MOODY'S
INVESTORS SERVICE

Credit Opinion: Faroe Islands, Government of

Global Credit Research - 21 Apr 2011

Ratings

Category	Moody's Rating
Outlook	Negative
Issuer Rating -Fgn Curr	Aa3
Issuer Rating -Dom Curr	NR
Bonds -Dom Curr	NR

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Key Indicators

Faroe Islands, Government of

	2002	2003	2004	2005	2006	2007	2008	2009	2010
Interest Payments/Operating Revenue (%)	4.0	4.0	3.3	3.0	1.0	1.5	2.4	4.2	3.0
Accrual Financing Surplus(Requirement)/Total Revenue (%)	3.9	0.5	-3.2	-4.5	11.8	21.0	-11.0	-12.8	-10.3
Gross Operating Balance/Operating Revenue (%)	9.8	5.7	1.6	-0.5	8.0	6.9	-0.9	-8.8	-7.6
Net Direct and Indirect Debt/Operating Revenue (%)	114.3	99.0	96.1	97.5	67.5	65.8	74.4	88.0	107.6
Short-term Gross Direct Debt/Gross Direct Debt (%)	54.9	33.7	58.9	35.3	20.1	51.3	55.3	54.4	28.2
Intergovernmental Transfers/Operating Revenue (%)	16.9	17.1	17.3	17.2	15.3	14.9	15.1	15.3	14.9
Real GDP growth (%)	4.0	-2.2	3.2	3.0	12.9	5.8	-0.9	-4.1	0.8

Opinion

Rating Rationale

The Aa3 foreign currency rating with negative outlook for the Faroe Islands reflects a number of factors, including the islands' wealthy and increasingly diverse albeit volatile economy, and the government's powers to raise revenues through taxation and fees and to control spending. In addition, the rating takes into account the relatively large financing deficits in the recent past, following a long period of strong financial results since 1995. The Faroese government maintains ample reserves, while the debt level and interest burden is moderate but increasing. The rating incorporates the islands' relationship within the Kingdom of Denmark and the subsidies it receives for joint matters, which it administers in conjunction with the Kingdom of Denmark.

The Aa3 rating also reflects Moody's assessment of a high likelihood that the Kingdom of Denmark (Aaa, stable) would act to prevent a default by the islands.

On April 18th, 2011 the issuer rating of the Faroe Islands has been downgraded to Aa3 from Aa2, and the outlook has been changed to negative from stable. The key drivers of this rating action include the challenges that the government is facing in rebalancing its long-term finances and the difficulties in addressing the long-term sustainability issues of fishing stock management and fleet overcapacity.

Credit Strengths

Credit strengths for the Faroe Islands include:

- Its development as a wealthy industrialised country, based on the growth of fishing and fish-related industries

- Autonomous powers to set tax rates and fees, control spending and set the level of reserves

- Stable relationship within the Kingdom of Denmark and the orderly process in the consideration of further autonomy and potential independence

- Large reserves to address the historical volatility of the economy and government revenues, and to provide for the future costs of an ageing population

Credit Challenges

Credit Challenges for the Faroe Islands include:

- The current deficits are projected to be closed only in 2015, and will be financed mainly through an increase of debt

- Volatility of the fishing industry, which is exposed to boom and bust in terms of price and volume, as well as substantial challenges in the management of commercial exploitation of its fishing grounds; these effects are somewhat mitigated by increasing diversification in the fishing-related industries and in the economy at large

- Large volatility of the trade balance, sharply negative until 2008 and now improving thanks to a decline in import prices during 2009 and the first half of 2010. The trade balance remains highly exposed to any decline in fishing, which accounts for almost all of the islands' exports, and to increases in imports of petroleum products, which appear very likely given the current economic conditions

- Potential independence has at times been a politically volatile issue; if poorly managed this could put substantial subsidies from the Kingdom of Denmark at risk

- Ageing population and partly unfunded pension system

Rating Outlook

The outlook on the Faroe Islands' Aa3 rating is negative, reflecting the current budgetary pressures and the volatility of the fishing economy.

What Could Change the Rating - Up

Given the current economic and financial situation, Moody's considers unlikely a rating upgrade in the near future.

What Could Change the Rating - Down

The rating could come under pressure if the Faroese government fails to rebalance its budget, which would ultimately result in a further deterioration of the debt profile. A substantial economic downturn, particularly one caused by environmental or structural changes in the fishing industry, could also exert negative pressure on the rating. Precipitous political actions taken by either the Faroe Islands or the Kingdom of Denmark could have a significant impact on the resources of the Faroese government, although such actions are deemed unlikely.

DETAILED RATING CONSIDERATIONS

The ratings assigned to the Faroe Islands reflect the application of Moody's Joint-Default Analysis (JDA) rating methodology for regional and local governments (RLGs). In accordance with this methodology, Moody's first establishes the BCA for the jurisdiction and then considers the likelihood of support coming from the national government to avoid a default by the jurisdiction, should this extreme event ever occur.

Baseline Credit Assessment

Faroe Islands' BCA of 6 (on a scale of 1-21, where 1 represents the lowest credit risk), reflects the following factors:

Financial Position and Performance

The gross operating balance (GOB) has been highly variable in recent years, belying the volatility of the economy and ultimately the lower baseline credit assessment (BCA) than historical financial ratios might indicate. In 2010, the GOB-to-operating revenues ratio was negative at -7.6%. This compares with results that have swung widely from 9.8% to -8.8% over the period 2002-2010. The budget deficit slightly improved to just above DKK 560 million in 2010 from approximately DKK 690 million in 2009, equal to 4.7% and 5.8% of GDP respectively. The expected deficit in 2011 amounts to approximately DKK 500 million or 4.2% of GDP.

The current government projects further deficits for the next four years up until 2015. In Scandinavian countries it is not unusual for deficit plans to be resolved within three years, and the Faroese themselves closed a deficit of over DKK 2.5 billion in the early 1990s, albeit with substantial financing support from Denmark. The Faroese government is taking a longer period to minimise the impact on the economy from sharply reduced government spending, and this strategy may also contribute to limiting emigration that traditionally occurs during economic downturns. The longer period and somewhat higher levels of debt may, however, leave the Faroes more exposed to the volatility of the economies of its trading partners and to variability in the costs of its capital financing.

Debt Profile

The Faroe Islands' direct debt level is increasing, and reached approximately 93% of revenue as of 2010, and is expected to increase further in the coming years given continuous deficits. The annual increase in debt should however be curbed down in line with the deficit reduction plan. The relatively short tenors of the islands' debt incur refinancing risk in international financing markets that are likely to remain variable. Current debt-management policies will seek to limit annual maturities to less than 70% of the DKK 1.9 billion liquidity fund.

Due to the high investment requirement, an investment fund and build-operate-transfer financing are used for large-scale infrastructure projects; these amounts are not on the balance sheet of the Faroese Government. Government guarantees are limited to a portion of the pre-2000 pension savings in a pension fund, and no additional guarantees have been released after 2000. In addition, the Faroese municipalities accumulated a net debt of about DKK 800 million, which relies on transfers from the Faroese Central Government. Moody's considers the guaranteed pension deposits to be largely self-supporting, while it includes the net municipal debt in the indirect debt calculations.

Governance and Management Factors

The Faroe Islands has built up its capacity for fiscal and economic management, with particular emphasis on the regulation of fishing and fishing-related industries. Debt management practices have been conservative, but must be carefully managed given increasing debt levels and likely reductions in liquidity reserves that have, to date, been healthy. The reserves are invested in highly rated liquid assets outside the Faroese economy.

Transparency and disclosure are sufficient for the government to manage its finances, and the Faroese have enhanced their longer-term economic and fiscal modelling. As of January 2010, the municipalities use the same accounting standard as the central government, which is closely related to the standard used in Denmark. A stronger political coordination between the central government and the municipalities in the

fiscal policy planning - as achieved in other Nordic countries - is yet to be realised in the Faroe Islands.

Economic Fundamentals

The Faroese economy - albeit diversified into different sectors in the last ten years - continues to rely heavily on fishing and related industries, which account for over 20% of wages and 89% of exports. The management of the economy therefore largely depends on the finely balanced regulation of domestic and international commercial interests, environmental factors and renewable - potentially fragile - resources. As Faroese waters provide 60-65% of the total value of the catch, the productivity of other fishing grounds under Faroese control can have a profound impact on the economy. The introduction of fishing rights in Faroese waters, allocated and traded among all the industry players, is currently on the political agenda, and could result in a more sustainable utilisation of fishing resources as well as in the generation of additional central government revenues.

The global financial and economic crisis has lowered fish prices and caused a drop in the land-based economic activity, particularly in trade and house building. Oil prices have substantially increased, thereby putting pressures on fishing activities and on parts of the land-based economy. The growth of pelagic fisheries (i.e. shallow and mid-water fishing) in Faroese waters has been strong during recent years, but is largely outside government control. Furthermore, a dispute on mackerel quotas with the EU and Norway might affect the Faroe Islands' international relationships and ultimately limit its access to key trading partners.

Demersal fisheries (i.e. deep-water fishing) are showing some signs of recovery, but some grounds remain closed and some key stocks, including cod, haddock and saithe remain under pressure. Salmon and trout fish farms have offset the reduction in other areas of high-value catch, particularly for export; but these also appear to be reaching biological limits. Nonetheless, structural problems such as over-capacity in the fleet and fish processing, combined with pressure on fish stocks appears to be weighing on the long-term profitability of the domestic fishing industry and future growth.

Whilst house prices and housebuilding activity has weakened, this sector appears less vulnerable to further deterioration in the economy. Faroese households are generally well consolidated, and household loans are only around one third of property values. Household debt as a percentage of GDP amounted to 81% in December 2009 compared to 75% in December 2008.

Landsbanki Føroya, the governmental bank of the Faroe Islands, projects a nominal GDP growth of 6% in 2011, due to recovery in prices, with knock-on benefits to the land-based economy. The country remains particularly exposed to a slowdown in Western Europe, its main trading partner.

Operating Environment

The operating environment of the Faroe Islands - as part of the Kingdom of Denmark - is typical of advanced industrial economies and reflected in the high GDP per capita, low GDP volatility and a high ranking on the World Bank's Government Effectiveness Index. These characteristics suggest a low level of systemic risk. Nevertheless, the economy of the Faroe Islands itself has much higher volatility, which must be considered in the rating given the islands' path to increasing autonomy and potential independence.

Institutional Framework

Following the crisis of the 1990s, the institutional framework was reshaped to encourage greater autonomy while promoting prudent financial management and decreasing moral hazard. The powers of the Faroe Islands are set by agreements with Denmark over the allocation of responsibilities, with the respective roles of the Kingdom and the Faroe Islands being clear. The government of the Faroe Islands has full powers to set its tax rates and fees, and to set levels of spending on the services it provides. Levels of essential services may be adjusted at the discretion of the Faroese, and the government has historically implemented substantial cuts in spending when required, e.g. in the crisis of the 1990s.

The broad control of revenues supports Faroese financial flexibility and has enabled the country to make strong budgetary corrections in the past. Some 87% 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 sources. The Kingdom of Denmark provides 13% of operating revenue with grants for governmental services that, by agreement, it administers in conjunction with the Faroe Islands. Denmark and The Faroe Islands have fixed the level of grant in bilateral agreements and, over the medium to long term, these subsidies are set to decrease as more responsibilities are passed to the full control of the Faroe Islands.

Spending is also flexible. The Faroese government has almost complete control over all its spending and it is not constrained by service levels or labour costs negotiated outside its control.

Municipal governments account for almost 20% of total government spending and have considerable flexibility in terms of spending, particularly for capital investments. They can incur debt of up to their level of total tax revenues, and to date have not been well integrated into the national budgeting process. Reforms are proposed to bring their finances more in line with national priorities. The islands' 33 municipalities vary widely in terms of size, from fewer than 50 inhabitants to approximately 20,000, therefore the reform remains an ongoing and still-unresolved political question. A current reform suggests reducing the number of municipalities from 33 to less than ten.

The Faroe Islands has independent powers of borrowing, although in the past these have been circumscribed in agreements with Denmark to address the fiscal crisis. The Faroese government has repaid all interest-bearing debt (to Denmark) undertaken under these agreements.

Extraordinary Support Considerations

Moody's assigns a high likelihood of the extraordinary support from the Kingdom of Denmark, reflecting Moody's assessment that the current relationship with the Kingdom of Denmark, unlikely changes to this relationship in the medium term and the period of intensive extraordinary support in response to the financial crisis of the 1990s.

Moody's also assigns a low level of default dependence, reflecting the significant differences between the economies of the Kingdom of Denmark and the Faroe Islands, due to the importance of fishing to the Faroese economy.

Output of the Baseline Credit Assessment Scorecard

In the case of the Faroe Islands, the BCA scorecard (presented below) generates an estimated BCA of 4, compared to the BCA of 6 assigned by the rating committee. The two notches differential between the assigned BCA and the reference point generated by the scorecard reflects the volatility of the economy of the Faroe Islands and the challenges of managing the key fishing and fishing-related industries. The differential is also motivated by the unique features of the Faroe Islands, primarily its special legal status, which ensures wide autonomy within the Kingdom of Denmark.

The BCA scorecard, which generates estimated baseline credit assessments from a set of qualitative and quantitative credit metrics, is a tool used by the rating committee in assessing regional and local government credit quality. The credit metrics captured by the scorecard 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 the scorecard 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 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 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 ".mx" for Mexico. For further information on Moody's approach to national scale ratings, please refer to Moody's Rating Implementation Guidance published in August 2010 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.

Country Ceilings for Foreign Currency Obligations

Moody's assigns a ceiling for foreign-currency bonds and notes to every country (or separate monetary area) in which there are rated obligors. The ceiling generally indicates the highest rating that can be assigned to a foreign-currency denominated security issued by an entity subject to the monetary sovereignty of that country or area. In most cases, the ceiling will be equivalent to the rating that is (or would be) assigned to foreign-currency denominated bonds of the government. Ratings that pierce the country ceiling may be permitted, however, for foreign-currency denominated securities benefiting from special characteristics that are judged to give them a lower risk of default than is indicated by the ceiling. Such characteristics may be intrinsic to the issuer and/or related to Moody's view regarding the government's likely policy actions during a foreign currency crisis.

Baseline Credit Assessment

Moody's baseline credit assessment incorporates the government's intrinsic credit strength and accounts for ongoing operating subsidies and transfers from the supporting government. In effect, the baseline credit assessment reflects the likelihood that a local government would require extraordinary support.

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 low (0% - 30%), moderate (31% - 50%), high (51% - 70%), very high (71% - 95%) or fully supported (96% - 100%).

Default Dependence

Default dependence reflects the likelihood that the credit profiles of two obligors may be imperfectly correlated. Such imperfect correlation, if present, has important diversifying effects which can change the joint-default outcome. Intuitively, if two obligors' default risks are imperfectly correlated, the risk that they would simultaneously default is smaller than the risk of either defaulting on its own.

In the application of joint-default analysis to RLGs, default dependence reflects the tendency of the RLG and the supporting government to be jointly susceptible to adverse circumstances leading to defaults. Since the capacity of the higher-tier government to provide extraordinary support and prevent a default by an RLG is conditional on the solvency of both entities, the more highly dependent -- or correlated -- the two obligors' baseline default risks, the lower the benefits achieved from joint support. In most cases, the close economic links and/or overlapping tax bases and/or close intergovernmental fiscal arrangements between different levels of government result in a moderate to very high degree of default dependence.

Default dependence is described as low (0% - 30%), moderate (31% - 50%), high (51% - 70%) or very high (71% - 100%).

Rating Factors

Faroe Islands, Government of

Baseline Credit Assessment Scorecard - 2009	Value	Score	Sub-Factor Weighting	Sub-Factor Total	Factor Weighting	Total
Factor 1: Operating Environment						

National GDP per capita (PPP basis, $US)	36,509	1	50.0%	1.50	50.0%	0.75
National GDP Volatility (%)	2.4	3	25.0%			
National Govt Effectiveness Index (World Bank)	2.19	1	25.0%			
Factor 2: Institutional Framework						
Predictability, Stability, Responsiveness	1	1	50.0%	1.00	10.0%	0.10
Fiscal Flexibility (A): Own-Source Revenues	1	1	16.7%			
Fiscal Flexibility (B): Spending	1	1	16.7%			
Fiscal Flexibility (C): Extent of Borrowing	1	1	16.6%			
Factor 3: Financial Position & Performance						
Interest Payments/Operating Revenue (%)	2.2	3	33.3%	9.00	10.0%	0.90
Accrual Financing Surplus(Req)/Total Revenue (%)	-6.2	12	33.3%			
Gross Operating Balance/Operating Revenue (%)	-4.5	12	33.3%			
Net Working Capital/Total Expenditures						
Factor 4: Debt Profile						
Net Direct and Indirect Debt/Operating Revenue	114.4	9	50.0%	10.50	10.0%	1.05
Short-Term Direct Debt/Direct Debt (%)	36.5	9	25.0%			
Net Debt/Operating Revenue Trend	17.7	15	25.0%			
Factor 5: Governance & Management						
Fiscal Management	7.5	7.5	40.0%	5.55	10.0%	0.56
Investment & Debt Management	1	1	20.0%			
Transparency & Disclosure (A)	7.5	7.5	15.0%			
Transparency & Disclosure (B)	7.5	7.5	15.0%			
Institutional Capacity	1	1	10.0%			
Factor 6: Economic Fundamentals						
Regional or Local GDP pc PPP - estimated ($US)	30,167	3	100.0%	3.00	10.0%	0.30
Estimated BCA						**4**

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