

Credit Outlook

29 June 2020

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Policy measures will provide a degree of support, but shocks to trade, commodities and financial market sentiment will weigh on growth prospects.

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GFL Environmental's acquisition of strategic assets in US is credit positive

Originally [published](#) on 24 June 2020

On 24 June, [GFL Environmental Inc.](#) (B1 stable) announced that it has entered a definitive agreement to acquire a portfolio of vertically integrated assets for \$835 million. The assets include 32 collection operations, 36 transfer stations, 18 landfills and 380 collection vehicles and are located in the US across 10 different states.

The credit-positive acquisition increases GFL's US footprint with entry to a new market in Wisconsin and expanded volume in other states where GFL has existing operations. The assets are being divested by [Waste Management, Inc.](#) (WM, Baa1 stable) and [Advanced Disposal Services Inc.](#) (ADS, B1 stable) as part of WM's acquisition of ADS and are substantially all of the divestitures the US Department of Justice is likely to require to approve the transaction.

The acquisition continues GFL's growth strategy and will add approximately \$345 million in revenue on an annual basis. The company expects that the acquired assets will generate margins in the high 20% range (before synergies). GFL expects the transaction to close in the third quarter, pending final clearance from the US Department of Justice and also the closing of WM's acquisition of ADS.

GFL has a successful history of completing sizable acquisitions to support its growth strategy, and the company has completed over 100 acquisitions since 2007. The most recent large acquisitions include those of County Waste and American Waste, which expanded its operations to Virginia and Eastern Pennsylvania. The acquisition of the WM and ADS assets expands GFL's operations to the US Midwest. GFL will retain the existing management team of the Wisconsin assets, which primarily provide commercial waste management and landfill services. These new assets will provide a good foothold for other growth opportunities with possible expansions to residential services which fit well with GFL's existing operations.

GFL expects to fund the acquisition through cash on hand and additional amounts drawn from its CAD628 million revolving credit facility (undrawn and fully available as at 31 March 2020). GFL currently has approximately CAD700 million in cash after the issuance of its \$500 million senior secured notes in April.

With the incremental EBITDA provided by the newly acquired assets and the small increase in debt from the revolver draws, we expect GFL's leverage for 2020 will remain around mid-4.0x (pro forma 4.6x for last 12 months to first-quarter 2020). Without other debt-financed acquisition transactions, we expect that GFL will deleverage gradually because its free cash flow can be used for debt reduction and the repayment of the outstanding amounts under its revolving credit facility. However, an increase in leverage towards 5x would negatively pressure GFL's rating, as would elevated risks related to the integration of the acquired assets. Overall, despite the increase in leverage from GFL's post-IPO financial metrics (which we projected then at 4.1x for 2020), the acquisition is credit positive because it increases GFL's geographical diversification and scale of its operations.

GFL Environmental Inc., headquartered in Toronto, provides solid waste and liquid waste collection, treatment and disposal solutions and infrastructure and soil remediation services to municipal, industrial and commercial customers in Canada and the US. GFL closed its IPO transaction on 5 March 2020 and is publicly traded on the New York Stock Exchange and Toronto Stock Exchange. BC Partners, Ontario Teachers Pension Plan and GIC, along with GFL's management own about 70% of the company. Revenue for the 12 months that ended 31 March 2020 were \$3.6 billion.

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

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Kantar Global's term loan add-on improves liquidity

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On 24 June, [Kantar Global Holdings S.a.r.l.](#) (B2 negative) announced the launch of a \$150 million (euro equivalent) add-on on its B1-rated senior secured facilities. Kantar plans to use the proceeds to repay \$150 million drawn under its \$400 million revolving credit facility. The transaction is leverage neutral and helps improve the Kantar's liquidity profile of Kantar.

We continue to view Kantar's liquidity as comfortable. As of end of May 2020, the company had \$740 million of cash and cash equivalents, net of the remaining proceeds due to be paid to WPP for Kantar's disposal transaction, and the revolving credit facility was drawn for \$383 million (\$233 million pro forma for the add-on). The leverage covenant under the revolving credit facility is unlikely to be tested in 2020 given that the revolving credit facility drawn net of cash should remain significantly below 40% of the total amount. We believe that the liquidity available will be more than sufficient to cover the company cash needs in 2020. And the company does not have any significant maturity until June 2026, when the revolving credit facility matures.

This issuance was launched following the release of Kantar's first-quarter 2020 trading update, when the company communicated a 10% revenue decline to May 2020 year to date. The decline is in line with the favourable end of our current expectations, but we remain cautious on the rest of 2020 as market environment remains quite uncertain. Kantar expects to partly offset the pressure on revenue with the planned delivery of \$190 million of cost savings, of which \$60 million are expected to be recurring in the future.

We expect Kantar's Moody's-adjusted debt/EBITDA to temporarily rise to more than 8.0x in 2020 (from around 6.0x in 2019) and the negative outlook on the ratings captures the risk of weaker than currently anticipated 2020 as well as a slower recovery in 2021 particularly in the Insights division.

Stabilization of outlook will require some recovery in the company's business from second half of 2020 such that 2021 sees the business trends normalizing in a way that the company's Moody's-adjusted gross leverage begins to trend towards 6.5x.

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Tesco's new Aldi price-matching campaign will likely spark credit-negative sector price wars

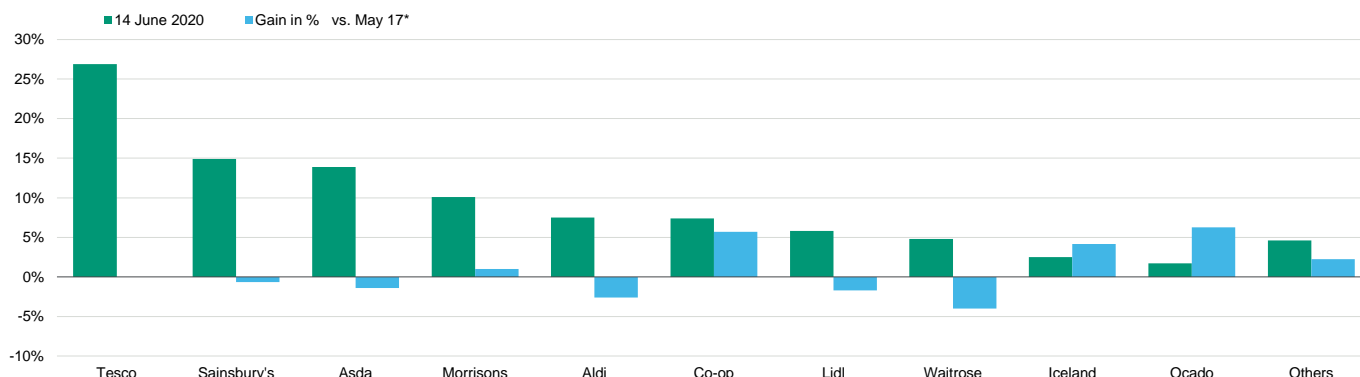
Originally [published](#) on 26 June 2020

On 26 June, the UK's largest grocer by market share, [Tesco PLC](#) (Baa3 stable), announced that it was extending its campaign to match the prices of German discounter Aldi to around 500 of its near 1,600 product lines, including branded items. Tesco has doubled its online delivery capacity to 1.3 million slots a week.

Tesco's actions are credit negative for the sector because they will probably spark a new price war, with retailers that are unable to negotiate lower prices with suppliers likely to see margins erode, in our opinion. Tesco has scale and should benefit from its renewed focus on keeping prices and costs low, but smaller UK grocers will probably struggle. Tesco has steadily improved its EBITDA margin in the past few years. In fiscal year 2020, ended 28 February 2020, it was 7.3%, up from 6.5% in fiscal 2019.

The German discounters Aldi and Lidl have been steadily gaining market share in the UK for the past decade. However, the coronavirus pandemic has halted this march, with shoppers opting for online deliveries or large weekly in-store purchases with the large grocers like Tesco, J. Sainsbury PLC, Asda and [Wm Morrison Supermarkets Plc](#) (Baa2 stable) during lockdown. According to data from market research company Kantar Worldpanel, [Aldi and Lidl have both lost UK market share recently](#). Co-op Food and [Iceland VLNCo Limited](#) (B2 negative) have benefited from increased convenience shopping, while [Ocado Group Plc](#) (B2 stable) has benefited from its online presence (see exhibit).

Ocado and Iceland have gained most market share recently UK grocers' market share (12 weeks ending)



*Market share as at 14 June 2020 minus market share as at 17 May 2020 divided by market share as at 17 May 2020.

Source: Kantar Worldpanel

In its first-quarter trading update for the 2021 fiscal year ending 29 February 2021, Tesco said group sales had risen 9.1% in the UK, driven by a 48.5% increase in online sales and an 9.9% increase in convenience store sales (Tesco Express and One Stop). Tesco estimates that if it can increase its online delivery capacity it should be able to generate £2 billion online sales this year, based on its current run rate. Online as a share of total annual sales would rise to 16% from 9% in fiscal 2020.

We expect more significant shifts in market shares driven by ongoing changes in shopping habits. An economic slump this year will probably fuel a focus by consumers on value. The winners will be those grocers which can increase their online delivery capabilities and negotiate with suppliers so they can keep prices low without eating into their margins. Tesco, Morrisons and Sainsbury's have narrowed their product ranges and made other efficiency improvements in the past three years, investing these gains in price cuts. As a result their market shares have stabilised after several years of losses to the German discounters as well as [B&M European Value Retail S.A.](#) (Ba3 stable) and HomeBargains.

If Tesco is able to negotiate lower prices with some of the large consumer goods companies it would have a strong competitive advantage and should be able to gain market share without eroding its credit quality. However, as UK grocers continue to fight for market share, we do not expect their credit quality to improve much during the next 12-18 months.

Lastly, we note that Tesco stated that it does not intend to trigger "anything irrational in the marketplace" but simply make sure that it can "offer best value in the marketplace". It remains to be seen if the competitive landscape in the UK grocery market has stabilised or if the looming recession will further significant changes, in our opinion.

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Bouygues Telecom's acquisition of Euro-Information Telecom is credit positive

On 26 June, Bouygues Telecom, a subsidiary of French conglomerate [Bouygues S.A.](#) (Bouygues, A3 stable), announced that it had entered an exclusive agreement to acquire Euro-Information Telecom (EIT), France's largest mobile virtual network operator (MVNO), a subsidiary of [Groupe Credit Mutuel](#) (Crédit Mutuel). The acquisition will expand Bouygues Telecom customer base and strengthen its distribution network, a credit positive for Bouygues.

The acquisition price includes a fixed part of €530 million and a variable component between €140 million and €325 million, depending on revenue growth over several years, which we expect Bouygues to finance in cash. The group has sound liquidity, with liquid sources totaling €11.3 billion at 31 March 2020, pro forma for the €1 billion bond issuance completed in April. The transaction is subject to merger clearance and is expected to close by the end of the year.

EIT is the largest MVNO provider in France, with more than €500 million of revenue and in excess of 2 million mobile clients. It operates through brands NRJ Mobile, CIC Mobile, Crédit Mutuel Mobile, Auchan Mobile and Cdiscount Mobile. Although MVNOs tend to be more aggressive on prices than the four incumbent French telecom operators, we believe EIT's customers include postpaid subscribers, independent workers and small businesses, derived from its bank distribution network, a positive for Bouygues Telecom. Pro forma for the acquisition, we estimate that Bouygues Telecom's mobile customer base will be around 14 million, closer to [Altice France S.A.](#) (B2 negative) subsidiary Société Française du Radiotéléphone's (SFR) approximately 15 million, and more than Free's approximately 12 million. EIT's revenue equals around 8% of Bouygues Telecom's revenue and around 1% of Bouygues' revenue.

This acquisition will significantly expand Bouygues Telecom's retail distribution network thanks to EIT's large banking network access, with more than 4,200 Crédit Mutuel and [Credit Industriel et Commercial](#) (Aa3/Aa3 stable, baa1¹) branches and more than 30,000 customer advisors versus Bouygues Telecom's only 500 retail stores.

This acquisition also makes sense because organic growth in France's mature market is challenging from a timing, price and marketing perspective, and the direct acquisition of a portfolio of customers is a faster move to gain scale in mobile, with some potential for pricing upgrade and fixed-mobile cross selling options overtime. We also expect some costs synergies once EIT's roaming agreements with SFR and [Orange](#) (Baa1 stable) will end.

We expect Bouygues' earnings and cash flow generation to be negatively affected by the coronavirus outbreak in 2020.² But, for now, we believe that the company's solid liquidity and conservative financial policy are strong mitigating factors that will help absorb the shock. On its own, we estimate that the acquisition will have a limited effect on Bouygues' credit metrics this year, and will positively affect earnings and cash flows from mid-2021 and beyond. Even if funded by debt, the maximum acquisition costs of €855 million would only translate into a 20 basis point increase in Bouygues' leverage (gross debt to EBITDA as adjusted by Moody's), which was 2.9x in the 12 months to 31 March 2020.

While the EIT acquisition will require some initial capital spending, notably in terms of IT and network migration, we believe the required investments will remain manageable for the group, and mitigated by the cut in investments related to 5G, which are temporarily delayed because of the coronavirus, as well as the group's suspension of dividends, which were €710 million in 2019.

Endnotes

¹ The ratings shown are Credit Industriel et Commercial's deposit rating, senior unsecured debt rating and Baseline Credit Assessment.

² See [Coronavirus outbreak is credit negative, but manageable, for Bouygues](#), 8 April 2020.

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Indian Oil's inventory losses and weak refining margins lower fiscal 2020 earnings

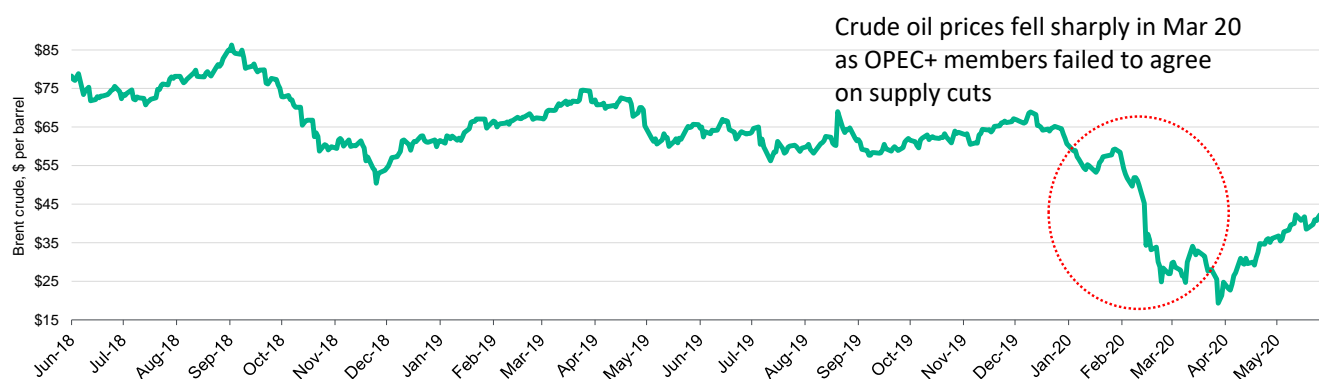
Originally [published](#) on 26 June 2020

On 24 June, [Indian Oil Corporation Limited](#) (IOCL, Baa3 negative, Baseline Credit Assessment ba1) reported that fiscal 2020 (ended 31 March 2020) EBITDA declined 76% from fiscal 2019, largely attributable to inventory losses the fiscal fourth quarter. Excluding inventory losses, EBITDA fell 26% from fiscal 2019. The decline in EBITDA, although credit negative, is already factored into IOCL's rating and outlook and will have no immediate ratings effect.

During fiscal 2020, IOCL incurred inventory losses of INR166.3 billion compared to an inventory gain of INR41.7 billion in the previous year. The inventory loss was due to a sharp decline in crude oil prices in March 2020 (Exhibit 1). However, our IOCL credit metric calculations exclude inventory losses or gains to eliminate any volatility from fluctuating crude oil prices.

Exhibit 1

Sharp drop in crude oil prices resulted in significant inventory losses for IOCL



Source: Factset

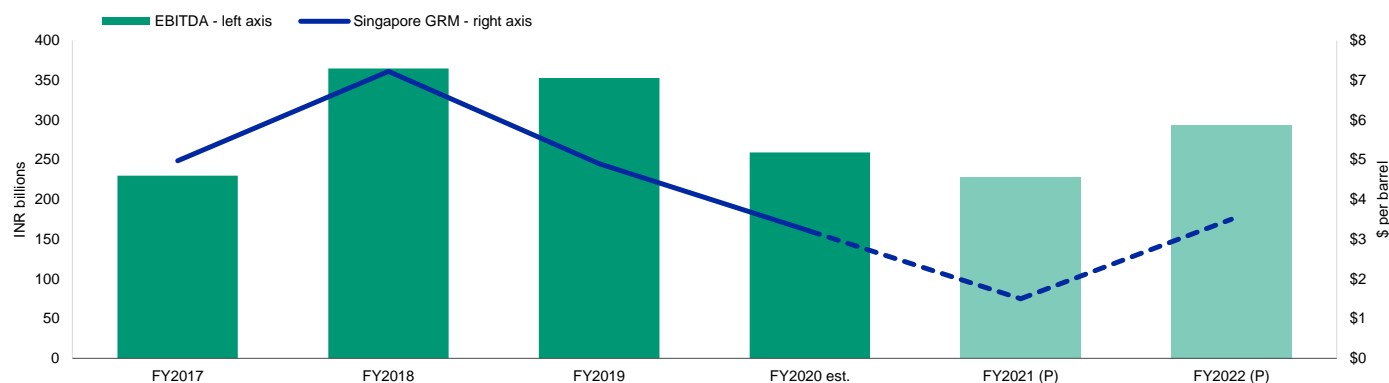
Aside from the inventory effect, EBITDA weakness reflects lower refining margins and refinery throughput in fiscal 2020. The company's reported gross refining margins (GRM) declined to \$0.08 per barrel for fiscal 2020 compared to \$5.41 per barrel in fiscal 2019 and \$8.50 per barrel in fiscal 2018. Excluding the impact of inventory losses, IOCL's GRM was around \$3.97 per barrel in fiscal 2020 compared to \$4.60 per barrel in the previous year.

The decline in IOCL's GRM followed the Singapore benchmark decline to \$3.20 per barrel from \$4.90 per barrel over the same period. Nonetheless, the decline in IOCL's margins was less severe owing to its marketing operations which are relatively more stable and not impacted by the movement in the benchmark margins.

The deterioration in benchmark margins was largely on account of extremely weak fuel oil spreads, which in turn were driven by International Maritime Organization's new regulation restricting the use of heavy fuel oil in marine transportation.

We expect IOCL's refining margins and EBITDA to remain pressured over the next six to 12 months, in line with the weak industry environment. Under our base case assumptions, we expect the Singapore benchmark refining margins to remain around \$1.50-\$2.50 per barrel in 2020 before improving to \$3.50-\$4.00 per barrel in 2021 (Exhibit 2).

Exhibit 2

EBITDA will continue to decline in fiscal 2021 in line with the weak industry environment

EBITDA excludes inventory losses or gains

Sources: Moody's Financial Metrics and Moody's Investors Service estimates

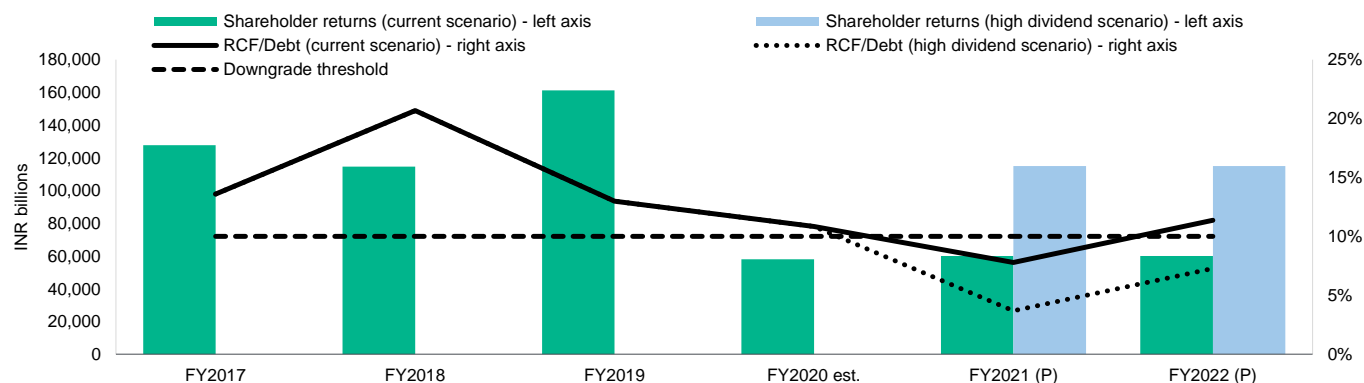
IOCL's EBITDA was also affected by lower throughput during the fourth-quarter amid India's coronavirus-related lock-down, beginning 25 March. With the economy now opening, IOCL's refinery utilization rates have improved after falling to around 60% in April and May. We expect the company's fiscal 2021 capacity utilization to remain low at around 90% relative to its historical average of close to full utilization, adding pressure to the company's earnings and cash flows during the year.

Notwithstanding the lower earnings, total shareholder return during the year declined significantly to INR58 billion from INR161 billion in fiscal 2019. Consequently, our estimated adjusted leverage as measured by retained cash flow (RCF)/adjusted debt declined to around 10.8% for fiscal 2020 from 13.0% in the previous year.

If the company is able to sustain its shareholder returns at or near current levels, it will help mitigate the effect of lower earnings in fiscal 2021. However, IOCL's credit metrics will come under pressure if the company increases its shareholder returns back to historical levels at a time when operating performance is expected to remain weak.

While IOCL's credit metrics will remain weakly positioned for its ba1 Baseline Credit Assessment (BCA) over the next six to 12 months, we expect refining margins and utilization levels to start to improve from fiscal 2022 onwards on the back of normalization in economic activity. This in turn will drive an improvement in the company's credit metrics such that they are more appropriately positioned for its current BCA. In particular, we expect RCF/debt to improve to 11%-12% in fiscal 2022 after a temporary weakening to 7.5%-8% in fiscal 2021 (Exhibit 3).

Exhibit 3

Credit metrics will improve from fiscal 2022 after a temporary weakening in fiscal 2021

Sources: Company Information and Moody's Investors Service estimates

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Qantas' equity raise and restructuring are credit positive

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On 25 June, [Qantas Airways Ltd.](#) (Baa2 negative) announced that it will raise up to AUD1.9 billion in equity in a fully underwritten institutional placement of around AUD1.36 billion and a non-underwritten share purchase plan for eligible existing shareholders of up to AUD500 million. The equity raise is credit positive because Qantas will use the proceeds to strengthen its balance sheet and improve its financial flexibility, in line with its financial framework.

Management also announced measures to right-size and restructure the business as it adjusts expected structural changes and ongoing uncertainty in the airline sector. The measures include significant staff cuts and ongoing standing-down of staff, the retirement and grounding of aircraft, and the deferral of the delivery of A321 neo and 787-9 aircraft. The cost to implement these measures will be around AUD1 billion, most of which will be incurred in fiscal 2021.

Qantas had AUD2.5 billion of cash, undrawn facilities of AUD1 billion and an unencumbered fleet valued at AUD2.7 billion as of 5 May. Total liquidity will increase to AUD4.6 billion, excluding unencumbered aircraft, following the completion of the equity raise.

Pro forma net debt was AUD4.7 billion as of 31 May, and Qantas has no major debt maturities until June 2021 (these figures exclude the AUD500 million share purchase plan proceeds, which will only be received in July).

Qantas has prioritized balance-sheet strength and liquidity for a number of years, despite record earnings, and the coronavirus outbreak has shown the benefit of this. The company has taken a number of actions to reduce cash burn as revenue has fallen amid the coronavirus disruption to air travel, including standing down employees, deferring capital spending and revoking the declared first-half 2020 dividend. It also utilized its unencumbered fleet to raise AUD1.75 billion in debt to boost liquidity. Qantas' management has a strong track record in transforming the business. Therefore, it is positive that at the board's request, Alan Joyce agreed to remain group CEO at least until the end of fiscal 2023, ending 30 June 2023.

Relative to fiscal 2019, Qantas expects average domestic capacity to recover to 70% in fiscal 2021 and 100% in fiscal 2022. Qantas expects international capacity to be around 50% in fiscal 2022. While it is encouraging that Qantas is providing capacity forecasts, the reality is that it is difficult to forecast capacity with accuracy in the current environment.

It is also very hard to forecast company results in the current environment, and financial policy and governance come to the fore in our credit analysis as a result. We view Qantas' adherence to its financial framework as highly supportive of its rating because it ensures that its capital structure remains robust and its liquidity strong.

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Avangrid's New York utility rate settlement is credit negative despite strong customer relations

On 22 June, [Avangrid, Inc.](#) (Baa1 negative) utility subsidiaries, [New York State Electric and Gas Corporation](#) (NYSEG, A3 stable) and [Rochester Gas & Electric Corporation](#) (RG&E, A3 stable), filed a proposed rate case settlement with the New York Public Service Commission (NYPSC). The 3-year settlement included support from more than 20 stakeholders and could bring approximately \$440 million in rate increases. NYSEG and RG&E are also committing to a zero-net increase in natural gas volumes through the end of the rate plan, in April 2023.

The joint proposal shows that the utilities are maintaining cooperative and constructive customer relationships amid COVID-19 economic challenges; however, the plan could also reduce the utilities' key financial ratios below historical averages and highlights challenges to the long-term growth of its natural gas business.

The 20 stakeholders include customer intervenor groups, which is positive because it illustrates a constructive stakeholder process. The shape of the rate increases help customers over the near term mitigate economic shocks from the coronavirus. More sizable rate increases are scheduled for the second and third years of the plan.

Some of the more important cost deferral features include new rates effective in October 2020, but with \$30 million in customer credits applied by year-end; cuts to operations and maintenance budgets, and capital spending delays, such as the Grid Model Enhancement Project (approximately \$9 million) and a one-year delay to the deployment of advanced metering infrastructure.

Despite these positive features, the utilities' financial profiles look weaker. Absent mitigation efforts, we estimate that both RG&E and NYSEG generated ratios of cash flow from operations before changes in working capital (CFO pre-WC) to debt are going to fall toward the mid-teens percent range (see exhibit).

Illustrative: NYSEG and RG&E financial profiles could result in cash flow to debt ratios below 20% (\$MM)

	NYSEG			RG&E		
	Year 1	Year 2	Year 3	Year 1	Year 2	Year 3
	Apr. 2021	Apr. 2022	Apr. 2023	Apr. 2021	Apr. 2022	Apr. 2023
Net Inc. + D&A	\$332	\$362	\$402	\$190	\$217	\$240
Deferred tax	\$24	\$26	\$29	\$16	\$18	\$20
Funds from operations (FFO)	\$356	\$388	\$431	\$206	\$235	\$260
Beginning-year adj. debt	\$1,951	\$2,107	\$2,278	\$1,212	\$1,287	\$1,363
Capex	\$636	\$696	\$655	\$356	\$386	\$327
Dividends	\$0	\$0	\$0	\$0	\$0	\$0
Free cash flow (FCF)	-\$281	-\$308	-\$224	-\$151	-\$152	-\$67
Year-end adj. debt	\$2,107	\$2,278	\$2,410	\$1,287	\$1,363	\$1,397
FFO/debt (Moody's)	16.9%	17.0%	17.9%	16.0%	17.2%	18.6%

Key Assumptions: FFO is used as a proxy for CFO pre-WC to debt; Deferred tax is 50% of the rate plan's tax expense, Beginning-year adjusted debt is as of 31 March 2020; FCF deficits are financed 50/50 debt/equity.

Sources: NYSEG and RGE settlement filing and Moody's Investors Service assumptions

Our illustrative analysis does not consider any current stress related to the COVID-19 pandemic (or future recoveries of associated costs). For now, we see the business models of regulated utilities as well positioned to absorb near-term shocks over the next 24-36 months. As a simplifying assumption, we exclude other potential adjustments, which can be positive or negative. Examples include

changes related to large line items that have affected the utilities' cash flow historically, such as tax, pension and storms. It is also based on the rate plan year (i.e., new rates beginning each April) and not calendar year GAAP reporting.

Longer-term, we expect challenges for NSYEG's and RG&E's gas business. The settlement includes plans to limit increases in volume sales. According to the filing, this means that weather-normalized levels of billed gas use for NYSEG and RG&E do not exceed gas use projected for the April 2020 – April 2021 time frame, or 56 million dekatherms for NYSEG and nearly 59 million dekatherms for RG&E.

The proposal puts forth several limitations on gas infrastructure investment, which are focused, instead, on developing non-pipeline alternatives and enhancing electrification strategies. We see the agreement is a first step to help achieve the state's objectives to limit carbon emissions and natural gas use. As such, we expect that more material reductions will follow in years after the rate plan, which increases the risk for the rate base if mitigating measures are not put in place, such as adjustments to gas asset depreciation rates.

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Ofgem decision on National Grid's coronavirus-related balancing charges is credit positive

Originally [published](#) on 25 June 2020

On 23 June, Ofgem, the energy regulator for Great Britain, published its decision¹ to allow [National Grid Electricity System Operator Ltd.](#) (NG ESO, Baa1 stable) to continue recovering the majority of electricity system balancing costs in the usual way, a credit positive.

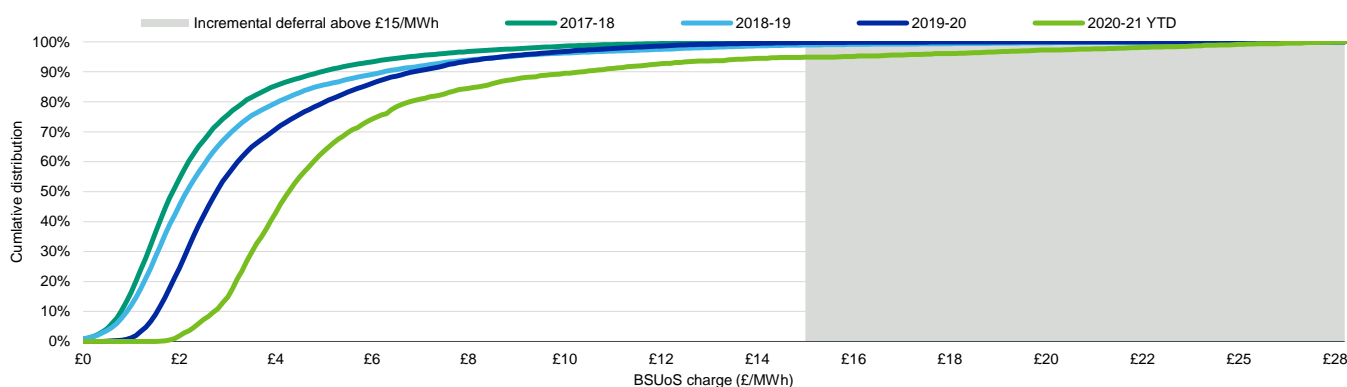
The decision rejects a supplier lead proposal² that would have delayed recovery of up to £500 million of additional coronavirus related balancing costs to future years. If the regulator had accepted the proposal, then NG ESO would have faced much higher working capital requirements.

With Ofgem's decision, NG ESO will be able to continue to promptly recover balancing costs for all half-hourly periods where the charge is below £15/megawatt hour (MWh). However, until 31 August, NG ESO will be required to defer incremental charges in excess of £15/MWh, to be collected over the next charging year (charging year 2021-22), which ends 31 March 2022. Charges are typically below the new £15 threshold (Exhibit 1).

Exhibit 1

We expect the incremental deferral to apply to the minority of charging periods

Distribution of half-hourly periods by balancing charges over recent years



Distribution of half-hourly charging periods for charging years ending 31 March. 2020-21 year to date (YTD) represents final settlement runs until 31 May 2020.

Sources: ESO data portal and Moody's Investors Service

Additionally, Ofgem stated it would intervene further if the incremental deferral exceeded £100 million, placing an upper limit on NG ESO's volume exposure through balancing costs over the low electricity demand summer period. Together with Ofgem's announcement that the RIIO-2 price control (1 April 2021 - 31 March 2026) will contain a formal bad debt recovery mechanism for balancing costs, limiting exposure to supplier or generator failure, we view the regulator's actions as credit supportive to NG ESO, with limited liquidity risk.

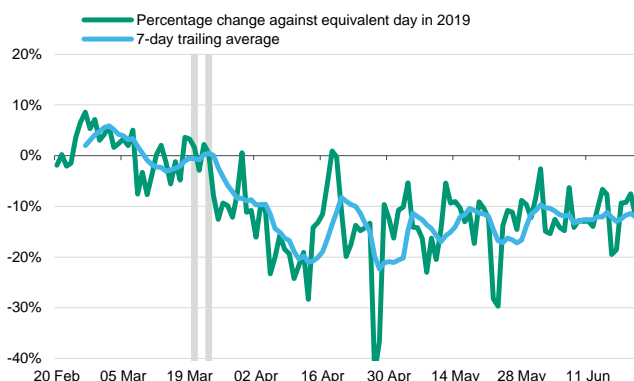
Amid coronavirus-related measures including mothballing factories and other large-scale energy users, combined with unseasonably warm weather, significantly reduced electricity demand from usual levels at this time of year. In April 2020, electricity demand was 20% lower than April 2019, and remains approximately 10% below comparative levels in June (Exhibit 2).

The combination of reduced demand pushing gas plants out of the merit order and high solar output has resulted in a higher-than-expected proportion of system non-synchronous renewable output, which has necessitated the procurement of additional auxiliary services to control frequency and inertia. NG ESO has also taken actions to reduce supply, launching new services to curtail output from embedded generators and contracting [Electricite de France's](#) (EDF, A3 negative) Sizewell B nuclear power station to restrict output for the remainder of the summer.

NG ESO's [latest forecasts](#) on 12 June suggests that balancing costs will be £250-£400 million higher over summer 2020 than summer 2019 (Exhibit 3). The additional costs of balancing services spread over a lower demand base has increased the balancing services use of system (BSUoS) charges to £5-£7/MWh, from an average of £2-£3/MWh over recent years.

Exhibit 2

Electricity demand remains suppressed due to lockdown measures Demand in Great Britain (excluding Northern Ireland)

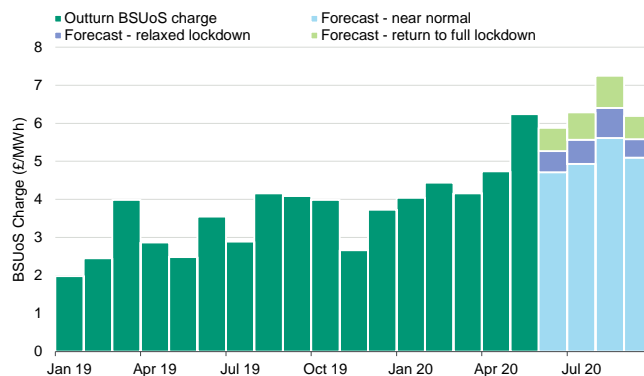


Comparisons on certain days are distorted due to the different timing of the Easter and various bank holidays. Grey bars denote the various stages of lockdown.

Sources: ENTSO-E and Moody's Investors Service

Exhibit 3

Balancing charges are expected to peak in August Monthly volume weighted average BSUoS charge



Forecasts are NG ESO and do not represent Moody's view. A 'near normal' forecast represents a 5% demand suppression over summer 2020, while 'relaxed lockdown' and 'return to full lockdown' represent a 10% and a 15% suppression respectively.

Sources: NG ESO and Moody's Investors Service

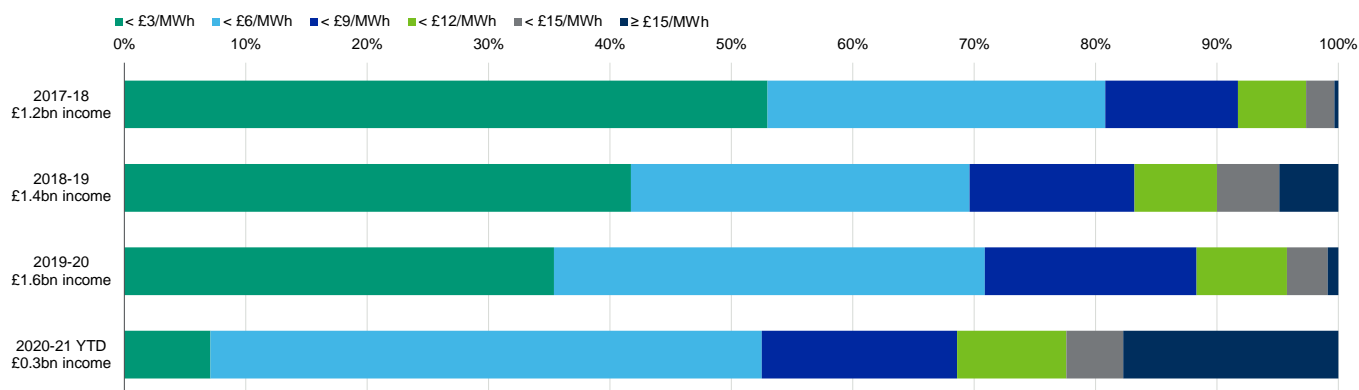
We believe that the majority of the additional BSUoS costs will be charged to users under the existing framework and with essentially no volume exposure for NG ESO.

Between 25 June and 31 August 2020, half-hourly BSUoS charges will be effectively capped at £15/MWh. Incremental costs above that level will be carried by NG ESO during financial year 2020-21 and will be collected during 2021-22, spread evenly over all half-hourly periods.

In the 2020-21 charging year to 31 May, 5.1% of half-hourly periods have had BSUoS charges in excess of £15/MWh (Exhibit 4). These periods represent £58 million or 17.7% of income collected by NG ESO for balancing services. If the deferral mechanism had applied from the start of the charging year, NG ESO would have had to defer £16.6 million. We expect this proportion to increase during summer 2020 given NG ESO's forecast of increasing average BSUoS charges. We note that Ofgem does not expect the deferral to exceed 5% of total BSUoS charges while the mechanism is active.

Exhibit 4

The coronavirus outbreak has increased the proportion of revenue from periods of high BSUoS charges NG ESO balancing income proportioned by half-hourly BSUoS charge bands



For charging years ending 31 March. 2020-21 YTD covers two months to 31 May 2020.

Sources: ESO data portal and Moody's Investors Service

Given Ofgem's statement of further intervention if the deferral exceeds £100 million, we believe the liquidity risk to be manageable within NG ESO's existing liquidity facilities, part of which we expect will be utilised to fund under recovery of electricity transmission charges in 2020-21. NG ESO has a £550 million committed revolving credit facility (RCF) not maturing before March 2022 and containing no financial covenants. The facility is held within the National Grid group, but is only available to NG ESO.

Endnotes

¹ Ofgem, [Connection and Use of System Code \(CUSC\) CMP345: Defer the additional COVID-19 BSUoS Costs](#), 23 June 2020.

² Suppliers, in this case SSE Generation (part of [SSE plc](#), Baa1 stable), can propose modifications to the relevant charging code. A working group is then formed to analyse the proposal and its alternatives, which makes a recommendation to the regulator. Ofgem makes the ultimate decision whether to approve or reject the modification.

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Brazilian regulators halt Facebook's payments service, a blow for participating institutions

Originally [published](#) on 25 June 2020

On 23 June, Banco Central do Brasil, the central bank, and Brazilian competition authority CADE suspended Facebook Inc.'s payment system on its cross-platform messaging and voice over IP service WhatsApp, eight days after the payment system launched. The suspension is negative for the participants in payment system, including [Banco do Brasil S.A.](#) (BB, Ba3/(P)Ba2 stable, ba2¹), [Banco Cooperativo Sicredi S.A.](#) (Sicredi, Ba2 stable, ba2), [Cielo S.A.](#) (Ba1 stable), [Visa Inc.](#) (Aa3 stable) and Nubank, because the payment platform would have increased the volume of transactions and fee income. The suspension highlights challenges of technology firms branching out into financial services overseen by various regulators and of regulators to keep up with a quickly changing industry.

The WhatsApp-based payments system allows users to send and receive money peer to peer and to make purchases from companies with corporate versions of the messaging application. In Brazil, cash transfers were to be capped at BRL1,000 (\$196) and limited to 20 transactions per user per day with a monthly limit of BRL5,000 per user. To use the service, users had to have a Visa- or Mastercard-branded debit or credit card issued by BB, Sicredi or Nubank, and the card issuers were expecting to increase the number of their card holders from whom they earn annual fees and to earn interchange fees with each purchase from a company.

WhatsApp is currently used by almost 120 million Brazilians – a number larger than the total number of clients of all banks in Brazil. BB, Sicredi and Nubank expected the partnership to contribute to growing the number of cardholders from whom they would earn annual card-holding fees.

For Cielo, the inability to start processing transactions in the system reduces its first-mover advantage. As initially proposed, we believe Cielo would add clients including small and midsize enterprises, micro-merchants and entrepreneurs with the roll-out of the system, but that benefit would wane as other companies join the agreement and other payment systems emerge. Now, the beneficial impacts will depend on the ruling by the central bank and CADE, the timing of such ruling, and any possible adjustments to the proposed payment system.

According to the central bank, the suspension of Facebook's payment system operations will give the regulator time to evaluate possible risks to competition, efficiency and data privacy in the Brazilian payments system. CADE, meanwhile, determined that the agreement could give Cielo, which is already Brazil's largest card acquirer with a 36% share of total payment volume as of first-quarter 2020, even greater market power to the detriment of competitors. WhatsApp has stated that it continues to work with the central bank to offer digital payments for its users in an open manner in conjunction with local partners and the central bank.

In addition, the Brazilian central bank is in the final stage of launching its own instant payments system, PIX, which includes both peer-to-peer and business-to-business payments. The system will be live in November and will provide a new channel for payments without the use of debit or credit cards — a significant change in how payments are traditionally made in Brazil. As of June 2020, almost 1,000 financial institutions are preparing to be part of the new PIX system, including large banks, acquirers and fintechs. Once PIX is launched, a shift toward instant payments instead of debit card payments and cash transfers will pressure card payments volumes and reduce banks' cash transfer income.

For Brazil's other large banks that were not initially involved in the WhatsApp payments system, the suspension staves off a competitive threat to cash transfer and payment processing revenues. Facebook's system had the potential to eliminate the use of point-of-sale equipment to process merchant payments and reduce banks' fee income from acquirer services if clients switched to the new payment system. For BB, they will no longer see a shift toward instant payments via WhatsApp instead of cash transfers on which they make fee income. Revenue from card issuances and acquiring services has been challenged over the past two or three years amid competition, but on average still accounted for 26%-31% of total fee income in the first quarter of 2020 for large Brazilian banks.

For fintechs PagSeguro and Stone, which have a major share of the market with small and midsize merchants, the suspension is also beneficial because Facebook's payments system targets their active client base.

Endnotes

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

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For digital bank Banco Modal, Credit Suisse's investment is credit positive

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On 23 June, [Banco Modal S.A.](#) (Modal, B1 stable, b1¹), which operates a full digital banking platform known as Modalmais, announced that [Credit Suisse AG](#) (CS, A1/A1 positive, baa2) via its Brazilian subsidiary, Banco de Investimentos Credit Suisse (Brasil) S.A., had agreed to buy up to 35% of Modal through the purchase of stock options held by its controlling shareholders. In addition, the banks will offer complementary products and services to clients as part of a strategic partnership.

The deal is credit positive for Modal because its digital bank platform will offer CS products including structured notes, funds, fixed income and public offerings to its client base, increasing the range of investment products available to existing customers and leveraging those relationships to boost the client experience and fee revenue. At the same time, CS will offer a digital account option to its own private banking clients in Brazil through Modalmais, a credit positive for both banks. Modal currently has roughly 1 million clients, up from 300,000 18 months ago, and BRL10 billion in assets under custody. CS' private banking operation has BRL230 billion in assets under management in Brazil. The banks' client profiles are distinct enough to make the partnership complementary to both.

The banks did not disclose the deal value or a time frame for completion, but did say that CS would not make a direct capital injection into Modal. Additionally, the transaction requires regulatory approval in Brazil.

Brazil's investment industry has been disrupted by the rise of digital competitors such as XP Inc., the country's largest online investment platform with BRL400 billion in assets under custody, Modalmais, Genial Investimentos, Guide Investimentos, [Banco BTG Pactual S.A.](#) (Ba2 stable, ba2) through its digital platform BTG Digital, and Órama. These entities over the past five years have accelerated innovation and disrupted the business model of traditional banks such as [Banco do Brasil S.A.](#) (Ba2 stable, ba2), [Itau Unibanco S.A.](#) (Ba2 stable, ba2), [Banco Bradesco S.A.](#) (Ba2 stable, ba2), [Banco Santander \(Brasil\) S.A.](#) (Ba1 stable, ba2) and [Caixa Economica Federal](#) (Ba2 stable, ba3), which combined control almost 57% of Brazil's assets under management. Social-distancing measures aimed at combatting the spread of COVID-19 have also increased the usage of financial services through digital channels.

Modalmais was created in 2015 as an online investment platform, initially offering brokerage services for equities, mutual funds and fixed-income products. In November 2018, Modal upgraded the brokerage service to a full digital banking platform, pursuing a larger integration of the brokerage platform into traditional banking services. Since then, Modal has focused on growing its brokerage and banking services to a wider customer base of retail investors, which together with the capital markets and investment banking activities, have become the key strategic priorities.

Endnotes

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

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Banorte will expand digital services with Rappi partnership

On 23 June, [Banco Mercantil del Norte, S.A.](#) (Banorte, Baa1 negative, baa2¹), Mexico's fourth-largest bank, and Colombia-based Rappi S.A.S., an on-demand delivery mobile app, announced a joint venture to offer financial services in Mexico. Banorte and Rappi will each own 50% of the new company's equity.

Banorte's new partnership with Rappi, one of Latin America's few tech startups whose valuation exceeds \$1 billion, is credit positive. Banorte's digital and technological strategy will accelerate and the bank will gain diversity in its growing digital services platform. The transaction awaits Mexican regulators' approval.

Banorte will have access to Rappi's more than 6 million customers in Mexico, most of whom are young individuals attracted to low-cost and innovative online services. The partnership will promote financial inclusion and financial intermediation, which is low in Mexico, and Banorte will gain important cross-selling potential. The bank committed to invest up to MXN4 billion (\$180 million) in the joint-venture over the next 18 months.

In November 2018, Rappi launched Tecnologías Rappi S.A.P.I. de C.V. (RappiPay México), the first in Mexico to implement virtual wallets using quick response (QR) codes. Since then, the company has advanced in the fragmented payment business sector through partnerships. Its alliances include one with [SoftBank Group Corp.](#) (Ba3 negative), which invested \$1 billion in Rappi, and a partnership with [Visa Inc.](#) (Aa3 stable) and Accendo Banco, S.A., a small commercial bank in Mexico, to launch a new debit card. Since 2019, following SoftBank investment, Rappi has become Latin America's third-largest financial technology firm (fintech) by market capitalization, behind Argentinean e-commerce Mercado Libre S.R.L and Brazilian payment solution fintech Nu Pagamentos S.A. (Nubank).

Mexican financial institutions are offering digital solutions at a faster pace in recent years, but at the end of 2019, just 30% of customers had completed digital transactions. Mexico's banks have sizable network of traditional branches, but social-distancing measures amid the coronavirus has fast-tracked banks' digitization plans. These efforts will likely help banks reduce operating costs amid Mexico's sharp economic deterioration since 2019, which the pandemic has worsened.

Banking app usage in Mexico increased 35% over the 12-month period that ended in April 2020, with more than 25 million downloads of banking services apps in the first six months of this year. Focused on the growing customer demand for online services and the growing competition of low-cost fintechs, Mexican banks in 2019 introduced mobile payment technology CoDi, whose mobile payment transactions grew 140% in the first six months of 2020.

Endnotes

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

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All large US banks pass Fed's stress test, but must submit new capital plans to reflect coronavirus

On 25 June, the US Federal Reserve (Fed) published the results of the 2020 Dodd-Frank Act Stress Test (DFAST) for 33 of the largest US banking groups.¹ The Fed's accompanying actions following the stress test and a coronavirus sensitivity analysis of these banks are inconclusive but leave room for credit-positive actions later in the year.

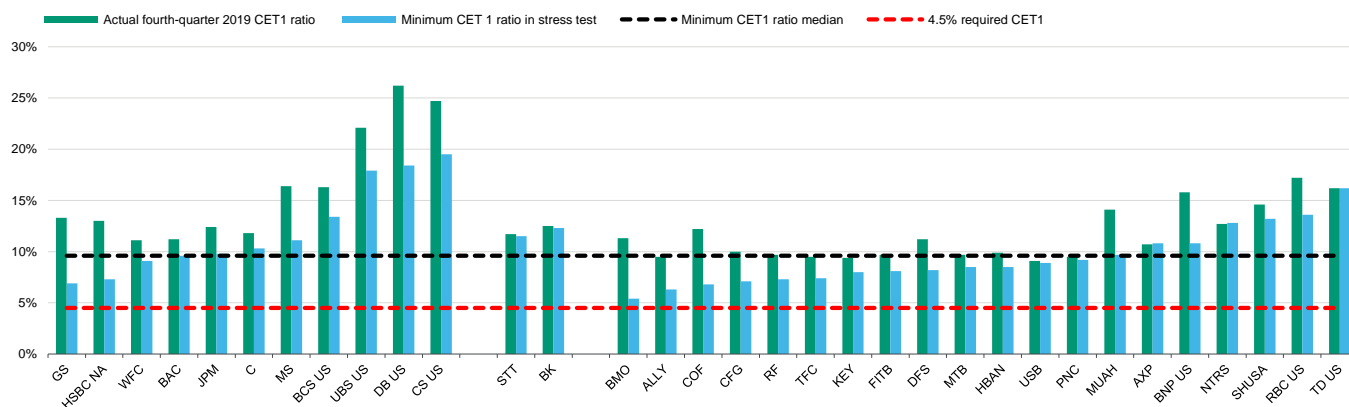
All 33 of the banking groups in the 2020 stress test exceeded the required minimum capital and leverage ratios under the Fed's severely adverse stress scenario, which is credit positive. However, several of the underlying assumptions were relaxed in 2020, which makes this year's results less comparable with DFAST results from previous years, and the Fed did not publish results for the Comprehensive Capital Analysis and Review (CCAR). Furthermore, because the stress scenarios were formulated before the economic effects of the coronavirus began to crystallize in March, the Fed also applied a sensitivity analysis under three distinct economic scenarios – a V-shaped recovery, a U-shaped recovery and a W-shaped double dip recession. The results of this analysis were only disclosed in aggregate, but revealed that the U and W scenarios would significantly weaken many banks' capital ratios, with banks in the worst-performing quartile approaching the minimum requirements, even assuming they had stopped paying common dividends and repurchasing shares at the start of 2020.

In response to its coronavirus sensitivity analysis, the Fed is requiring all 33 banks to suspend third-quarter share repurchases, has capped their dividends, and is also requiring the banks to resubmit their capital plans to reflect coronavirus-related uncertainty, which we view as credit positive. The revised capital plans will inform the Fed's further assessment of the banks' financial health and risks later in the year.

The exhibit segments the firms into three groups: 11 firms subject to both the global market shock and counterparty default components on the left; two firms subject to the counterparty default component but not the global market shock in the middle; and remaining firms not subject to either of these additional scenarios on the right. The minimum stressed Common Equity Tier 1 (CET1) ratios for all are well above the minimum CET1 requirement of 4.5% (see exhibit). The median minimum CET1 ratio of 9.6% for the group is below the 9.9% aggregate, reflecting a higher minimum for the larger firms in the group. Even though the larger firms are also subject to the additional global market shock and counterparty default, they start from a higher position. [BMO Financial Corporation](#) (Baa1 stable) had the lowest minimum CET1 ratio at 5.4% and Credit Suisse Holdings (USA), Inc. had the highest at 19.5%.

All participating banks in DFAST are well above the required minimum 4.5% CET1 under stress

US banks' CET1 ratios under the Federal Reserve's severely adverse scenario and actual ratios as of 31 December 2019



The 33 firms that participated in the 2020 DFAST are: ALLY = Ally Financial Inc.; AXP = American Express Company; BAC = Bank of America Corp.; BK = Bank of New York Mellon Corp.; BCS US = Barclays US LLC; BMO = BMO Financial Corp.; BNP US = BNP US Paribas USA, Inc.; COF = Capital One Financial Corp.; C = Citigroup; CFG = Citizens Financial Group, Inc.; CS US = Credit Suisse Holdings (USA), Inc.; DB US = DB USA Corp.; DFS = Discover Financial Services; FITB = Fifth Third Bancorp; GS = Goldman Sachs Group, Inc.; HSBC NA = HSBC North America Holdings Inc.; HBAN = Huntington Bancshares Incorporated; JPM = JPMorgan Chase & Co.; KEY = KeyCorp; MTB = M&T Bank Corp.; MS = Morgan Stanley; MUAH = MUFG Americas

Holdings Corp.; NTRS = Northern Trust Corp.; PNC = PNC Financial Services Group, Inc.; RBC US = RBC US Group Holdings LLC; RF = Regions Financial Corp.; SHUSA = Santander Holdings USA, Inc.; STT = State Street Corp.; TD US = TD Group US Holdings LLC; TFC = Trust Financial Corp. (2018 is legacy BB&T Corp.); UBS US = UBS Americas Holding LLC; USB = U.S. Bancorp; WFC = Wells Fargo & Company

Sources: US Federal Reserve and Moody's Investors Service

For most firms participating in the test, the minimum required Tier 1 leverage ratio and supplementary leverage ratio (SLR) were more constraining than the minimum required CET1, consistent with previous years. In addition, the participating banks' pre-provision net revenue (PPNR), the first buffer against stress losses, is about the same percentage of risk-weighted assets (RWA) as in last year's stress test. The median PPNR/RWA was 3.7% under the severely adverse scenario in 2020 versus 3.8% in 2019, but quite a bit lower than the 4.7% median in 2018, when the scenario had a much steeper yield curve that considerably boosted PPNR.

Stressed losses under DFAST for non-complex firms are primarily from loan loss provisions, reflecting the skew of their business mix toward bank lending. Trading and counterparty losses and other losses/gains are most prevalent among the US-based global investment banks, the foreign-owned firms, and the trust and custodian banks (excluding Northern Trust), which have substantial capital markets operations or counterparty risk from other activities. The differences in losses across firms reflect the specific risk characteristics of each firm's trading positions, inclusive of hedges.

[Click here](#) for the full report.

Endnotes

¹ The 2020 CCAR and DFAST included 33 participants compared with 18 in 2019. The 2020 test includes those less-complex firms (generally those with total assets between \$100 billion and \$250 billion) that are now on a two-year supervisory stress test cycle.

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Brazil adds new measures to stimulate bank loans to small and midsize enterprises

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On 23 June, Brazil's central bank announced a new round of measures to encourage increased bank lending, particularly to small and midsize enterprises (SMEs) – defined as those with annual sales of up to BRL50 million. The new measures will mitigate nonperforming loan formation by allowing banks to extend longer-term loans to support borrowers most affected by coronavirus pandemic. SMEs are a key component in Brazil's economy, but the new measures will likely prolong banks' asset-quality weakness if systemwide leverage rises and the economic recovery slows and increases downside risks.

The new measures temporarily reduce the capital requirement on deferred tax assets (DTAs) related to contingent liability provisions on the condition that banks originate loans to SMEs. As of December 2019, in total, banks had BRL105 billion of capital allocated for a BRL127 billion stock of DTAs, an amount that could be replaced by loans to SMEs.

The central bank also lowered to 35% from 50% the risk-weighting factors for capital allocated to deposits guaranteed under the Deposito com Garantia Especial (DPGE) program. Small and midsize banks issue these DPGEs to support their liquidity and funding, which are exposed to institutional investor confidence in volatile markets. Additionally, banks will be able to deduct new loans to SMEs and their DPGEs from the required reserves on savings deposits.

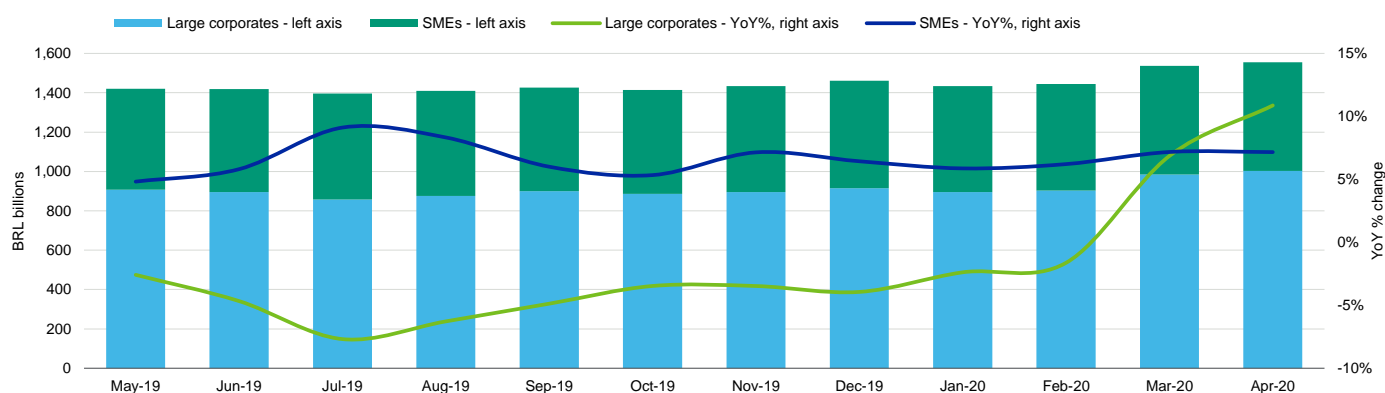
These measures are mainly directed to the largest commercial banks in the system, which hold the most DTAs and liquidity to invest in DPGEs. They include the private-sector banks [Itau Unibanco S.A.](#) (Ba2/(P)Ba2 stable, ba2¹), [Banco Bradesco S.A.](#) (Ba2/(P)Ba2 stable, ba2), [Banco Santander \(Brasil\) S.A.](#) (Ba1/(P)Ba1 stable, ba2), and [Banco do Brasil S.A.](#) (Ba2/(P)Ba2 stable, ba2) and state-owned savings banks [Caixa Econômica Federal](#) (Ba2 stable, ba3). These five banks combined have a roughly 95% market share of savings deposits. With lower capital consumption, these banks would be able to invest in DPGE deposits from small and midsize banks.

With temporarily lower capital requirements for DTAs and DPGEs, banks' capital can be redirected to higher-yielding SME lending activities. We expect increased SME lending to alleviate pressure on banks' profitability amid low interest rates and moderate business volume. As of April 2020, loans to SMEs comprised 15.4% of the systemwide loan book, while large corporates accounted for 27.9% and loans to households made up the remainder (see Exhibit 1). Between year-end 2019 and April 2020, banks' total loans increased 3.1%, fueled by nearly 10% corporate loan growth, while loans to SMEs increased just 1.5% during the same period.

Exhibit 1

Strong demand from large corporations overshadowed lending to SMEs, and increased risk aversion amid the sudden sharp economic deterioration

Loan-book breakdown and year-on-year change of loans to large corporates and SMEs

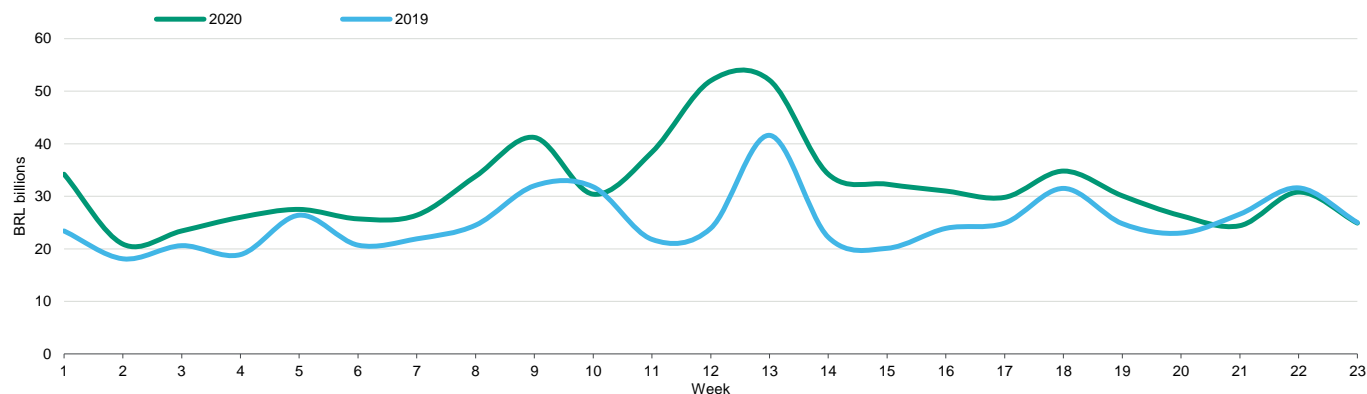


Sources: Central Bank of Brazil and Moody's Investors Service

As Exhibit 2 shows, loan originations slowed in May as banks focused on protecting capital and liquidity positions and supporting existing clients with good credit behavior.

Exhibit 2

Loan originations have moderated since May, after corporates' liquidity run in March at the onset of the pandemic
New loan origination to corporates per week in 2019 and 2020, from January through 19 June



Wholesale loans include loans to large corporates and to small and medium size companies combined.

Sources: Central Bank of Brazil and Moody's Investors Service

The regulator also announced that households are now allowed to use a single residential real estate asset as collateral for one or two new loans or to guarantee an outstanding loan. This measure aims to reduce lending rates to individuals while improving the credit risk profile. The central bank also set the guidelines for securities it will acquire in the secondary markets, a measure enacted on 7 May. The securities' eligibility criteria excludes subordinated and non-convertible securities, bonds rated below Ba3, and maturities shorter than 12 months.

Only loans originated between 29 June and 31 December 2020 with a minimum tenor of three years and a six-month grace period qualify under these new programs. Some measures will benefit smaller banks' liquidity and balance sheet capacity. According to the regulator, the new package has a potential to increase lending to the SME segment by BRL212 billion (\$40 billion).

Exhibit 3 details all the measures aimed at stimulating SME lending.

Exhibit 3

New measures to stimulate SME lending and support small banks' liquidity position

Measures announced on 23 June 2020	Objective	Amount and scope	Largest beneficiaries
Lower capital requirements for small financial institutions, mainly cooperatives and finance companies	Release capital to support credit	Potential credit expansion of BRL16.5 billion	S5 group according to central bank's classification by size
Cut reserve requirement on savings deposits when providing working capital to firms with annual revenue below BRL50 million and holding small banks' time deposits (DPGE)	Support credit	BRL55.8 billion	Small companies and banks from groups S3, S4 and S5
Lower risk weight on DPGE holdings to 35% from 50%, which has potential to free up BRL1 billion of capital	Support liquidity of small financial institutions	Potential investment in DPGE of BRL12.7 billion	Small financial institutions
Lower deferred tax assets deduction from capital through working capital finance to SMEs	Support credit	Potential credit expansion of BRL127 billion	All banks
Residential property as collateral for more than one loan	Support credit	Potential credit expansion of BRL60 billion	Households
A framework and eligibility criteria of private securities accepted under central bank's liquidity facility	Support local capital market liquidity	Not disclosed	Banks and companies with access to local capital markets

Banks in Brazil are designated among five segments for regulatory purposes, depending on their size and international activity. Segment 1 comprises the largest banks while Segment 5 includes the smallest.

Sources: Central Bank of Brazil and Moody's Investors Service

Endnotes

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

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Brazil's central bank reinforces small and midsize banks' liquidity and capital

Originally [published](#) on 26 June 2020

On 23 June, Brazil's central bank announced a new round of measures to support small and midsize financial institutions' capital and liquidity. The measures include a temporary reduction in the minimum capital requirement of small financial institutions, largely credit cooperatives and credit financial technology firms (fintechs). The regulator also reduced the capital charge on banks' exposure to special-guarantee certificates of deposit (*depósitos com garantia especial*, or DPGEs¹) with the aim of encouraging large banks to buy these instruments from midsize lenders.

The measures will increase midsize banks' funding capacity through DPGEs and provide capital relief to smaller financial institutions, which are largely focused on lending to small companies. The moves are the latest in a series of actions by Brazil's regulatory authority to stimulate credit markets and support economic activity by alleviating pressure on businesses and individuals affected by the pandemic.

Small banks, credit cooperatives and other small credit institutions, such as fintechs are an important source of financing to small and midsize enterprises (SMEs), which have been among the hardest hit companies during the coronavirus pandemic. By lowering the minimum capital requirement, the central bank will enable the country's smallest banks, those categorized as Segment 5,² to free up BRL1.3 billion (\$245 million) that will allow them to increase lending by up to BRL16.5 billion. At the end of 2019, these banks accounted for 2.25% of the system's total loans.

Since the beginning of the crisis, the central bank has taken measures to support banks' liquidity in light of the sudden market volatility that could affect their institutional-based funding structure. The measures have included the creation of Letra Financeira Garantida (LFG), a temporary liquidity facility with the central bank; banknotes backed by loans; and the DPGEs. Although these measures were not exclusively created for the benefit of midsize banks, they have helped to reinforce these banks' cash positions and to maintain their lending capacity, whereas large banks can rely on steady and low-cost core deposits.

Until 5 June, all banks in the system had issued BRL26 billion in LFGs and about BRL5 billion in DPGEs. The exhibit shows banks' outstanding LFG and DPGE amounts grouped according to the Brazilian central bank's classification by size. Segment 3, 4 and 5 banks are the main beneficiaries of these instruments, but they are much smaller in size than banks in Segment 1 and 2.

Segment 3 and 4 banks that account for 13.3% of total loans have been the main beneficiaries of DPGEs and LFGs

	% Market share		DPGE		LFG	
	Loans	Funding	Year-to-date June 10		Year-to-date June 5	
Groups			in BRL million		in BRL million	
S1			253	5%	8,970	35%
S2			-	-	1,392	5%
S3	8.0%	8.0%	1,964	39%	12,627	49%
S4	5.3%	3.9%	2,735	54%	2,979	11%
S5	2.3%	1.5%	118	2%	-	-
Total			5,070	100%	25,968	100%

Sources: Central Bank of Brazil and Moody's Investors Service

By lowering the capital allocation on DPGEs, the central bank is encouraging primarily large banks to acquire these instruments, potentially injecting about BRL12.7 billion of liquidity into small and midsize banks, according to the regulator. About 49% of DPGEs issued to date have been acquired by investment funds, private banking and institutional customers. Banks have acquired only 13% of the outstanding amount.

Endnotes

- [1](#) Brazil's National Monetary Council introduced DPGEs in April 2009 as an extraordinary funding mechanism to supply small and midsize banks with longer-term liquidity following the global financial crisis. They were relaunched in March 2020 in response to the coronavirus pandemic.
- [2](#) Banks in Brazil are allocated to one of five segments for regulatory purposes, depending on their size and international activity. Segment 1 comprises the largest banks while Segment 5 includes the smallest.

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Plan to end Slovak bank levy is credit positive

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On 22 June, Slovakia's new government concluded a memorandum of understanding with the Slovak Banking Association (SBA) that would end the levy on domestic bank deposits beginning in 2021. In return, the banks would finance €1.5 billion of public and private loans each year. Pending parliamentary approval, which we expect in July, this year's bank tax will decline to 0.2% of eligible liabilities excluding equity from 0.4%, and apply retroactively for the full year. The levy will be fully eliminated in 2021.

Cutting this year's levy by half and eliminating it in 2021 is credit positive for Slovak banks and will markedly improve their capacity to internally generate capital and profit, which will strengthen their ability to withstand coronavirus-related economic and systemic stress.

At 0.2% for full-year 2020, banks must pay €150 million, and they already paid that in the first and second quarters when the levy was 0.4%. Therefore, we expect 2020 systemwide pre-tax profits to be as much as 20% higher than banks previously budgeted.

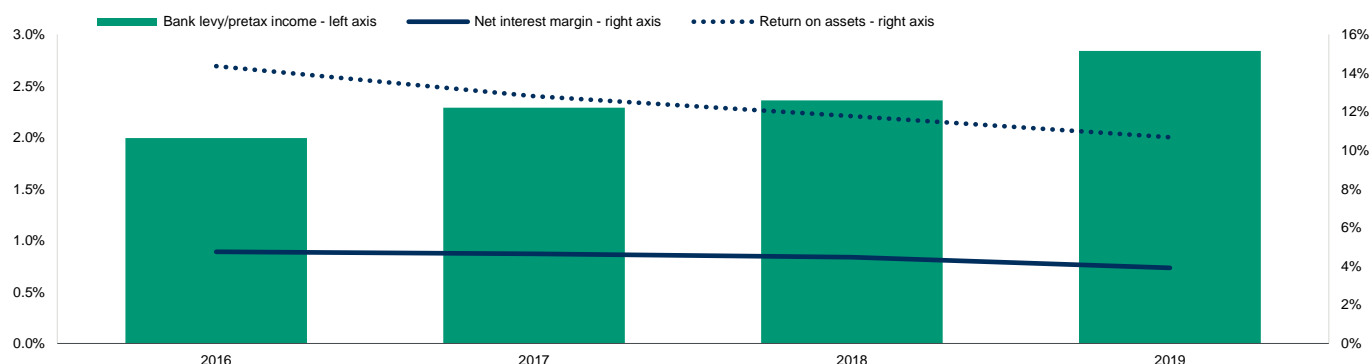
Small and midsize banks, which are less profitable than larger peers, will benefit most because the levy was approximately 25% of year-end 2019 profit. Larger banks with higher earnings capacity will also benefit meaningfully. At the current 0.4% levy rate, [Slovenska sporitelna, a.s.](#) (SLSP, A2 stable, baa2¹), the country's largest bank by assets, reported its bank levy absorbed 40% of its unconsolidated pretax profit in the first quarter of 2020, up from 14% at year-end 2019. SLSP estimated this year's second-half cost savings at around €35 million, or 15% of 2019 pretax profit.

[Tatra banka, a.s.](#) (A3 stable, baa3), the third-largest bank, paid €17 million in the first quarter, consuming 35% of its quarterly pretax profit, up from 12% at year-end 2019.

For 2021, we estimate that SLSP, [Vseobecna uverova banka, a.s.](#) (VUB, A2 negative, baa2), Tatra banka and [Ceskoslovenska obchodna banka, a.s.](#) (CSOB-SK, Baa1 positive, ba1), the country's largest banks, will each benefit from the abolished bank levy by up to an equivalent of 24%-32% of 2019 pretax profit.

We expect that without the levy, Slovak banks' regional profitability and internal capital generation capacity will improve relative to Central and Eastern Europe (CEE) peers,² whose regulatory cost burden remains high amid the deteriorating operating environment. Slovak banks are among the weakest in terms of profitability compared to CEE peers (see exhibit).

Slovak banks' profitability weakened in recent years as margins declined amid prolonged negative euro area interest rates, growing competition and the bank levy burden



Median of Moody's-rated Slovak banks is reflected for bank levy/pretax income; average is reflected for return on assets and net interest margin
Source: Moody's Investors Service

The government and SBA also agreed to dividend-payment restrictions that require banks to retain profits equal to 0.2% of liabilities, excluding equity, for 2019-22, a credit positive. We estimate that the retained earnings will build about €150 million of additional core capital per year, improving banks' loss-absorbing capacity and ability to finance loans and support the economy.

The government introduced the bank levy in 2012, and initially planned to keep it in effect until the end of 2020. However, Slovakia's previous government at the end of 2019 [extended the levy and doubled the rate](#). The previous government's 2019 decision was strongly criticized by the National Bank of Slovakia, the banking regulator, and the European Central Bank, which [cited risks to financial stability](#) because of the levy's disproportionate and procyclical effect on system profitability.

Endnotes

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

² Except Czech banks in the absence of bank levy legislation.

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Russia's lower risk weights for mortgages aim to support loan origination

On 22 June, the Central Bank of Russia (CBR) proposed differentiating and reducing risk weights for mortgage loans. The measure is credit positive for Russian banks because it will ease the burden on their capital and encourage mortgage loan origination, which carries a lower risk than other loans, in the currently difficult operating environment.

The beneficiaries of the proposal are banks with the largest exposure to mortgage sector (Exhibit 1). Among banks we rate, [Absolut Bank](#) (B2 stable, caa1¹) has the largest share of mortgage loans in its total assets and will benefit the most from the proposed reduction in risk weights.

Exhibit 1

Banks with the largest exposure to the mortgage lending segment Data as of the end of 2019

	RUB millions	RUB millions	Mortgage loans as % of total assets	as of 1 April 2020
PJSC ROSBANK	1,199,992	515,091	43%	13.3%
Absolut Bank (PAO)	221,322	79,053	36%	5.1%
Center-Invest Bank	119,521	36,458	31%	11.3%
Transkapitalbank	275,437	53,895	20%	7.7%
Bank Uralsib	444,979	73,593	17%	9.2%
Sberbank	29,851,500	4,291,200	14%	13.1%
Metallinvestbank JSCB	97,853	13,408	14%	13.0%
Commercial Bank AK BARS, PJSC	551,819	72,015	13%	13.9%
AO RAIFFEISENBANK	1,273,587	140,346	11%	14.6%
CB Kuban Credit Ltd	109,962	11,563	11%	13.0%
Bank ZENIT PJSC	234,220	23,598	10%	15.2%
Bank Saint-Petersburg PJSC	673,651	67,015	10%	13.6%
Bank VTB, PJSC	15,516,100	1,456,800	9%	12.0%

Note: Total capital adequacy ratio is consolidated regulatory capital ratio of the banking group (N20.0) for all banks except Center-Invest Bank and CB Kuban Credit Ltd, for which it is standalone regulatory capital ratio (N1.0)

Source: Banks' 2019 IFRS reports and Central Bank of Russia

At present, only mortgages with a loan-to-value (LTV) ratio of less than 70% and issued to borrowers with a payment-to-income (PTI) ratio of less than 50% qualify for reduced risk weights of between 35% and 70%. All other loans are weighted at 100%. The CBR has proposed a more differentiated grid of risk weights based on these ratios and has reduced the range to 20%-100% (Exhibit 2). New risk weights will allow banks to unlock RUB300 billion of capital allocated to the outstanding mortgage loans, the equivalent of around 3% of the banking system's total capital. The proposed measure follows amendments eliminating buffers to risk weights set at 100-200 percentage points that took effect on 1 April.

Exhibit 2

Proposed new scale of risk weights in % for mortgage loans depending on loan-to-value and payment-to-income ratios

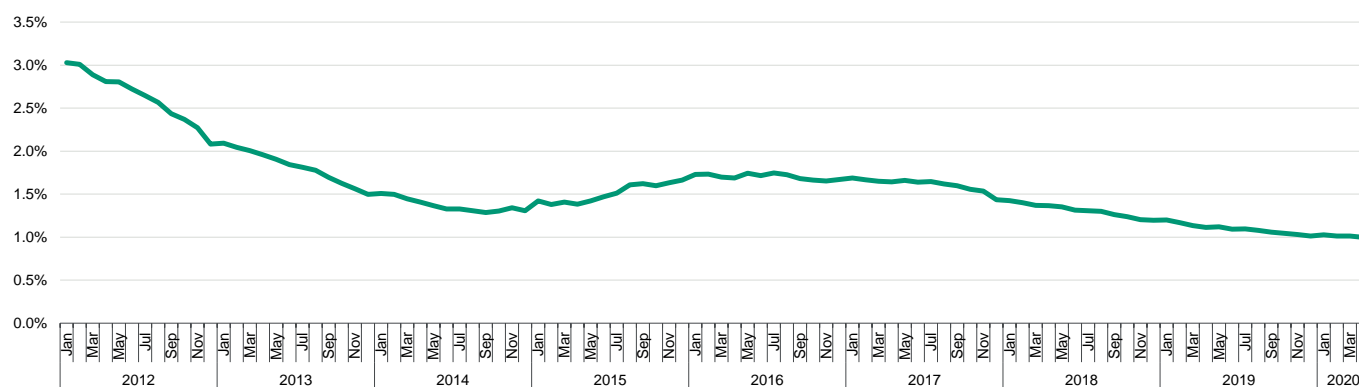
PTI \ LTV	(0;50]	(50;60]	(60;70]	(70;80]	(80;85]	(85;90]	(90;100]	100+
Not available	25	30	40	50	60	60	70	90
(0; 30]	20	30	35	45	50	50	60	80
(30; 40]	25	30	40	50	60	60	70	90
(40; 50]	25	30	40	50	60	60	70	90
(50; 60]	25	30	40	50	60	60	70	90
(60; 70]	25	30	40	50	60	60	70	90
(70; 80]	25	30	40	55	65	65	75	95
80+	25	30	40	55	65	65	75	95

Categories of mortgage loans that benefit from reduced risk weights under current regulations are marked in blue.

Source: Central Bank of Russia

Good asset quality and a low historical level of losses in Russia's mortgage lending segment (Exhibit 3) support the easing of capital requirements for mortgages without undermining banks' solvency.

Exhibit 3

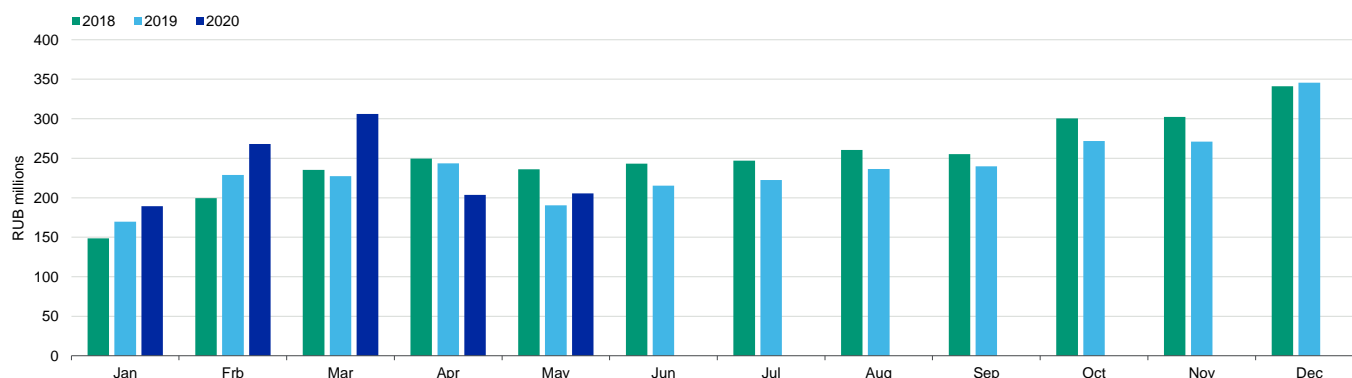
Mortgage loan asset quality has been good and steadily improving since 2016**Share of mortgage loans overdue more than 90 days**

Source: Central Bank of Russia

The proposed measure, which follows the introduction in late April of a government programme to subsidise mortgage interest rates at 6.5%, aims to further encourage mortgage loans origination and underpins government efforts to support Russia's mortgage and housing construction sectors during the coronavirus pandemic. Lower risk weights will make mortgage loans relatively more profitable and attractive for banks. Coupled with a buildup of systemic risks in other segments, particularly unsecured consumer loans and loans to small and midsize enterprises, the measure has the potential to shift asset allocation in favour of lower-risk secured mortgage loans.

Mortgage loan origination fell sharply in April after the government imposed a lockdown and quarantine regime to counter the coronavirus outbreak. It resumed in May, supported by the government programme to subsidise mortgage interest rates (see Exhibit 4).

Exhibit 4

Mortgage loan originations

Source: Central Bank of Russia

Lower interest rates have supported the demand for mortgages. The government programme of subsidised mortgage lending and a sharp reduction in the CBR's key rate pushed the average interest rate on mortgage loans to 7.4% in May 2020, down from 9.0% at the end of 2019. The CBR's lowering of its key rate by one percentage point on 19 June suggests there is room for a further decrease. At the same time, the Russian population's limited purchasing power and reduced household disposable income in the current challenging economic conditions constrain potential mortgage growth. As such, we do not expect mortgage lending growth this year to outperform 2019.

The CBR does not impose restrictions on the use of capital released from lower mortgage risk weights. As an alternative to lending growth, banks may opt to use free capital to create additional loan-loss provisions to prepare for a deep recession and deterioration in asset quality.

Endnotes

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

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South Africa's GDP and revenue contract, spiking debt and making 2023 stabilisation unlikely

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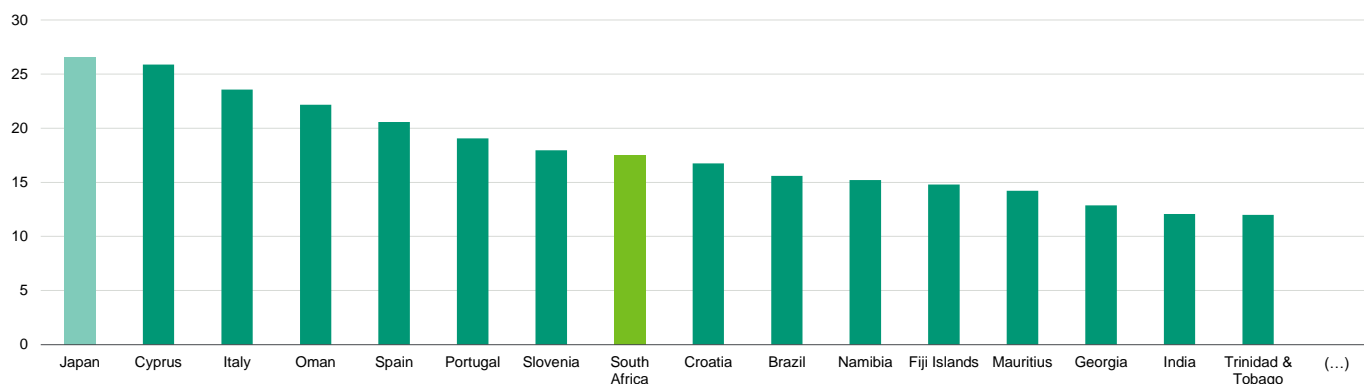
On 24 June, the [Government of South Africa](#) (Ba1 negative) released its supplementary budget review for 2020. The government now expects declining revenue will widen its headline fiscal deficit to 15.7% of GDP in fiscal 2020 (ending 31 March 2021), while spending cuts offset most of the additional coronavirus-related outlays. This deficit and the economic contraction increase the government debt burden 18 percentage points to 82% of GDP this fiscal year, according to the budget.

This is among the largest increases in South Africa's Baa/Ba-rated peers (see Exhibit 1) but in line with our previous forecasts. Moreover, stabilising debt by 2023 in line with the government's target laid out in this budget will be very difficult to achieve given the challenging growth outlook and fiscal rigidities (controlling spending, recovering taxes).

The government now forecasts a main budget deficit – which excludes some items from the 15.7% consolidated government figure like social security funds and is a better measure of debt dynamics – of 14.6% of GDP in fiscal 2020. This represents a significant upward revision from the 6.8% figure forecast in February and a sizeable deterioration from the 6.7% number recorded for fiscal 2019. We had adjusted our fiscal deficit forecast to a similar level in April when the government announced its ZAR500 billion (10% of GDP) economic support package.¹

The increase in South Africa' debt burden will be among the highest for Baa/Ba-rated sovereigns this year

Change in government debt (fiscal 2020 - fiscal 2019, pp), top 15 Baa-Ba sovereigns



Note: We also include [Japan](#) (A1 stable) as the advanced economy that will experience the largest increase in debt based on our forecasts. Sovereigns displayed may have different fiscal years. South Africa ranks seventh out of 19 sovereigns in Baa-Ba.

Sources: National authorities and, Moody's Investors Service

The budget projects gross tax revenue to fall by ZAR304 billion (6% of GDP) compared to last year, or 21% lower than estimates from the initial budget. The National Treasury now forecasts revenue in the main budget at 22.6% of GDP in fiscal 2020. The smaller tax base stemming from lockdown measures, job losses and lower confidence account for the vast majority of the revenue shortfall, while the tax-relief measures announced in April only account for ZAR26 billion of the expected revenue losses.

The government expects to contain any increases on the spending side. The budget allocated ZAR145 billion (3% of GDP) in additional spending, which primarily relates to the economic support package but also includes a ZAR3 billion (less than 0.1% of GDP) equity investment in [Land and Agricultural Development Bank](#) (B3 negative). Budget reallocations and other adjustments worth ZAR109 billion (2% of GDP) will compensate for most of the additional spending.

The 2020 fiscal deficit combined with the severe economic contraction – which the National Treasury forecasts at 7.2% and we forecast at 6.5% – will push debt to close to 82% of GDP (excluding guarantees) in fiscal 2020. The budget plans to use deposits at the South African Reserve Bank from sterilisation to limit its recourse to borrowing, but it will only marginally contain it.

The speed at which the government recovers its revenue intake and is able to ultimately curb the debt trend will drive creditworthiness. In its “active scenario”, the government hopes to achieve a primary surplus by fiscal 2023 that would stabilise debt. The National Treasury warns that this would require a fiscal adjustment of ZAR250 billion (5% of GDP) and a recovery in growth and taxes over the two subsequent fiscal years. Its “passive scenario” based on weaker macroeconomic assumptions and no fiscal savings sees the debt rising steeply and inexorably. Given South Africa's weak track record of fiscal consolidation in recent years and the weak medium-term economic outlook, debt stabilisation by 2023 will be very difficult to achieve. Details on fiscal consolidation will come at its earliest in October this year when the government will unveil its Medium Term Budget Policy Statement.

Endnotes

¹ See [Coronavirus support package will soften economic shock, but contribute to a sharp jump in debt](#), 24 April 2020.

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UK FCA's enhanced authority to manage Libor transition is credit positive for RMBS and banks

On 23 June, HM Treasury announced that it plans to give the Financial Conduct Authority (FCA) additional regulatory powers to deal with a narrow pool of legacy contracts that cannot be transitioned from the London Interbank Offer Rate (Libor).¹ These contracts either have no alternatives or only inappropriate ones, with no realistic ability to be renegotiated or amended. The announcement is credit positive for UK residential mortgage-backed securities (RMBS) with exposure to contracts referencing Libor because it reduces any related uncertainties when the index is wound down by year-end 2021. Likewise, it is credit positive for UK banks because it reduces legal and reputational risks for those unable to transition their stocks of legacy contracts to new benchmark rates over the same time frame.

The announcement will benefit UK RMBS with exposure to contracts referencing Libor because it reduces any related uncertainties after 2021. The UK government is showing a clear willingness to provide the FCA with sufficient powers to ensure the orderly wind-down of Libor, including altering its methodology and prolonging its use for those contracts with limited possibilities to transition to another rate. The announcement also benefits UK banks by reducing legal and reputational risks for those unable to transition all their stocks of legacy contracts to new benchmark rates by the end of 2021.

Among the challenges for banks, the Working Group on Sterling Risk-Free Rates (RFRWG) listed the need to seek agreement on change in terms for a very large volume of bilateral loans, including mortgages from unsophisticated individual borrowers. For instance, the proposals reduce the possibility that mortgage borrowers with legacy contracts that cannot be unlinked from Libor pay an inappropriate or unfair rate. An indication of the potential risk occurred in March, when one-month Libor increased to nearly 1% soon after the Bank of England rate had been cut to 0.1%. At the time, the number of market transaction-based submissions upon which Libor is preferably based (according to the current method of calculating Libor) fell to very low levels.²

The FCA has identified 200,000 mortgage contracts linked to Libor,³ which tend to be concentrated in the nonconforming and buy-to-let sectors. Older Libor-linked mortgage loans are more difficult to transition because they originated before the announcement that the benchmark was likely to end. Many contracts did not factor in the permanent cessation of Libor, even if they included contingency language addressing the disruption.

The plans do not offer a legislative solution to facilitate transition of any legacy contracts; the obligation to do so remains on market participants. If the plans do become law, they will only mitigate some of the negative effects by ensuring an orderly wind-down of Libor. Additionally, details of the exact powers the FCA will gain, and whether they will be enough to meet the stated objective of protecting consumers and ensuring market integrity remains unknown.

Endnotes

¹ See [Financial Services Regulation: Written statement \(HCWS307\) from Rishi Sunak, The Chancellor of the Exchequer, 23 June 2020](#).

² See [Bank of England Interim Financial Stability report](#), May 2020.

³ See [FCA Sector Views](#), February 2020.

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ASEAN-5 responses mitigate COVID-19 economic damage but are unlikely to offset rising credit risk

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The ASEAN-5 economies – [Malaysia](#) (A3 stable), the [Philippines](#) (Baa2 stable), [Indonesia](#) (Baa2 stable), [Vietnam](#) (Ba3 negative) and [Thailand](#) (Baa1 stable) – have taken steps to mitigate the economic damage of the coronavirus outbreak. The support packages vary in scale and scope, and are largely contingent in nature. While they will broadly help reduce some of the negative effects of the crisis, they will not offset the rising recessionary or credit risks for most sectors.

- » **Policy measures will provide a degree of support, but the confluence of shocks will weigh on growth prospects.** The growth slowdown in the region will be significant relative to previous crisis episodes, but will still be moderate compared to other regions. Nonetheless, the ASEAN-5 are negatively impacted by sharp falls in external trade flows, sluggish commodity prices that weigh on the fiscal revenues of commodity exporters, and financial market volatility that can trigger capital outflows.
- » **Policy measures will have significant fiscal costs.** Government revenue across the region will decline and spending will rise as countries try to mitigate the effects of the crisis. Fiscal costs of support measures will be significant, with debt burdens only stabilising from 2021 for most economies. However, the ASEAN-5 countries had adequate fiscal buffers before the pandemic that gives them fiscal space to respond to the crisis.
- » **Credit risks for banks have increased, despite policy support.** Policy measures have mostly focused on providing liquidity to banks to support new lending, and through credit restructuring such as debt moratoriums. As moratoriums are lifted, banks' problem loans will likely increase.
- » **Few corporate sectors will benefit directly from government support.** Strategically important state-owned enterprises will likely take priority in receiving direct financial support. Privately owned companies will get some support from broader policy measures such as temporary tax relief and lower interest rates.
- » **Infrastructure sector will get limited policy support but essentiality of services may help shore up demand for some companies.** With the exception of Indonesia, few countries in the region have taken steps to support utilities and other infrastructure companies. Governments have instead shifted some of the burden related to policy support to the utilities and other infrastructure providers.

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