring and mackerel) were up by DKK1.179 million and DKK122 million over the same period. Export of main demersal species (cod, haddock and saithe) was higher by DKK49 million in 2021 compared to the previous year, but still below the pre-pandemic results.

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. 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.

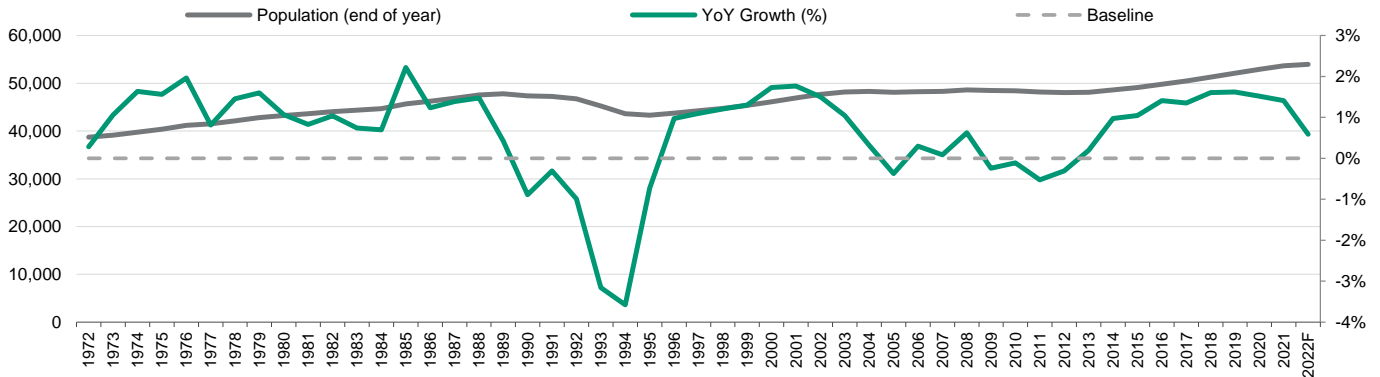
Faroe Islands' growing population and sub-sea tunnels drive high infrastructure investments

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 DKK500 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 the sub-sea tunnel to Sandoy, with an estimated cost of around DKK1.1 billion and plan to be opened for traffic in the summer of 2023. In 2021, the construction has started on additional two 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.
 Source: Landsbankin Føroya, Moody's Investors Service

Extraordinary support considerations

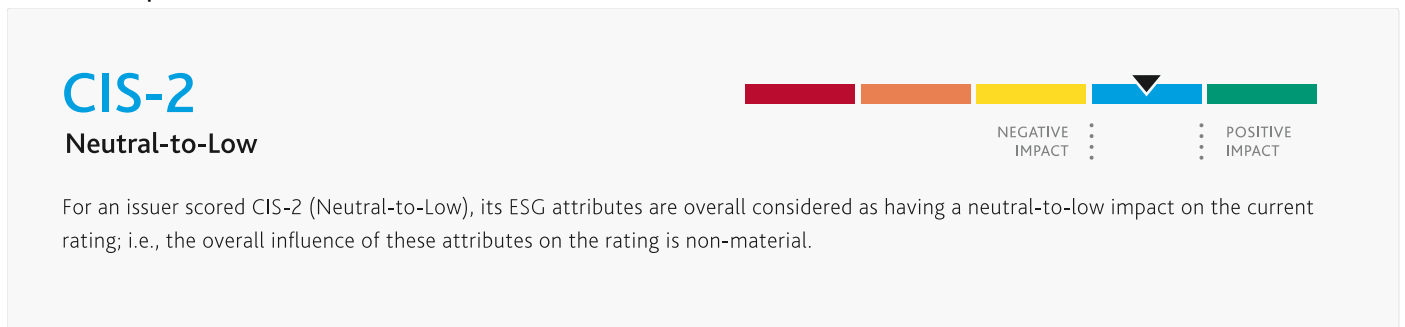
We consider Faroe Islands to have a strong likelihood of extraordinary support from the Government of Denmark. This reflects our assessment that the current relationship with the Government of Denmark is unlikely to change in the medium term. We also take into consideration the intensive extraordinary 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 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 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

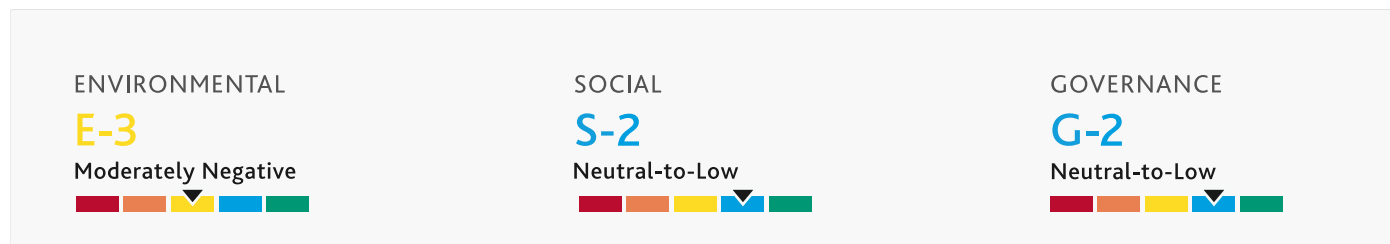


Source: Moody's Investors Service

Faroe Islands' ESG Credit Impact Score is neutral-to-low (**CIS-2**), reflecting moderate exposure to environmental and low exposure to social risks, and strong governance and capacity to respond to shocks.

Exhibit 7

ESG Issuer Profile Scores



Source: Moody's Investors Service

Environmental

Faroe Islands' overall environmental issuer profile is moderately negative (**E-3**). Specifically, Faroe Islands' is exposed to physical climate risks, including sea rising level risk because of rising temperatures, which would impact its 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 impact of these risks on the intrinsic financial position of Faroe Islands. With 18 islands, Faroe Islands is also exposed to moderate water management risks. To become completely independent of fossil fuel for power production, the government is aiming to reach a 100% renewable electricity system by 2030.

Social

Overall, we assess Faroe Islands' S issuer profile score as neutral to low (**S-2**). Faroe Islands has low exposure to most sources of social risks, with widely available and accessible education, housing, healthcare and basic services. Faroe Islands face a trend of ageing population, resulting in declining labour supply and higher pension and social costs, but we view the long-term economic and fiscal pressures as limited.

Governance

Faroe Islands' institutions and governance strength is reflected in the issuer profile score (**G-2**). Faroese governance and management are considered very good with prudent budgetary practices as the efficient and very transparent institutional framework provides a high degree of confidence in the authorities' ability to implement effective policies. 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.

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 scorecard-indicated BCA of aa3. The matrix-generated 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	100.80%	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	7.44%	12.5%			
Interest Burden [3]	1	0.20%	12.5%			
Liquidity	1		25%			
Debt Burden [4]	5	72.03%	25%			
Debt Structure [5]	5	24.05%	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
Scorecard-Indicated BCA Outcome						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 2021.

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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