MOODY'S
INVESTORS SERVICE

Credit Opinion: Faroe Islands, Government of

Global Credit Research - 11 Sep 2013

Ratings

Category	Moody's Rating
Outlook	Negative
Issuer Rating	Aa3

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Key Indicators

Faroe Islands, Government of

	2008	2009	2010	2011	2012
Interest Payments/Operating Revenue (%)	2.4	4.2	3.4	3.0	3.0
Accrual Financing Surplus(Requirement)/Total Revenue (%)	-10.4	-12.7	-10.1	-5.3	-5.5
Gross Operating Balance/Operating Revenue (%)	-0.8	-8.8	-7.6	-2.0	-2.3
Net Direct Debt and Guarantees/Operating Revenue (%)	49.3	63.0	79.5	92.8	90.4
Short-term Gross Direct Debt/Gross Direct Debt (%)	38.8	44.5	16.1	14.7	25.7
Intergovernmental Transfers/Operating Revenue (%)	15.1	15.1	14.6	13.6	13.5
GDP growth (%)	-0.8	-1.7	7.0	2.4	1.9

Opinion

SUMMARY RATING RATIONALE

The Aa3 issuer rating with negative outlook reflects ample Faroese reserves, currently moderate amounts of debt, a track record of prudent budgeting and independence to set revenue and expenditure levels. European Commission adopted trade sanctions against the Faroe Islands, 20 August 2013. These imposed sanctions impact only approximately 12% of Faroese exports of goods. More extensive sanctions would have a material negative impact on the Faroese economy.

Credit Strengths

Credit strengths for the Faroe Islands include:

- Autonomous powers to set tax rates and to control spending

- A large liquidity buffer which mitigates refinancing risk

- Stable relationship with the Kingdom of Denmark (Aaa, stable)

Credit Challenges

Credit Challenges for the Faroe Islands include:

- European Union adopted trade sanctions on Faroe Islands, 20 August 2013

- Reliance on relatively concentrated investor base for debt refinancing

- Faroese economy is dominated by fishing sector

Rating Outlook

The negative outlook reflects a) economic uncertainty associated with sanctions, b) the threat of more extensive sanctions, and c) limited financial flexibility because of long deficit reduction period (years 2008 to 2015).

What Could Change the Rating Up

An upgrade is currently unlikely given the uncertainty associated with trade sanctions. However, structurally balanced budgets combined with steady debt reduction could put upward pressure on the rating.

What Could Change the Rating Down

The Aa3 rating with negative outlook would come under pressure if the imposed sanctions prove damaging for the Faroese economy. More extensive EU trade sanctions, impacting for example Faroese exports of Salmon, would also put downward pressure on the Aa3 rating. The rating could also come under pressure if the Faroe Islands fail to cut its deficit as planned and/or is forced to materially increase the level of borrowing above current levels. A weakening of its relationship with Denmark could also put the rating under pressure.

Issuer Profile

Faroe Islands consist of 18 islands located in the Atlantic Ocean, between Scotland and Iceland. The islands are populated by approximately 48 thousand inhabitants. Faroe Islands is an autonomy, which forms part of Denmark (Aaa, stable). Faroe Islands independently take decisions on revenue and expenditure.

DETAILED RATING CONSIDERATIONS

The rating assigned to Faroe Islands combines the baseline credit assessment (BCA) for the island group and the likelihood of extraordinary support coming from the Danish government in the event that Faroe Islands faced acute liquidity stress.

Baseline Credit Assessment

Faroe Islands' BCA of a2 reflects the following factors:

Financial Performance and Debt Profile

The islands' gross operating balance (GOB) has been variable in recent years, reflected in GOB-operating revenue ratios that have ranged from 12.0% to -8.8% over 2006-2012. The budget deficit slightly deteriorated in 2012 to just over DKK 329 million from approximately DKK 312 million in 2011. These deficits equal 2.4% and 2.3% of GDP in 2012, respectively.

The government projects further deficits for the next two years until the end of 2015. In Scandinavian countries, it is not unusual for deficit plans to be resolved within three years, and the Faroese government itself closed a deficit of over DKK 2.5 billion in the early 1990s, albeit with substantial financing from Denmark. The long deficit reduction period means that Faroese reliance on debt financing will remain at historically high levels, at least until the deficit is cut.

Debt levels have been trending upwards in recent years. The Faroe Islands' direct debt stood at approximately 82% of operating revenues in 2012. Whilst debt is expected to remain at historically high levels, debt intake should slow alongside its deficit-reduction plan. Faroe Islands' debt maturity profile requires the autonomy to refinance approximately one billion DKK annually. The refinancing risk is evident for the Faroe Islands because it sells bonds mainly to small and mid-sized Danish financial institutions. Debt-management policies seek to limit annual maturities to less than available liquidity.

Governance and Management

The threat of sanctions should be viewed against the Faroe Islands' solid track record of fiscal and economic management. Historical performance shows that Faroese budgets closely match actual performance. Debt-management practices are conservative and direct debt has not exceeded 40% of GDP in recent years. The Faroe Islands also have a policy to maintain a liquidity reserve, no smaller than 15% of GDP (or approximately

35% of operating revenues), which mitigates refinancing risk. The reserve is invested in highly rated liquid assets outside the Faroese economy.

Transparency and disclosure are sufficiently strong for the government to manage its finances, and the Faroese have enhanced their longer-term economic and fiscal modeling. The municipalities use the same accounting standards as the central government, which are closely related to the standards used in Denmark.

Economic Fundamentals

Despite some diversification over the last 10 years, the Faroese economy continues to rely heavily on fishing and related industries. Fishing and aquaculture account for approximately 18% of total Faroese output (as of 2011). According to the Faroese statistical office "Manufacture of food products and beverages" contribute with an additional 15% to Faroese output (as of 2011). We understand that a significant part of this category is directly fish related. Furthermore, fish products account for approximately 91% of Faroese exports of goods (as of 2012).

The Faroe Islands have in recent years engaged in disputes with the EU over fishing quotas. The disagreements escalated in September 2012, when the EU adopted measures, which allowed it to impose sanctions on the Faroe Islands. In March 2013, the Faroe Islands unilaterally increased its quota for herring and mackerel. EU member states responded in July by voting in favor of sanctions against the Faroe Islands. Sanctions on Herring and Mackerel were imposed in August, 2013.

The sanctions come at an sensitive time for the Faroese economy. The Faroese government has posted a deficit, every year since 2008. It is unclear to what extent the imposed sanctions will impact the Faroese economy. Restrictions on exports to the EU is a negative. On the other hand, higher quotas mean that the Faroe Islands can sell more fish, to non-EU countries. That said, more extensive sanctions, if imposed, would likely impact the fishing sector and potentially derail the deficit reduction plan. Indeed, trade sanctions have not been factored into the Faroese plan to cut the deficit by 2016.

A weaker fishing sector would likely force the Faroese government to resort to external borrowing in order to enable continuous provision of services, which characterize the Faroese welfare state. Faroese debt is mainly bought by small and mid-sized Danish financial institutions. Due to the narrow investor base, Faroe Islands are exposed to refinancing risk, although partially mitigated by their liquidity reserve (15% of GDP).

Institutional Framework

Following the crisis of the 1990s, the institutional framework was reshaped to encourage greater autonomy while promoting prudent financial management. Spending responsibilities and powers are clearly designated by agreements with the Danish government. The Faroe Islands has full powers to set its tax rates and fees, and to set levels of spending on the services it provides. The government has historically implemented substantial cuts in spending when required (e.g., during the crisis of the 1990s). However, the Faroe Islands have opted for more debt, rather than implementing spending cuts, since the global economic crisis in 2008/09.

The broad control over revenue supports Faroese financial flexibility. 89% 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 11% of operating revenue with grants for governmental services that it administers in conjunction with the Faroe Islands. We expect these subsidies to decrease if more responsibilities are passed to the full control of the Faroe Islands.

Municipal governments account for more than 20% of general 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' 30 municipalities vary widely in terms of size, from fewer than 50 inhabitants to approximately 20,000; as a result, any reform remains an ongoing and still-unresolved political process. Current reform priorities include reducing the number of municipalities from 30 to less than 10.

The Faroe Islands has independent borrowing powers, with DKK 4.8 billion outstanding debt (2012), including DKK 500 million borrowed from Denmark. The Faroe Islands do not pay interest on the DKK 500 million borrowed from Denmark and the Kingdom is expected to forgive the entire DKK 500 million unless the Faroe Islands find hydrocarbons by 2018.

Extraordinary Support Considerations

We assign a strong likelihood of extraordinary support from the Kingdom of Denmark, reflecting our assessment that the current relationship with the Kingdom of Denmark is unlikely to change in the medium term and the intensive extraordinary support provided to the islands in response to the financial crisis of the 1990s. The Danish economy would likely not be materially impacted by a severe stress in the Faroese economy. We however believe that a severe stress in the Faroese economy would constitute a reputational problem for Denmark.

Output of the Baseline Credit Assessment Scorecard

In the case of the Faroe Islands, the BCA matrix generates an estimated BCA of aa3, compared with the BCA of a2 assigned by the rating committee.

The matrix-generated BCA of reflects (1) an idiosyncratic risk score of 5 (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 sovereign bond rating (Aaa stable). The two-notch differential reflects a number of factors not captured in the scorecard, including; (1) overwhelming reliance on fish sector, now subject to EU trade sanctions (2) almost complete reliance on small and mid-sized Danish financial institutions for refinancing of debt, (3) a tiny population which is geographically isolated from its closest trading partners.

The idiosyncratic risk scorecard and BCA matrix, which generates estimated baseline credit assessments from a set of qualitative and quantitative credit metrics, are tools used by the rating committee in assessing regional and local government credit quality. The credit metrics captured by these tools 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 these tools 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 October 2012 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.

Baseline Credit Assessment

Baseline credit assessments (BCAs) are opinions of entity's standalone intrinsic strength, absent any extraordinary support from a government. Contractual relationships and any expected ongoing annual subsidies from the government are incorporated in BCAs and, therefore, are considered intrinsic to an issuer's standalone financial strength.

BCAs are expressed on a lower-case alpha-numeric scale that corresponds to the alpha-numeric ratings of the global long-term rating scale.

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 either low (0% - 30%), moderate (31% - 50%), strong (51% - 70%), high (71% - 90%) or very high (91% - 100%).

Rating Factors

Faroe Islands, Government of

Baseline Credit Assessment Scorecard	Score	Value	Sub-factor Weighting	Sub-factor Total	Factor Weighting	Total
Factor 1: Economic Fundamentals						
Economic strength	7	85.39	70%	7.6	20%	1.52
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 (%)	7	-3.01	12.5%	4.25	30%	1.28
Interest payments / operating revenues (%)	5	3.09	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	5	90.36	25%			
Short-term direct debt / total direct debt (%)	5	25.66	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						4.5(4)
Systemic Risk Assessment						Aaa
Suggested BCA						Aa3