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26 July 2023

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Government of Isle of Man - Aa3 negative

Annual credit analysis

RATINGS

Isle of Man

	Foreign Currency	Local Currency
Gov. Bond Rating	Aa3/NEG	Aa3/NEG
Country Ceiling	Aaa	Aaa

TABLE OF CONTENTS

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OVERVIEW AND OUTLOOK

The credit profile of the Isle of Man (IoM) reflects the island's high wealth levels and economic resilience. The IoM's economy is more diversified than that of most entities of its size, having moved away from a reliance on offshore banking towards information and communications technology (ICT), insurance and e-gaming. Access to skilled labour remains the largest structural risk to the island's sustained economic success.

Despite the IoM's small size, its institutions are robust and benefit from close ties to the UK (Aa3 negative). They have also shown themselves to be proactive and effective in dealing with the shocks of Brexit and the coronavirus pandemic, likely mitigating the risk of long-term economic scarring from the latter. The government's very strong public finances are a key credit strength. The IoM's very low direct debt and prudent management of government finances have resulted in high levels of reserves through which fiscal deficits are financed.

The IoM's significant links with the UK leave its credit profile exposed to the deterioration in the UK's creditworthiness. Inflation remains high and close to the level in the UK, given the IoM's large energy and trade dependence. The potential for higher inflation to become more persistent poses a risk to the economic outlook. While the immediate impact of Brexit has been limited, the close links between the UK and the IoM mean the UK's decision to leave the EU (Aaa stable) will continue to have repercussions for the island's long-term economic prospects. The IoM also remains vulnerable to global and regional tax coordination efforts that can affect the sector. The international agreement on a new 15% minimum tax rate for multinationals highlights the risks posed by shifts in international tax regulations for low-tax jurisdictions.

An abatement of the credit challenges facing the UK, reducing the risk of consequences for the IoM's own credit profile, would likely lead to a stabilisation in the outlook. Given the significant credit links 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 significant deterioration in the IoM's own economic or fiscal position.

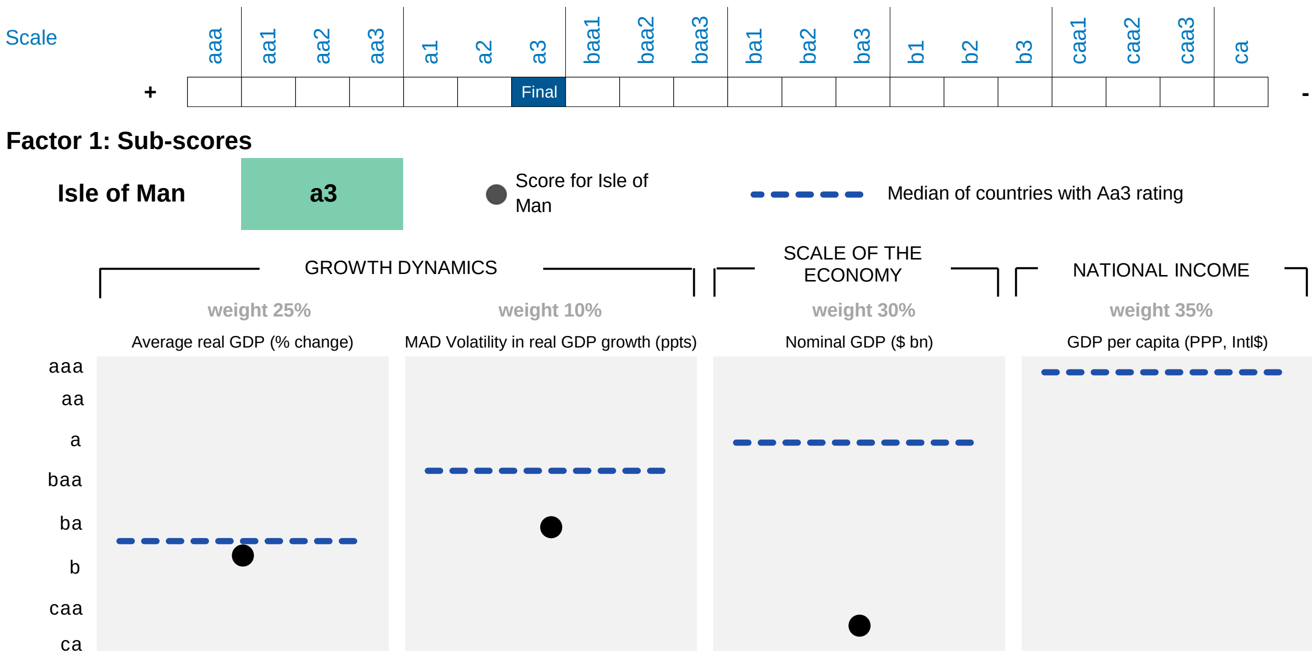
This credit analysis elaborates on the IoM's credit profile in terms of economic strength, institutions and governance strength, fiscal strength and susceptibility to event risk, which are the four main analytic factors in our Rating Methodology: Sovereigns.

CREDIT PROFILE

Our determination of a sovereign's government bond rating is based on the consideration of four rating factors: Economic strength, institutions and governance strength, fiscal strength and susceptibility to event risk. When a direct and imminent threat becomes a constraint, that can only lower the scorecard-indicated outcome. For more information, please see our Rating Methodology: Sovereigns.

Economic strength score: a3

Factor 1: Overall score



Economic strength evaluates the economic structure, primarily reflected in economic growth, the scale of the economy and wealth, as well as in structural factors that point to a country's long-term economic robustness and shock-absorption capacity. Adjustments to the economic strength factor score most often reflect our judgement regarding the economy's flexibility, diversification, productivity and labour supply.

Note: the initial factor score is shown in light blue in the scale above. In case the initial and final factor scores are the same, only the final score will appear in the table above.

We score the IoM's economic strength at "a3", underpinned by its high wealth levels and track record of strong economic growth, but balanced by the economy's very small size, which limits its capacity to absorb shocks. That said, the pandemic pushed the economy into contraction for only the second time in the past three decades, although has since posted a robust recovery. Of the IoM's closest peers specialising in similar economic sectors, the Cayman Islands (Aa3 stable) and Macao SAR, China (Aa3 stable) both receive scores of "baa2".

Exhibit 1

Peer comparison table factor 1: Economic strength

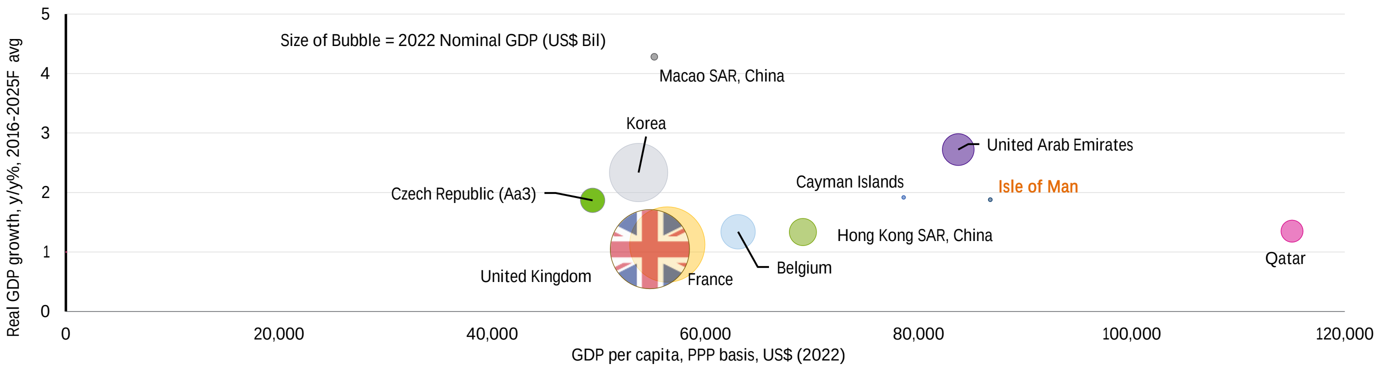
	Isle of Man	a3 Median	Czech Republic	Hungary	Austria	Belgium	Finland	Chile
	Aa3/NEG		Aa3/NEG	Baa2/STA	Aa1/STA	Aa3/STA	Aa1/STA	A2/STA
Final score	a3		a3	a3	a2	a2	a2	baa1
Initial score	--		a2	a2	a2	a2	a3	a3
Nominal GDP ($ billion)	7.5	271.3	290.9	178.8	470.7	577.8	280.4	300.7
GDP per capita (PPP, Intl$)	--	42,044.5	49,421.0	42,044.5	66,984.0	63,070.2	58,651.1	29,083.1
Average real GDP (% change)	1.4	2.5	1.5	3.1	1.4	1.3	1.2	2.1
MAD Volatility in real GDP growth (ppts)	1.5	1.1	0.6	0.9	0.9	0.5	1.6	0.9

Sources: National authorities, IMF and Moody's Investors Service

Wealth and comparatively high diversification partly offset economy's small size

The economy is very small; we estimate nominal GDP at $7.5 billion as of year-end 2022, making it one of the smallest economies that we rate globally, which naturally reduces its capacity to absorb shocks (see Exhibit 2).

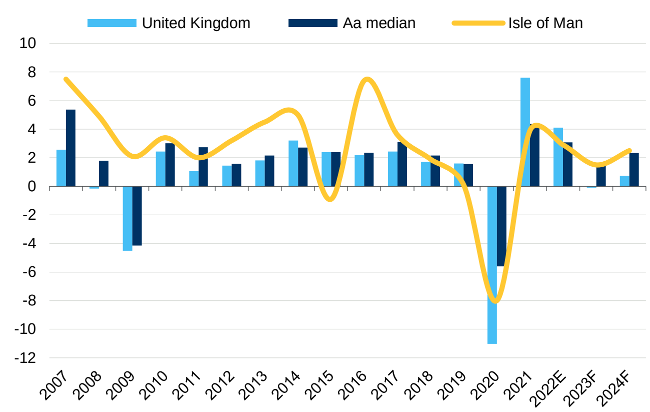
Exhibit 2
The IoM is an outlier in terms of both wealth and size
Economic wealth, scale and growth compared with other Aa-rated sovereigns



GDP per capita is on a purchasing power parity (PPP) basis for all except the IoM and the Cayman Islands. GDP growth figures for the IoM are estimates for the 2020-21 period.
Source: Moody's Investors Service

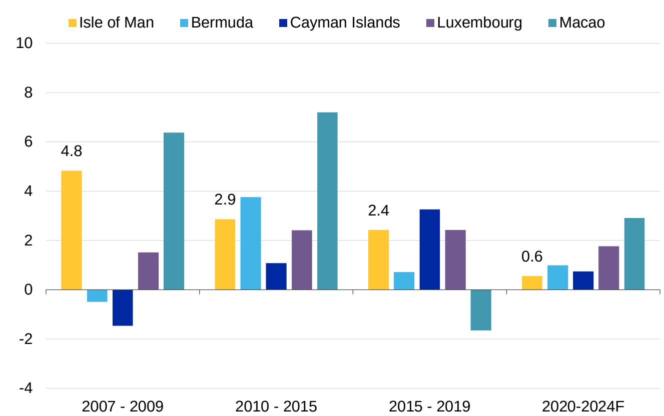
Real GDP growth averaged 1.9% in the decade to the end of the 2020-21 financial year,[1] the last decade of available data. The IoM has performed better than most other offshore centres, with growth before the pandemic having been more resilient and less volatile than that of Bermuda (A2 stable), the Cayman Islands and Macao (see Exhibits 3 and 4).

Exhibit 3
The island's growth has historically been very resilient...
Real GDP growth, in percentage terms



IoM real growth numbers are estimates.
Source: Moody's Investors Service

Exhibit 4
... particularly compared with many other offshore centres and small economies before the pandemic
Real GDP growth, in percentage terms



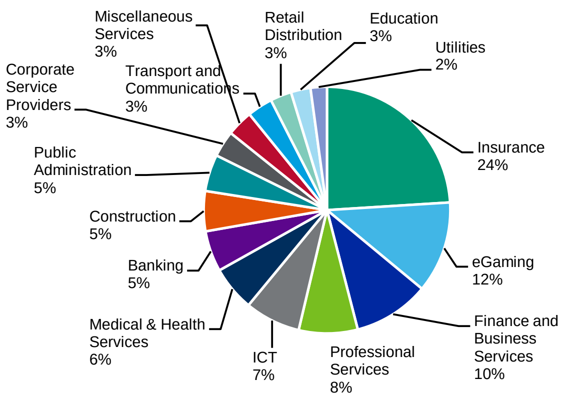
Source: Moody's Investors Service

However, it is more diversified than many other economies of a similar size. This diversification, which sustained the economy during the global financial crisis, is supported by specific government policies. Per capita income of around $85,000 in 2022 is one of the highest among the sovereigns we rate.

Diversification away from traditional banking activities has supported growth

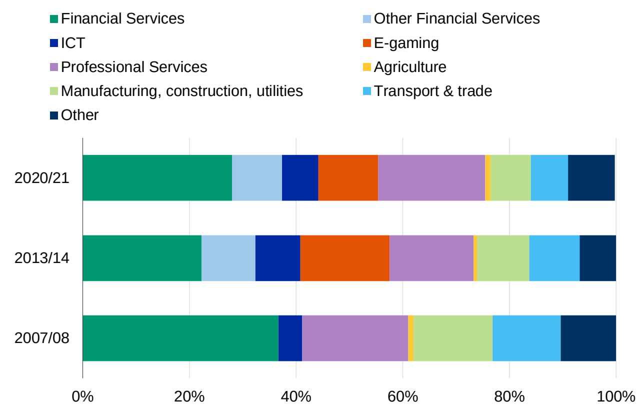
The IoM's economy is more diversified than that of other offshore financial centres and many other small economies (see Exhibit 5). The importance of financial services to the IoM's GVA has fallen significantly since the late 1990s. E-gaming is now one of the largest sectors, accounting for 12% of national income in the financial year 2020-21 (see Exhibit 6). However, the number of corporations in each sector is naturally small, and the largest companies can have a disproportionate impact on the overall growth performance of both their sector and the economy more broadly. Moreover, the IoM calculates GDP using the income method, which magnifies the impact of fluctuations in corporate profit. Corporate income accounted for around 60% of GDP in 2020-21, a similar share to previous years.

Exhibit 5
Isle of Man's economy is relatively diversified ...
National income by economic activity, percentage share of total (2020-21)



Sources: Isle of Man Treasury and Moody's Investors Service

Exhibit 6
...and has moved away from banking activities since the global financial crisis
Sectoral composition of GVA, percentage of total



Sources: Isle of Man Treasury and Moody's Investors Service

The IoM's financial services are mainly offered in offshore banking, captive insurance, offshore life insurance, fund management, and trust and company services. While the broader financial services industry is still the largest sector of the economy, the banking sector's contribution has fallen since the global financial crisis and the number of licensed deposit-taking institutions on the island has declined. As a share of GVA, the banking sector was 5% in 2020-21, compared with 15.6% in 2008-09. On the other hand, the insurance sector — notably the offering of life insurance policies for expatriates and global high-net-worth individuals — has resurged in recent years, overtaking e-gaming. The insurance sector continues to be the island's largest sector and main driver of growth in recent published national accounts.

Government policies have supported the transformation of the IoM into a more diversified economy, particularly through low-tax legislation, which was initially directed towards financial services. Further changes to tax legislation (including the introduction of a zero corporate tax rate in 2006), the development of a modern telecommunications infrastructure and a skilled population, as well as the IoM's flexible regulatory and business environment, have attracted a broader range of sectors. Besides ICT and e-gaming, the island has several companies engaged in niche manufacturing, including for the aerospace industry, and specialised services such as shipping and aircraft registers.

ICT and e-gaming have grown strongly over the past decade and accounted for a combined 18% of GVA in 2020-21. However, the share fell from 24.5% in 2019-20, as the pandemic weighed on sports betting and company restructurings put a strain on value added. However, e-gaming has seen a marked rise in demand for gaming licences in recent years, and the sector had a robust rise in employment in 2022. The island also benefits from its relatively robust regulatory environment for the gaming sector at a time when other jurisdictions, such as Malta (A2 stable), have come under scrutiny for their efforts to curb money laundering.

The ICT and e-gaming sectors' development has been helped by the island's high-quality telecommunications and IT infrastructure. The authorities have also focused on creating an ecosystem of auxiliary services, such as software developers and engineers, to help foster the sectors. However, shortages of digital skills remain a limiting factor in the growth of these industries.

Rising inflation will hamper the economic recovery

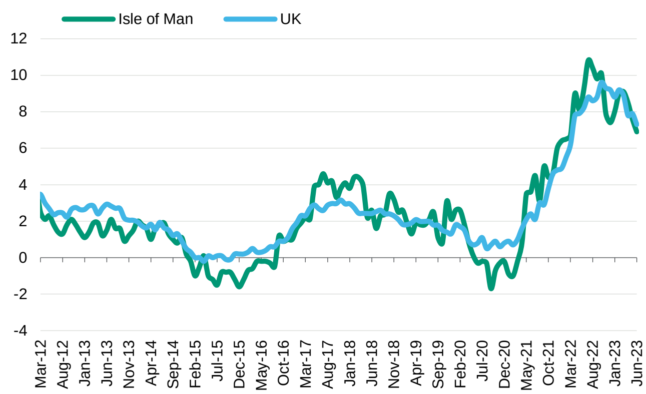
The economy has swiftly recovered from the pandemic shock, with real GDP growth estimated to average 3.4% over 2021 and 2022, driven by higher consumer spending. Travel restrictions eased significantly from mid-2021 onwards, leading to a gradual recovery in tourism, with the annual Isle of Man Tourist Trophy motorcycle racing event, an important source of tourism, having resumed in 2022. The labour market shows limited to no signs of scarring, as unemployment was at 0.5% as of June 2023, a historical low.

However, the economic growth outlook has weakened because of the energy crisis in the wake of Russia's invasion of Ukraine (Ca stable). Inflation rose significantly in 2022, peaking at 10.8% in July and averaging 9.4% over the second half of last year. Inflation has proven to be persistently high and, while declining, remains at 6.9% in June 2023, not far off the level in the UK given the IoM's large energy and trade dependence (see Exhibit 7). The rise was mainly driven by food (16.0% year-over-year increase), restaurants and hotels (up 13.4%), and alcohol and tobacco (up 8.9%), while lower energy prices helped contribute to more muted rises in transport (up 5.8%), and housing, water and electricity (up 4.1%) (see Exhibit 8).

Exhibit 7

Inflation remains persistently high, in line with the UK

Consumer price index year-over-year increase, in percentage terms

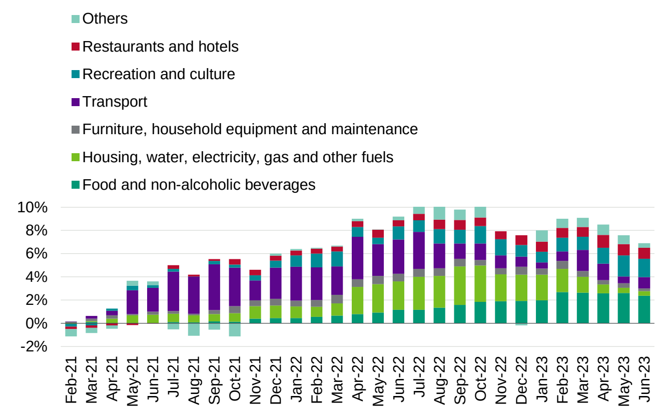


Sources: Statistics of Isle of Man and Moody's Investors Service

Exhibit 8

Inflation has been led by higher energy and food prices

Contributions to inflation, year-over-year increase, in percentage terms



Sources: Statistics of Isle of Man and Moody's Investors Service

Gas prices nearly trebled over the course of 2022, although the fall in wholesale prices has prompted cuts to tariffs since late last year. Furthermore, there will be a staggered rise in electricity prices this year following the end of the six-month price freeze, with bills estimated to rise 34% in 2023; although the fall in wholesale prices in recent months means the hikes are lower than originally planned.

The strain on real incomes and wider consumer confidence will weigh on real GDP growth in the coming years, which we forecast to slow to 1.5% in 2023. Further, the likely slowdown in the UK economy — where we forecast a small contraction in real GDP growth in 2023 — will have knock-on effects on the island and broader confidence. However, growth will still remain robust, as consumption will continue to be supported by the island's very high wealth levels. Economic growth will recover further in 2024, with real GDP expanding by 2.5%, as inflation reaches more moderate levels, supporting consumption, and the international facing sectors benefit from stronger global demand.

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. Further, persistently high inflation in the UK, reflecting in part the impact of Brexit and strong wage growth, would feed through to higher imported inflation for the IoM. More broadly, a further large rise in energy prices and the risk of a wider European gas shortage in winter 2023 also pose risks to the economic outlook. Energy prices and the island's broader energy security are strongly correlated with those of the UK, given the IoM's dependence on the UK for gas and electricity imports.

Skill shortages remain the main structural challenge over the long term

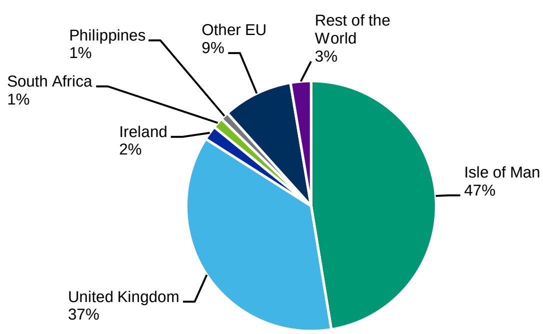
The biggest long-term structural risk to the island's sustained economic success is access to skilled labour. Before the pandemic, significant skill shortages were evident in most sectors of the economy because of a tight labour market. Shortages have arguably become even more acute since 2020.[2]

The number of job vacancies remains close to record highs in June 2023, even as private sector employment rose strongly in 2022. There are four to five vacancies per job seeker, with the ratio particularly high in the digital and finance industries, as labour shortages and skills mismatches threaten to limit the growth potential of the key sectors of the economy.

Outward migration of the native population contributes to demographic challenges, particularly in relation to university graduates, many of whom do not return to the island following their studies. The latest census from 2021 showed some progress in tackling these negative trends. The resident population had grown by 755 or 0.9% between 2016 and 2021 to reach 84,069, which only partly reverses the 1.4% fall (1,200) that occurred between 2011 and 2016. The economically active population grew by 4.9%, which compares with a 4.1% decline between the previous two census dates. At the same time, the average age rose slightly to 44.4 years from 42.5 years in 2016, while those over 64 years account for 22% of the resident population, a similar share as in 2016 (21.7%).

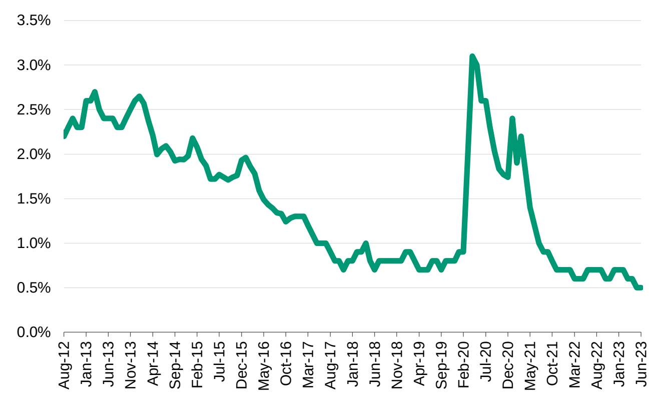
Reflecting these challenges, the IoM has traditionally been very open to workers from abroad (see Exhibit 9). According to the latest census, the share of the population born outside the island increased to 10.3% in 2021 from 8.3% in 2016. Immigrants from the UK are by far the largest group because of the Common Travel Area (CTA), which gives citizens of the UK and the IoM reciprocal residential rights.[3]

Exhibit 9
The IoM has an open attitude to immigration
Resident population by place of birth, percentage of total (2021 census)



Sources: Isle of Man Treasury and Moody's Investors Service

Exhibit 10
Unemployment is at historical lows
Unemployment rate, in percentage terms



Sources: Isle of Man Treasury and Moody's Investors Service

The authorities recognise the need for continued inward migration, particularly in the health care and ICT-related growth sectors, and are implementing various initiatives to attract highly skilled labour to the island and increase the economically active population, including as part of its new economic strategy (see discussion below)[4].

Furthermore, a special parliamentary committee looking into population imbalances recommended that a specific population policy be developed by year-end 2023,[5] alongside a range of initiatives to support parenthood on the island, including reforming parental leave and child benefits. The island's effective response to the pandemic, as well as the potential for a sustained trend towards greater remote working, might act as a catalyst for additional relocations by businesses and high-net-worth individuals.

New 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[6].

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. 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.

The development of wind farms to take advantage of the island's natural resources will help support the IoM's diversification away from its dependence on hydrocarbons for energy, which will be beneficial for domestic sectors that require significant energy such as data centres, as well as provide new sources of revenue for the government in the medium term. 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.

Brexit will continue to pose obstacles to the IoM's economy

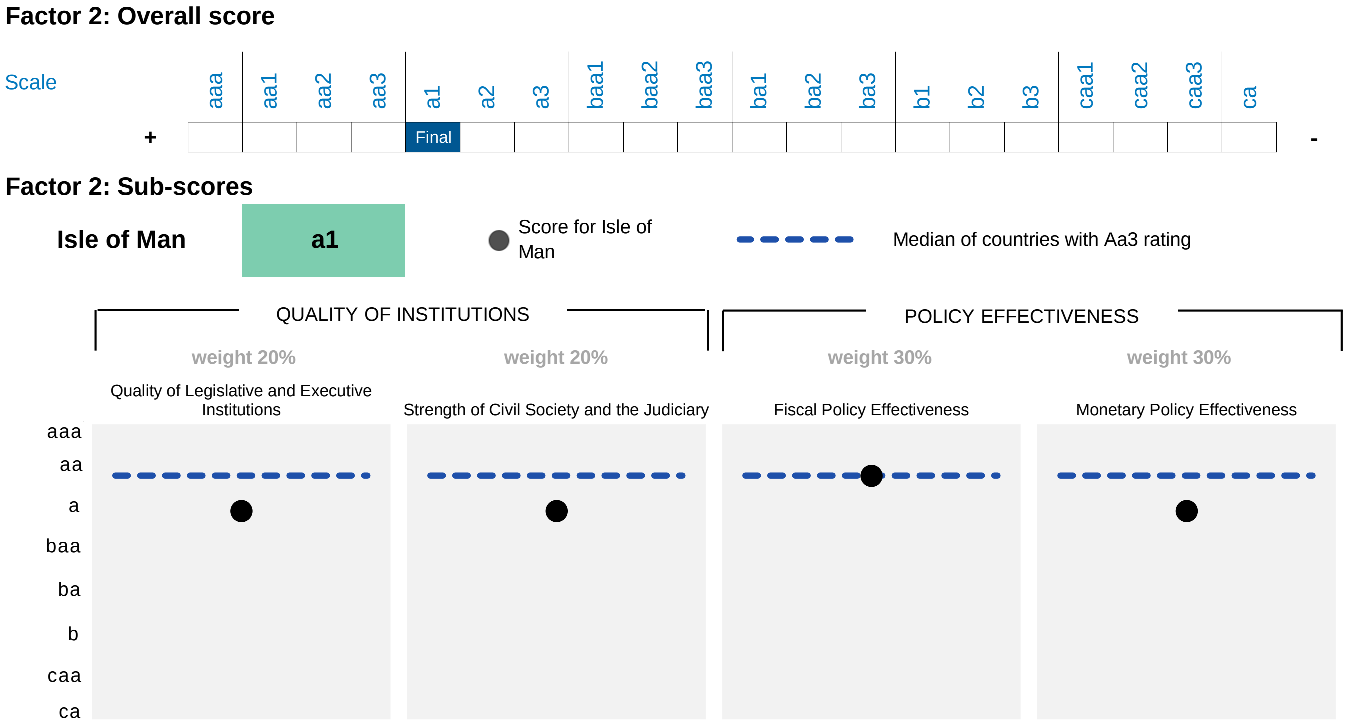
We expect Brexit will continue to have manageable but negative implications, on balance, for the IoM's economic prospects, both through direct channels given additional frictions to trade as well as indirectly through our lower growth and higher inflation assumptions for the UK. Brexit, along with the pandemic, is also likely exacerbating labour supply challenges, particularly for those parts of the domestic economy that were reliant on seasonal EU workers.

The IoM is covered by certain parts of the UK-EU Trade and Cooperation Agreement, signed at the end of 2020.[7] This pact allows for the export of tariff-free and quota-free goods, both agricultural and manufactured, to the EU. Despite being a source of serious concern for around half of all engineering and manufacturing businesses,[8] the end of the Brexit transition period has had a relatively limited impact to date. However, as with the UK, disentangling the economic effects of the pandemic is difficult and the full extent of the impact of Brexit will only become clear over the coming years.

Exporters now face significant non-tariff barriers in trading with the EU, creating additional costs and frictions to trade. The sectors affected the most are those with the highest reliance on exporting goods to the EU, namely manufacturing, agriculture and fisheries. These sectors make a small direct contribution to the economy — around 2.8% of GVA — but their contribution to employment is larger, accounting for a combined 6.3% of the employed population, according to the island's most recent census in 2021. The impact on other sectors, including the far more important ICT and e-gaming sectors, is likely to be much smaller. The Windsor Framework agreement paves the way for a more constructive relationship between the UK and the EU and could help ease trade frictions and relieve some of the Brexit-related uncertainty for businesses on the island.

The island's proactive approach to managing the risks posed by Brexit has likely contributed to the manageable impact. Throughout the Brexit process, the IoM's government maintained close contact with the relevant UK ministries to raise awareness of the island's position and prepare the economy for the consequences of the UK leaving the EU.[9] The IoM is also part of the CTA between the UK, the Channel Islands and the Republic of Ireland (Aa3 stable), which provides for the movement of CTA nationals without immigration controls.

Institutions and governance strength score: a1



Institutions and governance strength evaluates whether the country's institutional features are conducive to supporting a country's ability and willingness to repay its debt. A related aspect is the government's capacity to conduct sound economic policies that foster economic growth and prosperity. Institutions and governance strength is most often adjusted for the track record of default, which can only lower the final score.
Note: the initial factor score is shown in light blue in the scale above. In case the initial and final factor scores are the same, only the final score will appear in the table above.

We assess the IoM's institutions and governance strength as "a1", given the country's robust and transparent institutional framework. As a Crown Dependency, although independent and self-governing, the IoM benefits strongly from the UK's institutions and governance strength, which we also assess as "a1". The island has established a good regulatory framework for its important e-gaming sector, which serves as a source of competitive advantage, and works closely with the UK's Prudential Regulation Authority (PRA), given the largest banks on the island are UK-based financial institutions. There are no Worldwide Governance Indicators for the IoM, so we rely mostly on a qualitative assessment for the island's institutional strength.

Exhibit 11

Peer comparison table factor 2: Institutions and governance strength

	Isle of Man Aa3/NEG	a1 Median	Israel A1/STA	Lithuania A2/STA	United Kingdom Aa3/NEG	Belgium Aa3/STA	Cayman Islands Aa3/STA	Czech Republic Aa3/NEG
Final score	a1		a2	a1	a1	aa3	aa3	aa3
Initial score	a1		a2	a1	a1	aa3	aa3	aa3
Quality of legislative & executive institutions	a	a	a	a	a	aa	aa	aa
Strength of civil society & judiciary	a	a	a	a	aaa	aa	aa	a
Fiscal policy effectiveness	aa	aa	baa	aa	baa	a	aa	aa
Monetary & macro policy effectiveness	a	a	aa	a	aa	aa	a	aa
Fiscal balance/GDP (3-year average)	-1.1	-1.4	-0.7	-1.8	-4.3	-4.8	1.0	-3.5
Average inflation (% change)	3.5	3.2	2.0	5.0	2.9	3.1	3.6	4.6
Volatility of inflation (ppts)	2.6	2.4	1.5	5.6	2.1	2.9	2.5	4.3

Sources: National authorities, IMF and Moody's Investors Service

We consider the IoM's fiscal policies to be forward-looking and prudent, as 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. Its proactiveness in this area is a source of competitiveness, attracting new entrants to its market.

The UK and IoM enjoy a stable constitutional relationship based on a UK government royal commission (known as the Kilbrandon Report) that reported in 1973. The UK is responsible for the island's defence, international representation and “good governance”, and is able, as a last resort, to legislate on the IoM’s behalf, normally with the consent of the IoM authorities.[10] The IoM was not part of the EU directly before Brexit but had a relationship with the regional body under Protocol 3 of the 1972 treaty, under which the UK acceded to the EU. Thus, there is a high level of conformity between the IoM's institutional arrangements and those of the UK.

The IoM's institutions have been proactive and effective in dealing with the shocks of Brexit and the pandemic, as well as the current sharp rise in energy prices. The island (and the other Crown Dependencies) presented its own legislative equivalent of the UK's “Great Repeal Bill”, including provisions to allow EU instruments that fell within the scope of Protocol 3 to be incorporated into domestic law as part of the Brexit transition.[11] Similar to the UK, the IoM also introduced its own six-month energy price cap in 2022, which has proven effective in helping consumers and businesses manage the impact of very high levels of inflation. The IoM’s programme of engagement with the UK includes regular meetings with relevant UK ministries, including HM Treasury and the Home Office.

Use of sterling has historically delivered low and stable inflation

The IoM's use of the Manx pound, which is pegged to the British pound at parity, has historically delivered low and stable inflation despite the island's reliance on imports and strong exposure to global oil price volatility. The sterling's depreciation following the Brexit referendum, combined with swings in energy prices, has since fuelled increased volatility in prices. Furthermore, the currency board has contributed to imported inflation and, similar to the UK, more pronounced price increases compared with most of Western Europe. Nevertheless, we consider the relative exchange rate flexibility that the currency union with the UK provides to be positive for the IoM.

Strong regulatory framework for banking and e-gaming sectors

Given the size of the IoM banking sector and its offshore nature, a strong regulatory framework is an important contributor to its overall institutional strength. The UK government has a strong interest in ensuring its Crown Dependencies follow best practices for regulation and disclosure, and has, in the past, commissioned several reviews that found the IoM to be compliant or largely compliant with international principles of banking regulation.[12] The Isle of Man Financial Services Authority (IoMFSA) and the UK PRA have a cooperative relationship, reflecting the fact that around half the banks on the island are based in the UK. A memorandum of understanding between IoM and UK regulators, which has been in place since 2003, establishes a formal basis for cooperation between the two institutions, including the exchange of information and investigative assistance, while IoM regulators regularly participate in supervisory colleges at the Bank of England.[13]

The other area in which the IoM has implemented a strong regulatory regime is the e-gaming industry, with a framework for the sector established as early as 2001 under the Online Gambling Regulation Act. The Gambling Supervision Commission (GSC) has a broad range of powers to monitor the compliance of e-gaming operators, including off-site reviews and on-site inspection visits. Importantly, operators are obliged to keep clients' funds separate from their working capital and ensure that these funds are fully protected.

In 2016, the IoM underwent an inspection by MONEYVAL — the Council of Europe's anti-money laundering (AML) and counterterrorism financing (CFT) body. MONEYVAL concluded that the IoM had enacted a strong legal and technical framework, although it also noted that gaps remained with respect to internal controls for e-gaming operators and supervisory and sanctioning powers available to the GSC.

The IoM Parliament has since passed new legislation aimed at addressing some of MONEYVAL's recommendations, including acts providing the GSC with a wider range of administrative sanctions and supervisory powers, and increasing financial sanctions for companies that fail to provide law enforcement authorities with timely access to information. The latest follow-up report by MONEYVAL in November 2022 found continued progress in addressing the technical compliance deficiencies identified six years prior, although the island remains under enhanced follow-up given outstanding deficiencies around independent audit functions and AML/CFT programmes[14]. The authorities are looking to address these deficiencies ahead of the next review with the date yet to be confirmed. While gaps remain, the e-gaming sector's relatively advanced position in this area compared with competing jurisdictions still acts as a source of competitive advantage.

Shifts in international tax regulations pose a risk, but authorities have been responsive to evolving standards

The IoM's “zero-10” tax system — under which the corporate tax rate is zero with the exception of the banking sector and large retailers (10%), and personal income tax is low (with a top tax rate of 20%)[15] — has made the island, like other low-tax jurisdictions, vulnerable to accusations it is facilitating tax avoidance and money laundering. 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, while the release in November 2017 of the “Paradise Papers” — leaked documents detailing companies and individuals allegedly involved in offshore investments — underscored the risk of reputational damage for small jurisdictions. The UK's departure from the EU has removed its generally supportive voice at the EU table and indirectly reduced the IoM’s influence over EU policies on tax harmonisation.

In response, the IoM has tended to proactively sign up for international initiatives designed to reduce tax avoidance and increase transparency. It is rated “compliant” by the OECD's Global Forum on Transparency and Exchange of Information for Tax Purposes and is one of only a handful of small offshore financial centres to achieve this rating.[16] Additionally, the IoM is an active participant in the OECD’s action plan on “harmful tax practices” related to profit-shifting by multinational companies. The strategy pursued by the authorities to diversify away from traditional banking and encourage companies to establish significant operations on the island will help mitigate the impact of these initiatives on the IoM.

In March 2019, the IoM was removed from the European Commission's “grey list” of noncooperative tax jurisdictions following the passing of tax legislation by Tynwald in December 2018 that set out new requirements for IoM resident companies deriving income from activity in a range of sectors, including banking, insurance and headquartering.[17] As part of its annual review published in January, the OECD declared the system's tax practices “not harmful” and identified no issues in the effectiveness in practice for 2022.

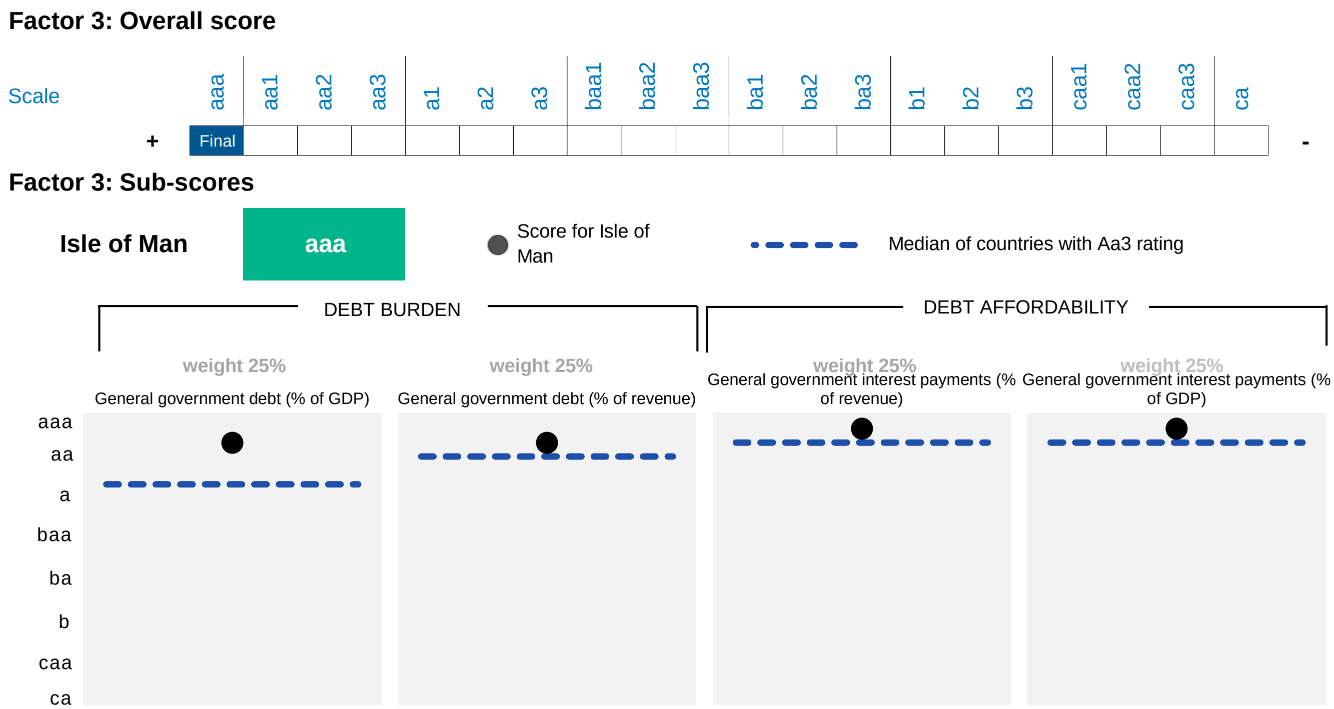
Following cross-party pressure from the UK Parliament, the IoM, along with the other Crown Dependencies, also pledged in June 2019 to adopt public registers of the ultimate owners of offshore companies incorporated in their jurisdictions. Currently, only local authorities, law enforcement authorities and their international counterparts can access this information. The phased transition would see registers become first available for Isle of Man financial services businesses that require access for corporate due-diligence purposes, and finally to the public.[18]

Furthermore, the IoM is a participant in the OECD agreement for a two-pillar solution to the tax challenges arising from the digitalisation of the economy, which will place further pressure on low-tax jurisdictions. In particular, the aim to introduce a global minimum tax rate of 15% for large companies under Pillar 2 of the agreement, endorsed by the G20 group of countries in July 2021, demonstrates strong cross-country commitment to increase fairness in the global tax system.

The Isle of Man agreed a joint approach with Jersey and Guernsey in relation to the implementation of the 15% minimum tax rate from 2025, as part of efforts to ensure that the new tax does not impact their competitiveness across the three jurisdictions. In the short term, the new tax will support government revenue. However, the impact on the island's ability to compete as a low- or no-tax jurisdiction over the longer term is uncertain and will depend on how firms react. Nevertheless, the change will only be applicable to large multinationals,[19] helping mitigate the overall effect of this policy on the IoM’s credit profile, with most companies remaining within the Island’s established “zero-10” tax regime.

Overall, we expect the pressure on low-tax jurisdictions to revise their tax systems to continue to increase in the coming years.

Fiscal strength score: aaa



Fiscal strength captures the overall health of government finances, incorporating the assessment of relative debt burdens and debt affordability as well as the structure of government debt. Some governments have a greater ability to carry a higher debt burden at affordable rates than others. Fiscal strength is adjusted for the debt trend, the share of foreign currency debt in government debt, other public sector debt and for cases in which public sector financial assets or sovereign wealth funds are present. Depending on the adjustment factor, the overall score of fiscal strength can be lowered or increased.

Note: the initial factor score is shown in light blue in the scale above. In case the initial and final factor scores are the same, only the final score will appear in the table above.

We assess the IoM's fiscal strength at "aaa", given its very low direct general government debt and high level of overall reserves, which total around 30% of 2022 GDP. The IoM issued its first direct bond in 2021 amounting to £400 million, or 6.6% of 2022 GDP, which remains one of the lowest debt burdens among the sovereigns we rate. The government also indirectly supports the debt issued by the combined electricity and water utility, the Manx Utilities Authority (MUA), amounting to a combined £260 million (around 4.3% of 2022 GDP), which poses a contingent liability for the government. The government's commitment to fiscal consolidation, despite relatively limited fiscal tools, is also supportive of the island's fiscal strength.

Exhibit 12

Peer comparison table factor 3: Fiscal strength

	Isle of Man Aa3/NEG	aaa Median	Abu Dhabi Aa2/STA	Estonia A1/STA	Macao SAR, China Aa3/STA	Saudi Arabia A1/POS	Switzerland Aaa/STA	Cayman Islands Aa3/STA
Final score	aaa		aaa	aaa	aaa	aaa	aaa	aa1
Initial score	aaa		aaa	aaa	aaa	aaa	aaa	aa1
Gen. gov. debt (% of GDP)	6.6	14.5	14.5	18.4	0.0	23.8	27.6	8.9
Gen. gov. debt (% of revenue)	34.6	48.7	39.1	47.8	0.0	78.1	83.8	49.6
Gen. gov. interest payments (% of GDP)	0.1	0.1	0.2	0.1	0.0	0.7	0.3	0.3
Gen. gov. int. payments (% of revenue)	0.6	0.3	0.5	0.2	0.0	2.4	0.9	1.6

Sources: National authorities, IMF and Moody's Investors Service

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

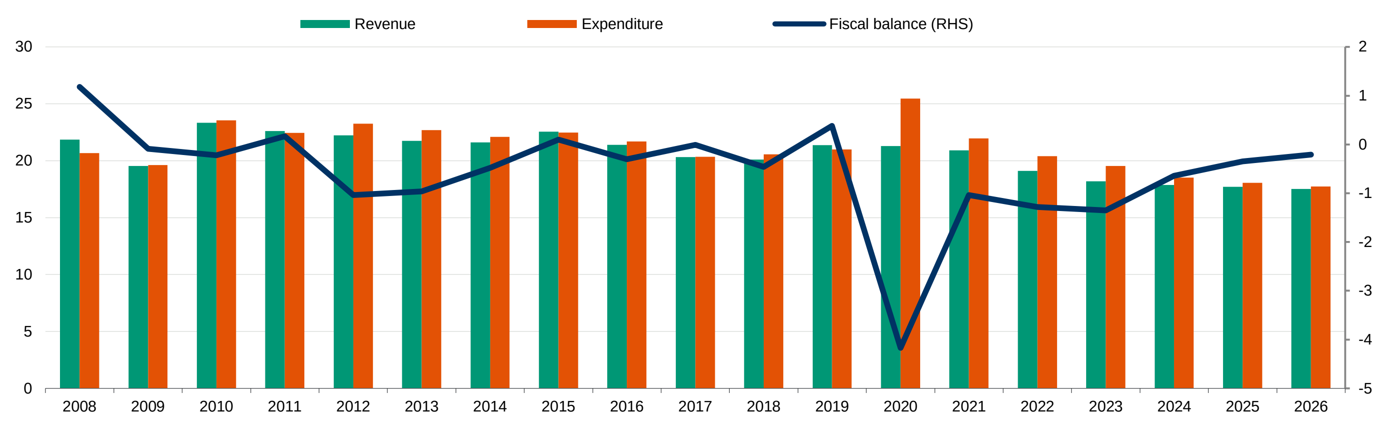
Government finances continue to gradually improve after they deteriorated during the pandemic, when the structural budget deficit reached around £217 million in financial year 2020-2021 because of higher health spending and economic support, and weaker tax revenue. The relatively moderate size of the fiscal shock from the pandemic was largely because of the strong initial position of the IoM's public finances in the years prior, with the government posting a surplus of £68.9 million on the revenue account in 2019-20. However, the government's latest budget (Pink Book, financial year [FY] 2023-2024) estimates that the structural budget deficit (excluding transfers from reserves) deteriorated somewhat in FY 2022-2023 to £144.4 million, higher than the budgeted £97.4 million, given the need for additional financial support during the energy crisis.

The latest Pink Book forecasts a slight increase in the deficit to £152.9 million in FY 2023-24, as inflationary pressures are not likely to abate in the short term and will continue to push up costs, after which the deficit is forecast to gradually decline in subsequent years because of higher income levels. However, previous plans by the government to move to a structural surplus by 2024-25 are no longer likely to be met given higher spending on health and social care, and the government's extensive capital programme. Employee costs and welfare payments are forecast to increase by 7.6% and 6.4%, respectively, between 2022-2023 and 2025-2026. Transfers to the capital financing reserve are forecast to double over this period, reaching £40 million.

We project, according to our general government definition,[20] that the budget deficit will remain around 1.3% 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 expenditure will continue to face pressure 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, impeding efforts to reduce the structural budget deficit in the wake of the pandemic. The government has provided around £18 million (0.3% of 2022 GDP) in direct financial support since 2022, and the electricity price cap expired in March 2023 (although the facility made available to the MUA for financing the cap was not drawn).

Exhibit 13
The IoM's budget is recovering after a large deficit in 2020
General government financial balance, percentage of GDP

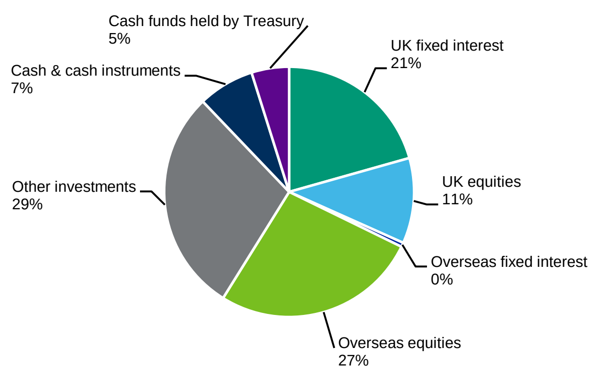


2022 to 2026 are our own estimates or forecasts.
Sources: Isle of Man Treasury and Moody's Investors Service

The deficit will continue to be financed through the use of reserves, which provide an important buffer to offset recent shocks. The IoM's reserves, built up from the robust fiscal surpluses the government recorded before the global financial crisis, remain among the strongest across the sovereigns that we rate and are a key support for the island's fiscal strength.

The market value of total externally invested funds was an estimated £1.8 billion (around 30% of estimated GDP) in March 2023, according to the latest Pink Book, slightly below the market value at the end of March 2022 (around £2 billion), with a significant proportion held in the National Insurance Fund (around £1 billion). The latest budget expects reserves to grow moderately to around £1.9 billion by FY 2027-28. The external funds are mainly invested in liquid assets such as traded equities and fixed-income instruments, although the precise nature of the underlying investments varies according to each fund's purpose. The IoM government appoints external investment managers, whose tenures last five years. As Exhibit 14 shows, the investment portfolio (as of the end of March 2022) is diversified.

Exhibit 14
Reserve funds hold a diversified portfolio
Market value of reserves by asset type, % of total (March 2022)

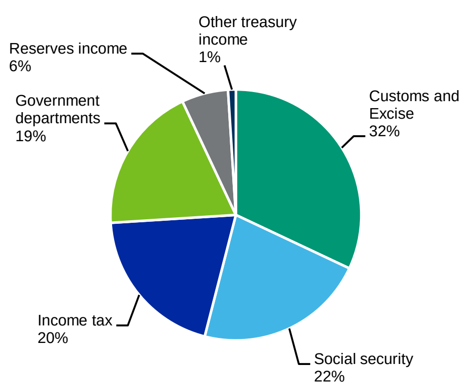


Sources: Isle of Man Treasury and Moody's Investors Service

Government is planning to reduce its reliance on reserve deficit financing ...

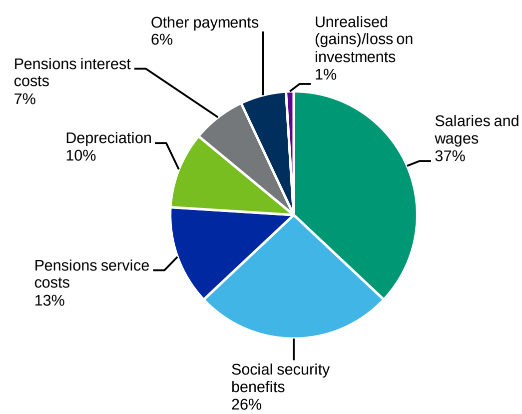
The government has maintained a conservative approach to public finances since the global financial crisis, following a significant decline in tax revenue that was led by the renegotiation between the IoM and the UK government on their sharing of common duties (including value-added tax [VAT]). Fiscal deficits have been met by drawing upon the island's substantial reserve funds, rather than issuing debt. The issuance of its first bond in 2021, amounting to £400 million, has also added to reserves, with around £91 million left in a dedicated Bond Issue fund at the end of March 2023.

Exhibit 15
Reliance on VAT revenue remains high
Government revenue by source, percentage of total (2021-22)



Sources: Isle of Man Treasury and Moody's Investors Service

Exhibit 16
Focus has been on reducing the wage bill and pension outlays
Government expenditure by source, percentage of total (2021-22)



"Salaries and wages" also includes other employee costs.
Sources: Isle of Man Treasury and Moody's Investors Service

Overall, we expect fiscal policy to remain prudent and to continue to have the preservation of financial reserves as a key aim, even as structural challenges persist. Since 2010, the government has enacted significant spending cuts to reduce the structural deficit. These include cuts to the public-sector headcount and the restructuring of several government departments.[21] The government has also focused on reducing the public-sector wage bill by outsourcing or stopping some services and centralising the procurement of goods and services. Before the energy crisis, the government had also capped salary growth at 1%.[22]

In contrast, the government has limited room for manoeuvring on the revenue side, given that the IoM's low-tax environment constitutes a competitive advantage and that the proportion of VAT receipts is already high (see Exhibit 15).

... although public finances face structural challenges from capital investment, health and pensions

However, the budget's aim to reduce the government's ongoing reliance on reserves will face challenges from its extensive capital development plan and spending pressures from health and social care, and pensions.

As part of the budget, the government outlined a new five-year £442 million capital development plan. The plan includes £115 million allocated for the 2023-24 financial year with a focus on improving the port and highway infrastructure, hospital equipment, and measures to support climate change adaptations as part of achieving the government's net-zero carbon emissions target by 2050. 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. The government plans for its ambitious capital spending programme to be fully financed from its revenue by 2027-28, one year later than previously planned, as part of the gradual move towards a balanced budget.

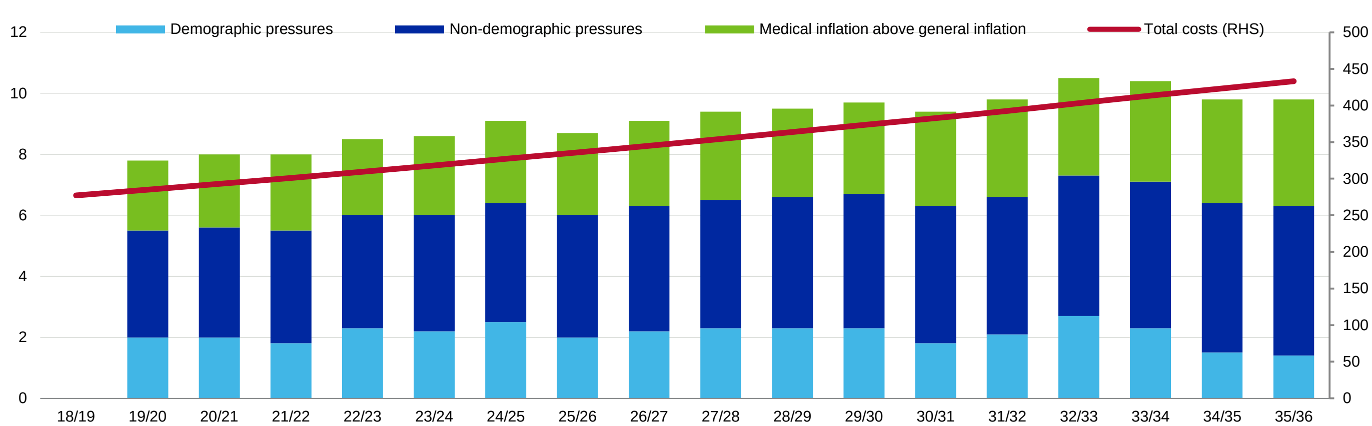
Health had already been a recurrent source of spending pressure before the pandemic, with the Department for Health and Social Care (DHSC) receiving a total of £42.5 million in supplementary funding between 2016 and January 2020. The government plans for the health and care funding gap in the 2023-24 budget to be partially met through the use of £8.5 million from the investment income of the Manx National Insurance Fund, similar to last year. A plan to sustainably finance the gap from 2024-25 through the end of the five-year forecast, estimated at around £170 million (2.8% of GDP), is to be outlined in due course. The shortfall continues to be shown separately in the budget to ensure transparency and help build consensus around a potential funding solution.

An independent review of the health service concluded in May 2019 and made 26 recommendations, most notably the separation of the policy and strategy-setting body from the delivery organisation. A key milestone was reached on 1 April 2021 with the establishment of Manx Care, in line with the recommendations of the report for a new independent body to provide frontline health and social care. Tynwald has approved the recommendations and allocated a further £3.5 million to the Healthcare Transformation Fund, on top of the £15 million allocated in previous years, to fund their implementation. In a no-change scenario, the review estimated that health and social care funding needs would rise by an average of £9.2 million a year through 2035-2036 (see Exhibit 17).

Exhibit 17

Health continues to be a key source of spending pressure

Future cost forecast broken down by source of cost increase, in a no-change scenario (in £ million)



Sources: Independent Health and Social Care Review and Moody's Investors Service

Pensions for public-sector employees are the most significant longer-term obligation for the government. Like the UK, the IoM had built up reserves in a specific Public Service Employees Pension Reserve, but these were depleted in FY 2022-23 and public-sector pensions are now funded out of the general budget. Expenditure for public-sector pensions amounted to £30 million in FY 2022-23 and will rise to £43 million in FY 2023-24 and to around £49 million in 2024-25, according to the latest financial plan, leading to additional pressure on the revenue account. The most recent IFRS estimate places net pension liabilities at £4.6 billion, or 76% of GDP, as of the end of March 2022.

The IoM has also been advancing the reform of state pensions and benefits. Following a comprehensive review of the social security system, the Parliament approved a new Manx state pension scheme that came into effect in April 2019.[23] This year, the PSPA introduced a voluntary defined contribution arrangement for new public servants as a further measure to reduce pension costs.

New VAT survey has been confirmed and the government has adopted conservative management of customs duty income expectations

The IoM has had a Customs and Excise Agreement or Common Purse Agreement with the UK for several decades, which serves to make the UK and IoM a single VAT and customs area. The current agreement dates back to 1979 and provides for the sharing of common duties by way of a revenue-sharing agreement (RSA). The RSA covers VAT, customs duties and many, although not all, excise duties, and means that there are no customs barriers between the two sides.

Negotiations with the UK over revising the RSA concluded in March 2016, removing a key uncertainty for the island's public finances. The formula adopted under the agreement — the final expenditure revenue-sharing arrangement (FERSA) — provides the IoM with a share of the joint indirect tax revenue based largely on final expenditure by IoM households and exempt businesses. FERSA provides that final expenditure surveys will be undertaken every five years, and in between survey years, the island's provisional share is calculated by indexation of the base year.

While FERSA alleviates uncertainty over how much income will be due to the island, income through the arrangement — accounting for around one-third of the IoM's total revenue — could be weaker than expected as part of an annual adjustment, particularly if weaker UK economic growth strains the IoM economy.

Work on a new series of VAT surveys will take place in 2023-24 with a new set of calculations and a renewal of the indexation rate to be agreed with the UK Treasury thereafter. The conclusion of the surveys may result in an adjustment payment due by the IoM if the economy performed worse than what was expected when the indexation rate was agreed upon in February 2020. However, the IoM has already paid a one-off adjustment to the Island's share of the FERSA (amounting to £23.8 million) to take account of the impact of the pandemic on the island's share of VAT.[24]

The IoM government has also tried to address these risks by adopting conservative assumptions, for example, by assuming growth in the VAT budget of only 3.35% (rather than 4.35% in the agreement) per year in its recent medium-term fiscal plans. On the other hand, a positive outcome would not only result in better-than-expected indirect tax revenue but also allow for the release of provisions held back over previous years to deal with a negative outcome, as it happened in 2020.

In a more extreme scenario, the IoM could be exposed to changes in the RSA by the UK, although the UK government would be required to give two years' notice.

Very low direct debt is a key strength, with public utility's indirect debt to be repaid from sinking fund

The IoM issued its first direct government bond in September 2021, raising £400 million in sustainable bonds (equivalent to 6.6% of 2022 GDP) with a 30-year maturity and a 1.625% coupon. The proceeds will be used for the refinancing of local state-owned enterprises but also for investments in infrastructure, health care and climate-related projects. Around £87 million from the bond issue is budgeted to be available in reserves by the end of April 2024. The Treasury has established a sinking fund to support the future repayment of its new bond issue.

The IoM also has indirect obligations with respect to the MUA, amounting to £260 million (4.3% of GDP). The MUA was created in April 2014 through the merger of the Isle of Man Water and Sewerage Authority and the Manx Electricity Authority (MEA). Upon the merger, a 20-year financial plan for the combined entity was developed to build up sufficient funds to repay both entities' external debt obligations, which were originally raised to fund large infrastructure projects.

The water authority had a sinking fund that will allow it to repay a £75 million (around 1.2% of GDP) bond that comes due in 2030. In contrast, the MEA was in poor financial shape and, in 2013, had to use £35 million of the government's reserve funds to meet financial obligations. This situation highlights the close link between the MUA's obligations and the government, and the entity's obligations represent a contingent liability for the government. The MUA has been reducing its operating losses and improving its efficiency, although higher energy costs and increased net finance costs on gas forward contracts have posed a significant challenge for the entity.

The sinking fund was transferred into the Treasury's name in April 2015 and renamed the MUA Bond Repayment Fund, with the aim of growing the funds so that both outstanding bond issues, totalling £260 million, can be repaid in 2030 and 2034 (see Exhibit 18). The fund's market value was estimated at £52.3 million at the end of March 2023, according to the latest Pink Book. The MUA is paying into the fund on an annual basis to ensure the government will not have to use its own reserves for future repayments.

Exhibit 18
IoM government also has indirect obligations on behalf of the MEA and water authority

Statutory Board	Amount	Interest rate	Maturity Date
Manx Utilities Authority (former Isle of Man Water and Sewerage Authority)	£75 million	5.625% (fixed)	29 March 2030
Manx Utilities Authority (former Manx Electricity Authority)	£185 million	5.375% (fixed)	14 August 2034

The amounts shown in the table have been issued by the Treasury on behalf of the MUA.
Sources: Isle of Man Treasury and Moody's Investors Service.

Government guarantees amounted to around £275 million at the end of March 2021. These are mainly guarantees extended to local authorities to support the borrowing for housing projects, and largely constitute letters of comfort issued by the Treasury to the banks in relation to authorised borrowings of local authorities amounting to £266 million. The local authorities' accounts are largely in balance. During 2020-21, the government also agreed to underwrite 80% of up to £60 million of new lending by banks through the Loan Disruption Agreement, although no claims had been made during the 2021-22 financial year.

Susceptibility to event risk score: a

Factor 4: Overall score

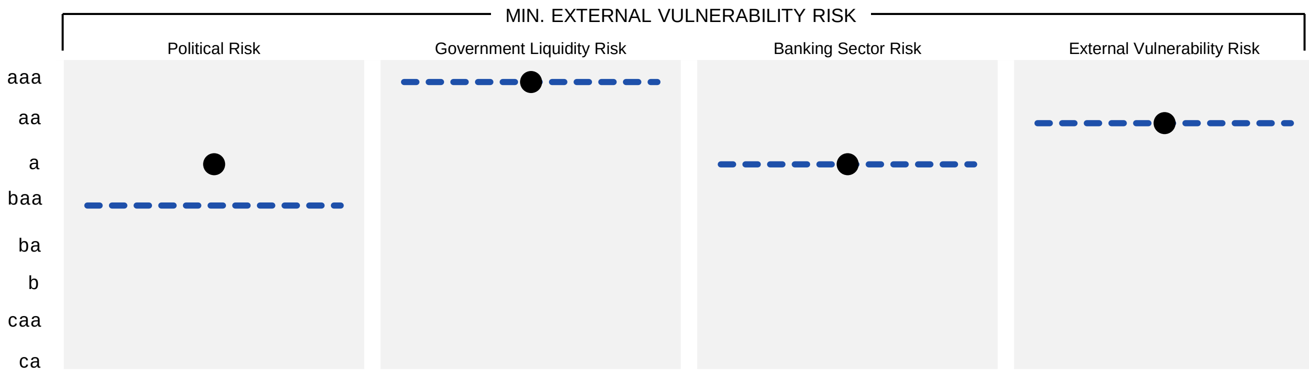
Scale	aaa	aa	a	baa	ba	b	caa	ca	
+			Final						-

Factor 4: Sub-scores

Isle of Man	a

● Score for Isle of Man — Median of countries with Aa3 rating

Overall adjustment to Factor 4 Susceptibility to Event Risk: 0



Susceptibility to event risk evaluates a country's vulnerability to the risk that sudden events may severely strain public finances, thus increasing the country's probability of default. Such risks include political, government liquidity, banking sector and external vulnerability risks. Susceptibility to event risk is a constraint which can only lower the scorecard-indicated outcome.
Note: the initial factor score is shown in light blue in the scale above. In case the initial and final factor scores are the same, only the final score will appear in the table above.

The "a" susceptibility to event risk score is driven by our assessment of political and banking sector risks.

Political risk is limited, although the UK Treasury's decisions can affect revenue intake

We recently lowered our political risk score from "aa" to "a" to reflect an increased (although still low) risk of contagion from Russia's invasion of Ukraine. The direct exposure of the IoM to security, energy and trade risks stemming from Russia's invasion is limited, largely because of its distant location. However, the probability of such risks materialising or generating spillovers from other European countries (including the UK through the energy channel) have become more elevated in light of the ongoing military conflict. Nevertheless, political risks are lower for the IoM than for most European sovereigns, partly because the IoM, as a non-NATO member, is not exposed to contagion security risks through the potential activation of NATO's collective defence clause.

The risks from the domestic political environment are limited. While there are several political parties, they wield only very limited influence in Tynwald. The 24 members of the lower branch are elected directly by popular vote, with the chief minister, in turn, elected by the members of Tynwald. General elections to the House of Keys, the lower branch of Tynwald, were held on the island in late September 2021, with independents winning 86.3% of the vote and 21 out of the 24 seats, while the Manx Labour Party gained two seats at the expense of the Liberal Party. Alfred Cannan, who was previously Treasury Minister, was elected as the IoM's new Chief Minister. Given the stable institutions and predictable policymaking, we do not expect the results of the next parliamentary election in 2026 to drive credit outcomes.

Exhibit 19

Peer comparison table factor 4a: Political risk

	Isle of Man	a Median	Bermuda	Chile	Ireland	Macao SAR, China	Cayman Islands	Czech Republic
	Aa3/NEG		A2/STA	A2/STA	Aa3/STA	Aa3/STA	Aa3/STA	Aa3/NEG
Final score	a		a	a	a	a	aa	baa
Voice & accountability, score[1]	--	0.6	0.0	1.0	1.4	-0.5	0.8	1.0
Political stability, score[1]	--	0.9	1.0	0.1	0.9	1.0	1.7	1.0

[1] Composite index with values from about -2.50 to 2.50: higher values correspond to better governance.
Sources: National authorities, IMF and Moody's Investors Service

While the IoM's revenue intake can be adversely affected by the UK government's decisions, these RSAs are voluntary, and if they are seen to offer too many disadvantages for the island, it can withdraw and unilaterally change its policies. However, this flexibility also introduces some political uncertainty and dependence on UK government decisions, which the "a" political risk score also reflects.

Government liquidity risk is very low

Government liquidity risk is assessed as "aaa". The IoM has no external limitations on its ability to borrow, although direct debt remains very low, with the island issuing its first £400 million bond only recently in 2021. This first issuance has opened the IoM's access to capital markets and is a step towards establishing a track record of reliable market access that can be tapped in the future if needed. A Bond Repayment Sinking Fund has been established to meet the government's repayment obligations for this 30-year maturity bond. According to the government's latest five-year financial plan, £3.5 million will be allocated to the fund each year from 2022.

The government also continues to stand behind the MUA's debt. Its willingness to provide support to the utility was clearly demonstrated when the government used £35 million of its reserve funds to cover the MEA's obligations in 2013. The merger of the island's electricity and water utilities, which was completed in 2014, puts the combined entity on a more sustainable financial footing to ensure repayment of the MUA's debt. The MUA is paying into a sinking fund on an annual basis to ensure the government will not have to use its own reserves to cover the repayment of its outstanding bond issues totalling £260 million.

Exhibit 20

Peer comparison table factor 4b: Government liquidity risk

	Isle of Man	aaa Median	Austria	Finland	France	Hong Kong SAR, China	Israel	Taiwan, China
	Aa3/NEG		Aa1/STA	Aa1/STA	Aa2/STA	Aa3/STA	A1/STA	Aa3/STA
Final score	aaa		aaa	aaa	aaa	aaa	aaa	aaa
Initial score	aaa		aaa	aaa	aaa	aaa	aaa	aaa
Ease of access to funding	aaa	aaa	aaa	aaa	aaa	aaa	aaa	aaa
Gross borrowing requirements (% of GDP)	1.3	5.7	15.7	10.4	16.4	3.9	6.2	3.0

Sources: National authorities, IMF and Moody's Investors Service

Fiscal deficits continue to be financed through transfers from the island's reserve funds. As discussed in the fiscal strength section, these funds remain significant. The Treasury also retains significant cash on hand to address liquidity needs.

Banking sector poses limited risks to government balance sheet despite large size

Banking sector risk is assessed as "a". The IoM's large exposure to the financial services sector remains one of its main sources of event risk. Total assets of licensed banks rose over the course of 2022 to £44.2 billion, although still lower than a decade earlier, equivalent to more than six times the island's estimated GDP. However, nearly all of those assets (with the significant exception of Conister Bank)[25] relate to foreign-owned entities. Also, rising international pressure to enhance tax transparency could pose challenges to the financial sector. However, the risks emanating from the banking sector are mitigated by the low-risk nature of the business, which is predominantly foreign-owned, and high levels of capital.

Exhibit 21

Peer comparison table factor 4c: Banking sector risk

	Isle of Man Aa3/NEG	a Median	Belgium Aa3/STA	Czech Republic Aa3/NEG	Estonia A1/STA	France Aa2/STA	Hong Kong SAR, China Aa3/STA	Taiwan, China Aa3/STA
Final score	a		a	a	a	a	a	a
Initial score	a		a	a	a	a	a	a
BCA[1]	--	baa2	baa1	baa1	baa3	baa1	a3	baa1
BSCE[2]	aaa-a3	baa2	baa1	baa1	baa3	baa1	aaa-a3	baa1
Total domestic bank assets (% of GDP)	652.4	170.6	232.3	131.7	105.4	435.8	781.5	292.8

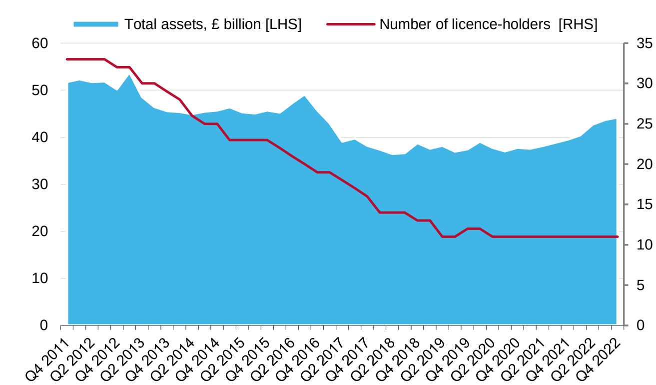
[1] BCA is an average of Baseline Credit Assessments (BCAs) for rated domestic banks, weighted by bank assets.
[2] Where we have no or small rating coverage in a system, we estimate the risk of a banking sector credit event (BSCE) based on available data for aggregate banking system.
Sources: National authorities, IMF and Moody's Investors Service

There are currently only 11 deposit-taking institutions on the island, down from 33 in 2012 (see Exhibit 23). Several institutions have surrendered licences and closed their IoM operations in previous years, including Permanent Bank International Limited, Duncan Lawrie (IOM) Limited and Nationwide Building Society, consistent with the broad slowdown in the growth of traditional banking services in the IoM.

Exhibit 22

Number of banking licence holders has declined since the global financial crisis...

Total assets in £ billion (LHS) and number of licence holders (RHS)

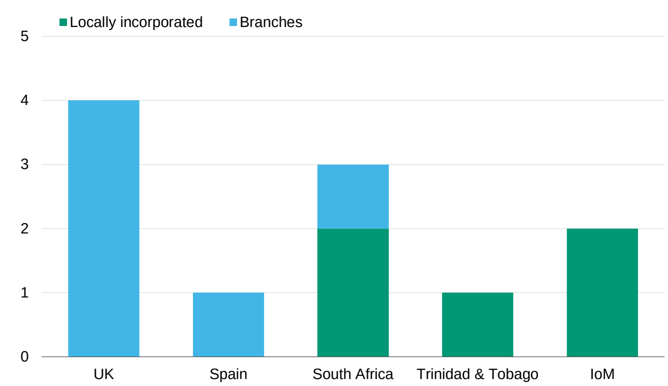


Sources: Isle of Man Financial Services Authority and Moody's Investors Service

Exhibit 23

...falling to just 11 holders in 2022

Ultimate country of origin of banking groups operating in the IoM (December 2021)



Sources: Isle of Man Financial Services Authority and Moody's Investors Service

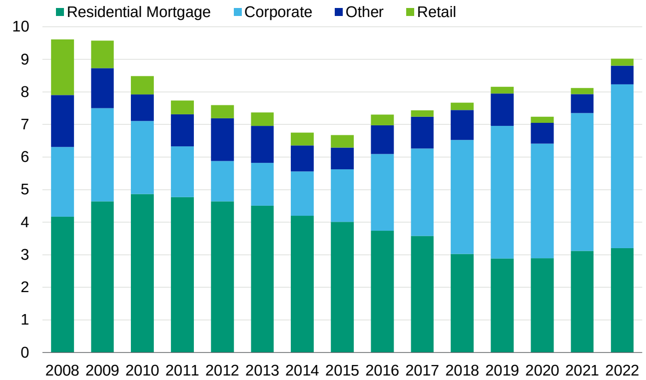
Despite the banking system's large size relative to GDP, only Conister Bank Limited and Capital International Bank Limited are not part of a wider banking group subject to consolidated supervision outside the IoM. Conister Bank had about £354 million in assets (around 5.8% of GDP) at the end of 2022. Most of the other banks are UK-based, although there are also a small number of Spanish, South African, and Trinidad and Tobago institutions.

The financial industry's declining importance to the IoM's economy can also be seen in the composition of assets and liabilities in the banking sector, not including those held in overseas branches of IoM-incorporated banks. Since the end of 2012, total assets have fallen by around 14%. As of December 2022, most assets consisted of loans to parent banks (£29.9 billion, or 68% of total assets). By contrast, only £9 billion of assets were loans, advances and leases[26] (see Exhibit 24). On the liabilities side, most of the banks' obligations consisted of deposits (£42.8 billion or 97% of total liabilities), which were much lower than in 2008. The vast majority of deposits are retail or corporate, with close to two-thirds of customer deposits coming from residents in the IoM or the UK (see Exhibit 25).

Exhibit 24

Corporate loans continue to expand despite broad decline in lending

Non-bank lending by sector, in £ billion

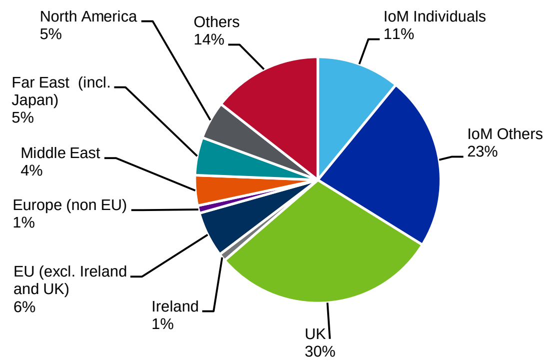


Sources: Isle of Man Financial Services Authority and Moody's Investors Service

Exhibit 25

Deposits are largely sourced from the IoM and the UK

Geographical source of non-bank deposits (percentage of total, December 2021)



The total may not add up to 100% because of rounding.
Sources: Isle of Man Financial Services Authority and Moody's Investors Service

Although rising interest rates and inflation have put pressure on the financial position of banks' customers, credit quality has not been significantly strained to date, given households' high savings and prudent stress testing of new mortgages in recent years. Banks are likely to see an impact on credit quality in the coming quarters, but prudential risk remains well controlled. At the same time, higher interest rates are supporting banks' profitability.

A new bank resolution and recovery regime came into effect at the start of 2021, providing a wider range of mechanisms other than liquidation to deal with a failing bank, and broadly reflecting similar legislation in the UK. While it applies to all domestic operations, it is likely that any decisions around distressed branches would need to be taken in conjunction with the affected group's home regulator. As part of the new model, resolution plans are being prepared for each bank incorporated in the island, in conjunction with overseas regulators.

The IoM has a long-standing Depositors' Compensation Scheme (DCS), introduced in 1991. The DCS does not maintain a standing fund, and the net total amounts to be provided to the fund for all compensation costs arising from defaults in any 10-year period are limited to £100 million apiece for both the banks and the IoM government.[27] A review of the wider framework for dealing with bank failures is due to be finalised by early 2025 and will consider improvements to asset recovery, including early warning indicators and contingency plans,[28] prioritisation of creditors in a bank insolvency, future changes to the limits of the DCS scheme and its funding structure to help bring the scheme in line with new international standards, and the legal structure of banks operating in the IoM.

In contrast with the actions surrounding other banking failures during the global financial crisis, the Manx authorities did not need to resort to borrowings — with associated fiscal costs — during the resolution and liquidation of the Icelandic subsidiary Kaupthing Singer & Friedlander (Isle of Man) after its failure in 2009. The liquidator recovered the full value for depositors because of the high asset quality of the subsidiary.

The regulator also continues to be proactive in updating supervisory and regulatory practices to bring them in line with international standards.

The regulator recently started to implement a new funding model for firms regulated and supervised by the IoM Financial Services Authority (IoMFSA), as part of efforts to reduce the amount of government financial support and make the regulator predominantly industry-funded by 2025-26.[29] The regulator also updated its supervisory approach in 2023 to ensure that supervisory activity is proportionate to the firm's impact, given its size, activity and potential to cause disruption to the island's financial system. High- and medium-impact firms, which include regulated banks, will continue to receive proactive monitoring, while the supervision of low impact firms will rely on data automation and exception reporting. The FSA is also continuing towards implementing Basel 3 liquidity requirements for banks as part of efforts to keep in line with international regulatory standards. We consider it unlikely that these changes would alter the overall competitive landscape of the banking sector, particularly because more substantial regulatory changes have already prompted notable restructurings in recent years.

However, two main factors will continue to pose risks to the IoM's banking sector:

» **The evolution of the UK banking structural reform process, particularly with regard to ring-fencing rules that came into full effect in January 2019 and which are likely to evolve further as part of the UK's 2022 Edinburgh Reforms:** Since 2019, the IoM operations of the large UK banking groups are required to be outside of the ring-fenced parts of these groups. Such a situation raises uncertainty as to their place within the new group structures and strategies. However, most of the resulting groupwide restructuring is likely to have now taken place, and the IoM operations have proven to be a valuable source of liquidity for their banking groups. In a similar vein, any loosening of these rules under the recently announced Edinburgh Reforms is unlikely to have a significant impact on the operations in the IoM. Nevertheless, intense scrutiny of bank regulations and banking sector structures in both the UK and at the EU level following the global financial crisis – which will in turn affect the UK's legal framework – means the IoM faces a structurally higher degree of legislative and political risk than before.

» **International focus on recovering funds from offshore financial centres, as advanced economies around the world face greater fiscal challenges:** This situation will likely constrain growth in the IoM's banking industry. Nevertheless, the IoM has been proactively implementing Tax Information Exchange Agreements to alleviate such international pressure. It has also been at the forefront among the Crown Dependencies in adopting FATCA-style agreements on automatic information exchanges with the UK and US authorities.

To mitigate potential effects on the sector, the authorities proactively implemented an alternative banking regime, which was introduced in August 2016, including the creation of two new types of banking licences aimed at enticing new entrants to the market, especially in the corporate lending segment.[30] Nevertheless, despite these developments, the overall structure of the banking sector has remained relatively stable over the past 5 years.

External vulnerability risk is absent because of the customs and currency relationship with the UK

The IoM uses the Manx pound, which is pegged to sterling at a 1:1 exchange rate. The UK pound, a global reserve currency, is also legal tender in the IoM. Because of its customs relationship with the UK, the IoM does not produce balance-of-payments statistics.

Exhibit 26

Peer comparison table factor 4d: External vulnerability risk

	Isle of Man Aa3/NEG	aa Median	Finland Aa1/STA	Lithuania A2/STA	Qatar Aa3/POS	Belgium Aa3/STA	Korea Aa2/STA	Taiwan, China Aa3/STA
Final score	aa		aa	aa	aa	aaa	aaa	aaa
Initial score	aa		aa	aa	aa	aaa	aaa	aaa
Current account balance (% of GDP)	--	-0.8	-3.9	-5.1	26.6	-3.6	1.8	13.4
Net IIP (% of GDP)[1]	--	0.6	-2.7	-6.6	--	53.9	46.1	--
External debt (% of current account receipts)	--	146.1	95.0	71.9	152.5	--	74.9	34.6
External vulnerability indicator (EVI)[2]	--	36.0	--	--	--	--	68.5	35.4

[1] Net international investment position (percentage of GDP).
[2] (Short-term external debt + currently maturing long-term debt + total nonresident deposits over one year)/official foreign-exchange reserves.
Sources: National authorities, IMF and Moody's Investors Service

ESG considerations

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

Exhibit 27
ESG Credit Impact Score

CIS-2
Neutral-to-Low

NEGATIVE IMPACT | POSITIVE IMPACT

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 capacity to respond to shocks in general.

Exhibit 28
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
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 and 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 supports 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.

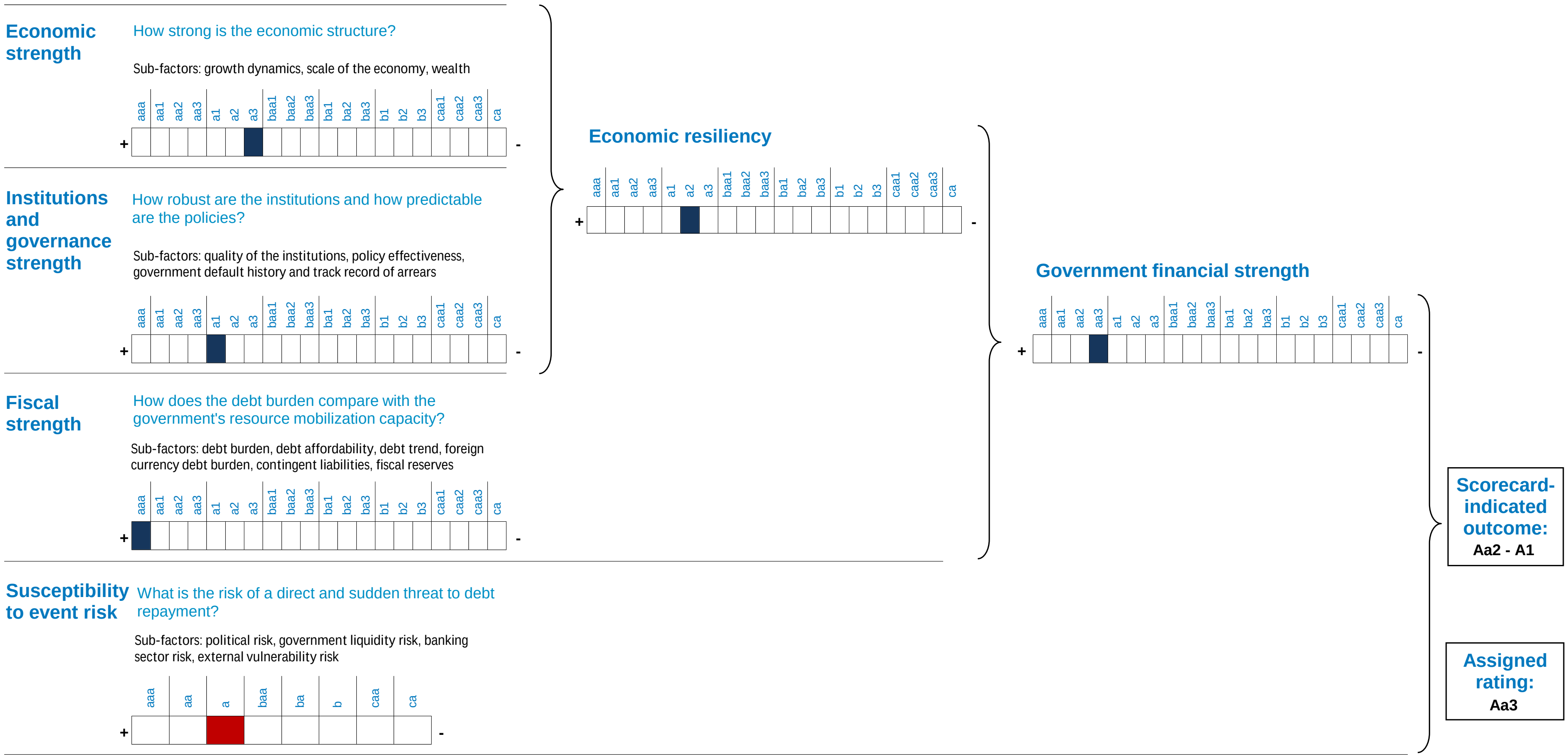
All of these considerations are further discussed in the "Credit profile" section above. Our approach to ESG is explained in our report on how the scores depict varied and largely credit-negative impact of ESG factors and our cross-sector methodology General Principles for Assessing Environmental, Social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

Scorecard-indicated outcome

Combining the scores for individual factors provides the scorecard-indicated outcome. While the 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 Rating Methodology: Sovereigns.

Exhibit 29

Sovereign rating metrics: Isle of Man



Source: Moody's Investors Service

Comparatives

This section compares credit relevant information regarding the IoM with other sovereigns that we rate. It focuses on a comparison with sovereigns within the same scorecard-indicated outcome and shows the relevant credit metrics and factor scores. The IoM, in common with most other Aa-rated sovereigns, benefits from a high level of economic development and strong institutions. Measured by GDP per capita, which we estimate at around $87,000 in 2022, the IoM is one of the richest jurisdictions in the Aa rating category. The IoM has very low direct debt outstanding and also has access to significant reserves.

Exhibit 30

Isle of Man's key peers

	Year	Isle of Man	Taiwan, China	Hong Kong SAR, China	Czech Republic	France	Estonia	Aa3 Median	Western Europe Median
Rating/outlook		Aa3/NEG	Aa3/STA	Aa3/STA	Aa3/NEG	Aa2/STA	A1/STA	Aa3	Aa3
Scorecard-indicated outcome		Aa2 - A1	Aa2 - A1	Aa1 - Aa3	Aa2 - A1	Aa2 - A1	Aa3 - A2	Aa2 - A1	Aa2 - A1
Factor 1		**a3**	**aa3**	**a1**	**a3**	**a1**	**baa1**	**a1**	**a2**
Nominal GDP ($ bn)	2022	7.5	761.8	361.0	290.9	2777.4	38.0	326.0	528.5
GDP per capita (PPP, Intl$)	2022	--	69,151	69,153	49,421	56,426	45,480	69,151	64,656
Avg. real GDP (% change)	2018 - 2027F	1.4	3.2	1.2	1.5	1.0	2.4	1.8	1.5
MAD Volatility in real GDP growth (ppts)	2013 - 2022	1.5	0.5	0.9	0.6	0.7	1.4	0.8	0.9
Factor 2		**a1**	**aa2**	**aa3**	**aa3**	**aa2**	**aa3**	**aa3**	**aa2**
Quality of legislative & executive institutions	Latest available	a	aa	aa	aa	aaa	aa	aa	aa
Strength of civil society & judiciary	Latest available	a	aa	baa	a	aaa	a	aa	aaa
Fiscal policy effectiveness	Latest available	aa	aa	aaa	aa	a	aaa	aa	aa
Monetary & macro policy effectiveness	Latest available	a	aa	aa	aa	aa	a	aa	aa
Gen. gov. fiscal balance (% of GDP)	2022 - 2024F	-1.1	-2.0	-4.6	-3.5	-4.8	-2.5	-1.5	-2.0
Average inflation (% change)	2018 - 2027F	3.5	1.3	2.2	4.6	2.5	4.9	2.8	2.7
Volatility of inflation (ppts)	2013 - 2022	2.6	1.0	1.3	4.3	1.7	5.8	2.4	2.3
Factor 3		**aaa**	**aa3**	**aaa**	**aa3**	**a2**	**aaa**	**aa2**	**a1**
Gen. gov. debt (% of GDP)	2022	6.6	31.1	10.2	44.1	111.7	18.4	36.7	66.2
Gen. gov. debt (% of revenue)	2022	34.6	226.0	48.7	107.7	209.0	47.8	115.2	152.2
Gen. gov. interest payments (% of revenue)	2022	0.6	2.9	0.1	2.8	3.5	0.2	2.8	2.2
Gen. gov. interest payments (% of GDP)	2022	0.1	0.4	0.0	1.2	1.9	0.1	0.5	0.8
Factor 4		**a**	**ba**	**baa**	**baa**	**baa**	**ba**	**baa**	**baa**
Political risk	Latest available	**a**	**ba**	**baa**	**baa**	**baa**	**ba**	**baa**	**baa**
Government liquidity risk	Latest available	**aaa**	**aaa**	**aaa**	**aa**	**aaa**	**aa**	**aaa**	**aaa**
Gross borrowing requirements (% of GDP)	2023F	1.3	3.0	3.9	8.3	16.4	4.6	3.0	9.3
Banking sector risk	Latest available	**a**	**a**	**a**	**a**	**a**	**a**	**a**	**a**
BSCE[1]	Latest available	aaa-a3	baa1	aaa-a3	baa1	baa1	baa3	baa1	baa1
Total domestic bank assets (% of GDP)	2022	652.4	292.8	781.5	131.7	435.8	105.4	262.6	232.3
External vulnerability risk	Latest available	**aa**	**aaa**	**aa**	**a**	**aaa**	**a**	**aa**	**aa**
Current account balance (% of GDP)	2022	--	13.4	10.7	-6.1	-2.1	-2.2	-3.6	0.6
External vulnerability indicator (EVI)	2024F	--	35.4	--	--	--	--	35.4	--
External debt (% of current account receipts)	2022	--	34.6	196.5	83.6	--	91.5	174.5	285.5
Net international investment position (% of GDP)	2022	--	--	486.4	-20.4	-26.1	-20.5	21.5	24.6

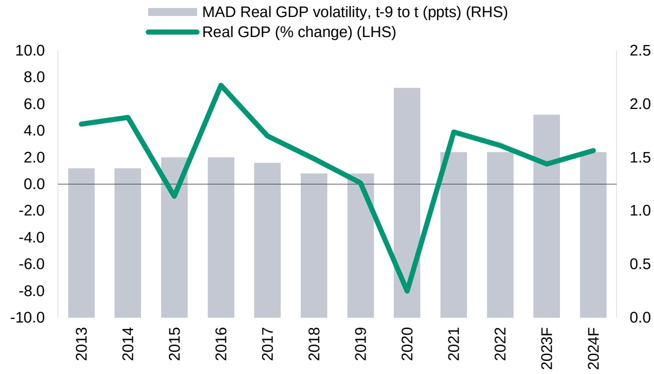
[1] BSCE is our estimate of the risk of a banking sector credit event (BSCE), which we use for sovereigns where we have no or very limited rating coverage of a system. Otherwise, we use the Baseline Credit Assessment (BCA) for rated domestic banks, weighted by bank assets.

Sources: National authorities, IMF and Moody's Investors Service

DATA, CHARTS AND REFERENCES

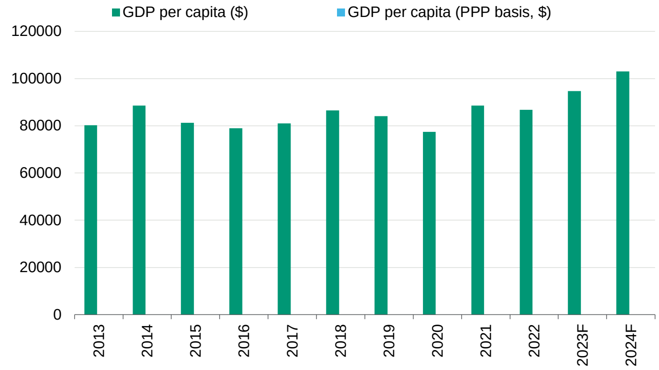
Chart pack: Isle of Man

Exhibit 31
Economic growth



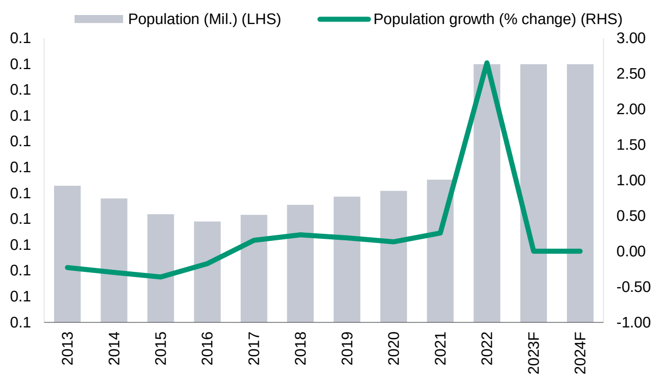
Source: Moody's Investors Service

Exhibit 32
National income



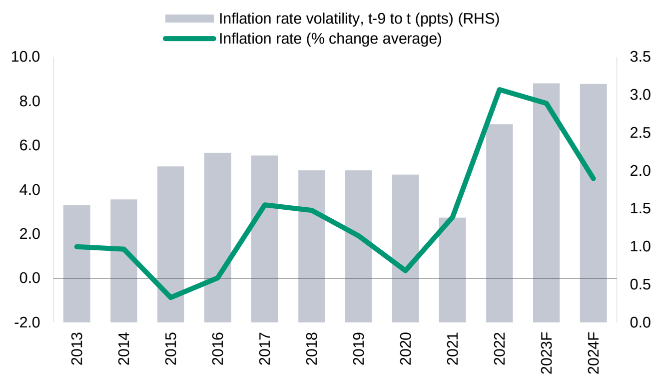
Source: Moody's Investors Service

Exhibit 33
Population



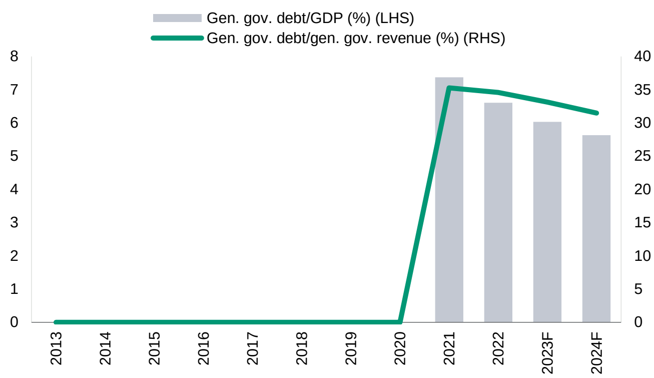
Source: Moody's Investors Service

Exhibit 34
Inflation and inflation volatility



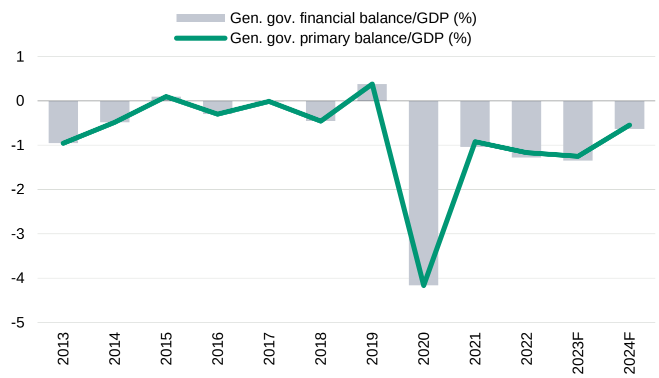
Source: Moody's Investors Service

Exhibit 35
Debt burden



[1] Composite index with values from about -2.50 to 2.50: higher values suggest greater maturity and responsiveness of government institutions.
Source: Worldwide Governance Indicators

Exhibit 36
Debt affordability



Source: Moody's Investors Service

Rating history

Exhibit 37
Isle of Man

Long Term Ratings		Outlook	Review Action		Short Term Ratings		Action Date
Foreign Currency	Local Currency		Foreign Currency	Local Currency	Foreign Currency	Local Currency	
Aa3	Aa3	NEG	-	-	-	-	Oct-22
Aa3	Aa3	STA	-	-	-	-	Oct-20
Aa2	Aa2	NEG	-	-	-	-	Nov-19
Aa2	Aa2	STA	-	-	-	-	Sep-17
Aa1	Aa1	NEG	-	-	-	-	Jun-16
Aa1	Aa1	STA	-	-	-	-	Dec-13
Aaa	Aaa	RUR	Possible Downgrade	Possible Downgrade	-	-	Jul-13
Aaa	Aaa	RUR	Possible Downgrade	Possible Downgrade	-	-	Oct-09
Aaa	Aaa	STA	-	-	-	-	15-Nov-03
Aaa	Aaa	-	-	-	-	-	3-Oct-00
Aaa	-	-	-	-	-	-	16-Dec-97

[1] Table excludes rating affirmations and ceilings. Please visit the issuer page for Isle of Man for the full rating history.
Source: Moody's Investors Service

Annual statistics

Exhibit 38

Isle of Man

	2013	2014	2015	2016	2017	2018	2019	2020E	2021E	2022E	2023F	2024F
Economic structure and performance												
Nominal GDP (US$ bil.)[1]	6.8	7.4	6.8	6.6	6.8	7.2	7.1	6.5	7.5	7.5	8.2	8.9
Population (Mil.)	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
GDP per capita (US$)	80,276	88,537	81,250	78,997	81,009	86,460	84,112	77,469	88,512	86,733	94,742	102,992
GDP per capita (PPP basis, US$)	--	--	--	--	--	--	--	--	--	--	--	--
Nominal GDP (% change, local currency)	7.6	4.5	-1.5	9.8	7.7	3.2	1.9	-8.2	6.8	11.7	9.5	7.1
Real GDP (% change)[1]	4.5	5.0	-0.9	7.4	3.6	1.9	0.1	-8.0	3.9	2.9	1.5	2.5
Inflation rate (% change average)	1.4	1.3	-0.9	0.0	3.3	3.1	1.9	0.3	2.8	8.5	7.9	4.5
Unemployment rate (%)	2.5	2.1	1.8	1.5	1.0	0.8	0.8	2.1	1.3	0.8	0.9	0.9
Gross investment/GDP	--	--	--	--	--	--	--	--	--	--	--	--
Gross domestic saving/GDP	--	--	--	--	--	--	--	--	--	--	--	--
Nominal exports of G & S (% change, US$ basis)	--	--	--	--	--	--	--	--	--	--	--	--
Nominal imports of G & S (% change, US$ basis)	--	--	--	--	--	--	--	--	--	--	--	--
Real exports of G & S (% change)	--	--	--	--	--	--	--	--	--	--	--	--
Real imports of G & S (% change)	--	--	--	--	--	--	--	--	--	--	--	--
Net exports of goods & services/GDP	--	--	--	--	--	--	--	--	--	--	--	--
Openness of the economy[2]	--	--	--	--	--	--	--	--	--	--	--	--
Government Effectiveness[3]	--	--	--	--	--	--	--	--	--	--	--	--
Government finance												
Gen. gov. revenue/GDP[4]	21.7	21.6	22.6	21.4	20.3	20.1	21.4	21.3	20.9	19.1	18.2	17.9
Gen. gov. expenditures/GDP[4]	22.7	22.1	22.5	21.7	20.3	20.6	21.0	25.5	22.0	20.4	19.5	18.5
Gen. gov. financial balance/GDP	-1.0	-0.5	0.1	-0.3	0.0	-0.5	0.4	-4.2	-1.0	-1.3	-1.3	-0.6
Gen. gov. primary balance/GDP	-1.0	-0.5	0.1	-0.3	0.0	-0.5	0.4	-4.2	-0.9	-1.2	-1.2	-0.5
Gen. gov. debt (US$ bil.)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.5	0.5	0.5	0.5
Gen. gov. debt/GDP	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	7.4	6.6	6.0	5.6
Gen. gov. debt/gen. gov. revenue	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	35.3	34.6	33.1	31.5
Gen. gov. interest payments/gen. gov. revenue	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.6	0.6	0.5	0.5
External payments and debt												
Nominal exchange rate (local currency per US$, Dec)	0.6	0.6	0.7	0.8	0.7	0.8	0.8	0.7	0.7	0.9	0.8	0.8
Real eff. exchange rate (% change)	--	--	--	--	--	--	--	--	--	--	--	--
Relative unit labor cost	--	--	--	--	--	--	--	--	--	--	--	--
Current account balance (US$ bil.)	--	--	--	--	--	--	--	--	--	--	--	--
Current account balance/GDP	--	--	--	--	--	--	--	--	--	--	--	--
Net foreign direct investment/GDP	--	--	--	--	--	--	--	--	--	--	--	--
Net international investment position/GDP	--	--	--	--	--	--	--	--	--	--	--	--
Official forex reserves (US$ bil.)	--	--	--	--	--	--	--	--	--	--	--	--

[1] 2022 onwards are our estimates.
[2] Sum of Exports and Imports of Goods and Services/GDP.
[3] Composite index with values from about -2.5 to 2.5: higher values suggest greater maturity and responsiveness of government institutions.
[4] Fiscal year ending 31 March, e.g., 2019 refers to fiscal year 2019/20; Includes National Insurance.
Source: Moody's Investors Service

Related websites and information sources

» Sovereign risk group web page

» Sovereign ratings list

Endnotes

1 The IoM's financial year runs from 1 April to 31 March. 2020-21 refers to the period from 1 April 2020 to 31 March 2021.

2 Close to 60% of businesses are seeing their growth constrained by a lack of access to suitable labour and clients, KPMG Pulse survey Q1 2021.

3 IoM citizens can work in the UK without a work permit, and while UK citizens need a work permit for the IoM, obtaining one is straightforward.

4 For example, in 2019, the government introduced a national insurance rebate scheme that is open to new residents and returning graduates. The government's LOCATE initiative also provides funds to businesses seeking to bring people to the island, helping to cover the costs and investment associated with staff relocation.

5 Report of the Select Committee of Tynwald on Population Rebalancing, 2022-23.

6 See Isle of Man Economic Strategy, November 2022

7 The Brexit transition period, during which Protocol 3 (which governed relations between the IoM and the EU under the UK's EU Accession Treaty) continued to function, concluded at end 2020.

8 Economic Recovery Group Business Survey, January 2021.

9 An arrangement between the UK Treasury and the Manx government was signed in November 2018, establishing a customs union to allow the island to trade with the UK free of tariffs following the end of the transition period. This replaced the previous Protocol 3 arrangement.

10 For example, when the UK negotiates new international treaties, it asks the IoM whether or not to include it in such agreements.

11 Following a public consultation, the bill was passed by Tynwald and received Royal Assent in January 2019.

12 The Foot Commission in October 2009 focused on UK Overseas Territories and Crown Dependencies acting as offshore financial centres.

13 See Memorandum of understanding, 2003.

14 See MONEYVAL'S Isle of Man 4th Enhanced Follow-up Report and Technical Compliance Re-Rating, November 2022

15 IoM land and property tax is charged at 20%.

16 See the full rankings here.

17 Relevant companies are now required to demonstrate that they have sufficient presence in the IoM — including an adequate number of qualified employees and physical presence — to access the island's corporate tax regime. Failure to do so can result in sanctions, including fines of up to £100,000

18 Plans to make the register public by 2023 have been delayed following privacy concerns in a ruling by the European Court of Justice in November 2022.

19 Pillar 1 (the shift in taxing rights to where companies have business activities and earn profits) applies to multinationals with a global turnover of more than €20 billion, and Pillar 2 (a new minimum 15% global tax rate) applies to multinationals with a turnover of at least €750 million.

20 Our definition of the general government balance constitutes the capital and revenue accounts, including income from reserve funds. The capital account is used for capital investment, while the revenue account includes all spending other than capital spending.

21 This included the merging of the Health and Social Care departments in 2014 and the disbanding of the Community, Culture and Leisure department.

22 To account for inflationary pressures, the government has raised pay costs by 6% for FY 2023-24 and 2% per year thereafter until FY 2027-28.

23 The scheme introduces a single-tier pension of £180 a week; gradually raises the state pension age from 65 to 67, in line with life expectancy on the island; and phases out the Manx Pension Supplement.

24 See details.

25 Capital International Bank also holds a restricted deposit-taking license.

26 Around £3.2 billion consisted of residential mortgages, and around £5 billion — a growing share — represented corporate lending.

27 The scheme limits compensation to £50,000 of net deposits for individual accounts, and pays up to £20,000 for most other depositors.

28 Recent reforms require all major banks with subsidiaries in the IoM to produce a comprehensive strategic plan outlining ways to disengage from its group in the event of forward-looking triggers such as a rating downgrade. Furthermore, smaller banks are now subject to stricter large exposure rules.

29 The new funding model, which is being phased in over three years from April 2023, will increase the fees paid by firms for regulation and oversight.

30 One licence is targeted at institutions serving the corporate or high-net-worth sectors, and deposits with these banks are not covered under the deposit insurance scheme. The other permits foreign banks to open a representative office, which enables potential new market entrants to test the market.

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