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CREDIT OPINION
2 May 2023

Update

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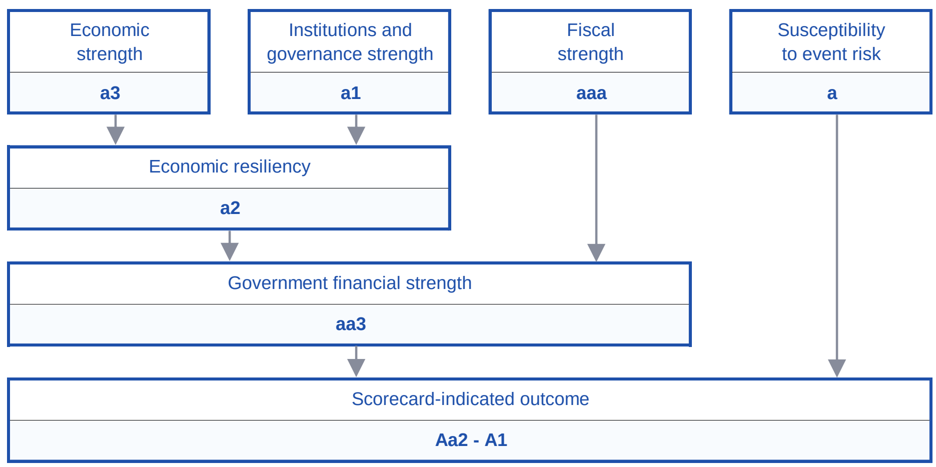
Government of Isle of Man – Aa3 negative

Regular update

Summary

The Isle of Man's (IoM) credit profile is supported by high wealth levels created against the backdrop of a long track record of robust economic growth, strong institutions, prudent fiscal policies, very low direct debt and substantial reserves. Linkages between the IoM and the United Kingdom (UK, Aa3 negative) are substantial; while these fortify the IoM's institutional strength, they also leave its credit profile exposed to the deterioration in the UK's creditworthiness.

Exhibit 1
The Isle of Man's credit profile is determined by four factors



Source: Moody's Investors Service

Credit strengths

» A wealthy and relatively diversified economy for its very small size;

» Strong institutions, pragmatic policymaking, and a prudent fiscal policy;

» Low debt and substantial reserves.

Credit challenges

» Exposure to deterioration in UK creditworthiness including uncertainty regarding the ultimate impact of Brexit;

» Economic volatility that arises from a small economic base;

» Challenges for offshore financial centres from global and regional tax coordination efforts.

Rating outlook

The negative outlook reflects the long-standing close and material institutional, economic and financial linkages between the UK and the IoM such that the UK's sovereign credit trend continues to have a significant impact on the IoM's credit profile. As a result, the increased risks to the UK's economic and fiscal prospects – given heightened unpredictability in policymaking as well as higher borrowing and high inflation – have negative consequences for the IoM's own creditworthiness, particularly given the IoM's large trade and energy dependence on the UK as well as the peg to the British pound. At the same time, the IoM's very high wealth levels and long track record of robust economic growth, as well as very strong public finances, continue to support its credit profile.

Factors that could lead to an upgrade

The negative outlook indicates that an upgrade is unlikely. An abatement of the credit challenges facing the UK, reducing the risk of consequences for the IoM's own credit profile, would lead to a stabilization in the outlook. Indications that the negative credit spillovers from the current challenges facing the UK are less significant than we expect would also support a stabilization of the outlook at the current rating level.

Factors that could lead to a downgrade

Given the material credit linkages between the IoM and the UK, a downgrade of the UK's sovereign rating would likely put pressure on the IoM's rating. Downward pressure on the rating would also arise if we were to observe a material deterioration in the IoM's own economic or fiscal position.

Key indicators

Exhibit 2

Isle of Man	2017	2018	2019	2020	2021	2022E	2023F	2024F
Real GDP (% change)[1]	3.6	1.9	0.1	-8.0	3.9	2.9	1.5	2.5
Inflation rate (% change average)	3.3	3.1	1.9	0.3	2.8	8.5	7.9	4.5
Gen. gov. financial balance/GDP (%)	0.0	-0.5	0.4	-4.2	-1.0	-1.3	-1.3	-0.6
Gen. gov. primary balance/GDP (%)	0.0	-0.5	0.4	-4.2	-0.9	-1.2	-1.2	-0.5
Gen. gov. debt/GDP (%)	0.0	0.0	0.0	0.0	7.4	6.6	6.0	5.6
Gen. gov. debt/revenues (%)	0.0	0.0	0.0	0.0	35.3	34.6	33.1	31.5
Gen. gov. interest payment/revenues (%)	0.0	0.0	0.0	0.0	0.6	0.6	0.5	0.5
Current Account Balance/GDP (%)	--	--	--	--	--	--	--	--

[1] 2019 onwards are Moody's estimates.

Source: Moody's Investors Service

Detailed credit considerations

We consider the Isle of Man's (IoM) **economic strength** to be "a3", underpinned by high wealth levels and a long track record of robust economic growth. Per-capita income is one of the highest in our universe of rated sovereigns, while real GDP growth has averaged 2.1% between 2012-2021. In 2020, the coronavirus pandemic pushed the IoM into a rare economic contraction, although it posted a robust recovery in 2021.

Despite the very small size of the economy — which we estimate at $7.5 billion in 2021, one of the smallest in our rating universe — we consider the economy to have a comparatively higher degree of diversification than many other economies of a similar size. This diversification, which has been supported by specific government policies, has proved able to sustain the economy during the global financial crisis and through the pandemic given that key sectors such as ICT, financial services and e-gaming were only moderately affected.

That said, the IoM economy's close links to that of the UK mean the weakening in the UK's growth prospects, particularly given high and potentially persistent UK inflation, will also weigh on the island's economic outlook. The IoM's large trade and energy dependence on the UK as well as the peg to the British pound means that inflation tends to closely follow that of the UK. Furthermore, the UK's departure from the European Union (EU, Aaa stable) will likely have negative repercussions for the IoM's economic prospects over the long term. The island had enjoyed indirect access to the EU Single Market for its goods via the UK, an arrangement that ended when the UK left the EU.

Institutions and governance strength is assessed as “a1”, given the country's robust and transparent institutional framework. As a Crown Dependency, although independent and self-governing, the Isle of Man benefits strongly from the UK's institutions and governance strength, which is also assessed at “a1”. The island has established a good regulatory framework for its important e-gaming sector and works closely with the UK's Prudential Regulation Authority, also because the largest banks on the island are UK-based financial institutions.

We consider the Isle of Man's fiscal policies to be forward-looking and prudent, exemplified by the large fiscal buffers that were accumulated over many years. Importantly for its status as a low-tax jurisdiction, it has a good track record of complying with international tax standards and is rated “compliant” by the OECD's Global Forum on Transparency and Exchange of Information for Tax Purposes, one of only a handful of small offshore financial centres to achieve this rating.

That said, the IoM's “zero-10” tax system has made the island, similar to other low-tax jurisdictions, vulnerable to accusations it is facilitating tax avoidance and money laundering. We expect international pressure on small financial centres, to revise their tax systems and eliminate regulatory and fiscal arbitration, is likely to remain significant in the coming years, as evidenced by the OECD/G20 two-pillar solution to reform international tax rules which was agreed in 2021.

The Isle of Man's **fiscal strength** is assessed at “aaa”. The Isle of Man benefits from a high level of overall reserves, which totaled around 30% of GDP as at end of April 2023, and very low direct debt. The Isle of Man issued its first bond in 2021 amounting to £400 million (around 7.4% of 2021 GDP), with the debt burden one of the lowest in our rated universe. The government also indirectly supports the debt issued by the combined electricity and water utility, the Manx Utilities Authority (MUA), which poses a contingent liability for the government. The MUA is in the process of building up a reserve fund out of its own resources, so as to be able to repay its two outstanding bonds, amounting to a combined £260 million (4.3% of 2022 GDP), in 2030 and 2034.

The government has maintained a conservative approach to the public finances since the global financial crisis, following a significant decline in tax revenue, and this commitment to fiscal consolidation is also supportive of the island's fiscal strength. Since 2010, the government has enacted significant spending cuts to reduce the structural deficit, including cuts to public-sector headcount and the restructuring of several government departments. A challenge for fiscal consolidation is that the IoM has relatively limited policy tools, given that the island's low tax environment constitutes a competitive advantage and that the proportion of receipts from the UK (mainly VAT) is already high. Nevertheless, we expect fiscal policy to remain prudent and to continue to have the preservation of financial reserves as a key aim.

Our “a” **susceptibility to event risk** assessment captures the island's very low external vulnerability risk given the customs relationship with the UK and the peg with sterling as well as very low government liquidity risks. The overall event risk score is driven by our assessment of political and banking sector risks.

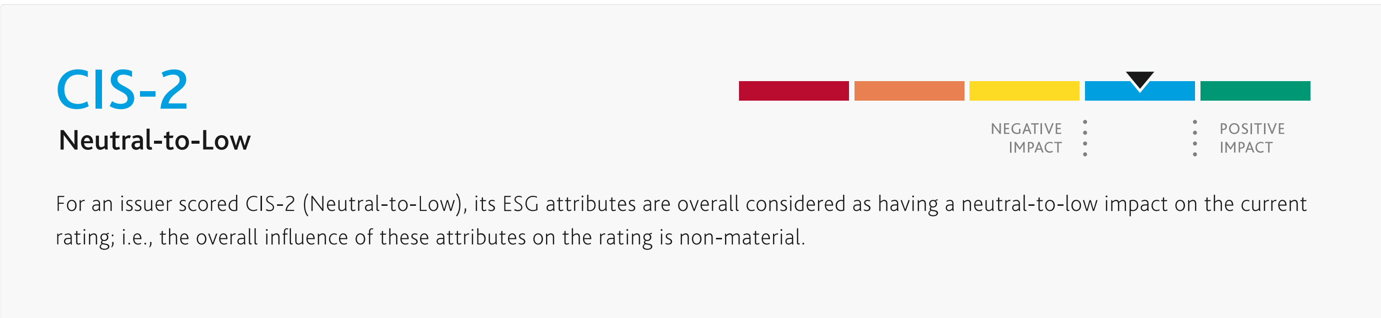
The banking sector risks mainly reflect the large size of the banking system; total assets of the banking system have fallen in recent years but were still equivalent to more than seven times the island's estimated GDP as at the end of 2021. However, nearly all of those assets (with the material exception of Conister Bank) are foreign-owned entities. A new bank resolution and recovery regime came into effect at the start of 2021, although there are limits to the extent to which the IoM authorities can mitigate the risk arising from the large share of deposits held by the branches of overseas banks. Also, rising international pressure to enhance tax transparency as well as the evolution of UK banking structural reforms could pose challenges to the financial sector. Nevertheless, the risks to the IoM's credit profile emanating from the banking sector are mitigated by the low-risk nature of the business, which is predominantly foreign-owned, and the high levels of capital.

The political risk score of "a" reflects an increased (albeit still low) risk of contagion from the Russia's invasion of Ukraine (Ca stable). The direct exposure of the IoM to security, energy and trade risks stemming from Russia's invasion is limited, in large part due to its distant location. That said, the probability of such risks materializing or generating spillovers from other European countries have become more elevated in light of the ongoing military conflict. Nevertheless, political risks are lower for the IoM than for the majority of European sovereigns, in part due to the fact that, as a non-NATO member, the IoM is not exposed to contagion security risks through the potential activation of NATO's collective defense clause.

ESG considerations

Isle of Man's ESG Credit Impact Score is Neutral-to-Low CIS-2

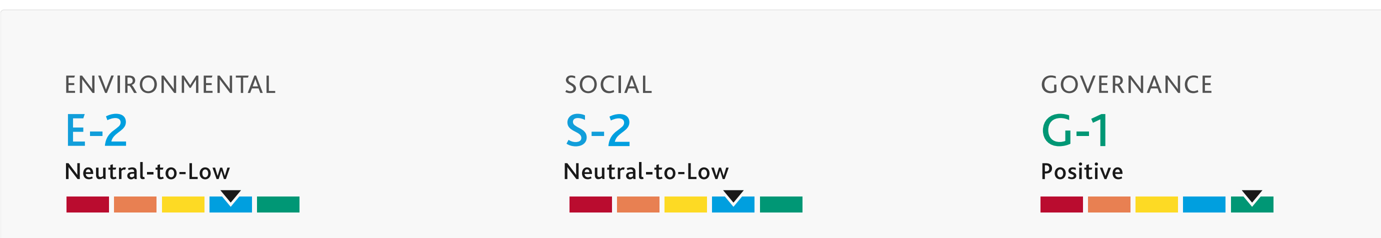
Exhibit 3
ESG Credit Impact Score



Source: Moody's Investors Service

The Isle of Man's ESG Credit Impact Score is neutral to low (**CIS-2**), reflecting low exposure to environmental and social risks and, like many other advanced economies, a very strong governance profile and in general capacity to respond to shocks.

Exhibit 4
ESG Issuer Profile Scores



Source: Moody's Investors Service

Environmental

Its overall E issuer profile score is neutral to low (**E-2**), reflecting low exposure to environmental risks across most categories. Natural capital is a particular point of strength for the IoM, as the entire island is a UNESCO biosphere reserve.

Social

We assess its S issuer profile score as neutral to low (**S-2**), reflecting low exposure to social risks over most categories as well as a strong focus on quality of life for residents, although outward migration of the population contributes to demographic challenges. Reflecting these challenges, the island relies on immigration, predominantly from the UK, to attract the skills needed to support its high value added sectors, which has become more challenging in the wake of the pandemic and Brexit.

Governance

The Isle of Man's very strong institutions and governance profile support its rating and this is captured by a a positive G issuer profile score (**G-1**). Coupled with high wealth levels and very high government financial strength, this supports a high degree of resilience.

All of these considerations are further discussed in the "Detailed credit considerations" section above. Our approach to ESG is explained in our report on how the scores depict varied and largely credit-negative impact of ESG factors and our cross-sector methodology General Principles for Assessing Environmental, Social and Governance Risks Methodology.

Recent developments

High inflation hampers activity, while weaker UK growth weighs on economic prospects

The surge in inflation as a result of the sharp rise in energy prices in the wake of Russia's invasion of Ukraine has weakened economic growth in the Island after a relatively robust recovery from the pandemic. Real GDP is estimated to have grown close to 4% in 2021 before moderating in 2022 given the negative impact of high inflation on real incomes and wider consumer confidence. We estimate that real GDP growth will moderate further to 1.5% in 2023 as inflation remains elevated, after an estimated 2.9% growth in 2022, although the Island's very high income levels will continue to provide a buffer to the rise in the cost of living. At the same time, much weaker growth prospects for the UK, particularly given the impact of higher prices and tighter financing conditions, with UK real GDP growth forecast to average just 0.2% over 2023-2024, will also weigh on the island's economic outlook.

Inflation rose significantly in 2022, peaking at 10.8% in July and averaging 9.4% over the second half of last year. Inflation has proved to be persistently high, remaining at 9.1% in March 2023. High levels of inflation have been driven largely by the substantial increases in energy prices, particularly given the importance of gas in electricity generation. Gas prices nearly trebled over the course of 2022, although the fall in wholesale prices has prompted cuts to tariffs since late last year. At the same time, a 51% hike in electricity prices is planned to be phased in during April and July this year, following the end of a six-month electricity price freeze which has shielded consumers from volatility in the energy market.

The economic outlook faces risks from the potential for higher inflation to give rise to second-round effects and become more persistent, particularly if strong price growth were to become embedded in higher wages. A further large rise in energy prices as well as the risk of a wider European gas shortage in winter 2023 also poses risks to the economic outlook. Energy prices and the island's broader energy security are strongly correlated with the UK given the IoM's dependence on the UK for gas and electricity imports

Public finances face risks from persistent inflation although reserves continue to provide a strong buffer

The government finances improved in recent years after the pandemic drove an overall deterioration of the island's public finances, on account of higher health spending and economic support, as well as weaker tax revenue. The government's recently announced budget (Pink Book) estimates that the budget deficit (excluding transfers from reserves) in the 2022-23 fiscal year was £144.4 million, higher than the budgeted £97.4 million given the impact of higher inflation and need for additional financial support during the energy crisis. The new budget for 2023-24 forecasts a slight increase in the deficit to £152.9 million as inflationary pressures are not expected to abate in the short-term.

The government's latest Pink Book forecasts a gradual decline in the structural budget deficit over the next four years, which will continue to be funded from the IoM's substantial reserve funds rather than by issuing debt for that purpose. Previous plans by the government to move to a structural surplus by 2024-25 won't be met given higher spending on health and social care as well as the government's extensive capital programme.

As part of the budget, the government outlined a new five year £442 million capital development plan, including £115 million allocated for the 2023-24 fiscal year, with a focus on improving the port and highway infrastructure, hospital equipment as well as measures to support climate change adaptations as part of achieving the government's net-zero carbon emissions target by 2050. The government plans for its ambitious capital expenditure programme to be fully financed from its revenues by 2027-28, one year later than previously planned, which will support the gradual move towards a balanced budget. To address the low project delivery rates, the government has also amended the capital approvals process to allow departments to seek approval for funding on a more frequent basis, rather than yearly, from 2023.

We project, according to our general government definition, the budget deficit will remain around 1.3% of GDP in 2023, a similar level as seen in 2022, before declining below 1% of GDP in 2024. Revenue from direct taxation is forecast to return back to prepandemic levels in 2023-24 and grow by 4% per year thereafter, helped by a reduction in the tax-free allowance for higher earners, while government expenditures will continue to face pressures from health, benefit and pension spending.

More persistent inflation poses a risk to budget performance as the government may face demands to provide further fiscal support to alleviate the rise in the cost of living, challenging efforts to reduce the structural budget deficit in the wake of the pandemic. The government has provided around £18 million (0.1% of 2022 GDP) in direct financial support since 2022 and the cap on electricity prices - which is estimated to cost up to £26 million (0.4% of 2022 GDP), to be funded via a 20 year loan to Manx Utilities - is due to expire at end March 2023.

Furthermore, the sizable funding gap in Health Care sector, estimated at around £170 million (2.8% of 2022 GDP) through to the end of the budget's five-year forecast, poses a risk to the government achieving a balanced budget by 2027-28. During the current year, the gap is being partially met through the investment income of the Manx National Insurance Fund and a plan to sustainably finance the gap from 2024-25 is to be outlined in due course.

The deficit will continue to be financed through the use of reserves, built up due to the robust fiscal surpluses that the government recorded prior to the global financial crisis, which provides an important buffer to offset recent shocks and in the face of heightened risks to the economic outlook. The market value of total externally invested funds stood at an estimate £1.8 billion (around 30% of 2022 GDP) in March 2023, with a significant proportion held in the National Insurance Fund used for the financing of the employee support programmes. The latest budget envisages reserves growing moderately to around £1.9 billion by 2027-28.

New draft economic strategy aims to further develop the domestic economy and raise the resident population

The government's newly published long-term economic strategy, approved by Tynwald (the Parliament of the IoM) in November 2022, aims to grow the number of residents on the island to 100,000 by 2037, from around 84,000 now, as part of efforts to increase the size of the economy to £10 billion and raise government revenue by £200 million. The strategy envisages an investment programme of £1 billion that will be supported by an initial £100 million Economic Strategy Fund focused on initiatives that encourage immigration and investments in skills and productivity; broaden the tax base; and invest in the island's Climate Change Action Plan, including offshore wind production.

This draft strategy is more comprehensive than previous incarnations as, in addition to supporting the island's export sectors, it also aims to develop the domestic economy in order to be able to better attract and retain labour. The biggest long-term structural risk to the island's continuing economic success revolves around access to skilled labour, and the ability to attract the skills needed to support its high value added sectors has become more challenging in the wake of the pandemic and Brexit. Unemployment remains low at 0.7% in February 2023 and the number of job vacancies remains close to record highs, while outward migration of the population, particularly university graduates, contributes to demographic challenges.

Moody's rating methodology and scorecard factors: Isle of Man - Aa3 negative

Factor / Sub-Factor	Metric	Indicator Year	Indicator	Initial Factor Score	Final Factor Score	Weights
Factor 1: Economic strength				--	a3	50%
Growth dynamics	Average real GDP growth (%)	2017-2026F	2.5	baa3		25%
	MAD Volatility in Real GDP Growth (%)	2012-2021	1.3	baa3		10%
Scale of the economy	Nominal GDP ($ billion)	2021	7.5	caa3		30%
National income	GDP per capita (PPP, Intl$)	2021	--	--		35%
Adjustment to factor 1	*# notches*				0	max ±9
Factor 2: Institutions and governance strength				a1	a1	50%
Quality of institutions	Quality of legislative and executive institutions			a		20%
	Strength of civil society and the judiciary			a		20%
Policy effectiveness	Fiscal policy effectiveness			aa		30%
	Monetary and macroeconomic policy effectiveness			a		30%
Specified adjustment	Government default history and track record of arrears				0	max -3
Other adjustment to factor 2	*# notches*				0	max ±3
F1 x F2: Economic resiliency				--	a2	
Factor 3: Fiscal strength				aaa	aaa	
Debt burden	General government debt/GDP (%)	2021	7.4	aa1		25%
	General government debt/revenue (%)	2021	35.3	aa1		25%
Debt affordability	General government interest payments/revenue (%)	2021	0.6	aaa		25%
	General government interest payments/GDP (%)	2021	0.1	aaa		25%
Specified adjustments	*Total of specified adjustment (# notches)*			2	2	max ±6
	Debt Trend - Historical Change in Debt Burden	2013-2021	7.4	0	0	
	Debt Trend - Expected Change in Debt Burden	2021-2023F	-1.3	0	0	
	General Government Foreign Currency Debt/ GDP	2021	0.0	0	0	
	Other non-financial public sector debt/GDP	2021	0.0	0	0	
	Government Financial Assets including Sovereign Wealth Funds / GDP	2021	36.8	2	2	
Other adjustment to factor 3	*# notches*				0	max ±3
F1 x F2 x F3: Government financial strength				--	aa3	
Factor 4: Susceptibility to event risk				a	a	Min
Political risk				a		
	Domestic political risk and geopolitical risk			a		
Government liquidity risk				aaa	aaa	
	Ease of access to funding			aaa		
Specified adjustment	High refinancing risk				0	max -2
Banking sector risk				a	a	
	Risk of banking sector credit event (BSCE)	Latest available	--	aaa-a3		
	Total domestic bank assets/GDP	2021	728.6	80-180		
Adjustment to F4 BSR	*# notches*				0	max ±2
External vulnerability risk				aa	aa	
	External vulnerability risk			aa		
Adjustment to F4 EVR	*# notches*				0	max ±2
Overall adjustment to F4	*# notches*				0	max -2
F1 x F2 x F3 x F4: Scorecard-indicated outcome				-	Aa2 - A1	

Note: While information used to determine the grid mapping is mainly historical, our ratings incorporate expectations around future metrics and risk developments that may differ from the ones implied by the scorecard-indicated outcome. Thus, the rating process is deliberative and not mechanical, meaning that it depends on peer comparisons and should leave room for exceptional risk factors to be taken into account that may result in an assigned rating outside the scorecard-indicated outcome. For more information please see our Sovereign Ratings Methodology.

Footnotes: (1) Initial factor score: scorecard indicators combine with the automatic adjustments to produce an initial factor score for every rating factor, as detailed in Moody's Sovereign Ratings Methodology. **(2) Final factor score:** where additional analytical considerations exist, initial factor scores are augmented to produce a final factor score. Guidance on additional factors typically considered can be found in Moody's Sovereign Ratings Methodology; details on country-specific considerations are provided in Moody's research. **(3) Scorecard-indicated outcome:** Factor 1: Economic Strength, and Factor 2: Institutions and Governance Strength, combine with equal weight into a construct we designate as Economic Resiliency (ER). An aggregation function then combines ER and Factor 3: Fiscal Strength, following a non-linear pattern where Fiscal Strength has higher weight for countries with moderate ER and lower weight for countries with high or low ER. As a final step, Factor 4, a country's Susceptibility to Event Risk, is a constraint which can only lower the government financial strength as given by combining the first three factors. **(4) There are 20 ranking categories for quantitative sub-factors:** aaa, aa1, aa2, aa3, a1, a2, a3, baa1, baa2, baa3, ba1, ba2, ba3, b1, b2, b3, caa1, caa2, caa3, ca and 8 ranking categories for qualitative sub-factors: aaa, aa, a, baa, ba, b, caa, ca **(5) Indicator value:** if not explicitly stated otherwise, the indicator value corresponds to the latest data available.

REPORT NUMBER 1359921

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