MOODY'S
PUBLIC SECTOR EUROPE

CREDIT OPINION
21 February 2017

Rate this Research

RATINGS

Faroe Islands, Government of

Domicile	Denmark
Long Term Rating	Aa3
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.

Contacts

Amir Girgis 44-20-7772-5310
Analyst
amir.girgis@moodys.com

Olivier Heinen 44-20-7772-1429
Associate Analyst
olivier.heinen@moodys.com

Harald Sperlein 49-69-70730-906
VP-Senior Analyst
harald.sperlein@moodys.com

David Rubinoff 44-20-7772-1398
MD-Sub Sovereigns
david.rubinoff@moodys.com

Faroe Islands, Government of

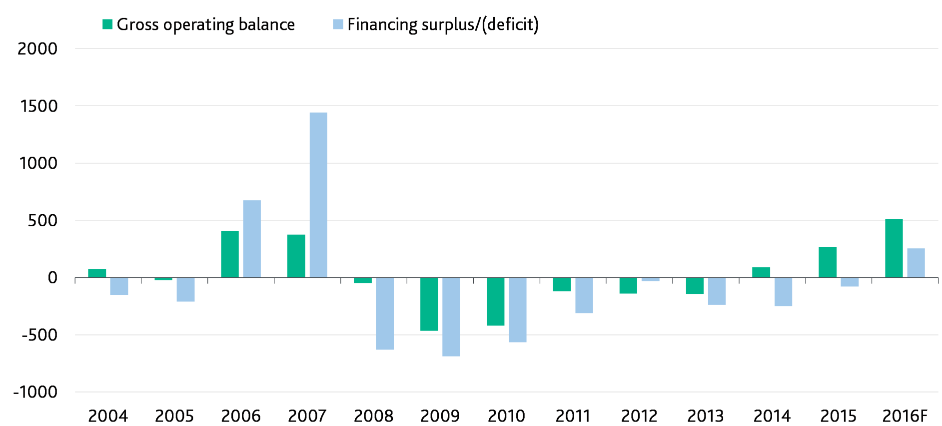
Update to Reflect Major Infrastructure Project

Summary Rating Rationale

The Aa3 issuer rating with stable outlook reflects the Faroe Islands' fiscal autonomy resulting in 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), with joint matters clearly defined under the 1948 Home Rule Act, is also credit positive. While the Faroese economy has a high dependence on the fishing industry, this is somewhat offset by regular fish stock control and a push to diversify the country's trade partners. The rating also takes into account the government's strong liquidity buffer, which mitigates the refinancing risk associated with the government's reliance on short term borrowing.

On 7 February 2017, Moody's affirmed the Aa3 long-term issuer rating of the Government of the Faroe Islands with a stable outlook. The affirmation outlines our view that the Faroe Island's current rating and credit strengths are sufficient to withstand the challenges associated with the provision of a minimum traffic guarantee on two major sub-sea tunnels (Eysturoy and Sandoy tunnels). The tunnels represent the biggest infrastructure deal in the history of the Faroe Islands with an expected cost of approximately DKK2.64 billion (38% of operating revenues). Despite the potential exposure to construction risk, we expect the Faroe Islands to deliver strong financing surpluses in 2016 and onwards to mitigate any unforeseen construction cost overruns.

Exhibit 1
The Faroe Islands expect to deliver their first financing surplus since 2007
Gross operating balance and financing surplus/(deficit) in DKK million, by year



Note: 2016 is an estimated figure.
Source: Gjaldstovan, Moody's

Credit Strengths

- » Fiscal autonomy allows for revenue and expenditure flexibility
- » Reforms will improve long term public finances
- » Stable relationship with the Kingdom of Denmark (Aaa, Stable)
- » Delivery of positive financing surplus
- » Large liquidity buffer mitigates refinancing risk

Credit Challenges

- » Faroese economy dependence on fishing and fish farming sector
- » High debt levels expected to remain flat
- » Major infrastructure project guarantee exposes government to a contingent liability
- » Refinancing risk due to debt structure and reliance on short term borrowing

Rating Outlook

The stable outlook reflects the successful implementation of a long term deficit reduction plan, improved macroeconomic metrics and a stable relationship with the Kingdom of Denmark.

Factors that Could Lead to an Upgrade

A combination of the following could have positive rating implications:

- » A return to long-term structurally balanced budgets
- » Steady reduction in debt to pre-recession levels
- » Reduced reliance on short-term borrowing

Factors that Could Lead to a Downgrade

One or a combination of the following could have negative rating implications:

- » A weakening of the Faroe Islands' relationship with Denmark
- » An adverse shock impacting the Faroese fishing industry
- » Materially increased debt levels above current projections
- » Increased contingent liabilities via additional government guarantees
- » Construction risk from the infrastructure project resulting in significant project cost overruns

Key Indicators

Exhibit 2

Faroe Islands, Government of

	2011	2012	2013	2014	2015	2016F
Interest Payments/Operating Revenue (%)	3.0	3.0	2.3	1.8	1.6	0.9
Accrual Financing Surplus(Requirement)/Total Revenue (%)	-5.3	-5.6	-3.8	-3.8	-1.2	3.7
Gross Operating Balance/Operating Revenue (%)	-2.0	-2.4	-2.4	1.4	4.1	7.5
Net Direct and Guaranteed Debt/Operating Revenue (%)	104.6	106.3	109.8	104.6	107.2	100.2
Short-term Gross Direct Debt/Gross Direct Debt (%)	34.4	30.8	19.9	40.2	29.7	36.1
Intergovernmental Transfers/Operating Revenue (%)	13.6	13.5	13.9	12.7	14.0	13.4
Real GDP growth (%)*	0.1	0.9	8.2	6.9	8.1	8.8

* The Faroe Islands do not have a GDP deflator. Instead, the Consumer Price Index (CPI) in the Faroe Islands is used to calculate real GDP growth.
Source: Moody's

Detailed Rating Considerations

The rating assigned to the Faroe Islands combines (1) a baseline credit assessment (BCA) of a2, and (2) a strong likelihood of extraordinary support coming from the Government of Denmark (Aaa, stable).

Baseline Credit Assessment

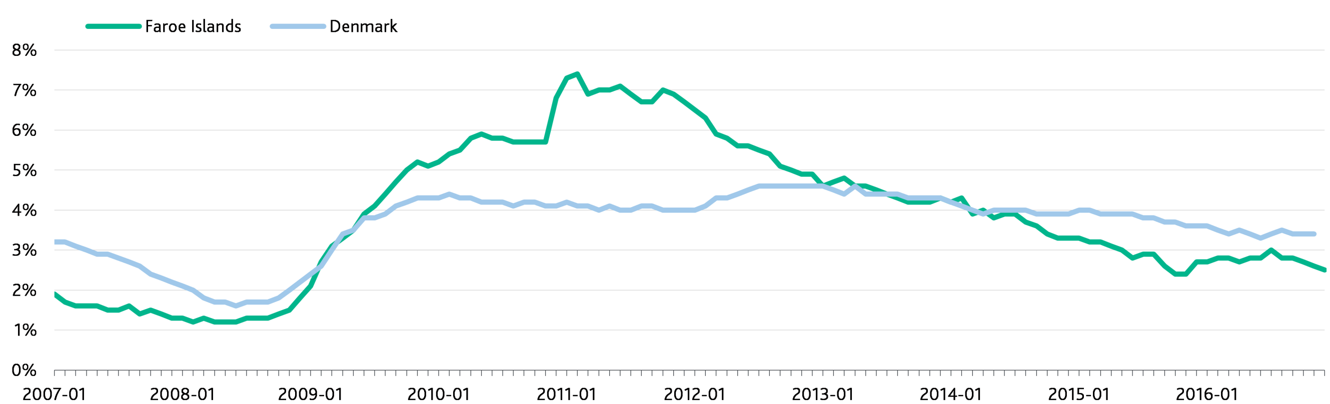
FISCAL AUTONOMY ALLOWS FOR REVENUE AND EXPENDITURE FLEXIBILITY

The Faroe Islands consist of 18 islands located in the Atlantic Ocean, between Scotland and Iceland with a population of approximately 49,000 inhabitants. While part of the Kingdom of Denmark (Aaa, Stable), the Faroe Islands are governed by the Home Rule Act, which gives the Faroese government full powers to set its tax rates and fees. This broad control over revenue supports Faroese financial flexibility; approximately 90% of the Faroese government's operating revenues are derived from sources under its control. The Kingdom of Denmark provides an annual block grant of DKK700 million which accounts for 10% of the Faroes' operating revenues. This grant is for “Joint Matters” that have not been transferred to Faroese control (see below for relationship with Denmark).

The Faroese government has in the past implemented substantial cuts in spending when required. During the banking crisis of the early 1990s, the government demonstrated its expenditure flexibility by reducing expenditure by 15% in just two years. However, following the global economic crisis in 2008-09, instead of spending cuts, the government used their autonomy and opted for a loose fiscal policy. This policy choice was able to support the economy as demonstrated in Exhibit 3, which shows that unemployment in the Faroe Islands is currently low, edging below the Danish national average since the end of 2013.

Exhibit 3

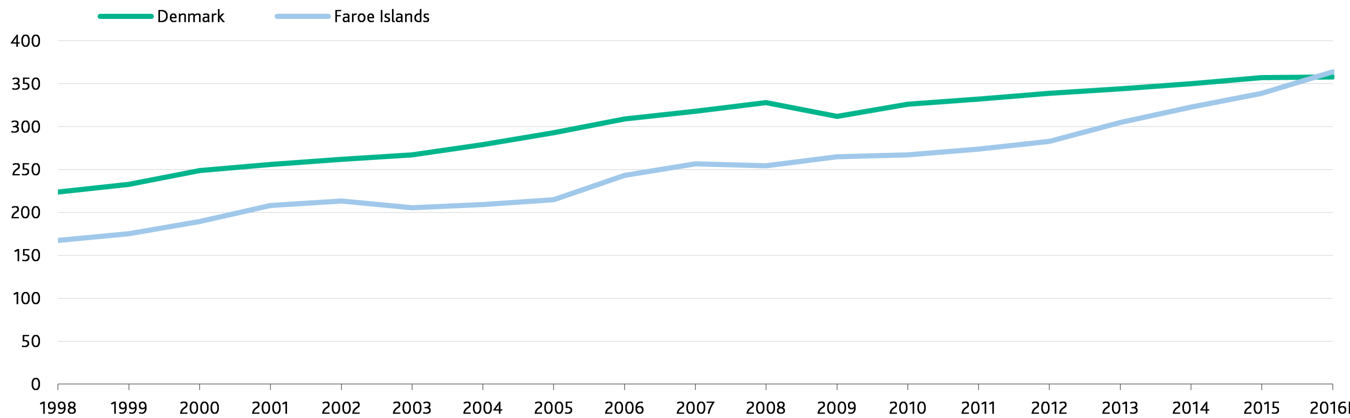
Faroese unemployment has fallen after peaking in 2011 and is now below the Danish rate
Unemployment as a % of labour force by country, by year



Note: Figures are seasonally adjusted.
Source: Statistics Denmark, Hagstova Foroya (Statistics Faroe Islands)

This choice of expansionary spending was effective at stimulating the Faroese economy. More recently, as the Faroese economy has entered a stage of recovery (average real GDP growth[1] of 8.0% between 2013-2016F), GDP per capita has improved substantially and is anticipated to surpass the Danish GDP per capita in 2016 (see Exhibit 4).

Exhibit 4
Faroese GDP per capita is anticipated to surpass Danish GDP per capita in 2016
Nominal GDP per capita by country in DKK thousand, and by year



Note: GDP per capita for the Faroe Islands for 2014, 2015, and 2016 are estimates. Danish GDP per capita in 2016 is a forecast.
Source: Statistics Denmark, Hagstova Foroya (Statistics Faroe Islands)

REFORMS WILL IMPROVE LONG TERM PUBLIC FINANCES

The government has pledged to deliver fishing and pension reforms that will enhance and sustain the government's long term public finances. The fishing reform is expected to introduce legal and administrative frameworks to promote equal rights and wider access to the fish stock while increasing government revenue. This fishing reform is expected to be implemented before January 2018 as existing fishing rights are set to expire by the end of 2017. We expect the government to introduce an auction-based market system, and this should result in additional revenue uplift when compared with the existing allocation model. The existing fishing fees model generated DKK213 million in fishing fees in 2016, a level deemed well below market value. Future fishing rights could generate up to double the amount under a new market based model. This revenue uplift would be credit positive and has prudently not been incorporated in the government's future budget plans.

In addition, pension reforms aim to control public pension liabilities in the medium and long run. All citizens will be expected to pay in at least 3% of their income into a pension scheme starting in 2017, after which contributions will increase every year by 1% until 2029. This means that by 2029, all citizens will pay at least 15% of their income into a pension scheme[2], helping reduce the public pension liability. The government's pension reform work is ongoing and potentially includes an increase to the retirement age as well (currently at 67 years).

The Faroe Islands are introducing tax reform and are considering municipal reforms. The islands' 29 municipalities vary widely in terms of size, from fewer than 50 inhabitants to approximately 20,000, with some including Klaksvikar and Torshavnar delivering strong surpluses, while others like Runavikar realising budget deficits. Tax reform and an equalisation system similar to that seen in other Nordic countries could be credit positive[3].

STABLE RELATIONSHIP WITH THE KINGDOM OF DENMARK

The Faroese relationship with Denmark (Aaa, Stable) is stable. In 1948, the Faroe Islands were granted Home Rule, and in 2005 it gained further authority over matters described below.

The Faroese control "Special Matters" covering the economy, finances (independence to raise taxes), industry, foreign trade, mineral rights, and the education system[4]. "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. 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 their own finances. In addition, the Faroe Islands have two seats in the Danish parliament, which historically has had some influence in Danish politics, particularly in parliaments with thin majorities. As previously mentioned, Denmark provides an annual block grant to the Faroe Islands. Historically this grant played a bigger role in the Faroese government's finances but now represent 10% of operating revenue. The grant is intended and indeed is spent on social welfare, schools and health sectors, though the Faroese government does maintain freedom over how the grant is used.

If the Faroe Islands were to choose to separate from Denmark, a referendum would be assumed. The debate over independence has received less attention in recent years. The general elections held in September 2015 resulted in a Social Democrat led coalition, which sees the link with Denmark as favourable. We do not expect any changes toward independence in the medium term, and such a transition would be gradual. Nevertheless, although deemed unlikely, any push for separation from Denmark would exert downward pressure on the credit.

DELIVERY OF POSITIVE FINANCING SURPLUS

The Faroe Islands forecast a strong increase in its gross operating surplus to DKK512 million in 2016 from DKK269 in 2015, which supports the return to a positive financing surplus. This operating balance amounts to 7.5% relative to operating revenues (Exhibit 1), a considerable improvement from its 2012-2016 average of 1.6%. This performance was the result of an 18% increase in operating revenue between 2011 and 2016, driven by direct tax growth, while operating costs only increased by 7% over the same time frame. Meanwhile, the government seeks to cut capital expenditures in 2016 to DKK330 million, a reduction of approximately 5% compared to the average yearly spend over the last three years (DKK347 million), as the government nears the end of its 2011-2016 fiscal deficit reduction programme. The improvement in gross operating balance, coupled with decreasing net capital expenditures, is expected to generate a financing surplus of DKK254 million in 2016 (see Exhibit 1), the first realised surplus since 2007.

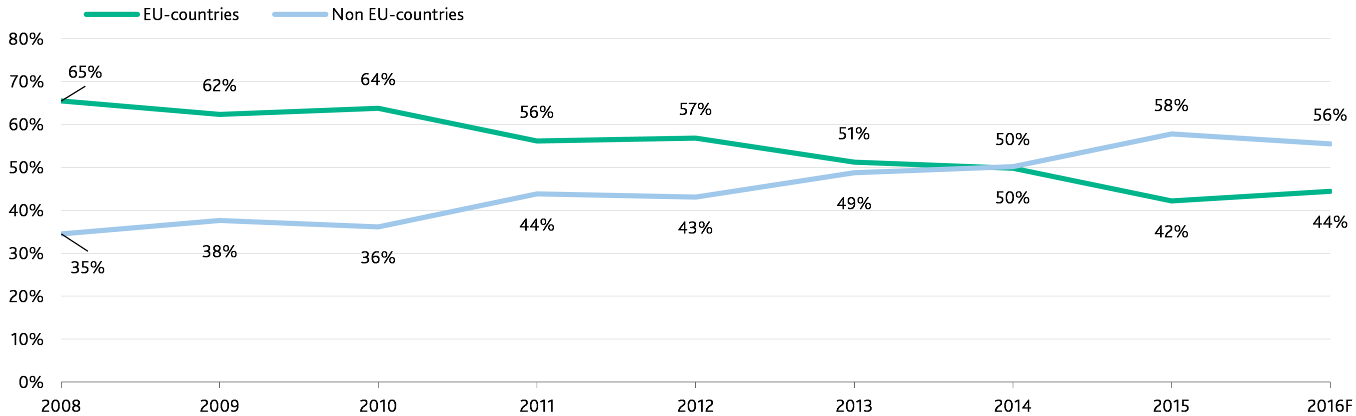
LARGE LIQUIDITY BUFFER MITIGATES REFINANCING RISK

The Faroe Islands have a large liquidity reserve, amounting to DKK2.8 billion (41% of operating revenues) in December 2016. According to internal best practice, this reserve is only to be used during times of heightened market stress - if the reserve is drawn upon and drops below 15% of GDP, it is expected to be addressed and again reach internal limits during the next borrowing round. In 2016, the liquidity reserve represented 15.6% of Faroese GDP. The reserve amount exceeds necessary borrowing requirements in any single year and this mitigates the refinancing risk associated with their reliance on short term borrowing (see section "Refinancing risk due to debt structure and reliance on short term borrowing"). The liquidity pool is sufficient to cover scheduled debt repayments for the next two years. The fund is invested in a portfolio of highly rated securities with investments being spread across various assets classes with defined limits in order to maximise the returns. At least 70% of the total liquidity pool is invested in Aaa bonds.

FAROESE ECONOMY DEPENDENCE ON FISHING AND FISH FARMING SECTOR

The Faroese economy continues to rely on the fishing industry with fishing accounting for nearly 20% of national GDP and for an estimated 96% of total exports in 2016. 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 last years, a combination of high global demand and low oil prices has benefited the Faroese fishing sector, and indirectly government receipts. This has particularly been true for the pelagic and fish farming industries which have grown substantially and have contributed to the economic growth of the country. Meanwhile, the traditional demersal fishing industry (cod, haddock, etc.) has remained stagnant due to low stock levels.

Exhibit 5
Faroe Islands have been diversifying their export partners
Share of exports to destination by percentage, by year



Note: 2016 is an estimated figure.
Source: Hagstova Foroya (Statistics Faroe Islands)

The Faroes have also increased trade with non-EU countries as can be seen in Exhibit 5 above, which shows how the share of exports to non-EU countries have for the first time surpassed their EU trade partners in 2015. 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 sanctions.

REFINANCING RISK DUE TO DEBT STRUCTURE AND RELIANCE ON SHORT TERM BORROWING

The Faroe Islands has a high proportion of debt coming due in any one year. In 2016, the Faroe Islands paid a mandatory scheduled repayment of DKK 1.36 billion, financed primarily through new borrowings of DKK 1.35 billion. The government also has rolling short-term creditor debt that is repaid each year. At FYE2016, short-term gross direct debt as a percentage of gross direct debt stood at 36.1%, increasing from 29.7% in 2015 as the mandatory debt repayment in 2016 was relatively high (2015: DKK 0.89 billion). The Faroe Islands' average maturity of its outstanding debt is between two to three years, a level we consider exposes the Faroes to refinancing risk. However, this has allowed the Faroe Islands to benefit from the current low rate environment with spreads as low as 0.25% over 5-year DKK swap in June 2016. Mitigating the refinancing risk is the Faroe Islands' liquidity buffer currently at DKK2.8 billion or 15.6% of GDP (see section titled “A large liquidity buffer which mitigates refinancing risk”) which could cover the scheduled repayments coming due over the next two years.

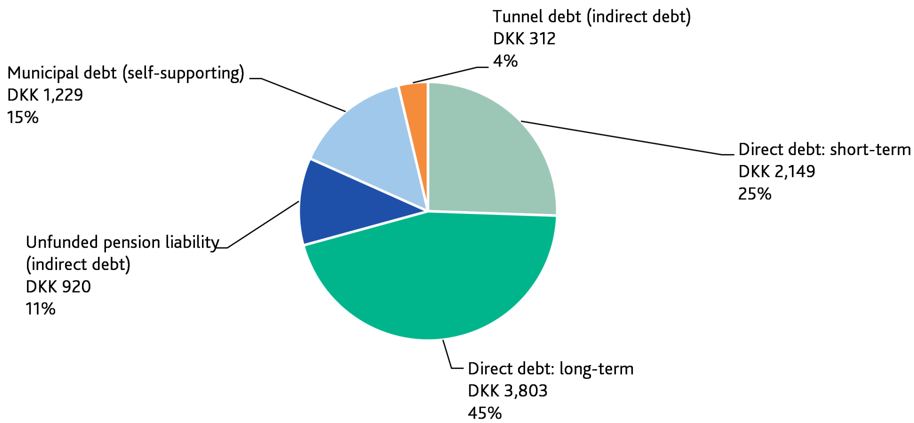
INCREASED DEBT LEVELS EXPECTED TO REMAIN FLAT

The Faroese government's expansionary fiscal policy following the financial crisis has resulted in increased debt levels. The government largely issued debt to finance large scale infrastructure projects, spending an average of DKK269 million per year on fixed capital construction between 2012-2016, 50% higher than the pre-crisis average annual spend of DKK179 million (between 2003-2007). As a result of ongoing financing deficits since 2007, net direct and indirect debt as a percentage of operating revenue is expected to reach 100% in 2016 from 62% in 2007. While we had anticipated the Faroese government's debt burden to trend downwards over the next five years, the introduction of a guarantee on a major infrastructure project (see section “Major infrastructure project guarantee exposes government to a new contingent liability”) has negatively affected our debt projections as we attempt to capture the underlying construction risk that the Faroese government has underwritten.

Exhibit 6

The Faroese government's total debt portfolio of DKK8.4 billion is made up primarily by direct debt

Total direct and indirect debt in DKK million, 2016F



Source: Moody's

Exhibit 6 above shows the direct and indirect debt portfolio as of 2016. The Faroese government has guaranteed an unfunded pension liability of approximately DKK0.92 billion under Foroya Livstrygging (LIV) and this is therefore included in our indirect debt calculations. The previously outlined pension reforms are not expected to impact this government exposure, which was fully self-funded up to 2008. Since the onset of the financial crisis and the subsequent low interest rate environment, LIV's self-funding ratio has fallen below 100%. Although part of our debt calculation, it is important to note that the government will not be exposed to any of LIV's liabilities before their own assets are fully depleted. With a current asset base of DKK2.1 billion, we expect that this will take 20-25 years to be depleted. 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. Municipal debt is considered self-supporting as the government does not provide a guarantee on their debt and they may only incur a total debt burden up to their level of total tax income in any one year. In addition, the Faroese government benefits from a DKK500 million interest free conditional loan by the Danish government that will be written off in 2018 (as long as the Faroese government does generate income from oil production).

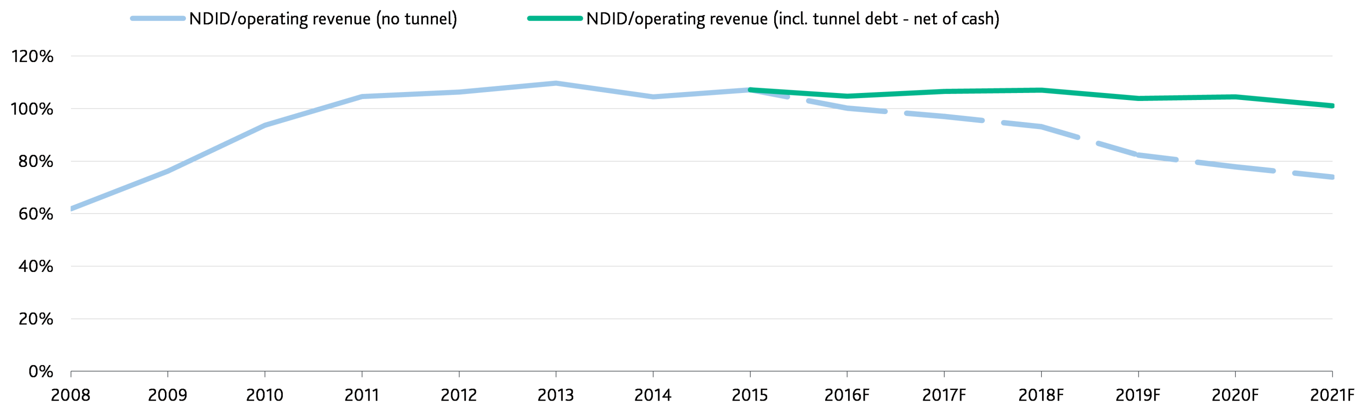
MAJOR INFRASTRUCTURE PROJECT GUARANTEE EXPOSES GOVERNMENT TO A CONTINGENT LIABILITY

By providing a minimum revenue guarantee, the Faroese government has exposed itself to construction and operational risk by underwriting the major infrastructure project that involves two sub-sea tunnels, Eysturoy and Sandoy. The tunnels represent the biggest infrastructure deal in the history of the Faroe Islands with an expected cost of approximately DKK2.64 billion. The financing of the project includes DKK400 million which has been appropriated by the Faroese Government over a ten year horizon, while DKK 2.68 billion was raised as senior secured notes under a special purpose entity. The Faroese government owns 100% of the Project company and is the ultimate sponsor of the project, with the Project company responsible for the construction and operation of the tunnels and roads. The debt drawn for the project is expected to be repaid through toll fees, with the government providing a minimum revenue guarantee that ensures a floor average debt service coverage ratio (ADSCR) of 1.05x at each calculation date throughout the project's debt service timeline.

Exhibit 7

By incorporating the outstanding debt of the project, the government's NDID is expected to remain flat despite previously being anticipated to drop

Net direct and indirect debt as a % of operating revenue by scenario, by year



Note: 2016F and onwards are estimated figures. Debt of the tunnel project is calculated net of project cash.
Source: Moody's, Faroese Statistical Office

Taking into account the risk of this project during the construction phase, our debt projections remain flat over the next five years, a trend we had elsewise expected to reverse over the coming years (see Exhibit 7 above). We treat the net debt associated with the tunnel as indirect debt given the wholly-owned Project Company and the minimum revenue guarantee. We note the difference in financial viability between the tunnels, with the future earnings from the Eysturoy tunnel expected to cover the majority of the debt service requirements. The Sandoy tunnel remains financially non-viable on a standalone basis and once operational will only contribute approximately 10% of total combined income over the next 40 years.

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.

While Denmark has no formal obligation to provide extraordinary support to the Faroe Islands, it has historically supported the Faroese on a number of occasions. In the 1990s, the Faroese government borrowed - largely from Denmark, given the scale of the crisis - in order to fund the nationalisation of Føroya Banki and Sjovinnubankin and to bridge the deficits of the recovery plan. As reforms were established, the Faroese began standalone borrowing, ultimately using these and other 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 being responsible 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

In the case of the Faroe Islands, the 2015 BCA matrix generates an estimated BCA of aa3 compared to the assigned BCA of a2 by the rating committee. 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 sovereign bond rating (Aaa stable). The two notch differential reflects a number of factors not captured in the scorecard including: 1) the Faroese industry's concentration on the fishing sector; 2) Refinancing risk and 3) small population limiting revenue generation.

Exhibit 8

Baseline Credit Assessment	Score	Value	Sub-factor Weighting	Sub-factor Total	Factor Weighting	Total
Scorecard						
Factor 1: Economic Fundamentals						
Economic strength	7	94.41	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 (%)	5	2.40	12.5%	4.25	30%	1.28
Interest payments / operating revenues (%)	3	1.79	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	7	107.24	25%			
Short-term direct debt / total direct debt (%)	5	29.74	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

Regional and Local Governments, January 2013 (147779)

Ratings

Exhibit 9

Category	Moody's Rating
FAROE ISLANDS, GOVERNMENT OF	
Outlook	Stable
Issuer Rating	Aa3

Source: Moody's Investors Service

Endnotes

1 The Faroe Islands do not have a GDP deflator. Instead, the Consumer Price Index (CPI) in the Faroe Islands is used to calculate real GDP. Note that CPI has been negative between 2013-2016F.

2 Those persons who already pay 15% or more of their income into a pension scheme will not be required to pay more than what they already do.

3 See *Nordic Local Governments: Credit quality boosted by support expectation and inherent strengths*, published May 2016.

4 For more information on the division of tasks, see *Delivery of Faroe Islands' Fiscal Plan Supports Creditworthiness*, published July 2015

REPORT NUMBER 1058517

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