Moody's International
Sub-Sovereign

Credit Analysis

March 2008

Faroe Islands

Kingdom of Denmark

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Summary Rating Rationale

The Aa2 issuer and foreign currency debt rating with stable outlook for the Faroe Islands reflects a Baseline Credit Assessment (BCA) of 5 (on a scale of 1 to 21, where 1 represents the lowest credit risk) and a high likelihood that the Kingdom of Denmark (Aaa stable) would act to prevent a default by the Islands.

The Faroe Islands' BCA of 5 reflects a number of factors, including its economic strength and increasing diversification. The BCA also reflects the government's powers to raise revenues through taxation and fees and to control spending as well as the strong financial results the Faroe Islands has achieved since 1995. The Faroe Islands maintains ample reserves while the debt level is moderate and decreasing and the interest burden falling. The BCA takes into account the Islands' relationship with the Kingdom of Denmark and the funding it receives for 'Joint Matters', which it administers in conjunction with the Kingdom of Denmark. The support (see below) also take into account the establishment of the settled relationship the Faroese takes with Denmark in the consideration of further autonomy and potential independence.

Rating Outlook

The outlook on the Faroe Islands' Aa2 rating is stable, reflecting its robust management of Home Rule responsibilities and the orderly process being conducted with Denmark vis-à-vis autonomy and potential independence.

This analysis provides an in-depth discussion of credit rating(s) for the Faroe Islands and should be read in conjunction with Moody's most recent Credit Opinion and rating information available on Moody's website. Click here to link.

Moody's Investors Service

Issuer Overview

The Faroe Islands is a self-governing country within the Kingdom of Denmark. Located in the North Atlantic, its closest neighbours are the United Kingdom and Iceland. It consists of 18 islands and has a population of 48,350. The great distance to Denmark – 1,300 kilometres to Copenhagen – has allowed the Faroese to preserve their distinct language[1] and culture.

The long distance has also influenced the political relationship. The Faroe Islands has historically been a special jurisdiction within the Kingdom of Denmark. Since 1947, the potential for Faroese independence has been an important political issue in both Denmark and the Islands. In 1948, the Faroe Islands was granted Home Rule, which allows matters of common concern to be assigned wholly or partly to the Faroese government. In 2005, an act of the Danish Parliament[2] supplemented the Home Rule Act and granted the Faroe Islands the authority to take over all matters, except those related to full independence.[3] In the Faroese elections of January 2008, independence received relatively little attention, indicating that the relationship with Denmark – including consideration of further steps towards independence – is in a period of stability.

The Faroe Islands is an independent area within the Kingdom of Denmark with regard to customs, excise duties and taxation. When Denmark entered the European Community in 1973, the Faroese Parliament (*Løgting*) voted unanimously against joining. The Faroe Islands has instead established a separate trade agreement with the EU and negotiated agreements with other countries for trade and fishing rights. The currency of the Faroe Islands is the Faroese Króna, a version of the Danish Krona issued by the Danish National Bank.[4]

Key Rating Considerations

The Crisis of the 1990s

The financial crisis of the 1990s and the response of the Faroese and Danish authorities provide the backdrop for the reforms that followed. The Faroese economy's dependence on fishing proved the need to balance commercial incentives for efficiency with greater diversification and tighter management of stocks. Indeed, the crisis prompted a drive for increased diversification in the economy as a whole as well as leading to the introduction of tighter fiscal controls on governmental spending and the establishment of substantial reserves.

Moral hazard within the Faroese economy and the national accounts has been substantially reduced by fixing the level of subsidies from Denmark. Further steps to autonomy are clearly linked to self-sufficiency. After more than a decade of prudent management, these measures have largely proven successful. The economy has stabilised and grown, with similar results for governmental finances. Further growth and stability, if not independence itself, depend on maintaining the fine balance of fiscal, commercial, political and environmental policies in the Parliaments of Tórshavn and Copenhagen.

1 Faroese is a West Nordic language, closely related to Icelandic and Norwegian.
2 Act No. 91/2004 and reflected by the Faroese parliament under *Acts of Assumption of Fields of Responsibility, Act 79 12 May 2005*
3 The following Joint Matters are inalienable to the Kingdom of Denmark and are excluded from the process of increasing autonomy and potential independence: the Danish Constitution, Danish internal affairs, the Danish Supreme Court, foreign affairs, security and defence policies, currency and monetary policy. The division of responsibilities under this 2005 agreement is discussed further under *Institutional Factors* and in Appendix 4, *Division of Responsibilities between the Faroe Islands and Denmark*.
4 Faroese Krona is issued in notes. Coins in circulation are Danish Krona.

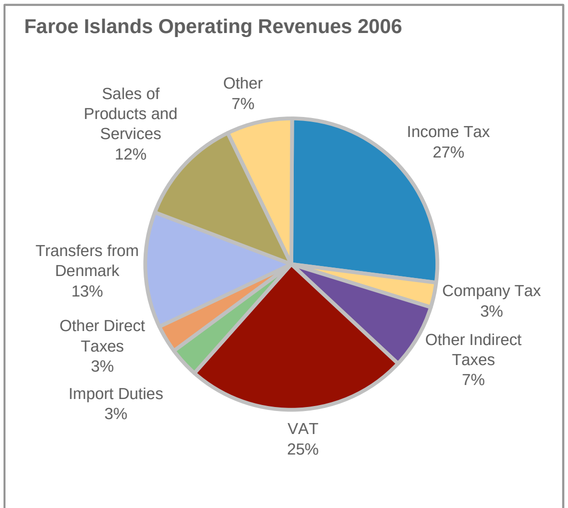
Financial Position and Performance

Revenues

The government finances of the Faroe Islands have benefited from the steadier economy and a stable regime for subsidies from Denmark.

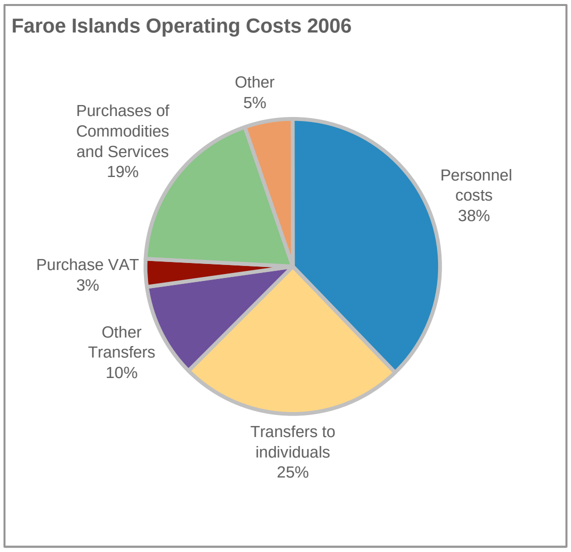
As shown in Figure 1, the DKK5.1 billion of operating income of the national government is widely distributed by source. Some 87% comes from economically driven taxes, and all but 13% of transfers are under the control of the Faroese government. This distribution has been stable for the past five years. In spite of this diversity, total revenues still depend on a variable economy (see *Economy* and Appendix 3, *The Fishing industry today*). Between 2003 and 2005, operating income fell by 1%-2% annually, only to increase by more than 10% in 2006. In 2007, similar growth is expected.

Figure 1:



Source: Landsbanki Føroya

Figure 2:



Block grant from Denmark remains a key source of funding

The annual block grant from Denmark was set in 2002 at DKK615.5 million.[5] The Danish government spends another approximately DKK280 million in the Faroe Islands on matters under Danish control, such as public order and judicial administration. These amounts do not appear in the Faroese budgets. (See *Institutional Factors* below for the division of responsibilities between the Faroe Islands and Denmark.)

Expenses

As of 2006, total operating expenditure was DKK4.7 billion, with the major components as shown in Figure 2. Since 2002, operating expenses have shown growth of 1.5%-2.5% per year.

Gross operating balances have been volatile, but generally positive

Gross operating balances have fluctuated widely, due to the volatility of revenues. The surplus of 9.8% in 2002 gradually fell to a deficit of -0.5% in 2005, only to rise to 8.0% in 2006. Landsbanki Føroya anticipates the final accounts for 2007 will show a slightly lower result than in 2006, and expects that 2008 again will produce a surplus, despite a projected slowing of investment and consumption in the economy. See *Governance – Fiscal Management* (below) for a discussion of budgeting practices, which contribute to maintaining balance across periods of economic volatility.

[5] In this year, the grant was lowered by DKK366 million, mostly due to the official transfer of public education to the Faroese.

Investments

To support the diversification of the economy, the Faroe Islands has emphasised investments in communications and transport. Direct government investment is expected to continue at a baseline of about DKK200 to 300 million per year, with planned amounts for 2009 and 2010 somewhat higher (see Appendix 1, *Major investment projects*). Approved spending levels are generally inflexible, so projects must be frequently reprioritised to keep within this budget constraint.[6]

For larger projects that would strain the annual budget process, the Faroese government also relies on alternative funding sources, such as the Faroese Infrastructure Investment Fund, which will be used for the airport runway extension. The government will also fund investments through special purpose corporations, with the Faroese government as shareholder and debt from private lenders.

Spending from the Investment Fund and special purpose corporations is accounted separately from the national government's budget.

Debt Profile

The debt burden of the Faroese government has fallen to moderate levels since the financial crisis. At year-end 2006, debt totalled DKK3.3 billion, down 21% from 2005. Debt as a percentage of total revenues fell to 59% of revenues, down from 91% in 2005.

These levels stand in sharp contrast to those resulting from the financial crisis. The cost of nationalising two of the country's largest banks, funding reserves and managing structural deficits in the budget pushed debt to DKK7.3 billion in 1995 (263% of revenues), of which most was provided by the Danish government.[7]

By 1997, these actions and the refinancing of foreign debts had resulted in debt to the Kingdom of Denmark reaching DKK5.8 billion. In 1998, Denmark and the Faroese government agreed to restructure these obligations. Short-term maturities were extended into approximately 20-year annuity repayments. The Danish government forgave some DKK900 million and agreed to convert DKK500 million into a non-interest bearing, non-maturing, loan, which the Faroese will repay with interest if oil is found within their economic zone before 2018.[8]

The Faroese government has since repaid all of its interest-bearing debt to the Danish state. The Faroese government now issues bonds on the Faroese securities market within OMX Nordic Exchange Iceland. Average debt maturity is approximately 3.5 years.

Municipalities are estimated to have DKK0.7 billion of debt outstanding as of 2007; this is not counted within the national government's accounts. The municipal debt burden varies widely, with some municipalities having a net debt of DKK60,000 per inhabitant while others have modest debt or no debt at all. For those with high debt burdens, interest and repayments comprise a large part of their municipal budgets (see *Institutional factors* below for further discussion).

Landsbanki Føroya, which administers the loans and borrowings of the Treasury, maintains an overdraft facility of DKK400 million with Nordea (Aa1, stable), which can be used for short-term liquidity.[9] The Faroese government also has a repurchase facility, which can draw 90% (DKK1.1 billion) against the security of Danish treasury bonds and Danish mortgage bonds, held in the DKK1.45 billion[10] Liquidity Fund (see *Governance).* The Faroese government may tap this facility, equal to 29% of total annual expenses, within 24 hours.

6 The government maintains an extensive multi-year investment plan, showing costs and their impacts on the governmental budget. The plan is adjusted annually to keep within spending targets.
7 Føroya Banki and Sjóvinnubankin
8 The DKK500 million loan will be written off after 2018, if no oil is found
9 There is no adverse change clause and the money is available instantaneously.
10 Year-end 2006

Faroe Islands

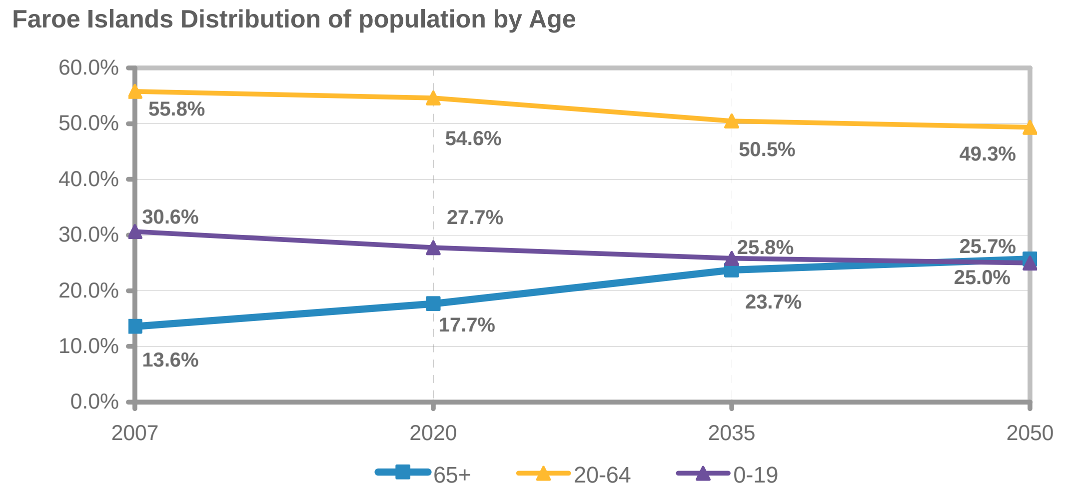
Guarantees

The financial crisis led the Faroese government to reform its economic policies by curtailing guarantees for industries and, for the past 15 years, offering no new guarantees. Today, the only outstanding guarantees are for debt of Faroese municipalities borrowed from the Danish specialised lender KommuneKredit (Aaa, Stable), and which are matched with guarantees by the Kingdom of Denmark.

Pensions

The Faroe Islands is following the lead of other Scandinavian countries by preparing for the future cost of supporting its gradually ageing population. As seen below, the proportion of elderly within the population is expected to grow from 13.6% in 2007 to 25.7% in 2050. Over the same period, the proportion of working age will decrease from 55.8% to 49.3% while the proportion of young people will fall from 30.6% to 25.7%.

Figure 3:



Source: Landsbanki Føroya

Currently, there are unfunded pensions liabilities of approximately DKK2.0 billion, amounts to close this deficit are covered within the yearly budget. To fund future pension costs, the Faroese government are moving to pre-funding of their public and private pension systems from a pay-as-you-go system.[11] Landsbanki Føroya has responsibility for the supplementary pension fund (or "AMG") established by law. As of 2007, this fund totalled DKK500 million in diversified investments, in line with the requirements of Danish law.

Governance and Management

As its autonomy has increased, the Faroe Islands has built up its institutions in order to manage the expanding range of revenue, spending, economic and risk-management decisions.

The Faroese Parliament, the *Løgting,* is the legislative assembly for Faroese affairs and consists of 33 MPs. It appoints the Prime Minister (*Løgmaður*), who, with his/her cabinet ministers, constitutes the Faroese government (*Landsstýri*). The most recent election took place on 19 January 2008, which kept the pre-existing Prime Minister but with a new coalition.

In addition to electing the Løgting, the Faroes elect two representatives to the Danish Parliament. The Faroese head of state is Queen Margrethe II of Denmark.

[11] The private pension fund is being created with 15% of personal income (shared between employer and employee), which has been implemented earlier in the public sector, which pays all the 15% on behalf of their employees.

Faroese internal politics has historically been stable and, in line with other Nordic countries, based on consensus. Most elections take place as planned, every four years. No party can achieve a political majority on its own. Coalition governments create a base for timely and orderly consideration of key national issues. Changes in economic policy are usually measured and specifically related to managing the fishing industry. Both governing and opposition parties broadly endorse the need for fiscal discipline, as a legacy of the 1990s. Moody's does not anticipate any significant weakening of fiscal or economic policies from the new coalition in power since the January 2008 elections.

Fiscal management

One of the key results of the crisis of the 1990s is that the path for greater autonomy and potential independence has been aligned with prudent management of government finances. As agreed with Denmark, the Faroese government must finance any budget deficits from its own resources. Following the crisis, the Faroese government accepted restrictions on borrowing and on issuing guarantees; these restrictions continued until 1998. In general, the Faroese Government's budget policy has limited spending to prudent increases over prior-year budgets, rather than being re-based to consume windfall revenues from boom years in the economy. In this way, periods of economic growth create multi-year surpluses, whilst government service and spending levels remain stable.

No formal targets for future surpluses have been established. Plans to build up the National Savings Fund (see below) will, however, require surpluses of approximately DKK100 million to DKK200 million per year. Maintaining these and other reserves – and potentially increasing them – has broad consensus across the major political parties. Debate focuses largely on how much they should increase from their already healthy levels.

The Parliament is the central appropriation authority. The Minister of Finance presents the Government Budget Proposal for the next fiscal year to Parliament before October.[12] Parliament must then approve the budget before the beginning of the budget year.

The budget may be revised two to three times annually and is always revised in the early fall, when the proposal for the following year's budget is presented.

Role of Liquidity Fund within government finances

The 1995 Act on the Treasury's deposits and loans in the Landsbanki requires the government to maintain a liquidity reserve (often referred to as the "Liquidity Fund") of 15% of GDP. These amounts are deposited with Landsbanki Føroya to meet immediate shortfalls, to provide liquidity for debt repayments and, if required, to serve as bridging funds to smooth deficits over a multi-year period. At year-end 2006, the government had drawn DKK0.5 billion, about one quarter of the reserve, to repay debt. This left the balance at DKK1.4 billion, equal to 30% of operating expenses. Until recently, the government anticipated restoring the 15%-of-GDP balance with revenues from planned privatisations, although recent instability in the financial markets makes the timing of these uncertain. The new government may also consider borrowing to restore the fund's target balance.

National Savings Fund from any oil revenues and other resources

In order to safeguard potential revenues from oil, all the Faroese political parties have agreed to set up a National Savings Fund (*Búskapargrunnur* or 'Economy Fund'). This fund is to be based on principles similar to the Norwegian national oil fund and would be used to meet the future costs of the ageing population. The fund would capture taxes on oil revenues, proceeds from privatisations (in addition to those noted for the Liquidity Fund, above), and surpluses above "structural" budget limits.[13] The government would only tap funds in excess of inflation[14] for use in its annual budgets. The fund will be established with DKK1.3 billion from privatisations that have already been completed, with further additions possible. The major political parties broadly agree with the aim of building this fund up to 50% of GDP, or DKK6.0 billion at current prices.

12 The budget year follows the calendar year.
13 The definition of structural surpluses would have to be defined by future governments within the setting of operating budgets and investment plans
14 Average real return for the last seven years

Other Funds

The Danish authorities set up an Investment Fund in 1964, which has since come under Faroese control.[15] It currently holds almost DKK850 million of assets, of which approximately half represent infrastructure loans to national or municipal governments or companies contracted for capital works.[16] These loans may be long-term, and to date have always been repaid. The balance of liquid funds is deposited with Faroese banks.

The Faroese government is also building up an unemployment compensation fund, currently valued at approximately DKK500 million. These amounts are invested largely outside the Faroe Islands. Neither the Investment Fund nor the Unemployment Fund appears on the government's balance sheet, as these funds are not directly accessible by the government for spending within the national budget. They may, however, purchase government bonds or invest in Faroese bank deposits, therefore supporting broader liquidity within the budget and the banking system.

The pension fund has risen to approximately DKK500 million (see *Pensions* above).

Together, the funds totalled DKK4.4billion at year-end 2007, equal to almost 40% of GDP or 80% of total costs (2007 estimate).

Investment management

The Liquidity Fund is invested abroad to avoid risks correlated with Faroese banks. Investments of the Liquidity Fund are limited to highly rated banks and to fixed-income securities with little market risk and access to T+1 liquidity Due to their longer-term spending horizon other funds, such as the planned National Savings Fund and the supplementary pension fund, may be invested in longer-term securities and up to 20% in shares. The Faroese government does not maintain strict rating thresholds (although for non-Faroese banks it does require ratings). Internal policies, not all of which are formalised in writing, limit counterparty exposures beyond government bonds and Danish mortgage bonds to a maximum of 20%.

Debt management

As established by a 1978 Act of the Løgting, Landsbanki Føroya is the government's banker. It administers the loans and borrowings of the Treasury and provides economic and fiscal analysis to the government and Parliament.

Since 1994, the government has raised new debt denominated in Danish Kroner through medium-term bonds. The relatively short tenors give the Faroese government the option to pay down frequently maturing principal with surpluses or reserves. The relatively short tenors, of course, also incur refinancing risk.

Transparency and disclosure

The monitoring systems for governmental spending are good, with some improvements pending. However, the detail provided within the annual accounts has not reached the level of other Scandinavian countries. For example, the balance sheet of the national government only lists financial assets, liabilities and working capital, rather than presenting a full range of GAAP-standard accruals.

Nevertheless, the current system of managing against published budgets is a good foundation for improvement. Some 70% of central government spending is updated immediately from general ledger entries; the balance is updated monthly. Income tax receipts are reported as collected. Value Added Tax (VAT) collections are reported quarterly.

The national government aims to update its online accounting systems to consolidate municipal accounts into the national totals every month. The separation of municipal and national accounts is frequently noted as a potential concern in overall economic and fiscal management, especially when more responsibilities and spending are being moved to the municipalities.

[15] The fund was originally capitalised in the 1960s by Denmark. The fund is now governed by a board appointed by the Minister of Finance of the Faroe Islands.

[16] The investment fund has loaned to the undersea tunnel companies, the Faroese Telecom company, and municipal electric companies.

Audits

The auditing system is good and tied to public scrutiny within the democratic process. The President of the Parliament appoints the Auditor General, who heads the National Audit Office (NAO). Each of the four largest parties in parliament chooses a representative for the Audit Committee, on which the Auditor General serves as secretary.

The NAO (or other authorised accountants) ensures that spending remains with budget directives, that there are proper accounting and control systems, and that sound economic management has been applied.

The Auditor General may audit the accounts of the government and entities owned by the government. It may also audit entities receiving any kind of financial support from the Faroese government and audit most public agencies, institutions and government foundations. The Auditor General conducts a performance audit of the results against planned goals. The Audit Committee may require the NAO to prepare reports on an extended performance audit on areas of special interest.

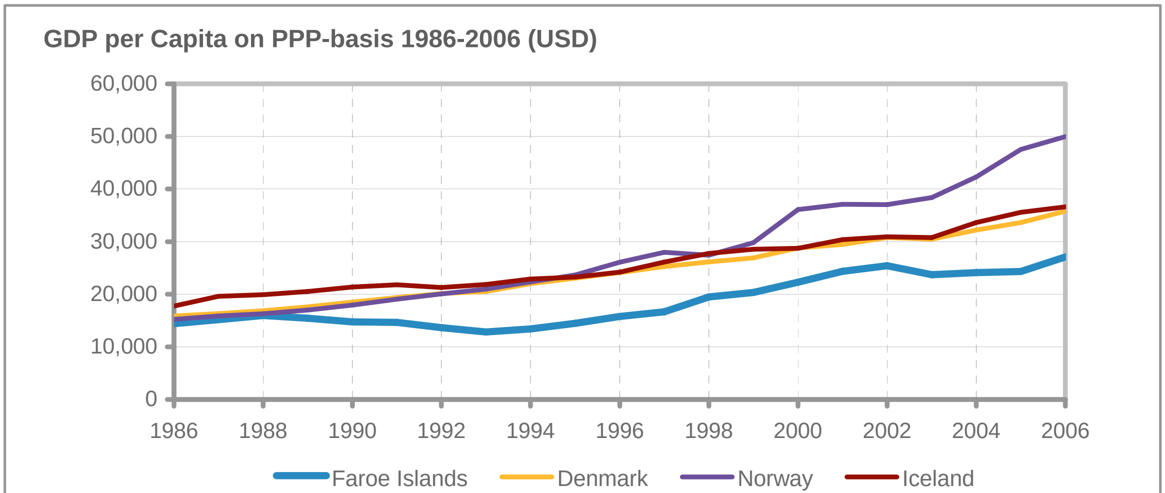
The Audit Committee has the final governmental authority to scrutinise the public accounts and to ensure their compliance with appropriation limits. Each April, the Minister of Finance presents the prior year's public accounts to the Audit Committee. Parliament then approves the accounts, based on the recommendation of the Audit Committee.

Economic Fundamentals

Since the crisis of the 1990s, the economy of the Faroe Islands has emerged as modern and market-based, with increasing diversification in its sectors. Economic output has stabilised, albeit at levels of volatility that remain high compared to those of OECD countries, due to the continuing influence of fishing and related industries. GDP per capita[17] for 2006 was US$27,084, approximately 75% of the level for Denmark, with disposable income at US$38,847, approximately 80% of Denmark's.[18] Total GDP is estimated at DKK11.9 billion for 2007.

Due to the large role of fishing, economic volatility has been higher than in other Scandinavian countries. Since 1986, growth in GDP[19] has had a standard deviation of 6.7% compared to 1.9% for Denmark.[20] Moody's anticipates the continuing dominance of fishing-related industries in the economy will keep volatility relatively high.

Figure 4:



Source: Landsbanki Føroya

[17] On an estimated PPP-basis
[18] Income and GDP as a % of Denmark is an average of the last three years
[19] Measured on a PPP basis, estimated by Landsbanki Føroya
[20] Source: Landsbanki Føroya

Faroe Islands

The Faroe Islands have a high dependence on agriculture, fishing and quarrying, with fishing making up 14% of GDP. Finance and Business activities and Manufacturing compose a substantially smaller part of the Faroese economy than they do in Denmark.

Figure 5:

GDP Distribution on Industrial Basis, 2006

	Faroe Islands	Denmark
Agriculture, fishing and quarrying	15%	5%
Manufacturing	11%	15%
Electricity, gas and water supply	1%	2%
Construction	7%	6%
Wholesale and retail trade	12%	12%
Transport, post and telecommunication	10%	9%
Finance and business activities	20%	24%
Public and personal services	25%	27%

Source: Landsbanki Føroya

Currently, the fishing fleet employs 9% of the workforce and the fish-processing industry 7%, with wages and salaries representing 15% and 6% respectively of the national total. Despite the sector's continued dominance of the economy, total employment in fishing and fish processing industries has registered declines every year since 2004.

The dependence on fishing and fish farming is most visible in exports, with fish and fish products making up 94.1% of their total value in 2006. In comparison, Iceland had 52.2% of its export value from the fishing industry in 2006, a level that has been rapidly decreasing. (For further discussion of the management of the Faroese fishing industry, see Appendix 3, *The fishing industry today.*)

Historically, swings between trade deficits and surpluses begin with large imports of goods and equipment for investment. As this investment boosts production capacity, exports increase, thus rebalancing trade and driving surpluses. Given that the production of fishing-related industries may increasingly be constrained by the supply of fish, any self-correcting flows of imports and exports could depend on further progress in expanding other sectors of the national economy.

Given the stagnation of exports since 2000 and the increasing trade deficit,[21] a substantial decline in the value of fishing-related exports could have a significant impact on the economy.

Figure 6:

Trade Balance Faroe Islands

(Million DKK)	1998	1999	2000	2001	2002	2003	2004	2005	2006
Export	2,961	3,297	3,857	4,294	4,235	3,913	3,689	3,587	3,869
Import	2,497	3,176	4,163	3,983	3,717	4,677	3,610	4,298	4,483
Trade Balance	**464**	**121**	**-306**	**310**	**518**	**-765**	**79**	**-711**	**-614**
Ships excluded	468	432	185	421	636	250	37	-178	-558

Source: 1998-2003 Faroese Statistical office, 2004-2006 Landsbanki Føroya

[21] The trade deficit in 2005 is attributed to a DKK527 million increase in imports due "solely to the import of more ships"

Faroe Islands

Key trading partners are shown in the charts below:

Figure 7:

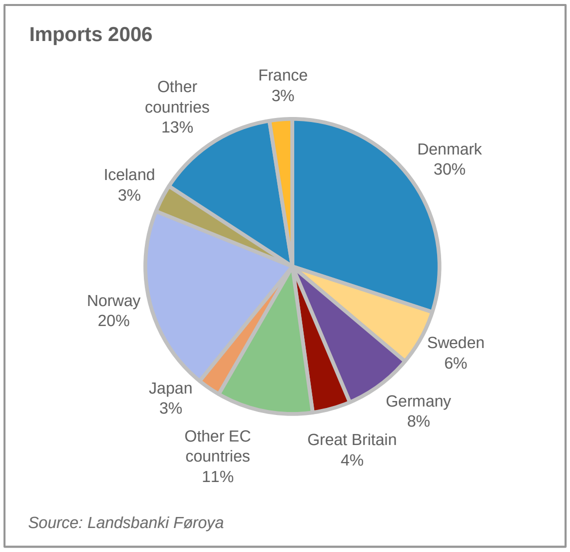
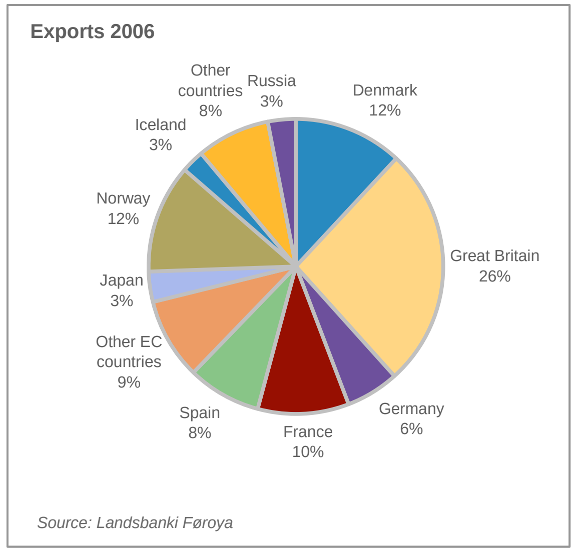


Figure 8:



The labour market of the Faroe Islands is somewhat fluid, with shifts between self-employment, employment, unemployment and employment abroad across economic cycles. Employment regulations make it easier for Faroese workers to find work abroad in Nordic and EU countries than it is to attract workers from the more limited pool of Nordic countries alone, so boom times can lead to labour shortages and inflation pressure. As the economy has recently been quite strong, unemployment stood at 1.3% as of December 2007, well below the normal range of 2% to 5%. The government has postponed investments in infrastructure, mainly to reduce overheating in the construction sector.

Oil

On 22 December 1992, the Danish government agreed to transfer mineral rights in the Faroe Islands' subsoil to the Faroese government. Oil reserves (Foinaven and Schiehallion) have been located in UK territory near the Faroese border. After some initial enthusiasm from these finds, accessible reserves within Faroese waters have not yet materialised. The outlook for future activity remains uncertain, and the government does not include oil-related revenues, other than from current or planned exploration activity, in its economic and fiscal projections.

Financial sector

The major Faroese banks have seen significant expansion on the back of the strengthening economy. Four banks – Eik Banki, Føroya Banki, Norðoya Sparikassi and Suðuroyar Sparikassi – service the financial market in the Faroe Islands. In mid-2007, Føroya Banki was privatised,[22] and Eik Banki (until 2006 Føroya Sparkassi) listed on the stock exchange. Employment in financial services grew by 8% in both 2006 and 2007. Business lending was up 56% and lending to households up by 18% in 2006. Portfolio management activities are also reported to be expanding.

[22] Føroya Banki is the result of the 1994 merger of Føroya Banki and Sjovinnubankin, and has been owned by the Financing Fund of 1992. Since 1998 the Financing Fund has been controlled by the Faroe Islands

Population

The Faroe Islands is thought to have been originally settled by persons of both Scandinavian and Irish descent. The last two centuries have seen the population increase from about 5,000 inhabitants in 1801 to almost 50,000 today, with the increase attributed to the larger economic base generated by the fishing industry. The net balance of in- and out-migration generally varies with the strength of the domestic economy. This was particularly visible during the crisis of the 1990s when the population decreased substantially, predominantly amongst the working-age segment. In recent years, high growth has seen net in-migration, due to increased consumption and investment in the islands.

The population has been increasingly urbanised due to infrastructure expansion and changes in government policy designed to support regional development over that of the villages. Tórshavn, the capital, has 18,000 inhabitants.

Due to its lack of higher education facilities, the Faroe Islands loses a significant portion of the population aged 20-29 to higher education and job-training abroad.

Connections

There are regular scheduled connections from the Faroe Islands for maritime trade to Iceland, Great Britain and the European mainland. The Islands have modern infrastructure with good roads and many tunnels, which have helped integrate and urbanise the population centres under the regional development policy. Inter-island ferries operate on all major routes. The only airport on the Islands, Vagar Airport, reports over 200,000 passengers per year. At four times the national population, this figure underscores the good international connections of the Faroese people and their participation in the international economy. Over 34,000 Faroese are Internet users.

Operating Environment

The World Bank does not evaluate the Faroes Islands in its Government Effectiveness Index. Moody's believes that the governmental effectiveness of the Faroe Islands, its promotion of the rule of law, resistance to corruption and respect for governmental institutions owe much to the cultural, institutional, and historical ties to Denmark[23] and its North Atlantic neighbours, with levels comparable to those in the OECD countries.

Institutional Framework

Under the Home Rule agreements with the Kingdom of Denmark, the Faroese government enjoys broad latitude in raising revenues and setting spending. The Faroe Islands has two seats in the Danish Parliament. This has arguably contributed to a more active consideration of the Islands' interests – sometimes with considerable benefit – within the political dialogue of the Kingdom than its small size might suggest.

Revenue flexibility

There are few legal limits on the Faroese government's ability to generate revenues. It can set its own rates for personal income taxes, VAT, import duties, corporate tax rates and other charges. These make up 87% of governmental revenues. The Faroes Islands may set fees for services as it sees fit. Current policy, like that of other Nordic countries, is to keep fees either to costs or to subsidised levels in order to meet policy goals, as determined by the democratic process.

One source of revenues with essentially no flexibility – other than downwards – is the annual subsidies from Denmark for "Joint Matters" (see below) that have not been transferred to Faroese control. As these subsidies make up a relatively small portion of governmental revenues (12.9%), revenue flexibility for the Faroese government is relatively high for a sub-sovereign entity. In Moody's view, the fixing of subsidies promotes financial discipline and removes what otherwise would be a constant point of friction in Faroese-Danish relations.

[23] Most civil servants are educated in Denmark and there are obviously intense commercial, cultural and political ties within the Kingdom.

Expense flexibility

The Faroe Islands has constitutional powers to set costs and to negotiate wages without the need for approval or to follow precedents from Denmark. This flexibility was borne out in the crisis of the 1990s, when the Faroese government cut spending by 5% in 1992 and 10% the following year. However, in the long run, due to expectations of the Faroese as citizens of the Kingdom and to the need for Faroese businesses to keep workers from migrating to neighbouring countries, wages and standards – which are two large determinants of costs – tend to follow developments in Denmark, albeit at a lower level.

Flexibility of borrowing

In the 1990s, the Faroese government borrowed – largely from the Kingdom of Denmark under distressed conditions – to fund the nationalisation of Føroya Banki and Sjovinnubankin and to bridge the government's financial plan from deficits to structural stability. As its finances stabilised in the following years, the Faroese government showed that it can use its powers effectively, by reducing debt even in times of slow growth, such as in 2004 and 2005 and by borrowing without guarantees in order to repay Denmark.

Municipal governments have substantial powers

The Faroe Islands is divided into 34 municipalities, which have substantial powers with regard to spending and infrastructure investments.[24] Faroese municipalities have the right to borrow independently and to maintain debts of up to one year of operating income.

The municipal governments undertake significant infrastructure investments and have accepted responsibility for providing children's day care, under an agreement with the Faroese national government. The populations of the municipalities range between 44 and 19,382 inhabitants. The structure of the municipalities has provoked various calls for reforms. A report published by a parliamentary committee in 1998 suggested there should be seven to nine municipalities, with clearer distinctions between their powers and the role of national government. Since then, the question of merging municipalities – and more tightly controlling their spending – has remained controversial.

Predictability and responsiveness

The current division of responsibilities between the Faroe Islands and the Kingdom of Denmark is stable, with the parties committed to change within a well-defined process. Act No. 91/2004 of the Danish Parliament grants the Faroe Islands the authority to take over all matters, except those related to full independence, without approval from the Danish authorities.

Matters under Faroese control are deemed "Special Matters". These include finance and the economy, industry, foreign trade and mineral rights, and since 2002, the educational system. The Faroese Parliament has legislative authority over these issues, and the government has full executive power in its administration. Direct taxes and other revenues of the Faroese government fund these responsibilities.

"Joint Matters" are administered by the Danish Government according to the laws of the Kingdom of Denmark. Whilst certain Joint Matters are inalienable to the Kingdom of Denmark,[25] some may be wholly or partly assigned to the Faroe Islands, or undertaken by Danish and Faroese authorities jointly. For example, social welfare and health services are administered by the Faroes, while the legislative authority for these matters remains with the Danish Government. The full division of responsibilities between the Faroe Islands and the Kingdom of Denmark is shown in Appendix 4.

[24] In 2006, operating expenditure is estimated to have been DKK0.9 billion and investments DKK0.3 billion

[25] The following Joint Matters are inalienable to the Kingdom of Denmark and are excluded from the process of increasing autonomy and potential independence: the Danish Constitution, Danish internal affairs, the Danish Supreme Court, foreign affairs, security and defence policies, currency and monetary policy

Potential independence

Moody's does not see the current path towards potential independence as problematic to the credit. The 2005 agreement with Denmark, which essentially leaves the country's final relationship in the hands of the Faroese, has reduced friction and may have muted the immediate calls for independence. Independence was not a major issue in the recent elections, and recent governing coalitions have combined pro-union and pro-independence parties.

Consensus in both the Faroes and Denmark has formed around maintaining an orderly political process with a solid financial foundation. Amongst the Faroese, most views suggest that final steps toward independence, were they to occur, could take about 15 years, as the Islands would gradually assume all of the remaining permitted Joint Matters.

It is not obvious what final independence would look like. Some form of continuing confederation with Denmark has been discussed, and it currently appears unlikely that the political, economic, and cultural ties of centuries would be cast aside lightly.

Secession of the Faroe Islands from Denmark would require a referendum.

Appendix 1. Major investment projects

The three most important capital investment projects are being funded from the Investment Fund, special purpose corporations, and the government owned Faroese telecom company, which are accounted separately from the national government's budget.

These projects are:

1. A new road tunnel between Tórshavn and Eysturoy. This is a toll tunnel build by a special purpose corporation, with the Faroese government as shareholder and debt from private lenders. The two most recently constructed tunnels in the Faroes were built as toll tunnels. [26]
2. A runway extension of 350 metres at Vágoy Airport. Estimated government funding of DKK365 million has been accumulated in the Investment Fund, and therefore does not count as current expenditure in the governmental budget.
3. Expansion of fibre-optic cable capacity between the Faroes and Iceland, and the Faroes and the UK (Shetlands). This is to be funded by the Faroese telecom company.

The investments planned to be funded within the budget are:

Figure 9:

Faroe Islands' Investment Plan

Project (DKK millions)	Total 2008-2018	2008	2009	2010	2011	2012-2015	2016-2019
Roads	1,462	116	120	111	106	427	583
Harbours	163	2	4	12	17	128	0
Airport	5	1	1	2	2	0	0
Heliports	2	2	0	0	0	0	0
Ferries	130	40	15	25	20	30	0
Strevmov-Sandov	740	20	60	60	60	240	300
Airport in Vágun	365	65	150	150	0	0	0
Maintenance and operations	778	58	59	60	62	259	280
Transport- and security measures	107	8	8	8	8	36	39
Reparations because of insufficient maintenance	161	12	12	12	13	54	58
Total	**3,914**	**323**	**429**	**441**	**288**	**1,173**	**1,259**

Source: Office of Public Works

[26] The two main tunnel projects of Vagatunnilin and Nordoyatunnilin were financed based on a BOT model. The government provided the equity, which represented around a third of the total expenditure. The remainder was raised as non-recourse debt. Since their commissioning, both projects have amortised debt faster than anticipated, as traffic volumes and revenues have exceeded the original projections. As of 31 December 2006, Vagatunnilin's debt was DKK85 million, down from DKK161 million at inception; Nordoyatunnilin's debt was DKK 249million. Operations started 29 April 2006.

Appendix 2. Economic crisis of the 1990s

The financial crisis of the 1990s has its roots in the 1970s, with other nations' extension of their national Economic Exploitation Zones. This forced the Faroese fleet out of many of its previous fishing grounds and back to its home waters, as boat-owners sought to preserve their capital, fishermen their livelihood, and the government the employment of the fleet. In a pattern that has played out in other regions, the forcing of overcapacity into a zone of finite resources resulted in over-fishing, a crash in stocks and the eventual failure of the industry's finances.

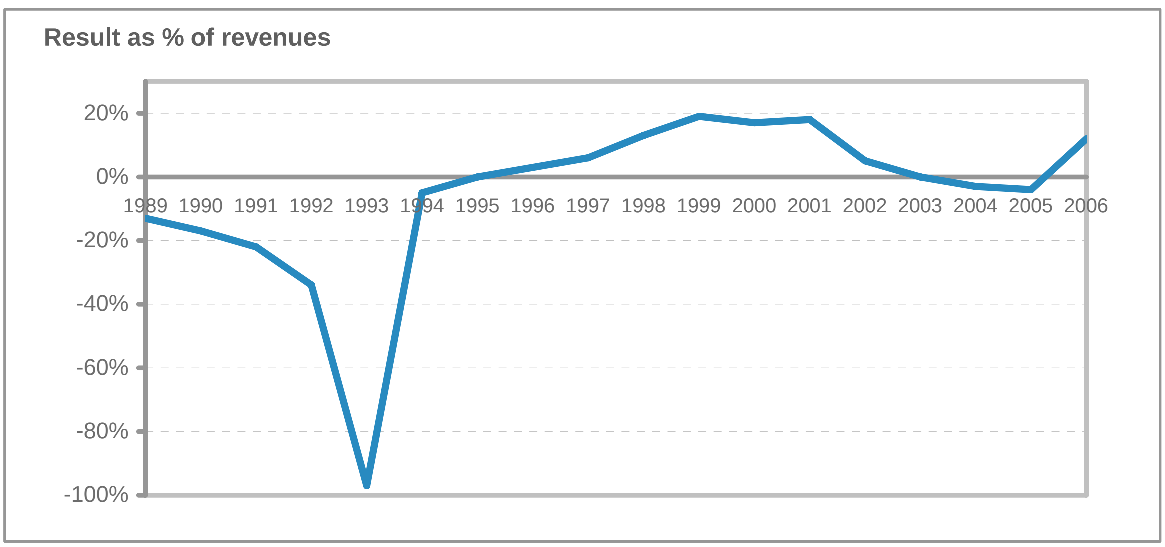
In 1992, reforms in fishing practices and the removal of government subsidies promoting overcapacity were carried out. The economy began to stabilise and the government's budget was expected to return to balance. However, by late 1992, the accumulated losses in fishing and its related industries – mainly the shipyards, transport companies and fish farms – drove widespread bankruptcies. The Faroese banks, which had funded previous expansions, were forced to write off huge amounts of loans, and were on the brink of failure.[27] The near-collapse of the banking system forced a DKK2.7 billion government bailout through privatisation. In 1993, the national budget recorded a deficit before financing of DKK2.5 billion – 97% of total cash revenues – and unemployment hit 25%.

Figure 10:

Faroe Islands Revenues, Costs and Balance

(DKK millions)	89	90	91	92	93	94	95	96	97	98	99	00	01	02	03	04	05	06
Total Revenues	3.2	2.8	2.7	2.6	2.6	2.6	2.8	2.8	3.0	3.1	3.5	3.6	3.9	3.8	3.8	3.6	3.7	4.6
Total Costs	3.6	3.2	3.3	3.5	5.0	2.8	2.8	2.7	2.9	2.7	2.8	3.0	3.3	3.6	3.8	3.8	3.9	3.9
Financing Result	-0.4	-0.5	-0.6	-0.9	-2.5	-0.1	0	0.1	0.2	0.4	0.6	0.6	0.7	0.2	0	-0.2	-0.2	0.7
Result as % of Revenues	-13	-17	-22	-34	-97	-5	0	3	6	13	19	17	18	5	0	-3	-4	12

Figure 11:



[27] Fossbankin, a relatively small bank, was allowed to fail, as it was deemed by the Faroese government that this particular bank would not have a significant impact on the banking system or the economy as a whole. Savings banks, which largely did mortgage lending, weathered the crisis.

Legacy of the crisis: reform, accountability and management of scarce resources

The economic crisis in the 1990s led to seven economic agreements between Denmark and the Faroe Islands. These were mostly related to ensuring the survival of two of the largest Faroese banks and to the accumulation of liquidity for the Faroese Treasury. The agreements also required the Faroese government to accept temporary restrictions on its borrowing and on its ability to extend loan guarantees.

The crisis forced a reduction in the Faroese fishing fleet of a third. Previously, the government had supported the fishing industry partly to subsidise employment. After this had contributed to over-capacity and inefficiency in the industry - not to mention cost to the government - the Faroese government decided to minimise its involvement in private commercial enterprises. It sharply reduced subsidies and guarantees and, by 1998, subsidies to businesses had been removed altogether. This rebalanced fishing capacity, reduced the pressure on fish populations and allowed the recovery of the fish stocks in Faroese waters. Subsequent higher catches and higher prices for fish restored profits to the industry and growth in the wider economy. In turn, government finances recovered with the resurgence in the large share of economically sensitive taxes.

Appendix 3. The fishing industry today

One of the most important results of the financial crisis of the 1990s has been the recognition that the management of the structure of the Faroese fishing infrastructure, and the fishing stocks in home waters, are essential to the long-term viability of the national economy. The crisis forced greater diversification within the industry. A wider range of target species from national, foreign and international fishing grounds has made the total value of the catch less variable. Despite the success of diversification, volumes and price by individual species remain volatile. Additional international cooperation and agreements could further diversify the industry.

Importantly, the lines of business within the Faroese processing industry now depend on a wider range of species, a broader range of fishing grounds, more product types and more of the production and processing chain. The fishing-related industries are diversified in the following way:

1. Fishing and fish farming:
   - **Fishing in other territorial waters,** based on bilateral agreements between the Faroese government and other governments or agreements with individual fishing companies and countries providing licences.
   - **Local ground fishing** on the continental shelf regulated by the Faroese government, undertaken via the method of licences for fishing days.
   - **Pelagic fishing** with a relatively new system of quotas based on international quota agreements.
   - **Fish farming,** covering seven operators in a licensing system. Fish farming had been a small but growing sector of the fishing industry, but collapsed earlier in the decade due to epidemics in the stock. Production in 2006 stood at less than a third of its 2003 level. Projections for 2007 and 2008 are for a recovery to approximately 50% of earlier levels.
2. **Processing.** Approximately 85% of the catch is caught close to shore and processed on the Faroe Islands. Some production is also conducted directly on bigger Faroese ships. Other elements of the fishing-related industries include machinery and equipment for fishing and fish farming, and computer systems for monitoring fish processing.

The largest part of the catch by value in 2006 was pelagic fishing and fishing from large factory trawlers, primarily in the Barents Sea. These made up 46% of the catch.

The catch does not depend on local waters alone. Some 35% to 40% of the total value of the catch comes from fishing in foreign waters and on the high seas. Most of the fishing in foreign waters involves granting reciprocal rights to foreign countries in the Faroese Exclusive Economic Zone.

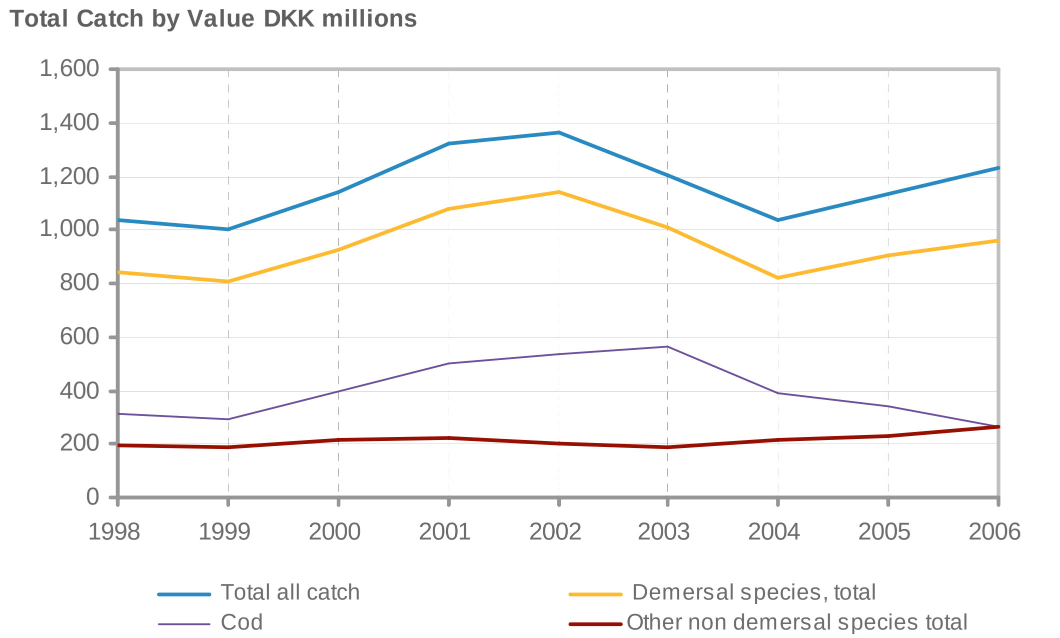
At present, the fishing industry relies very little on subsidies, although some indirect measures, e.g. tax breaks for fishermen, have been implemented instead. The goal is profit maximisation and consequently a lower proportion of the population is active in both the fleet and the processing industry.

Diversification of species within the catch

As can be seen in the chart below, in spite of the decline of cod, the total value of the catch has increased in the last two years. The catches of saithe (*Pollachius Virens*) and other demersal species have more than compensated for the decline. Other species, such as monkfish and pelagic fishes, used for fishmeal and oil, have helped spread risk within the Faroese fleet and related industries.

The economics of even a diversified fishing industry remain challenging, however. Fish prices have risen in real terms for the past two decades, despite rolling waves of over-fishing in waters around the world and with many grounds being pushed to the barest levels of sustainability or being closed. The total volume of the catch from Faroese waters is not expected to rise from current levels, and the total volume of free-catch (non-farmed fish) has been stable globally for many years. Inelastic prices for fish over the past two decades – spurred by demand from the expanding Asian economies and shortages of key species – have compensated, and in some cases over-compensated, for declining or vulnerable supplies. Economic incentives, even on well-managed fishing grounds, tend to push stocks to stressed levels. This, many scientists believe, makes them much more vulnerable to environmental factors that would normally have modest impacts on fish health levels.

Figure 12:



Source: Ministry of Fisheries and Landsbanki Føroya

Another significant factor beyond the control of the Faroese is the impact of global warming. Biologically, the phenomenon could affect domestic stocks as well as the key international and foreign catches. Preliminary research on the impacts of a shift south in the Gulf Stream, which now warms Faroese waters, offers mixed implications. Whilst some stocks may suffer, cold-water fish such as cod could benefit.

Global warming may also open northern transport lanes hitherto blocked by Arctic ice. This would bring more ships through the Faroese waters, bringing with them the possibility of accidents and environmental damage - with potentially dramatic impacts on stressed fish populations.

Cod as an example of species management

The management of cod provides a useful example of the scientific and political processes that must work together to maintain such key resources.

Fishing rights in the waters of the Faroe Islands are governed by fishing days, which the Parliament currently grants without charge.[28] These rights are partly tradable, allowing more efficient (therefore profitable) vessels to buy rights from less efficient ones, and thereby maximise the total catch. This also allows less efficient operators to remain in business. To squeeze out what may be viewed as a subsidy to lingering overcapacity in the fleet, there have been proposals for the government to auction fishing rights. Such a move would also increase income to the government from national resources. Moody's understands that such proposals remain politically charged and, if adopted, they would probably not come into effect until 2018.

Cod fishing has a long tradition on the Faroe Islands. There has historically been substantial demand for cod as both a primary commodity for export and for processing the catch of other countries. However, over-fishing, spurred by subsidies and changes in international fishing regulations caused stocks to crash. The decline of this single species constituted a major component of the Faroese financial crisis.

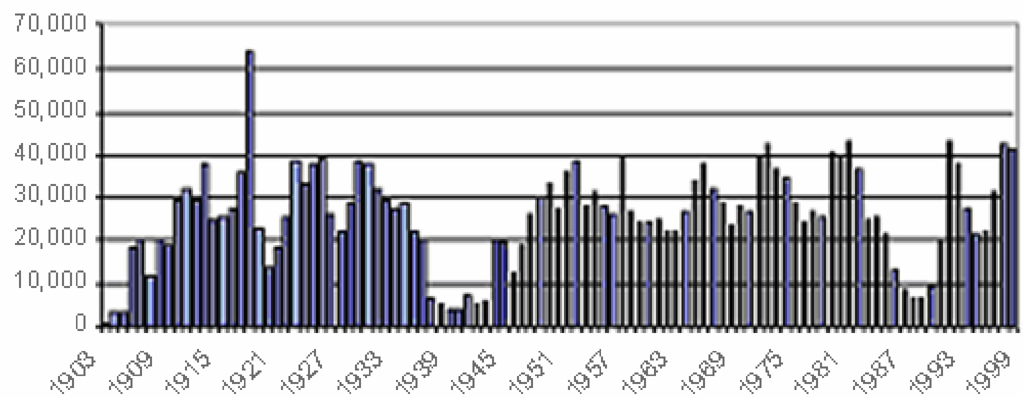
Figure 13 below illustrates of the sensitivity of this natural resource to unrestrained harvesting.

[28] The parliament grants fishing days each 1 September to 31 August based on proposals from the Minister of Fisheries. All companies that were active in fishing on 1 January 1995 gained by law the right to a permit. The parliament distributes fishing days to groups of vessel categories. Each company in a group gets its relative share of fishing days within a vessel group. All vessels in a group initially received the same amount of fishing days but some have bought or sold fishing days. They are tradable within each vessel group but not so easily between vessel groups. 25/01/2008.

Faroe Islands

Figure 13:

Catch of Cod in the Faroe Islands



Source: Faroe Ministry of Fisheries
(Records and estimates from before 1939 are not considered reliable)

Between 2004 and 2006, the demand increased sharply which increased the price of cod rose by 25%, and the profitability of the catch. Since 2002, however, both the volume and the catch of cod and haddock have declined, due to over-fishing and biological conditions. Faroese marine biologists, who report independently to the Ministry of Fishing and to Parliament, estimate that the stock of cod is at its lowest levels for 100 years. The biologists suggest cutting fishing days by 40%. The government proposed a 2% cut and extended conservation orders for certain areas, underscoring the tension of managing these issues within a democratic, free-market country.

Appendix 4. Division of responsibilities between the Faroe Islands and Denmark

Figure 14:

Faroe Islands, division of responsibilities

	Faroese Municipalities	Central Government of Faroe Islands	Danish Government
Childcare	X		
Water & Sewage	X		
Waste management	X		
Planning and zoning	X		
School buildings (maintenance)	X		
Road Maintenance	X	X	
Healthcare		X	
Public Transport		X	
Education		X	
Elderly Care		X	
Social Security		X	
Police Force			X
Judicial system			X
Banking supervision			X

Source: Landsbanki Føroya

Faroe Islands

Rating History – Issuer rating

Faroe Islands	
Rating assigned	Aa2
Date	12-Feb-08

Faroe Islands

Annual Statistics

Faroe Islands

DKK million	2002 realized	%	2003 realized	%	2004 realized	%	2005 realized	%	2006 realized	%
FINANCIAL INDICATORS										
Total revenues [1]	4,848		4,744		4,654		4,616		5,648	
Total expenses [2]	4,625		4,737		4,785		4,820		4,958	
OPERATING REVENUES										
Taxes	3,103	*64.0*	3,064	*64.6*	3,021	*65.0*	3,047	*66.0*	3,482	*68.1*
Direct tax	1,670	*34.4*	1,577	*33.2*	1,534	*33.0*	1,503	*32.6*	1,676	*32.8*
Indirect tax	1,433	*29.6*	1,487	*31.4*	1,486	*32.0*	1,543	*33.5*	1,806	*35.3*
Intergovernmental revenues	819	*16.9*	810	*17.1*	804	*17.3*	793	*17.2*	781	*15.3*
From the State (general grants)	670	*13.8*	659	*13.9*	673	*14.5*	661	*14.3*	658	*12.9*
From the Municipalities and Governmental institutions	149	*3.1*	152	*3.2*	131	*2.8*	132	*2.9*	123	*2.4*
Other [3]	925	*19.1*	868	*18.3*	826	*17.8*	774	*16.8*	850	*16.6*
Total operating revenues	4,848	*100.0*	4,743	*100.0*	4,650	*100.0*	4,613	*100.0*	5,113	*100.0*
OPERATING EXPENSES										
Administrative & Personnel costs	1,544	*35.3*	1,632	*36.5*	1,748	*38.2*	1,743	*37.6*	1,775	*37.7*
General expenses	2,634	*60.2*	2,654	*59.3*	2,677	*58.5*	2,755	*59.4*	2,878	*61.2*
Interest expenses	196	*4.5*	191	*4.3*	151	*3.3*	138	*3.0*	51	*1.1*
Total operating expenses	4,374	*100.0*	4,477	*100.0*	4,577	*100.0*	4,635	*100.0*	4,704	*100.0*
Primary Operating Balance	669		457		225		116		461	
Gross Operating Balance	474		266		74		-22		409	
Net Operating Balance	29		-181		-753		-453		-436	
Gross Operating Balance	474		266		74		-22		409	

Faroe Islands

Faroe Islands

DKK million	2002 realized	%	2003 realized	%	2004 realized	%	2005 realized	%	2006 realized	%
CAPITAL REVENUES										
Asset sales	0	*0.0*	0.4	*100.0*	4	*100.0*	2	*100.0*	0	*0.0*
Repayments	0	*0.0*	0	*0.0*	0	*0.0*	0	*0.0*	535	*100.0*
Interest income	0	*0.0*	0	*0.0*	0	*0.0*	0	*0.0*	0	*0.0*
Total capital revenues	0	*0.0*	0	*100.0*	4	*100.0*	2	*100.0*	535	*100.0*
CAPITAL EXPENSES										
Investments	251	*100.0*	260	*100.0*	208	*100.0*	185	*100.0*	254	*100.0*
Asset purchases	0	*0.0*	0	*0.0*	0	*0.0*	0	*0.0*	0	*0.0*
Interest expense	0	*0.0*	0	*0.0*	0	*0.0*	0	*0.0*	0	*0.0*
Other	0	*0.0*	0	*0.0*	0	*0.0*	0	*0.0*	0	*0.0*
Total capital expenses	251	*100.0*	260	*1.0*	208	*1.0*	185	*1.0*	254	*1.0*
Gross Capital Balance (before Reserve Transfers)	-251		-260		-204		-183		281	
FINANCING DEFICIT/SURPLUS	223		6		-130		-205		690	

Faroe Islands

Faroe Islands

DKK million	2002 realized	%	2003 realized	%	2004 realized	%	2005 realized	%	2006 realized	%
DEBT INDICATORS										
DEBT MOVEMENTS										
Gross new borrowings	300		1,495		750		1,924		0	
Debt repayment	445		2,201		827		2,001		977	
Mandatory	445		448		827		431		846	
Early	0		1,753		0		1,571		131	
Change in debt	-145		-706		-77		-77		-977	
TOTAL BUDGET BALANCE	78		-700		-207		-282		-287	
DEBT STOCK										
Direct debt	5,125	*97.0*	4,383	*97.3*	4,136	*97.7*	4,209	*98.1*	3,316	*98.3*
Short-term	726	*13.8*	683	*15.1*	483	*11.4*	584	*13.6*	592	*17.5*
Long-term	4,398	*83.3*	3,701	*82.1*	3,653	*86.3*	3,625	*84.5*	2,725	*80.7*
Guaranteed debt	157	*3.0*	123	*2.7*	97	*2.3*	81	*1.9*	59	*1.7*
Indirect debt	0	*0.0*	0	*0.0*	0	*0.0*	0	*0.0*	0	*0.0*
Other	0	*0.0*	0	*0.0*	0	*0.0*	0	*0.0*	0	*0.0*
Total debt	5,281	*100.0*	4,506	*100.0*	4,233	*100.0*	4,290	*100.0*	3,375	*100.0*
DEBT SERVICE										
Interest expenses	196	*30.6*	191	*8.0*	151	*15.5*	138	*6.4*	51	*5.0*
Debt repayment	445	*69.4*	2,201	*92.0*	827	*84.5*	2,001	*93.6*	977	*95.0*
Total debt service	640	*100.0*	2,392	*100.0*	978	*100.0*	2,139	*100.0*	1,029	*100.0*

Faroe Islands

Faroe Islands

DKK million	2002 realized	%	2003 realized	%	2004 realized	%	2005 realized	%	2006 realized	%
KEY RATIOS AND INDICATORS										
TOTAL ACCOUNTS										
Population (millions)	0.51		0.52		0.52		0.52		0.52	
Total revenue growth rate [1] (%)	--		-2.15		-1.88		-0.83		22.37	
Total expense growth rate [2] (%)	--		2.42		1.00		0.74		2.85	
Total revenues per capita	9,530		9,168		8,918		8,844		10,823	
Total expenses per capita	9,092		9,156		9,168		9,236		9,500	
Total tax revenues/ total revenues (%)	64.01		64.60		64.90		66.01		61.65	
Total intergovernmental revenues/total revenues (%)	16.90		17.08		17.27		17.18		13.82	
Financing deficit/surplus as % of total revenues (%)	4.60		0.14		-2.80		-4.43		12.22	
OPERATING ACCOUNTS										
Operating revenues/total revenues (%)	100.00		99.99		99.91		99.95		90.53	
Operating expenses/total expenses (%)	94.58		94.50		95.65		96.16		94.87	
Tax revenues/operating revenues (%)	64.01		64.61		64.96		66.04		68.10	
Intergovernmental revenues (op. related) /operating revenues (%)	16.90		17.09		17.29		17.19		15.27	
Primary operating balance/operating revenues (%)	13.81		9.64		4.84		2.51		9.01	
Gross operating balance/operating revenues (%)	9.77		5.62		1.59		-0.48		8.01	
Net operating balance/operating revenues [3] (%)	0.60		-3.83		-16.19		-9.81		-8.53	
Financing (deficit/surplus)/operating revenues (%)	4.60		0.14		-2.80		-4.43		13.50	
Tax revenues/operating expenses (%)	70.94		68.45		66.01		65.73		74.03	
CAPITAL ACCOUNTS										
Capital revenues/total revenues (%)	0.00		0.01		0.09		0.05		9.47	
Capital expenses/total expenses (%)	5.42		5.50		4.35		3.84		5.13	
Net operating balance/capital expenses (%)	11.63		-69.67		-361.77		-244.81		-171.62	

Faroe Islands

Faroe Islands

DKK million	2002 realized	%	2003 realized	%	2004 realized	%	2005 realized	%	2006 realized	%
DEBT										
Total debt growth rate (%)	--		-14.69		-6.06		1.35		-21.32	
Total debt per capita	10,381		8,708		8,110		8,220		6,467	
Total debt /total revenues (%)	108.94		94.99		90.94		92.94		59.75	
Total debt in yrs of gross operating balance (yrs)	11.15		16.91		57.39		-195.26		8.24	
Debt [4] growth rate (%)	--		-14.47		-5.64		1.77		-21.21	
Debt per capita	10,074		8,471		7,925		8,065		6,354	
Direct Debt/total revenues (%)	105.71		92.40		88.86		91.19		58.71	
Total Debt/operating revenues (%)	108.94		94.99		91.02		92.98		66.01	
Net Debt/Operating Revenues	105.71		92.41		88.93		91.23		64.86	
Net Debt/Total Revenues (%)	105.71		92.40		88.86		91.19		58.71	
Direct Debt in yrs of gross operating balance (yrs)	10.82		16.45		56.07		-191.59		8.10	
Short-term debt/direct debt (%)	14.17		15.57		11.68		13.88		17.84	
Interest expense growth rate (%)	--		-2.50		-20.75		-8.80		-62.73	
Interest expenses/total revenues (%)	4.04		4.02		3.25		2.99		0.91	
Interest expenses/operating revenues (%)	4.04		4.02		3.25		2.99		1.01	
Debt service growth rate (%)	--		273.62		-59.11		118.71		-51.91	
Debt service/total revenues (%)	13.21		50.43		21.01		46.34		18.21	
Gross new borrowings/debt (%)	5.85		34.11		18.13		45.71		0.00	
Gross new borrowings/debt repayment (%)	67.49		333.81		90.70		446.75		0.00	
Gross new borrowings/capital expenses (%)	119.64		574.12		360.26		1040.61		0.00	
Debt repayment/gross operating balance (%)	93.85		168.10		1121.01		1960.35		206.57	

Faroe Islands

Faroe Islands

DKK million	2002 realized	%	2003 realized	%	2004 realized	%	2005 realized	%	2006 realized	%
BCA SCORECARD RATIOS										
Interest Payments/Operating Revenue (%)	4.04		4.02		3.25		2.99		1.01	
Debt Service/Total Revenue	13.21		50.43		21.01		46.34		18.21	
Cash Financing Surplus(Requirement)/Total Revenue (%)	4.60		0.14		-2.80		-4.43		12.22	
Accrual Financing Surplus(Requirement)/Total Revenue (%)										
Gross Operating Balance/Operating Revenue (%)	9.77		5.62		1.59		-0.48		8.01	
Net Working Capital/Total Expenditures (%)	--		--		--		6.50		17.07	
Net Direct and Guaranteed Debt / Operating Revenue	105.7		92.4		88.9		91.2		64.9	
Short-term Gross Direct Debt/Gross Direct Debt (%)	13.8		15.1		11.4		13.6		17.5	
3 yr change in net debt / operating revenue ('03-'06)	--		--		--		-0.137		-0.30	
Intergovernmental Transfers / Operating Revenues	0.17		0.17		0.17		0.17		0.15	
Real GDP Growth	3.50		-4.00		-0.10		0.40		8.10	

ADDITIONAL INFORMATION

Faroe Islands

BALANCE SHEET	2003	2004	2005	2006
ASSETS				
Current Assets:	--	--	1,697	1,485
Fixed Assets:	--	--	2,418	2,474
Total Assets	--	--	4,115	3,959
LIABILITIES:				
Current Liabilities:	--	--	1,384	639
Long-term Liabilities:	--	--	2,825	2,677
Total Liabilities	--	--	4,209	3,316
EQUITY:	--	--	-94	643
Total Liabilities and Equity	--	--	4,115	3,959

Faroe Islands

Moody's Related Research

Statistical Handbook:

- Non-U.S. Regional and Local Governments, February 2007 (101002)

Special Comment:

- The Application of Joint Default Analysis to Regional and Local Governments, October 2006 (99025)
- Non-US Sub sovereign Cases of Default: Despite Various Potential Default Triggers, Overall Credit Quality Is Solid Albeit Not Risk-Free, December 2002 (76759)

Rating Methodology

- Local and Regional Governments Outside the US, October 2006 (100125)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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