Credit Outlook

16 July 2020

NEWS AND ANALYSIS

Corporates

» Acquisition of Maxim Integrated Products strengthens Analog Device's high-performance portfolio 2

» Hewlett Packard Enterprise's acquisition of SD-WAN provider is credit positive 4

» Asda job comparison court case may set credit-negative precedent for UK grocery sector 5

» Proposed merger with Shandong Energy is credit positive for Yankuang and Yanzhou Coal 6

» Macao ends quarantine for mainland tourists, a credit positive for gaming companies 8

» Modernland Realty's default risk stays elevated despite approval to restructure bonds 10

Infrastructure

» Kansas regulator authorizes Evergy to defer COVID-19-related costs and lost revenue 11

Banks

» Barclays' CET1 improvement is credit positive 12

» AIB customer compensation for overcharged mortgages adds to earnings pressure and social risk 14

» Bulgarian and Croatian banks will benefit from entry to EU banking union and future euro adoption 15

» Opera's proposed acquisition of Fjord Bank is credit negative for other Lithuanian banks 17

» Indonesia Deposit Insurance Corporation can now provide short-term liquidity to banks, a credit positive 19

Exchanges and Clearing Houses

» European clearing houses pass ESMA's regulatory stress test, a credit positive 20

Insurers

» For Global Atlantic, KKR's acquisition is credit positive 22

» India injects capital in three state-owned insurers, a credit positive amid operational challenges 24

Sovereigns

» Weakening of Poland's institutions will likely continue after presidential election, a credit negative 25

CREDIT IN DEPTH

» Racial disparities exemplify US' long-standing and growing income and wealth inequalities that raise social risk 27

Many social and economic issues have contributed to the US' increased political polarization, and racial inequality will be a potent force for further potential polarization.

» Coronavirus pandemic will accelerate and reshape credit trends in structured finance 30

COVID-19 will alter the risk profile of many asset classes in the global structured finance market. We assess credit implications likely to materialize a few years from now.

RECENTLY IN CREDIT OUTLOOK

» Articles in last Monday's Credit Outlook 31

» Go to last Monday's Credit Outlook

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Acquisition of Maxim Integrated Products strengthens Analog Device's high-performance portfolio

Originally published on 13 July 2020

On 13 July, Analog Devices Inc. (Baa1 stable) announced an agreement to acquire Maxim Integrated Products Inc. (Baa1 stable) in an all-stock transaction that values the combined enterprise at over $68 billion, with Maxim valued at approximately $21 billion. The credit-positive transaction, unanimously approved by both companies' board of directors, will strengthen Analog with increased breadth and scale across multiple end-markets. Subject to shareholder and regulatory approvals, the companies expect the transaction to close in mid-2021. Upon closing, current Analog shareholders will own approximately 69% of the combined company, while Maxim stockholders will own approximately 31%.

In addition to the acquisition's strong strategic fit, the acquisition would combine two very profitable analog semiconductor companies with complementary technologies, products, and capabilities, solidifying Analog's very strong position in the high performance analog market, with $7.7 billion of combined revenue and $3.3 billion of EBITDA as of the 12 months to 31 March 2020. Reflecting very high quality earnings and efficient business models, the combined companies convert over 80% of EBITDA into cash flow after capital spending.

Both companies have strong positions in very diversified end markets with Maxim having relative strength in automotive and data center markets, while Analog excels across the broad industrial, optical communications and digital healthcare markets. The combined entity will have highly differentiated products across similar end-markets in industrial (44% of combined revenue), communications (21%), automotive (18%), and consumer (17%), all of which contributes to gross margins in the high 60% range.

The broader portfolio and revenue base over which the company will be able to leverage research and development spending (18% of combined revenue), should improve profit margins and cash flow from already strong levels. With a growing scarcity of analog engineers at customer operations, those customers increasingly rely on analog semiconductor companies like Analog to help design increasingly complex electronic systems.

Analog targets $275 million of cost synergies over the first two years from closing, which Moody's views as achievable, subject to low execution risk, and consistent with the company's previous acquisitions of Hittite Microwave Corporation ($2.4 billion purchase price in July 2014) and Linear Technology Corporation ($15.8 billion in March 2017). The targeted savings are split roughly equally between cost of goods sold and operating expenses, with most of the operating expense savings coming from SG&A. Additional cost synergies can be realized by optimizing the manufacturing and back-end test and assembly footprints over a longer period.

Even during the COVID-19-driven weakness in end demand during 2020 that will pressure earnings, we project leverage of the combined entity will be modest at closing, with adjusted gross debt to EBITDA of about 2x and free cash flow after dividends to adjusted gross debt near 30%. With a suspension of share buybacks until closing and Maxim agreeing to suspend its dividend payment (after its first quarter payment) during the approval process, we project combined cash balances will grow to over $3 billion by the expected closing in mid-2021.

Over the last decade, Analog has been free cash flow positive every quarter, and Maxim has had only two quarters of negative working capital-driven free cash flow ($10 million and $14 million). Over the next year, we anticipate Analog will use its free cash flow to repay a $450 million debt maturity in January 2021. Analog also maintains an unused $1.25 billion unsecured revolving credit facility that matures in June 2024 under which it has full access, same day availability, no requirement to re-represent as to no material adverse change, and significant cushion under its financial covenant.

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

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Hewlett Packard Enterprise's acquisition of SD-WAN provider is credit positive

Originally published on 13 July 2020

On 13 July, Hewlett Packard Enterprise Co. (HPE, Baa2 stable) it will acquire privately held Silver Peak, a provider of software-defined wide area networking platforms and services for $925 million. With estimated revenue that is about 0.5% of HPE's annual revenue, the credit- positive acquisition will augment HPE's ability to help enterprise and service provider customers simplify and provide secure branch connectivity that integrates with local edge compute that manages and controls application traffic from users and Internet-connected devices. It will not materially affect HPE's overall results.

Silver Peak has about a 9% share (behind market leader Cisco's 16% share, VMware and Fortinet) of an estimated $2 billion market that is growing over 20% per year. A challenge for HPE will be to effectively integrate Silver Peak with HPE's existing Aruba-based network offerings to ensure a consistent approach to hardware, software, licensing, go-to-market and technology roadmap.

HPE' maintains good market positions, diversity, and significant scale and breadth of product offerings in areas such as servers, storage, and networking. Nevertheless, a shifting IT landscape and competitive pressures on price and performance from large and smaller emerging competitors will remain intense, thereby raising the bar on consistent execution and cost containment while investing in R&D and effectively partnering. Targeted acquisitions will play an important role in building out capabilities and offsetting declines in legacy offerings, requiring the use of balance sheet cash and/or incremental debt.

With cautious and weak IT spending during the COVID-19 induced reduction of business activity, we project HPE's revenue will decline by around 15% to about $25 billion in fiscal 2020. Reflecting ongoing mix shifts to higher value offerings, EBITDA margins improved by nearly one percentage point during fiscal 2019 to 16.5% and, despite currently weak demand conditions, increased to 16.7% for the 12 months ended April 2020. With cost savings offset by challenging competitive dynamics, we project EBITDA margins will remain in the 16% range through fiscal 2020.

Modest leverage, with adjusted gross debt to EBITDA projected to be below 2x for fiscal 2020 and solid liquidity supports investment needs to pursue the company's strategies encompassing cloud enabled, edge-centric, and data driven enterprise computing. After having repurchased $355 million of stock in the first half of fiscal 2020, HPE suspended share repurchase activity in April at the onset of COVID-19. We expect dividends for the full year will approximate $620 million, with variation driven by working capital.

HPE maintains a strong liquidity profile, with $5.1 billion of cash and equivalents at April 2020. In fiscal 2020, after dividends of about $620 million, Moody's expects $600 million of free cash flow, with variation driven by working capital. We expect cash and equivalents to decline to about $3.6 billion by the end of fiscal 2020 after assuming repayment of a $3 billion note in October. HPE has additional liquidity in the form of a $4.75 billion, revolving credit facility that matures August 2024 to support commercial paper borrowings, which were $605 million at April 2020. The revolving credit facility has same day availability and ample room under financial covenants.

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Asda job comparison court case may set credit-negative precedent for UK grocery sector

Originally published on 14 July 2020

On 13 July, the UK Supreme Court began hearing an appeal by UK supermarket Asda, owned by US retail giant Walmart Inc. (Aa2 stable), seeking to overturn a ruling that store workers' roles can be directly compared to those of depot workers.

If the court does not overturn the previous rulings it will be credit negative for Asda and other UK grocery retailers Tesco PLC (Baa3 stable), Wm Morrison Supermarkets plc (Baa2 stable), J. Sainsbury plc and the Co-op because they face similar pay claims. If the final decision in this long-running litigation finds in favour of the claimants, Asda may ultimately[1] have to pay compensation to store workers, ongoing higher labour costs, and the case may set a precedent for other retailers' ongoing claims.

Asda claims that more than 40,000 mostly female store workers cannot compare their jobs with those of the mostly male workers at its distribution centres, who are paid more, because the roles require different skills. Hearings in other courts will determine whether the two job types are of equal value and should be paid the same. Hourly rates of pay in stores are the same for male and female colleagues and this is also the case in the distribution centres.

Lawyers for the workers say the five supermarket chains could have to pay out £8 billion if the legal actions, which started more than a decade ago, are successful. If the previous rulings are upheld, Asda could be forced to pay compensation of £10,000-£20,000 to each claimant, implying compensation £430-£860 million a year.

Our view of Tesco and Morrisons' credit quality does not factor in the potential payout of compensation from their own ongoing legal claims because of the high degree of uncertainty about the final outcomes. However, human capital, including labour relations, is one of the key social considerations under Moody's social heatmap. Although clearly credit negative if the companies were ultimately forced to pay compensations, we estimate Tesco would have to pay £2.5 billion of compensation in one year and raise debt before its Moody's-adjusted debt/EBITDA ratio exceeded 4.5x, which is the upper end of what we expect for its Baa3 rating. Our calculation is based on Tesco's pro forma figures for the 2020 fiscal year, which ended 29 February. Morrisons would have to pay out £400 million before its leverage ratio would rise to 3x, the upper end of what we expect for its Baa2 rating.

Increasing the basic hourly rate for all store staff would also add to companies' operating costs. EBITDA would decline as a result, assuming retailers did not offset the decline by cutting staff numbers or increasing automation.

If Asda loses its appeal, the court will begin the process of determining if the two roles are of equal value. This will probably take years to work its way through the court process. Although the Asda case does not predetermine the outcome of the similar claims against other UK grocers, it sets a precedent that the courts would have to consider when evaluating other cases.

Endnotes

1 We understand that if the court does not find in favour of Asda in this case it does not determine the final outcome but means that the claimants can continue to run their case.

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Proposed merger with Shandong Energy is credit positive for Yankuang and Yanzhou Coal

Originally published on 15 July 2020

On 12 July, Yanzhou Coal Mining Company Limited (Ba1 stable) announced that its parent Yankuang Group Company Limited (Ba1 stable) and Shandong Energy Group Company Limited are working on a merger, pending regulatory approval.

The potential merger of Shandong province's top state-owned coal mining firms and their reorganization would be credit positive for Yankuang and Yanzhou Coal because both would likely benefit from the stronger credit profile of a larger group.

Reorganization details have not been released but the combined group will strengthen its business profile through a larger scale, increased diversity and a market-leading position, particularly in China's coal industry, assuming the merger is equal. We estimate that the combined raw coal production volume of Yankuang (including Yanzhou Coal) and Shandong Energy would be about 290 million tonnes in 2019, making the combined group the second-largest coal producer in China.

The combined group will generate business synergies as the companies have coal mining, chemical, trading and construction businesses. Shandong Energy also holds power generation assets that can be integrated with the combined group's coal mining businesses. This will help the combined group reduce the inherent volatility of its coal and power generation operations.

Because the combined group will derive most of its businesses from coal mining, we expect its credit profile to remain constrained by significant carbon transition risks and exposure to coal-price volatility.

We estimate that the combined group's credit profile would be stronger, with pro forma consolidated debt/EBITDA at around 4.9x compared with Yankuang's weaker 5.8x at year-end 2019 (see exhibit).

Pro forma of key financials of Yankuang and Shandong Energy
2019

(RMB millions)	Yankuang	Shandong Energy	Pro-forma
Revenue	285,415	358,497	643,912
Gross Profit	44,102	41,336	85,438
EBITDA	32,809	30,768	63,577
EBITDA Margin (%)	11%	9%	10%
Debt	191,546	122,371	313,918
Reported Assets	318,548	310,333	628,881
Debt/EBITDA	5.8x	4.0x	4.9x
Raw coal production (million tonnes)	166	125	291

[1] All ratios for Yankuang are based on "Moody's-adjusted' financial data and incorporate Moody's Global Standard Adjustments for non-financial corporations.
[2] All ratios for Shandong Energy are Moody's estimates
Sources: 2019 audited annual reports of Yankuang and Shandong Energy, Moody's Financial Metrics™ and Moody's Investors Service estimates

As a state-owned enterprise (SOE), we expect the combined group will continue to benefit from the strong support of the Shandong Provincial Government. We estimate the combined group will have total assets of RMB629 billion and revenue of RMB644 billion, which will make it either the largest or second-largest SOE under the control of the Shandong government. However, provincial support will remain constrained by the predominantly commercial and competitive businesses of the combined group.

Details not yet announced include the final terms of the merger, and the merger includes integration challenges and asset and business restructuring issues, factors that could affect the credit profiles and ratings of Yankuang and Yanzhou Coal.

The reorganization is consistent with the state-owned enterprise reform promoted by the Shandong government to concentrate its state-owned assets in leading companies to enhance efficiency and asset profitability.

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Macao ends quarantine for mainland tourists, a credit positive for gaming companies

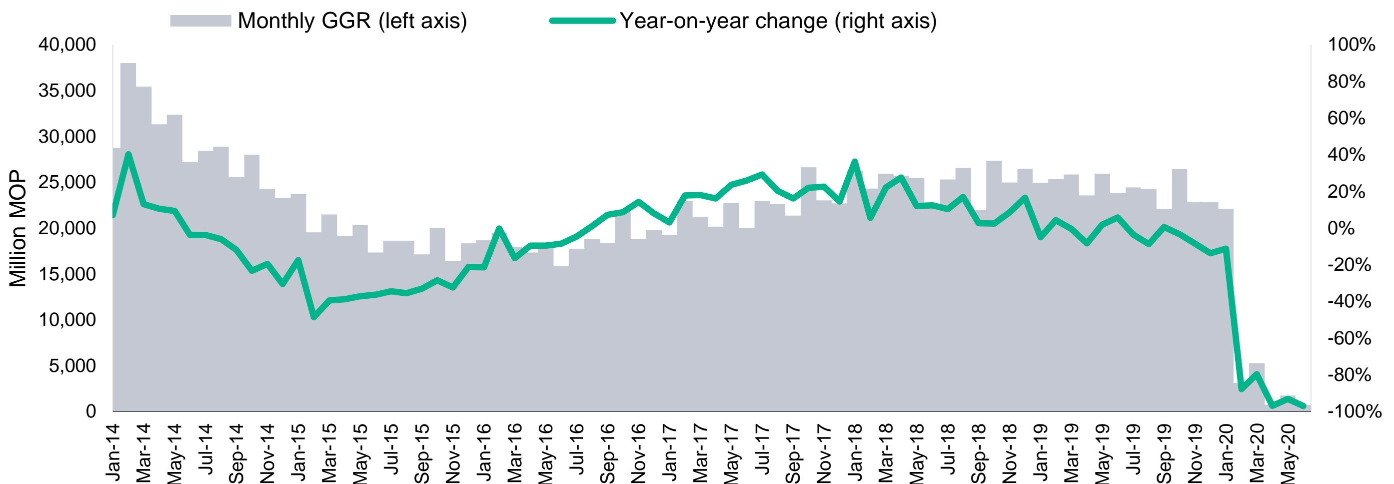
Originally published on 14 July 2020

On 14 July, the Government of Macao SAR (Aa3 stable) and Zhuhai Municipal Government announced that the 14-day mandatory quarantine requirement for travel between the SAR and Guangdong province will be removed, effective 15 July.

The development is credit positive for gaming companies with operations in Macao SAR because Chinese tourists accounted for around 71% of tourist arrivals to Macao SAR in 2019; they also accounted for a high percentage of gaming operators' Macao revenue in our estimate. Macao SAR is the largest gaming destination globally in terms of gaming revenue. For instance, Melco Resorts & Entertainment Limited, the parent of Melco Resorts Finance Limited (Ba2 negative), derived about 87% of revenue from Macao SAR in 2019.

We expect the removal of the quarantine requirement will lead to a gradual rebound in Macao's gross gaming revenue (GGR) because of the likely pent-up demand for tourism for people from mainland China. The city's GGR fell 77% during the first half of 2020 from MOP150 billion ($18.8 billion) a year earlier – with a 97% drop in June – because of travel restrictions in place as a result of the coronavirus outbreak.

Macau's monthly gross gaming revenue (GGR)



Source: Gaming Inspection and Coordination Bureau of Macao SAR

A moderate rebound in the GGR in the second half of 2020 will reduce the extent of the gaming operators' cash burn. We estimate that gaming companies' Macao operations will need the GGR to return to 35%-50% of the 2019 levels to break even at the EBITDA level.

However, we expect that recovery in Macao SAR's gaming market will be prolonged. For example, the Government of China's (A1 stable) issuance of the Individual Visit Scheme (IVS) permits for Macao SAR remains suspended. In 2019, about half of Chinese tourists traveled to Macao on these permits. Various new requirements such as negative test results for the coronavirus and a mandatory 14-day stay in Guangdong province for non-Guangdong residents returning from Macao are also likely to limit the recovery.

Travel restrictions remain mostly in place for travelers from Hong Kong SAR (Aa3 stable), where the number of new infections has risen recently. Tourists from Hong Kong SAR accounted for 19% of arrivals in Macao SAR in 2019.

We expect that recovery in Macao SAR's gaming market will continue over the next one to two years. But risk persists because of the likely reluctance of some tourists to travel during the coronavirus outbreak and sluggish economic growth. The highly discretionary and nonessential nature of consumer spending on casino gaming makes the sector vulnerable to changes in regional and domestic economic conditions. We do not expect financial metrics of gaming operators with operations in Macao SAR in 2021 to recover to the 2019 levels because of the prolonged recovery of revenue and an increase in debt.

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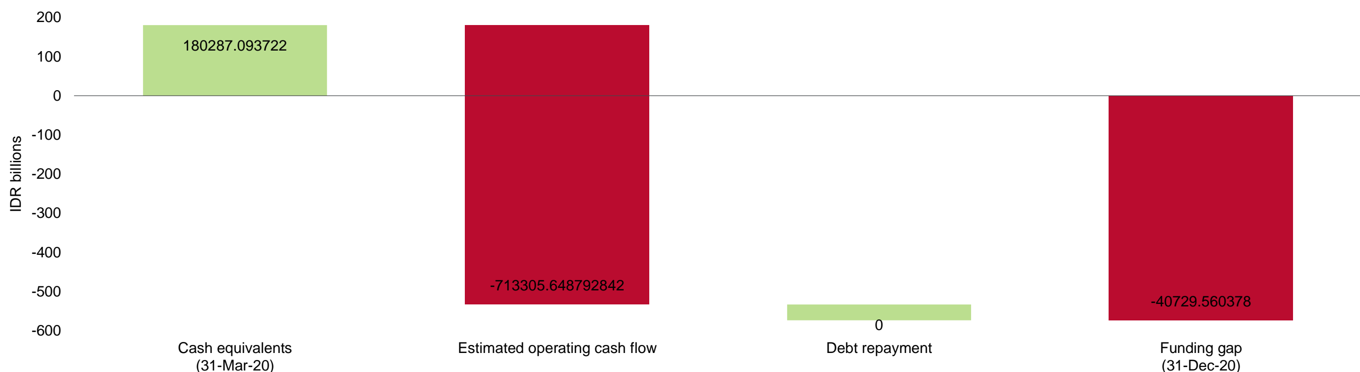
Modernland Realty's default risk stays elevated despite approval to restructure bonds

Originally published on 15 July 2020

On 14 July, Modernland Realty Tbk (P.T.) (Ca negative) announced that it had held a formal meeting with onshore bondholders and received approvals to restructure its IDR150 billion ($10 million) bond that was supposed to be repaid on 7 July 2020. The successful restructuring within a 10-day grace period from the maturity of the IDR bonds has allowed Modernland to advert an event of default under the indentures of its US dollar bonds – I.e. $150 million with coupon of 10.75% due August 2021 and $240 million with coupon of 6.95% due April 2024. Nonetheless, the risk of default on Modernland's US dollar bonds remains elevated.

Unless the company is able to secure external funding, we expect it will not have sufficient funds to meet the interest payments on its US dollar bonds of around $8 million in August 2020 and another $8 million in October 2020. A missed payment not remediated within a 30-day grace period will lead to an event of default under the bond indentures.

Modernland will require external funds to cover ongoing cash needs in 2020



Debt repayment considered the payment extension on Modernland's IDR150 billion bond.
Sources: Moody's Financial Metrics™ and Moody's Investors Service estimates

Majority of Modernland's onshore bondholders agreed to extend the IDR150 billion bond principal payment by one year to 7 July 2021 and reduce the coupon rate to 10% from 12.5%. In return, Modernland will provide additional collateral in the form of land, such that value of the collateral will cover 200% of the principal amount. At the same time, the company agreed to make a mandatory prepayment if its cash balance increases to IDR300 billion, which is twice the principal amount.

Modernland's restructuring of its IDR bonds constitutes a distressed exchange, which is included in our definition of default event (see Default Trends – Global : Distressed exchanges will likely rise in tandem with corporate defaults, 27 March 2020). This transaction allowed Modernland to avoid an eventual default event since the company does not have sufficient funds to make the principal payment. Further, the one-year debt maturity extension at a lower coupon rate reflects an economic loss to bondholders.

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Kansas regulator authorizes Evergy to defer COVID-19-related costs and lost revenue

Originally published on 15 July 2020

On 10 July, the Kansas Corporation Commission (KCC) authorized Evergy Metro Inc. (Baa1 stable) and Evergy Kansas Central Inc. (Kansas Central, Baa1 stable) to defer expensing all incremental costs, net of savings, and track lost revenue related to the coronavirus pandemic, accumulating a regulatory asset. This regulatory asset plus carrying costs will be considered for potential future recovery, a credit positive if ultimately recovered.

Evergy Inc. (Baa2 stable), Evergy Metro's and Kansas Central's parent company, said it will ask the KCC to decide the amount of expense deferrals and lost revenue the utilities can recover in its next general rate case, expected in the second half of 2023. On 29 June, Indiana's regulatory commission denied a group of Indiana utilities' request to recover lost revenue associated with COVID-19. Many other utilities have filed for deferral of COVID-19 incremental costs or bad debt expense for future recovery, which have been approved. Any allowed recoveries will be considered an alternative revenue under GAAP.

Under the accounting authority order, Evergy will accumulate and defer for potential recovery all incremental costs, net of any cost savings, as well as any lost revenue associated with the COVID-19 pandemic, per conditions in the KCC Staff Report and Recommendation of 20 May, summarized in the exhibit below.

Summary of Kansas Corporation Commission's staff conditions

Conditions
A detailed identification of all COVID-19-related cost increases and decreases that Evergy has tracked to date.
- These costs should be separated and reported by detailed cost category and by month.
A detailed identification of revenue changes by customer class (both increases and decreases) during the COVID-19 pandemic.
The impact COVID-19 had on Evergy' s capital expenditure program during the previous quarter.
Any issuances of short-term and long-term debt during the previous quarter and the all-in costs at which that financing was issued.
The embedded cost of short-term debt for that quarter.
Updated and most recent credit metrics calculated by Evergy or provided to the company by nationally recognized credit rating agencies.
Any correspondence with nationally recognized credit rating agencies and equity analysts during the previous quarter.
Copies of credit rating agencies and equity analysts' reports published during the previous quarter.

Source: Kansas Corporation Commission

The ability to recover under-collected revenue compared to an authorized revenue level is akin to a temporary decoupling mechanism and would be a constructive regulatory outcome. However, the KCC is seeking an enhanced level of tracking and reporting under the accounting authorization order, similar to its 20 June order seeking additional disclosure related to activist investor Elliott Management Corp's involvement under a February 2020 governance agreement with Evergy. Any recoveries under the accounting authorization order will be beyond 2020 and we expect Evergy's 2020 financial results will still reflect the margin lost due to the pandemic.

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Barclays' CET1 improvement is credit positive

Originally published on 14 July 2020

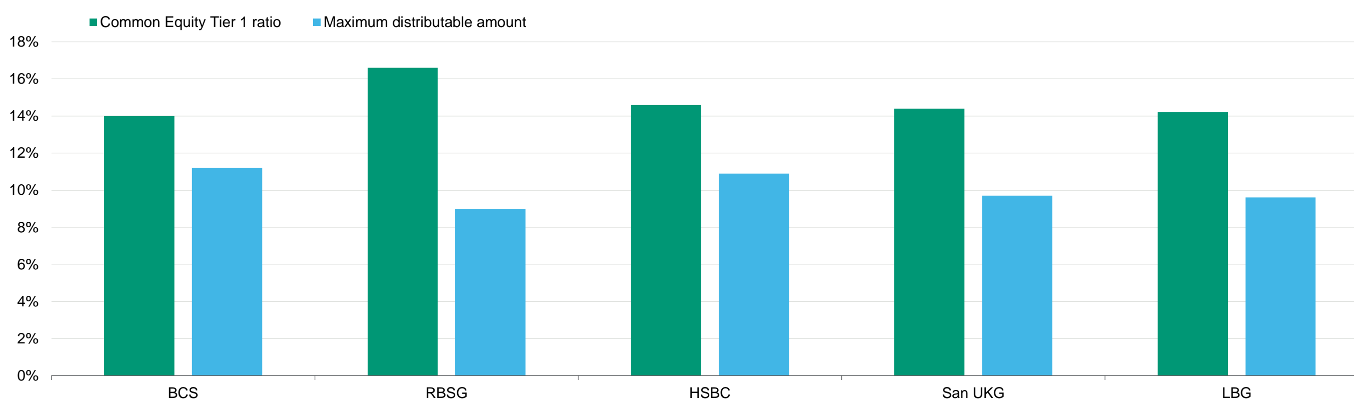
On 13 July, Barclays PLC (Baa2 stable, baa2[1]) announced that its Common Equity Tier 1 (CET1) capital ratio had risen to approximately 14% at 30 June 2020 from 13.1% at 31 March. The credit-positive increase exceeded the market's expectations and was the result of both regulatory changes and lower-than-expected risk-weighted assets (RWAs). The regulatory changes reflected changes to the Capital Requirements Regulation implemented in June 2020, which include transitional relief[2] for IFRS9 impairments, revised rules for calculating the prudential valuation adjustment to capital.

Although positive, the improvement in the CET1 ratio and the increased buffers relative to minimum requirements brings Barclays more in line with other large UK banks, which have yet to report their second-quarter CET1 ratios and will likely also benefit from similar regulatory calculation revisions. Barclays' CET1 buffers also benefitted from the Prudential Regulatory Authority's (PRA) change in its approach to calculating Pillar 2A requirements from a percentage of RWAs to a nominal basis, which reduced the maximum distributable amount hurdle[3] to 11.2% at 30 June 2020 from 11.5% at 31 March 2020 (see Exhibit 1).

Exhibit 1

Large UK banks' Common Equity Tier 1 capital ratio and maximum distributable amount

Data as at 31 March 2020; Barclays as of 30 June 2020

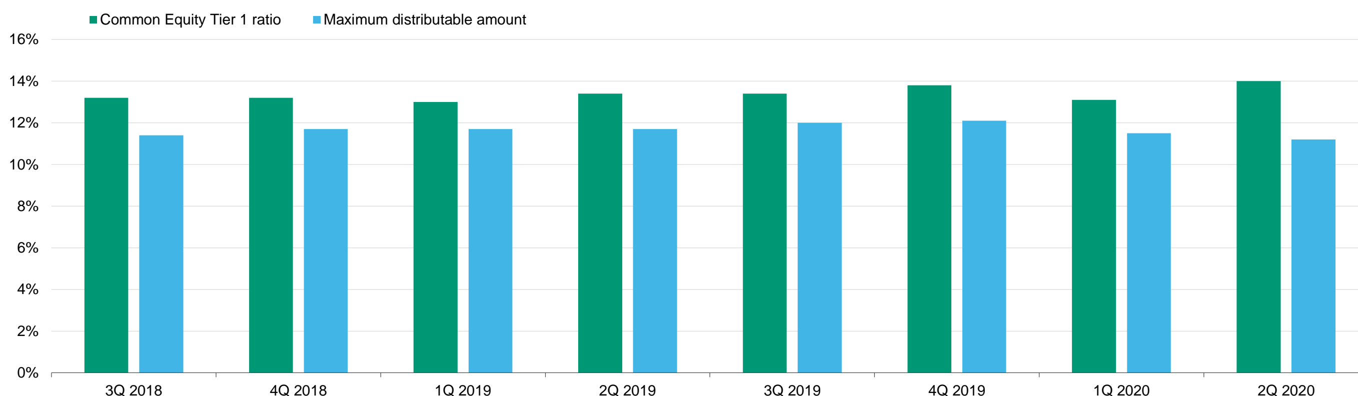


Key: BCS = Barclays plc; RBSG = The Royal Bank of Scotland Group; HSBC = HSBC Holdings plc; San UKG = Santander UK Group Holdings plc; and LBG = Lloyds Banking Group

Sources: The banks

We note that capital generation was not referred to as driving Barclays' reported increase in the CET1 ratio, and that instead highlighted it was revisions in regulatory and accounting rules for the calculation of capital and lower than expected RWAs. We therefore expect the CET1 ratio and buffers to decline over the coming quarters. The decline will reflect the deterioration in the economic environment because of the coronavirus pandemic, including effects on Barclays' customer base, resulting in an increased level of RWAs. The decline will also affect pre-provision income because of a lower demand for credit, to the extent this it is not offset by stronger capital markets earnings. The ratio will also be challened by transitional relief for IFRS9 impairments tapering off over the medium term.

Exhibit 2
Barclays Common Equity Tier 1 ratio and maximum distributable amount



Source: Barclays

Endnotes

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

2 Transitional relief is where a proportion of new impairment provisions are added back to CET1 on a reducing scalar basis until 2022.

3 This is the regulatory requirement which banks capital must exceed to continue to make capital distributions to shareholders. Regulators will incrementally prevent capital distributions if a bank's capital falls below this amount.

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AIB customer compensation for overcharged mortgages adds to earnings pressure and social risk

On 13 July, the Central Bank of Ireland (CBI) indicated that it expects AIB Group plc (Baa2 stable), the holding company of Allied Irish Banks, p.l.c. (AIB, A2/A2 stable, baa2[1]), to immediately compensate more than 1,100 of its customers after the bank used the wrong tracker mortgage rate. AIB estimates the average compensation at €6,000 each, or a total of €6.6 million. Although the expense is modest, it is credit negative for AIB, particularly from a social risk perspective, as well as the additional pressure it puts on its bottom line amid low credit demand and increased loan-loss provisions in the coronavirus-induced recession.

The compensation would go to customers with tracker mortgages from AIB subsidiaries EBS dac (A2 stable, baa2) and Haven Mortgages Limited, which AIB identified as being charged the wrong margin over the European Central Bank rate. The incidents of overcharging date back to 2006.

The €6 million expense is modest relative to AIB's €610 million total tracker provisions as at year-end 2019. The provisions include €70 million allocated for enforcement and €264 million already utilized towards direct and indirect costs of regulator-mandated customer redress of tracker mortgages. In December 2015, the CBI launched an industrywide tracker mortgage examination, which ended last year, but their conclusions have not yet been announced.

Tracker mortgages accounted for 13% of AIB's gross loans as of year-end 2019. The bank's ratio of problem loans to gross loans was a moderate 5.38% as of the same date. AIB is the highest capitalized and most profitable bank in Ireland. It had fully loaded Common Equity Tier 1 (CET1) capital of €10.7 billion, resulting in a ratio of CET1 capital to risk-weighted assets of 17.3%[2] versus its peers' average of 14.9% as of year-end 2019. Given AIB's solid capital and sizable provisioning reserves for tracker mortgages, the bank is in a position to accommodate potential regulatory fines and mortgagors' compensation.

The CBI's tracker mortgage investigation reflects a social risk to which banks are exposed through their interactions with customers, employees and other stakeholders. As we stated in our 2019 report on how environmental, social and governance risks affect bank ratings, social risks generally have a moderate effect on banks' credit quality because banks' financial and operational flexibility and history of adjusting to emerging social issues generally act as mitigants.

AIB reported net income of €364 million as of year-end 2019, resulting in an annualized rate of return on average assets of 0.38%. However, we expect much weaker earnings for 2020 because of interest margin pressure from low interest rates, low fee income generation, rising credit costs, limited new lending opportunities and higher provisioning costs, despite the flexibility of IFRS9 provisioning for performing borrowers.

Endnotes

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

2 Excluding 90 basis points indicative Targeted Review of Internal Models (TRIM) adverse impact.

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Bulgarian and Croatian banks will benefit from entry to EU banking union and future euro adoption

On 10 July, the European Commission (EC) said it welcomed the inclusion of the Bulgarian lev and the Croatian kuna in the Exchange Rate Mechanism II (ERM II), and the European Central Bank (ECB) governing council's decision to establish close cooperation with the regulators in both countries marking their entry into the Banking Union. This milestone in Bulgaria's (Baa2 positive) and Croatia's (Ba2 positive) efforts to join the euro area is credit positive because it will enhance banking supervision for Bulgarian and Croatian banks supporting financial stability and improve investor confidence.

Beginning 1 October 2020, the ECB will be in charge of direct supervision of the significant institutions in both countries and while national supervisors will continue to monitor the remaining banks, it will oversee the supervisions of these less significant institutions, and be in charge of common procedures for all supervised entities.

Both countries were already aligning their processes and procedures with those in the euro area through various EC-recommended reforms to support financial stability. Bulgaria focused on strengthening banking supervision through measures such as aligning supervisory processes and internal rules with the ECB, adopting guidelines on nonperforming loans and rules on large exposures and related-party lending. It also improved its insolvency framework, anti-money-laundering framework and the governance of state-owned enterprises. Croatia focused on strengthening its macroprudential framework; anti-money-aundering framework; collection, production and dissemination of statistics; public-sector governance and reducing the financial and administrative burden. Bulgaria will continue implementing reforms in the judiciary and in the fight against corruption and organised crime. The countries' efforts support investor and depositor confidence in both banking systems.

As a result of the close cooperation between the central banks and the ECB, banks in the two countries, most of which are subsidiaries of euro area banks, will also be part of the Single Resolution Mechanism (SRM). This will include the Single Resolution Fund (SRF), whereby banks in each country will have to contribute funds into the SRF to finance resolution operations where necessary. Entry to the SRM provides a backstop in the effective application of the resolution tools and can alleviate potential effects from failing banks on the sovereign debt and protects taxpayers' money. A potential pan-European deposit guarantee scheme would also be positive for both countries given the relative small size of their banking sectors compared with other euro area countries.

Countries need to successfully participate in ERM II for at least two years before potential entry to the euro area. Therefore, the earliest date for Bulgaria and Croatia's adoption of the euro is 2023.

Their potential adoption of the euro will enhance access to the euro area's more developed capital markets and improve liquidity for banks in the two countries. Although Bulgarian bank's liquidity is strong, the Bulgarian National Bank's ability to control money supply or act as lender of last resort is limited because of Bulgaria's currency board arrangement. This would no longer be an issue once Bulgaria completes it adoption of the euro.

For Croatia, the banking system is euro-ised to a significant extent: foreign-currency or foreign-currency-indexed loans accounted for 55% of total loans as of December 2019. Therefore, Croatia's potential adoption of the euro will reduce euro liquidity and credit risks from the potential depreciation of the kuna. Bulgarian banks share this risk, with loans denominated in euro at 35% of total as of the end of 2019, but the risk is mitigated by Bulgaria's currency board system that pegs the lev to the euro. Bulgaria will maintain its currency board arrangement until the country joins the euro area and adopts the common currency.

Participation in ERM II will strengthen Bulgaria's and Croatia's anchor to the euro area, fostering their economic and institutional convergence process with the rest of the EU. This will likely lead to increased business for the banks. Greater integration with euro area countries could also spur investment and international trade, via the elimination of the exchange rate risk. However, the benefits should be relatively limited, given both countries credible monetary arrangement and the already strong role of the euro in the economy.

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Opera's proposed acquisition of Fjord Bank is credit negative for other Lithuanian banks

On 9 July, Opera Limited, a Norway-based software company primarily focused on web browsers, announced that it intends to acquire Fjord Bank, a Lithuania-based digital bank. The acquisition, which is subject to regulatory approval, would be credit negative for other Lithuanian banks because its launch of online deposits and lending products will lead to increased price competition on deposits and loans.

Lithuania currently has one of the most concentrated banking systems in Europe, with the three largest banks having a combined 89% market share in new lending in 2019, and the authorities, including the central bank, are working to increase competition by attracting new entrants. Affected incumbent banks include Siauliu Bankas, AB (Baa2 stable, ba1[1]) SC Citadele Banka (Ba1 review for upgrade, ba3), Luminor Bank AS (Baa1/Baa2 stable, ba1) and the Baltic subsidiaries of Swedbank AB (Aa3/Aa3 stable, baa1) and SEB AB (Aa2/Aa2 stable, a3).

The announcement is the latest example of a large software company entering the European banking space, competing directly with incumbent banks rather than partnering with them. Opera will aim to provide disruptive services in personal banking. What these services will be is uncertain, but in the beginning of 2020, Opera purchased the Estonian financial technology company (fintech) PocoSys, which specialises in banking-as-a-service software. In Nigeria and Kenya, Opera provides payment and lending apps.

We do not expect that Fjord Bank and Opera will become an immediate threat to incumbent banks in Lithuania, but the number of banks with specialized licences are steadily growing there and will increasingly take market share. At the end of 2019, there were 10 banks with a bank or specialized banking licence in Lithuania, with Fjord Bank being one of three to have received its license during the year. The Bank of Lithuania, the central bank, together with the European Central Bank are examining granting two more licenses.

Opera has yet to explain how it intends to make its products disruptive, given that banking products are relatively homogenous. However, it has likely identified a niche in digital banking that is currently not mature, such as the manner in which banking products are distributed. The rapid pace of evolution in mobile financial services, together with the European Union's second payment services directive PSD2, is creating new ways of incorporating financial services in third-party applications.

For Opera, the advantages of using a Lithuania-based bank are the relative speed with which the Bank of Lithuania approves banking licences compared with other European countries, and the ability to passport the licence to offer banking services in other parts of Europe. Lithuania has also made efforts to attract fintechs, taking advantage of Lithuania's educated work force. The Bank of Lithuania has repeatedly stated that the Lithuanian banking system has become increasingly concentrated, with fintech entrants competing marginally with incumbents. Fjord Bank currently only offers services in Lithuania, but we expect that Opera will want to expand Fjord Bank beyond its home market.

Fintech banks challenging incumbent banks in Europe are using payment services to quickly build a large customer based that it can then bundle other products, such as credit cards and consumer loans. One example is Revolut, which has a specialised banking licence from Lithuania and is growing rapidly in Europe through its digital debit card and ability to send cash electronically among individuals.

Although these fintechs currently complement incumbent mainstream banks, the fact that they have banking licences will enable them to build additional products, particularly in lending. Nordic and Baltic banks are known for being digitally advanced and their customers expect a digital and user-friendly experiences. We expect that banks that are advanced in terms of digitalisation will be better able to compete in the increasingly digitalised financial services sector, making it likely that Fjord Bank will expand outside of Lithuania.

Fjord Bank received a specialised banking licence, with certain restrictions on offering savings products, in December 2019. Further, it has also recently announced the launch of its exclusively online deposit and loan service.

Endnotes

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

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Indonesia Deposit Insurance Corporation can now provide short-term liquidity to banks, a credit positive

On 10 July, Indonesia Deposit Insurance Corporation (IDIC), which insures bank deposits and oversees the resolution of failing banks in Indonesia, announced that a 7 July government regulation will allow it to provide short-term liquidity to banks outside of resolution. The new regulation is credit positive because it will provide Indonesian banks with a source of government liquidity aside from Bank Indonesia, the country's central bank.

IDIC will now be able to place its funds with banks at up to 30% of its total assets, capped at 2.5% per bank. Placement periods will be for up to one month, but can be extended up to a maximum of five times. IDIC's assets totaled IDR120.6 trillion as of 31 December 2019.

IDIC's new role will expand the Indonesian government's financial toolbox and help prevent bank failures related to the coronavirus pandemic. It will help prevent weaker banks – particularly small commercial and rural banks – from becoming insolvent while freeing up the central bank to focus on broader financial market stability.

In addition, IDIC will jointly supervise banks that are already under the Financial Services Authority's close supervision and start preparing for the resolution of these banks. These measures will improve regulatory oversight and speed up the resolution process. IDIC previously would only step in once a bank had failed.

In determining whether to save or liquidate banks that are not systemically important, the regulation does not confine IDIC's decision to resolution costs. Rather, IDIC will be able to consider other factors, such as the effect on the financial system and the availability of investors, boosting failing banks' chances of survival.

The regulation also allows IDIC to raise its own funding through repo agreements with the central bank, sales of government securities to the central bank, borrowings and issuances of debt securities. As a last resort, IDIC can also borrow from the government.

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European clearing houses pass ESMA's regulatory stress test, a credit positive

Originally published on 15 July 2020

On 13 July, The European Securities and Markets Authority (ESMA) reported the results of its latest annual EU-wide stress test of central counterparty clearing houses (CCPs). ESMA assessed the resilience of 16 CCPs, including all authorised EU CCPs and three UK CCPs, and determined that overall, they are resilient to common shocks and multiple defaults for credit, liquidity and concentration stress risks.

The results, although not unexpected because of the strong risk management and regulatory scrutiny that pervades the sector, are credit positive for the CCPs and their owners, including Cboe Global Markets, Inc. (A3 stable), Intercontinental Exchange, Inc. (A2 stable), London Stock Exchange Group plc (A3 review for downgrade) and Nasdaq, Inc. (Baa2 stable). Should ESMA have identified significant deficiencies, the affected CCPs would likely have had to expend resources on remediation and could have suffered franchise damage.

ESMA tested the CCPs' counterparty credit risk (resilience to multiple clearing member defaults and simultaneous market price shocks) on two specified dates in December 2018 and March 2019, with incremental testing on the latter date for liquidity risk (measuring sufficiency of funds to meet payment obligations in a timely manner) and concentration risk (testing costs to liquidate concentrated positions expeditiously).

ESMA said the overall severity of the shocks was comparable to the severity of shocks in its previous CCP supervisory stress tests, as well as actual market movements amid the coronavirus pandemic. ESMA also indicated that the CCPs demonstrated their resilience during the unexpected and unprecedented impact of the pandemic on the global financial system.

In the March 2019 counterparty credit risk test, LME Clear Ltd, owned by Hong Kong Exchanges and Clearing Limited, exhibited a €266 million shortfall in prefunded resources. However, ESMA said there was no systemic implications from this given the shortfall's small size, which it said LME would cover using its right to call on non-defaulting members' non-prefunded resources.

ESMA's stress tests applied extreme market price shocks to CCPs using one common market stress scenario. From a credit risk perspective (excepting investment risks), ESMA said that only simultaneous defaults combined with extreme, adverse shifts of market prices would pose risk to a CCP: one factor without the other would be manageable, given that clearing members routinely post margin to meet their obligations.

The market stress scenarios comprised instantaneous shocks following triggers initiated in various market segments, with the primary trigger a disorderly increase in risk premia related to increasing global political and policy uncertainty. The associated market price shocks included a modest steepening of swap curves and a large fall in other asset prices, together with repricing sovereign spreads and increased yields on non-financial corporate bonds.

ESMA split into two components its counterparty credit risk testing, with the first component assuming the simultaneous default of the two largest clearing member groups pertaining to each respective CCP, and the second component being the default of the two clearing member groups with the largest aggregate exposures across all EU CCPs. Overall, testing for the first component proved to be more onerous, but even then, under at least one of the assumed stress scenarios, only three of the 16 CCPs faced a consumption rate greater than 50% of pre-funded resources beyond margin (with LME exceeding 100%). In reverse-stress-testing the outcomes, the incremental changes in market shock severity were more harmful than increases in the number of defaulting groups.

The credit stress test evaluated whether each CCP had enough default waterfall collateral available to cover losses caused by clearing member defaults. In contrast, since some of this collateral might not be immediately available to a CCP, and accordingly the CCP could seek access to other liquid resources in order to meet its obligations on time, the liquidity stress test assumed the default of two entities to which the CCP is exposed from a liquidity perspective. For each CCP, these entities could include clearing members, issuers,

custodians, payments banks and repo counterparties. ESMA said its liquidity stress test did not reveal any systemic risk, and there was no particular deficiency found.

For the concentration risk component, ESMA said that overall risk in the EU is clustered in one or two CCPs for most asset classes, with the largest concentration risks being found in fixed-income derivatives, and then in commodity derivatives and in equity securities and derivatives.

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For Global Atlantic, KKR's acquisition is credit positive

Originally published on 14 July 2020

On 8 July, Global Atlantic (Fin) Company (Baa3 positive) and KKR & Co., Inc. announced that KKR would acquire Global Atlantic for 1.0x book value as of when the deal closes. For context, book value as of 31 March 2020 was approximately $4.4 billion. The acquisition would be credit positive for Global Atlantic because it would provide access to capital and improve the company's business profile. Those benefits, along with Global Atlantic's own improvements to its credit profile prompted us to change Global Atlantic's outlook to positive from stable.

The parties expect the transaction to close in early 2021, subject to regulatory and shareholder approval and other customary closing conditions. After closing, Global Atlantic will continue to operate as a separate business with its existing brands and management team. KKR plans to serve as Global Atlantic's investment manager, subject to receipt of applicable regulatory approvals. Global Atlantic offers annuities, life insurance and pre-need funeral insurance products through its insurance subsidiaries. It also supplies reinsurance solutions to life and annuity insurance companies.

We expect KKR's ownership to help Global Atlantic grow and manage its business. Specifically, the transaction will support Global Atlantic's growth as a result of greater access to capital. It will also strengthen the company's distribution because of KKR's relationships with financial institutions. Global Atlantic has a broad individual channel distribution platform that includes banks, wirehouses and broker/dealers that are complemented by its institutional channel business. KKR's access to capital also has the potential to provide less costly access to debt financing.

Global Atlantic's credit profile had already been improving before the announced deal, improving its market position by growing its distribution reach through both its retail and institutional channels. The company's assets and book value have expanded along with its product growth, as shown in the exhibit. Meanwhile, as a result of prudent risk management, profitability and capitalization are strong. The company has also become less reliant on bank financing and has demonstrated increased access to capital markets.

Global Atlantic's assets, revenue and book value have been growing

Sources: Company filings and Moody's Investors Service

Although we expect KKR to manage Global Atlantic's investment portfolio prudently so as to protect the franchise value of their investment, there is a risk, given what we have seen with similar transactions, that KKR will increase the complexity – and therefore the risk – of Global Atlantic's investments in an effort to boost yields. KKR might also reduce the capital levels of the insurance operating companies, although the company said on its call for investors that it expects to continue maintaining a high risk-based capital (RBC) ratio. As of year-end 2019, Global Atlantic's consolidated RBC ratio, including its Bermuda companies, was 481%, above the industry median of 454% for our rated companies. Increasing investment risk or reducing Global Atlantic's RBC ratio could more than offset the transacton's credit benefits.

Other risks to Global Atlantic's profitability include the trajectory of the coronavirus pandemic. We believe the coronavirus-driven economic disruption and ultra-low interest rates will stress most aspects of life insurers' financials, including those of Global Atlantic. This includes sales, investments, reserves and capital adequacy. Most life insurers, including Global Atlantic, start with healthy capital and asset quality to weather this storm over the near term, but these conditions persist, they will weaken insurers' creditworthiness.

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India injects capital in three state-owned insurers, a credit positive amid operational challenges

Originally published on 15 July 2020

On 8 July, the Government of India (Baa3 negative) approved an INR124.5 billion ($1.65 billion) capital injection for state-owned National Insurance Co. Ltd., The Oriental Insurance Co. Ltd. and United India Insurance Co. Ltd. and stopped a plan to merge the three insurers and instead focus on improving each company's profitability.

The capital infusion is credit positive for the insurers, which are among the largest non-life companies in India's insurance market, because their capital has been significantly depleted by several loss-making underwriting years and significant top-line growth. Focusing on the insurers' profitability will ensure that the improvements in capital and risk management are maintained.

Underwriting losses resulting in combined operating ratios consistently over 100% and significant top-line growth reduced regulatory required solvency margin (RSM) ratios over the past few years. National Insurance's solvency ratio was 1.04x for the fiscal year that ended 31 March 2019, below the 1.5x minimum regulatory RSM; Oriental Insurance's solvency ratio was 1.57x and United India Insurance's was 1.52x also as of fiscal 2019 year end, according to Insurance Regulatory and Development Authority of India's 2018-19 annual report.

After the capital injection, we expect renewed focus on improving the insurers' risk management and profitability. We expect the insurers to enhance their risk-based pricing and underwriting discipline to ensure organic capital growth and attract foreign reinsurance coverage, which will further aid capital adequacy.

Only after these actions are implemented, we believe the government's goal of listing the companies on the stock market will become feasible. The stock market listing itself brings in prospects of foreign ownership, which would diversify funding sources, reduce exposure to high-risk assets, enhance actuarial-led reserve and pricing and enhance the risk-based capital management.

Additionally, given these state-owned insurers' dominant position in India and ability to undercut other companies' pricing, improved pricing discipline will benefit the wider market's underwriting performance. However, if after the capital injection the three insurers continue to write business on loss-making terms and profitable growth is not achieved, their capital depletion and volatile RSMs will persist, which would put the plans to list the insurers at risk.

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Weakening of Poland's institutions will likely continue after presidential election, a credit negative

Originally published on 14 July 2020

On 12 July, Poland's (A2 stable) incumbent President Andrzej Duda, backed by the ruling conservative Law and Justice party (PiS), won a narrow victory against Warsaw Mayor Rafał Trzaskowski, backed by the centrist Civic Platform, in the second and final round of the presidential election. Duda took 51.03% of the votes, according to the National Electoral Commission. Voter turnout was 68.18%, the highest since the second round of the presidential elections in 1995, and the poll was viewed by the voters as a clear choice between the policies of the ruling PiS and the main opposition party.

Duda reiterated during his election campaign that he would continue to support the PiS' institutional and economic reforms, which we expect will weaken Poland's institutional strength further and pose a risk to Poland's medium-term competitiveness, a credit negative.

Since gaining power in 2015, the PiS government has implemented a number of reforms that threaten the rule of law in Poland by weakening the independence of the judiciary. As a result, the country's Worldwide Governance Indicators have deteriorated, falling below those of many of its rating peers.

Duda's reelection will also preserve the government's expansionary economic and fiscal policy stance. Even before the coronavirus pandemic, the government's fiscal policies included generous financial support for families and pensioners, as well as an increased minimum wage, posing a risk to the country's medium-term competitiveness.

Moreover, the election outcome indicates the long-running dispute between Poland and the European Union (EU, Aaa stable) over judicial independence will continue. The European Commission, the EU's executive branch, is concerned that changes to Poland's judicial system infringe on the separation of power between the government and the judiciary, undermining the rule of law. Most recently, the EU's highest court, the European Court of Justice, ordered the suspension of Poland's new disciplinary chamber, which has a politically elected membership and extraordinary powers to prosecute Polish Supreme Court judges. In 2017, the EU initiated its toughest punishment procedure, known as Article 7, against Poland for its judicial system reforms, which could pave the way for sanctions and potentially the suspension of its EU voting rights.

The president plays an important role in government policymaking, effectively having the power to block the legislative process. With Duda's reelection as president for another five years and no major polls due in Poland before parliamentary elections in 2023, the PiS government's policies are set to continue uninterrupted for at least the next three years.

The Polish president's prerogatives include the power to sign or veto bills passed by parliament and appointing some senior positions. A presidential veto can only be overturned by a statutory three-fifths majority vote in the presence of more than half the members of the lower house of parliament. Because the PiS government has only a slight parliamentary majority of 51%, the president effectively has the power to block the legislative process. Before signing a bill, the president can also check it complies with the constitution by referring it to the Constitutional Court, which would delay the legislative process.

Senior appointments in the gift of the president include three of the nine members of Narodowy Bank Polski's Monetary Policy Council, who serve for a term of six years. Two of the president's three nominees end their terms in 2022, namely Kamil Zubelewicz and Łukasz Hardt, who were both appointed on 17 February 2016. The president of Narodowy Bank Polski is appointed by parliament for a term of six years on the recommendation of the Polish president.

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CREDIT IN DEPTH

Racial disparities exemplify US' long-standing and growing income and wealth inequalities that raise social risk

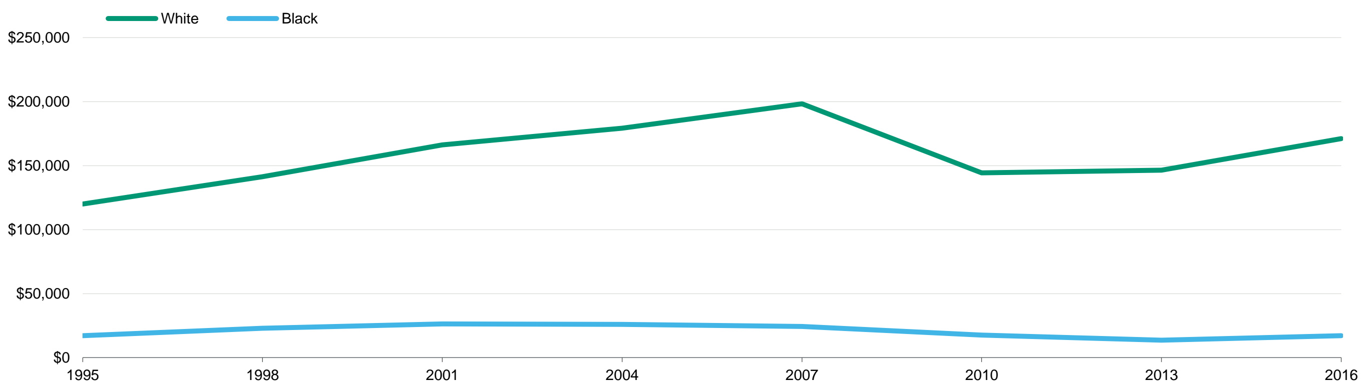
Originally published on 14 July 2020

Recent events have highlighted the corrosive impact of inequality in the US (Aaa stable) with a particular focus on the long-standing, deeply institutionalized inequality faced by the Black community. In past research,[1] we have noted how income and wealth inequality in the US is both high relative to other highly rated countries and rising, and that it could have a negative impact on the US' fiscal, economic and institutional strength. The unequal position of the Black community in the US is a salient and persistent feature of the inequality dynamic that exemplifies and exacerbates credit-relevant social risks.

Credit-negative institutional and economic barriers to equality in the US impact the Black community disproportionately

In our previous research, we documented the increase in income and wealth inequality in the US in recent decades. For instance, we noted how the top 10% of income earners have seen their overall median net worth increase by almost 200% since 1995, while the bottom 40% of income earners experienced a decline over the same period. Significant disparities are also evident along racial lines: white households saw a 43% increase in their net worth between 1995 and 2016 while Black households' net worth remained flat (see Exhibit 1). The overlap reflects the disproportionate presence of Black households in lower income and wealth brackets. In 2016, the median income for Black households was slightly above half that of white households ($35,400 vs. $61,200) while the median Black household's net worth was less than a tenth of that of the median white household.[2]

White households' net worth is more than ten times that of Blacks in the US
Median net worth for families with financial asset holdings, 2016 dollars



Source: Federal Reserve 2016 Survey of Consumer Finances

Inequality is driven both by macro trends and by obstacles specific to the Black community

The disproportionate representation of Black households in poorer income and wealth brackets suggests that Black households will have been relatively more affected by the macro trends identified in our earlier comment that have driven the broad rise in inequality in the US. These include globalization of trade, capital and labor; displacement of labor through automation; rising educational requirements alongside highly uneven quality of schooling; and uneven access to credit. Illustrating the relevance of the latter to both racial and income inequality, the Consumer Financial Protection Bureau estimates that Blacks are 73% more likely than whites to lack a credit score.[3] "Credit redlining" practices have also weighed disproportionately on Black communities. A study by the Federal Reserve found that individuals living in neighborhoods with predominantly white residents were more likely to get credit cards than those living in predominantly Black neighborhoods, despite identical non-repayment risk assessments (i.e., credit scores).[4]

These trends can be self-perpetuating. For example, access to credit influences the ability to build wealth and pass it on to subsequent generations. Constrained access to credit can sustain – in this case racial – wealth inequalities. Homeownership, which is influenced by

access to credit, is one illustration: in 2019, 44% of Black households owned their homes, compared with 74% of white households.[5] More broadly, parents' earnings and store of wealth are an important determinant of children's future earnings, and high inequality contributes to low intergenerational economic mobility.[6] This disparity also stands out along racial lines in the US: in 2016, 8% of Blacks inherited wealth (averaging $83,000 in 2013 dollars) compared with 26% of whites (averaging $236,000 in 2013 dollars, 2.8x the average Black inheritance).[7] Many of these trends affect all sectors of the population, but the Black community has been disproportionately impacted. Other drivers of inequality more specific to the Black community arise from various forms of discrimination including in the criminal justice system (illustrated by the disproportionately high number of Black prison inmates[8]) and in the workplace. The disproportionate exposure to economic or social (health-related) shocks that this entails can be seen in the higher incidence of both coronavirus cases and unemployment among the Black community in recent months.[9]

Inequality, racial or otherwise, raises social risk and can lower economic, fiscal and institutional strength

Institutional features that limit the educational and economic opportunities of a material share of a country's residents ultimately limit its long-term economic potential. Research by the IMF suggests that higher inequality is associated with lower GDP growth.[10] A disproportionate share of income vested in wealthier households with a lower marginal propensity to consume lowers aggregate demand. A larger share of low-income households less able to accumulate physical and human capital, including through educational attainment, lowers economy-wide labor productivity. This is particularly true in countries like the US with relatively shallow social safety nets. According to the consultancy group McKinsey & Company, lowering inequality in the US by closing the racial wealth gap could raise the level of real GDP by 4%-6% by 2028, which in turn could lift GDP per capita by up to $4,300.[11]

High inequality is also associated with relatively lower institutions and governance strength, and the political polarization often associated with it can raise susceptibility to event risk. While the US' institutions remain very strong overall from a credit standpoint and political event risk remains low, the social risks implied by entrenched racial inequalities were amply demonstrated by the widespread protests in the US following the death of George Floyd on May 25 while in police custody in Minneapolis (Aa1 stable). While largely centered on the role of the police and on the criminal justice system, long-standing issues relating to the willingness and capacity of US legislators to address racial inequality through institutional and governance reforms have also gained prominence.

Even if the immediate credit implications of the protests were limited, rising social risk, if left unaddressed by policymakers, can carry negative longer-term implications. The strength of the US' institutions has diminished somewhat in recent years in the context of the increasingly polarized political environment. And there is a rising tension within the US' credit profile arising from the growing need for policymakers to act to contain the ongoing erosion of the sovereign's fiscal strength, and the inertia with respect to that erosion stemming from increased political polarization. Some research suggests that income plays an increasing role in driving congressional polarization on tax and redistribution issues.[12] While there are indeed many social and economic issues that have contributed to the US' increased political polarization in recent years, looking ahead, the combination of income and racial inequality is set to be a potent force for further potential polarization and inertia.

Endnotes

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3 See Who are the credit invisible? How to help people with limited credit histories, US Consumer Financial Protection Bureau, December 2016.

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6 See Causes and Consequences of Income Inequality: A Global Perspective, International Monetary Fund, June 2015.

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8 As of year-end 2017, the imprisonment rate for black males stood at 2.3% of the Black resident population compared to a rate of 0.4% for white males. See https://www.bjs.gov/content/pub/pdf/p17.pdf.

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CREDIT IN DEPTH

Coronavirus pandemic will accelerate and reshape credit trends in structured finance

Originally published on 15 July 2020

COVID-19 will likely cause a paradigm shift for key credit risk components and drivers of the global structured finance market, altering the risk profile of many asset classes. In this report, we assess the likely effects of the pandemic on structured finance transactions several years from now, once the immediate effects and health risks of the virus recede.

» **Low long-term growth prospects will erode performance.** Permanent scars from the severe COVID-19 shock will hurt collateral performance for structured finance transactions. Those scars include a long-lasting slowdown in growth in many countries, even lower productivity and an increase in long-term unemployment.

» **Persistently low interest rates will heighten risk as investors hunt for yield.** Very low interest rates will help collateral performance amid weak economic growth across structured finance sectors, which will also benefit from favorable lending conditions. However, if low interest rates and weak risk differentiation among investors lead to a hunt for yield, the credit quality of new securitized debt will weaken, with riskier assets included in collateral pools.

» **Government intervention will alter the risk profile of most asset classes.** Government intervention, such as payment or bankruptcy moratoriums, state-guaranteed emergency loans or other types of state aid, particularly in strategically important sectors, will be more likely in the future. The increased potential for government intervention alters the risk profile of structured finance transactions in most asset classes via immediately beneficial effects. But it comes at the long-term cost of weakening obligors' debt affordability and increasing refinancing risk, a few years from now.

» **Disrupted supply chains will weaken some corporate securitizations and bolster certain CMBS and NPL ABS, but overall impact will be limited.** Disruption of global supply chains will negatively affect some corporate securitizations with high exposure to global export and/or global supply chains, such as small and medium-sized enterprise (SME) asset-backed securities (ABS) and equipment ABS. However, the disruption will benefit some commercial mortgage-backed securities (CMBS) and nonperforming loan (NPL) securitizations backed by commercial real estate in the logistics sector. That said, the overall impact will be limited to a narrow range of asset classes and a subset of transactions.

» **Accelerated adoption of disruptive technologies and new business practices will benefit structured finance transactions.** Shifts in consumer habits will accelerate tech disruption and business changes, such as increasing use of e-commerce and e-servicing, and further reinforce pre-COVID-19 credit trends across structured finance asset classes. These trends will increase operational efficiency and transparency, but also heighten operational and cyber risks across the board, while eroding the credit quality of CMBS tied to the office sector and traditional retail in particular.

» **Increased social and environmental consciousness will heighten risk in several sectors.** Increased environmental and social consciousness will slow international travel, with negative implications particularly for structured finance transactions exposed to the broader hospitality and aircraft sectors. Increased focus on environmental issues will also accelerate auto sector transformation, with mixed implications for auto ABS. RMBS, CMBS and covered bonds will be increasingly exposed to regulatory penalties for weak energy efficiency of existing buildings. The expansion of social safety nets will be positive for consumer ABS, RMBS, covered bonds, and negative for some corporate securitizations. Asset selection will increasingly take ESG considerations into account, changing from negative screening to proactive selecting.

Click here for the full report.

Articles in last Monday's Credit Outlook

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Corporates

» Main Street Lending Program offers new liquidity backstop for eligible issuers

» US deems Philip Morris IQOS tobacco heating system as modified risk tobacco product, a credit positive

» Provisional new law offers financial relief to Brazil's pandemic-hit airline sector

» MTR Corp.'s profit warning for first half 2020 results is credit negative

» ITOCHU's tender offer for FamilyMart is credit negative

Infrastructure

» Dominion will sell around $10 billion of natural gas assets and cancels Atlantic Coast Pipeline, a credit positive

» CPFL Energia prepays higher-cost loans with BRL2.4 billion loan from parent, a credit positive

Banks

» US withdraws ability-to-pay underwriting requirements, a credit positive for payday lenders

» Introduction of cashback services would be positive for Brazilian banks and payment acquirers

» Chile's direct support measures for households mitigate systemwide asset risks

» Dutch banks will create a common platform to combat money laundering, a credit positive

» Increase in transactions suggests a rebound in Russia's economy, a credit positive for banks

» More losses from Swiss-franc mortgages add to mBank's profitability challenges, a credit negative

» Australia extends loan deferrals, benefitting banks during coronavirus disruption

Insurers

» Chubb reports record catastrophe losses, driven by coronavirus pandemic

» Acquisition of National General increases Allstate's leverage and integration risk

Asset Managers

» Virtus Investment's partnership with Allianz Global is credit positive

Sovereigns

» UK government's Summer Statement adds further policy support to mitigate coronavirus-induced shock

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Securization

» Australian banks' extension of coronavirus relief measures will support RMBS

CREDIT IN DEPTH

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REPORT NUMBER 1237587