

# Credit Outlook

12 October 2020

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## General Electric's Wells notice from SEC highlights lingering risks of contingent liabilities

Originally [published](#) on 07 October 2020

On 6 October, [General Electric Company](#) (GE, Baa1 negative) announced that the US Securities and Exchange Commission (SEC) issued it a Wells notice. The notice advises GE that the SEC is considering a civil enforcement proceeding related to the historical premium deficiency testing for GE Capital's run-off insurance operations, as well as GE's disclosures of such run-off insurance operations.

The Wells notice is credit negative because an enforcement action is probable and comes as GE has to contend with challenges across most of its business units. At the same time, lower interest rates are likely to adversely affect the company's pension deficit and insurance reserves.

The Wells notice suggests it is likely that the SEC will proceed with an enforcement action related to the historical annual reserve testing of GE's legacy insurance operations. Still, there is no certainty at this time that the SEC will commence an enforcement proceeding, nor can the amount of civil monetary penalties, if any, reasonably be estimated. GE stated that it disagrees with the SEC staff's recommendation to bring an enforcement action and that it will respond through the Wells notice process.

GE's ability to manage its remaining contingent liabilities diminished because the proceeds from additional asset dispositions could be limited to the value of its remaining 36.8% ownership stake in [Baker Hughes Co.](#) (Baa1 negative), less than \$5 billion at current market value. Although GE's industrial cash balance following the sale of BioPharma in March remains considerable (\$25.4 billion at the end of June), there are competing uses for the deployment of this cash. These uses include the need to reduce GE's debt balance and the equity infusions to GE Capital, which we expect to continue to help fund the insurance reserve contributions of close to \$2 billion annually. We estimate that GE needs to maintain a very substantial amount of cash to manage its intra-quarter funding needs.

GE resolved a number of contingent liabilities in the past few years, including a settlement with the Department of Justice (DoJ) regarding possible violations of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) by WMC, GE Capital's former US mortgage business. WMC's subsequent Chapter 11 filing helped resolve its remaining reps and warranties litigation. Still, GE's remaining contingent liabilities are considerable. Among others, the scope of the SEC investigations include the accounting practices related to long-term service agreements and the 2018 goodwill impairment charge in the Power segment. The DoJ is also investigating these matters while GE is subject to a range of shareholder lawsuits regarding accounting and disclosure practices. Additionally, the adequacy of the \$15 billion incremental insurance reserves for risks associated with legacy long-term care policies remains uncertain.

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## IBM's infrastructure services unit spinoff will sharpen focus on fast-growing hybrid cloud and AI businesses

Originally [published](#) on 09 October 2020

On 8 October, [International Business Machines Corp.](#) (IBM, A2 stable) announced a plan to spin off its managed infrastructure services unit. The spin-off is credit positive for IBM because it will sharpen its focus on its fast-growing hybrid cloud and AI businesses.

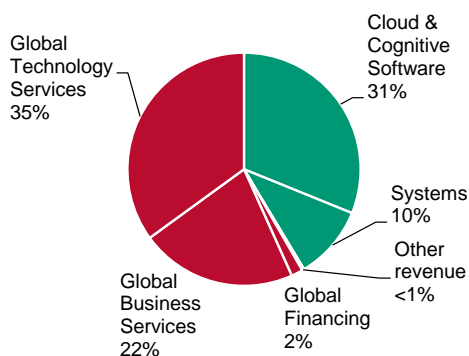
The proposed transaction, structured as a tax-free separation to shareholders, is a continuation of IBM's multiyear effort to build an open hybrid cloud platform, which accelerated in 2019 with its purchase of Red Hat. IBM plans to create a second publicly traded company (NewCo) by the end of 2021, subject to customary closing conditions. To address costs caused by the spin-off, IBM will take an estimated \$2.3 billion charge at the end of this year. We expect the transaction to be leverage neutral.

When the spin-off is complete, recurring revenue from cloud and AI offerings will generate about 55% of IBM's topline. Both of these business segments grew in the first half of 2020 and we expect them to continue to grow over the next 18 months. In contrast, growing business segments represented only 41% of total revenue in the first half of 2020, which resulted in overall revenue declines (see Exhibits 1 and 2).

Exhibit 1

### Growing segments generate 41% of revenue

Revenue by business segment, last 12 months to 30 June 2020 (actual)

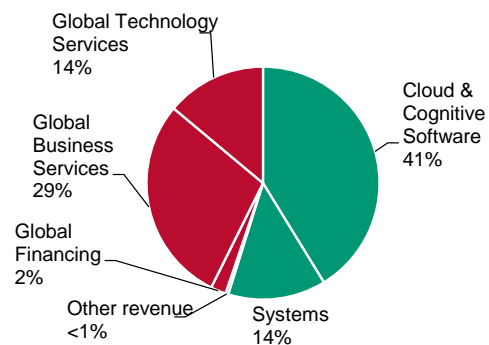


Blue represents segments with revenue declines for six months ending June 2020; green represents segments with revenue gains for six months ending June 2020.  
Source: Company filings

Exhibit 2

### ...but 55% after the spin-off

Revenue by business segment, last 12 months to 30 June 2020 (pro forma for the spin-off)



Red represents segments with revenue declines for six months ending June 2020; green represents segments with revenue gains for six months ending June 2020.  
Sources: Company filings and Moody's Investors Service estimates

These positives will help offset the reduction in both IBM's scale and business diversity caused by the transaction. IBM indicated that the operations it plans to spin off represent \$19 billion, or roughly 70%, of the revenue generated by its global technology services segment and less than 24% of IBM's revenue overall.

In addition to a sharper focus on faster-growing businesses, the transaction's restructuring charges will support higher margins. IBM will be able to direct future cash flows to research and development and other growth investments, including tuck-in acquisitions, to further expand its faster-growing cloud and AI offerings. IBM will also be able to expand its relationships with partners that previously were competitors in the managed infrastructure business.

We expect IBM will continue to target leverage in the low 2x range. At closing, we also expect IBM will be able to reduce debt with a cash distribution from NewCo or IBM will effectively transfer a portion of its debt to NewCo. We believe IBM will continue to suspend share buybacks (historically \$4.5 billion per year) until financial targets are reached. To the extent we expect IBM will be unable to

quickly reach leverage or cash flow targets, there could be downward pressure on ratings. Another leveraging transaction prior to achieving targeted credit metrics, including leverage, would also pressure ratings.

We believe that IBM will realize cost benefits within one to two years of taking the planned \$2.3 billion charge at the end of this year to cover one-time structural actions. Separately, cash transaction costs related to the spin-off include about \$1.5 billion in non-US taxes, IT set up costs, severance, training, and other expenses. IBM in the first quarter took a \$0.9 billion charge aimed at reducing costs in its global technology services business. The company has already realized a significant portion of the benefits from that charge and will realize the rest by the end of 2020.

As a standalone, publicly traded company, NewCo will be a leading managed infrastructure services provider, with more than 4,600 clients in 115 countries, including more than 75% of the Fortune 100, and a revenue backlog of \$60 billion. NewCo will be focused on managing and modernizing client-owned infrastructures for a market opportunity the company estimates is \$500 billion in size. Offerings will include hosting and network services, services management, infrastructure modernization, and migrating and managing multi-cloud environments. After the separation from IBM, NewCo will be able to develop partnerships with former cloud and software competitors.

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## HCA Healthcare's plan to return \$6 billion CARES Act funds is credit negative

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On 8 October, [HCA Healthcare, Inc.](#) (HCA, Ba1 stable) announced that it will return approximately \$6 billion in government aid from the Coronavirus Aid, Relief, and Economic Security (CARES) Act is credit negative because it will reduce the company's earnings and liquidity. Lower social risk from returning the CARES Act grants and early repayment of accelerated Medicare payments will partially mitigate the credit negative effects.

We expect HCA to maintain very good liquidity (i.e., Speculative Grade Liquidity rating of SGL-1) following the repayment of the roughly \$1.6 billion of grants and \$4.4 billion of accelerated Medicare payments from the CARES Act. On 30 June, the company had cash of \$4.6 billion. The company's liquidity is enhanced by its \$2.0 billion secured bank revolver expiring in June 2022, its \$3.75 billion asset-based revolver expiring June 2022, and its \$2.0 billion 364-day secured term loan credit facility that matures in March 2021. These facilities were all undrawn as of 30 June. Pro forma for the repayment of the \$6 billion of CARES Act funds, which we expect to occur during the fourth quarter this year, HCA would still have had more than \$6 billion of total liquidity as of 30 June.

The company's upcoming third-quarter earnings report will reflect a reversal of \$822 million worth of grant aid that HCA recognized as earnings during the second quarter. This reversal will cause HCA's third-quarter adjusted EBITDA (on a reported basis) to be \$255 million lower relative to the same period last year. That said, HCA expects to report a nearly 5% increase in third quarter revenue to \$13.3 billion, as revenues continue to benefit from a significantly higher acuity mix since the pandemic began and a favorable payer mix. Moreover, HCA's same facility adjusted admissions, though down roughly 9% in Q3 2020, have recovered significantly from the depths of the pandemic in April.

By returning the CARES Act funds, we expect HCA to benefit from some social risk tailwinds. A series of actions taken in March and April to reduce expenses, conserve cash flow, and codify its COVID-19 operating strategy has helped put HCA in a position enabling it to return CARES Act funds as hospital volumes have recovered. Given how highly dependent hospitals have been on CARES Act funds, we view HCA's plan to return these funds in a socially responsible light.

Despite its very good liquidity, it is not clear from a financial policy perspective when HCA will look to restart share repurchases or resume paying a dividend to shareholders. We believe it is more likely than not that these initiatives will not be resumed until 2021.

HCA is the largest for-profit acute care hospital operator in the US as measured by revenues. In addition, the company operates psychiatric facilities, a rehabilitation hospital, as well as ambulatory surgery centers and cancer treatment and outpatient rehab centers. Facilities are located in 21 states in the US and in England. HCA, headquartered in Nashville, Tennessee, generated net revenue of approximately \$52 billion over the last 12 months.

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## Kindred Healthcare's sale of contract therapy business is credit positive

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On 7 October, [Kindred Healthcare LLC](#) (B2 stable) announced that it will sell its contract therapy business, RehabCare, to privately owned Select Rehabilitation for an undisclosed amount. The transaction is credit positive because Kindred will sell a non-core asset with lower margins than its inpatient rehabilitation facility and long-term acute care hospital businesses and, at least initially, it will benefit liquidity. The company expects the transaction to close prior to year-end.

With last-12-months revenue of around \$490 million through 30 June, Kindred's RehabCare business provides more than 10,000 therapists to work with patients at various post-acute facilities such as skilled nursing facilities, assisted living facilities, continuing care retirement communities and outpatient facilities. RehabCare comprises roughly 15% of Kindred's revenue and contributes less than 10% to its adjusted EBITDA. Furthermore, this business is more administratively intensive (e.g., back office operations) than Kindred's other businesses. From a strategic standpoint, selling RehabCare will narrow Kindred's focus to delivering care to a higher-acuity patient population in inpatient rehabilitation and long-term acute care facilities.

Proceeds from the transaction will further boost Kindred's unusually sizeable liquidity, which has been helped by several elements of the Coronavirus Aid, Relief, and Economic Security (CARES) Act that was implemented in March 2020. Kindred's \$434 million cash balance on 30 June reflects the CARES Act benefits of \$264 million of accelerated Medicare payments that will begin to be repaid in April 2021, \$78 million of grant aid, and \$22 million of deferred payroll taxes. Ultimately, Kindred will use the RehabCare sale proceeds to either repay existing term loan debt, which would facilitate modest deleveraging, or reinvest into the business per the terms of the company's credit agreement. We estimate the company's LTM adjusted debt to EBITDA to be roughly 3.7x at 30 June.

Kindred Healthcare LLC is one of the largest providers of long-term acute care and acute rehabilitation services in the US. Pro forma for the pending RehabCare sale, revenue for the 12 months that ended 30 June approximated \$2.8 billion. The company is owned by private equity firms TPG Capital and Welsh, Carson, Anderson and Stowe.

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## Tesco delivers solid results from UK retail operations, but higher pension liabilities increase leverage

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On 7 October, [Tesco Plc](#) (Baa3 stable) announced in its results for the 26 weeks that ended 29 August 2020 (first-half fiscal 2021) that its International Accounting Standard No. 19 (IAS 19) liabilities had increased by around £1 billion during the period. Although the company intends to reduce its pension obligations by £2.5 billion upon completion of its disposals of its Asian operations, the higher pension liabilities have increased leverage, measured in terms of Moody's-adjusted debt to EBITDA, to 4.2x pro forma for the disposals, from 3.8x as of fiscal 2020 ended 29 February), a credit negative.

Tesco's Moody's-adjusted gross debt increased by £982 million during the first half of fiscal 2021 mainly<sup>1</sup> because of a £742 million increase in the IAS19 pension deficit, which in turn was driven by a reduction in the discount rate underlying the calculation of the pension liability and partly offset by an increase in scheme assets. Despite the increase, Tesco's Moody's-adjusted leverage is comfortably within the 3.75x-4.5x range we expect for the Baa3 rating.

In terms of operating performance, Tesco's UK retail business was strong in the first half, particularly in essential categories such as grocery and household, reflecting customers stocking up on key items ahead of the lockdown restrictions and more meals at home. Coronavirus-related costs were a challenge, even after factoring in the UK government's relief for businesses. Even so, those costs were lower than management had previously anticipated. The lockdown also affected the operations of Booker, Tesco's fully owned foodservice wholesaler serving caterers, independent convenience stores, grocers, pubs, and restaurants.

Operating profits in the core UK and Irish business rose 6.2% to £1.1 billion, but a weaker performance in the smaller Central European operations and the bad debt provisions taken by Tesco Bank resulted in total group operating profit to decline by 15.8% to £1.037 billion in the first half, as shown in the exhibit.

### Tesco's operating performance in UK retail was solid in the first half of fiscal 2021

#### Key segmental results

	Sales (£ millions)	Year-over-year change (constant rates)	Like-for-like sales change	Operating profit (£ millions) (1)	Year-over-year change (constant rates)	Operating profit margin
UK & ROI	£24,337	8.5%	7.2%	£1,133	6.2%	4.3%
-UK	£19,537	7.7%	7.6%			
-ROI	£1,322	14.5%	15.5%			
-Booker	£3,478	11.0%	2.2%			
Central Europe	£1,929	-1.5%	-0.9%	£59	-23.4%	3.0%
<b>Retail</b>	<b>£26,266</b>	<b>7.7%</b>	<b>6.5%</b>	<b>£1,192</b>	<b>4.2%</b>	<b>4.2%</b>
Bank	£386	-31.4%	-	-£155	-278.2%	n/m
<b>Group</b>	<b>£26,652</b>	<b>6.8%</b>	<b>6.5%</b>	<b>£1,037</b>	<b>-15.8%</b>	<b>3.6%</b>

(1) Before exceptionals and amortisation of acquired intangibles

Source: Company information

Tesco's price competitiveness improved during the first half as the Aldi price match campaign helped Tesco gain customers from the German discounter for the first time in a decade, according to the company. Tesco also reported increased customer loyalty thanks to its Clubcard Plus scheme. However, Tesco's market share fell slightly to 26.8% in the 12 weeks to 6 September from 27.2% in the 12 weeks to 23 February, according to Kantarworldpanel.

Tesco's online sales rose 69% year on year in the first half (including 90% in the second quarter), and delivery capacity more than doubled to 1.5 million slots per week. Tesco's online grocery sales have grown to over 16% of total UK sales by the end of the half year,

up from around 9% in fiscal 2020. The company said it expects online grocery sales for the whole UK sector to reach around 20% from 11% currently. That would portend industry profit margins likely being under pressure unless offset by higher volumes or lower costs.

The company expects its retail operating profit in fiscal 2021 to be “at least” at the same level as fiscal 2020 despite a first half of the year. The somewhat cautious guidance suggests broadly flat EBITDA in the second half compared to first, with leverage likely unchanged from current pro forma levels. The ongoing fight for market share and investments in online delivery capabilities are likely to limit the upside for meaningful EBITDA growth, in our opinion.

Tesco’s liquidity was solid, with £2.6 billion of liquidity as of 29 August, including cash of £1.6 billion and money market funds of £900 million on its balance sheet, and limited near-term funded debt maturities. Additionally, Tesco recently refinanced its committed facilities of £2.5 billion now maturing in 2023.

## Endnotes

<sup>1</sup> The issuance of a £450 million bond due April 2030, part of whose proceeds were used for the early redemption of a €295 million bond due November 2020, contributed to the higher debt.

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## Fox's Biscuits disposal will allow Boparan to reduce leverage before potential refinancing

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On 7 October, leading UK food manufacturer [Boparan Holdings Limited](#) (Caa1 stable) announced plans to sell part of its Fox's Biscuits business to Ferrero Group, one of the world's largest chocolate and confectionery producers. The disposal is credit positive since it will strengthen Boparan's liquidity and allow the company to reduce leverage ahead of potential refinancing of two senior unsecured notes, both due in July 2021.

The sale will allow Boparan to focus on its key poultry business, although it will reduce the scale and scope of the company's business, leaving it more exposed to a relatively commoditised and low margin poultry segment.

The company expects proceeds from the Fox's Biscuits sales to be £246 million, making it Boparan's largest single disposal so far. In the past, proceeds from disposals and cash on balance sheet were used to reduce the leverage. As of April 2020, the company had a significant cash balance of £102.5 million, which was supported by proceeds from a £34 million new secured loan. Still, we view the company's liquidity as weak because we anticipate negative free cash flow generation in the next 12-18 months and given the upcoming maturities of its senior unsecured £330 million and €300 million notes (both due in July 2021). Fox's transaction will strengthen the company's liquidity ahead of the potential refinancing, a credit positive.

In the past few years, Boparan has been executing a turnaround plan to improve efficiency and cash generation with a clear objective to regain focus on its core poultry segment. The company previously disposed of several non-core assets, including Goodfella's (frozen pizza), 2SRM (red meat), Manton Wood (sandwiches), Matthew Walker (Christmas pudding) and Green Isle businesses (frozen fish and vegetables) with combined proceeds from the disposals of around £440 million since 2017.

Since the third quarter of fiscal 2019 (ended July) Boparan's profitability has been on an improving trend, with substantial margin recovery across all UK divisions as a result of its turnaround strategy. The company reported EBITDA of £32.1 million in the fiscal third quarter (ended April 2020) up 47.9% year on year, and £107.8 million on a last 12-month (LTM) basis, up 14.2% year on year. In the LTM to April 2020, Moody's-adjusted leverage was 10.5x. If proceeds from Fox's Biscuits were used to reduce debt, pro forma leverage as of April 2020 would be around 9.4x.

Fox's Biscuits, which includes brands like Rocky Bars, Party Rings, Crunch Creams, Crinkle Creams, Chocolatey and Viennese, is a well-known operator in the UK biscuit market.

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## Deutsche Post's improved guidance reflects faster-than-anticipated business recovery

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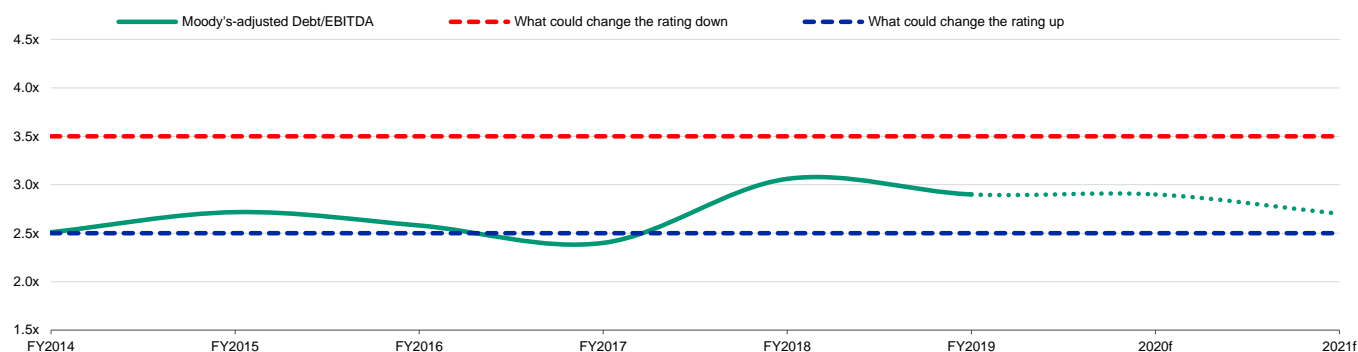
On 7 October, [Deutsche Post AG](#) (A3 stable), the incumbent postal operator in Germany and the world's largest logistics service provider, raised its 2020 EBIT guidance to between €4.1 billion and 4.5 billion from €3.5 billion-€3.8 billion previously and its free cash flow guidance to more than €1.8 billion from €1.4 billion previously. The revised guidance follows the release of solid preliminary results for the third-quarter 2020, with reported EBIT increasing to €1.37 billion from €942 million in third-quarter 2019, notwithstanding additional €215 million costs related to one-time payments to employees for special bonus and due to a new contract agreement in Germany.

The guidance upgrade is credit positive and demonstrates a stronger business recovery than we have anticipated. Operating profit in third-quarter 2020 improved in all divisions, apart from Supply Chain that posted an EBIT of €110 million from €162 million in third-quarter 2019. Performance was particularly strong in the Express division that reported EBIT of €750 million in third-quarter 2020 (€454 million in third-quarter 2019) and eCommerce Solutions, with EBIT at €75 million (€6 million in third-quarter 2019). As a result, free cash flow improved to more than €1 billion in third-quarter 2020 from €507 million in third-quarter 2019. Management expects a strong Christmas season to support performance also in fourth quarter.

The revised 2020 guidance points to an EBIT growth between 0% and 7% from 2019, which is much better than our previous expectation of a 15%-25% decline in operating profit. As a result, we are now expecting the company's credit metrics to remain solid, with Moody's-adjusted debt/EBITDA remaining at 2.8x-2.9x in 2020 (2.9x in 2019), compared to our previous expectation of a slight deterioration to above 3.0x. This comfortably positions the rating at the current level (see exhibit).

### Leverage will remain comfortably within the boundaries for the current rating

#### Deutsche Post's Moody's adjusted gross debt/EBITDA



All figures and ratios are calculated using Moody's estimates and standard adjustments. Moody's forecasts (f) or projections (proj.) are Moody's opinion and do not represent the views of the issuer. Periods are financial year-end unless otherwise indicated. LTM refers to last twelve months. Deutsche Post adopted IFRS 16 from 2018

Sources: Moody's Financial Metrics™ and Moody's Investors Service forecasts

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## Indonesia now allows foreign ownership of apartments, a credit positive for developers

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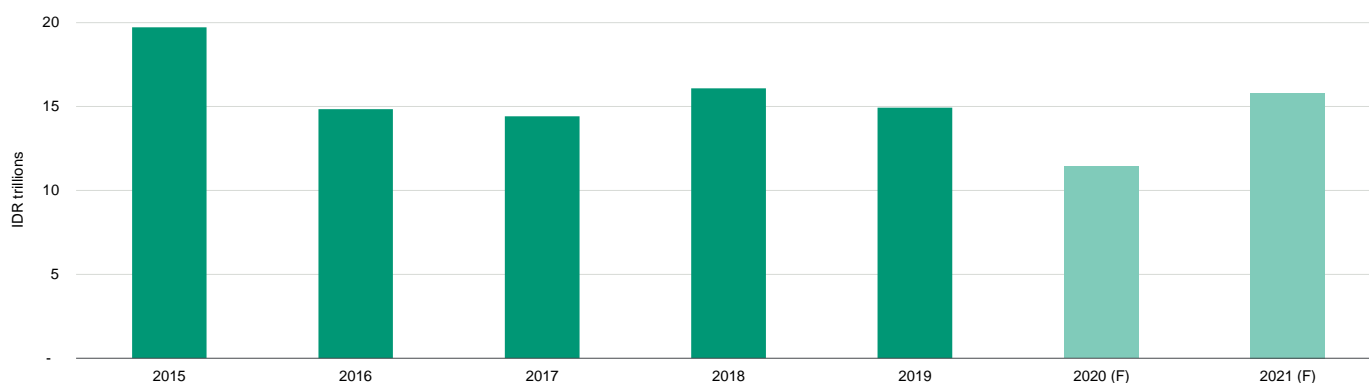
On 6 October, the [Government of Indonesia](#) (Baa2 stable) passed the Job Creation Law, which allows foreigners to own apartments in Indonesia. The new law permits foreign citizens, foreign legal entities that have a representative office in Indonesia, or representatives of a foreign country and an international institution in Indonesia (foreign buyers) to purchase apartments, condominiums and other similar buildings in Indonesia. Previously, foreigners were only permitted to purchase rights-to-use titles that could be renewed up to 80 years and at floor prices depending on the region. The new law does not apply to landed houses.

The relaxation in foreign property ownership is credit positive for property developers in Indonesia because it opens up the Indonesian property market to foreign buyers and encourages demand for apartments. Additionally, the new law passed at a time when property demand has been weak because of the impact of the coronavirus pandemic and uncertainty in Indonesia's economic recovery.

We expect property developers that are focused on the development of apartments and condominiums to benefit most from the new law. Of our six rated developers, [Pakuwon Jati, Tbk. \(P.T.\)](#) (Ba2 stable) derived most of its property development revenue from the sale of high-rise residential projects. Other developers such as [Bumi Serpong Damai TBK \(P.T.\)](#) (Ba3 stable), [Lippo Karawaci Tbk \(P.T.\)](#) (B3 stable) and [Agung Podomoro Land Tbk \(P.T.\)](#) (B3 negative), which have apartments and condominiums for sales, will also stand to gain.

Overall, we expect the improvement in marketing sales from the new law will be more pronounced in 2021 than in 2020. Consequently, we expect marketing sales in 2021 to grow around 35% from 2020 or around 10% compared with 2019. For 2020, we expect marketing sales to decline around 25% from 2019 (see exhibit).

### Marketing sales to grow around 35% in 2021 from 2020



Sources: Company data and Moody's Investors Service estimates

The improvement in marketing sales will not result in an immediate improvement in credit metrics because of the time lag between revenue recognition and marketing sales. Following the adoption of accounting standard IFRS 15, revenue recognition for apartments and offices will be based on handover, which could be two to three years after the booking of marketing sales.

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## Morgan Stanley's agreement to acquire Eaton Vance is credit positive

Originally published on 08 October 2020

On 8 October, [Morgan Stanley](#) (A2 stable) announced that it had entered a definitive agreement to acquire asset management company [Eaton Vance Corp.](#) for approximately \$7 billion. The acquisition is credit positive for Morgan Stanley because the firms have complementary products and activities, and it tilts Morgan Stanley's business mix further toward lower-risk, recurring revenue streams. These features bear a strong similarity to Morgan Stanley's 2 October acquisition of [E\\*TRADE Financial, LLC](#) (A3 stable), another credit-positive deal that contributed to [Morgan Stanley's recent ratings' upgrade](#).

The addition of Eaton Vance's high-quality investment and distribution capabilities to Morgan Stanley's investment management business will strengthen Morgan Stanley's competitiveness in the industry. Eaton Vance brings Morgan Stanley a number of differentiated, at-scale investment capabilities in segments that provide significant organic asset under management (AUM) growth opportunities on a combined \$1.2 trillion AUM base.

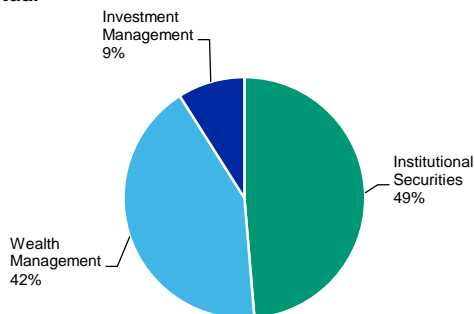
Importantly, many of these capabilities aim to deliver value to clients beyond active outperformance or providing pure low-cost beta, such as custom portfolios, tax solutions and environmental, social and governance (ESG) offerings. Both firms' products and activities are highly complementary: most significantly, Eaton Vance will substantially improve Morgan Stanley's fixed-income franchise, ESG offerings and portfolio customization capabilities. Eaton Vance's concentration in the US market has the potential to benefit from Morgan Stanley's extensive global distribution capabilities.

Morgan Stanley's acquisition of E\*TRADE and planned acquisition of Eaton Vance tilt its business mix further toward lower-risk, recurring revenue streams from its inherently higher-risk institutional securities segment. For 2019, institutional securities' revenue share would reduce to 44% on a pro forma basis from 49% actual (see Exhibit 1).

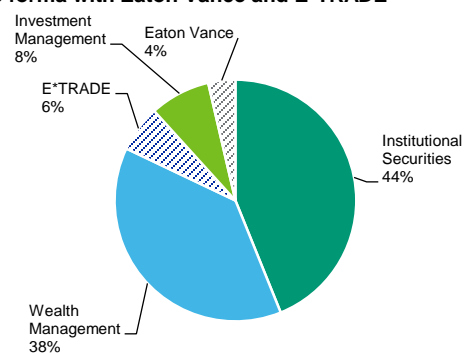
Exhibit 1

**Eaton Vance and E\*TRADE will reduce share of revenue attributed to Morgan Stanley's higher-risk institutional securities segment**  
Morgan Stanley's actual fiscal 2019 segment revenue contributions and proforma including Eaton Vance and E\*TRADE

2019 actual



2019 pro forma with Eaton Vance and E\*TRADE



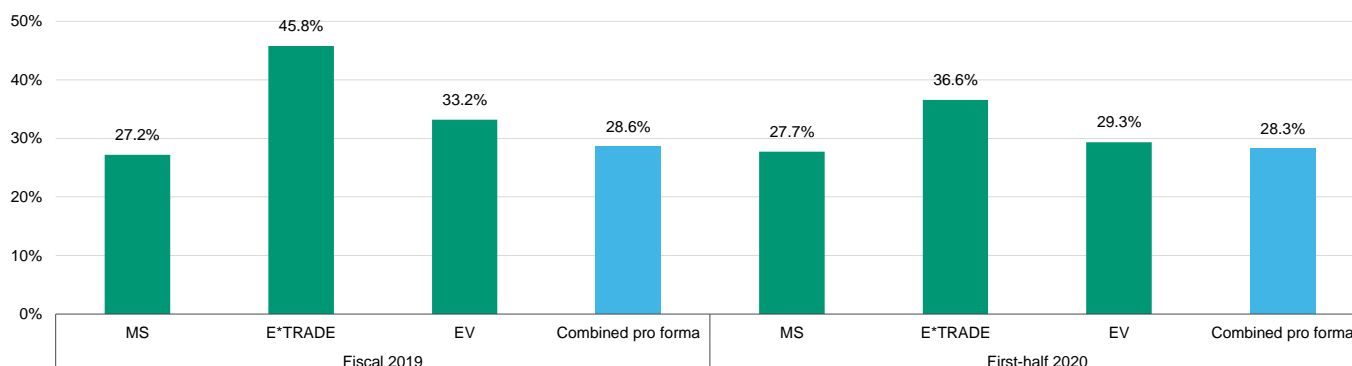
Morgan Stanley's and E\*TRADE's is fiscal years end 31 December, while Eaton Vance's ends 31 October.  
Sources: Company reports and Moody's Investors Service

The profit margins of all three companies were robust during the first half of fiscal 2020 following the onset of the coronavirus crisis, compared with fiscal 2019 (Morgan Stanley's and E\*TRADE's fiscal years end 31 December, while Eaton Vance's ends 31 October). Eaton Vance and E\*TRADE have higher margins than Morgan Stanley, resulting in a modest improvement in combined pro forma pretax margin compared with Morgan Stanley's standalone results (see Exhibit 2).

Exhibit 2

**Eaton Vance's and E\*TRADE's pretax margins are higher than Morgan Stanley's**

Morgan Stanley's actual fiscal 2019 and H1 2020 pretax margins and proforma including Eaton Vance and E\*TRADE



Morgan Stanley's and E\*TRADE's is fiscal years end 31 December, while Eaton Vance's ends 31 October.

Sources: Company reports and Moody's Investors Service

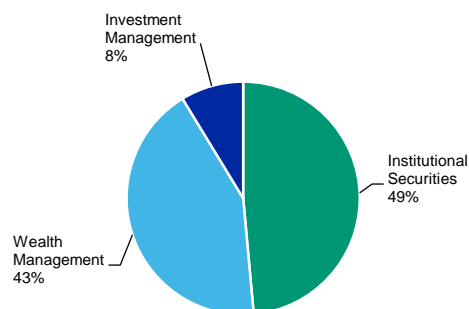
Eaton Vance's and E\*TRADE's higher profit margins indicate a modestly more pronounced shift in business mix when measured by pretax earnings rather than revenue. For fiscal 2019, institutional securities' pretax income share would decline to 42% on a pro forma basis from an actual of 49% (see Exhibit 3).

Exhibit 3

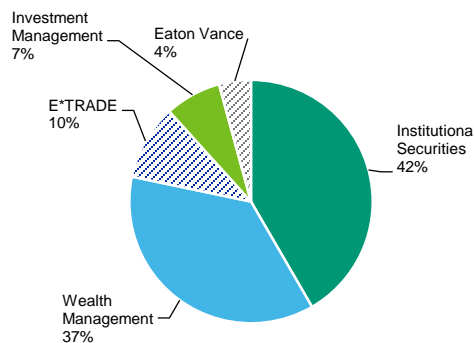
**Eaton Vance and E\*TRADE will dilute pretax income attributed to Morgan Stanley's higher-risk institutional securities segment**

Morgan Stanley's actual fiscal 2019 segment pretax income contributions and proforma including Eaton Vance and E\*TRADE

**2019 actual**



**2019 pro forma with Eaton Vance and E\*TRADE**



Morgan Stanley's and E\*TRADE's is fiscal years end 31 December, while Eaton Vance's ends 31 October.

Sources: Company reports and Moody's Investors Service

Under the acquisition agreement, Morgan Stanley's approximately \$7 billion purchase consideration will be roughly half in common stock and half in cash. Morgan Stanley said the deal will utilize about 100 basis points of its excess regulatory capital, and expects its standardized-approach Common Equity Tier 1 ratio to be about 300 basis points above its minimum required 13.2%. Morgan Stanley expects to complete the acquisition in the second quarter of 2021, subject to customary closing conditions.

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## Regulatory actions and \$400 million fine for Citigroup are credit negative

Originally [published](#) on 09 October 2020

On 7 October, two of [Citigroup Inc.](#)'s (A3 stable) principal regulators took enforcement actions including levying a \$400 million fine and imposing additional hurdles to approve significant acquisitions that require Citigroup's board and management to promptly address long-standing deficiencies in risk management, data governance and internal controls.

The regulators' actions are credit negative for Citigroup. Despite the bank's multiyear effort to strengthen its safety and soundness and enhance its regulatory relations, the actions reflect Citigroup's complexity even after simplification and restructuring.

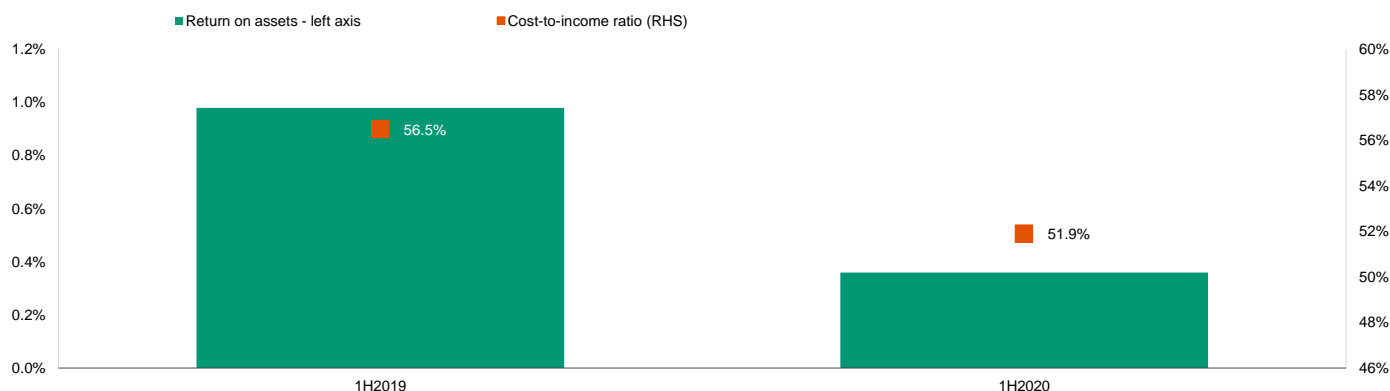
The Federal Reserve Board and the Office of the Comptroller of the Currency (OCC), which regulates [Citibank N.A.](#) (Aa3/Aa3 stable, baa1<sup>1</sup>), require Citigroup's board of directors and senior management to develop plans to address deficiencies in risk management and data governance and strengthen compliance and other internal controls.

The actions include levying a \$400 million fine and requiring Citibank to secure a non-objection from the OCC for significant future acquisitions. The OCC Consent Order is sharply critical of Citibank's enterprise-wide risk management, compliance function, internal controls and data governance, finding that these programs were not commensurate with the bank's size, complexity and risk profile. The orders require Citigroup and Citibank to perform a "gap analysis" to identify shortcomings in these key elements, then create a plan complete with adequate financial resources to address the shortcomings and report on progress regularly to the examiners.

The fine, the need to prioritize control investments and seek special approvals for significant acquisitions will reduce management's flexibility and increase costs amid reduced profitability, adding to existing profit pressures in the second half of 2020 (see exhibit). Return on assets (ROA) was down sharply to 36 basis points in first-half 2020 from 98 basis points in first-half 2019, in large part because of a \$10.5 billion reserve build in anticipation of future credit losses tied to the coronavirus pandemic's economic effects. The firm-wide cost-to-income ratio improved to 51.9% in first-half 2020, down from 56.5% in first-half 2019, reflecting robust capital market revenue and strong operating leverage within the Institutional Client Group so far this year.

### Regulatory and compliance costs will increase while profits are down

Return on assets and cost-to-income ratios for first half 2019 and 2020



Sources: *Company financials and Moody's Investors Service*

Citigroup reports third-quarter results on 13 October. Management has guided to "meaningfully lower" reserve build for the quarter, but also to revenue declines in the "high-single-digit" range compared to the prior period because of negative pressures on the net interest margin and loan volume, with expenses flat to up slightly. This implies a third-quarter cost-income ratio of roughly 61%.

Despite these pressures, management considers enhancing the risk and control environment a strategic priority and will make \$1 billion in additional control investments this year. The goal is to fund the investment largely through savings realized elsewhere, such as by digitizing client engagement, replacing legacy technology and re-engineering processes. In the long run, if remediation efforts succeed, Citigroup will have fortified its operating platform.

## Endnotes

<sup>1</sup> The ratings shown are Citibank's deposit rating, senior unsecured debt rating and Baseline Credit Assessment.

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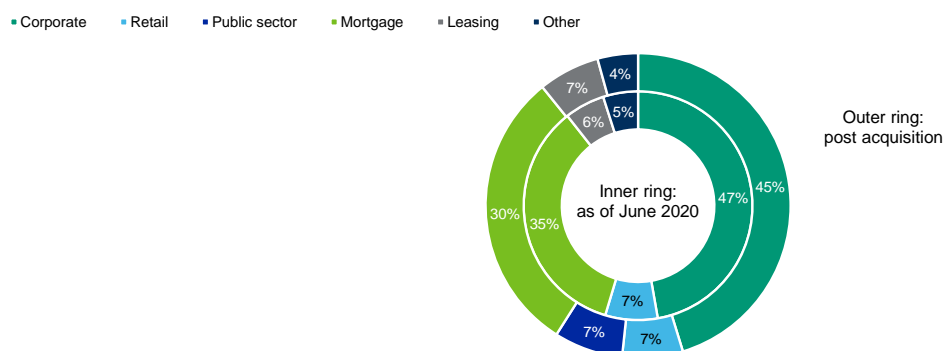
## LHV Bank's acquisition of Danske Bank's portfolio will fuel fast loan growth

On 3 October, [AS LHV Bank](#) (LHV Bank, Baa1 stable, baa3<sup>1</sup>) announced that it had completed its acquisition of a €274 million loan portfolio from [Danske Bank A/S](#) (A2 negative/A3 stable, baa2). The acquisition, which will increase Estonia-based LHV Bank's loan book by 14%, is credit negative because it will help fuel the bank's very fast loan growth in an uncertain economic environment.

The acquisition, which will increase LHV Bank's loan portfolio by 14% based on June 2020 data, suggests an aggressive growth strategy following the earlier acquisition of the €393 million portfolio of Estonian private customers from Danske Bank completed in November 2019. The bank's newly acquired loan portfolio comprises 56% public-sector loans and 44% corporate loans, all made in Estonia. Following the acquisition, LHV Bank's portfolio composition will continue to be largely concentrated in corporate customers, but will now include 7% exposure to the low-risk local public-sector (see Exhibit 1), somewhat reducing the risk of a significant tick-up in soured loans.

Exhibit 1

### LHV Bank's loan book composition

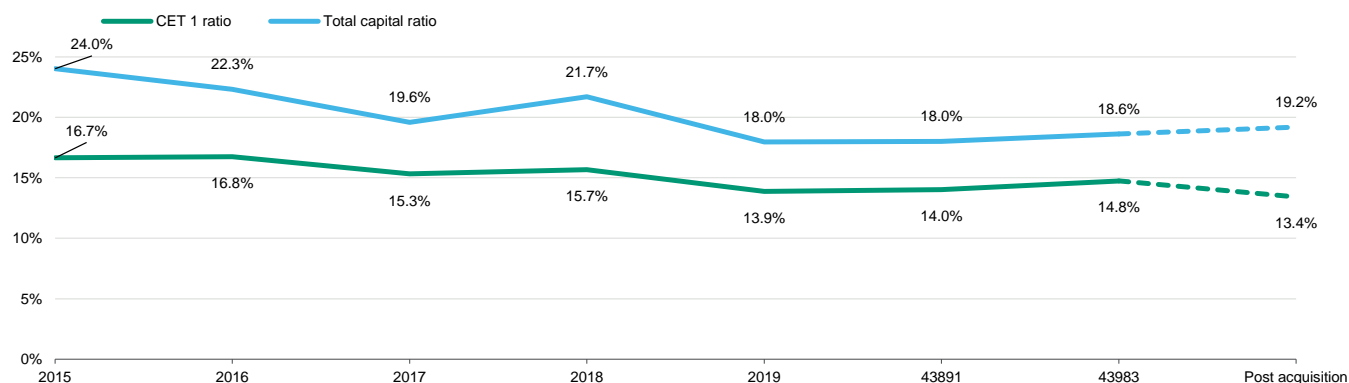


Sources: The bank and Moody's Investors Service

Given the most recent data available, we estimate that AS LHV Group's<sup>2</sup> pro forma Common Equity Tier 1 (CET1) capital ratio will decrease to 13.4% from 14.8% as of the end of June 2020 following the inclusion of risk-weighted assets from the new portfolio (see Exhibit 2), although we expect the bank's capital to recover over the next 18 months. The pro forma Tier 1 ratio of 13.4% will be higher than its regulatory requirement of 11.3%, although the bank's loss-absorption capacity will initially decline, a credit negative considering the current economic downturn. The bank's total capital ratio will be strong, supported by a €35 million Tier 2 issuance concluded in September 2020.

Exhibit 2

## LHV Group's regulatory capital evolution



Forecasted capital ratios post acquisition are our estimates based on end of June 2020 figures and the estimated risk-weighted assets of the acquired portfolio.

Sources: The bank and Moody's Investors Service

LHV Bank purchased the portfolio at the discounted price of €254 million and will fund the purchase with a combination of €200 million from the European Central Bank's (ECB) targeted longer-term refinancing operations (TLTRO) III programme and existing deposits. The bank aims to replace ECB's funding with local deposits over the next three years. As such, we estimate that LHV Group's ratio of market funds to tangible banking assets will rise to 12% from 7.4% as of the end of June 2020 and 0.8% at the end of 2019. In the first half of 2020, the bank's market funds also included the recent issuance of an inaugural €250 million covered bond.

Our estimates indicate that the acquisition will be profitable for LHV Bank, but it is not yet clear to what extent it will lead to an improvement in net income to tangible assets.

LHV Bank's portfolio acquisition follows Danske Bank's announcement in February 2019 that it was exiting the Baltic market. Earlier this year, other banks also acquired portions of Danske Bank's portfolio, including [SC Citadele Banka](#) (Baa3 stable, ba2), which acquired a portfolio of private customers in Latvia, and [Siauliu Bankas, AB](#) (Baa2 stable, ba1) which did so in Lithuania.

## Endnotes

- 1 The ratings shown in this report are the bank's deposit rating, senior unsecured rating (where available) and Baseline Credit Assessment.
- 2 The bank is a wholly owned subsidiary of AS LHV Group. For the purpose of the standalone assessment of LHV Bank, we consider the consolidated accounts of LHV Group, which additionally consolidated AS LHV Varahaldus, the second largest pension fund manager in Estonia; OU Cuber Technology; and AS LHV Finance, in which it holds a 65% stake.

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## P&C (re)insurers expect losses as Hurricane Delta makes landfall on Louisiana coastline

Originally [published](#) on 09 October 2020

On 9 October, Hurricane Delta made landfall on the western Louisiana coastline as a Category 2 storm, bringing damaging winds, storm surge and flash flooding from heavy rainfall. Delta is the 10th named storm to make landfall this year in the continental US – the most ever in one year.

Delta follows [Hurricane Laura](#), which struck Louisiana on 27 August as a Category 4 storm, with insured losses estimated at \$9-\$13 billion,<sup>1</sup> according to catastrophe risk solutions firm RMS. It will take time to determine the magnitude of insured damages and the degree to which the hurricane affects primary property and casualty (P&C) insurers, with regionally focused carriers most vulnerable. Because Delta's projected path is similar to Laura's, buildings that were already damaged could be more susceptible to loss. We expect some of the losses from both Laura and Delta to make their way to the reinsurance market through quota-share and excess-of-loss contracts.

Exhibit 1 shows the top 10 homeowners insurers in Louisiana based on direct premiums written. State Farm, [The Allstate Corporation](#) (A3 stable), and [United Services Automobile Association](#) (Aaa, negative) have leading market shares. Given their careful monitoring of exposures, geographic diversification, high quality reinsurance protection and strong capital bases, these large national carriers can withstand this hurricane event. Regional insurers and state insurance funds will experience greater effects based on their geographic concentrations.

Exhibit 1

### Top 10 homeowners insurers in Louisiana, 2019

Company	Louisiana direct premiums written (\$ millions)	US direct premiums written (\$ millions)	Premium concentration in Louisiana	Surplus (\$ millions)
State Farm	504	18,978	2.7%	116,232
Allstate	213	8,723	2.4%	19,887
USAA	121	6,836	1.8%	30,476
Liberty Mutual	109	6,861	1.6%	20,539
Louisiana Farm Bureau	93	93	100.0%	169
United	79	861	9.2%	416
Progressive	76	1,647	4.6%	13,670
Lighthouse	60	254	23.7%	55
FedNat	43	525	8.3%	142
Geovera Holdings, Inc.	36	211	16.9%	93
Total - Top 10	1,333	44,989	3.0%	201,678
Industry	1,965	108,831	1.8%	866,628

Sources: SNL Financial L.C. (contains copyrighted and trade secret materials distributed under license from SNL, for recipient's internal use only) and Moody's Investors Service  
Data reflect homeowners and farmowners lines.

If heavy rain causes widespread flooding, economic losses could be significant. However, homeowners policies typically do not cover flood damage. Homeowners located in a flood zone often obtain coverage from the government-backed National Flood Insurance Program, a division of the Federal Emergency Management Agency (FEMA). In previous hurricanes, FEMA has provided some disaster assistance, including repair or replacement of homes for uninsured and underinsured homeowners. Flood damage often becomes a point of dispute when the immediate cause of loss (wind versus flood) is unclear. Commercial property insurers might face losses from flooding, which is typically an optional commercial coverage.

Exhibit 2 shows the top 10 commercial property insurers in Louisiana based on direct premiums written. [CNA Financial Corporation](#) (Baa2 stable), [Liberty Mutual Group Inc.](#) (Baa2 stable) and [American International Group, Inc.](#) (Baa1 stable) have leading market shares.

Apart from property losses, commercial policies typically cover business interruption claims, which could be sizable if the hurricane disrupts critical infrastructure, causes long-term power outages or otherwise blocks access to covered properties.

Exhibit 2

### Top 10 commercial property insurers in Louisiana, 2019

Company	Louisiana direct premiums written (\$ millions)	US direct premiums written (\$ millions)	Premium concentration in Louisiana	Surplus (\$ millions)
CNA	128	4,445	2.9%	10,787
Liberty Mutual	89	6,285	1.4%	20,539
AIG	77	3,731	2.1%	17,439
Zurich	76	2,555	3.0%	7,673
Factory Mutual	71	3,771	1.9%	13,708
State Farm	68	1,802	3.8%	116,232
Chubb	56	4,037	1.4%	17,646
Louisiana Citizens	55	55	100.0%	186
Travelers	49	4,410	1.1%	20,670
Nationwide	44	2,892	1.5%	15,749
Total - Top 10	713	33,983	2.1%	240,629
Industry	1,660	84,111	2.0%	866,628

Data include allied lines, commercial multiple peril – non liability, fire, and inland marine. Premium concentration in four states calculated as 2019 commercial property direct written premiums in Louisiana as a percentage of countrywide commercial property premiums. A large portion of CNA's commercial property business is inland marine, which mainly comprises a cellphone warranty fronting arrangement, and is not considered catastrophe-exposed.

Sources: SNL Financial L.C. (contains copyrighted and trade secret materials distributed under license from SNL, for recipient's internal use only) and Moody's Investors Service

We expect that significant losses along the Louisiana coast will be absorbed by Louisiana Citizens Property Insurance Corporation (LA Citizens). LA Citizens acts as a residual market mechanism for Louisiana residents and small businesses unable to procure property insurance through the voluntary market in homeowners, commercial multiple peril, fire and allied lines. As a residual market insurer, its risk exposures are concentrated in major cities and in the most hurricane exposed areas of the state. LA Citizens sustained large losses from Hurricanes Katrina and Rita in 2005 (approximately \$1.1 billion net), which exhausted existing claims-paying resources, requiring regular assessments on insurers operating in the state, as well as the issuance of \$978 million in revenue bonds backed by future emergency assessments on Louisiana policyholders in subject lines of business.

LA Citizens currently has \$560 million in total reinsurance and catastrophe bonds in place to pay storm losses. LA Citizens also has a \$50 million line of credit with Regions Bank (A2/Baa2 stable, baa2<sup>2</sup>) for additional liquidity. LA Citizens can impose regular assessments on insurers in the state for up to 10% of their written property premiums to help cover its deficits each calendar year. Based on present premium volumes, LA Citizens could collect a regular assessment of approximately \$260 million within 30 days. In addition to the resources mentioned above, LA Citizens can levy an emergency assessment for up to 10% of written premiums on Louisiana property owners once a year to offset any debt incurred on storm losses. Based on present state premium volumes, including premiums of LA Citizens, an emergency assessment of approximately \$267 million could be collected each calendar year.

In addition to homeowners and commercial property exposures highlighted here, P&C insurers face potential claims on private passenger and commercial vehicles, watercraft and other insured assets. With regard to business interruption claims, the coronavirus and related economic downturn might complicate coverage calculations and heighten the number of disputes. Some interruption claims might reflect a combination of hurricane and coronavirus effects, with coverages depending on a range of specific policy provisions.

The frequency of weather-related catastrophe events has trended higher as temperatures increase and sea levels rise. We expect (re)insurers to continue to push for higher pricing and better terms and conditions in an effort to better align pricing with their updated view of risk.

## Endnotes

<sup>1</sup> The estimate includes losses to the National Flood Insurance Program (NFIP) of \$400-\$600 million.

<sup>2</sup> The ratings shown are Regions Bank's deposit rating, senior unsecured debt rating and Baseline Credit Assessment.

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## Protracted political uncertainty would impede Kyrgyz Republic's economic recovery

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On 6 October, [Kyrgyz Republic's](#) (B2 stable) then-incumbent Prime Minister Kubatbek Boronov resigned after opposition parties disputed the preliminary results of the 4 October parliamentary elections. While the vote has since been annulled, various opposition parties have attempted to seize control, including by setting up a People's Coordination Council and appointing a new prime minister, Sadyr Japarov, who was released from prison just hours before being appointed. President Sooronbai Jeenbekov remains in power, although he has expressed openness to step down amid calls for his resignation.

The absence of a functioning government and political leadership, as well as the potential for a contested power grab at odds with constitutional processes threaten to deepen the coronavirus-induced economic uncertainty in the near term. If protracted, the political uncertainty could deter long-term investment and hinder the development of institutions, curbing economic progress and weighing on the commitment to or effectiveness of measures to reduce the government's debt burden.

We expect real GDP to contract by 5% in 2020, reflecting the impact of coronavirus-related lockdown measures in Kyrgyz Republic and our projection of a recession in [Russia](#) (Baa3 stable), which will weigh on remittances and foreign direct investment (FDI) flows. Activity has only begun to normalise over the past month, after a second round of movement restrictions that were imposed between March and May.

Political uncertainty at this time has the potential to weigh on the economic recovery, such as by slowing decisions related to public spending on infrastructure, the approval and implementation of private investment, and the full reopening of the economy and gradual reopening of borders. Should law and order continue to be disrupted for an extended period, it may also affect production: attacks have occurred on the premises of several key foreign investors since the unrest began, including the Bishkek office of Centerra Gold – owner of the country's most productive gold deposit – and the production facilities of the Jerooy gold deposit, which were looted and damaged. While we anticipate a recovery to GDP growth of 7% in 2021 (which includes a significant base effect), the current political situation threatens this outlook.

In the medium to long term, protracted political uncertainty would strain government resources away from limiting the rise in the government's debt burden or implementing effective measures to reduce debt over time. We expect the government's debt burden to jump to around 69% of GDP this year, because of lower tax revenue that will contribute to a wider fiscal deficit of around 6%-6.5% of GDP this year, compared to around 2.5%-3% over the past three years, coupled with the economic contraction. Beyond this initial shock, our forecast is for a gradual decline in the government's debt burden, as the incumbent government had signalled its commitment to narrower fiscal deficits of less than 3% of GDP over the next three years in its proposed fiscal rule. However, the absence of an effective government and/or legislature would pose challenges to the consolidation of government finances.

Moreover, any disregard for constitutional processes in promoting change may call into question the commitment of future governments to the rule of law and undermine their legitimacy, potentially weakening institutions and governance in the country. Weaker institutions, whether real or perceived, would in turn weigh on perceptions of Kyrgyz Republic as a place to do business. This could weigh on long-term FDI inflows, putting pressure on the balance of payments, and hobble the country's economic potential. FDI inflows have averaged around 6% of GDP in the last five years, serving as a source of financing for Kyrgyz Republic's large structural current account deficit, and providing technical expertise for the implementation of long-term projects, particularly in mining.

Multiple cabinet positions, including that of prime minister (the position of which is currently claimed by multiple candidates), have been claimed in backroom meetings or at street protests without a clear constitutional mandate. The situation is further muddied by the annulment of the parliamentary election result, leaving it uncertain as to who should legitimately be involved in the decision-making process. Tolerance of these extrajudicial appointments would signal severe deficiencies in the rule of law. Furthermore, the re-emergence of several prominent politicians convicted of abuse of power related crimes – several of whom were sprung from prison or returned from exile as the unrest began – could undermine the credibility of the government's efforts to control corruption.

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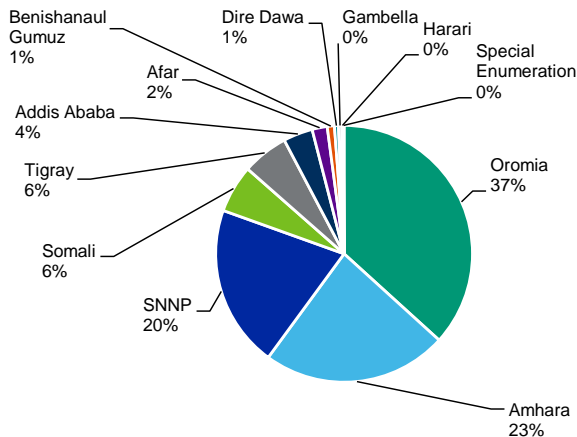
## Ethiopian parliament severs ties with Tigray regional authorities, fuelling domestic political tensions

On 7 October, the Ethiopian House of Federation, the federal upper house of parliament, voted to sever ties with the Tigray regional authorities in the aftermath of unsanctioned regional elections held on 9 September. The House of Federation's actions, combined with statements days earlier from representatives of the Tigray administration that it will not recognise any federal laws passed after 5 October, mark a significant escalation in ethnic tensions between the Tigray region and the federal government, risking further political unrest ahead of the general elections scheduled in the next nine to twelve months.

The Tigray regional elections conflicted with the federal government's decision to postpone Ethiopia's first multiparty democratic general elections because of the coronavirus outbreak, with each side as a result now refusing to recognise each other's legitimacy. While the federal government also announced at the same time that it would continue to work with local institutions in Tigray to provide basic services, suggesting that the parliamentary decision does not amount to a complete break in relations, the standoff has reached a point from which there is no easy return.

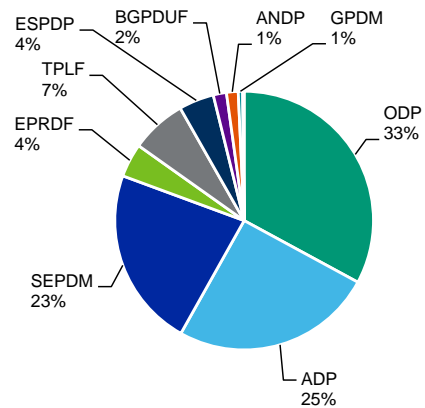
Though the Tigray region does not represent a large proportion of the population or representatives in parliament (see Exhibits 1 and 2), its traditional political leadership dominance and role in these political tensions underscore the credit relevance, particularly in light of Ethiopia's reliance on donor support and the implications for geopolitical tensions.

Exhibit 1  
**Oromia and Amhara are by far the most populous states...**  
 Share of population by state (2007 census)



Source: Moody's Investors Service

Exhibit 2  
**... and their ethnic parties hold the majority of seats**  
 Share of parliament seats by party (2015 elections)



All groups have since merged into the Prosperity Party, except for the TPLF  
 Source: Moody's Investors Service

We capture the risks associated with Ethiopia's recent history of domestic political tensions in our high political risk assessment of the sovereign. Over the last couple of years, although political risks have not manifest in a reduction in foreign direct investment, were ethnic tensions to increase between the Tigray region and the federal government leading to political unrest, it would likely exert negative credit pressures.

Given Ethiopia's dependence on bilateral and multilateral financial support, domestic political tensions risk critical financing being delayed or cancelled given the deterioration in governance that this development demonstrates. The extent of fallout from the development partners will depend on whether the domestic political situation worsens.

Moreover, even though these political tensions are largely domestically driven, the Tigray region is sufficiently close to the Eritrean border to risk triggering geopolitical unrest and close the borders between the countries. This would jeopardize the recent gains following the peace treaty signed in 2018 and, given Ethiopia's landlocked status, would affect trade routes to the ports in that area, constraining Ethiopia's export capacity.

In 2019, Prime Minister Abiy abolished the longstanding Ethiopian People's Revolutionary Democratic Front (EPRDF) and replaced it with the People's Party, and has allowed new political parties to be formed. The Tigray People's Liberation Front opted not to join the new governing party. The new governance arrangements have improved voice and accountability, one of the governance indicators on which we focus, but at the same time it has provoked ethnic tensions, increasing political risks.

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## Korea's new fiscal rules will enforce post-coronavirus budgetary discipline, supporting credit quality

Originally [published](#) on 08 October 2020

On 5 October, the government of [Korea](#) (Aa2 stable) proposed new fiscal rules to ensure budgetary consolidation following a pronounced increase in spending in response to the coronavirus outbreak. If passed by the National Assembly, the new rules will support sovereign credit quality, particularly in light of a sharp near-term rise in government debt and climbing fiscal pressures from an aging population over the longer term.

Broadly speaking, the proposal limits government debt to 60% of GDP and the fiscal deficit to 3% from 2025. However, the actual rule is expressed as a formula that simultaneously provides flexibility and enforces budgetary discipline:

$$\frac{\text{Government debt (\% of GDP)}}{60\%} \times \frac{\text{Consolidated fiscal balance (\% of GDP)}}{-3\%} \leq 1.0$$

For example, once government debt has reached 60% of GDP, the proposed fiscal rule would cap the deficit at 3%; should government debt levels stabilize at 50% of GDP, the fiscal deficit could widen to 3.5% of GDP, subject to certain conditions such as an economic downturn. The government proposes to make this fiscal rule binding, with a failure to meet the formula compelling the government to undertake remedial measures, such as increasing revenue generation or controlling expenditure growth, to reduce deficits.

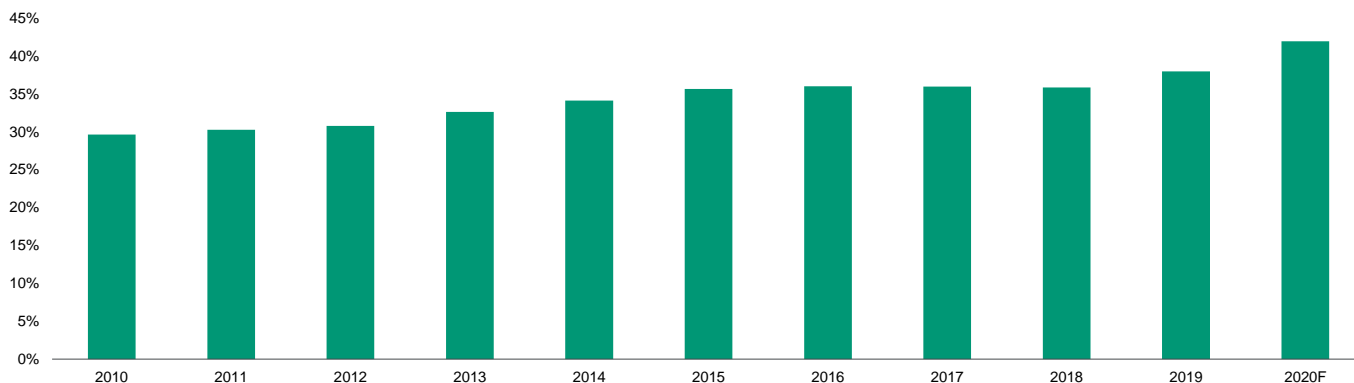
Additional flexibility would be provided by specific exceptions, including a one-year relaxation of the rule should the economy face particularly difficult circumstances, such as a pandemic. The temporary suspension would be followed by a four-year recovery period to work toward meeting the rule.

We view the implementation of new fiscal rules as a prudent measure that will stabilize Korea's debt burden as the government signals continued fiscal accommodation beyond the pandemic shock. In its latest National Fiscal Management Plan, the government projects the consolidated fiscal balance to remain in deficit through 2024, while the debt burden will reach 58.3% of GDP by 2024, up more than 20 percentage points from 2019.

Since the beginning of 2020, the Korean government has introduced several relief packages to offset negative pressures from the coronavirus pandemic. The stimulus measures encompass three supplementary budgets – with a fourth proposed – that contribute to the general government fiscal deficit widening to 4%-5% of GDP in 2020, versus 0.6% in 2019, and government debt rising above 40% of GDP, versus 38.0% in 2019 (see Exhibit 1).

Exhibit 1

**Korea's government debt will exceed 40% of GDP in 2020**  
(General government debt, % of GDP)



Sources: Ministry of Economy and Finance and Moody's Investors Service

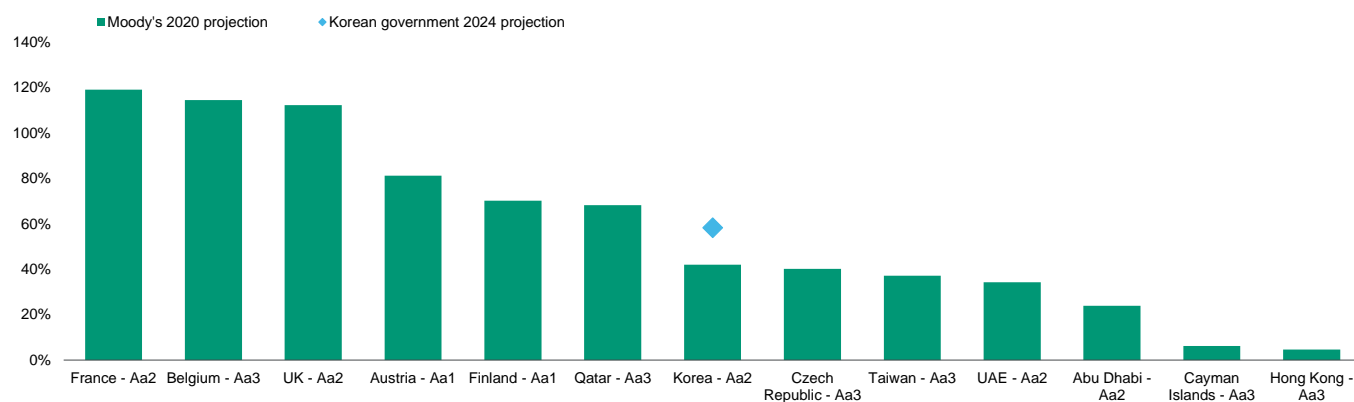
Although we expect that some deficit consolidation will start in 2021, Korea's debt metrics will erode further given the expansionary stance adopted by the current administration even before the coronavirus pandemic. In the past few years, the government has focused on inclusive growth, allocating larger amounts of spending to the creation of public-sector employment, strengthening social safety nets and supporting low-income households.

In addition, there has been a strategic emphasis on promoting innovation and reviving investment. Key projects include the Korean New Deal announced earlier in 2020, which comprises investment within smart infrastructure and further adoption of "high" technologies such as green, artificial intelligence and blockchain. Also included is the upgrading of medical facilities to enhance disease prevention capabilities.

The proposed fiscal rules will preserve Korea's strong fiscal position relative to peers. Even in the event that its debt burden reaches the prospective ceiling of 60% of GDP, we expect that Korea will remain less indebted than advanced economies that share a similar rating, such as [France](#) (Aa2 stable) and the [UK](#) (Aa2 negative) (see Exhibit 2).

Exhibit 2

**Korea's debt burden will remain lower than other Aa-rated advanced economies**  
(General government debt, % of GDP)



Sources: Ministry of Economy and Finance and Moody's Investors Service

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## Proposed maturity extension and increased overcollateralization for Pfandbrief is credit positive

On 2 October, the German Ministry of Finance proposed amendments to the Pfandbrief Act that would allow covered bond administrators to extend the maturities of outstanding covered bonds and increase statutory minimum overcollateralization (OC) requirements.

The proposed amendments would strengthen the legal framework for covered bonds and implement changes the European covered bond directive requires to be enacted into national law by 8 July 2021.

If, as we anticipate, the parliament approves the amendments, they would allow the cover pool administrator to postpone payments to covered bondholders in order to reduce operational risk and refinancing risk after an issuer default. Initially, the administrator would be able to postpone the principal and interest payments due within four weeks of the administrator's appointment. Thereafter, the administrator would have the option to postpone principal payments twice, for a period of six months each (12 months total) while interest payments remain payable at the original due dates. The proposed amendments also include provisions to ensure that the sequence the covered bonds are due does not change, as is required by the covered bond directive.

To comply with the amended European Capital Requirements Regulation (CRR) requirements on minimum OC, the statutory minimum OC levels would be amended so that nominal OC would be required in addition to the Pfandbrief Act's current 2% OC requirement which is based on a stressed present value. This stressed present value OC must be maintained in scenarios that feature upward and downward stress assumptions for interest rates and currency exchange rates (in case exchange rate risks exists in the covered bond programme). The additional minimum nominal OC requirement would be specific for each type of Pfandbrief, as shown in the exhibit below. The new requirements would exclude assets used to cover the 2% stressed present value OC requirement from the calculation of nominal OC.

### Statutory minimum OC levels for Pfandbrief

	Current statutory OC requirement (stressed present value only)	Proposed statutory OC requirement (stressed present value OC plus nominal value OC)
Mortgage covered bonds	2%	2% / 2%
Public sector covered bonds	2%	2% / 2%
Ship mortgage covered bonds	2%	2% / 5%
Aircraft mortgage covered bonds	2%	2% / 5%

Sources: Pfandbrief Act and German Ministry of Finance

**Stricter eligibility criteria for financial institutions are also credit positive.** Most other proposed amendments ensure that the Pfandbrief Act will reflect all requirements set by the European covered bond directive and by the CRR so that German covered bonds maintain their current regulatory treatment for investors.

Among these other changes, the strengthened requirements for cover pool eligibility of claims against financial institutions go beyond what is required by the covered bond directive and would exclude counterparties that belong to the same banking group, a credit positive because it reduces the likelihood of a joint default by the issuer and the counterparty. The cover pool eligibility would further require the financial institution to be rated and to qualify for credit quality step 1 or 2 as defined in the CRR, which is equivalent to a minimum Moody's rating of A3.

Some of the changes, such as the higher OC requirements, are scheduled to come into force in July 2022, which is the final deadline set by the European covered bond directive, while other provisions, such as the maturity extension option, will come into force when the law is enacted.

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## PODCASTS AND VIDEOS

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### Podcasts and Videos

**Podcast: US presidential election will shape policies on economy, healthcare and the environment**, 8 October 2020

Atsi Sheth and Robard Williams of the Credit Strategy & Research team discuss the credit effects of key policy challenges that will confront the next US presidential administration, and the uncertainties surrounding the election.

Related report: [\*Credit Conditions- US: Next administration will confront five policy challenges with wide-ranging credit impact\*](#)

**Focus on Finance - Podcast: Banks' battle with low rates goes global; financial institutions prepare to leave Libor**, 7 October 2020

As policy rates continue to decline globally, Banking team member Laurie Mayers examines the effect on UK banks, while Shunsaku Sato does so for Japanese banks and Farooq Khan for Brazilian banks. Plus, Olivier Panis of the Banking team and Stefan Kahandaliyanage of the Asset Management team update financial institutions' readiness for the transition away from Libor in 2021.

Related reports: [\*Banks - Japan: Low rates and slow cost-cutting amid excess capacity will keep profitability weak\*](#), [\*Financial Institutions - Global: IBOR phaseout 15 months away, but hurdles could stretch beyond finish line\*](#), [\*Banks - United Kingdom: Low for longer rates will exacerbate margin pressure for UK banks\*](#) and [\*Banks - Brazil: Net interest margins will be tested as rates stay low for longer\*](#)

**Podcast: Pandemic accelerates digital transformation, benefitting many US tech subsectors**, 6 October 2020

Raj Joshi and Rick Lane of the Corporates team discuss how the coronavirus pandemic is accelerating the adoption of technology by businesses and consumers. As global macroeconomic conditions improve, these shifts will be credit positive for cloud infrastructure services, cloud-based software, semiconductors, IT services and the financial technology subsectors.

Related report: [\*Technology - Global: Structural shifts triggered by COVID will benefit a majority of tech subsectors\*](#)

## RECENTLY IN CREDIT OUTLOOK

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### Articles in last Thursday's Credit Outlook

#### NEWS & ANALYSIS

##### Corporates

- » Buyout of American Renal Holdings is credit positive
- » Garda's hostile bid for G4S would be credit positive
- » Cascades expands its containerboard platform with its Bear Island mill conversion, a credit positive
- » Natura's equity issuance is credit positive for Natura and its subsidiary Avon
- » Danone's disposal of Yakult stake is credit positive
- » Weir's sale of its oil and gas division for \$405 million would be credit positive
- » Germany's new online regulations are credit negative for gaming operators
- » Medco Energi's weaker financial performance is credit negative

##### Infrastructure

- » Proposed equity exchange is credit positive for both TC Energy and TC Pipelines

##### Banks

- » Royal Bank of Canada acts on ESG principles by not financing Arctic Refuge exploration, a credit positive
- » Brazil will keep banks' time deposit reserve requirements below pre-pandemic levels into 2021
- » Brazilian central bank's instant payment system will erode banks' fee income
- » Record low Euribor will constrain Spanish banks' net interest margin, a credit negative
- » National Bank of Greece's first green senior bond issue is credit positive

##### Insurers

- » Mexico's infrastructure investment plan is credit positive for surety companies

##### Sovereigns

- » Saudi Arabia's higher 2020 spending will be offset by Aramco's dividend-paying capacity
- » Indonesia's omnibus law will support domestic and foreign investment, a credit positive

#### CREDIT IN DEPTH

- » Next US administration will confront five policy challenges with wide-ranging credit impact
- » Top of Mind: Frequently asked questions about top global corporate sectors

[Click here](#) for last Thursday's Credit Outlook.

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