

CREDIT OPINION

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Update

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Government of Isle of Man – Aa3 stable

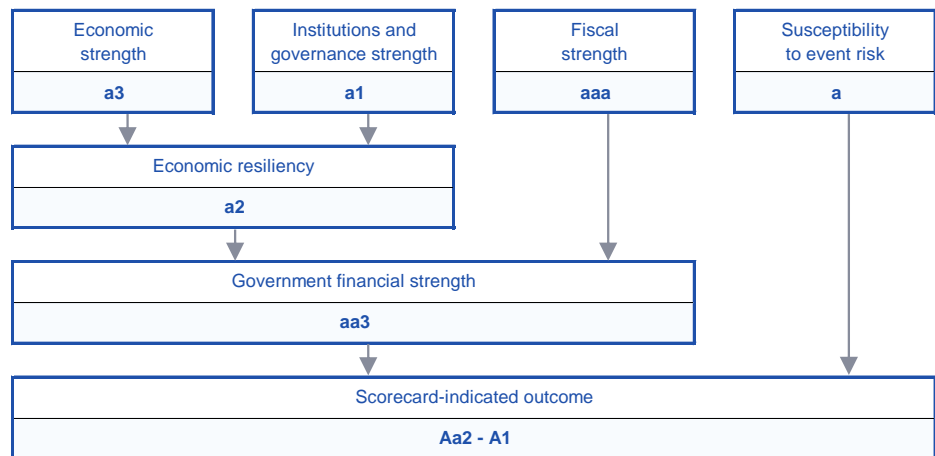
Update following downgrade to Aa3, outlook change to stable

Summary

The [Isle of Man's](#) (IoM, Aa3 stable) credit profile is supported by high wealth levels created by a long track record of strong economic growth, strong institutions and prudent fiscal policies. Moreover, the IoM has no direct debt. Linkages between the IoM and the [United Kingdom](#) (UK, Aa3 stable) 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 and the impact of Brexit.

Exhibit 1

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



Source: Moody's Investors Service

Credit strengths

- » A wealthy and also a relatively diversified economy for its very small size;
- » Strong institutions, pragmatic policy making, and a prudent fiscal policy; and
- » No outstanding debt and substantial reserves.

Credit challenges

- » High level of uncertainty regarding the impact of Brexit;
- » Economic volatility that can be associated with a small economic base; and

» Challenges for off-shore financial centres from global and regional tax coordination efforts.

Rating outlook

The IoM's credit strengths support a stable outlook on the Aa3 rating. Very high wealth levels provide a significant buffer against shocks, and the IoM has a long track record of strong GDP growth, with low volatility.

Another important credit strength are the Isle of Man's very strong public finances. A prudent approach to managing government finances has resulted in a high level of overall reserves through which fiscal deficits are financed, rather than through debt issuance. As a result, the IoM has no direct debt. Fiscal policies are forward-looking and prudent, exemplified by the large fiscal buffers (equivalent to around 30% of estimated 2019 GDP) that were accumulated over many years.

Factors that could lead to an upgrade

Upward pressure on the IoM's rating is unlikely over the medium-term due to the credit challenges that the UK faces. Technological or regulatory changes to key industries in the IoM, such as insurance, e-gaming, ICT, or banking could be material for the credit profile in either a positive or negative way given concentration in these sectors.

Factors that could lead to a downgrade

Given the material linkages between the IoM and the UK, a downgrade of the UK's sovereign rating could put pressure on the IoM's rating, though if the IoM's intrinsic credit strengths remained intact it is possible that the trajectory of the IoM and UK ratings could begin to diverge somewhat. Downward pressure on the rating would also arise if we were to observe a material deterioration in the IoM's economic or fiscal position.

Key indicators

Isle of Man	2014	2015	2016	2017	2018	2019E	2020F	2021F
Real GDP (% change)[1]	5.0	-0.9	7.4	3.6	1.9	3.3	-0.7	5.2
Inflation (CPI, % change, Dec/Dec)	0.2	-1.6	1.0	4.1	2.5	2.1	0.6	2.5
Gen. gov. financial balance/GDP (%)	-0.5	0.1	-0.3	0.0	-0.5	-0.7	-4.4	-0.9
Gen. gov. primary balance/GDP (%)	-0.5	0.1	-0.3	0.0	-0.5	-0.7	-4.4	-0.9
Gen. gov. debt/GDP (%)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gen. gov. debt/revenues (%)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gen. gov. interest payment/revenues (%)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Current Account Balance/GDP (%)	--	--	--	--	--	--	--	--

[1] 2019 onwards are Moody's estimates.

Source: Moody's Investors Service

Detailed credit considerations

On 23 October 2020, we downgraded the Isle of Man's long-term issuer and senior unsecured ratings to Aa3 from Aa2 and changed the outlook to stable from negative. This reflects our view that the correlation of credit risks between the UK and the IoM remains material; this means that an erosion in the UK's credit profile, such as that reflected in the 16 October downgrade of the UK's rating to Aa3 with a stable outlook, also affects the IoM's credit profile and, therefore, its rating.

We consider the Isle of Man's (IoM) **economic strength** to be "a3", underpinned by high wealth levels and a track record of strong economic growth. Per-capita income is one of the highest in our universe of rated sovereigns at around \$86,000, while real GDP growth has averaged 3.2% over the last decade of available data (2009/10 - 2018/19). The coronavirus outbreak is nevertheless likely to push the IoM into economic contraction, for only the second time in the past three decades.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moody's.com for the most updated credit rating action information and rating history.

Despite the very small size of the economy — which we estimate at \$7.3 billion as of 2019, one of the smallest in our global 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 financial crisis.

Notwithstanding that diversity, the IoM's economy has close links to that of the UK, and we believe that the UK's decision to leave the [European Union](#) (EU, Aaa stable) will likely have negative repercussions for the Isle of Man's economic prospects. The IoM shares a de facto currency union with the UK and the UK is the prime market for the island. The island currently has indirect access to the EU Single Market for its goods via the UK, an arrangement that will end when the UK leaves 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.

The Isle of Man's **fiscal strength** is considered to be "aaa", given the absence of direct general government debt and the high level of overall reserves, which total around 30% of estimated GDP. The government indirectly supports the debt issued by the combined electricity and water utility, the Manx Utilities Authority (MUA). 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 (around 4.8% of GDP), in 2030 and 2034.

The government's commitment to fiscal consolidation is also supportive of the island's fiscal strength. The prospect of significantly lower tax revenues as a result of the renegotiation with the UK government on the level of the island's share in customs duties and VAT revenues have prompted the government to embark on a multi-year fiscal adjustment programme. The programme has focused on increasing efficiencies in the public sector and reducing the public-sector wage bill and pensions outlays.

At the same time, the government intends to increase capital spending significantly, which will likely result in small overall budget deficits. Deficits will continue to be funded from the reserve funds rather than by issuing debt. 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.

Our "a" **susceptibility to event risk** assessment reflects the island's very low political and government liquidity risks and the absence of external vulnerability risk given the customs relationship with the UK and the peg with the Pound Sterling. The overall score is driven by our assessment of banking sector risks, which mainly reflects 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 six times the island's estimated GDP as of December 2019. It is worth noting that nearly all of those assets (with the exception of Conister Bank) are foreign-owned entities. Also, rising international pressure to enhance tax transparency could pose challenges to the island's banking system. However, the risks 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.

ESG considerations

How environmental, social and governance risks inform our credit analysis of the Isle of Man

Moody's takes account of the impact of environmental (E), social (S) and governance (G) factors when assessing sovereign issuers' economic, institutions and governance and fiscal strength and their susceptibility to event risk. In the case of the Isle of Man, the materiality of ESG to the credit profile is as follows:

Environmental considerations are not material to the rating.

Social risks affect the IoM's credit profile, given demographic pressures and a falling birth rate. Outward migration of the native population is also responsible for the tight labour market, particularly university graduates, many of whom do not return to the island following their studies.

In terms of governance, the IoM benefits from a robust and transparent institutional framework.

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 ESG risks influence sovereign credit profiles](#) and our cross-sector methodology [General Principles for Assessing ESG Risks](#).

Recent developments

The economic impact of the coronavirus-induced shock has so far been relatively limited, but will drive a historically large deficit

The coronavirus-induced shock has brought considerable pressures on the UK economy: we project the latter to contract by 10.1% this year. By contrast, the impact of the crisis on the IoM is likely to be relatively limited, and mitigated by the authorities' effective response on the health front. We forecast a contraction of around 0.7% this year, followed by a robust recovery in 2021. The IoM's borders remain closed, and only residents and people with an exemption or using an air bridge with Guernsey can travel to the island. This means that new coronavirus cases have been extremely low.

The impact on key sectors such as ICT and e-gaming (which account for around a quarter of gross value added in the latest national accounts) has been less pronounced than for other types of services, while successful containment measures enabled lockdown restrictions to be gradually lifted since the end of April (social distancing requirements were removed in June and the island has successfully organized several large events). Hospitality and tourism, two of the sectors likely to see the slowest pace of normalisation in activity despite a rise in domestic tourism, account for only 1% of the island's gross value added (GVA). Unemployment rose from 0.9% in February to a peak of 3% in May, but has since come down to 2.1% as of September on the back of a partial labour market recovery.

The pandemic will drive an overall deterioration of the island's public finances this year, on account of higher health spending and economic support, as well as significantly weaker tax revenue. According to the government's amended budget (Purple Book) presented to Tynwald in July, expenditure for the two employee support schemes is projected to reach £51.7 million (0.9% of estimated GDP) over the full financial year. This is around half of the government's initial estimate, despite the extension of the schemes. Departmental spending is also likely to be affected, most notably the Department of Health and Social Care (DHSC), the net expenditure of which is expected to rise by £7.1 million from the level outlined in the initial budget for this year.

However, the most material impact will be on the revenue side. The Purple Book outlines three scenarios for general taxation income, in which revenue is expected to fall by between £120.5 million and £191.3 million (2.1% to 3.3% of GDP). An additional impact on revenue is expected to come from the UK's temporary VAT cut for food and leisure attractions, part of the measures outlined in the Chancellor's July 8 Summer Statement. Overall, we project the general government deficit to reach around 4.4% of GDP, although uncertainty around this forecast is significant at this stage.

The deficit and funding for the support schemes will be met through the use of reserves, which provide an important buffer to offset the current economic shock. The IoM's reserves, built up due to the robust fiscal surpluses the government recorded prior to the global financial crisis, remain among the strongest across the sovereigns that we rate and support the island's fiscal strength. The market value of total externally invested funds stood at £1,749 million (around 30% of estimated 2019 GDP) in March 2019, with a significant proportion held in the National Insurance Fund (£897 million) used for the financing of the employee support programmes. The value of these funds has diminished somewhat in light of the coronavirus-related measures and market movements, but these declines are not large. For example, in its budget update presented on 21 July 2020, the government estimated that the National Insurance Fund would be worth £832.2 million by the end of the 2020/21 financial year.

The IoM also has a number of internally invested funds and reserves to help fund costs which are difficult to predict given their unforeseen nature or inherent volatility; these include a newly created £100 million Economic Recovery Fund, intended to support the

economy's recovery from the coronavirus shock through strengthening businesses, promoting innovation and new business sectors, creating training and employment opportunities, and accelerating capital infrastructure projects.

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

				Initial	Final	Weights
				Factor score		
Factor 1: Economic strength				--	a3	50%
Growth dynamics	Average real GDP growth (%)	2015-2024F	3.0	baa2		25%
	Volatility in real GDP growth (%)	2010-2019	2.2	baa2		10%
Scale of the economy	Nominal GDP (\$ billion)	2019	7.3	caa3		30%
National income	GDP per capita (PPP, Int\$)	2019	--	--		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 (%)	2019	0.0	aaa		25%
	General government debt/revenue (%)	2019	0.0	aaa		25%
Debt affordability	General government interest payments/revenue (%)	2019	0.0	aaa		25%
	General government interest payments/GDP (%)	2019	0.0	aaa		25%
Specified adjustments	Total of specified adjustment (# notches)			0	0	max ±6
	Debt trend	2016-2021F	0.0	0	0	
	Foreign currency debt/general government debt	2019	0.0	0	0	
	Other non-financial public sector debt/GDP	2019	4.8	0	0	
	Public sector assets/general government debt	2019	0.0	0	0	
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				aa		
	Domestic political risk and geopolitical risk			aa		
Government liquidity risk				aaa		
	Ease of access to funding			aaa		
Specified adjustment	High refinancing risk				0	max -2
Banking sector risk				a		
	Risk of banking sector credit event (BSCE)	Latest available	baa3	aaa-a3		
	Total domestic bank assets/GDP	2019	663.5	80-180		
Adjustment to F4 BSR	# notches				0	max ±2
External vulnerability risk				aaa		
	External vulnerability risk			aaa		
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.

Moody's related publications

- » **Credit Analysis:** [Government of Isle of Man – Annual credit analysis](#), 28 July 2020
- » **Outlook:** [Global Macro Outlook 2020-21 \(August 2020 Update\): Economic recovery remains tenuous as pandemic fears persist](#), 25 August 2020
- » **Rating Methodology:** [Sovereign Ratings Methodology](#), 25 November 2019

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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