MOODY'S
INVESTORS SERVICE

Rating Action: Moody's changes the outlook on the Isle of Man to negative; affirms Aa3 ratings

28 Oct 2022

London, October 28, 2022 -- Moody's Investors Service ("Moody's") has today changed the outlook on the Government of Isle of Man's (IoM) ratings to negative from stable and affirmed the domestic and foreign-currency long-term issuer and domestic-currency senior unsecured ratings at Aa3.

The announcement follows Moody's recent change in the outlook on the Government of United Kingdom (UK) to negative from stable. In this context, the negative outlook on the IoM's ratings reflects Moody's longstanding view that the UK's sovereign credit trend continues to have a significant impact on the IoM's credit profile, due to the close and material institutional, economic and financial linkages between the two jurisdictions.

For more details on the UK rating action, please refer to Moody's press release: https://www.moodys.com/research/--PR_469280 .

The affirmation of the Aa3 ratings reflects the IoM's very high wealth levels and long track record of robust economic growth, very strong public finances and the risks to the government's balance sheet posed by its large banking sector, albeit these risks are mitigated by the low-risk nature of the business, which is predominantly foreign-owned, and high levels of capital.

The IoM's local and foreign currency country ceilings remain unchanged at Aaa. The three-notch gap between the local currency ceiling and the sovereign rating is driven by the government's relatively small footprint in the economy, strong reliability of institutions and a relatively diversified economy given its small size. The foreign currency ceiling at the same level as the local currency ceiling reflects its openness to capital flows given the currency and customs relationship with the UK as well as reasonably effective policy management.

RATINGS RATIONALE

RATIONALE FOR THE CHANGE IN OUTLOOK TO NEGATIVE FROM STABLE

THE CORRELATION OF CREDIT RISKS BETWEEN THE UK AND THE IoM REMAINS SIGNIFICANT

The driver of the decision to change the outlook to negative from stable is the longstanding 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 credit challenges facing the UK ? heightened unpredictability in policy making as well as higher borrowing and high inflation ? will have negative consequences for the IoM's own creditworthiness. Therefore, at the current rating level, a deterioration in the UK's credit profile, such as that reflected in the 21 October 2022 change in the outlook on the UK's rating to negative, also affects the IoM's credit profile.

Institutional linkages between the IoM and the UK are strong, helping to offset some of the institutional capacity challenges from the island's small size. The IoM's status as a Crown Dependency means that the UK takes on some functions of government on the island's behalf. For example, the IoM does not enter into international treaties as a separate entity. Moreover, it had access to the European Union (EU, Aaa stable) Single Market for its goods as a result of the UK's EU membership, an arrangement which ended with Brexit. The IoM is now covered by certain parts of the UK-EU Trade and Cooperation Agreement signed at the end of 2020 which allows for the export of tariff-free and quota-free goods to the EU.

The UK is also responsible for defence, international representation, and the "good governance" of the island. As a last resort, the UK is able to legislate on the IoM's behalf, normally with the consent of the IoM authorities. The IoM also tends to follow a similar institutional framework as the UK, importantly with financial sector regulation, while there are significant informal linkages as the island benefits from the wide pool of skills available in the UK.

There also remain important economic and fiscal links between the IoM and the UK. The island's currency, the Manx pound, is pegged 1:1 to the British pound, with the Bank of England (Aa3 negative) its de-facto central

bank.

Furthermore, approximately a third of government revenue in fiscal year 2020-2021 was linked to a Revenue Sharing Agreement (RSA) with the UK authorities, though fluctuations in that revenue stream vary with the IoM's economic growth, not the economic growth of the UK itself. The RSA is voluntary which, while providing a degree of flexibility, introduces some political uncertainty and dependence on UK government decisions. For example, changes to the tax sharing agreement in the aftermath of the global financial crisis led to a significant decline in tax revenue for the island. Furthermore, the sharing of a single VAT and customs area means decisions on fiscal policy in the UK ? which has become less predictable in recent years and recent weeks ? can have a direct impact on the IoM's public finances. At the same time, the IoM's low-tax environment gives the government limited room to raise revenue in the event of a shock.

The financial sector is also an important source of linkage as UK banks play a large and important role on the island, with a memorandum of understanding providing a formal basis for co-operation between the UK and IoM regulators. A new bank resolution and recovery regime came into effect at the start of 2021, providing a wider range of mechanisms to deal with a failing bank, 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 IoM has managed the challenges of Brexit well and the end of the Brexit transition period in 2020 has had relatively limited economic impact to date. That said, Moody's expects Brexit to have manageable but still negative implications for the IoM's economic prospects over the medium term, both through direct channels as well as indirectly through lower growth assumptions for the UK. Exporters now face significant non-tariff barriers in trading with the EU, creating additional costs and frictions to trade.

Brexit is also likely exacerbating labour shortages which have worsened following the pandemic. In Moody's view, access to skilled labour in order to maintain the dynamism of key industries is the largest structural risk to the island's continuing economic success. The number of job vacancies remains close to record highs, while outward migration of the population, particularly university graduates, contributes to demographic challenges. The IoM has been very open to workers from abroad, with UK citizens comprising the predominant share of the foreign-born population and a key source of skills. The latest census showed some progress in tackling these negative demographic trends and the government's newly published draft economic strategy aims to grow the number of residents on the island to 100,000 by 2037.

It is important to stress that the IoM is not directly experiencing the same factors that drive the UK's negative outlook?(1) heightened unpredictability in policymaking amid weaker growth prospects and high inflation, and (2) risks to debt affordability from likely higher borrowing and risk of a sustained weakening in policy credibility. However, given the important credit linkages, Moody's expects the heightened risks to the UK's economic and fiscal prospects will have consequences for the IoM's own creditworthiness.

High and potentially persistent UK inflation will pose headwinds for the IoM's economy and public finances given the large trade and energy dependence on the UK as well as the peg to the British pound which means that inflation tends to closely follow that of the UK.

Inflation in the IoM stood at 9.8% in September 2022 driven largely by rising energy prices given the importance of gas, which is largely imported from the UK, in electricity generation and Moody's expects inflation to reach 11% by the end of 2022. The IoM's energy security is also closely tied to the UK through its electricity linkage with the country which would play an important contingency role in the event of a wider European gas shortage. The IoM introduced a cap on electricity prices for households and businesses until end March 2023, although the authorities may face demands to provide further fiscal support which may challenge efforts to reduce the structural budget deficit in the wake of the pandemic.

The impact of high inflation on real incomes and weaker consumer confidence will weigh on the IoM's economic growth in the coming years, with Moody's forecasting real GDP to grow 1.5% in 2023, lower than previously forecast. The much weaker growth prospects for the UK, particularly given the likely further significant tightening in monetary policy, with UK real GDP growth forecast to average just 0.3% over 2023-2024 and remain below potential until 2026, will also weigh on the island's economic outlook.

RATIONALE FOR AFFIRMING THE Aa3 RATINGS

The affirmation of the Aa3 ratings reflects the IoM's very high wealth levels and long track record of robust economic growth which provide a significant buffer against shocks. The economy is also relatively well diversified considering its very small size. The island has managed to diversify away from a reliance on

offshore financial services through the development of information and communication technology (ICT) and e-gaming sectors, which together account for around 25% of gross value added. Strong regulatory frameworks and a proactiveness to regulation are a source of competitiveness in the island's banking sector as well as its e-gaming industry. However, the number of corporations in each sector is still relatively small such that the performance of the largest companies can have a disproportionate impact on the island's overall economic performance.

The IoM is also exposed to shifts in international tax regulation and the planned introduction of a global minimum 15% corporate tax rate for large multinationals, which is estimated to impact around 3% of registered companies on the island, may challenge the IoM's ability to attract new businesses to the island. That said, the IoM has generally attracted smaller businesses than large multinationals and has taken steps in recent years to broaden its attractiveness to new investment beyond its tax competitiveness, including through developing an ecosystem of auxiliary services to help foster its ICT and e-gaming sectors. Nevertheless, this development reflects the continuing international pressure on low-tax jurisdictions.

Another important credit strength ? apart from the IoM's significant economic strength ? is the government's very strong public finances. A prudent approach to managing government finances has resulted in a high level of overall reserves (over 30% of 2021 GDP as at end March 2022) through which budget deficits are financed. The external funds are well diversified and mainly invested in liquid assets. As a result, the IoM has one of the lowest government debt burdens in our rating universe at 6.6% of GDP in 2021, mostly reflecting a debut bond issued in 2021 which has opened the IoM access to capital markets.

Finally, the island's large banking sector, with total assets of around six times the island's GDP as of end-2021, constitutes one of its main sources of event risk, although risks to the government balance sheet are mitigated by the low-risk nature of the business, which is predominantly foreign-owned, and high levels of capital.

ENVIRONMENTAL, SOCIAL, AND GOVERNANCE CONSIDERATIONS

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.

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.

Moody's assesses 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.

The IoM's very strong institutions and governance profile support its rating and this is captured by 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.

GDP per capita (PPP basis, US$): [not available] (also known as Per Capita Income)

Real GDP growth (% change): 3.9% (2021) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 2.4% (2021)

Gen. Gov. Financial Balance/GDP: -2.3% (2021) (also known as Fiscal Balance)

Current Account Balance/GDP: [not available] (also known as External Balance)

External debt/GDP: [not available]

Economic resiliency: a2

Default history: No default events (on bonds or loans) have been recorded since 1983.

On 26 October 2022, a rating committee was called to discuss the rating of the Government of Isle of Man. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic

strength, have not materially changed. The issuer's institutions and governance strength, have not materially changed. The issuer's fiscal or financial strength, including its debt profile, has not materially changed. The issuer has become increasingly susceptible to event risks.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

WHAT COULD MOVE THE RATINGS UP

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 Moody's expects would also support a stabilization of the outlook at the current rating level.

WHAT COULD MOVE THE RATINGS DOWN

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 Moody's was to observe a material deterioration in the Isle of Man's own economic or fiscal position.

PRINCIPAL METHODOLOGY

The principal methodology used in these ratings was Sovereign Ratings Methodology published in November 2019 and available at https://ratings.moodys.com/api/rmc-documents/63168 . Alternatively, please see the Rating Methodologies page on https://ratings.moodys.com for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found on https://ratings.moodys.com/rating-definitions.

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Evan Wohlmann
VP - Senior Credit Officer
Sovereign Risk Group
Moody's Investors Service Ltd.
One Canada Square
Canary Wharf
London, E14 5FA
United Kingdom
JOURNALISTS: 44 20 7772 5456
Client Service: 44 20 7772 5454

Alejandro Olivo
MD-Sovereign/Sub Sovereign
Sovereign Risk Group
JOURNALISTS: 44 20 7772 5456
Client Service: 44 20 7772 5454

Releasing Office:
Moody's Investors Service Ltd.
One Canada Square
Canary Wharf
London, E14 5FA
United Kingdom
JOURNALISTS: 44 20 7772 5456
Client Service: 44 20 7772 5454

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