MOODY'S
INVESTORS SERVICE

CREDIT OPINION
1 November 2023

Update

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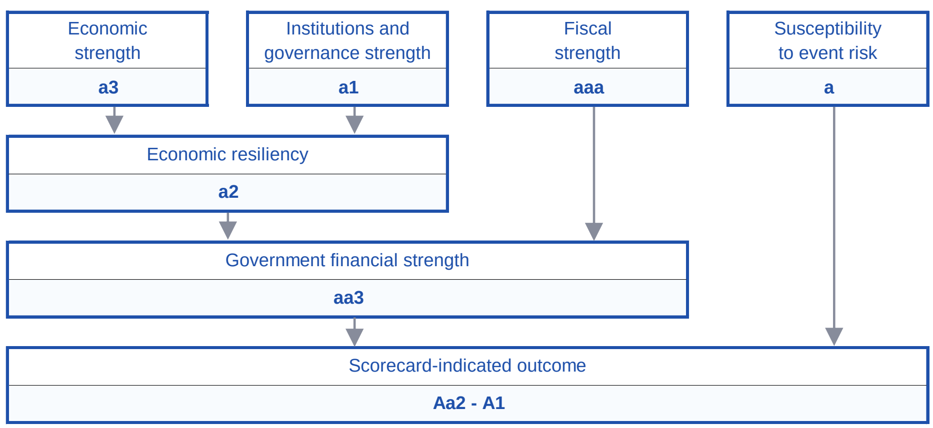
Government of Isle of Man – Aa3 stable

Update following change in outlook to stable; rating affirmation

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 stable) are substantial; while these fortify the IoM's institutional strength, they also leave its credit profile exposed to a potential deterioration in the UK's creditworthiness. At the same time, the IoM's inherent significant credit strengths will continue to help the island to manage the impact of structural challenges facing a small low-tax jurisdiction, including around access to skills and global pressure to revise its tax system.

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.

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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 posed by global pressure to revise its tax system.

Rating outlook

The stable outlook reflects our view that the restoration of UK policy predictability following the mini-budget episode supports a stabilisation in the IoM's credit profile. The longstanding close institutional, economic, and financial linkages between the IoM and the UK remain material such that the UK's sovereign credit trend continues to have a significant impact on the IoM's credit profile. In particular, the expected tightening in UK fiscal policy will be supportive of efforts to bring down UK inflation, which will feed through to lower inflation in the IoM, alleviating the downside risks to the IoM's economy and public finances from persistently high inflation.

The stable outlook also reflects our view that the IoM's inherent significant credit strengths, including its relatively diverse economy and proactive policymaking, will continue to help the island to manage the impact of structural challenges facing a small low-tax jurisdiction, including around access to skills and global pressure to revise its tax system. At the same time, the IoM's very high wealth levels and very strong public finances continue to support its credit profile.

Factors that could lead to an upgrade

In light of the material credit linkages between the IoM and the UK, the IoM's ratings could be upgraded if there was upward pressure on the UK's credit profile, including if there were indications that the erosion in the UK's economic and institutional strength since Brexit is reversing. There could be positive pressure on the IoM's ratings, separate from developments in the UK's credit profile, if we expected the island's inherent credit strengths, including its very strong fiscal buffers, to provide a stronger shock absorption capacity which is more consistent with a higher rating. 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

Conversely, a downgrade of the UK's sovereign ratings could put pressure on the IoM's ratings. However, consistent with the reference above to the possibility of a strengthening of the IoM's inherent credit strengths, it is possible that the trajectory of the IoM and UK ratings could begin to diverge if the IoM's intrinsic credit strengths remained intact despite stress in the UK credit profile or the negative spillovers to the IoM proved to be less significant than expected. Downward pressure on the rating would arise if we expected a material deterioration in the IoM's own economic or fiscal position.

Key indicators

Exhibit 2

Isle of Man	2017	2018	2019	2020	2021	2022	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	6.5	3.1
Gen. gov. financial balance/GDP (%)	0.0	-0.5	0.4	-4.2	-1.0	-1.3	-1.4	-0.7
Gen. gov. primary balance/GDP (%)	0.0	-0.5	0.4	-4.2	-0.9	-1.2	-1.3	-0.6
Gen. gov. debt/GDP (%)	0.0	0.0	0.0	0.0	7.4	6.6	6.1	5.8
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] 2023 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 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 an estimated 2% between 2013-2022. In 2020, the coronavirus pandemic pushed the IoM into a rare economic contraction, although it posted a robust recovery in 2021 and economic activity has been relatively resilient to the energy price and inflation shock over 2022-2023.

The IoM's small economic base limits its capacity to absorb shocks. That said, 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 Information and Communication Technology (ICT), financial services and e-gaming were only moderately affected.

The IoM economy's close links to the UK, notably the 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. After peaking at 10.8% in July 2022, inflation in the IoM has fallen to 5.7% in September 2023 and we expect inflation to fall further to average around 3% in 2024 given the stronger transmission of tight UK monetary policy and as food price inflation continues to slow. We expect real GDP growth to remain robust and stabilize at around 3% in the medium term as the island's very high wealth supports consumption and the international facing sectors benefit from stronger global demand.

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. That said, stronger co-operation between the UK and EU will help to relieve some of the Brexit-related uncertainty for businesses on the island.

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 robust 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. Strong regulatory frameworks and a proactiveness to regulation are a source of competitiveness for these sectors.

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, helping the public finances to absorb shocks. 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 to remain significant in the coming years, as evidenced by the OECD/G20 two-pillar solution to reform international tax rules, although ongoing efforts by the authorities to broaden the island's attractiveness to new investment beyond its tax competitiveness will, in our view, help the IoM to manage these pressures.

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 March 2023, through which budget deficits are financed and its general government debt burden (an estimated 6.6% of GDP in 2022) is one of the lowest in our rated universe. The Isle of Man issued its first bond in 2021 amounting to £400 million.

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. That said, the government's aim to reduce the budget's ongoing reliance on reserves will face challenges from its extensive capital development plan and spending pressures from health and social care as well as pensions, while the government has limited room for manoeuvre on the revenue side given the IoM's low-tax environment. Nevertheless, we still 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 is driven by political and banking sector risks. The assessment also 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. We have recently lowered our government liquidity risk score to “aa” from “aaa” as, while the government's recent bond issuance has opened its access to capital markets, we consider that the island's track record of reliable market access is not consistent with our highest possible score.

The banking sector risks mainly reflect the large size of the banking system with total assets of the banking system equivalent to more than seven times the island's estimated GDP as at the end of 2022. However, nearly all of those assets (with the material exception of Conister Bank) are foreign-owned entities which reduces the contingent liability risks for the government's balance sheet. Furthermore, the risks to the IoM's credit profile are mitigated by the low-risk nature of the business and the high levels of capital. 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.

The political risk score of “a” reflects an increased (albeit still low) risk of contagion from 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

CIS-2
Neutral-to-Low

For an issuer scored CIS-2 (Neutral-to-Low), its ESG attributes are overall considered as having a neutral-to-low impact on the current rating; i.e., the overall influence of these attributes on the rating is non-material.

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

ENVIRONMENTAL	SOCIAL	GOVERNANCE
E-2	S-2	G-1
Neutral-to-Low	Neutral-to-Low	Positive

Source: Moody's Investors Service

Environmental

The IoM's **E-2** environmental issuer profile score reflects 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

The IoM's **S-2** social issuer profile reflects 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 IoM's **G-1** governance issuer profile score reflects its very strong institutions and governance profile which support its rating. Coupled with high wealth levels and very high government financial strength, this supports a high degree of resilience.

ESG Issuer Profile Scores and Credit Impact Scores for the rated entity/transaction are available on Moodys.com. In order to view the latest scores, please click here to go to the landing page for the entity/transaction on MDC and view the ESG Scores section.

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

A more benign inflation outlook supports growth prospects

The recent surge in inflation as a result of the sharp rise in energy prices in the wake of Russia's invasion of Ukraine weakened economic growth somewhat in 2022 after a relatively robust recovery from the pandemic. The large trade and energy dependence between the IoM and the UK as well as the peg to the British pound resulted in similar inflation trajectories in both sovereigns. Inflation in the IoM peaked at 10.8% in July 2022, close to the UK peak of 11.1% in October 2022.

That said, the downside risks posed by persistently high inflation have abated as well-anchored and gradually falling UK inflation will feed through to more muted growth in consumer prices in the IoM. Inflation in the IoM stood at 5.7% in September 2023, helped by lower energy prices and slowing food price inflation. We expect IoM inflation will, in line with the UK, fall further to average around 3% in 2024 given the stronger transmission of tight UK monetary policy and as food price inflation continues to slow.

Although high inflation has had a negative impact on real incomes and wider consumer confidence, economic growth in the IoM has still been robust - we forecast real GDP growth to slow to around 1.5% in 2023, stronger than most of Europe. After reaching 2.5% in 2024, we expect economic growth to stabilise at around 3% from 2025 onwards as inflation reaches more moderate levels, supporting real incomes, and the international facing sectors benefit from stronger global demand. Furthermore, consumption will continue to be supported by the island's very high wealth levels.

Public finances impacted by high inflation although reserves continue to provide a strong buffer

Government finances continue to gradually improve after they deteriorated during the pandemic on account of higher health spending and economic support, as well as weaker tax revenue. The government's latest budget (Pink Book) estimates that the structural 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 need for additional financial support during the energy crisis. The budget forecasts a slight increase in the deficit to £152.9 million in 2023-24 followed by a gradual decline over the next four years. Budget deficits 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 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, restricting bids to those projects already underway or expected to commence this year.

We project, according to our general government definition, the budget deficit will remain around 1.4% of GDP in 2023, a level similar to that in 2022, before declining below 1% of GDP in 2024. Revenue from direct taxation is forecast to return to pre-pandemic 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.

The sizable health and care funding gap, estimated at around £170 million (2.8% of 2022 GDP) from 2024-25 through the end of the budget's five-year forecast, will challenge the government's efforts to achieve a balanced budget by 2027-28. The gap is being partially met from the investment income of the Manx National Insurance Fund during the current year and a plan to sustainably finance the gap from 2024-25 is to be outlined in due course. At the same time, expenditure for public-sector pensions will rise to £43 million in 2023-24 and to around £49 million in 2024-25, according to the latest financial plan, leading to additional pressure on the revenue account.

Economic strategy aims to further develop the domestic economy and raise the resident population

The government's newly published economic strategy, approved by the 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 proposes an investment programme of £1 billion, which will be supported by an initial £100 million Economic Strategy Fund. The strategy aims to 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.

The offshore wind generation firm Orsted (Baa1 stable) signed an agreement in 2015 for leasing part of the seabed within the IoM's territorial seas and, in 2023, set up an office on the island. Furthermore, the regeneration of brownfield sites through the Manx Development Corporation will help increase the attractiveness of the island as part of efforts to grow the population.

This strategy is more comprehensive than previous incarnations because, in addition to supporting the island's export sectors, it also aims to develop the domestic economy to be able to better attract and retain labour. Access to skilled labour remains the largest structural risk to the island's sustained economic success. Unemployment remains low at 0.6% in September 2023 and the number of job vacancies, while improving recently, remains high.

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

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 (%)	2018-2027F	1.4	b1		25%
	MAD Volatility in Real GDP Growth (%)	2013-2022	1.5	ba2		10%
Scale of the economy	Nominal GDP ($ billion)	2022	7.5	caa3		30%
National income	GDP per capita (PPP, Intl$)	2022	--	--		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 (%)	2022	6.6	aa1		25%
	General government debt/revenue (%)	2022	34.6	aa1		25%
Debt affordability	General government interest payments/revenue (%)	2022	0.6	aaa		25%
	General government interest payments/GDP (%)	2022	0.1	aaa		25%
Specified adjustments	*Total of specified adjustment (# notches)*			2	2	max ±6
	Debt Trend - Historical Change in Debt Burden	2014-2022	6.6	0	0	
	Debt Trend - Expected Change in Debt Burden	2022-2024F	-0.8	0	0	
	General Government Foreign Currency Debt/ GDP	2022	0.0	0	0	
	Other non-financial public sector debt/GDP	2022	0.0	0	0	
	Government Financial Assets including Sovereign Wealth Funds / GDP	2022	29.6	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				aa	aa	
	Ease of access to funding			aa		
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	2022	730.3	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.

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