

# Credit Outlook

6 July 2020

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## TLG's retail portfolio sale is credit positive, improving its real estate portfolio quality

Originally [published](#) on 02 July 2020

On 29 June, [TLG Immobilien AG](#) (Baa2 positive) announced the disposal of two food-anchored retail property portfolios for a total of €490 million, implying a sales premium to book value (undisclosed amount). TLG expects the transaction to close in the fourth quarter of 2020. Proceeds will primarily be used to bolster liquidity and finance its investment programme.

The portfolio sale is credit positive because it improves the quality of TLG's diversified real estate portfolio, which is increasingly focused on the office segment (estimated at 71% of gross asset value after the disposal of the two retail portfolios), with exposure to retail reduced to 20% gross asset value (out of which more than 70% is food-anchored) and to a lesser extent hotel properties (6% of the portfolio value) and others 3%. The transaction enhances the company's financial flexibility supporting its growth prospects, with development potential of about €800 million, of which less than 10% is currently committed to projects.

The portfolio sale shows the group's solid execution even in a [challenging operating environment for retail real estate](#) affected by social-confinement measures to curb the spread of coronavirus, which have also accelerated the structural move toward e-commerce.

As of 31 March, TLG's Moody's-adjusted ratio of debt to assets was a moderate 41.5% and its Moody's-adjusted fixed-charge coverage ratio was a strong 3.8x, both commensurate with its rating guidance.

We expect the company to continue its strong operating performance while maintaining leverage metrics in line with its financial policy of a maximum loan-to-value ratio of 45%. That should allow TLG to build a cushion to weather the expected tougher economic climate.

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## China Vanke's planned disposal of equity interests in property projects is credit positive

Originally [published](#) on 03 July 2020

On 29 June, [China Vanke Co., Ltd.](#) (Baa1 stable) announced that it had entered a cooperative agreement with a group of strategic investors to sell 50% of its equity interests in Guangzhou Wanxi Enterprise Management Co., Ltd. for RMB7.04 billion (about \$996 million). Guangzhou Wanxi will also repay RMB32 billion of shareholder loans from China Vanke with RMB7.04 billion in shareholder loans from new strategic investors and RMB24.96 billion from new bank loans. Upon completion of the transaction, China Vanke's ownership in Guangzhou Wanxi will decline to 50% from 100%. China Vanke will also cease to consolidate the financials of Guangzhou Wanxi.

The transaction is credit positive for China Vanke because it will provide the company with additional liquidity to support business growth over the next 12-18 months. Additionally, the new strategic investors are likely to provide the expertise to advance development of the projects held by Guangzhou Wanxi.

The projects in this transaction are distressed property projects that China Vanke [acquired in 2017](#). They have an estimated floor area of around 2.1 million square meters, subject to the approval from the Chinese authorities. They are mainly located in affluent core districts of Guangzhou, but the projects' large scale and the long development cycle would lock up China Vanke's capital. Additionally, unsettled legal and financial issues of these distressed projects and renegotiation of the project planning with the government authorities would add uncertainty to the timing of the development of the projects.

The introduction of new investors, including [China Cinda Asset Management Co., Ltd.](#) (A3 stable), can assist in moving those distressed projects forward because of the asset management company's experience in managing distressed assets and dealing with legal and financial disputes. Other investors with experience in city renovation and reconstruction will also support the development of the projects.

We expect that the disposal will have limited effect on China Vanke's financial metrics because the company is likely to use the proceeds to fund its business growth and debt repayment. At the same time, China Vanke's provision of financial guarantees for Guangzhou Wanxi's planned bank borrowings will increase its contingent liabilities.

We expect China Vanke's adjusted net debt/net capitalization at 26%-29% and EBIT/interest at 7.5x-7.7x will be largely unchanged over the next 12-18 months compared with our previous projection before the planned disposal. However, its revenue/adjusted debt ratio will weaken mildly to 122%-126% from 128%-132%, mainly because of an expected guarantee increase to Guangzhou Wanxi's borrowings.

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## ABM Investama's weak first-quarter cash generation is credit negative

Originally [published](#) on 02 July 2020

On 30 June, Indonesian resources company [ABM Investama Tbk \(P.T.\)](#) (B1 negative) announced its financial results for first-quarter 2020 (which ended in March), which showed that cash flow from operations (CFO) net of interest paid was negative \$2.6 million, partly driven by higher income tax payments. Its negative CFO would have been larger were it not for an improvement in working capital because of the deferral in payment of trade payables, with ABM's overdue trade payables rising considerably by around \$27 million from the previous quarter to \$48 million.

The weak cash generation in first quarter, which is credit negative, reflects uncertainty around ABM's ability to generate operating cash flow in this weak coal price environment. An inability to do so will weaken ABM's liquidity buffer.

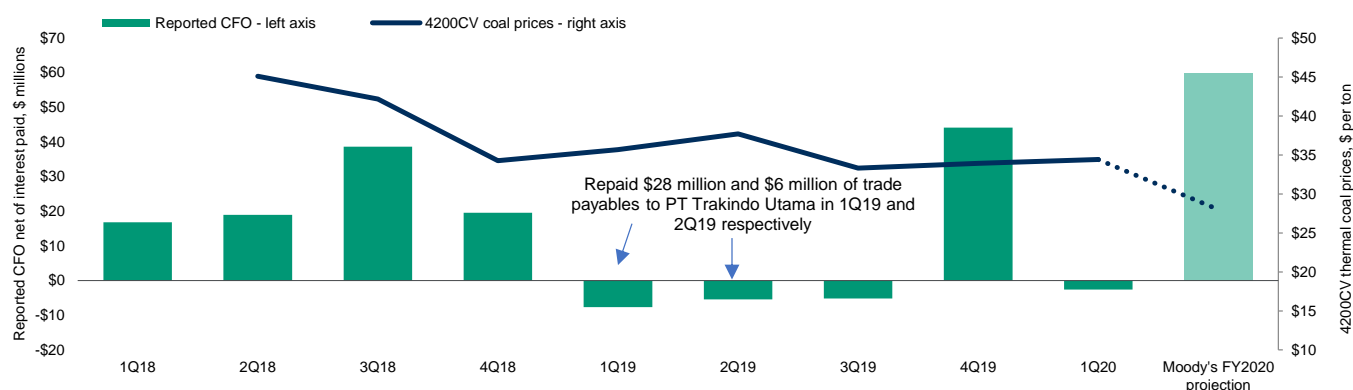
We expect that thermal coal prices, which have declined considerably in recent months, are unlikely to improve in 2020 as slowing economic growth amid the coronavirus pandemic weighs down thermal coal demand. Prices for thermal coal with a 4,200 kilocalorie/kilogram calorific value (CV) declined to around \$27 a ton in second-quarter 2020, compared with \$34 per ton in first-quarter 2020.

We expect that 4,200 CV thermal coal prices will remain weak at around \$25 per ton in the second half of 2020. If coal prices continue to decline, cash flow generation at ABM's coal mining business will likely be strained absent substantial cost reduction initiatives.

There is also uncertainty about the financial health of ABM's mining service customers and their ability to make timely payments to ABM amid weak coal prices. These heightened uncertainties highlight significant downside risks to our forecast for ABM to generate CFO of around \$60 million in 2020 (see Exhibit 1).

Exhibit 1

**Thermal coal prices will likely be lower from second to fourth-quarter 2020, constraining ABM's ability to increase CFO**



Thermal coal prices in the above chart reflect available data from 9 April 2018 to 30 June 2020; ABM pays semiannual coupon on its \$350 million bond in the first and third quarter of the year.

Sources: Bloomberg, ABM's financial statements and Moody's Investors Service estimates

ABM's liquidity buffer will decline if its CFO is substantially weaker than our expectations. We expect cash and time deposit balance of \$109 million as of 31 March 2020 and the projected CFO will be sufficient to cover its repayment of short-term bank loans of \$46 million, finance leases of about \$5 million and projected capital spending of \$60 million over the next 18 months (Exhibit 2). ABM also has flexibility to cut capital spending to preserve cash if necessary. Capital spending fell to only \$2 million in first-quarter 2020 from around \$29 million in the previous quarter.

Exhibit 2

**ABM will maintain adequate liquidity over the next 18 months**



Source: Moody's Investors Service estimates

A reduction in its liquidity buffer will increase ABM's reliance on raising additional debt to fund its planned acquisition of a coal mine to supplement depleting coal reserves.

Without a mine acquisition, ABM's business profile will weaken as we expect its PT Tunas Inti Abadi mine, which produced four million tons in 2019 (around 34% of ABM's 2019 coal production) is likely to run out of coal reserves by 2022. A weaker business profile could increase ABM's refinancing risk ahead of its \$350 million bond maturity in August 2022.

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## Lendlease's profit update is credit negative, but improved balance sheet provides a buffer to weaker results

Originally [published](#) on 02 July 2020

On 1 July, international property and infrastructure developer and manager [Lendlease Group](#) (Baa3 negative) updated its unaudited results for fiscal 2020, which ended 30 June, and announced that it expects core profit after tax of AUD50-AUD150 million, a considerable decline from the AUD804 million the core businesses achieved in fiscal 2019.

The credit-negative decline in earnings reflects coronavirus-related effects across the business, including delays in development and construction projects, settlement delays and cancellations in its Communities business, as well as revaluation losses in its investment portfolio.

Despite the sizable weakening in earnings, we consider recent improvements in Lendlease's balance sheet supportive. The group's balance sheet improved following its [recent AUD1.2 billion equity raise announced in April 2020](#), and it has indicated that gearing (net debt/net tangible assets) is expected to be below 10% with total liquidity above AUD5 billion as at 30 June 2020. We expect that the sale of engineering will add around 3% to Lendlease's gearing, reflecting a net cash outflow of around AUD400 million with sale proceeds being offset by a negative working capital balance. The group also advised that it does not expect to pay a final dividend from Lendlease Corporation Limited, which further helps to preserve liquidity.

In line with our expectations and observations of other issuers with property exposure, Lendlease expects revaluation losses across its Investments segment and weaker earnings from its retail asset management business through fiscal 2021. For second half fiscal 2020, Lendlease expects revaluation losses in the range of AUD130-AUD160 million across its investment portfolio of around AUD4 billion. This includes reductions across the group's co-investments within its funds platform, Retirement Living business and other assets.

While its Developments and Construction Segments will also have weaker earnings in fiscal 2020, we believe this reflects delays from the coronavirus outbreak rather than outright lost earnings. This includes delays in apartment settlements, although the group has flagged increased cancellations within the Communities business.

There has been progress on developments, including, a partnership to develop the around AUD4 billion Milano Santa Giulia project with Canadian pension fund PSP Investments and the forward sale of the first two buildings of this development, and a joint venture with Mitsubishi Estate to deliver the first tower of One Sydney Harbour, which will contribute around AUD100 million to profit after tax in fiscal 2021.

Lendlease does not expect an increase in the costs required to exit its non-core Engineering business, which also supports its credit profile, although the group now expects these costs at the top end of the previously guided AUD450-AUD550 million range. The group expects the agreed sale of the business to Acconia Infrastructure Asia Pacific to complete in early fiscal 2021. There were no changes to the previously announced sale parameters, with Lendlease to retain the Melbourne Metro Tunnel Project, NorthConnex and Kingsford Smith Drive projects.

Lendlease's credit metrics for its core operations were improving towards more appropriate levels for the rating prior to the COVID-19-related disruptions and delays, with completion of the sale of its Engineering business to Acciona a key milestone for its credit profile. Regarding its Baa3 rating and negative outlook, we will continue to monitor the timing around the closure of the engineering sale, and any further material disruptions to operations and earnings from the spread of COVID-19. We will also consider Lendlease's business profile and future strategy following the sale as it relates to any potential revisions to our credit metric tolerances for the rating.

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## Korea Gas increases frequency and timeliness of cost pass-through, a credit positive

Originally [published](#) on 02 July 2020

On 30 June, the [Government of Korea](#) (Aa2 stable) announced that [Korea Gas Corporation's](#) (Kogas, Aa2 stable) tariff on gas wholesale to retail gas distributors, excluding residential and commercial use, will be adjusted every month from 1 August 2020, regardless of the size of changes in imported gas prices. The government also announced a 13.1% tariff cut on the wholesale gas price – which is smaller than the 17.1% decline in Kogas' imported costs for gas – from 1 July 2020, under the cost pass-through tariff mechanism.

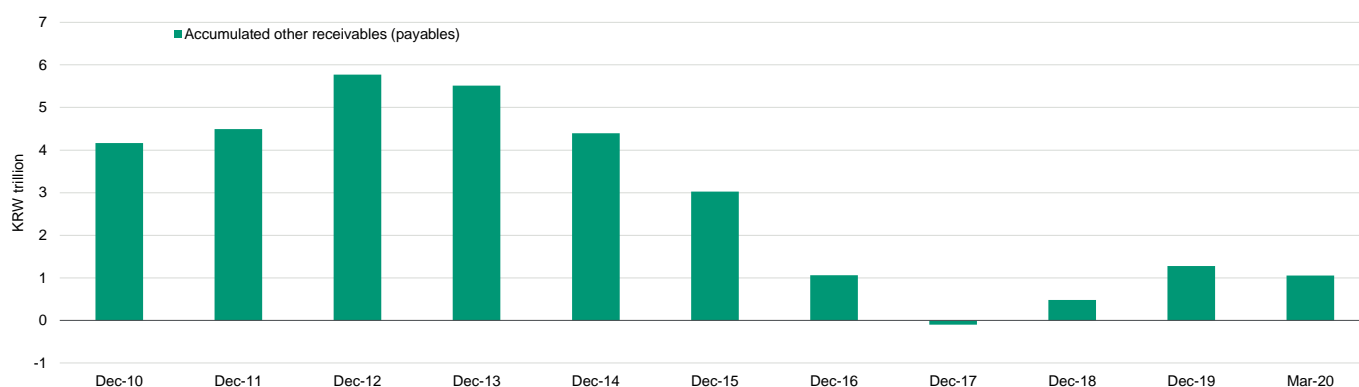
These initiatives are credit positive for Kogas because they will improve the predictability of the company's cash flow. The tariff adjustment frequency to every month will improve timeliness of Kogas' cost pass-throughs under its tariff mechanism. Under the current mechanism, the tariff for sales to retail gas distributors is adjusted every other month and only if fuel costs change by more than 3%.

Monthly tariff adjustments that reflect changes in imported costs of liquefied natural gas (LNG) means that Kogas is likely to maintain a predictable cash flow from 70%-75% of its sales volume, made up from around half of retail gas use and all of power generation. Those adjustments will incrementally apply to 25%-30% of Kogas' sales volume. Retail gas use, excluding residential and commercial use, accounted for 28% of Kogas' total sales volume in 2019. The tariff for power generation, which accounted for 44% of Kogas' total sales volume in 2019, has been adjusted on a timely basis to reflect movements in fuel costs.

The monthly tariff adjustments will also reduce Kogas' needs to fund its working capital through debt, particularly when the imported cost of LNG increases. Kogas' accumulated other receivables, stemming from the suspension of timely cost pass-throughs, amounted to KRW1.3 trillion in 2019 with a peak of KRW5.7 trillion in 2012 (Exhibit 1).

Exhibit 1

**Kogas' cash needs for accumulated other receivables have been mostly funded by debt.**

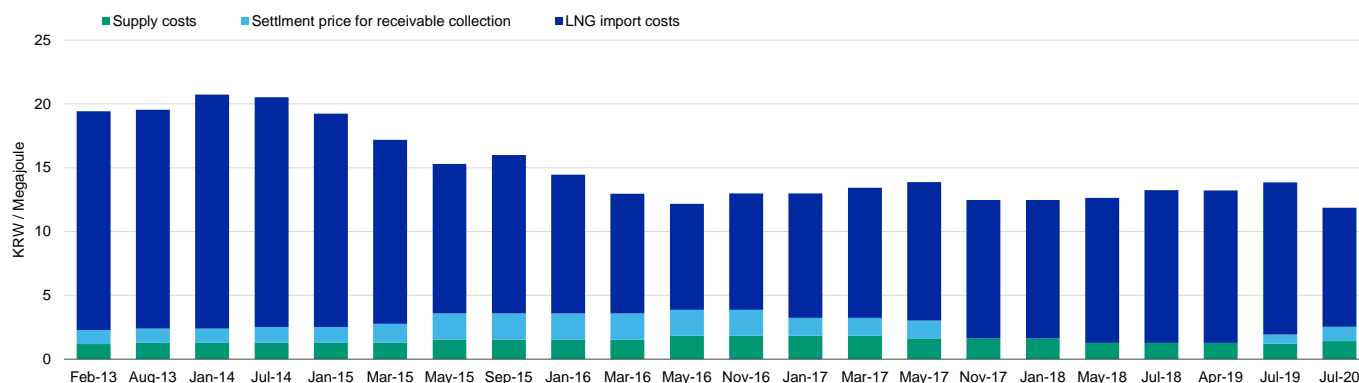


Source: Kogas' government filing

A tariff reduction was granted because of the decline in the cost of imported LNG. However, the announced tariff cut is smaller than the decline in Kogas' input costs. This is credit positive because it will improve Kogas' operating cash flow in the next 12-18 months. The tariff cut of 13.1% is calculated by a 17.1% decline in Kogas' imported costs of gas, along with a 2.6% increase to help the company collect accumulated other receivables and a 1.4% rise in supply costs to compensate for lower-than-budgeted sales volume in 2019 (Exhibit 2).



Exhibit 2

**Tariff adjustments reflect cost movements, higher compensation for supply costs and an increase in receivable collection**

Sources: Kogas and Korea's Ministry of Trade, Industry and Energy

We expect the tariff adjustment, along with the reduction in the tariff adjustment frequency for Kogas' sales to the retail gas users, will allow the company's funds from operation (FFO)/debt to remain at 7.5%-8.5% in 2020-21, which is similar to 8.1% in 2019. This expectation is despite a likely decline in profit from Kogas' overseas gas fields amid a large drop in crude oil prices.

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## Most US banks' meet regulatory capital buffer requirements and cap third-quarter dividends, both credit positives

Originally [published](#) on 02 July 2020

Over 29–30 June, most publicly traded US banks participating in the Federal Reserve's (Fed) 2020 Comprehensive Capital Analysis and Review (CCAR) announced their shareholder distribution plans for third-quarter 2020, as well as their preliminary stress capital buffers (SCB). All banks that disclosed their SCB, except for [The Goldman Sachs Group, Inc.](#) (A3 stable), met their Common Equity Tier 1 (CET1) buffer requirement as of 31 March, which is credit positive. The preliminary SCBs incorporate the Dodd-Frank Act Stress Test (DFAST) results, which were released on 25 June, and the Fed is required to finalize the SCB for all firms by 31 August.

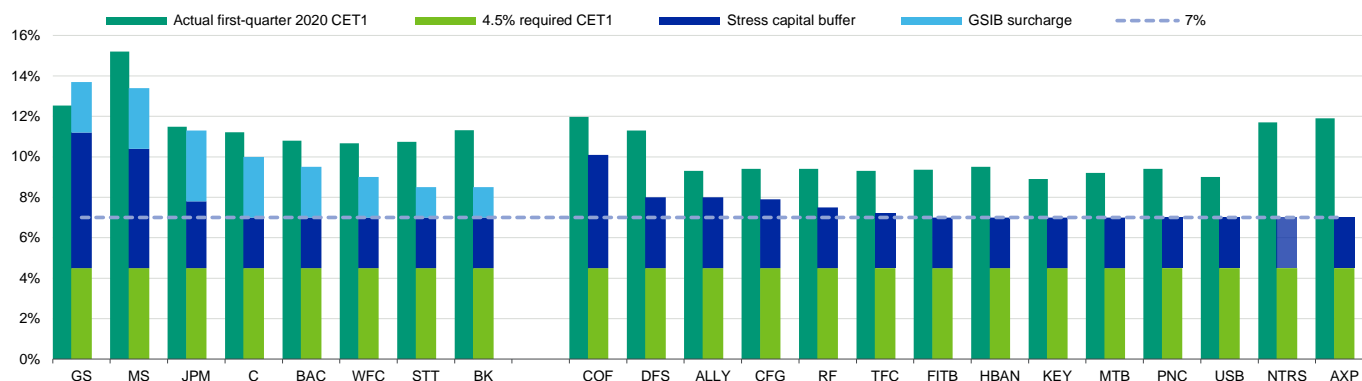
The SCB is effective 1 October and equals the higher of either 2.5% or the difference between the starting and minimum projected CET1 capital ratios under the DFAST severely adverse scenario plus four quarters of planned common stock dividends. The aim is to complement the existing US bank regulatory capital buffers originally developed as part of the Basel III capital framework. For banks subject to the Fed's DFAST stress test, the SCB replaces the Basel III 2.5% capital conservation buffer (CCB). To avoid regulatory restrictions on capital distributions or discretionary bonus payments, US banks must maintain a CET1 ratio above the sum of 4.5% (the Basel III CET1 minimum) plus their SCB (or CCB for banks not subject to DFAST), any applicable countercyclical capital buffer (there is presently none in the US), and for the eight US global systemically important banks (G-SIBs) their G-SIB surcharge.

The dividend caps, which are the result of the Fed's restrictions arising from its sensitivity analysis published in June, are credit positive because they will limit capital depletion in the third quarter.

As of 31 March, all DFAST banks had CET1 ratios that already exceeded this requirement, with the exception of Goldman Sachs, which will have a standardized CET1 requirement of 13.7% including its 6.7% SCB and its 2.5% G-SIB surcharge, compared with a 31 March standardized CET1 ratio of 12.54% (see exhibit). Goldman Sachs' management indicated on 29 June that its CET1 ratio had already risen above 13% and we expect that it will continue to build toward its requirement.

### Stress capital buffer is a new requirement that takes effect in the fourth quarter

CET1 ratios as of 31 March 2020 and buffer requirement including the stress capital buffer



Key: ALLY = Ally Financial Inc.; AXP = American Express Company; BAC = Bank of America Corporation; BK = Bank of New York Mellon Corporation; COF = Capital One Financial Corporation; C = Citigroup; CFG = Citizens Financial Group, Inc.; DFS = Discover Financial Services; FITB = Fifth Third Bancorp; GS = Goldman Sachs Group, Inc.; HBAN = Huntington Bancshares Incorporated; JPM = JPMorgan Chase & Co.; KEY = KeyCorp; MTB = M&T Bank Corporation; MS = Morgan Stanley; NTRS = Northern Trust Corporation; PNC = PNC Financial Services Group, Inc.; RF = Regions Financial Corporation; STT = State Street Corporation; TFC = Truist Financial Corporation; USB = U.S. Bancorp; WFC = Wells Fargo & Company. As of 1 July 2020, NTRS had not announced its preliminary SCB; 2.5% above is our estimate.

Sources: Company filings and Moody's Investors Service

Thirteen of the 22 banks included in the exhibit have an SCB at the 2.5% floor, making their CET1 requirement 7% (shown above as a horizontal line) before adding the G-SIB surcharge. Both [Citizens Financial Group](#) and [BMO Financial Corp.](#) (Baa1 stable), the

latter of which is not included in the exhibit, indicated they would make a formal request for reconsideration to the Fed. Citizens had a preliminary SCB of 3.4%, while BMO did not announce its SCB. The reconsideration process, which has been a part of the Fed's Comprehensive Capital Analysis and Review (CCAR) since 2011, must be made within 15 days of receipt of notification of SCB requirements. The Fed must respond within 30 days, but can extend that period, and can even delay the effective date of the SCB for such a firm, if needed.

Although nearly all the banks already exceed their likely fourth-quarter CET1 buffer requirements, the Fed nonetheless imposed several payout restrictions through at least the third quarter in response to the results of its coronavirus sensitivity analysis published in June. Those results revealed significant downside risks to capital depending on the trajectory of the economic recovery from the coronavirus pandemic. Firms cannot make share repurchases, except those related to employee stock ownership plans. Common dividends cannot be raised or exceed the average of net income for the four preceding calendar quarters.

[Wells Fargo & Company](#) (A2 stable) was the only firm to announce that it would cut its common dividend to comply with the Fed's restrictions, which we view as a credit-positive preservation of capital. Its dividend will be announced with its second-quarter earnings on 14 July. Its announced SCB of 2.5% accounts for a lower dividend rate. Our estimate of the SCB using the first-quarter dividend rate was 2.7%.

Most of the other publicly traded firms stated the common dividend would remain unchanged for the third quarter and there would be no share repurchases. The focus on capital retention is positive, however depending on the magnitude of loan-loss provisions in the second and third quarters, we expect that some banks will experience some capital depletion at current dividend rates, which would be credit negative because it reduces their ability to absorb unexpected losses.

In response to the results of its coronavirus sensitivity analysis, the Fed is also updating its economic scenarios and will require the banks to update and resubmit capital plans within 45 days of the release of those updated economic scenarios. We view this positively because a harsher scenario is likely to lead to banks' holding higher capital buffers and limiting capital payouts during a period of significant economic uncertainty. Per the SCB regulations the Fed can revise SCBs following the resubmission of a capital plan, but is not required to do so. Generally this must be done within 75 days of the plan's resubmission, although the Fed can extend that time frame. We expect that once banks have the Fed's approval of the revised capital plans, many will publicly announce those plans. We also assume that the dividends included in those plans will be incorporated in each bank's SCB beginning on 1 October.

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## Credit Acceptance's facility amendments are credit positive

Originally [published](#) on 02 July 2020

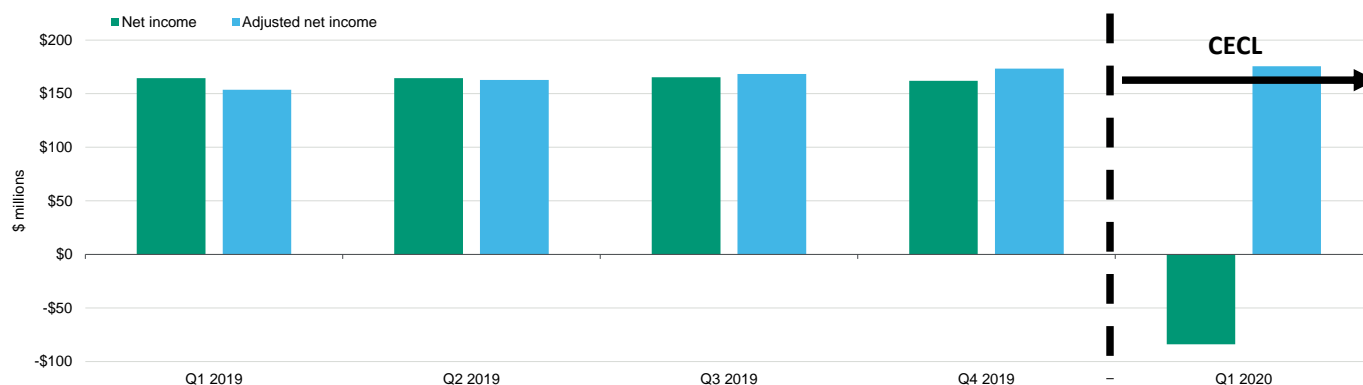
On 1 July, subprime auto lender [Credit Acceptance Corporation](#) (CACC, Ba3 stable) announced that it had made amendments to various facilities to modify the method of calculating two financial covenants. The amendments are credit positive because they will provide the company with more cushion against its covenants and reduce the risk of a covenant breach.

For the purposes of calculating the minimum net income and the fixed charge coverage ratio, the amendment modifies the method of accounting to US GAAP before 1 January 2020 from the current US GAAP. The most significant change in that period was the implementation of an accounting standard known as current expected credit losses (CECL), which has increased the difference between the firm's adjusted earnings and reported earnings (see Exhibit 1).

Despite coronavirus-related challenges in the first quarter, CACC remained solidly profitable on an adjusted basis and is likely to remain because of the conservative pricing of its loans. We expect this will provide the company with ample cushion against its covenants over the next year. The amended facilities include a \$340 million secured revolving credit facility and two warehouse funding facilities with a combined capacity of \$550 million. As of 1 July 2020, CACC had drawn \$163.3 million from the secured revolver and a combined \$326 million from the two warehouse facilities.

Exhibit 1

### CACC's adjusted results versus reported results, first-quarter 2019 to first-quarter 2020



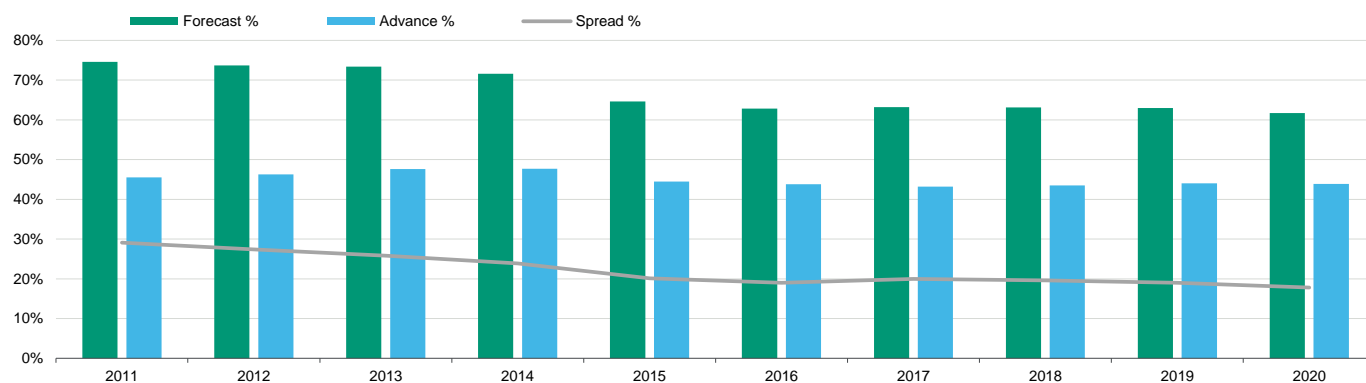
Sources: Company filings and Moody's Investors Service

Like other lenders, CACC is being challenged by the coronavirus pandemic. In first-quarter 2020, the company revised downward its forecast of net cash flows by \$206.5 million, resulting in the recognition of a \$196.8 million provision. Since then, collection forecasts have somewhat rebounded, but these gains may nevertheless reverse in the future if high unemployment persists or an absence of government stimulus programs to assist distressed borrowers.

Following steep declines in March and April, CACC reported a rebound in originations volumes in May. That rebound is likely attributable in part to pent-up demand following the restrictions on economic activity imposed in March and April in response to the outbreak. Additionally, the operating environment has become more favorable as some competitors pull back from subprime auto lending.

CECL increases the provision for credit losses that CACC must recognize because of the nature of its loans: CACC purchases auto loans at a fraction of the value of the cash flows they are contractually entitled to, normally 45%-50% of those cash flows. These auto loans are made to subprime customers and CACC normally only expects to collect 60%-70% of the contractual amount (Exhibit 2).

## Exhibit 2

**CACC's advance rate, collection forecast and spread, 2011 to first-quarter 2020**

Forecasted collections rate is as of 31 May 2020 from CACC's 8-K filing. Initial forecasted collections are taken from the company's 10-Q for the period that ended 31 March 2020.

Source: *Company filings*

However, under CECL, CACC must calculate the present value of the cash flows it expects to receive from its loans using a discount rate derived from the contractual amount. This figure is lower than the amount advanced to the dealer upon purchase of the loan and the difference between the two is recognized as a provision. Provided CACC's collection forecasts are correct, the provision is recognized as revenue on a level-yield basis over the life of the loan. Because CECL was only implemented on 1 January 2020, the higher revenue, which is recognized over a longer period, does not offset the higher provision expenses, which are recognized immediately once CACC purchases a loan.

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## Colombia's credit relief measures increase banks' asset quality risks

Originally [published](#) on 02 July 2020

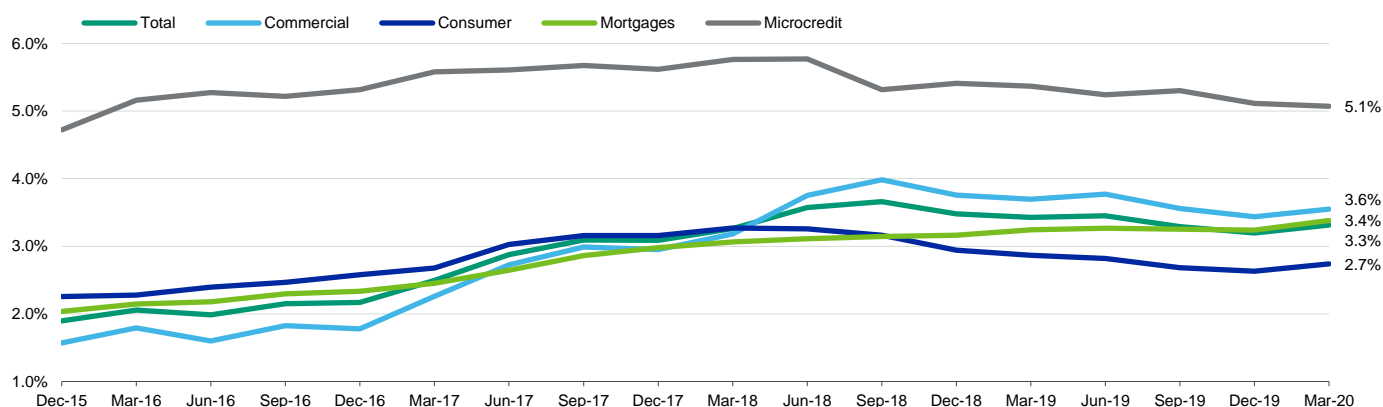
On 1 July, La Superintendencia Financiera (SFC), the Colombian financial regulator, published credit relief measures to support borrowers affected by the pandemic. Under the new measures, banks will have to offer installment deferrals or reductions to payments coming due without additional cost through year end, and banks' related provisions will be postponed.

Borrowers' relief programs are credit negative for Colombian banks because they will raise asset quality risks given the greater chance that these borrowers will default on their loans once the payment-deferment scheme ends. The effort is one of several government support measures for borrowers and financial institutions, such as easier provisioning requirements for any accruing loans being renegotiated and expanded access to central bank liquidity facilities for financial intermediaries.

While Colombian banks' asset risk, measured by problem loans over total loans, has been relatively stable in recent years (see exhibit), we expect problem loans to increase in light of the coronavirus pandemic. We forecast a gradual recovery to start in the third quarter of the year and an acceleration in 2021 supported primarily by domestic demand. However, the crisis will likely weigh significantly on formal employment and on private consumption should job creation be slower than expected in 2021. In addition, despite the government's support measures, small and medium enterprises, which employ a large share of the labor force, may be forced to cease operations, which would fuel delinquencies.

### Colombia's credit deferral measures pose risk to Colombian banks' stable asset quality

Problem loans as a % of gross loans



Sources: Superintendencia Financiera (SFC) and Moody's Investors Service

Overall, the measures that postpone provisioning will likely delay credit losses, requiring banks to reinforce reserve coverage levels during the remainder of the year. In March 2020, systemwide loan-loss reserves were 1.8x of problem loans, and will likely increase above the 2.3x peak in 2016.

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## Peru's proposed across-the-board payment freeze is credit negative for banks

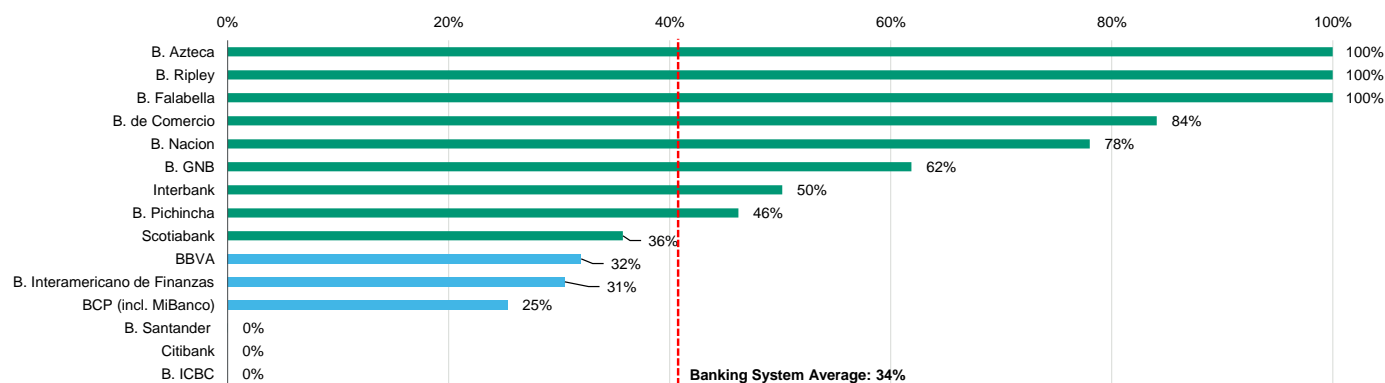
Originally [published](#) on 03 July 2020

On 27 June, the Peruvian congress' consumer protection committee approved a bill that would require all banks and finance companies to offer a 90-day grace period on outstanding consumer and mortgage loans. Additionally, the bill provides an option to extend a loan's maturity by as much as five years without incurring any penalties or additional interest, fees and related credit expenses.

If approved by Peru's unicameral congress, the bill would be credit negative because it would establish an indiscriminate grace period, even for borrowers who do not need one, and negatively affect banks' liquidity and solvency. The banks most exposed would be the smaller, less-diversified banks such as Banco Azteca del Perú S.A., Banco Ripley Perú S.A., Banco Falabella Perú S.A. and the domestic subsidiary of [Banco GNB Sudameris S.A.](#) (Ba2 review for downgrade, ba3 review for downgrade<sup>1</sup>) Large banks such as [Banco de Crédito del Perú](#) (BCP, Baa1/Baa1 stable, baa2) and [Banco BBVA Perú S.A.](#) (Baa1 stable, baa2) would be less affected because their portfolios are more diverse.

The exhibit below shows Peruvian banks' exposures to consumer loans, credit cards and mortgages as of May 2020.

**More than half of Peruvian privately owned banks would be highly exposed to indiscriminate grace periods in retail credit and mortgage**  
Consumer loans, credit cards and mortgages as a % of total credit



Data as of May 2020.

Source: Peru's Superintendencia de Banca, Seguros y AFP

The approval of such a bill comes amid Peruvian banks' efforts to reschedule specific loans and thus provide differentiated relief for borrowers who have been directly affected by the coronavirus pandemic. According to Peru's bank supervisor, 53% of banks' total consumer portfolio and 43% of their total mortgage portfolio had already been modified as of 19 June. Measures included retail and corporate loan deferrals and grace periods of up to 12 months on performing loans (without banks having to build additional mandatory loan-loss provisions), reductions of installment amounts, extensions of maturities, forgiveness of default interest, penalties and commissions, and lowering interest rates.

Troubled borrowers have also received direct support from the Peruvian authorities through direct cash transfers. Additionally, the government has provided support to smaller companies having trouble paying salaries. Both measures have helped to indirectly mitigate risks for banks. However, the committee's proposed measures would harm banks' capacity to meet their obligations with depositors and would halt credit origination at a time when banks have been offering credit relief programs to support borrowers through specific loan deferrals and government assistance. Longer loan deferrals and forbearance would add pressure to banks' weakened collection capacity, and mask credit quality deterioration.

Local authorities including the central bank, the bank and insurance supervisor and the Ministry of Economy oppose the proposed draft law. They argue the proposed measures overlap with similar measures in place since the onset of Peru's strict lockdown ordinances that have led to record low economic activity.

However, if Congress were to approve this bill or something similar, we expect that it will pass with various carve-outs so as not to affect Peru's financial stability. For example, the consumer protection committee appended to the proposed bill exemptions to smaller financial entities (*cajas municipales, cajas rurales* and *edpymes*) and employees whose work conditions have not changed since March. We expect that the effect on [Banco de la Nación](#) (A3 stable, baa2), Peru's largest state-owned bank, will be limited, given its large base of clients who are public employees and whose working conditions have not been affected since the pandemic outbreak.

Although it is unclear whether lawmakers will approve the proposal, it is increasingly probable that banks will have to continue providing differentiated credit-deferral services to vulnerable customers given that the coronavirus pandemic has resulted in an outsize shock to Peru's GDP growth in 2020. We expect Peru's GDP to contract 9.3% in 2020, followed by a strong economic recovery of 8% in 2021.

## Endnotes

<sup>1</sup> 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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## Brazil's proposed law will reduce effect of currency volatility on banks' capital, a credit positive

Originally [published](#) on 02 July 2020

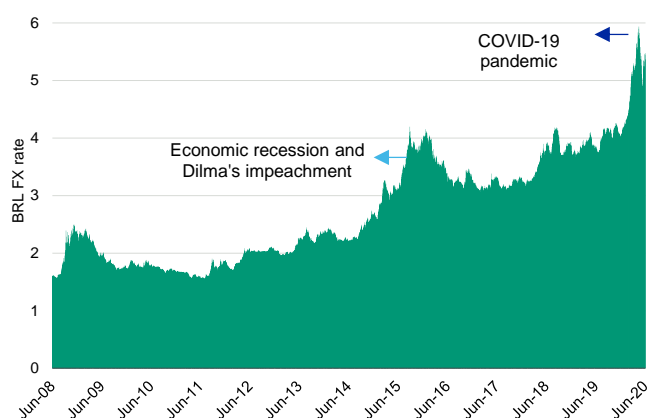
On 30 June, Brazil's federal government enacted a provisional measure that will eliminate banks' need to overhedge foreign investments, which is hedging an amount greater than the total investment abroad. The measure is positive for banks' capital because it will reduce fiscal losses on the overhedge position during periods of outsized currency devaluation. Such losses increase deferred tax assets (DTAs) deducted from the banks' capital base, reducing their tangible capital.

The largest banks, including [Banco do Brasil S.A.](#) (Ba2/(P)Ba2 stable ba2<sup>1</sup>), [Itau Unibanco S.A.](#) (Ba2/(P)Ba2 stable, ba2), [Banco Bradesco S.A.](#) (Ba2/(P)Ba2 stable, ba2) and [Banco Santander \(Brasil\) S.A.](#) (Ba1/(P)Ba1 stable, ba2), and small and midsize companies lender [Banco ABC Brasil S.A.](#) (Ba2 stable, ba2) will be most affected because they hold a significant portion of their assets in offshore branches or foreign subsidiaries. Offshore assets are typically hedged against US dollar volatility to avoid an earnings effect.

The real's 30% depreciation against the US dollar in the first quarter (see Exhibit 1) resulted in big losses on derivatives that are hedging investments abroad. The losses generated a large amount of tax credits from the temporary difference (which we fully deduct for our calculation of banks' capital ratios). Although the five banks reported average regulatory Common Equity Tier 1 (CET1) ratio of 10.5% as of March 2020, their average Moody's tangible common equity (TCE) to risk-weighted assets ratio<sup>2</sup> fell to 6.5% in the first quarter from 9.2% at the end of 2019, according to our capital metric (see Exhibit 2). Excluding this effect, we estimate the banks' average TCE ratio for the first quarter would have been 7.7%. The reduction in the banks' capital positions was due mainly to the elimination of DTAs from temporary differences, which increased as a result of the losses on the overhedge positions affected by foreign-exchange volatility.

Exhibit 1

**The real depreciated sharply in March because of the unexpected economic crisis and growing political uncertainty**



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

Exhibit 2

**A steep fall in the real's value in first quarter affected banks' TCE ratios, increasing DTAs related to the taxation of foreign investment hedging**

Bank	Regulatory CET1 ratio	Moody's TCE ratio		
	Mar-20	Dec-19	Mar-20	Mar-20 excluding DTA from overhedge
Banco do Brasil	10.0%	10.2%	9.5%	9.9%
Bradesco	10.3%	8.0%	5.5%	7.0%
Itau Unibanco	10.3%	9.4%	5.6%	6.8%
Santander Brasil	11.4%	7.4%	5.0%	6.8%
Banco ABC Brasil	10.8%	11.0%	6.9%	8.1%

Sources: Banks' management discussion and analysis and Moody's Investors Service estimates

Brazil's central bank on 18 March temporarily lowered the deduction of DTAs related to fiscal losses on foreign-exchange variations on investments abroad from the calculation of regulatory capital, softening the negative effect of currency depreciation on regulatory CET1 ratios until December 2021. Along with other government support measures at the start of the coronavirus outbreak, the central bank sought to increase banks' lending capacity amid growing concerns over borrowers' liquidity conditions. According to the central bank, the temporary capital benefit released BRL46 billion (\$9 billion) of common equity and had the potential to expand lending activity by BRL520 billion.

## Endnotes

- [1](#) The bank ratings shown in this report are the bank's domestic deposit rating, senior unsecured debt rating (where available) and Baseline CreditAssessment.
- [2](#) Our preferred measure of capitalization, which deducts from capital the intangible assets and a significant portion of deferred tax assets that do not provide significant loss absorption. In addition, we adjust the bank's risk-weighted assets by applying a risk factor of 100% to its significant holdings of Brazilian government securities, weighted 0% by local regulations.

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## UK regulator-led forum's climate guide will help financial firms manage climate risks

Originally [published](#) on 02 July 2020

On 29 June, the Climate Financial Risk Forum (CFRF), a regulator-led forum co-chaired by the UK's Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA), [published a guide](#) to help financial firms understand the risks and opportunities that arise from climate change. We regard the initiative as credit positive because it will help financial institutions understand the consequences of climate change for their business, support their efforts to develop climate risk management capabilities and capture the opportunities posed by climate change.

Written with the collaboration of financial industry experts, the guide outlines how to integrate climate change into firms' risk, strategy and decision-making processes. The guide also considers how firms can plan for the effect of climate policies over different time horizons, and assess their exposure to climate-related financial risks so they can adapt their businesses accordingly.

The guide highlights four topics as key priorities when developing a robust approach to responding to climate-related financial risks and opportunities: risk management, scenario analysis, disclosures and innovation. While a number of regulatory initiatives have already addressed the first three, the guide also emphasises innovation, making it a separate topic despite it complementing other components of a risk framework.

The guide identifies three areas where innovation can play a key role in the development of climate change capabilities: matching the sources of finance and pools of capital against potentially investable assets and technologies; the role of data innovation to improve the quality and availability of information that facilitates the effective allocation of capital; and measures financial institutions can take to address the mobilisation of finance to tackle climate targets.

The guide acknowledges that the understanding of climate risks is at an early stage and that several challenges exist. However, it urges financial institutions to take action, suggesting they lay out their approach now and develop it over time. Although the CFRF stresses that the guide has been written "by industry, for industry" and does not constitute "regulatory guidance", both the PRA and FCA have acknowledged its value to assist financial institutions in developing climate risk management capabilities. We expect the guide to be particularly useful for small institutions that lack the expertise and investment capacity of large firms.

For a number of years, UK regulators have shown global leadership in the management of climate risks for financial institutions. The PRA in April 2019 published a [supervisory statement](#) designed to enhance banks' and insurers' management of the financial risks related to climate change. In December 2019, the Bank of England opened a [consultation on a planned testing exercise](#) designed to assess the long-term resilience of UK banks and insurers to the financial risks posed by climate change.

The FCA has also launched several initiatives, including a proposal for enhanced disclosure requirements by listed issuers. Given the relevance of climate change to their strategic objectives, the PRA and the FCA established the CFRF in March 2019 as an industry-led forum bringing together senior representatives from the financial sector to develop practical tools and recommendations for firms in responding to climate change.

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## Surge in ECB's long-term refinancing operations will help mitigate EU banks' profitability pressures

On 30 June, the European Central Bank (ECB) released its latest weekly consolidated financial statement of the euro area, which showed a material surge in assets and liabilities of around €600 billion. The increase mainly reflects euro area banks' massive €1.3 trillion take-up of the ECB's Targeted Long-Term Refinancing Operations (TLTRO III) on 18 June. The surge is credit positive for banks because it eases funding and liquidity risks in the event of further economic deterioration and will moderate the negative effect of low interest rates on banks' profitability.

The success of the June tender for these three-year funding instruments was primarily because of the ECB's March change in pricing<sup>1</sup> that allowed borrowing rates in these operations to fall to negative 1% during the period of 24 June 2020 to 23 June 2021 from negative 0.5% in previous TLTRO programs, subject to meeting certain lending performance thresholds. Some 742 banks participated, bidding an average of around €1.8 billion each.

As the ECB intended, we expect that the TLTRO III take-up will support the provision of credit to the European economies confronting significant disruption because of the coronavirus crisis. In addition to the support this program provides to banks' liquidity and funding, we also expect that the program will support their cost of funding and moderate low interest rates' negative effect on banks' profitability.

According to the ECB's latest euro area weekly consolidated financial statement, total assets increased by around €600 billion from the previous week to €6.2 trillion as of 24 June, reflecting mainly the increase in long-term refinancing operations to €1.6 trillion from around €1 trillion a week earlier. Since the beginning of the coronavirus crisis and the implementation of lockdown measures in Europe early March, the ECB's lending to euro area banks has increased 157% (equal to €900 billion additional funding), which has helped banks cope with additional funding requirements from corporate borrowers negatively affected by coronavirus-related lockdown measures.

Mirroring the asset growth, liabilities to euro area credit institutions related to monetary policy operations (ECB current accounts and deposit facility) increased €580 billion from the previous week to €2.8 trillion as of 24 June and by around 150% since the beginning of the coronavirus crisis. The increase in banks' borrowing from the ECB since early March helped them respond to higher credit demand from nonfinancial corporate borrowers between March and May, during which lending increased year on year by between 4.9% in March and 6.7% in May, or by around €260 billion over the period, compared with a 2.6% growth rate in 2019. The recent additional take-up from the ECB's TLTRO operations will help banks meet higher credit demand in the coming quarters amid mounting economic uncertainties.

The success of the 18 June TLTRO III tender also is due to the new pricing that can go as low as 50 basis points below the average interest rate on the deposit facility (currently negative 0.5%, hence negative 100 basis points) during the 24 June 2020 to 23 June 2021 period, and as low as the average interest rate on the deposit facility during the rest of the life of the three-year TLTRO III maturity.

The new pricing, which also applies retroactively to the entire stock of TLTRO debt, now totaling around €1.6 trillion after the recent €1.3 trillion take-up, provides banks with a cost reduction compared with previous TLTRO scheme and an opportunity to place the funds back at central bank with a 0.5% differential that could provide a net interest margin improvement of around €8 billion, although we expect most of the new funding will be used for higher-yielding lending or investment opportunities. Banks used around 60% of the June €1.3 trillion take-up to refinance their previous ECB debt programs at 0.5% lower borrowing rate.

In September 2019, the ECB created a two-tier deposit mechanism, exempting from negative interest a maximum volume of six times a bank's minimum reserve requirement and instead charges 0% on these deposits. We estimate that the tiering system will save euro area banks around €5 billion from the €11 billion they would otherwise disburse based on the reserves and deposit facilities at the central bank as of May.<sup>2</sup> This amount, in addition to the €8 billion we expect banks to save as a result of the transition to TLTRO III's

new pricing, would amount to an approximately €13 billion cost transfer (the equivalent of around 10% of euro area banks' 2019 profit before tax) to the ECB from euro area banks between June 2020 and June 2021. We therefore expect long-term refinancing operations to help offset the profitability challenges faced by the region's banks.

## Endnotes

<sup>1</sup> See Article 5 of Decision ECB/2020/25. [Click here](#) to read the decision.

<sup>2</sup> See [Disaggregated Financial Statement of Eurosystem, 29 May 2020](#), 30 June 2020.

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## German banks' collective commitment on climate action is credit positive

On 30 June, 16 German banks and other financial institutions signed a [collective commitment](#) to foster environmental sustainability in their lending and investment portfolios. The self-imposed commitment is credit positive because it will urge German banks to reassess lending and investment criteria under the auspices of sustainable finance, which will help them reach climate targets.

The commitment is based on the United Nations Environment Programme Finance Initiative ([UNEP FI](#)) commitment to climate action. It is also in line with the European policy agenda on economic sustainability efforts involving the financial sector and with the German regulator Bundesanstalt für Finanzdienstleistungsaufsicht's (BaFin) [recommendation for good practices for sustainability risks](#).

Each participant commits to developing and implementing mutually accepted methods to measure the effects on climate of its lending and investment book, and managing its assets in line with climate targets of the Paris Agreement on Climate Change and Germany's Climate Protection Act and the Climate Action Programme. These targets include interim goals as well as achieving climate neutrality by 2050 to limit global warming to well below 2 degrees Celsius and striving to a maximum of 1.5 degrees Celsius. To reach these goals, the participants aim to focus on carbon, energy-intensive and transitional sectors first and publish sector-specific and scenario-based climate targets for their loan and investment books by the end of 2022.

The participants also commit to implementing a set of measures and reporting on their progress within the first 12 months following the initial agreement. The commitment does not apply to funds' business for which asset managers are obliged to implement investor orders. For those funds there will be only a gradual application of the commitment with no time frame.

That there are no details yet on concrete measures shows the early stage of the financial sector in dealing with environmental risks and sustainable finance in their daily operations. German banks in particular lag behind their international peers in terms of public commitments to sustainability and environmental exposures. None of the major German banks is among the [33 international banks](#) that committed to take immediate action following the UN Secretary-General's Climate Action Summit in September 2019.

Furthermore, only one member of the German savings banks association and only a few small specialized members of the cooperative sector thus has signed on to the German collective commitment, which currently only includes 16 domestic and foreign financial institutions operating in Germany. These 16 institutions include [Deutsche Bank AG](#) (A3/A3 negative, ba1<sup>1</sup>), [Commerzbank AG](#) (A1/A1 stable, baa2), [UniCredit Bank AG](#) (A2/A2 negative, baa2), [Landesbank Baden-Wuerttemberg](#) (Aa3/Aa3 stable, baa2) and [ING-DiBa AG](#) (A2 stable, a2).

Along with the banks' voluntary commitments, German regulators are intensifying their focus on sustainability risks and encouraging banks to integrate sustainability considerations into their business strategies. However, a 2019 [BaFin survey found](#) that only 1% of responding banks carried out a comprehensive analysis of sustainability risks and less than 1% said they considered environmental and climate-related risks a material risk for their bank. Even though 22% of respondents indicated that they plan to include these considerations in future analysis, the survey shows that German banks are at an early stage in assessing sustainable finance and environmental risk.

### Endnotes

<sup>1</sup> The bank ratings shown in this report are the bank's deposit rating, senior unsecured debt rating (if applicable) and Baseline Credit Assessment.

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## Cyprus' high loan payment deferrals reduce banks' potential asset quality deterioration

Originally [published](#) on 03 July 2020

On 30 June, the Central Bank of Cyprus published updated data up to 5 June on payment deferrals for borrowers affected by the coronavirus-induced economic disruption. Around one-third of Cyprus banks' gross loans had payment deferrals as of 5 June, adding to banks' credit risks.

Although the payment deferrals reduce the probability of acute asset quality stress this year, the high percentage of deferrals suggest that asset quality deterioration is still very likely next year. The deferrals will reduce the extent of any deterioration, but their ultimate effect will depend on the depth and duration of the economic downturn.

While Cyprus' construction, retail and restaurant sectors have reopened, the tourism sector will take significantly longer to recover. According to the World Travel and Tourism Council, the sector accounted for 13.8% of GDP and 13.2% of employment in 2019. We expect Cyprus' economy to contract by 7.5% this year before recovering in 2021, when we expect it to grow by 6.0%. High private-sector debt is exacerbating the strain on borrowers.

Policy response measures by the authorities will alleviate the immediate strain on creditworthy borrowers' cash flow and increase the likelihood of the recovery and longer-term viability of their loans<sup>1</sup>. The measures include a broad loan payment throughout 2020 available to all borrowers with previously performing obligations who request it.

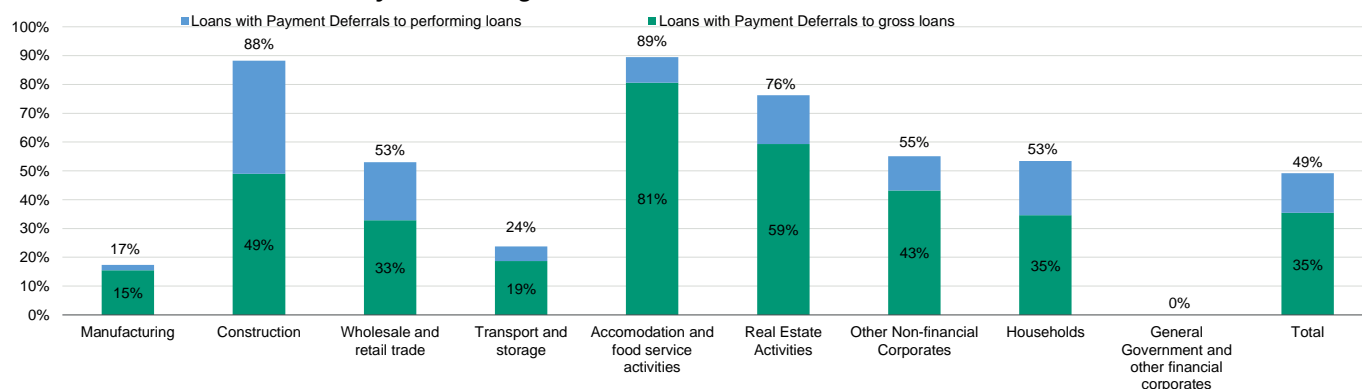
The gross carrying amount of credit facilities with payment deferrals is relatively high in Cyprus. With total loans with deferrals of €11.4 billion as of 5 June,<sup>2</sup> we estimate banking system loans with deferred payments at around a third of gross banking system loans. Loans with payment deferrals are in addition to nonperforming loans, which comprised 28% of systemwide gross loans at the end of 2019.

We estimate that loan deferrals make up almost half of the banking system's performing loans. Loans with deferrals among the four largest banks in [Greece](#) (B1 stable), another European banking system that faces high credit risks, are much lower on average, at around 9% of total gross loans or 16% of performing loans.

The high level of loan deferrals reflects the strains on Cyprus' economy, but also the broad and protracted payment deferral framework. The framework is mandatory as long as a borrower had performing obligations before the coronavirus pandemic began, which prevents banks from choosing whether to extend this assistance.

Loan deferrals for tourism-related loans (represented by accommodation and food service activities in the exhibit below) account for 81% of gross loans and 89% of performing loans. Other confidence-sensitive sectors such as real estate and the troubled construction sector also have high percentages of deferred loans. Combined, the three sectors account for more than 60% of loan deferrals for nonfinancial companies.

## Loan deferrals to loans broken down by loan book segments and economic sectors



Loans with payment deferrals are as of 5 June 2020 and include non-bank providers and acquirers like KEDIPEs. Gross and performing loans are for banks as of year-end 2019. Excluding loans with payment deferrals by KEDIPEs, total loan deferrals drop to 33% of gross loans and 46% of performing loans, but no details on the breakdown by segment and economic sector is available.

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

The exposure of the country's largest bank, [Bank of Cyprus Public Company Limited](#) (B3 positive, caa1<sup>3</sup>), to the tourism sector (including hotels and catering) was 11% of its non-legacy gross loans<sup>4</sup> as of March 2020. Of these, 96% have applied for a payment holiday.

Although the payment holiday will provide banks with flexibility to support and reschedule loans for viable borrowers in 2020 to better match revised cash flow expectations, we expect some borrowers to eventually default. The payment holiday will not automatically result in the loan being classified as nonperforming as long as the bank continues to expect the borrower to pay, which will be extremely difficult to assess under current conditions. Banks' asset quality will therefore largely be shielded until 2021, but forward-looking loan-loss provisions will affect their profitability this year.

## Endnotes

<sup>1</sup> See [Government coronavirus aid has near-term benefits, but could raise long-term risks](#), 30 March 2020, and [Government measures will blunt coronavirus' negative effect on Cypriot banks](#), 18 March 2020.

<sup>2</sup> KEDIPEs, a residual asset management company that took on loans of the now resolved Cyprus Cooperative Bank Ltd, has announced deferrals on loans of €733 million, which are not part of banking system loans.

<sup>3</sup> The ratings shown are Bank of Cyprus Public Company Limited's deposit rating and Baseline Credit Assessment.

<sup>4</sup> Loans for most business lines excluding those classified under restructuring and recoveries.

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## Dubai World's completed debt repayment is credit positive for UAE banks

Originally [published](#) on 02 July 2020

On 30 June, United Arab Emirates (UAE)-based investment company Dubai World announced that it repaid its original creditors the \$8.2 billion final tranche of its restructured debt, two years ahead of the final maturity date of 30 September 2022. Dubai World's \$8.2 billion debt repayment is credit positive for UAE banks because it clears the final tranche of the restructured debt owed to UAE banks and international investors.

Since the first debt restructuring in 2011, Dubai World has repaid a total of \$18.9 billion, including \$16.9 billion of principal to the original lenders (including capitalised payment-in-kind interest) and \$2 billion of cash interest. Dubai World is sole shareholder of UAE-based Port and Free Zone World FZE (PFZW), which is sole shareholder of UAE-based [DP World PLC](#) (Baa3 stable), a large container terminal operator.

To repay its restructured debt, Dubai World received funds from its portfolio companies through dividend payments, including \$6 billion in total dividends from PFZW and \$1.6 billion in dividends from Infinity World, along with asset sales including \$2.7 billion from the sale of Economic Zones World. Additionally, Dubai World raised a new \$3 billion loan from [Dubai Islamic Bank PJSC](#) (DIB, A3 negative, ba2<sup>1</sup>).

The \$8.2 billion repayment's credit-positive effects for creditor banks vary depending on whether and how much the bank contributed to financing the new \$9 billion of PFZW debt guaranteed by DP World.<sup>2</sup> PFZW raised \$9 billion of debt (guaranteed by DP World) to buy out the minority shareholders of DP World, pay a \$5.15 billion dividend to Dubai World, and refinance some upcoming debt maturities and DP World's \$254.4 million of outstanding convertible bonds.

For creditor banks that did not lend to PFZW, Dubai World's debt repayment reduces their exposure to the Dubai World Group, a credit positive. For creditor banks that did lend PFZW an amount similar to their repayment from Dubai World, the Dubai World debt repayment improves their credit by effectively moving their claims to DP World, the cash-generating operating company (and guarantor of the \$9 billion PFZW debt), from Dubai World, the non-income-generating holding company. For creditor banks that lent to PFZW, we expect their net exposure to the Dubai World Group to gradually decline, given that DP World intends to repay or refinance part of the \$9 billion debt in the debt capital markets at a later time. DP World began the refinancing process with DP World Salaam's 24 June issuance of \$1.5 billion hybrid sukuk reset subordinated perpetual certificates.

The differences in creditors' gross exposure, carried provisions and agreements also vary the effects of the repayment for creditor banks. Disclosures about banks' exposure to Dubai World are limited, but we estimated in 2015, when Dubai World restructured its debt for a second time, that UAE banks held about 40% of its total debt. UAE systemwide total assets were \$860 billion as of April 2020. We believe that [Emirates NBD PJSC](#) (A3/A3 negative, ba1), which had \$188 billion of total assets as of March 2020, was among Dubai World's largest domestic creditors. In 2014, Emirates NBD reported a \$2.3 billion exposure to Dubai World, which decreased through amortisation and is now fully repaid.

UAE banks currently have a challenging operating environment. The coronavirus pandemic shocked the UAE's open economy and coincides with a significant drop in oil prices that weighs on its growth. Macroeconomic conditions were challenging for the banks before the pandemic, as a confluence of slower global trade, a strong currency, geopolitical tensions, moderate oil prices and cuts in oil production weighed on the UAE's economy in 2019.

### Endnotes

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

<sup>2</sup> On 22 June, PFZW, which previously owned only 80.45% of DP World, paid \$2.7 billion to the 19.55% of shares that PFZW did not already own, giving PFZW full ownership of DP World, which was then delisted.

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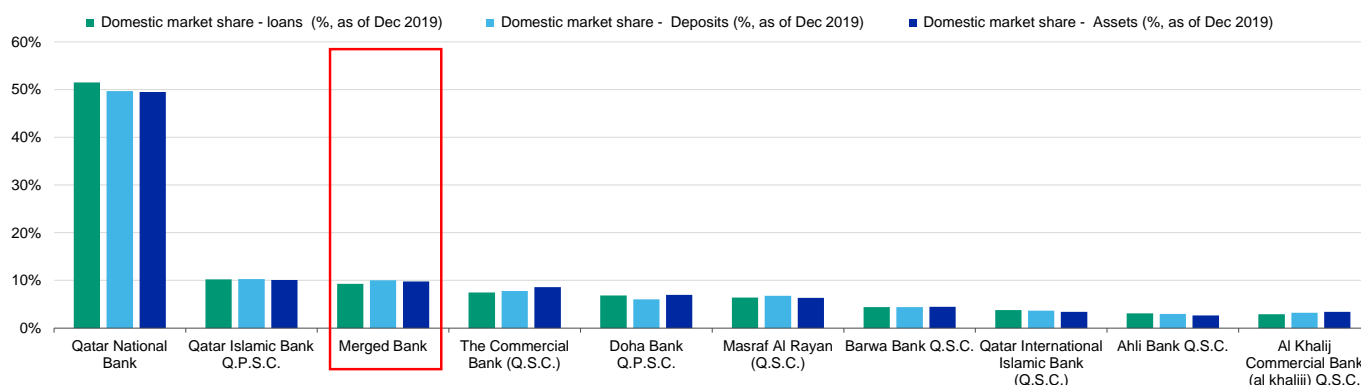
## Masraf Al Rayan's potential merger with Al Khalij Commercial Bank would enhance the combined entity's Qatar franchise

On 30 June, [Masraf Al Rayan \(Q.P.S.C.\)](#) (A1 stable, baa2<sup>1</sup>) and [Al Khalij Commercial Bank \(al khaliji\) PQSC](#) (A3 stable, ba1) announced that they had begun negotiations over a potential merger. The merged entity would continue to operate as an Islamic bank. Masraf is currently Qatar's fourth-largest bank, with a 6% share of banking system assets as of December 2019. Al Khaliji is one of the smaller banks in Qatar, with a market share of around 3% of system assets as of the same date. The proposed merger is at an early stage and subject to central bank, regulatory and government approvals, as well as the approval of the banks' shareholders once due diligence has been completed.

The merger would be credit positive for Masraf because the combined entity would lead to creation of an Islamic bank with an improved market share of total assets and position it as Qatar's third-largest bank behind [Qatar National Bank \(Q.P.S.C.\)](#) (Aa3 stable, baa1) and [Qatar Islamic Bank Q.P.S.C.](#) (A1 stable, baa2) (see Exhibit 1). The merger would also maintain the combined entity's (Masraf and Al Khaliji) position as Qatar's second-largest Islamic bank, enhancing its franchise and supporting its solid profitability. The merged entity would have total assets (both conventional and Islamic) of around \$45 billion, or around 9% share of total banking system assets.

Exhibit 1

### Banks in Qatar by market share



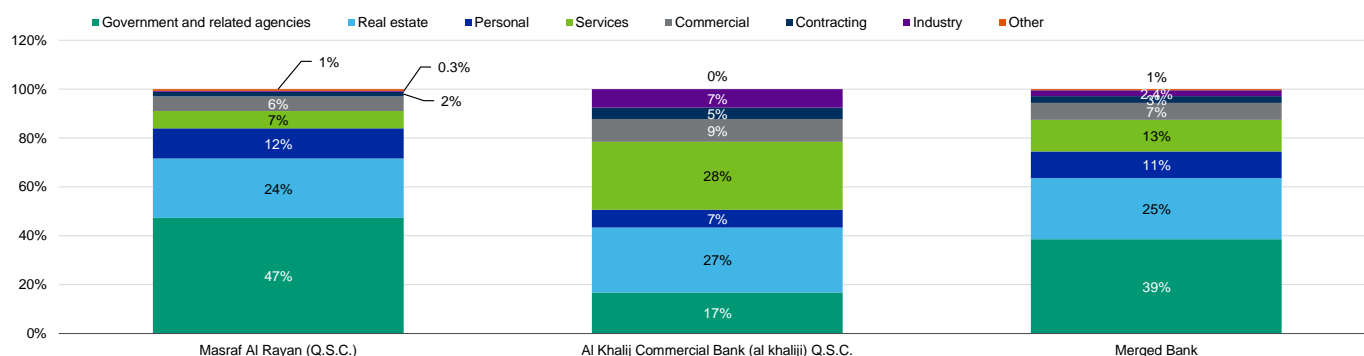
Sources: Banks' financial statements and Moody's Investors Service

The merged bank would have a larger Islamic franchise and market share, and therefore greater pricing power, which would support profitability. In addition, the larger scale will also help contain funding costs by enhancing the bank's deposit gathering ability amid Qatar's likely recession this year.

The merged bank's product diversification would benefit from the banks' individual segment strengths. Masraf has a strong relationship with the Qatari government, with loans to the government and public-sector entities making up around 47% of its financing book at year-end 2019 (see Exhibit 2). Al Khaliji has a solid corporate business, with loans to the government and public-sector entities comprising around 17% of its financing book at year-end 2019. While both Masraf and Al Khaliji have been focussing on retail banking, the merged bank will have the required scale which will support their retail banking business.

## Exhibit 2

## Financing portfolio breakdown by sector, December 2019



Figures for Masraf Al Rayan (Q.S.C.) include Al Rayan UK

Sources: Banks' financial statements and Moody's Investors Service

If the merger goes ahead, Masraf will absorb Al Khaliji's creditors, which would benefit from its stronger domestic government franchise and balance sheet. Masraf reports higher pre-provision income and net profitability, areas in which Al Khaliji compares unfavourably with domestic peers.

These potential benefits would need to be weighed against integration challenges that the merger may entail, as well as in light of the strategy the newly merged entity adopts. Once the new structure and strategy is agreed, we would assess any changes in overall risk profile, including the group's capital and profitability, liquid assets and access to funding.

The proposed merger would be the second consolidation in Qatar's banking system after [Barwa Bank Q.S.C.](#) (A2 stable, baa3) merged with International Bank of Qatar in 2019 to create Qatar's third-largest Islamic bank and sixth-largest bank overall. However, merger announcements in Qatar historically have not always resulted in a transaction. The successful merger between the above entities in 2019 followed the cancellation of a three-way merger between Masraf, Barwa Bank and International Bank of Qatar. Slowing economic growth amid low oil prices is driving banking sector consolidation both in Qatar and in the Gulf Cooperation Council states more broadly.

## Endnotes

<sup>1</sup> The bank ratings shown in this report are the banks' domestic deposit rating or issuer rating and Baseline Credit Assessment.

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## Kenya raises limit on insured deposits, a credit positive for smaller banks

Originally [published](#) on 03 July 2020

On 1 July, the Kenya Deposit Insurance Corporation (KDIC) increased the coverage limit of all deposits accounts to KES500,000 (around \$5,000) from KES100,000 per depositor per member institution, regardless of the currency denomination. Deposits covered include current, savings and time/fixed deposit accounts. The higher limit will cover 99% of deposits in banks and microfinance institutions (MFIs). The increase is credit positive for small and midsize Kenyan banks and MFIs because it will increase depositor confidence in them and decrease liquidity and funding risks related to volatility in retail deposits.

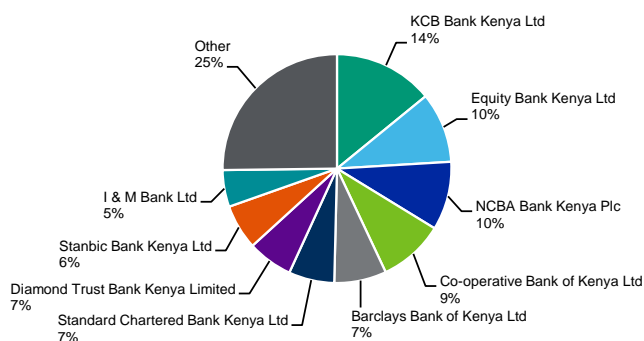
The higher deposit insurance will benefit most small and midsize banks, which typically attract retail depositors by offering higher interest rates than larger banks. The higher limit will support depositor confidence in smaller banks, helping them maintain retail deposit stability despite challenging market conditions.

The higher deposit insurance will have little effect on Kenya's largest banks, [KCB Bank Kenya Limited](#) (B2 negative, b2<sup>1</sup>), [Equity Bank \(Kenya\) Limited](#) (B2 negative, b2), NCBA Bank Kenya Plc and the [Cooperative Bank of Kenya Limited](#) (B2 negative, b2) because depositors already consider these the safest banks in the country and the higher deposit insurance is unlikely to affect their deposit flows.

Retail depositor confidence in Kenya's smaller banks has not fully rebounded from the failures of Imperial Bank, Dubai Bank and Charterhouse Bank between August 2015 and April 2016, which authorities allowed to enter liquidation, receivership and statutory management. Some depositors lost money beyond the deposit insurance guarantee. The increased deposit insurance, although still small compared to more developed markets, will cover 99% of Kenya's depositors and boost their confidence in smaller banks and MFIs.

The Kenyan banking system is overbanked for its size: 41 banks or about one bank per million of population compared with 0.3 in South Africa and 0.1 in Nigeria. We estimate that five banks control around half of system assets as shown in the exhibit below.

### Market shares in terms of assets, as of December 2018



The exhibit incorporates the 2019 merger of NIC Group Plc and Commercial Bank of Africa into NCBA.  
Sources: Central Bank of Kenya (Bank supervision annual report) and banks' financial statements

Most smaller banks with market shares below 5% have tougher funding conditions than larger banks because they have less ability to attract deposits. Consequently, they are more reliant on market funding which increases their funding costs and weighs on profitability. They often hold lower capital, have less efficient operations and are more exposed to the coronavirus- induced economic disruption.

Tighter supervision, higher global regulatory requirements globally and the need to invest in new innovative infrastructure and digital technologies are additional challenges.

KDIC administers the deposit insurance scheme. All deposit-taking financial institutions (such as commercial banks, financial institutions, mortgage finance companies, building societies and microfinance institutions) must be registered as a member with the KDIC. Every member institution contributes KES300,000 or 0.15% (the maximum limit as per the law is 0.4%) of the average of total deposit liabilities during the preceding 12-month period, whichever amount is the greater. To help banks tackle the effect of the coronavirus pandemic, premiums were delayed from July to December this year, while a risk-based premium model that would have been introduced in July, increasing the premiums, has been delayed by a year.

## Endnotes

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

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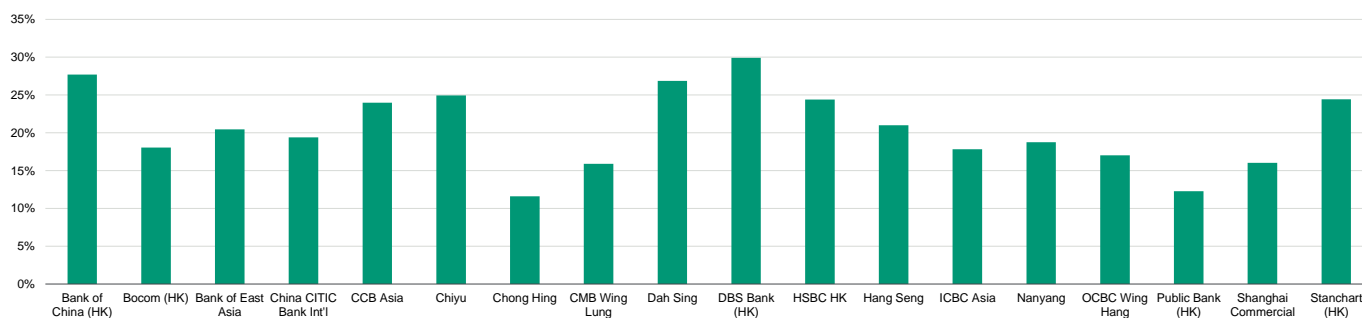
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## Launch of Wealth Management Connect Scheme is credit positive for Hong Kong banks

On 29 June, regulators in mainland China, Hong Kong and Macao launched the Wealth Management Connect Scheme, which will allow residents in Guangdong province, Southern China, to invest in eligible wealth management products distributed by banks in the special administrative regions (SARs) of Hong Kong and Macao, and for residents of the two SARs to invest in eligible products in Guangdong. The scheme is credit positive for Hong Kong banks because it will broaden the customer base of their wealth management products and increase their profitability.

Hong Kong banks have a competitive advantage over other banks in the Guangdong-Hong Kong-Macao Greater Bay Area in terms of mutual fund product offerings. The wealth management industry in Hong Kong is mature, comprising a host of well-established global asset management firms offering funds for diverse asset classes and geographies. Hong Kong banks are an important channel through which asset management firms distribute their mutual fund offerings and commissions from mutual fund sales are an important contributor to their overall profitability. Fee income on average accounted for 24% of 18 rated Hong Kong banks' total revenue in 2019 (see exhibit) and wealth management fee income accounted for between a low single-digit and double-digit percentage of their total fee income.

### Fee income accounts for a substantial proportion of Hong Kong banks' overall revenue



Sources: The banks and Moody's Investors Service

The potential market expansion is significant. Currently, individuals in Guangdong province do not have access to overseas mutual funds because of capital controls that limit fund outflows. Under the Wealth Management Connect Scheme, however, they will be able to open accounts with Hong Kong banks to invest in a diverse range of mutual funds. Guangdong is mainland China's wealthiest province with a GDP of RMB10.8 trillion (\$1.56 trillion) in 2019, compared with Hong Kong's HKD2.9 trillion (\$368 billion).

Banks with well-established wealth management sales activities in Hong Kong and whose affiliates have good access to affluent retail customers in Guangdong stand to benefit most from the scheme in terms of higher wealth management fee income. These banks include [The Hongkong and Shanghai Banking Corp. Ltd.](#) (HSBC HK, local currency Aa2 negative, a1<sup>1</sup>), [Bank of China \(Hong Kong\) Limited](#) (Aa3 stable, a2), [Industrial and Commercial Bank of China \(Asia\) Ltd.](#) (ICBC Asia, A1 stable, baa1), [Bank of Communications \(Hong Kong\) Limited](#) (Bocom (HK), A2 stable, baa2), [China Construction Bank \(Asia\) Corp. Ltd.](#) (CCB Asia, A1 stable, baa1) and [CMB Wing Lung Bank Limited](#) (A3 stable, baa1).

HSBC HK, in particular, has been expanding its footprint and product offerings in Guangdong province for a number of years. Besides mutual fund distribution, HSBC HK also has an asset management operation whose assets under management will also increase as a result of this scheme.

Although Hong Kong and Macao residents can also open accounts with mainland banks and invest in mainland wealth management products, the scheme will have less of an effect on mainland banks and asset managers. Potential fund inflows from residents in

Hong Kong and Macao into China will account for a small proportion of outstanding wealth management product asset pools in the mainland because of Hong Kong and Macao's small populations. The less mature wealth management industry in China may also deter investors in Hong Kong and Macao from allocating significant funds to mainland wealth management products under the scheme.

The official launch date of the scheme and details of its implementation are pending further announcements. Under the Wealth Management Connect scheme, funds transferred can only be used to invest in wealth management products and cannot be diverted to other uses.

## Endnotes

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

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## NEO's merger with Argo Capital adds to its core strengths, a credit positive

Originally [published](#) on 02 July 2020

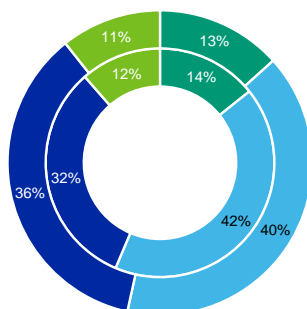
On 30 June, [NEO Investimentos](#) (MQ2 - very good) completed its merger with Argo Capital, an independent asset manager in Brazil focussed on multimarket funds. The merger is credit positive because it will raise NEO's assets under management (AUM) by 19% in its multimarket strategies, enabling it to earn more revenue and performance fees.

Established in 2003, NEO provides alternative investment vehicles including private equity, multimarket and long-only funds that target consistent long-term performance and capital protection. As of May 2020, the company had BRL3.7 billion in AUM, with three-quarters focused on equities and multimarket product types (see Exhibit 1). Argo is similarly focused on equity and multimarket products and on long-short strategies, making it a solid fit for NEO. On a combined basis, Neo's multimarket funds will increase by almost 20% to BRL1.5 billion, giving it an AUM boost from which it can earn more fees.

Exhibit 1

### Argo will add to NEO's core strengths...

■ Fixed income ■ Equities ■ Multimarket ■ Private equity

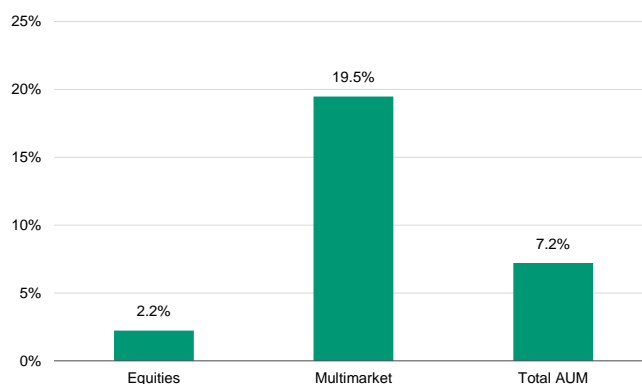


Inside circle is Neo standalone, outside circle is Neo and Argo combined. Data as of May 2020

Source: ANBIMA - Brazilian Association of Financial and Capital Market Institutions

Exhibit 2

### ...and lead to a 20% jump in multimarket AUM



Data as of May 2020

Source: ANBIMA

Argo was founded by Augusto Lange, a NEO founding partner who will return to a firm whose investment culture he helped create. We expect there to be limited integration risk. Argo currently has nine employees who will join NEO's team of 43 full-time employees.

The merger comes at an opportune moment for NEO: in January, another founding partner left the firm, although this had been planned, and during the first quarter NEO lost personnel to a bank-owned asset manager. Merging with Argo will help NEO shore up its investment management activities following those departures.

NEO's merger with Argo comes as Brazil's asset management industry grapples with the effects of the coronavirus pandemic. In April and May, net outflows from Brazilian funds wiped out the net positive inflows recorded in the first quarter of 2020, as market volatility led to a flight to quality. The industry's funds experienced approximately BR71 billion of net investment outflows during the first five months of 2020. Given that in the first quarter of the year net flows were positive, coronavirus-related volatility has wiped out first-quarter gains.

Total April and May outflows were BRL80.1 billion, driven by fixed-income fund outflows of BRL65.3 billion. However, equity inflows totaled BRL47.7 billion and multimarket inflows totaled BRL16.9 billion during the first five months of 2020. Against this backdrop, NEO reported net outflows of just BRL17 million in 2020 up to May, excluding the addition of Argo.

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## Tamaulipas, Mexico's new gas emissions fee revenue will aid own-source revenue recovery

On 30 June, the Mexican [State of Tamaulipas](#)' (Ba1/A1.mx negative) congress approved a new environmental fee on industrial air polluters. The fee is credit positive for Tamaulipas because it will generate new revenue for the state, supporting a recovery in own-source revenue in 2021 after its contraction this year amid a deep economic recession. The added fee revenue will give Tamaulipas additional financial flexibility and help contain operating and cash financing deficits.

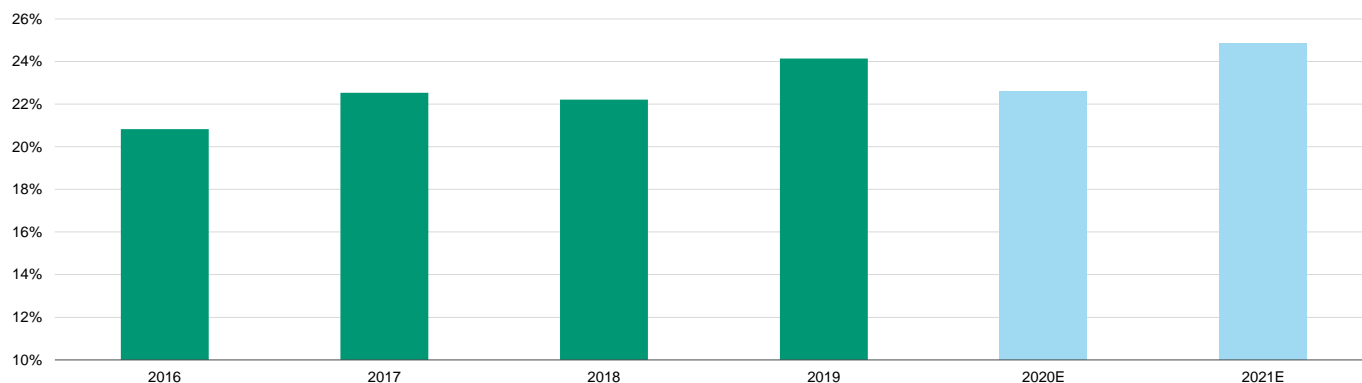
The fee will apply to companies that emit more than 25 metric tons of carbon dioxide per month, starting in 2021.<sup>1</sup> Tamaulipas will levy a fee of 261 pesos (\$11.50) per metric ton of carbon dioxide emissions,<sup>2</sup> as well as levies on other gases including methane, hydrofluorocarbons and sulfur hexafluoride.

The state projects that the new fee will generate MXN3.1 billion in additional revenue starting in 2021, a significant 36% increase over our estimates for 2021 total own-source revenue without the new emissions fee. However, we expect that the real effect will be much smaller given significant opposition to environmental taxes and fees from industrial groups, which have had some success using legal action to slow collections of environmental levies in the [State of Zacatecas](#) (Ba3/Baa1.mx negative). Nonetheless, Mexico's Supreme Court ruled last year that states are able to implement environmental levies, and we therefore project that Tamaulipas will be able to collect a portion of the new green fee.

While the state's own-source revenue, which includes taxes and fees, will likely contract in 2020 given the probability of a [deep recession](#) this year, we estimate the new emissions fee combined with the projected economic recovery next year will help lift Tamaulipas's own-source revenue to 25% of operating revenue in 2021 from our estimate that they will equal 23% of operating revenue in 2020 (see exhibit).

### Tamaulipas' emissions fee revenue will support a recovery in revenue in 2021

Ratio of own-source revenue to operating revenue



Sources: Financial statements of the State of Tamaulipas and Moody's Investors Service

Tamaulipas has been proactive in increasing its own-source revenue in recent years, implementing increases in its payroll tax rate and rolling out other new taxes on casinos and hotels, among other initiatives. The state's tax revenue grew at a compound annualized growth rate of 20% between 2015 and 2019, and own-source revenue as a share of operating revenue already exceeds the 17.7% median for Ba1-rated Mexican peers.

Despite rising revenue, Tamaulipas has had significant operating and cash financing deficits in recent years, which it financed with increased long-term borrowing. Given pressure related to the recession and the state's recurring spending pressures, we project that

Tamaulipas' cash financing deficit will widen to 4.1% of total revenue this year from 2.6% in 2019, but that the recovery in own-source revenue including the new emissions fee will support the deficit narrowing to 1.7% of total revenue next year.

The legislation creating the fee stipulates that the new revenue should be directed to projects that promote sustainable development and help prepare the state for climate change, encompassing a broad enough range of options that will allow the fee revenue to be used to fund infrastructure projects. Tamaulipas' liquidity position will nonetheless remain under pressure, which continues to be a key credit challenge.

## Endnotes

- 1** Companies will be responsible for reporting or estimating their emissions levels, which will be cross-referenced when needed against emissions registries maintained by the Federal Secretary of the Environment and Natural Resources (SERMANAT) and the state's Secretary of Urban Development and the Environment.
- 2** The fee will rise each year in line with the value of the Unidad de Medida y Actualización (UMA), an economic reference used to calculate fiscal obligations that is published by Mexico's statistics institute (INEGI).

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## Finland's measures support housing market, but weaken lending standards, a negative for banks and covered bonds

Originally [published](#) on 02 July 2020

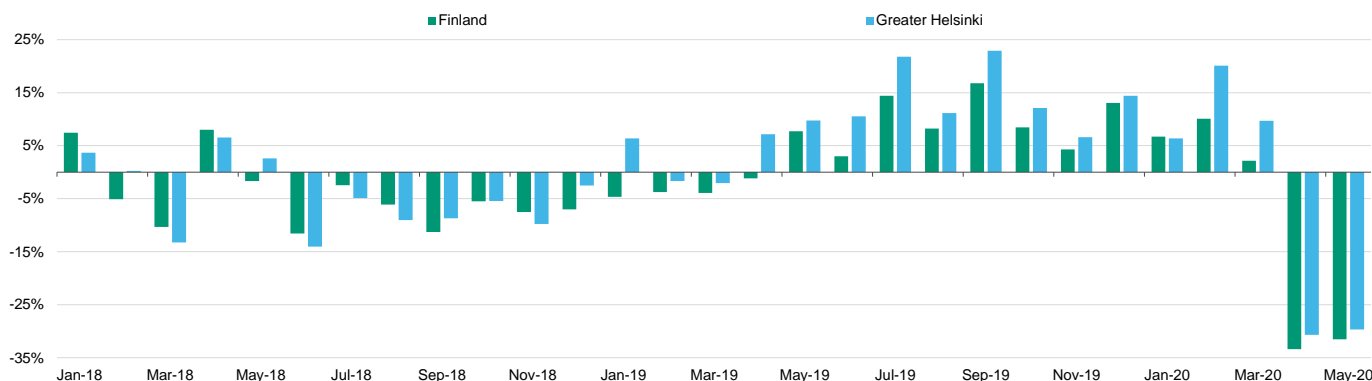
On 29 June, the Finnish Financial Supervisory Authority (FIN-FSA) [announced](#) that it would restore the maximum loan-to-collateral (LTC) ratio for residential mortgages to 90% from 85%, except for loans to first-time home buyers. The FIN-FSA measure supports the housing market amid disruptions caused by the coronavirus. The FIN-FSA decision is credit negative for lending standards affecting Finnish banks and covered bonds.

Restoring the LTC limit to 90% for mortgage loans is one of a series of actions by Finnish authorities to mitigate the coronavirus' negative economic effects. For instance, at the early stage of the crisis, the FIN-FSA reduced banks' capital requirements by [lowering the capital buffer requirements by 1%](#).

In the current climate of depressed activity in the housing and lending market, the FIN-FSA aims to support housing market activity, which has dropped sharply during the coronavirus lockdown. For instance, nationwide sales of apartments in housing companies decreased by 33.4% in April and 31.5% in May versus the prior year, as Exhibit 1 shows.

Exhibit 1

**Housing market activity has declined sharply during coronavirus lockdown**  
Annual change in the number of housing company apartment sales



Sources: Statistics of Finland and Moody's Investors Service

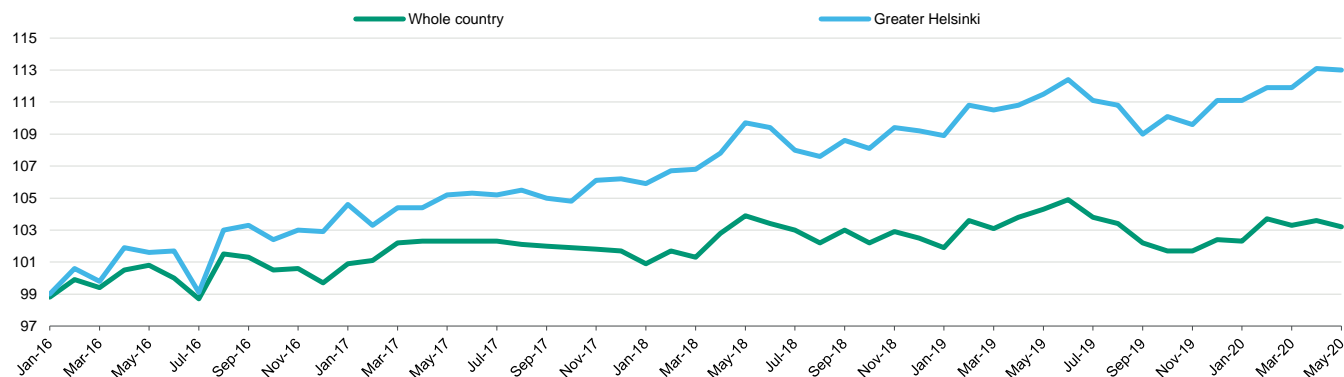
Raising the LTC cap indicates regulators' readiness to accept slightly higher leverage for households with strong loan repayment capacity as a way to allow more capital to flow into the housing market, thereby supporting house prices. The FIN-FSA has maintained its strict affordability lending restrictions to discourage borrowers taking on more debt than they can afford. Borrowers need to prove that they can repay the loan assuming a 6% interest rate and 25-year maturity. Moreover, currently low interest rates, which we expect will persist, support mortgage loan affordability in general. If the FIN-FSA and broader policy measures lead to a housing market rebound, then the credit quality of existing and new mortgages will improve.

Despite the significant lower number of transactions, property prices have not fallen markedly yet, supporting current loan to values for outstanding mortgages. In May 2020, the price of apartments in housing companies fell by 1.1% year on year in all of Finland, but increased 1.3% in the Greater Helsinki area (see Exhibit 2).

Exhibit 2

**Apartment prices fell moderately in Finland over year to May**

Price index for apartments in housing companies (2015 = 100)



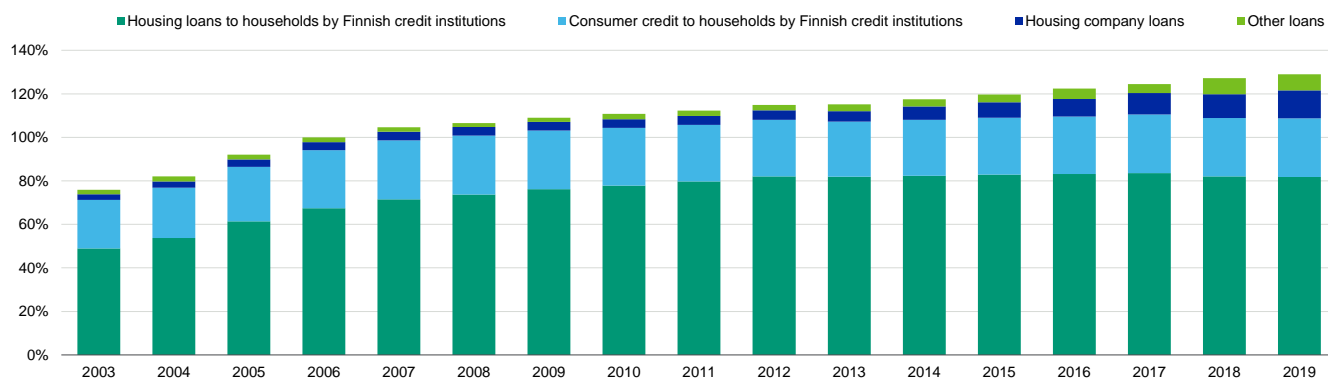
Source: Statistics of Finland

Higher leverage for new borrowers will reduce collateral value buffers for banks and covered bonds if banks adopt the higher LTC. If Finnish authorities' measures do not stabilize the housing market, a prolonged economic contraction and rising unemployment caused by the coronavirus pandemic risks triggering house price declines, increasing the risk that loan values for highly indebted borrowers will exceed collateral values. In such a scenario, the FIN-FSA's relaxation of lending standards will reduce mortgage asset quality in an environment where overall asset risk is already deteriorating because of rising unemployment and high household indebtedness. At the end of 2019, Finland's total household debt reached a record high level, representing 129% of disposable income (see Exhibit 3), but is still well below that of other Nordic countries.

Exhibit 3

**Household indebtedness has risen steadily in recent years**

Household indebtedness as percentage of disposable income



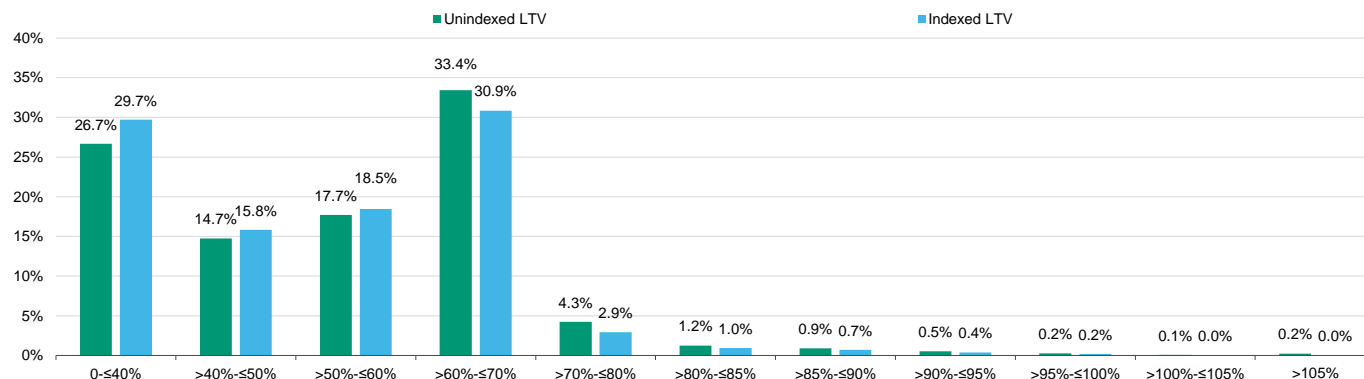
Sources: Statistics of Finland, Bank of Finland and Moody's Investors Service

Cover pool loans' relatively low leverage is the main specific mitigant for covered bonds to the potential negative effects of the relaxation of lending practices. On a continuous basis and by law, banks have to assure that their covered bonds are backed to 102% with residential mortgages and other high-quality assets. Only loan amounts up to 70% of the current property value count towards this calculation, providing a safety net against declining house prices. Loan-to-value (LTV) ratios for loans backing Finnish covered bonds are relatively low (Exhibit 4). The 70% LTV threshold is more conservative than the 80% threshold for residential mortgage loans that applies in many other European countries.

Exhibit 4

**LTV ratios of loans backing Finnish covered bonds are relatively low**

Average unindexed and indexed LTV distribution of Finnish covered bond programmes we rate



Data as of first-quarter 2020

Source: Moody's Investors Service

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# High US unemployment and low interest rates weigh on workers' compensation insurers' profitability

Originally [published](#) on 30 June 2020

Despite significant job gains in May, mandatory business shutdowns and loss of demand related to the coronavirus pandemic have caused a loss of 40 million jobs since March, pushing the US unemployment rate to 13.3% in June. This is an unprecedented decline for the workers' compensation sector, whose fortunes are closely tied to the macroeconomy, and payrolls in particular. Given ultralow interest rates and smaller reserve margins in addition to the high unemployment, profitability will decline for the sector over the next year even as claims frequency falls as a result of remote work and social-distancing measures.

**Sharp decline in payrolls will drive premiums lower.** Although the addition of 2.5 million jobs in May came as a surprise, the US economy has still nearly erased the total jobs created since the last financial crisis in 2009. The small business sector broadly and certain industries such as hospitality and leisure have been particularly hard hit. Workers' compensation insurers will see a sharp drop in premiums written in the coming quarters as payrolls decline, causing them to return some premiums to policyholders.

**Rates will likely decline further as claims frequency drops.** Workers' compensation rates have been declining for multiple years amid favorable loss cost trends. We expect rates to fall further, although the pace of decline is likely to slow. Despite a likely rise in claim costs from healthcare workers and first responders directly exposed to the pandemic, a sizable remote US workforce given the shelter-in-place restrictions will drive claims frequency down, keeping loss costs in check.

**Low interest rates and narrower reserve margins to pressure profits.** Workers' compensation insurers' profitability largely depends on investment income given the generally longer claim payout pattern that helps insurers earn money over time. The sharp decline in interest rates following the coronavirus-related economic downturn, as well as lower reserve margins from recent accident years, will reduce future earnings.

**Legislative and coverage issues complicate future claims.** Workers' compensation insurers face new regulatory challenges linked to coronavirus claims. Multiple states have recently amended regulations or passed new ones to shift the burden of proof for claims to employers, changing current law, which requires claimants to prove their cases. A handful of other states have enacted or announced workers' compensation rules that similarly presume employees contracted the disease because of their employment. These changes, and changes in the treatment of claims for furloughed workers, could lead to more coverage disputes, increased litigation, and rising costs for workers' compensation insurers.

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



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Nondas Nicolaides and Simon Ainsworth from the Financial Institutions team discuss the benign operating environment and reduced loan growth facing Swedish banks.

Related report: [\*Low for longer rates will challenge Swedish banks' margins and earnings resilience\*](#)

**Video: Financial conditions are stabilizing across emerging markets, but credit prospects remain fragile**, 29 June 2020

Rahul Ghosh from the Credit Strategy and Research team introduces our new Emerging Market Financial Conditions Indicators and outlines major emerging market credit prospects in the second half of 2020.

Related report: [\*Financial conditions stabilise, but pandemic fallout casts shadow on H2 credit prospects\*](#)

**Podcast: Pandemic hampers Latin American corporate liquidity but effects vary by country**, 29 June 2020

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REPORT NUMBER 1236423