SUB-SOVEREIGN

MOODY'S
PUBLIC SECTOR EUROPE

CREDIT OPINION

3 August 2020

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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)

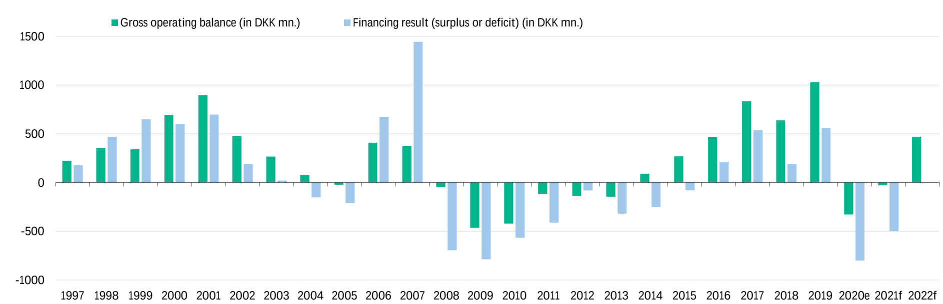
Update to credit analysis

Summary

The credit profile of the Government of Faroe Islands (the Faroe Islands, Aa2 stable) reflects the fiscal autonomy, resulting in a high level of financial flexibility, combined with a track record of prudent budgeting. The credit profile also takes into account the government's very large liquidity buffer, which mitigates any refinancing risk. The deterioration in the global economy following the coronavirus outbreak impacts Faroe Islands' economy significantly this year, with an expected decline of around 5%. Following significant financial surpluses over the last four years, we expect deficits in 2020 and 2021 due to the economic impact from the pandemic. Debt metrics will go up to a higher level but may start declining from 2021. We also take into account a strong likelihood of the government of Government of Denmark (Aaa stable) providing support if the Faroe Islands were to face acute liquidity stress.

Exhibit 1

Financial results are expected to weaken due to impact from coronavirus pandemic



2020e: Moody's estimated data; 2021f-22f: Moody's forecast.
Source: Issuer, Moody's Investors Service

Credit strengths

» Fiscal autonomy and stable relationship with the Government of Denmark

» Structurally sound balance and large liquidity buffer

» Moderate debt indicators, with some off-balance-sheet activities

Credit challenges

» Faroese economy is narrow and relatively exposed to the fishing industry

» Faroe Islands' growing population requires infrastructure investments

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) a higher than expected increase in debt level or structural financial deficits over several years; and (3) any unexpected adverse shock from the pandemic affecting the Faroese fishing industry.

Key indicators

Exhibit 2
Government of Faroe Islands

Faroe Islands, Government of	2015	2016	2017	2018	2019	2020E
Population (in '000)	48.9	49.5	50.1	50.9	51.7	52.4
Gross operating balance/Operating revenue (%)	4.2%	7.2%	11.4%	8.6%	12.8%	-4.6%
Intergovernmental transfers/Operating Revenue(%)	11.1%	10.3%	9.5%	9.5%	8.7%	9.8%
Cash financing surplus (Requirement)/Total revenue (%)	-1.2%	3.4%	7.3%	2.5%	7.0%	-11.3%
Net Direct and Indirect Debt/Operating revenue (%)	104.3%	85.5%	91.2%	76.0%	63.8%	95.3%
Short-term Direct Debt/Direct Debt (%)	24.5%	20.9%	9.4%	23.7%	35.2%	24.9%

2020e: Moody's estimated data
Sources: Issuer, 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

Fiscal autonomy and a stable relationship with the Government of Denmark

The Faroe Islands consist of 18 islands located in the Atlantic Ocean, between Scotland and Iceland, with a growing population, with more than 51 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 90% of the Faroese government's operating revenue is derived from sources under its control. The Kingdom of Denmark provides an annual block grant of around DKK700 million, which accounts for close to 10% of the Faroe Islands' operating revenue. 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.

Economic indicators are very strong, with a gross domestic product (GDP) per capita at the Danish average (as Exhibit 3 shows). Real GDP growth rate was above the Danish average over the many years in the past. Despite an increase in the number of unemployed during the pandemic, the unemployment rate is still extremely low at around 2%. However, with phasing out of employment support measures (financed by state employment agency), unemployment statistics could rise in second half of 2020.

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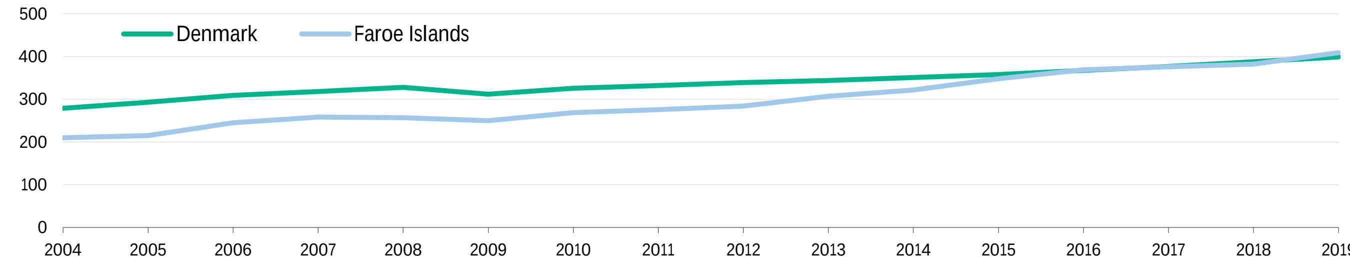
Exhibit 3
Faroese GDP per capita is now slightly above the Danish GDP per capita
Nominal GDP per capita in DKK thousands, by year



Source: Landsbankin Foroya (The Faroe Islands Governmental Bank)

In recent years, the former government had implemented reforms, including fishing and pension reforms, aiming to enhance and sustain government's financial health (see: Fishing Policy Reform - Issuer In-Depth Report, published October 2018).
As a result from 2019 election, the new government was formed, which made some amendments, e.g. to the Act on the Management of Marine Resources. The amended Act appears to be more favourable for the fishing industry, as it replaces the previous quota and auction system and extends fishing licences. Further parliamentary discussion of amending the Act are currently going on.

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.

Structurally sound budget and large liquidity buffer
The coronavirus has hit the Faroese economy quite severely this year and will continue to put pressure on the economic outlook. We expect a decline of around 5% in 2020 and a partial recovery in 2021.

As a result, we expect the budget 2020 to suffer heavily from tax shortfalls and additional cost. We expect the Faroese financing results will be negative in 2020 and 2021. We do respectively expect a financial deficit of around DKK800 and DKK500 million. While fishing exports and tourism services with travel restrictions were temporary hit hard, we forecast Faroe Islands to return to balanced financial budgets from 2022 onwards.

To address the negative impact, the Faroese government implemented some coronavirus relief packages accounting in total for around 1% of the Faroese GDP. The measures are expected to result in a material loss of operating revenues, mainly based on less economic activity leading to lower VAT revenues and dividend payments. in addition, the measures are expected to increase expenses for around DKK200-300 million.

The Faroe Islands reported a favourable gross operating surplus of DKK1,029 million and overall financing surplus of DKK561 million in 2019.

The Faroe Islands have a large liquidity reserve, amounting to DKK3.4 billion as of the end of December 2019 (compared with DKK3.7 billion in December 2018), which is well above the internal minimum liquidity threshold of DKK2.9 billion. In the context of the pandemic and recent funding activities, the Faroe Islands displays a liquidity reserve of DKK4.5 billion as of mid-2020. 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.

The 2019 liquidity reserve represented around 16% of the Faroese GDP or 89% of its outstanding direct debt. 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 four years. In June 2020, the government issued two bonds, amounting to DKK2.945 billion, of which DKK1.345 was refinancing of maturing debt. The remaining DKK1.6 billion was issued to pre-fund expected deficits in 2020 and 2021. 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 third of the total liquidity pool is invested in Aaa-rated securities.

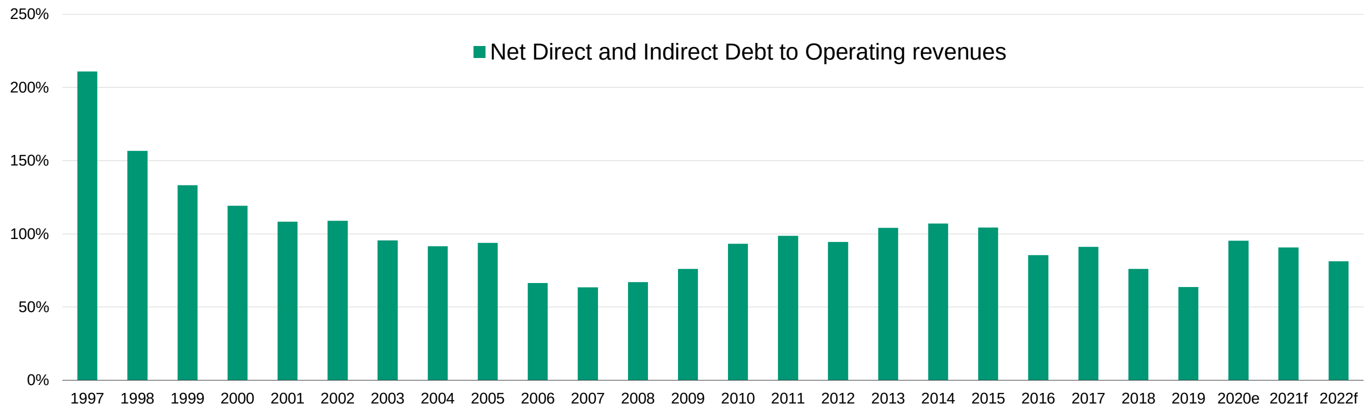
Declining debt indicators, with some off-balance-sheet activities

With the global financial crisis (2008-09), the government had increased debt levels but over the recent years, it is on a declining trend.

With the coronavirus pandemic and taken measures, debt metrics increase in 2020, but will continue the declining trend thereafter (Exhibit 4).

Exhibit 4

Debt increase after a decreasing trend following Covid-19 pandemic



2020e: estimated data; 2021f-22f: forecast.
Sources: Issuer, Moody's Investors Service

The net direct and indirect debt (NDID) consists mainly of direct debt (DKK3.8 billion as of December 2019). We count another DKK1.3 billion as indirect debt, which is because of the fact that the Faroese government has guaranteed an unfunded pension liability under Foroya Livstrygging (LIV). This translates into NDID of 64% of operating revenues as of year-end 2019. We expect NDID-ratio to jump to 95% of operating revenues in 2020, before continuing its declining trend.

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 also has some off-balance-sheet activities and public companies. 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. The Faroese government has provided a minimum revenue guarantee 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 94% 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.

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. In 2019, the Faroe Islands signed and a trade agreement with the United Kingdom which secures the access to the UK market.

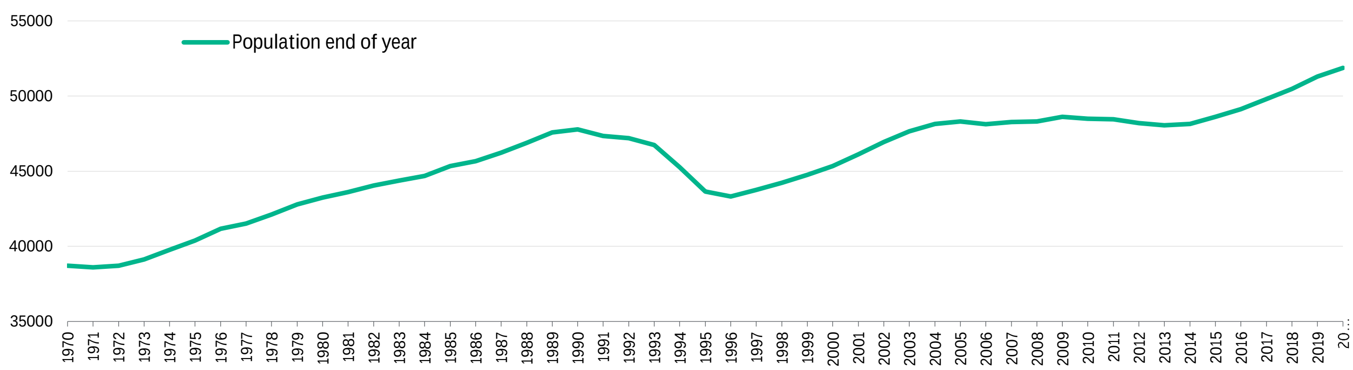
Faroe Islands' growing population requires infrastructure investments

The Faroese population is steadily growing by about a couple of hundred new inhabitants per year (as Exhibit 5 shows). Such population growth strains the government's operating but mainly capital expenditures. 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 up to DKK500 million annually over the coming years. In addition, government companies are also planning to invest to address infrastructure needs. The pandemic did not disturb their capital spending plans.

Exhibit 5

Population growth over the last half century



Source: Landsbankin Foroya (The Faroe Islands Governmental Bank)

Extraordinary support considerations

We consider Faroe Islands to have a strong likelihood of extraordinary support from the Kingdom of Denmark. This reflects our assessment that the current relationship with the Kingdom 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 Sjovinnubankin 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 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'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

Moody's takes account of the impact of environmental (E), social (S) and governance (G) factors when assessing sub-sovereign issuers' economic and financial strength. In the case of the Faroe Islands, we assess the materiality of ESG to the credit profile as follows:

Environmental considerations are material to Faroe Islands' rating. The Faroe Islands have mainly exposure to sea rising level risk, which would impact its fishing industry, and we do not expect any intervention from Denmark as the Home Rule Act gives to the Faroe Islands the responsibility in terms of environmental policies and resources management. To counterbalance climate change risks, the government has the ambition to be 100% green energy on electricity on land in 10 years.

Social considerations are material to the Islands' credit profile. Faroe Islands face a trend of ageing population, resulting in declining labour supply and higher pension and social costs. Over time, these challenges can add pressure on its finances. We view the coronavirus outbreak as a social risk under our ESG framework, given the substantial implications on economic growth, the coronavirus relief measures implemented, and therefore the consequences on its revenues and expenditures.

Governance considerations are material to Faroe Islands' rating. Governance and management are considered good with prudent budgetary practices associated with sound management of liquidity and debt.

Further details are provided in the “Detailed credit considerations” section above. Our approach to ESG is explained in our cross-sector methodology General Principles for Assessing ESG Risks.

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 (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 Denmark's Aaa stable sovereign bond rating.

For details about our rating approach, please refer to Rating Methodology: Regional and Local Governments, 16 January 2018.

Exhibit 6
Government of Faroe Islands

Faroe IslandsBaseline Credit Assessment	Value	Sub-Factor Score	Sub-Factor Weighting	Sub-Factor Total	Factor Weight	Total
Factor 1: Economic Fundamentals						
Economic strength	101.0	5	70%	6.2	20%	1.24
Economic volatility		9	30%			
Factor 2: Institutional Framework						
Legislative background		1	50%	1.0	20%	0.20
Financial flexibility		1	50%			
Factor 3: Financial Performance and Debt Profile						
Gross operating balance / operating revenues (%)	11.4	1	12.5%	3.0	30%	0.90
Interest payments / operating revenues (%)	0.6	1	12.5%			
Liquidity		1	25%			
Net direct and indirect debt / operating revenues (%)	63.8	3	25%			
Short-term direct debt / total direct debt (%)	35.2	7	25%			
Factor 4: Governance and Management						
Risk controls and financial management		1		5	30%	1.50
Investment and debt management		5				
Transparency and disclosure		1				
Idiosyncratic Risk Assessment						**3.84 (4)**
Systemic Risk Assessment						**Aaa**
Suggested BCA						**aa3**

Based on 2019 data
Source: Moody's Investors Service

Ratings

Exhibit 7

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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