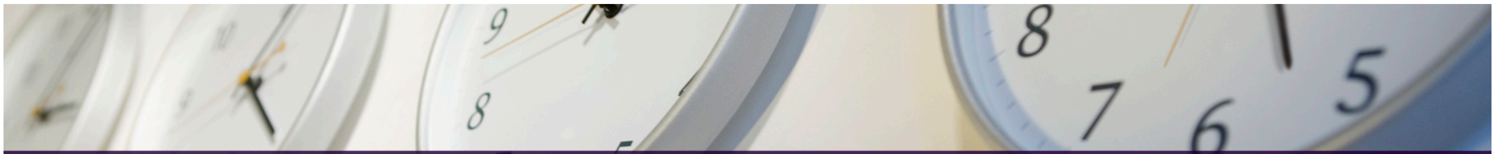

Credit Outlook

24 June 2019

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All 18 of the largest US banking groups passed the 2019 Dodd-Frank Act stress test and exceeded the required minimum capital and leverage ratios under the Fed's severely adverse stress scenario. Our report focuses on the severely adverse scenario.

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The likelihood of legislation to curb surprise medical bills is rising as we move into an election year. Proposals are mostly credit negative, especially for providers with a high percentage of out-of-network patients.

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Peabody and Arch join forces on coal assets in beleaguered Powder River Basin, a credit positive

On 19 June, US coal producers Peabody Energy Corporation (Ba3 stable) and Arch Coal, Inc. (Ba3 stable) said that they would form a new joint venture to combine seven operating coal mines and reserves in Colorado and the Powder River Basin (PRB) of Wyoming and Montana.The move is credit positive for both companies, improving and protecting cash flow over time from a very disadvantaged coal region in the western US. The companies expect $120 million in annual synergies over the initial 10 years of the venture, based on optimizing the mining plan for the combined assets, better blending, improved logistics, reduced capital spending, shared services, and other benefits.

Under the agreement, Peabody will own 66.5% of the joint venture and manage operations and marketing, and Arch will own the remainder. A five-person board will oversee the joint venture, with voting rights in proportion to ownership, and with certain items requiring supermajority approval – an especially important credit consideration for Arch. The assets in the new joint venture shipped a combined 206 million tons of coal in 2018. Peabody generated about $5.6 billion in consolidated revenue in 2018 (including PRB), and Arch about $2.5 billion.

Despite the joint venture's significant position in the western US, business conditions will remain weak for PRB coal, whose domestic thermal coal market is shrinking as more utilities switch to cleaner-burning natural gas. No significant change is likely for the western assets' supply/demand balance in the near term. Natural gas prices will remain competitive with coal for the foreseeable future, and the cost of renewable energy, particularly wind energy, continues to drop.

Exports are a less viable option for PRB coal, which cannot be exported as easily as eastern coal-producing regions that have greater access to ports and less social opposition to coal exports, although the venture would have better export options in Colorado, where each company is contributing a mine.

Even so, the new joint venture will help improve cash flow generation for Peabody and Arch, especially once there is more clarity about the operating plan for their combined assets and the status of other mines owned by companies now in bankruptcy. We still expect that cash margins will remain modest for the strongest mines in the basin, and stressed, or even nonexistent, for the weakest mines in the basin.

Both companies have strong liquidity today, owing largely to solid pricing for metallurgical (met) coal, which is used in steelmaking. We expect that strong pricing will enable both companies to continue to generate strong cash flow through 2020. Peabody had more than $1.1 billion of available liquidity as of 31 March 2019, including nearly $800 million in cash. Arch reported $490 million of available liquidity, including nearly $384 million in cash and short-term investments, but its plans to invest $360-$390 million in a new met coal mine will constrain free cash flow generation in 2020-21.

Strong met coal prices have also benefited leverage and cash flow metrics for both Peabody and Arch. Peabody had an adjusted debt/EBITDA ratio of 1.1x, adjusted net debt/EBITDA of 0.5x, and a ratio of cash flow from operations (CFO) minus dividends to debt of about 64% for the 12 months that ended 31 March 2019.

Arch's leverage metrics included an adjusted debt/EBITDA ratio of 0.8x, adjusted net debt/EBITDA of 0.3x, and ratio of CFO minus dividends to debt of about 118% for the 12 months that ended 31 March 2019. These metrics reflect strong met coal prices in recent quarters and improvements in balance sheets over the past few years.

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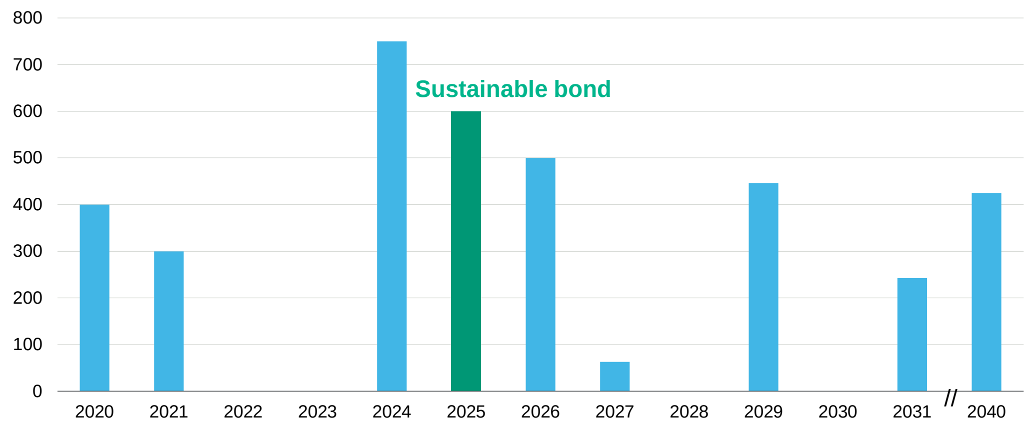
Ahold Delhaize's sustainable bond issuance brings some cost benefits, a credit positive

On 19 June, Dutch grocer Koninklijke Ahold Delhaize N.V. (Baa1 stable) announced the issuance of a €600 million six-year sustainable bond, the first issuance of a euro-denominated sustainable bond in the European retail sector. This transaction will enable Ahold Delhaize to lower its cost of debt and benefit to some extent its credit metrics as a result, a credit positive.

The issuance is priced at 99.272 and carries an annual coupon of 0.25%, which translates into a yield to maturity of 0.37%, according to our calculations, compared to an average cost of debt that we estimate at 4.43% in 2018. The notes will settle on 26 June.

Before issuing its sustainable bond, Ahold Delhaize already had a well-balanced bond maturity schedule, with an average maturity of eight years, as shown in the exhibit below.

Ahold Delhaize has a well-balanced bond maturity schedule
Bond maturity schedule, in € millions



Source: Ahold Delhaize

Ahold Delhaize will use the bond's proceeds to finance environmentally and community-focused projects in three areas: procurement of sustainably produced products, reduction of carbon emissions and food waste, and promotion of healthier eating. For instance, proceeds could be allocated to renewable energy installations, waste prevention or recycling. Such initiatives would improve profitability, to some extent, as well as improve brand image, a credit positive.

A sustainability bond committee will oversee the allocation of the proceeds and establish internal tracking systems. Pending the full allocation of the bond proceeds, Ahold Delhaize will invest the balance in money market instruments or potentially repay commercial paper, although there was no commercial paper outstanding at year-end 2018. Therefore, gross debt could temporarily increase until proceeds are fully used. The company will publish yearly updates until all proceeds are allocated.

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PTTEP's cash-funded acquisition of Partex will increase production and earnings, a credit positive

Originally published on 19 June 2019

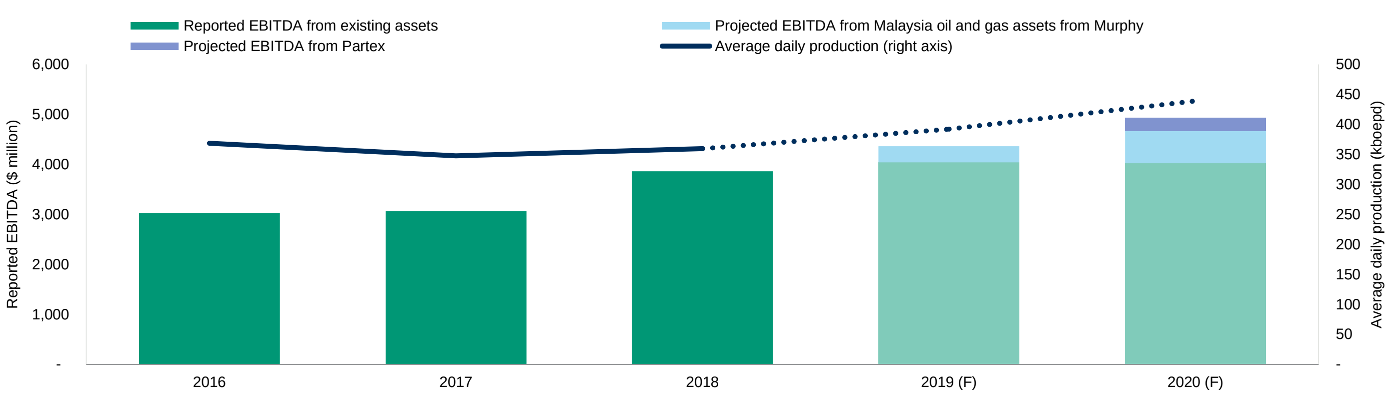
On 17 June, PTT Exploration and Production Public Company Limited (PTTEP, Baa1 stable) announced that it has signed a share purchase agreement (through its subsidiary PTTEP HK Holding Limited) with Calouste Gulbenkian Foundation to acquire 100% share of Partex Holding B.V. (Partex) for $622 million. Partex primarily owns working interests in a number of producing upstream oil and gas assets across four countries.

The proposed acquisition is credit positive for PTTEP because it will be funded with cash and will add to its production volumes and earnings. The company has sufficient cash on hand to fund the $622 million acquisition. It had cash and cash equivalents (including short-term investments) of $4.4 billion as of 31 March 2019, of which $2.1 billion will be used to finance the Murphy acquisition announced in March. Closing of the transaction is subject to customary consents and regulatory approvals.

The company expects the acquisition will add EBITDA of around $280 million per annum. This assumes the acquisition will yield additional sales volume of 16 thousand barrels of oil equivalent per day (kboepd), of which around 12.2 kboepd will come from Oman's largest producing oil asset, PDO (Block 6). It also reflects the company's guidance of a $65 per barrel realized price and a 75% EBITDA margin. Pro forma for the proposed acquisition, we expect PTTEP's credit metrics to remain strong, with retained cash flow/adjusted debt above 80% over the next 12-18 months. The company expects incremental capital spending requirements to be limited at around $100 million per year, given that its portfolio mostly consist of producing assets.

The acquisition, if successful, will add 65 million barrels of oil equivalent of 2P reserves to PTTEP, which is equivalent to around 10% of its 2P reserves at the end of 2018. The transaction follows PTTEP's announced acquisition of a portfolio of Malaysian oil and gas assets from Murphy Oil Corporation (Ba2 stable) for $2.1 billion in March 2019, which will increase production and reserves. We estimate that acquisitions announced so far in 2019 will lengthen PTTEP's proved reserve life to six years from five years. The company has faced declining reserves for a number of years and its recent string of acquisitions are in line with its strategy to arrest the decline. (See exhibit.)

Recent acquisitions will boost PTTEP's production and earnings



Source: Company presentations, Moody's Investors Service estimates

Over the next few years, PTTEP will likely continue to seek acquisitions to further add to its hydrocarbon reserves and lengthen its reserve life. We expect the company to keep to its stated acquisition strategy of assets that are already producing or near-producing, which will be immediately EBITDA-accretive. Investments in non-producing assets that require a long development lead time will be credit negative.

We believe this proposed acquisition is PTTEP's first step towards expanding its presence in the Middle East. While this provides some geographical diversification from their current assets which are predominantly located in Southeast Asia, the company will be exposed to heightened geopolitical risks given rising tensions in the Middle East. Nonetheless, this risk is partly mitigated given that the project partners include national oil companies and oil majors familiar with the operating landscape. We expect the company to adopt a cautious attitude towards further investments in the region given its limited experience, especially for large-scale projects without meaningful partnerships.

Other producing oil fields that Partex holds working interests in include Dunga at Kazakhstan, Mukhaizna (Block 53) at Oman and Potiguar at Brazil.

The company expects that the proposed transaction will be completed by the end of 2019.

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Mountain Valley Pipeline's further delays and rising costs are credit negative for ConEd

Originally published on 20 June 2019

On 17 June, EQM Midstream Partners, LP (EQM, Ba1 stable) announced a delay in the Mountain Valley Pipeline (MVP) project, now slated for completion in mid-2020 with an updated cost estimate of $4.8-$5.0 billion. The project, which started construction in February 2018, is now a year and a half behind schedule and more than $1 billion over budget. As a 12.5% owner of MVP, the update is credit negative for Consolidated Edison, Inc. (ConEd, Baa1 stable) because of unexpected increases in their financial commitment to the project cost and because the expected incremental cash flows to ConEd will be pushed out almost two years later than originally expected.

However, ConEd's ownership percentage remains relatively small for the large holding company and there is currently no debt associated with the project. As such, ConEd's credit metrics will hinge on the outcome of Consolidated Edison Company of New York, Inc.'s (CECONY, A3 stable) rate case and its ability to support the parent company's financial profile from around a 16% ratio of current cash-flow from operations before changes in working capital to debt. As part of ongoing annual funding plans, ConEd also committed to issue roughly $500 million of a forward equity, approximately $400 million of which has already settled.

MVP's additional delays and costs are yet another example of the recent challenges that gas pipelines face, even after construction begins. MVP has endured various legal challenges throughout the permit approval and construction process, currently related to the line's ability to cross the Appalachian Trail in Northern Virginia.

In December, the US Court of Appeals invalidated permitting for a similar gas pipe project, the Atlantic Coast Pipeline (ACP), to build across the Appalachian Trail. ACP has undergone many similar challenges to MVP, weighing on sponsors, including Dominion Energy, Inc. (Baa2 stable), which has a 48% ownership interest in ACP, and Duke Energy Corporation (Baa1 stable), which has a 47% ownership interest in ACP, since the project began construction in May 2018. ACP halted construction following a series of vacated permits because of court orders and the companies await a Supreme Court appeals decision and are also pursuing legal and administrative paths for resolution. The project is expected to be in service in 2021, two years behind schedule (see exhibit).

MVP and ACP have had various delays and cost increases since beginning construction in 2018

	Mountain Valley Pipeline	Atlantic Coast Pipeline
Began construction	February 2018	May 2018
Original cost estimate ($B)	$3.0 - 3.5	$6.0 - 6.5
Original in-service estimate	Year-end 2018	Late 2019
Update 1		
Date of announcement	July 2018	November 2018
In-service date (delay from original)	Q1 2019 (~3 months)	Mid-2020 (~0.5 years)
Cost (increase from original)	$3.5 - 3.7 (~$0.5)	$6.5 - 7.0 (~$0.5)
Update 2		
Date of announcement	February 2019	February 2019
In-service date (delay from original)	Q4 2019 (1.0 years)	Early 2021* (~1.5 years)
Cost (increase from original)	$4.6 (~$1.0)	$7.0 - 7.5 (~$1.0)*
Update 3		
Date of announcement	June 2019	
In-service date (delay from original)	Mid-2020 (1.5 years)	
Cost (increase from original)	$4.8 - 5.0 (~$1.5)	

*An alternative scenario for ACP includes a total cost of $7.25-$7.75 (~$1.5) and in-service date of late 2021
Sources: Consolidated Edison, EQM Midstream Partners and Dominion Energy

For MVP, EQM has proposed a land exchange such that the federal government will own private land around the Appalachian Trail, and subsequently grant MVP access to construct across those lines. However, this plan would likely encounter further environmental challenges, adding costs and uncertainty to when and how the project will be completed.

MVP's cash flow contribution will also be delayed, increasing the negative pressure on ConEd's cash flow ratios. As such, the CECONY rate case outcome will be crucial in supporting the parent company's financial profile, for which the company expects a final decision by the end of this year.

MVP is one of the largest pipeline projects under construction (along with ACP), and is designed to deliver two billion cubic feet per day of gas from the Marcellus and Utica shale basins to Virginia and West Virginia. MVP is owned by EQM (45.5%), NextEra Energy Resources (31%), ConEd (12.5%), WGL Midstream (10%) and RGC Midstream (1%).

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Malaysia's clarity on new regulatory framework is credit positive for Malaysia Airports Holdings Berhad

Originally published on 20 June 2019

On 18 June, the Malaysian Aviation Commission (MAVCOM) published its second consultation paper on its new tariff setting framework for Malaysia Airports Holdings Berhad (MAHB, A3 stable). In the report, MAVCOM presented its decisions on a number key regulatory parameters, which – if implemented – will likely keep MAHB's aeronautical revenue from its operations in Malaysia close to or above the actual revenue recorded in 2018.

MAHB's credit profile has been negatively affected by uncertainties associated with the new framework and the potential effect it may have on the airport's credit metrics and revenue stability. We believe the additional disclosure in MAVCOM's latest report has reduced MAHB's downside revenue risk upon implementation of the framework in 2020.

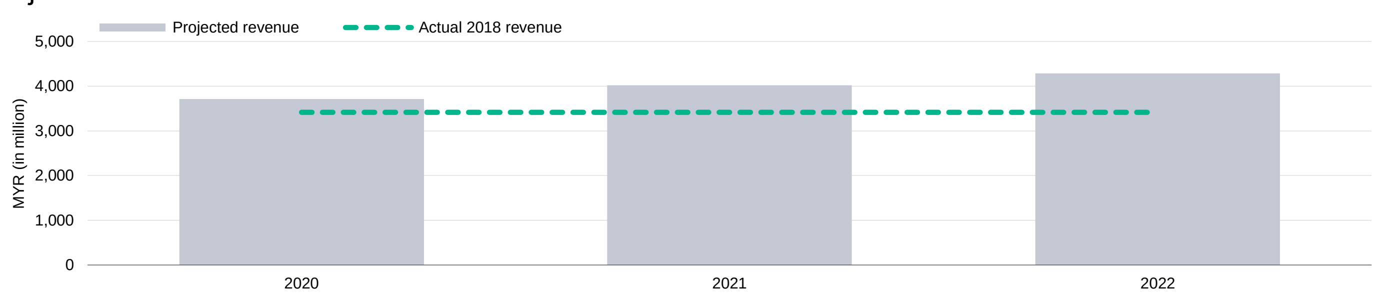
In the last consultation paper published in October 2018, MAVCOM outlined its decision to adopt a building-block-based tariff-setting framework. However, key inputs to the framework that could have a material revenue effect – such as the regulated assets base (RAB) or the regulated return on capital (WACC) – were still being finalized at that time.

Such risks are partially alleviated by the draft base case revenue projections provided by MAVCOM in its latest report, which projected revenue of MYR3.7 billion in 2020, broadly in line with the level recorded in 2018. The projection takes into account an inaugural RAB of MYR8.5 billion for MAHB and a WACC of 10.88%.

MAHB's revenue is expected to grow during the regulatory period, driven in part by the additional capital expenditures of MYR5 billion that had been incorporated into the projections, up significantly from the MYR200-300 million spent annually between 2014 and 2017.

Based on a hypothetical funding ratio of 70%, the airport will require additional debt of around MYR3.5 billion, higher than MAHB's net debt balance of MYR2.3 billion at the end of 2018. As such, growth in revenue and cash flow provided under the framework will be important to the airport's ability to preserve its financial profile during the expansion period (see exhibit).

Projected aeronautical revenue for MAHB for 2020-22 under MAVCOM's draft base case



Actual 2018 revenue (1) has not been adjusted for intercompany revenue and (2) includes both aeronautical and non-aeronautical revenue from its operations in Malaysia
Sources: MAVCOM and MAHB

Under the new framework, MAHB will remain exposed to passenger volume risk based on the regulator's decision to regulate on a price cap basis. However, MAHB will benefit from the opportunity to re-open a tariff decision should traffic deviate by more than 10% from the projected level, and a refresh of traffic projections at the start of each regulatory period.

The treatment of non-aeronautical revenue will also change, given MAVCOM's decision to adopt a single-till tariff model. Although non-aeronautical revenue will no longer be considered as a separate revenue stream from aeronautical tariffs, the potential revenue effect would likely be manageable in the first control period, given that MAHB's total revenue, including non-aeronautical activities, is projected to be broadly in line with existing levels.

A final tariff order is expected by the last quarter of 2019, and some of the regulatory variables – such as the final WACC parameters, non-aeronautical revenue and passenger growth assumption – might still change. We will assess the credit effect of the final decision as more information becomes available.

Separately, MAHB is also negotiating the final terms of its concession agreements with the government of Malaysia, which were formally extended in April 2019. As part of the negotiation, MAHB is seeking a greater role in future airport expansions, which will put it more in line with rated regional and global peers. Under the original concession agreements, the government has control and responsibility over airport developments.

Although the additional responsibility, if granted, would expose MAHB to higher execution risks and funding requirements, it would also provide it with greater control over the funding and timing of expansions to meet its operational needs. MAHB's negotiation with the government is expected to conclude during 2019.

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Facebook's Libra puts big tech in fintech

On 18 June, Facebook and 27 other partner companies formally announced Libra, a form of digital currency powered by blockchain technology. Facebook will launch a new subsidiary, Calibra, in 2020 that will offer a digital wallet for Libra and be available in Facebook Messenger and WhatsApp, as well as through a standalone app. At launch, Calibra will focus on peer-to-peer (P2P) transfers of Libra, but could later introduce the digital currency as an alternative for consumer-to-business (C2B) payments.

We see the launch as supporting Facebook's efforts to integrate more deeply with its 2.4 billion users beyond social media platforms and to potentially attract new users. The launch could also help the company tap new data sources, making its advertising more efficient and boosting overall advertising revenue.

From the payment processing industry's perspective, the launch of an alternative payments platform by a technology leader as ubiquitous as Facebook is likely to accelerate electronic payments' share gains from cash and checks. The key issue that remains unclear at this time is how Libra will tie into the rest of the world's financial ecosystem. Visa and Mastercard appear to be more natural partners for Libra than national automated clearing house systems in light of the global nature of Facebook's effort.

Still, Libra faces a range of regulatory hurdles. The announcement has already attracted the attention of financial regulators globally. Some US lawmakers have been quick to raise privacy concerns, while national authorities in Europe and Asia have raised concerns regarding the stability of digital currencies. The adoption of new forms of currency that fall outside of a country's control raise a variety of issues for sovereign issuers, in that digital currencies can adversely affect national and regional central banks' ability to implement monetary policy. Governor of the Bank of England (BoE) Mark Carney signaled the BoE's intent to engage with tech companies to ensure consistent regulatory treatment and ultimately allow payment providers access to central bank overnight accounts – similar to commercial banks.

For potential efficiencies to be realized, Facebook and its partners will need to overcome a number of hurdles, in particular, regulatory acceptance, which will be a key determinant of Libra's path. In addition, for Libra to develop economic characteristics associated with currencies, a critical mass of users will need to trust it, its price and liquidity will have to be relatively stable and there will need to be a means to control supply. It is unclear what other 'money-like' applications Libra will ultimately be used for beyond the ability to make P2P transfers within a relatively contained context.

According to the Libra white paper, the currency will be backed by reserve assets consisting of bank deposits and short-term government securities (in a basket of so-called stable currencies) to minimize price volatility. The reserve feature of Libra makes it distinct from Bitcoin and most other cryptocurrencies. A wide range of firms, including online payment processors, telecom companies and major merchants, will govern the new currency through a new group known as the Libra Association, as shown in the exhibit.

Founding members of the Libra Association: the goal is for membership to reach 100

Industry	Member
Payments	Mastercard, PayPal, PayU, Stripe, Visa
Technology and marketplaces	Booking Holdings, eBay, Facebook/Calibra, Farfetch, Lyft, MercadoPago, Spotify AB, Uber Technologies, Inc.
Telecommunications	Iliad, Vodafone Group
Blockchain	Anchorage, Bison Trails, Coinbase, Inc., Xapo Holdings Limited
Venture Capital	Andreessen Horowitz, Breakthrough Initiatives, Ribbit Capital, Thrive Capital, Union Square Ventures
Nonprofit and multilateral organizations, and academic institutions	Creative Destruction Lab, Kiva, Mercy Corps, Women's World Banking

Source: Libra White Paper

Libra is positioned as a stable, real asset-backed currency built on a secure and stable open-source blockchain. One of its primary goals is to improve access to financial services for the global underbanked population, which is estimated at 1.7 billion people[1].

The significant issue that remains unclear at this time is which processing infrastructure the new digital currency will use. On the network side, Visa Inc. (Aa3 stable) and MasterCard Incorporated (A1 stable) appear to be more natural partners for Libra than national automated clearing house (ACH) systems in light of the global nature of Facebook's effort. If Facebook were to launch a separate payment processing network, it would be credit negative for the card networks. On the merchant processing side, there will be a role for processors to handle transactions settled with Libra, as they handle transactions in national currencies today. With operational details not yet available and the launch for C2B payment applications some time away, we believe that the impact to the industry will be broadly positive, but it is too early to judge the magnitude and timing.

The widening application of digital distribution and product development in financial services is materially changing the basic terms of competition across banking business segments, including payments, lending, capital markets, and wealth management. In the fast-evolving digital ecosystem, the largest technology firms are poised to become formidable competitors in retail financial services, undercutting banks' transaction fees. Facebook is certainly not the first company to launch a crypto payment solution; however, with its immense user base it would pose a threat to the banking industry should the initiative gain traction with consumers and businesses. In particular, this new platform could effectively provide an alternative ecosystem for payments, bypassing existing players and obviating some of the roles banks traditionally play. Another key factor to watch as the product evolves is whether Calibra and other Libra wallets ultimately offer deposit-like products and other financial services and, if so, to what extent clients, including consumers and businesses, use them.

As big tech companies like Facebook position themselves as financial service providers, their success could allow them to control not only a significant portion of distribution and customer mindshare, but also to compete more directly with incumbents by manufacturing financial products, controlling the user experience and, ultimately, capturing a greater share of associated profit.

Endnotes

1 See **Libra White Paper**

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Privacy breach is credit negative for Desjardins Group

Originally published on 21 June 2019

On 20 June, Desjardins Group, the Canadian cooperative association of the Fédération des caisses Desjardins du Québec (Aa1/Aa2 negative, a1[1]), announced that a rogue employee had released outside the organization the personal and banking data of 2.7 million retail and 170,000 small business members, representing around one-third of its total membership. The data include names, addresses and social insurance (national tax identification) numbers, as well as information on members' banking habits and their products with Desjardins. Passwords, security questions and personal identification numbers (PINs) were not compromised and Desjardins has not seen an increase in fraudulent cases in recent months.

The privacy breach is credit negative for Desjardins because it could give rise to future financial losses in the form of member indemnification. Such losses could occur over the next several years as the data are used in identity theft or for other nefarious purposes. More immediately, there is a potential adverse reputational effect stemming from members who react to the perception that Desjardins had not sufficiently protected their personal and financial data and move their business elsewhere. This also has potential liquidity considerations as members close accounts. However, we believe that Desjardins has adequate contingent liquidity arrangements in place to weather any related member withdrawals.

Desjardins has begun to notify affected members and set up a website and a call center to help members with questions they may have. It is also offering credit monitoring services for the next five years and fraud consultation services to affected members. We believe these actions will help mitigate loss of reputation and franchise value.

Cybersecurity threats, both external and internal, are a growing operational risk for banks and other financial institutions, which are increasingly vulnerable to the loss of proprietary data from customer-facing applications and internal systems. Such risks expose institutions to legal action, regulatory scrutiny, fines and other unexpected expenses, while their reputation for reliability and safety is also at stake.

Canadian financial institutions have committed significant resources to safeguarding clients' personal and financial information. Strong network security and ensuring that client and internal systems have robust access management controls reduce the potential for data loss and other cyber risks. However, as the Desjardins privacy breach shows, the threat from within remains one of the greatest challenges financial institutions face in protecting their most valuable data.

Endnotes

1 The ratings shown are Desjardins Group's long-term deposit rating, senior unsecured bank debt rating and Baseline Credit Assessment.

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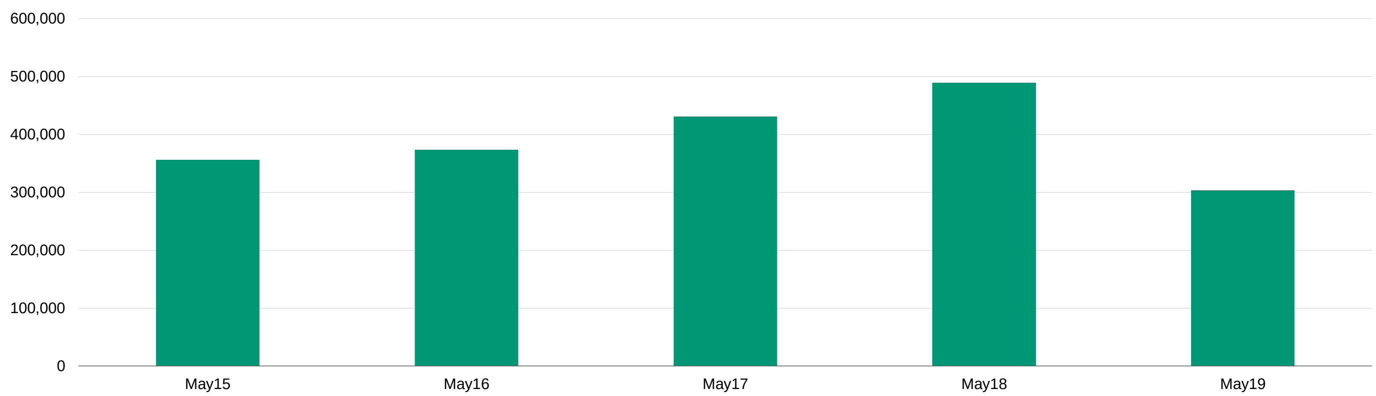
Slowdown in Mexican job creation is credit negative for banks and pension funds

Originally published on 23 June 2019

On 18 June, the Mexican Social Security Institute (IMSS) published its May 2019 bulletin of new associates, which showed a five-month cumulative drop in job creation of almost 40% from a year earlier (see Exhibit 1). The slower job creation is credit negative for Mexican banks that focus on consumer financing, as well as those that have experienced high growth in that segment. Lower employment growth is also credit negative for mandatory pension funds' (*afores*) business development.

Exhibit 1
Mexico's new job creation slowed dramatically in the first five months of 2019
Five-month cumulative number of new enrollees in the Mexican Social Security Institute



Source: Mexican Social Security Institute

The slower job formation aligns with a drop in consumer confidence, which follows a decline in corporate confidence that began in February related to policymaking uncertainty. Less private investment is weakening medium-term economic prospects in Mexico. We expect that Mexico's economy will expand by 1.2% this year, substantially below our October expectation of 2.2%.[1]

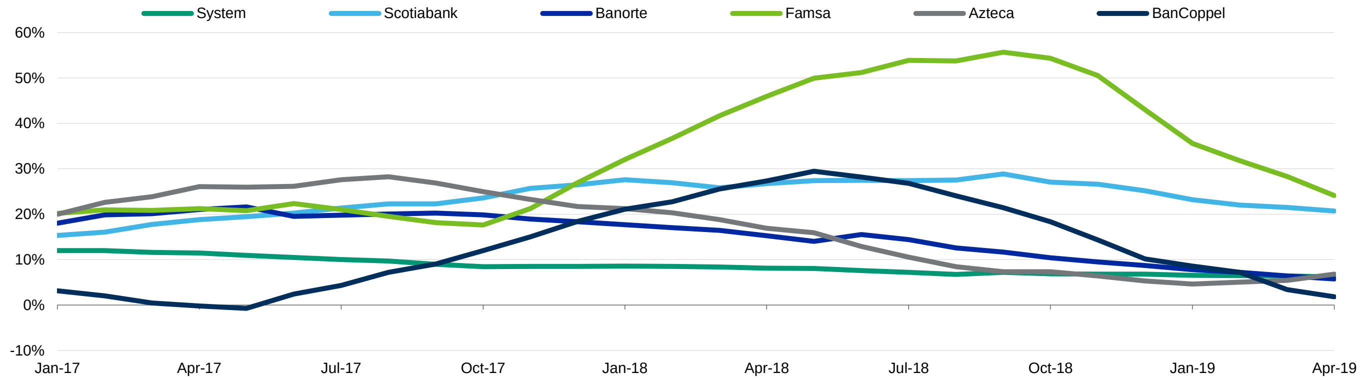
Several large banks, including Scotiabank Inverlat, S.A. and Banco Mercantil del Norte, S.A. (Banorte, A3 negative, baa2[2]), as well as small banks focused on consumer financing, including Banco Azteca, S.A. (Baa3 stable, ba2), BanCoppel, S.A. and Banco Ahorro Famsa, S.A. (Famsa, B1 stable, b1), have experienced higher than average growth in their consumer portfolios over the past two years, when job creation expanded the number of bankable clients. Job creation got a boost following 2014 reforms that provided companies with various tax incentives and their employees immediate access to social security benefits and unemployment insurance and prompted the registration of personnel with the IMSS. A drop in job creation will expose these banks to higher than average deterioration in asset quality.

Exhibit 2 shows several banks whose loan growth has exceed the system average, of which Famsa, Scotiabank, BanCoppel, Azteca and Banorte stand out.

Exhibit 2

While the system's consumer loan growth has largely been conservative, several banks' growth has been very high

Year-over-year monthly consumer loan growth



Source: Comisión Nacional Bancaria y de Valores

Although we expect increased delinquencies because of the slowdown in job formation, deterioration in nonperforming loan ratios would start from a historically low level. The banking system's nonperforming loan ratio for consumer loans was 4.3% as of April 2019, down from 4.6% a year ago.

Deterioration in asset quality at large banks such as BBVA Bancomer, S.A. (A3/A3 negative, baa1), Banco Nacional de México, S.A. (Citibanamex, A3/A3 negative, baa1), Banorte and Banco Santander México, S.A. (A3/A3 negative, baa2) will not be significant because their consumer portfolios are geared toward higher-income individuals. Furthermore, deterioration will also be limited by the banks' prudent underwriting, well diversified loan portfolios with a focus on lower risk commercial lending, and adequate loan-loss reserve coverage. Deterioration at Banorte will be limited because its expansion has targeted its roster of well-known clients.

We expect that small banks such as Azteca, BanCoppel and Famsa, whose main focus is on lower-end consumer financing, will be more affected. While also focused on lower-end consumer financing, finance companies such as Crédito Real, S.A., and Alpha Holding, S.A. (B1 negative) will be shielded from a deteriorating operating environment because they focus on payroll-deducted loans to government employees, which are less risky. Government employees tend to have job stability.

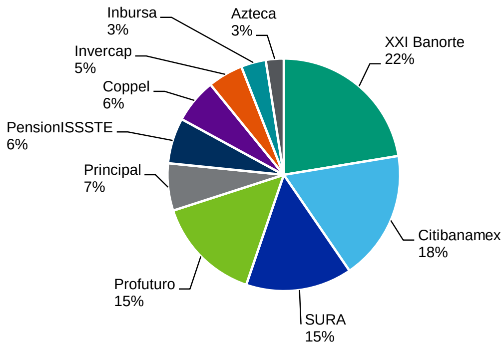
Higher delinquencies will have a direct effect on the banks' profitability. As of April 2019, credit costs consumed a very high 47% of the banking system's core earnings. Credit costs related to consumer financing constituted the bulk at 83% of total credit costs as of April 2019.

Banks have already begun to reduce their projected loan growth for this year, with estimates falling to 7%-8% from 10% at the end of last year. Our expectation is that banks will expand 5%-6% over the next two years, based on loan growth relative to nominal GDP over the past two years.

Afores' assets under management (AUM) growth is highly correlated to the creation of formal employment and to the performance of the capital markets. Afores receive employers' periodic salary contributions that go directly to their pension funds accounts. The main revenue source for afores are the fees they charge on the funds' AUM. Consequently, lower growth or even a decrease in AUM will negatively affect profitability and limit business development. Despite the fact that this is negative for the entire sector, profitability at the largest afores, such as Afore XXI Banorte, S.A. de C.V., Afore Citibanamex, S.A. de C.V. and Afore SURA, S.A. de C.V. (see Exhibit 3), will be more negatively affected given their relatively higher fixed cost structure.

Exhibit 3

Mexican mandatory pension funds by assets under management
AUM as of May 2019



Source: Comisión Nacional del Sistema de Ahorro para el Retiro

Endnotes

1 See Government of Mexico – A3 negative: Annual credit analysis," 19 June 2019.

2 The bank ratings shown in this report are bank's domestic deposit rating, senior unsecured debt rating (where available) and Baseline Credit Assessment.

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New CEO will strengthen BNDES' role in privatizations, a credit positive

Originally published on 21 June 2019

On 17 June, Brazil's (Ba2 stable) Economy Ministry appointed Gustavo Montezano as CEO of development bank Banco Nac. Desenv. Economico e Social – BNDES (Ba2 stable, ba2[1]). Montezano's mandate will likely increase BNDES' alignment with the government's agenda of privatizing state-owned companies, a credit positive given the bank's expertise in privatizations and long-term project financing. If BNDES' board of directors approve the appointment, Montezano will replace Joaquim Levy following the latter's brief five-month stint at the helm of the wholly government-owned bank.

Under Levy's direction, BNDES planned to strengthen its role in advising and structuring infrastructure projects and privatizations while reducing the use of its balance sheet, which grew substantially between 2008 and 2014 as the government sought to bolster national champions and boost credit supply. This strategy has since been reversed as BNDES focuses on its core lending to infrastructure and privatization projects, coinciding with a steady decline in loan disbursements by the bank since 2015 amid weak demand for long-term financing.

Although infrastructure investment remains modest in Brazil, the federal administration is determined to reduce the government debt burden. Proceeds from the privatization of state-owned enterprises, along with concessions for and the licensing of government assets, will likely support these objectives.

Levy resigned on 16 June after Brazil's President Jair Bolsonaro publicly criticized the slow pace at which the development bank was implementing measures his administration has prioritized, including more rapidly repaying loans the government extended mainly between 2008 and 2014 and divesting BNDES' large equity holdings in government-owned companies including Centrais Eletricas Brasileiras S.A. – Eletrobras (Ba3 stable) and Petroleo Brasileiro S.A. – Petrobras (Ba2 stable).

BNDES in May repaid the government BRL30 billion ($7.8 billion) of a total of BRL305.9 billion in loan principal and interest outstanding as well as hybrid instruments owed to the National Treasury, but the Economy Ministry has asked that it repay BRL126 billion in 2019 as a whole. In line with its reduced balance sheet, BNDES may use its liquidity to accelerate repayment of part of the debt it owes the government. As of March this year, it had liquid assets of around BRL115.9 billion, an ample cash position in view of still weak credit demand.

Endnotes

1 The ratings shown in this report are BNDES' senior unsecured debt rating and Baseline Credit Assessment.

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European Banking Authority's proposed EU-wide guidelines for loan origination and monitoring are credit positive

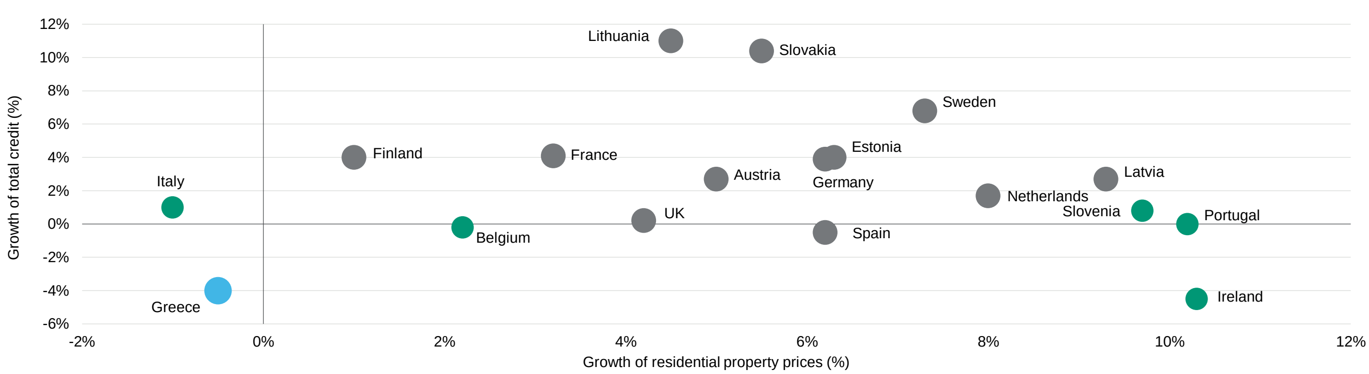
On 19 June, the European Banking Authority (EBA) published draft guidelines on loan origination and monitoring. The guidelines will set minimum standards in the European Union (EU) for loan credit-risk taking, monitoring and management. If implemented, the guidelines will be credit positive for consumer securitisations and covered bonds backed by loans originated in the EU.

The guidelines will apply to both providers of consumer credit under the Consumer Credit Directive and to non-bank mortgage credit providers under the Mortgage Credit Directive, a first for the EBA. The wide application will level the playing field for credit providers and reduce the risk of lenders competing by lowering credit underwriting standards. Historically, lenders offering the looser credit standards have forced competing lenders to follow suit, driving down credit standards in the respective market segment that the lender operates in. Recently, some non-bank lenders targeted borrowers with weaker credit in an effort to gain market share, underlining the importance of the proposed guidelines covering non-bank mortgage credit providers.

The EBA guidelines require lenders to verify borrowers' incomes and apply loan-to-income ratio and debt-service-to-income (DSTI) ratio limits in their underwriting decisions. Lenders will also have to consider the implications of potential negative scenarios in their underwriting decisions, such as interest-rate increases and income reductions if the loan term extends beyond a borrower's expected retirement age. The EBA guidelines give national authorities the option of setting specific limits in each country, so that they are tailored to the vulnerabilities building up in their jurisdictions. We think this is appropriate given the different macroeconomic circumstances in EU countries, as shown in the varying levels of credit and property price growth across the bloc (see Exhibit 1).

Exhibit 1

Credit growth across the EU varies widely



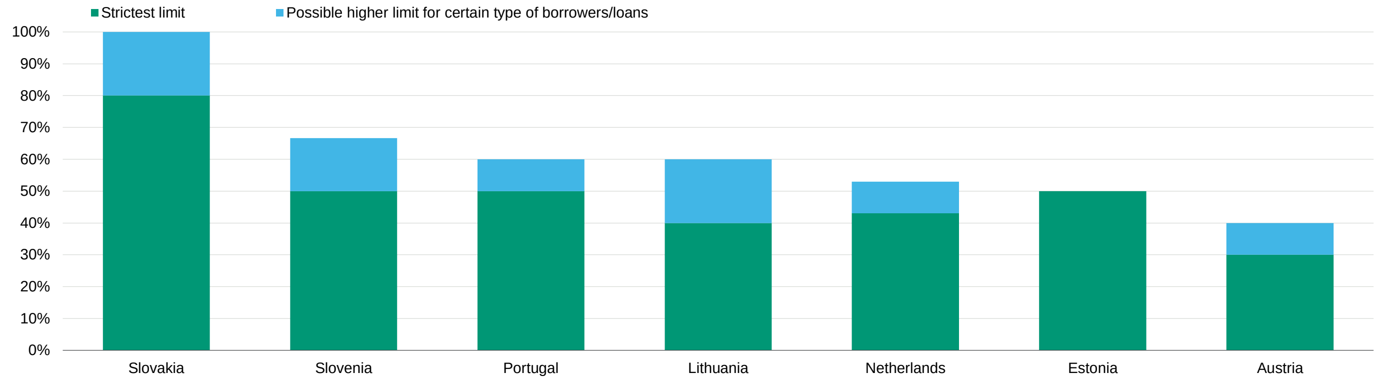
Average year-on-year growth for the last four quarters

Source: European Systemic Risk Board

Lending standards vary considerably across the EU. For example, of the countries shown in Exhibit 2, only those shown in Exhibit 3 have DSTI ratio limits specified by their national regulators. While national authorities will set specific lending limits for their respective countries, the EBA's guidelines have the potential to make the measurement of factors like borrowers' incomes more consistent, once underlying regulatory technical standards are harmonised.

Exhibit 2

DSTI ratios vary considerably across the EU



The possible higher DSTI limits for certain types of borrowers/loans have different criteria in different countries. For example, in the Netherlands the exact level of the DSTI limit depends on the type of credit, the income of the debtor, the interest rate and the age of the debtor.
Source: [European Systemic Risk Board]

In addition to consumer loans, the EBA guidelines will apply to lending to professionals, small and midsize enterprises, commercial real estate and shipping. The guidelines detail sector-specific risk drivers that lenders should take into account. For example, for commercial real estate loans, lenders would be required to perform a cash flow analysis that considers a property's income-producing capacity and its prospects of refinancing; tenants' credit quality; the property's re-letting prospects; and the risk the property could become obsolete as a result of changing energy consumption regulations.

The EBA guidelines require lenders to incorporate environmental, social and governance considerations in their lending practices. For example, in their loan underwriting decision, lenders are required to consider the risks to borrowers from the transition to a low-carbon and climate-resilient economy.

The EBA proposes that the guidelines apply from 30 June 2020, meaning they will need to be adopted by national competent supervisory authorities and implemented by lending institutions by this date. The requirements for loan origination will also apply to existing loans where terms are renegotiated or specific actions are triggered by the regular credit review of the borrower.

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European Banking Authority's proposed lending guidelines focusing on anti-money laundering risks are credit positive

On 19 June, the European Banking Authority (EBA) launched a consultation on draft guidelines on loan origination and monitoring with a view to enhancing European banks' underwriting standards and credit risk management. The proposed guidelines also aim to ensure that banks have appropriate policies and procedures that address anti-money laundering (AML) and counter-terrorist financing (CFT) risks. The EBA's proposal reflects the increased attention paid by European authorities to those risks following the discovery in 2017 of large-scale money laundering issues at Danske Bank's Estonian branch. This focus has already resulted in amendments to the European "Banking Package" proposed in 2016, and which was recently adopted. If adopted, the EBA's guidelines identifying, assessing and managing AML and CFT risks would be credit positive for banks.

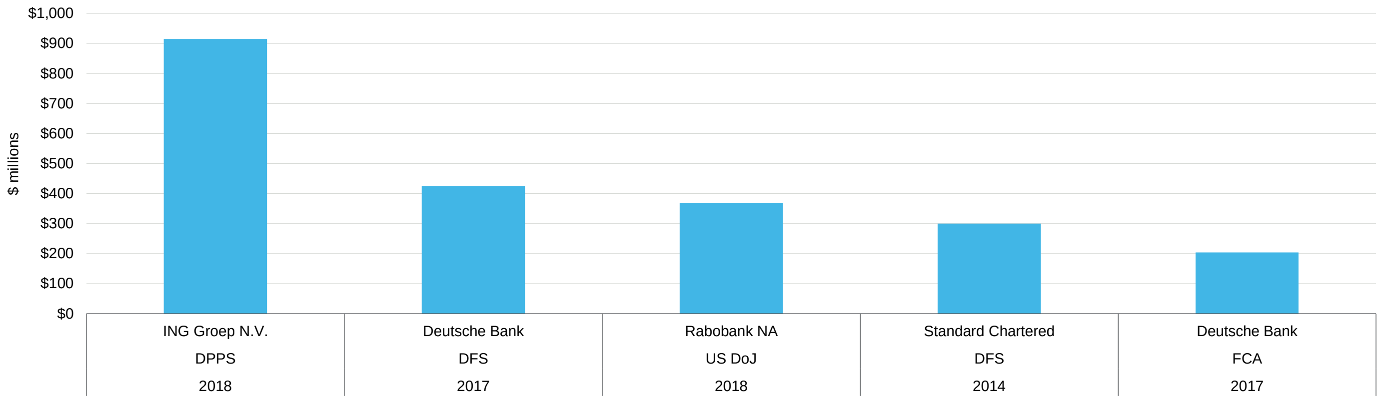
The draft EBA guidelines on loan origination and monitoring propose that financial institutions identify, assess and manage AML/ CFT risks associated with the geographies and customers they service, the distribution channels they use and the products they offer. Additionally, the EBA's proposals set out that financial institutions should take measures to identify the source of the funds their customers use to service the credit and detect doubtful funds.

Financial institutions are also required to have an internal process to ensure that information obtained to assess customers' creditworthiness can also be used for AML/CFT purposes. And, the guidelines demand that policies and procedures for disbursement of loans include sufficient controls to ensure they are in sync with credit decisions and AML/CFT rules, with adequate record keeping and documentation. The draft guidelines provide a detailed list of information and documentation requirements along with a list of expected verifications that may vary between consumers and professionals.

The EBA publication follows the recent adoption of the so-called Banking Package proposed by the European Commission in 2016. Among the additional risk-reduction measures introduced since 2016 and included in the recently adopted Capital Requirements Directive V (CRD V), some aim to combat money laundering and terrorist financing. The EBA was tasked with issuing guidelines by 1 January 2020, specifying the cross-border cooperation and information exchange between supervisory authorities on AML/CFT. This regulation complements the adoption of the Anti-Money Laundering Directive V in July 2018, which improved in Europe the transparency of beneficial owners of legal entities and trusts; broadened the criteria for assessing high-risk countries; and enhanced the cooperation mechanisms between financial intelligence units and financial supervisory authorities, among other reforms.

The proposed guidelines on loan origination and monitoring, if adopted, will contribute to develop a harmonised regulatory and supervisory framework in the European Union on AML/ CFT. Between 2012 and 2018, European banks paid more than $16 billion in fines prompted by shortcomings on AML and trade sanction breaches (see exhibit).

European banks paid heavy fines for AML violations that facilitated money laundering
Five largest fines imposed on European banks for money laundering breaches up to year-end 2018



Key: DPPS = Dutch Public Prosecution Service; DFS = New York's State Department of Financial Services, DoJ = US Department of Justice; FCA = UK Financial Conduct Authority
In 2019. Standard Chartered was fined an additional $1.1 billion for AML breaches.
Source: Moody's Investors Service

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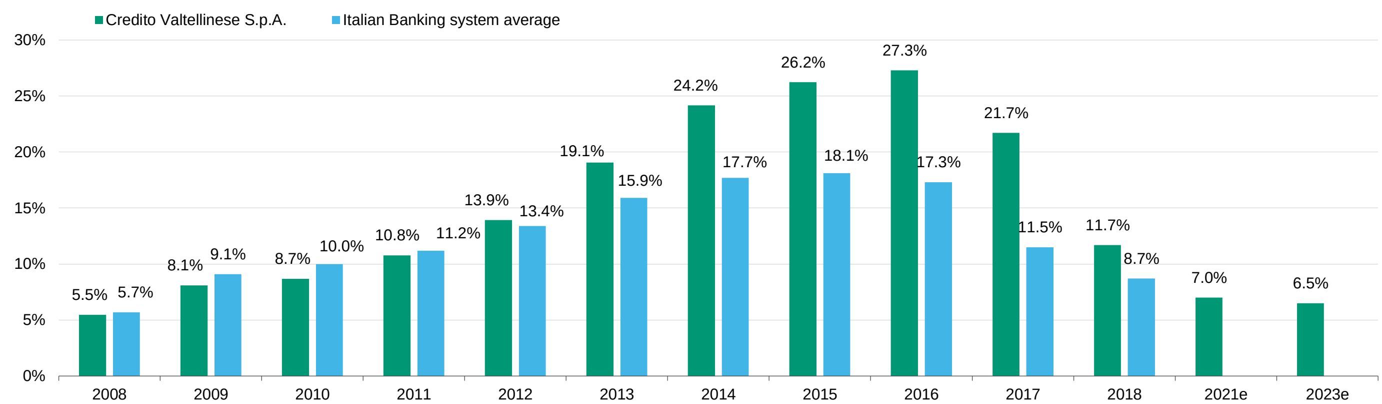
Credito Valtellinese's new business plan is credit positive

On 18 June, Italian bank Credito Valtellinese S.p.A. (Creval, Ba3/(P)B2 negative, b1[1]) announced a five-year business plan that aims to substantially shrink the bank's problem loans, halve its securities portfolio and improve profitability via cost-cutting. The plan is credit positive for Creval because it signals the bank's commitment to improving its loan portfolio and fundamentals.

To meet its problem loans target, Creval, which has total assets of €26.5 billion, is relying on portfolio sales, €800 million of which the bank must disposed of by 2020. However, this would be partly offset by new problem loans the bank will generate during the execution plan. Overall, the bank's goal is to shrink its problem-loan portfolio to €1.1 billion by December 2023 from €1.9 billion as of December 2018 and lower the bank's nonperforming loan ratio to 6.5% from 11.4% over the same period (see Exhibit 1). Yet while the reduction would be substantial, Creval's problem-loan ratio target for 2023 would remain worse than the European Banking Authority's (EBA) current European average of 3.2% as of December 2018.

Creval plans to reduce its problem loans with its new five-year business plan



Sources: The bank and Bank of Italy

Creval also plans to reduce its securities portfolio to €4 billion, or 15% of total assets, at the end of 2023 from €7.9 billion, or nearly 30%, at the end of 2018, and will match the reduction with a new funding strategy that is less reliant on funding from the European Central Bank (ECB). Creval aims to use more wholesale market funding to replace its existing interbank and ECB fundings. Doing so will shrink Creval's high exposure to relatively high returning Italian government bonds. Creval held €5.3 billion of Italian government bonds (close to 20% of total assets) as of December 2018.

The bank's new strategy differs from many Italian peers which have been increasing their exposure to domestic government bonds.[2]

Creval has previously met its problem-loan reduction and capital-increase targets, which bodes well for its ability to implement its new plan. But the bank remains some way from achieving an earlier profitability target. Former management had targeted net income of €150 million by the end of 2020 but the bank's net income was just €35 million for 2018. Creval's new board of directors now aims for net income to reach €93 million in 2021 and €138 million in 2023.

Looking ahead, Creval will seek to continue to dispose of problem loans, maintain good capitalization, improve its profitability and restart dividend payments (with a 50% payout ratio in 2020 and 75% in 2022). This will be difficult to achieve because the bank will not increase its loan book. That said, Creval expects some growth in net interest and fee income as it aims to reshuffle its lending activities towards customers that yield higher revenue. Increasing costs of funding will be partly offset by a higher return on household loans book which will include a higher proportion of consumer finance and SMEs. Overall Creval's ambitious objectives will also require lower loan loss provisions and cost reductions. These actions will facilitate Creval's future integration into a larger banking group.

Endnotes

1 The bank ratings shown in this report are the bank's domestic deposit rating, senior unsecured debt rating and Baseline Credit Assessment.

2 See Italian banks' high domestic sovereign exposure increases capital volatility, 9 April 2019.

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Piraeus Bank's subordinated debt placement supports its capital base and funding diversification, a credit positive

On 19 June, Piraeus Bank S.A. (Caa2/(P)Caa2 positive, caa2[1]) announced that it had successfully placed €400 million of Tier 2 subordinated debt with international investors. The Tier 2 debt supports the bank's overall capital adequacy, adding about 90 basis points to Piraeus Bank's capital adequacy ratio (CAR). It also diversifies the bank's funding sources.

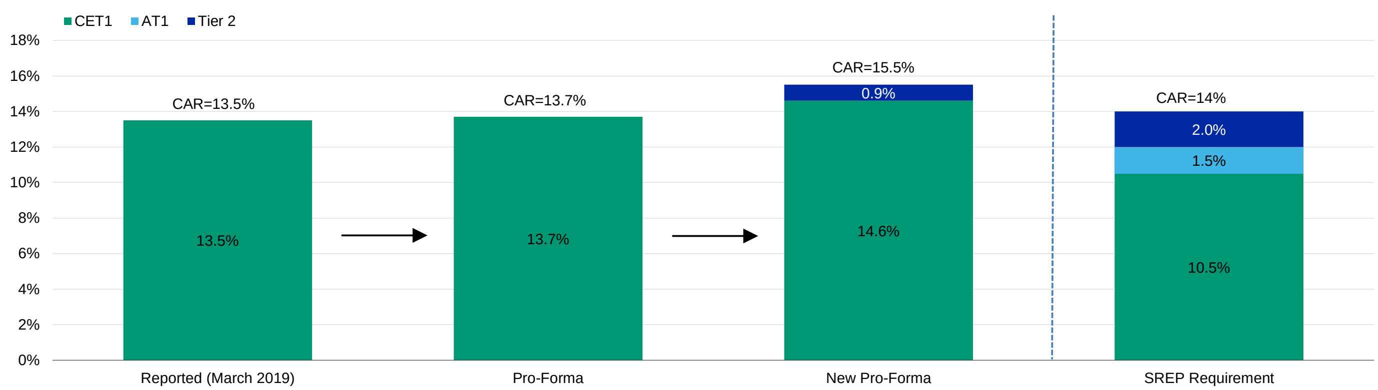
This was the first public Tier 2 issuance by a Greek bank since 2008. The successful placement shows a renewed investor appetite for Greek banks' unsecured debt, five years after banks were locked out of the unsecured debt capital markets amid Greece's economic crisis. We believe Piraeus Bank paves the way for other Greek banks to access the unsecured debt markets as well.

Piraeus Bank's Tier 2 instrument (maturing in 10 years with an issuer call after five years) was issued under its €25 billion euro medium term note (EMTN) programme with a coupon of 9.75%. The order book was strong with the demand reaching €850 million from more than 135 investors. We note that this issue follows the bank's agreement on 3 June with credit management services company Intrum AB (publ) (Ba2 stable) for servicing its €27 billion of nonperforming exposures (NPEs), which also adds around 85 basis points to its pro forma Common Equity Tier 1 (CET1) ratio and CAR.

Piraeus Bank reported a pro forma phased-in CET1 and CAR of 13.7% at the end of March 2019, taking into account the bank's earlier sale of its banking operations in Bulgaria as part of its restructuring plan. We estimate the bank's new pro forma phased-in CAR increases to approximately 15.5%, compared with its 2019 supervisory review and evaluation process (SREP) CAR requirement of 14% (see Exhibit 1). The increase translates into a capital buffer of around €690 million for the bank that now comfortably meets its SREP requirement, which is credit positive.

Exhibit 1

Piraeus Bank's capital adequacy level as of March 2019

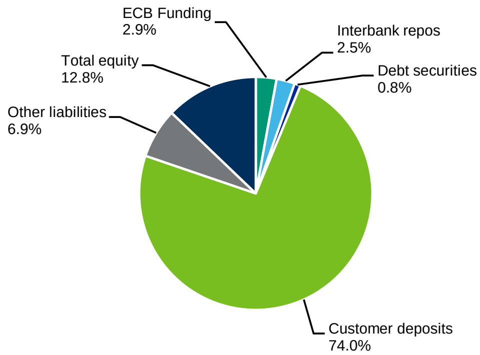


Pro forma accounts for the sale of banking operations in Bulgaria.
New pro forma accounts for the NPEs agreement with Intrum and the Tier 2 issue.
Source: Piraeus Bank's first-quarter results as of March 2019

The issuance also gives Piraeus Bank an alternative funding source beyond its existing customer deposits, European Central Bank (ECB) funding and interbank repos (see Exhibit 2). The subordinated bond issue allows the bank to reduce its reliance on secured funding that requires pledged assets, improving its funding and liquidity position. The bank's customer deposits grew by around 5% in 2018, amid an overall improvement in Greek depositor confidence over the past few years, and after all cash withdrawal restrictions were lifted in October 2018.

Exhibit 2

Piraeus Bank's funding mix as of March 2019



Source: Piraeus Bank's first-quarter 2019 results

Despite the relatively high cost involved, we consider Piraeus Bank's successful subordinated bond issue as a positive sign that in the wake of gradually improving economic conditions in Greece, there is renewed investor appetite for Greek bank debt that would allow banks to strengthen their capital bases. Regaining access to capital markets will also improve other Greek banks' funding positions, although it will come at a higher cost than secured funding from the ECB and the interbank repo market. Concurrently, we recognise that reduced revenue from shrinking loan books and still elevated loan-loss provisions, because of still very high systemwide NPEs of 45.4% of gross loans as of year-end 2018, will continue to challenge all Greek banks' operating performance in 2019-20.

Endnotes

1 The bank ratings shown in this report are the banks' deposit rating, senior unsecured debt rating and Baseline Credit Assessment.

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BMCE's capital injection from new strategic partner will be credit positive

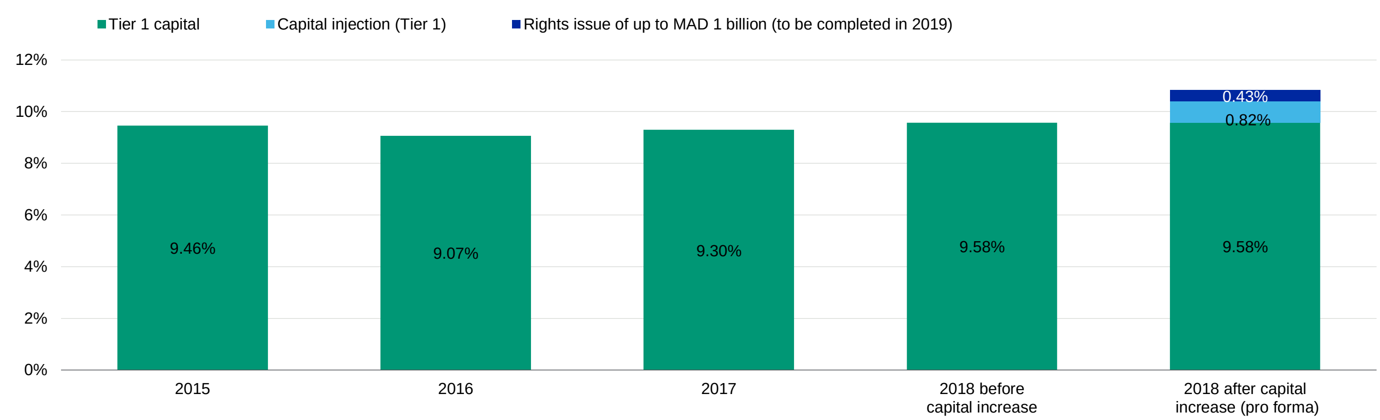
Originally published on 21 June 2019

On 19 June, Morocco-based BMCE Bank (Ba2 stable, b1[1]) and UK-based CDC Group announced that they had formed a strategic partnership focused on Africa. As part of the partnership, CDC, the UK's development finance institution, will acquire an approximately 5% equity stake in BMCE through a $200 million primary capital injection.

BMCE will benefit from CDC's expertise in African markets, and the credit-positive capital injection will increase BCME's core regulatory capital by around 82 basis points (based on reported risk-weighted assets at the end of 2018) for future capital consumption. The capital injection will be preceded this year by a rights issue of up to MAD1 billion ($105 million), increasing the core regulatory capital by up to an additional 43 basis points. BMCE will also increase its capital further through a separate scrip dividend.

Pending regulatory approvals, which we expect, we estimate that the capital injection will strengthen BMCE's reported regulatory Tier 1 capital ratio to around 10.40% of risk-weighted assets on a pro forma basis as of 31 December 2018, from an actual 9.58% (see exhibit). Including the 2019 planned rights issuance of up to MAD1 billion, pro forma regulatory Tier 1 capital will increase further to as much as 10.83% (see exhibit). A 10.83% Tier 1 capital ratio would exceed the 9% minimum that Bank Al-Maghrib, Morocco's central bank and banking system regulator, has imposed as part of its gradual implementation of Basel III capital requirements.

BMCE's reported Tier 1 capital



Note: Data include risk weights reported by the bank. Minimum regulatory capital is as of 1 January.
Source: Bank Al-Maghrib and BMCE Bank

BMCE's ratio of tangible common equity to risk-weighted assets, including our adjustments for sovereign debt holdings, intangibles and minority interests, was a modest 6.8% as of 31 December 2018 (before the capital issuance). We expect BMCE's capital buffers to remain modest, but the capital injection will help moderate the capital consumption effect from our expectation of rapid lending growth in sub-Saharan Africa (SSA) and stricter regulatory requirements in Africa (IFRS 9 accounting standards, risk-weighting of non-Moroccan government debt holdings and Basel III capital requirements in West Africa). Following rapid loan growth in the SSA portfolio during 2014-16, BMCE slowed its growth and optimised its balance sheet during 2017-18 amid lower capitalisation. We expect loan growth to pick up again in 2019-21.

The capital injection will increase the bank's loss-absorption buffers as its exposure to the risky SSA markets increases. We expect BMCE to continue to face asset quality challenges owing to its growing SSA exposure (28.6% of assets), which is more challenging than the bank's Moroccan exposure. BMCE's problem loans increased to 8.6% of gross loans in December 2018 from 8.2% in December 2017.

The planned capital increase will also support BMCE's solid liquidity, providing additional liquidity for future asset growth. The bank's liquid banking assets were high at 33.2% of tangible banking assets as of December 2018 (versus 37.2% as of December 2017). The bank's net loans to deposits ratio was solid at 89% in 2018.

We expect BMCE to benefit from CDC's knowledge of African markets. CDC has more than 70 years of experience investing in Africa and Asia and more than 700 businesses in its African portfolio. CDC plan to invest up to $4.5 billion in Africa by 2022 across different sectors and investment solutions. BMCE will benefit from CDC's experience in investing in small and medium enterprises.

BMCE had total assets of $31 billion as of December 2018, with a 14% market share in Morocco by deposits and a 13% market share by loans. At the end of 2018, the bank's largest shareholder was FinanceCom Group, a diversified private group based in Morocco, which held a 36.31% stake.

Endnotes

1 The bank ratings shown in this report are BMCE's foreign deposit rating and Baseline Credit Assessment.

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China's resolution of Baoshang Bank limits losses for large wholesale creditors, a credit positive for banks

On 16 June, the People's Bank of China (PBOC) released additional details about China Banking and Insurance Regulatory Commission's takeover in late May of Inner Mongolia-based Baoshang Bank.[1] The PBOC reported that around 99.98% of the bank's wholesale creditors received full repayment of their principal, including more than 400 large wholesale creditors that were owed more than RMB50 million. Those large wholesale creditors received full payment because the amount of their net claims on the bank (after netting out borrowing from the bank, such as interbank borrowing and loans) fell below RMB50 million. The remaining 0.02% of creditors received an average of 90% of their principal at this stage.

The results are credit positive for Chinese banks because the mild losses imposed on Baoshang's largest creditors will alleviate the market concern over counterparty risks that arose because of the Baoshang takeover and which had threatened regional banks' funding access. The results are also positive for Baoshang's creditors, which will have little to no losses on their exposures.

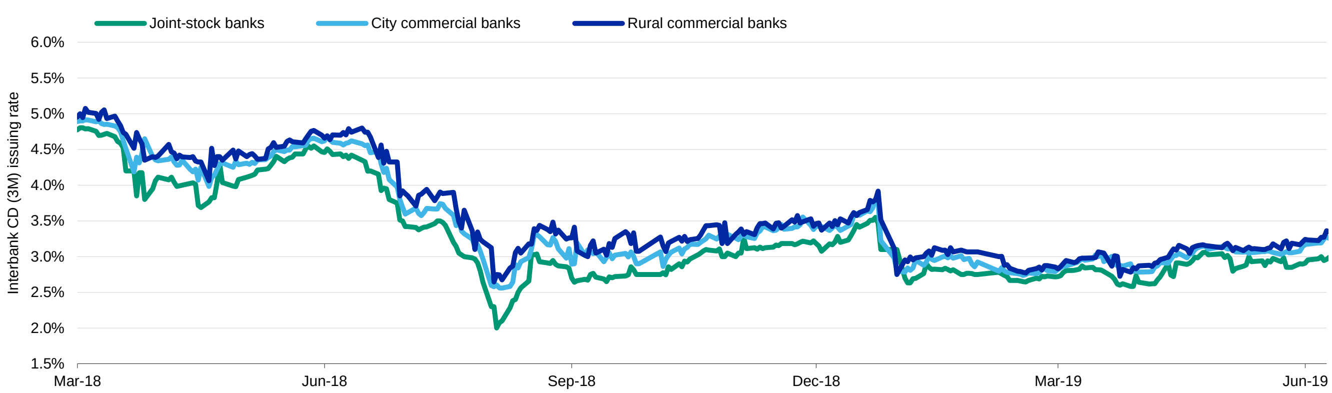
Although the PBOC's decision to impose mild losses on Baoshang's largest creditors reduces market fear of contagion, it still sends the message that authorities want wholesale creditors to evaluate counterparty risks more thoroughly. More thorough evaluation of counterparty risks will enhance credit market growth. More than 400 small and midsize financial institutions banked with Baoshang, and the modest burden-sharing for Baoshang's creditors reflects the regulator's commitment to maintain financial stability.

Deposits Insurance Fund Management Co. Ltd., an asset management company funded by deposit insurance funds, purchased and assumed the claims of the large wholesale creditors. After the takeover, the central bank and Deposits Insurance Fund Management will replace some of the previous creditors and become the new creditors.

After Baoshang's takeover, risk aversion in the interbank market heightened, with the demand for regional banks' interbank negotiable certificate of deposits (NCDs) declining and the pricing tightening to reflect greater uncertainty about whether and to what extent the government would apply similar resolution strategies to other distressed banks. Issuing rates for regional banks' interbank NCDs increased after the takeover. By contrast, issuing rates for joint-stock banks have remained relatively stable (see Exhibit 1).

Exhibit 1

Interbank NCD issuing rates for regional banks picked up after the takeover

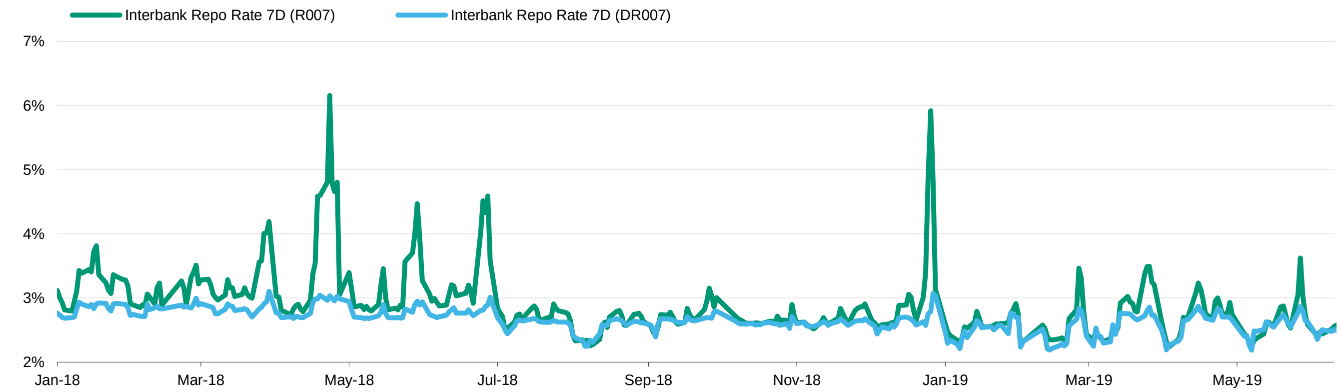


Sources: Wind Information Co. Ltd. and Moody's Investors Service

The risk aversion is also reflected in non-bank financial institutions' funding access and funding costs. Banks are becoming more reluctant to lend to non-bank financial institutions. The interbank repo rate for all financial institutions (R007) spiked after the Baoshang takeover, while the interbank repo rate exclusive to depositary institutions[2] (DR007) remained relatively stable (see Exhibit 2). In response, the central bank has injected interbank liquidity, a move that has pushed down R007 since the end of May.

Exhibit 2

Interbank repo rate for all financial institutions spiked after the Baoshang takeover



Source: Wind Information Co. Ltd. and Moody's Investors Service

The small magnitude of the imposed losses may sustain some overzealous risk-taking behavior. For example, some banks may continue aggressive interbank lending because the losses are minor compared with the potential gains from interbank business, especially as the returns for lending to smaller banks and non-bank financial institutions increase. Nonetheless, the outcome shows that the regulator is starting to address the issue of moral hazard in these activities and avert the scenario of an outright bailout using public funds.

Endnotes

1 See Initial plan to resolve Baoshang Bank is credit negative for large wholesale creditors, 28 May 2019.

2 Depository institutions include banks, credit cooperatives and finance companies.

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Ecuador's buyback of 2020 bonds removes near-term rollover and liquidity risk

Originally published on 21 June 2019

On 17 June, Ecuador (B3 negative) bought back 78% of its bonds maturing in March 2020, removing its rollover and liquidity risk, funding the buyback with proceeds from a bond issuance the week before. The sovereign's liability management operation (LMO) is credit positive.

The government issued $1.125 billion of 10-year bonds with a coupon rate of 9.85% on 10 June as the first step in its LMO. A week later, on 17 June, it purchased $1.175 billion of its $1.5 billion, 10.5% coupon bonds due March 2020 as the second and final step. The operation alleviates several of the factors, including limited market access and the government's ability to make the 2020 bond payment, that figured into our December 2018 change in its rating outlook to negative from stable.

The LMO reduced the government's outstanding debt by $50 million, confirmed improved investor sentiment via a lower coupon rate and most importantly removed uncertainty about how the government was going to finance its 2020 payment. Ecuador's perceived market risk had worsened significantly through 2018, with the sovereign risk spread widening above 800 basis points at year-end 2018. Although still high at around 600 basis points, the narrower spread denotes improved market access following the February 2019 announcement of an IMF program (see Exhibit 1).

Exhibit 1

Sovereign spread relative to US treasuries has narrowed since the IMF program was announced

Basis points

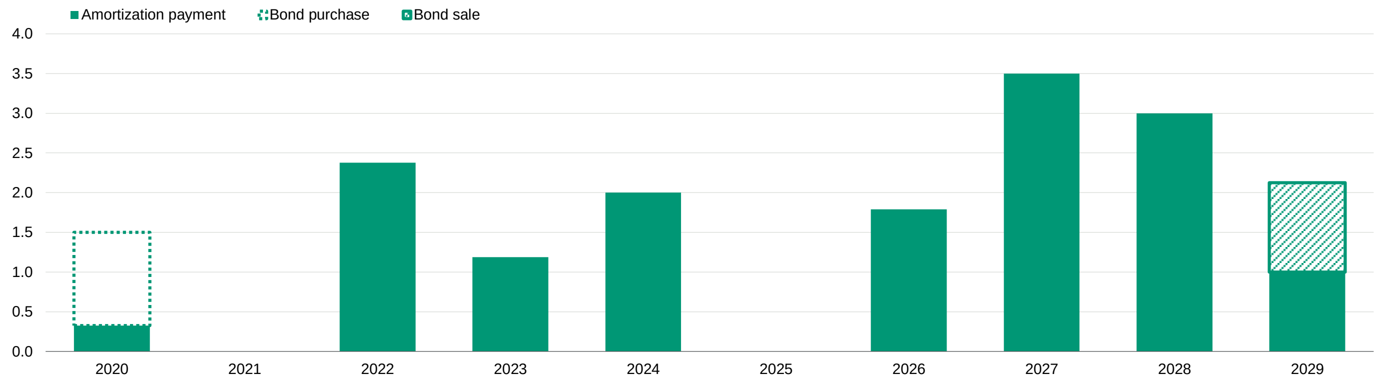
Sources: JP Morgan via Haver and Moody's Investors Service

The LMO has provided the government breathing room in 2019-20 by lowering rollover risks and removing pressure on foreign exchange reserves in 2020. However, the debt maturity profile over the coming decade is still demanding (see Exhibit 2). The government has $15.4 billion (14.2% GDP) in amortization payments due over the next 10 years, with the next payment of $2.4 billion in 2022.

Exhibit 2

Ecuador's demanding debt maturity profile

Amortization payment amounts ($)



Sources: Bloomberg and Moody's Investors Service

Additionally, the government is at the beginning of a rigorous, three-year IMF program that will lead to weak economic growth this year during a transition to a privately led economy and a public sector with more sustainable fiscal accounts. For this purpose, the government has a reform agenda that includes changes to the tax system and labor market regulation. We expect economic activity to contract 0.2% in 2019, given that the government intends to continue on the path of substantial fiscal consolidation under the IMF program. In 2020, we forecast GDP to return to growth (0.5%), based on our expectation that the brunt of the consolidation will be this year, and would therefore allow some pockets of the economy to restart in 2020. Ecuador's central bank revised its GDP growth estimate to 0.2% this year from 1.4% in February.

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Chile's inaugural sovereign green bond sets strong precedent for future issuances

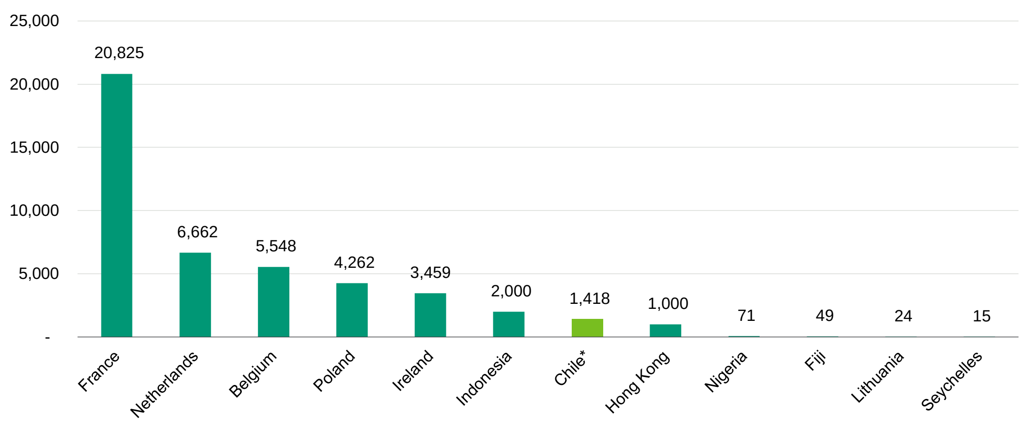
Originally published on 21 June 2019

On 17 June, Chile (A1 stable) became the first Latin American sovereign to issue a green bond (see Exhibit 1). The $1.418 billion 30-year bond, which was more than 12 times oversubscribed, consists of $895 million for liability management operations and $523 million in new notes.

The green bond issuance is in line with the government's commitments to reduce greenhouse gas emissions and adapt to climate change, as agreed to under the Paris Climate Agreement. Specifically, Chile has committed to a 30% reduction in CO_2 emissions per unit of GDP by 2030 from 2007 levels.

Chile's economy is exposed to climate shocks due to its low-lying coastal areas, susceptibility to natural disasters, and large swathes of land prone to drought and desertification.[1] Net proceeds from Chile's first green bond issuance will be dedicated to climate shock mitigation and adaptation projects in six sectors identified in the government's Green Bond Framework.[2] These include clean transportation; energy efficiency; renewable energy; living natural resources, land use and marine protected areas; efficient and climate-resilient management of water resources; and green buildings.

Sovereign green bond issuances by country as of 20 June 2019
$ millions



*Issuance only represents $523 million in new notes for Chile
Sources: Climate Bond Initiative, national sources and Moody's Investors Service

Strong investor appetite for Chile's inaugural green bond indicates that the sovereign has a ready pool of funding to support its commitment to combat climate change. While implementation of the Green Bond Framework will be key to realizing its sustainable development commitments, Monday's issuance sets a firm precedent for tapping markets to fund these initiatives in the future. The government plans to issue another $1 billion in green bonds in euro money markets in the coming weeks. This would increase Chile's foreign-currency indebtedness by $1.5 billion in 2019, assuming there are no further issuances, and is in line with the government's current annual financing plan.

More broadly, strong investor demand also highlights the ample market access from which Latin America's most highly rated sovereign consistently benefits. The terms of the issuance demonstrate that Chile's government, which is pursuing both structural reforms to improve its economic growth prospects and fiscal consolidation to deal with rising debt levels, commands the confidence of international investors. The 3.53% interest rate on the 30-year bond is the lowest rate in Chile's history for global bonds of similar tenor. That said, Chile is not alone in issuing at historically low rates this month. Emerging market peers including Peru (A3 stable), Lithuania (A3 stable), and lower-rated Croatia (Ba2 positive) have also issued global bonds (plain vanilla) at low and in certain cases, historically low rates. As such we note that the low rate earned on this week's issuance also reflects favorable global market conditions enjoyed by a number of emerging market issuers.

Endnotes

1 Chile is ranked 16th out of 181 countries in terms of vulnerability to climate change according to the 2019 Global Climate Risk Index.

2 Chile's Green Bond Framework is a joint project document designed by the Ministry of Finance and the Ministry of Environment, and sets out the main sectors to which proceeds from green bond issuances will be channeled. In seeking to align the framework with international best practice, the government's sovereign Green Bond Framework and associated portfolio of projects were finalized in consultation with independent international institutions including the World Bank and the Climate Bond Initiative.

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Banks pass Federal Reserve stress test with higher buffer than in 2018, a credit positive

Originally published on 23 June 2019

On 21 June, the US Federal Reserve (Fed) published the results of the 2019 Dodd-Frank Act stress test (DFAST) for 18 of the largest US banking groups, all of which exceeded the required minimum capital and leverage ratios under the Fed's severely adverse stress scenario. These results are credit positive for the banks because they show that the firms are able to withstand severe stress while continuing to lend to the economy. In addition, most firms achieved a wider capital buffer above the required minimum than in last year's test, indicating a higher degree of resilience to stress. The 2019 results support our view of the sector's good capitalization and benefit banks' creditors.

The median stressed capital buffer above the required Common Equity Tier 1 (CET1) ratio increased to 5.1% from 3.5% last year, a substantial change. However, the 18 firms participating in 2019 were far fewer than the 35 that participated in 2018, helping lift the results this year. This is because passage of the Economic Growth, Regulatory Relief, and Consumer Protection Act in May 2018 resulted in an extension of the stress test cycle to two years for 17 large and non-complex US bank holding companies, generally those with $100-$250 billion of consolidated assets, which pose less systemic risk.

This is the fifth consecutive year that all tested firms exceeded the Fed test's minimum CET1 capital requirement. As in prior years, the banks' Tier 1 leverage and supplementary leverage ratios had the slimmest buffers of 2.8% and 2.4%, respectively, above the required minimums as measured by the aggregate.

Under DFAST, the Fed applies three scenarios – baseline, adverse and severely adverse – which provide a forward-looking assessment of capital sufficiency using standard assumptions across all firms. The Fed uses a standardized set of capital action assumptions, including common dividend payments at the same rate as the previous year and no share repurchases. In this report, we focus on the severely adverse scenario, which is characterized by a severe global recession accompanied by a period of heightened stress in commercial real estate markets and corporate debt markets.

This year's severely adverse scenario incorporates a more pronounced economic recession and a greater increase in US unemployment than the 2018 scenario. The 2019 test assumes an 8% peak-to-trough decline in US real gross domestic product compared with 7.5% last year and a peak unemployment rate of 10% that, although the same as last year, equates to a greater shock because the starting point is now lower (the rise to peak is now 6.2% compared with 5.9% last year).

The severely adverse scenario also includes some assumptions that are milder than last year: housing prices drop 25% and commercial real estate prices drop 35%, compared with 30% and 40% last year; equity prices drop 50% compared with 65% last year; and the peak investment grade credit spread is 550 basis points (bp), down from 575 bp last year. We consider this exercise a robust health check of these banks' capital resilience.

Finally, the three-month and 10-year Treasury yields both fall in this year's severely adverse scenario, resulting in a mild steepening of the yield curve because the 10-year yield falls by less. As a result banks' net interest income faces greater stress than in last year's scenario, which assumed unchanged treasury yields and a much steeper yield curve.

Click here for the full report.

Curbs on surprise medical bills would impact hospitals, staffing companies

Originally published on 20 June 2019

» **Efforts to curb surprise medical bills are gaining steam**. Surprise medical bills are received by insured patients who inadvertently receive care from providers outside of their insurance networks, usually in emergency situations. Curbing surprise medical bills, which is part of the conversation around the affordability and accessibility of US healthcare, has rare bipartisan support. This raises the likelihood of federal legislative or regulatory action, particularly as we move into an election year.

» **Legislation to curb surprise bills would affect any provider that directly bills patients, but especially those that treat a high percentage of out-of-network patients**. If passed, legislation would likely impact hospitals, physician staffing companies, laboratories, radiology and other ancillary provider companies. There are also several proposals that would impact air ambulance providers.

» **Proposals under consideration are mostly credit negative**. Potential solutions include capping out-of-network charges for emergency medical services at in-network levels; or setting up an arbitration process to resolve out-of-network charges. Another approach is to require a single, "bundled bill" for all care received in an emergency room or have hospitals guarantee that all of their affiliated doctors and service providers are in-network.

» **Bundled billing/in-network guarantee would be the most negative for hospitals and staffing companies**. This is because many hospitals completely outsource the operations and billing of the emergency department to a staffing company. Bundling the services would require a significant change in the relationship between these entities. Further, an in-network guarantee would add significant complexity because many physicians and ancillary service providers are not employed or controlled by the hospital.

» **The largest providers would be least affected by any changes.** Thanks to their scale, the largest providers have significant negotiating leverage with insurers, making them likely to already be in-network. As a result, out-of-network exposure across rated healthcare corporates is relatively limited. That said, legislation could indirectly affect how they negotiate in-network rates with insurers, leading to pricing pressure.

» **Changes could accelerate consolidation.** Smaller providers are likely to have high out-of-network exposures because they are challenged to negotiate favorable in-network rates from insurers. Any changes would likely make them more willing to become part of a larger group. The proposals could also prompt hospitals to employ more physicians, which would add expense.

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