



# Credit Outlook

25 March 2021

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The credit effect of rising US fiscal deficits and debt is mitigated by debt affordability. Over the longer term, as interest rates rise, deficit reduction will become increasingly important.

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## Canadian Pacific Rail's acquisition of Kansas City Southern will increase its leverage

On 21 March, Canadian Pacific Railway Limited, the parent of [Canadian Pacific Railway Company](#) (CP, Baa2 stable), announced that it agreed to acquire [Kansas City Southern](#) (KCS, Baa2 stable) for about \$29 billion. CP will finance the acquisition with equity and \$8.6 billion of debt, which is already committed. CP will also assume approximately \$3.8 billion of KCS' outstanding debt.

CP's planned debt issuance will increase its leverage, a credit negative. The incremental debt from the acquisition funding will increase CP's pro forma adjusted leverage to 4.5x from 2.5x at year-end 2020. Consequently, we [downgraded CP's ratings to Baa2](#) from Baa1, keeping the outlook unchanged at stable.

We expect leverage to remain above 3x through 2023. We believe the company is committed to reducing its adjusted financial leverage toward the midpoint of its public 2x-2.5x leverage target, however the time to achieve this will be protracted.

CP must gain regulatory approval for its acquisition and control of KCS US railways from the US Surface Transportation Board (STB), creating a two-step process to complete the acquisition. First, CP will establish an independent voting trust to acquire the shares of KCS after shareholder approval, which will likely be completed by midyear and KCS shareholders will be paid at that time. CP's placement of KCS shares into the voting trust will insulate KCS from control by CP until the STB authorizes the acquisition. STB and other regulatory approvals are the second step of the process; reviews will likely be completed by the middle of 2022. After all approvals, CP will fully acquire KCS. Should regulatory approvals be withheld, CP would be required to unwind its purchase of KCS at an unknown price.

CP's acquisition of KCS will strengthen CP's rail network, creating the first Mexico-US-Canada rail network and expanding the reach of single hauls and service capabilities. In addition, CP will benefit from a larger, more diversified business with greater exposure to higher-margin merchandise business, increased customer diversity and breadth, the potential for synergies from network and equipment efficiencies as well as greater revenue expansion.

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## UK spectrum auction results are credit positive for UK mobile network operators

Originally [published](#) on 22 March 2021

On 17 March, Ofcom, the UK telecommunications regulatory authority, announced the results of the principal stage of the wireless spectrum auction that started on 12 March. Four operators — BT Group plc's [EE Limited](#) (Baa2 negative); [Telefonica S.A.](#)'s (Baa3 stable) Telefónica UK Limited, known as O2; [Vodafone Group Plc](#)'s (Baa2 negative) Vodafone Limited; and [CK Hutchison Group Telecom Holdings Limited](#)'s (Baa1 stable) Hutchison 3G UK Limited, known as Three — will pay a combined £1.36 billion for the spectrum auctioned. That only marginally exceeds the £1.1 billion reserve price set by Ofcom, and is significantly less than our £3 billion-£4 billion forecast. The spectrum auction is credit positive for UK telecom operators because of the low price compared with previous auctions in Europe.

The auction covered blocks of 80 MHz and 120 MHz in the 700 MHz and the 3.6-3.8 GHz bands, respectively. This auction will increase the total amount of spectrum available for mobile technology in the UK by nearly a fifth, bringing better and faster services to customers. The 700 MHz band is ideal for providing good-quality mobile coverage, both indoors and across very wide areas, including rural areas. The 3.6-3.8 GHz band, also known as the mid-band, is part of the primary band for 5G and capable of carrying lots of data-hungry connections.

EE and O2 will pay the highest amounts of £452 million and £448 million, respectively, followed by Three with £280 million and Vodafone with £176.4 million (Exhibit 1). In the next stage of the auction, the operators will have an opportunity to finalise the exact frequency range of their holdings within the 3.6-3.8 GHz band. However, we do not expect this will materially change the total amount to be paid by each mobile network operator.

Exhibit 1

### EE and O2 paid the highest amounts for the 700 MHz and 3.6-3.8 GHz spectrum bands

#### Overview of UK spectrum auction results

|  | EE         | O2         | Vodafone     | Three      |
|--|------------|------------|--------------|------------|
| <b>700 MHz Band</b>  |            |            |              |            |
| Total MHz  | 20         | 20         | 0            | 20         |
| % Total MHz  | 33%        | 33%        | 0%           | 33%        |
| Supplementary downlink spectrum MHz                                      | 20         | 0          | 0            | 0          |
| Price to be paid (£ millions)  | 284        | 280        | 0            | 280        |
| Price per MHz/population (£) - excluding supplementary downlink spectrum | 0.21       | 0.21       | 0.00         | 0.21       |
| <b>3.6-3.8GHz (Mid-band)</b>   |            |            |              |            |
| Total MHz  | 40         | 40         | 40           | 0          |
| % Total MHz  | 33%        | 33%        | 33%          | 0%         |
| Price to be paid (£ millions)  | 168        | 168        | 176.4        | 0          |
| Price per MHz/population (£)   | 0.06       | 0.06       | 0.07         | 0.00       |
| <b>Total price to be paid (£ millions)</b>                               | <b>452</b> | <b>448</b> | <b>176.4</b> | <b>280</b> |

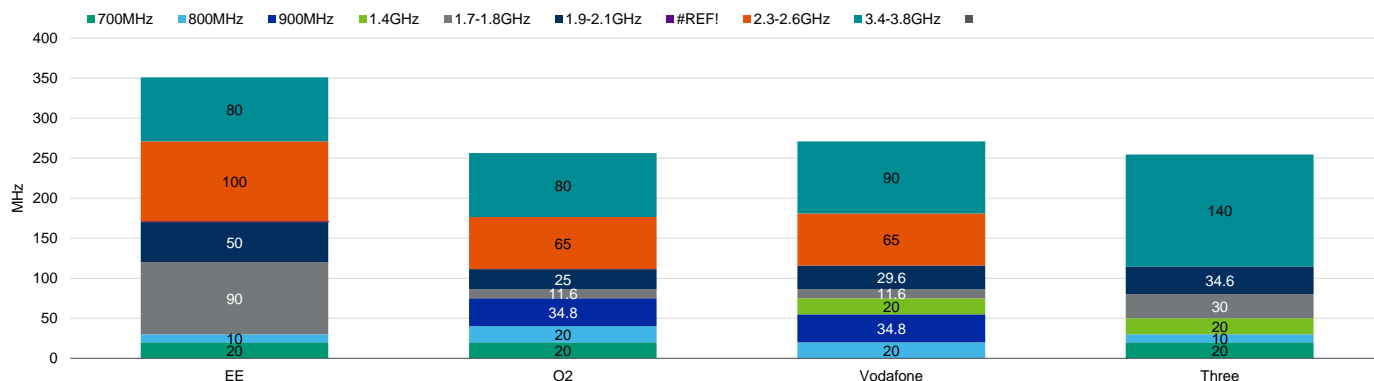
Sources: Ofcom and Moody's Investors Service calculations

Although the mid-band spectrum is critical for 5G capacity, we do not believe differences in the auction outcome are material enough to represent a key competitive advantage for any operator (Exhibit 2). EE, O2 and Vodafone will boost their 5G services through the acquisition of 40 MHz each in the 3.6-3.8 GHz band. While Three did not acquire any spectrum in that band, it already has spectrum available across the 3.4 GHz, 3.6 GHz, and 3.9 GHz bands from the acquisition of UK Broadband in 2017.

## Exhibit 2

### UK operators' spectrum position is balanced

UK spectrum ownership and distribution pro forma for latest spectrum auction



Note: EE also acquired 20 MHz downlink spectrum within the 700MHz band as part of the March 2021 spectrum auction.

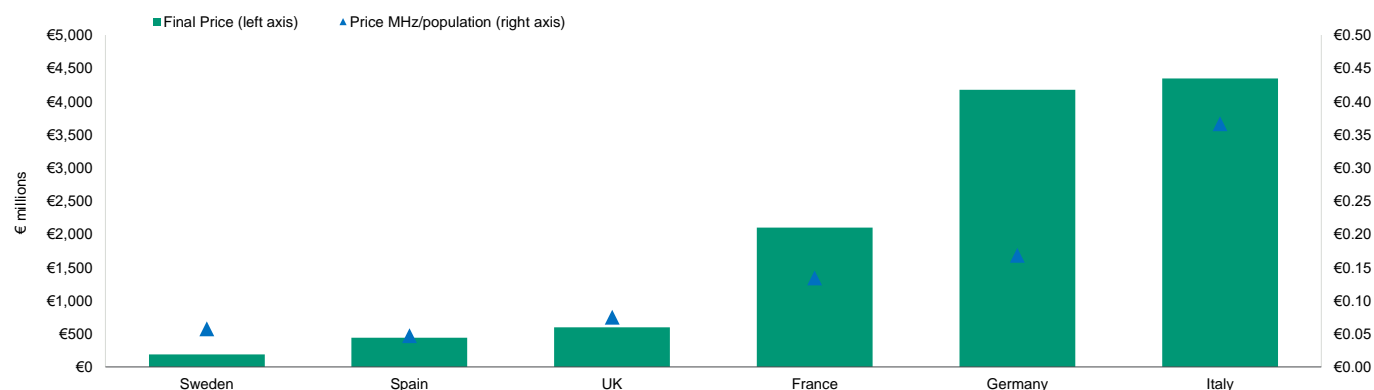
Source: Ofcom and Moody's Investors Service calculations

In comparison with other auctions in Europe, the 3.6-3.8 GHz UK spectrum auction ended at a low price, two to five times cheaper on a MHz/population basis than in France, Germany, or Italy, as Exhibit 3 shows. The average estimated price of mid-band MHz per inhabitant is €0.07 for the UK compared with €0.13, €0.17, and €0.37 for previous auctions in France, Germany, and Italy, respectively.

## Exhibit 3

### The UK auction is significantly cheaper than in France, Germany, and in particular Italy

Pricing of selected mid-band auctions across Western Europe



Sources: National regulators' data and Moody's Investors Service calculations

The amounts to be paid for the spectrum are manageable for the four telecom operators. For BT Group in particular, the low price achieved at the spectrum auction is a credit positive. The lower amount spent on securing this spectrum will free up liquidity to deliver its ambitious £12 billion plan to rollout fibre-to-the-home (FTTH) to 20 million homes across the UK by the mid- to late 2020s.

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## Shortage of semiconductors thwarts Volvo's production

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On 22 March, [AB Volvo](#) (A3 stable) announced that the global shortage of semiconductors will have a substantial effect on the company's second-quarter production, and that visibility into global supply chain of semiconductors and other components is very low. The company expects that the supply shortage will negatively affect earnings and cash flow.

As we understand the situation, Volvo is planning to halt production for two to four weeks at its various factories at the beginning of the second quarter. If we assume a quarterly delivery rate of around 50,000 trucks and an average selling price of SEK0.8 million, a production stoppage of three weeks could reduce second-quarter revenue by about SEK10 billion. This would be equivalent to 15% of truck revenue and 11% of group revenue during fourth-quarter 2020.

Given the poor visibility into the global supply chain of semiconductors as well as steel-based key components, continued strong consumer demand for electronics (which should decrease as COVID-19 restrictions are lifted), persisting bottlenecks in ocean freight and low capacity of air freight, we expect supply chain disruptions will negatively affect truckmakers globally during the remaining part of the year. But because underlying demand for trucks is strong, we expect only a delay in revenue generation.

The specific effect on truckmakers will depend on their individual supply chain situation, as well as pricing. Volvo's peer, Germany-based [TRATON SE](#) (Baa1 negative), said on the same day as Volvo's announcement that it foresees some supply disruptions in the second quarter, but considers this only a temporary effect that will probably catch up in the second half of this year.

Although Volvo's announcement is credit negative, the company's highly profitable service business, which comprises around 24% of total truck sales, is still functioning normally and will limit the effect of production disruptions on overall earnings. Consequently, Volvo's A3 ratings and stable outlook are unchanged and its credit metrics remain strongly positioned in the current rating category with debt/EBITDA of 1.3x and free cash flow/debt of 27% for 2020.

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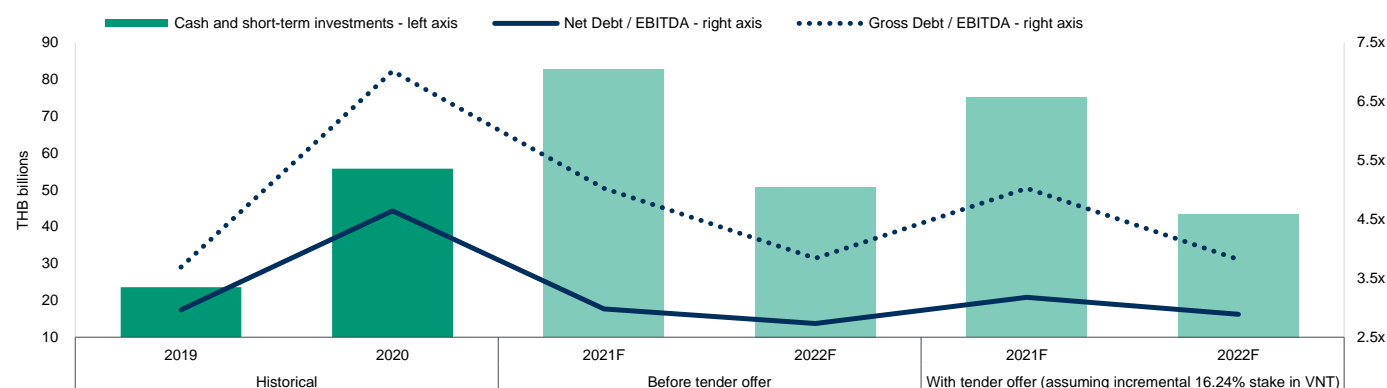
## PTT Global Chemical's planned tender offer for shares in Thai chemical producer is credit negative

Originally [published](#) on 22 March 2021

On 19 March, Thai chemical producer [PTT Global Chemical Public Company Limited](#) (PTTGC, Baa2 stable) announced plans to make a tender offer for all the ordinary shares in its 24.98%-owned associate, Vinythai Public Company Limited, currently not held by PTTGC. Japanese glass manufacturer [AGC Inc.](#) (A2 stable), the controlling shareholder of Vinythai with a 58.78% stake, said it does not intend to subscribe to the planned tender offer by PTTGC. Therefore, PTTGC could spend up to THB7.5 billion (\$235 million) in the tender offer to purchase an incremental 16.24% stake in Vinythai. The tender offer price of THB39 per share is subject to adjustments depending on corporate actions taken by Vinythai.

The planned tender offer for Vinythai shares is credit negative because it will reduce PTTGC's cash holdings (see exhibit). Its large cash holdings provide PTTGC with the financial flexibility to manage periods of earnings volatility despite the company's elevated leverage.

### PTTGC's cash holdings will decline following the tender offer, while its leverage will remain elevated



All ratios reflect Moody's standard adjustments. Adjusted net debt is net of cash on hand and assumes a 30% discount on short-term investments.

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

Gross leverage — as measured by adjusted debt/EBITDA — will remain unchanged following the tender offer as the share purchase will be funded by cash. However, we estimate that PTTGC's adjusted net leverage — as measured by net debt/EBITDA — will increase by 0.2x if it increases its stake in Vinythai by 16.24%. The size of the planned stake purchase is small but supports our view that PTTGC's growth aims are rising.

PTTGC will launch the tender offer for Vinythai's shares after various conditions are met, including securing regulatory approvals and approval by at least 75% of Vinythai's shareholders for the delisting of Vinythai. If Vinythai is successfully delisted, PTTGC and AGC plan to merge Vinythai with some of the chemical businesses under AGC.

Vinythai will remain an associate of PTTGC following the tender offer, and will remain equity accounted in PTTGC's financial statements. Under our standard adjustments, Vinythai's contribution to PTTGC's earnings will be based on the cash dividends that PTTGC receives from Vinythai. Vinythai paid dividends of THB1.54 billion in 2019 and THB1.66 billion in 2020.

PTTGC's higher stake in Vinythai will expand its ethylene derivatives segment and product coverage. Specifically, Vinythai produces caustic soda as well as Hydrogen and Sodium Hypochlorite, which are chemicals that PTTGC does not produce from its existing plants.

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## Lingering social risk of 2009 oil spill and Australian Court judgement are credit negative for PTT

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On 19 March, the Federal Court of Australia delivered a favorable judgement for an Indonesian seaweed farmer who launched a class action lawsuit against a subsidiary of Thai oil and gas producer, [PTT Exploration & Production Public Co. Ltd.](#) (PTTEP, Baa1 stable). A group of Indonesian seaweed farmers are claiming compensation against PTTEP Australasia (Ashmore Cartier) Pty Ltd (PTTEP AA) for causing damage to their seaweed crops because of PTTEP AA's oil spill in 2009.

The unfavorable judgement by the Federal Court of Australia against PTTEP AA is credit negative because it raises the potential that PTTEP will have to pay significant compensation, which will lower its cash reserves. PTTEP is currently considering its available appeal avenues<sup>1</sup>. The situation also illustrates the exposure of exploration and production companies such as PTTEP to social risk from oil spills.

The class action lawsuit was brought by Daniel Aristabulus Sanda, who is leading the claims on behalf of 15,000 seaweed farmers around West Timor. The Federal Court ruled that Sanda should be awarded around IDR253 million (around \$18,000). Total compensation paid by PTTEP could reach up to \$270 million if the other seaweed farmers are also awarded similar damages. Nevertheless, the claims of other seaweed farmers have yet to be determined and could be ruled differently from the judgement reached for Sanda's lawsuit.

We expect PTTEP to fund the potential compensation with internal cash. The company had cash and cash equivalents (including short-term investments) of \$3.8 billion as of 31 December 2020, of which \$2.45 billion will be used to finance its 20% stake purchase in Oman's Block 61 announced in February this year.

The Montara H1 ST1 well in Australia, operated by PTTEP AA, had an uncontrolled release in August 2009, resulting in nearly 30,000 barrels of oil being spilled to the Timor Sea off Northern Australia. The company was fined \$510,000 by the [Government of Australia](#) (Aaa stable) for the incident.

### Endnotes

<sup>1</sup> [PTTEP's announcement to the Stock Exchange of Thailand on 19 March 2021](#)

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## Latest delays in key Vogtle nuclear construction activities are credit negative for Georgia Power

Originally [published](#) on 23 March 2021

On 19 March, [Georgia Power Company](#) (Baa1 stable) announced that the start of hot functional testing for Plant Vogtle Unit 3 will be delayed into April from the original start date in the second half of this month. The latest setback is credit negative for Georgia Power because it signals the project's continued challenges and the likelihood of additional cost overruns and schedule delays in the Unit 3 in-service date. Such delays and cost overruns have the potential to lead to potential cost-recovery disallowances by state regulators. However, we expect key stakeholders, including state regulators and co-owners, to remain supportive of the project.

The delay is due to construction remediation work primarily related to electrical commodity installations to ensure compliance with quality and design standards as system turnovers are completed before starting hot functional testing and fuel load for Unit 3. Southern Nuclear Operating Company, a Georgia Power-affiliated entity that manages the project, may require additional remediation work as it reviews and inspects construction quality, but it continues to target a November 2021 in-service date for Unit 3. Still, the schedule is challenged and a delay is likely, which could add one month or more to the Unit 3 in-service date.

Georgia Power estimates that any schedule extension beyond November 2021 for Unit 3 would add base capital costs of around \$25 million per month. To date, the Georgia Public Service Commission (GPSC) has approved total construction and capital costs of \$7.3 billion (pursuant to a regulatory order of 11 January 2018). Of the \$7.3 billion total, state regulators deemed \$3.5 billion as prudent, and presumed an additional \$2.18 billion as prudent, which requires any party challenging such costs to bear the burden of proof. The GPSC would review any costs above \$5.68 billion for prudence after Vogtle Unit 4 has loaded fuel, and rates will be effective one month after Vogtle Unit 4 is placed in-service, which is scheduled for November 2022.

Georgia Power estimates its share of total project capital costs are around \$8.7 billion, net of a \$1.7 billion payment from a guarantee from Toshiba. Pursuant to the GPSC 2018 order, Georgia Power's return on equity, which is used to calculate the nuclear construction cost recovery tariff for Unit 3 costs, will be reduced 10 basis points each month after 1 June 2021 (but not lower than Georgia Power's average cost of long-term debt) until Unit 3 is commercially operational.

The latest delay follows Georgia Power's 18 February announcement that productivity had slowed into January 2021 largely due to a rise in active COVID-19 cases. Georgia Power estimates the productivity impacts of the COVID-19 pandemic have used up three to four months of the construction schedule and increased the total project budget by \$325 - \$415 million, of which its share is \$150-\$190 million. Active COVID-19 cases have abated in February and March.

During the fourth quarter of 2020, Georgia Power used the remaining construction contingency reserve of \$115 million to cover its share of the increased costs. As a result, Georgia Power established an additional contingency reserve of \$171 million adding to its share of total project costs. The company expects that the remaining contingency reserve will cover costs from the latest delay. However, if the delay exceeds the company's current expectations, costs will exceed the remaining balance in the contingency reserve.

Southern Nuclear expects Unit 3 fuel load to be this summer, which could take up to six months to complete. Fuel load, when enriched uranium is loaded into the reactor vessel for initial startup, is the last critical milestone prior to the unit's commercial operation. Nonetheless, the project has challenges, which have been exacerbated by the COVID-19 pandemic, including, but not limited to, higher-than-expected absenteeism, lower overall construction and subcontractor labor productivity, system turnover and testing activities and electrical equipment and commodity installation. As such, there is a risk that additional delays in construction and testing that raise costs for Units 3 and 4 will continue.

Georgia Power is a regulated vertically integrated utility subsidiary of [The Southern Company](#) (Baa2 stable) that owns 45.7% of Vogtle Units 3 and 4. [Oglethorpe Power Corporation](#) (Baa2 stable) owns another 30%, [MEAG Power](#) 22.7% and [City of Dalton, Georgia, Combined Utility Ent.](#) 1.6%.

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## Latest delays in key Vogtle construction activities are credit negative for Oglethorpe Power

Originally [published](#) on 23 March 2021

On 19 March, [Oglethorpe Power Corp.](#) (OPC, Baa1 stable<sup>1</sup>) announced through its 31 December 2020 10-K filing with the Securities and Exchange Commission that the start of hot functional testing for Plant Vogtle Unit 3 will be delayed from the original start date in the second half of this month. The latest setback is credit negative for OPC because it signals the project's continued challenges and the likelihood of additional cost overruns and schedule delays in the Unit 3 in-service date. However, we expect key stakeholders, including state regulators and co-owners, to remain supportive of the project.

The delay is due to construction remediation work primarily related to electrical commodity installations to ensure compliance with quality and design standards as system turnovers are completed before starting hot functional testing and fuel load for Unit 3. Southern Nuclear Operating Company, a [Southern Company](#) (Baa2 stable) subsidiary that manages the project, may require additional remediation work as it reviews and inspects construction quality, but it continues to target a November 2021 in-service date for Unit 3. Still, the schedule is challenged and a delay is likely, which could add one month or more to the Unit 3 in-service date.

OPC's current budget for its 30% ownership interest in Vogtle Units No. 3 and No. 4 is \$7.5 billion, which includes capital costs, allowance for funds used during construction, OPC's allocation of the project-level contingency estimated at \$113 million and a separate OPC-level contingency estimated at \$250 million. As of 31 December 2020, OPC's total investment in the additional Vogtle units was approximately \$6.0 billion and it estimates its share of total project construction and financing costs to be \$7.1 billion, net of \$1.1 billion payment from the Toshiba Corporation under a guarantee settlement agreement.

In the event that there is any schedule extension beyond the November 2021 and November 2022 regulatory in-service dates for Units No. 3 and No. 4, respectively, the OPC-level contingency level in its current \$7.5 billion budget is expected to be sufficient to withstand up to a four-month delay for Unit No. 3 and a three-month delay for Unit No. 4. Any further delays beyond these extended dates are expected to impact its cost by approximately \$55 million per month for both units and approximately \$25 million per month for Unit No. 4 only, including financing costs.

The latest delay follows Georgia Power's 18 February announcement that productivity had slowed into January 2021, which increased the total project budget by \$325-\$415 million, of which OPC's share is approximately \$98-\$125 million and is included in the project budget. A rise in active COVID-19 cases at the site delayed productivity, but these abated in February and March.

Southern Nuclear expects Unit 3 fuel load to be this summer, which could take up to six months to complete. Fuel load, when enriched uranium is loaded into the reactor vessel for initial startup, is the last critical milestone prior to the unit's commercial operation. Nonetheless, the project has challenges, which have been exacerbated by the COVID-19 pandemic, including, but not limited to, higher-than-expected absenteeism, lower overall construction and subcontractor labor productivity, system turnover and testing activities and electrical equipment and commodity installation. As such, there is a risk that additional delays in construction and testing that raise costs for Units 3 and 4 will continue.

OPC is a generation-only electric cooperative that owns 30% of Vogtle Units 3 and 4. [Georgia Power Company](#) (Baa1 stable) owns another 45.7%, MEAG Power 22.7% and City of Dalton, Georgia, Combined Utility Ent. 1.6%.

### Endnotes

<sup>1</sup> The rating shown is Oglethorpe's senior secured rating.

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## End of supplemental leverage ratio relief is credit positive for large US banks

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On 19 March, the Federal Reserve Board (Fed) announced it would decline to extend the current relief provided to US banks under its supplementary leverage ratio (SLR), which expires on 31 March. The end of SLR relief will restore higher capital requirements, a credit positive for the eight large complex and interconnected US banks classified as global systemically important banks (G-SIBs) and subject to the strictest SLR requirements. The Fed also said it will soon consider modifications to the SLR to address recent growth in central bank reserves and issuance of Treasury securities to prevent strains in the regulatory framework that would undermine economic growth and financial stability.

SLR relief allowed those large US banks subject to the ratio to exclude the on-balance-sheet amounts of U.S. Treasury securities and Federal Reserve deposits from the denominator of the ratio. It was put in place last April in response to economic disruptions resulting from the COVID-19 pandemic and related strains in Treasury markets, which the Fed now views as having stabilized.

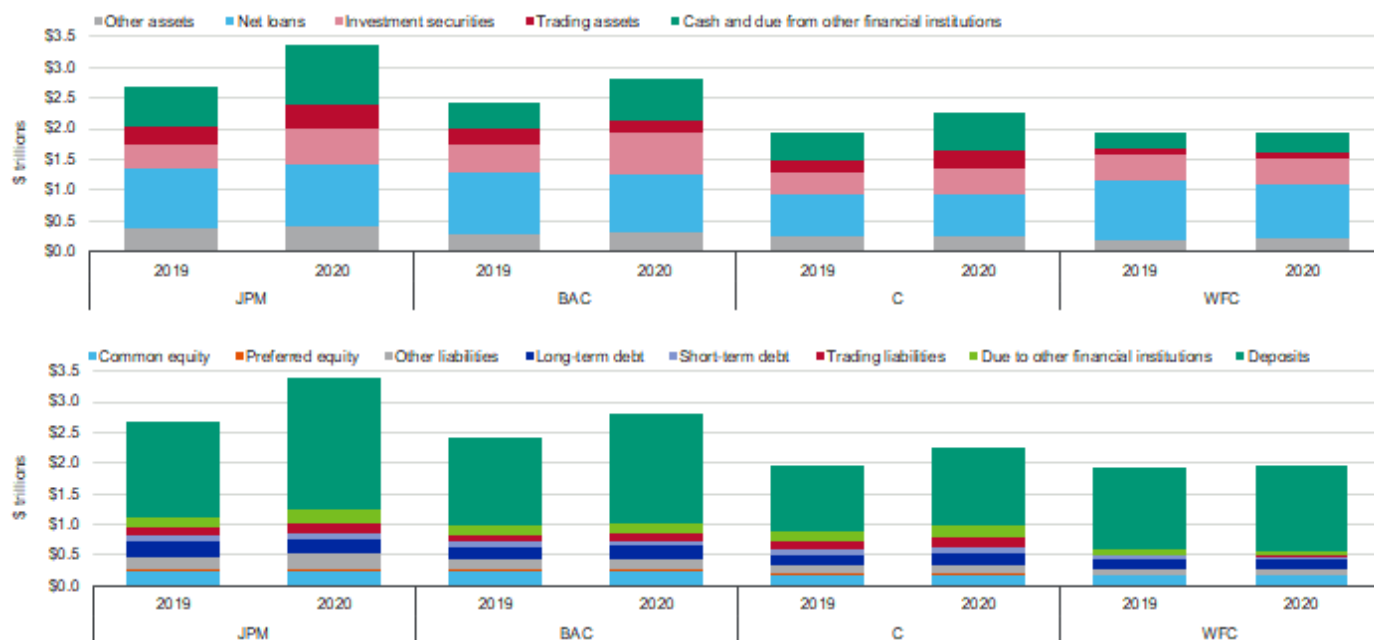
All US banks subject to the SLR currently operate with a ratio at least twice the minimum 3% requirement. However, the eight US G-SIBs presented in Exhibits 1 and 2 are subject to the enhanced SLR requirement, which includes an additional 2% regulatory buffer on top of the 3% minimum for a total requirement of 5%. If the ratio of one of these eight banks were to fall below the total requirement of 5%, it would become subject to increasingly onerous restrictions on capital distributions and executive bonuses.

As Exhibits 1 and 2 show, the combined fiscal and monetary response of US authorities to the pandemic led to rapid balance sheet growth at several G-SIBs during 2020. Accommodative monetary policy left many banks awash in deposits, which in the absence of loan demand drove growth in securities portfolios and excess reserve balances at the Fed. In addition, firms with extensive capital markets operations (BAC, C, GS, JPM, MS) had growth in trading inventories because of strong investor demand for liquidity provision (while MS also closed its E\*TRADE acquisition). The notable exception is Wells Fargo, whose balance sheet continues to be constrained by a regulatory asset cap, as a result of its legacy governance, oversight, compliance and operational risk management deficiencies.

Some of these effects will persist in 2021 as authorities continue to respond to the economic effects of the pandemic.

Exhibit 1

### Universal banks' balance sheets ballooned during pandemic in 2020

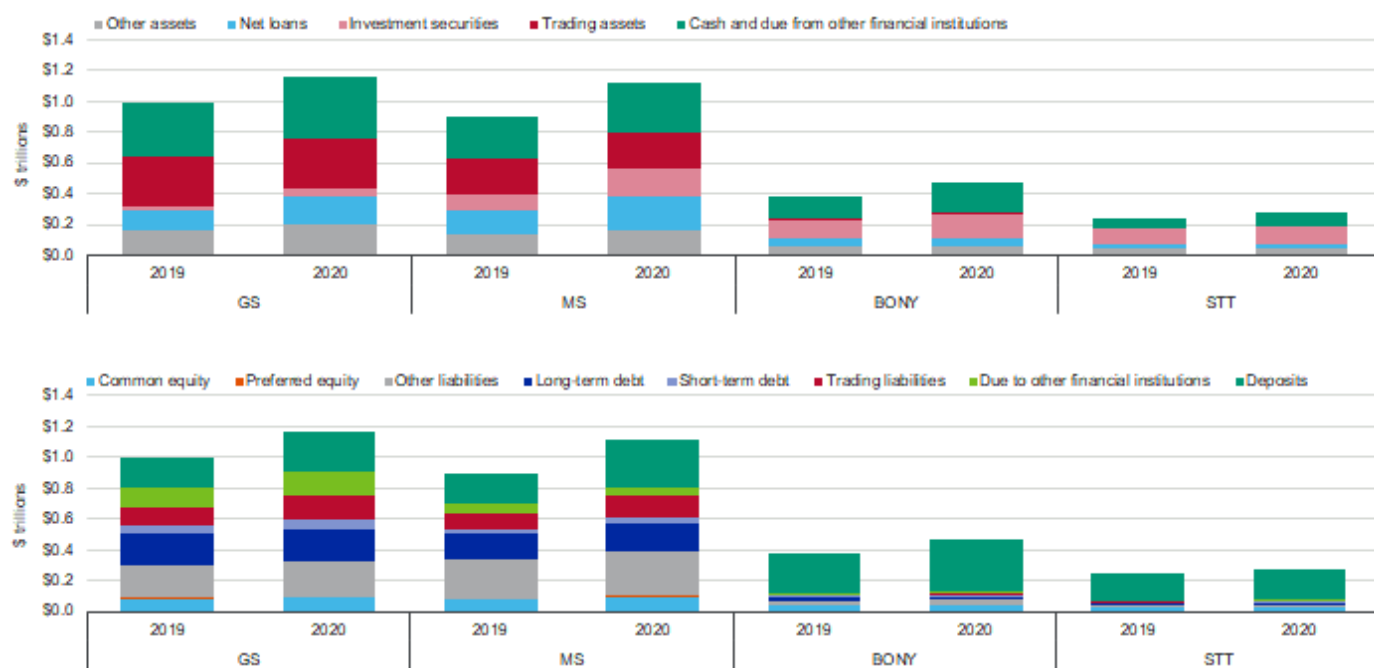


The four universal bank US G-SIBs and their senior long-term debt ratings are JPMorgan Chase & Co. (JPM, A2 stable), Bank of America Corporation (BAC, A2 stable), Citigroup Inc. (C, A3 stable) and Wells Fargo & Company (WFC, A2 negative).

Sources: FR Y-9C and Moody's Investors Service

Exhibit 2

### Investment banks and trust and custody banks also had balance-sheet expansion in 2020



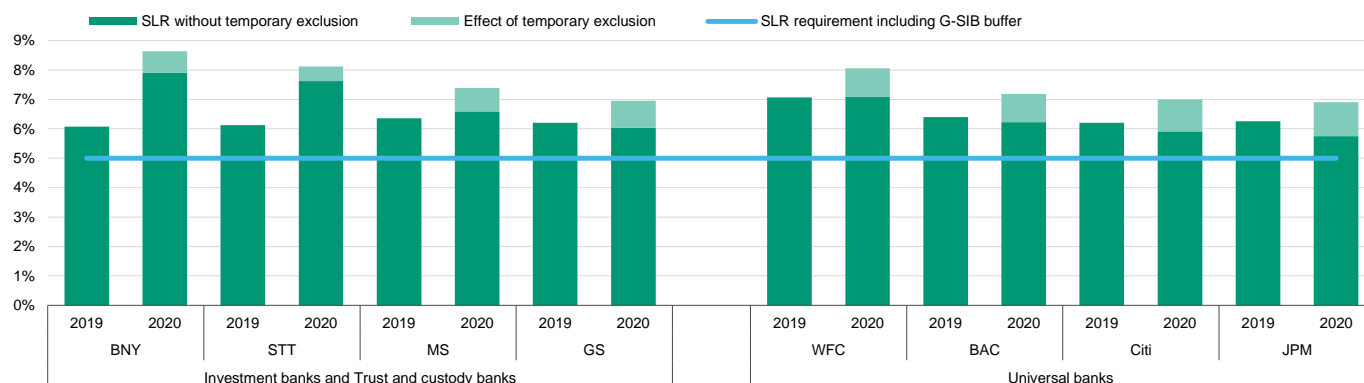
The four investment bank or trust and custody bank US G-SIBs and their senior long-term debt ratings are Goldman Sachs Group, Inc. (GS, A2 stable), Morgan Stanley (MS, A1 stable), Bank of New York Mellon Corporation (BONY, A1 stable) and State Street Corporation (STT, A1 stable).

Sources: FR Y-9C and Moody's Investors Service

Exhibit 3 illustrates that the temporary exclusion of Treasury securities and central bank deposits from the denominator of the SLR provided a benefit to these eight banks' reported SLRs ranging from 50 to 115 basis points as of year-end 2020. However, four of the eight G-SIBs (BNY, MS, STT and WFC) were able to strengthen their SLRs even without the benefit of temporary relief. Further, all eight will continue to exceed the SLR requirements even after the temporary exclusion is eliminated, and six of the eight will still have SLRs that are at least 100 basis points above the requirements. The trust and custody banks (BNY and SST) on the left have benefitted from a separate rule change last year. This permanently excluded from the SLR denominator certain central bank deposits (in OECD countries with zero percent sovereign debt risk-weightings) that are linked to fiduciary or custodial and safekeeping accounts.

Exhibit 3

#### All eight US G-SIBs exceed minimum SLR both with and without temporary exclusions



The SLR shown above is the consolidated bank holding company SLR for each of the eight US G-SIBs as of 31 December 2020. The SLR is defined as end of period Tier 1 Capital as a percentage of Total Leverage Exposure (TLE). TLE is defined as the daily average of on-balance-sheet assets in the quarter plus the average of certain off-balance-sheet exposures (calculated on the last day of each month in the quarter) less applicable Tier 1 Capital deductions.

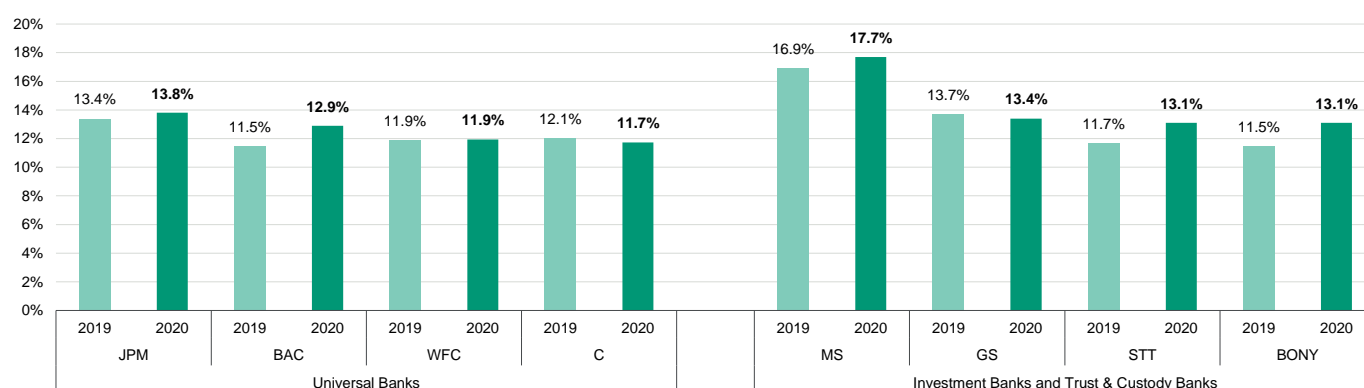
Sources: Company reports

Additionally, the eight banks' risk-based capital ratios held up well over the past year, despite an initial drop in the first quarter of 2020, aided by the cessation of share repurchases last spring (Exhibit 4). Five of the eight G-SIBs strengthened their risk-based capital ratios on the year and none dropped more than 40 basis points. These capital surpluses contributed to the Fed's judgment that relief will no longer be needed. We expect the banks' risk-based capital ratios to gradually decline if repurchases are allowed, but they look in good shape to continue their core functions of lending and liquidity provision in 2021.

Exhibit 4

#### Risk-based capital ratios held up well at most firms, thanks to cessation of repurchases

##### Common Equity Tier 1 Capital ratios (advanced approach) 2019-20



Sources: Company reports

The SLR and the Tier 1 leverage ratio are simpler ratios intended to complement risk-based capital requirements and act as a backstop on leverage at banks. However, we do not think it is the policy intention of bank regulators for these ratios to evolve into the primary binding constraint for banks. In addition to addressing the risk that recent growth in central bank reserves and the issuance of Treasury

securities could cause strains that constrain economic growth and undermine financial stability, this may be another reason why the Fed intends to reconsider the design and calibration of the SLR in the near future.

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## Banco do Brasil's CEO is replaced after six-month tenure, a credit negative

Originally [published](#) on 22 March 2021

On 18 March, [Brazil's](#) (Ba2 stable) Ministry of Economy indicated that Fausto de Andrade Ribeiro would be appointed as CEO of [Banco do Brasil S.A.](#) (BB, Ba2 stable, ba2<sup>1</sup>). The announced change in BB's senior executive position followed the publication of a resignation letter by CEO André Brandão, whose own tenure began when his predecessor resigned after 20 months as CEO. Brandão's resignation will be effective as of 1 April.

The change in BB's leadership is credit negative for the bank because it may affect the full implementation of the [restructuring plan](#) announced in January. The plan focused on expense reduction and on strengthening the bank's competitiveness against privately owned peers. The frequent CEO rotation could also weaken BB's governance practices and expose the bank to risks, including reputational and operational risks.

Ribeiro, the new CEO, has worked at BB since 1988. Despite his experience and familiarity with the bank's culture and employees, his appointment by the president raises concern about future governmental involvement in BB's senior management or its operations. In February, Bolsonaro [replaced the CEO](#) of [Petroleo Brasileiro S.A.](#) (Ba2 stable), whose opinion about the company's increases in fuel prices differed from Bolsonaro's.

In January, Brandão announced plans to reduce BB's bank branches and its workforce as part of the bank's strategy to reduce operating expenses. Additionally, the cost reduction measures aimed at improving efficiency during the pandemic, mirroring actions taken by rival banks [Banco Bradesco S.A.](#) (Ba2/(P)Ba2 stable, ba2), [Itau Unibanco S.A.](#) (Ba2/(P)Ba2 stable, ba2) and [Banco Santander \(Brasil\) S.A.](#) (Santander Brazil, Ba1/(P)Ba1 stable, ba2). BB estimated the intended restructuring plan would result in gross savings of BRL1 billion (\$183 million) in 2021 and up to BRL10 billion (\$1.83 billion) by 2025. However, the announcement of BB's restructuring plan was met with criticism from the administration.

Although BB has managed to develop robust and transparent corporate governance standards over the last decade, the federal government has intervened in the bank's operations in the past. In April 2012, President Dilma Rousseff focused on tightening banking spreads by making BB and other state-run banks to reduce lending rates in order to foster economic activity. After 2012, however, BB has created internal committee of human resources focused on hiring and fostering the independence of senior management. A 2016 bill on State Enterprise Law has also contributed to strengthen corporate governance in Brazilian state-owned enterprises (SOEs).

A bank can have good governance in terms of well-established financial controls, independent audit committees, transparent reporting to main stakeholders, and rigid policies against corruption and money laundering. However, for state-run banks, the government's pursuit of social objectives can often conflict with or constrain senior management's long-term objectives to support operational growth based on consistent origination of recurring revenue, maintenance of good asset quality metrics and sustainable capitalization.

### Endnotes

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

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## Single Resolution Board's decision on legacy liabilities governed by UK law is credit positive

Originally [published](#) on 23 March 2021

On 22 March, the European Union's (EU) Single Resolution Board (SRB) announced that it will consider as eligible for minimum requirement for own funds and liabilities (MREL) those liabilities governed by UK law that lack a contractual bail-in recognition clause, if the liabilities were issued on or before 15 November 2018<sup>1</sup>. The SRB's decision is credit positive because it ensures that banks can maintain their stock of bail-in-able instruments, leaving intact existing protections for senior bondholders. The move will also avert any disproportionate requirement for banks to refinance bonds at an early stage.

The announcement clarifies the treatment of these instruments following the UK's departure from the EU, and culminates discussions that were underway for some time. The EU law on resolution has not been directly applicable to the UK since the 31 December 2020 end of the transition period under the EU-UK Withdrawal Agreement, although the UK has preserved the law's provisions in its domestic legislation. As a result, liabilities issued under UK law are now treated under the same rules as those governed by laws of other countries and must therefore include a contractual bail-in recognition clause to be eligible for MREL.

According to the announcement, the SRB's exemption will apply until 28 June 2025 to ensure alignment with the prudential grandfathering of the requirement to introduce contractual recognition clauses in own funds instruments.

The volume of these type of "grandfathered" instruments will gradually decrease over time as they reach their respective maturity dates. The SRB will continue to monitor the resolvability of banks whose liabilities include such instruments and may review the announced decisions if this resolvability is affected.

EU banks' MREL shortfall increased to €134 billion as of 30 September 2020 from €74 billion at year-end 2019, according to the SRB's third-quarter MREL dashboard. This increase was mainly the result of an increase in the average MREL target to 28.6% of the total risk exposure amount, up from 25.6% in 2019. This was mostly because total liabilities grew following the European Central Bank's refinancing operations, which took place in response to the coronavirus pandemic.

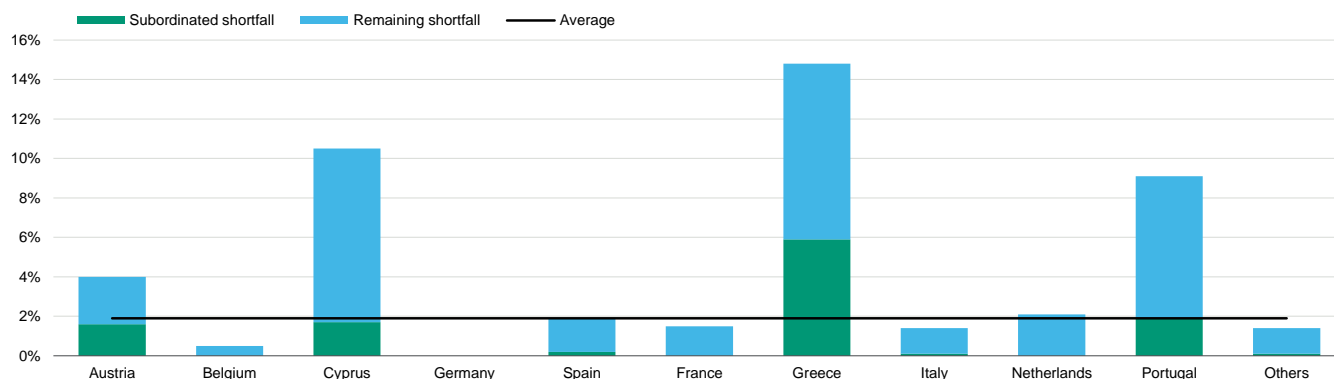
However, the increased MREL target was not accompanied by an increase in outstanding MREL-eligible liabilities over the first nine months of 2020 because depressed market conditions and a lack of market access for some banks limited issuance activity for European banks in 2020. Therefore, it resulted in a higher MREL shortfall for EU banks. Nevertheless, we believe that banks will be able to fill the MREL gap given that full compliance with MREL targets is not required until 1 January 2024.

This shortfall is especially relevant for banks in Cyprus, Greece, Portugal and Austria (see Exhibit 1). From a gross amount perspective, France, Spain and Greece showed the highest shortfalls (Exhibit 2).

Exhibit 1

**MREL shortfall for banks under the SRB's remit**

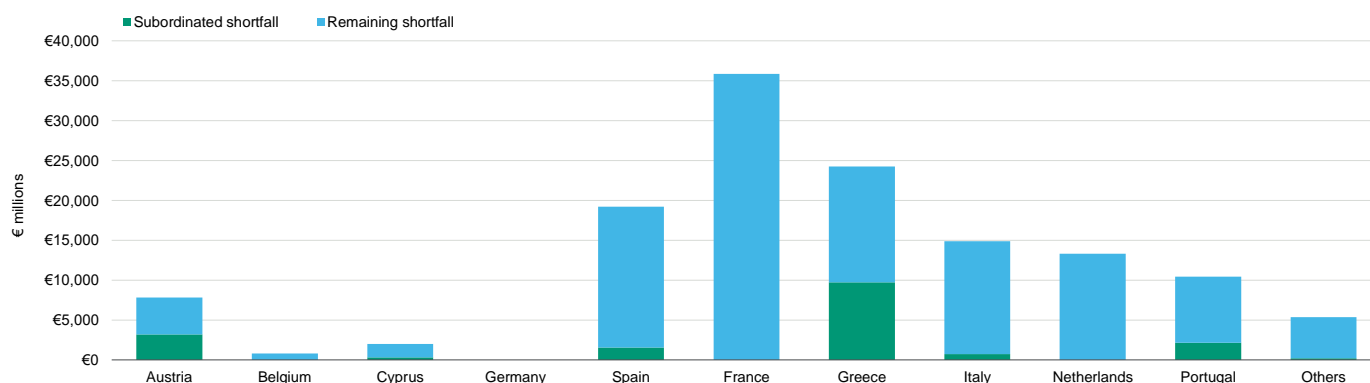
% of total risk exposure amount as of the end of September 2020



Source: Single Resolution Board's third-quarter MREL dashboard

Exhibit 2

**MREL shortfall for banks under the SRB's remit as of the end of September 2020**



Source: Single Resolution Board's third-quarter MREL dashboard

## Endnotes

- <sup>1</sup> As of this date, the SRB published its resolvability expectations for banks in the context of Brexit and noted the potential consequences of Brexit for banks' existing stock of MREL instruments governed by UK law.

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## Russia hikes key rates, increasing pressure on bank margins

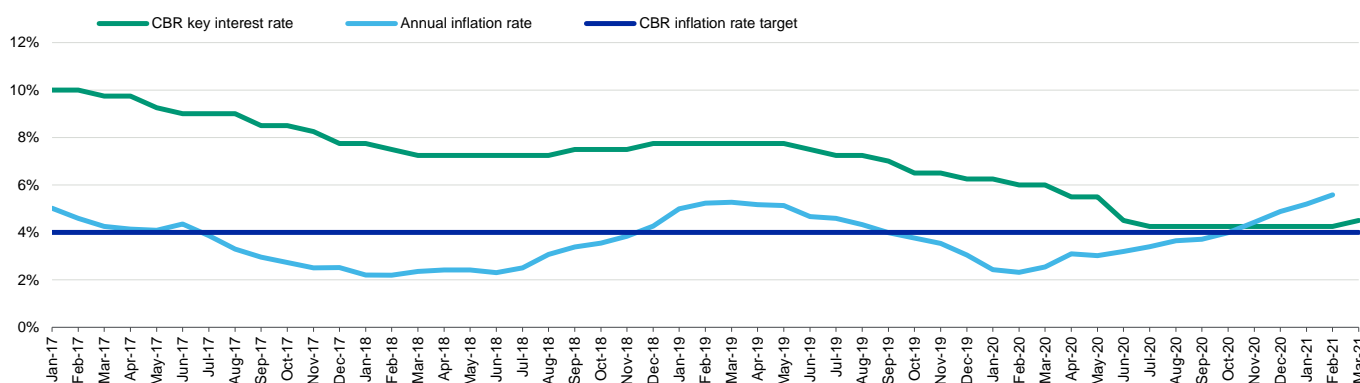
Originally [published](#) on 23 March 2021

On 19 March, the Central Bank of Russia (CBR) increased its key interest rate 25 basis points to 4.5%, its first monetary policy tightening since December 2018. The rate hike will increase banks' funding costs, a credit negative. We expect the systemwide net interest margin to narrow 15-20 basis points this year from the 3.9% average last year.

According to the CBR, an accelerated inflation rate prompted the policy tightening: as of 15 March, annual inflation increased to 5.8%, above the CBR forecasts published in February (see Exhibit 1). The central bank adjusts its monetary policy to keep the inflation rate close to its 4% target rate. It expects the rate hike to bring inflation closer to its target by the first half of 2022. CBR Chairwoman Elvira Nabiullina also signaled the possibility of additional rate hikes.

Exhibit 1

### The CBR tightened monetary policy after March inflation exceeded the CBR's forecasts



Sources: Central Bank of Russia and Russian State Statistics Service

The CBR's key rate is a driver of Russian banks' funding costs. The cost of CBR funding is directly linked to the key rate, and other funding sources also correlate with the rate. Borrowing from the CBR accounted for just 4% of the banking sector's total liabilities as of 1 February. However, once the CBR key rate increases, rates for interbank funding, which comprised 10% of the sector's total liabilities as of 1 February, will also increase.

The higher cost of CBR and interbank funding incentivises banks to attract deposits by offering higher deposit rates. Customer funds exceed 70% of the sector's total liabilities, but deposit volume stagnates and customer funds flow to demand deposits and current accounts from long-term deposits because low interest rates diminish the appeal of fixed-income deposits. Demand deposits and current accounts from individuals increased 1.5x in 2020 and their share in total retail funding increased to 37% as of year-end 2020 from 26% as of the beginning of the year. Household deposits account for about half of the sector's total customer funding.

Banks increasingly need to retain longer-term individual deposits to match the duration of their liabilities with that of lending, as loans with more than one-year tenors predominate in their portfolios. Since mid-2019, banks have consistently cut their deposit rates, following the CBR easing its key rate. However, late last year, the trend reversed and the top 10 deposit takers' [maximum rouble rate for retail deposits](#) increased 20 basis points to 4.53% in March 2021 from 4.33% in October 2020.

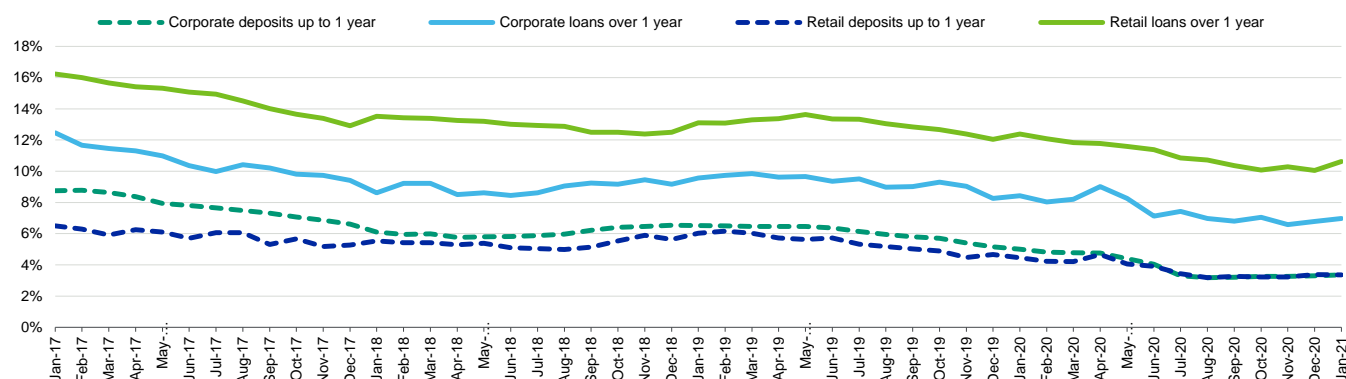
We expect the CBR's monetary tightening to reinforce an upward trend in deposit rates. Concurrently, banks will not be able to pass over the entire increase of their funding cost to borrowers. In corporate lending, only 36% of all loans were issued at floating rates as of year-end 2020, and the bulk of retail loans are issued with fixed rates. When the CBR first signalled a reversal in key rate policy early this year, the banks tried to increase lending rates for newly issued loans to preserve their net interest margins (see Exhibit 2). However,

we expect that in the remainder of 2021 and, highly likely, in 2022, competition for quality borrowers will cause lending rate increases to lag behind increases in deposit rates.

Exhibit 2

# **Banks will not be able to pass on all of their increased funding cost to borrowers**

**Banks' weighted average rates for ruble-denominated loans and deposits**



The data on ruble-denominated loan and deposit rates presented in this exhibit are for sector loans and deposits with the most common durations. At the beginning of 2021, RUB corporate deposits with a duration of up to one year comprised 80% of total RUB corporate deposits, while RUB retail deposits of up to one year comprised 69% of total RUB retail deposits. RUB corporate loans with a duration of more than one year comprised 66% of total RUB corporate loans and RUB retail loans of more than one year were 74% of total RUB retail loans.

Source: Central Bank of Russia

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## Extension of subsidised mortgage programme in Russia will support banks' revenue

On 19 March, Elvira Nabiullina, governor of the Central Bank of Russia (CBR), announced that she would support extending until the end of this year a subsidised mortgage lending programme for newly built homes from the middle of 2021 in a limited number of regions. As part of the programme, the government compensates banks for part of foregone interest income associated with a subsidised lending rate that in January 2021 was 6.5%, approximately 70 basis points below the reported average interest rate for mortgage loans. The extension, if successful, is credit positive for Russian banks because the lower lending rate will help banks generate more loans, interest and commission income, supporting their net interest margins and profitability, even if the programme continues in fewer Russian regions than before.

The government launched the subsidised mortgage lending programme in April 2020 to support the economy during the coronavirus pandemic, particularly the housing construction sector, and it has benefited adjacent industries such as building materials manufacturing, furniture and retail trade (do-it-yourself goods, home appliances, etc.). The programme is due to end on 1 July 2021 and so far has been available to qualified borrowers throughout Russia. As a result of low interest rate mortgage availability, stronger consumer demand in a few large regions including City of Moscow, Oblast of Moscow, St.Petersburg, Leningrad region and Krai of Krasnodar triggered significant inflation in real estate prices in 2020 and made new homes less affordable. Thus, the CBR supports programme extension only in a few regions where it had no such adverse effect.

We expect that the largest mortgage lenders, in particular, [Sberbank](#) (Baa3 stable, ba1<sup>1</sup>), [Bank VTB, PJSC](#) (Baa3 stable, b1) and [JSC DOM.RF](#) (Baa3 stable, ba3) will be among the main beneficiaries (see Exhibit 1). That is because they are market leaders in lending for newly built homes, and earn additional revenue from interest and commission income derived from stronger demand for loans and related financial services (settlement on real estate transaction, real estate and life insurance, lien registration payments, etc.). In addition, because the programme is a rate-subsidy scheme, not a risk-sharing scheme, the banks will remain in control of their lending criteria.

Exhibit 1

### Russias largest mortgage lenders

| Bank name                                  | Total assets, RUB billions | Mortgage loans, RUB billions | Mortgage loans as % of gross loans |
|--|----------------------------|------------------------------|------------------------------------|
| Sberbank (Baa3 stable, ba1)                | 36,016                     | 5,219                        | 22%                                |
| Bank VTB, PJSC (Baa3 stable, b1)           | 18,142                     | 1,776                        | 14%                                |
| JSC DOM.RF (Baa3 stable, ba3)              | 1,332                      | 891                          | 79%                                |
| Gazprombank (Ba1 stable, b1)               | 7,567                      | 406                          | 8%                                 |
| Russian Agricultural Bank (Ba1 stable, b3) | 3,216                      | 274                          | 11%                                |

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

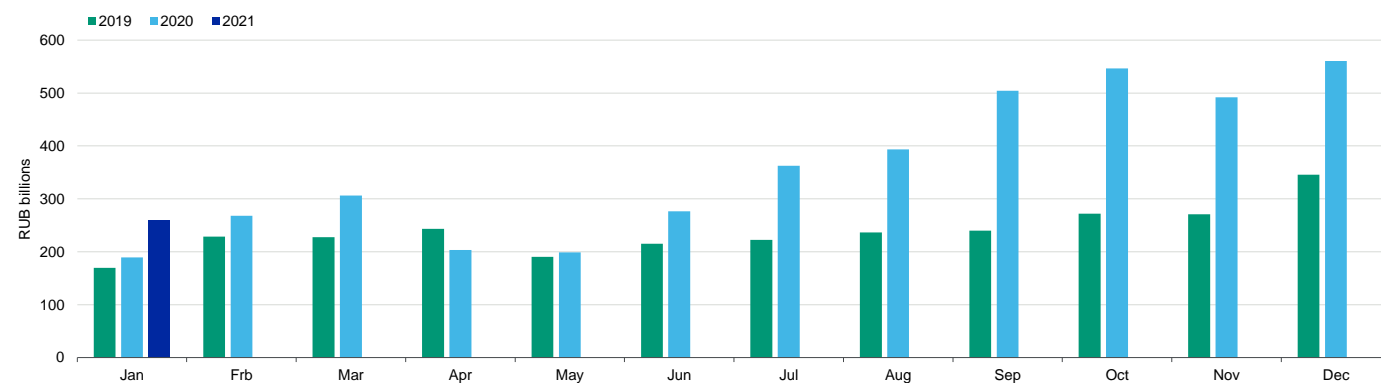
Sources: Banks' year-end 2020 IFRS reports, except for Russian Agricultural Bank, which is based on estimated year-end 2019 data, and Gazprombank, which is based on an IFRS report for the first nine months of 2020.

Secured mortgages have been the least risky lending product among retail loans to date, particularly since the coronavirus outbreak in March last year. As of 1 December 2020, mortgages overdue by more than 90 days constituted 1.3% of total mortgages systemwide, compared with a 5.1% share of problem loans across the retail loan portfolio as of the same date.

The subsidised mortgage lending programme allowed the government to compensate for the immediate adverse effect of lockdown measures and economic uncertainty, which caused a material year-over-year decline in mortgage production in April 2020. Monthly mortgage origination since then has materially exceeded prior-year levels (see Exhibit 2).

Exhibit 2

## Mortgage origination in Russia has considerably increased since the subsidised mortgage programme began



Source: Central Bank of Russia

## Endnotes

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

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## Turkish central bank governor's dismissal is credit negative for banks

On 19 March, Turkey's President Recep Tayyip Erdogan [replaced central bank governor](#) Naci Agbal two days after the central bank had raised its key policy rate by 200 basis points to 19%, and appointed as Agbal's replacement Sahap Kavcioglu, who has said that rate hikes contribute to inflation.

Replacing Agbal immediately after an interest rate hike and after only four months at his job – the fourth governor change in less than two years – is credit negative for Turkish banks' funding. The move hurts investor confidence, constraining banks' access to market funding. On 22 March, the Turkish lira fell sharply to around TRY7.80 per US dollar from TRY7.22 on 19 March, and the Istanbul stock exchange fell approximately 10%.

The 200-basis-point rate hike leading to Agbal's sudden replacement was one of several positive [monetary policy developments](#) since his appointment as central bank chief in November 2020, when he was tasked with fighting inflation of 15.6%, rebuilding the central bank's credibility and moderating last year's excessive loan growth of 35%.

Before Agbal's tenure at the central bank, excessively loose monetary policy and aggressive loan growth aligned with presidential policy led the lira to depreciate to record lows, constraining market access for Turkish banks. Monetary policy tightening of 875 basis points since November 2020 strengthened the lira by about 18%. That helped banks gain medium-term and subordinated market access at the beginning of this year, neither of which had been available since the start of the coronavirus pandemic last year. Without central bank credibility, market access is likely to again be costlier and limited to short-term syndications.

A weakening currency and high inflation will continue to erode the confidence of domestic depositors, prompting already-high deposit dollarisation (i.e., the level of deposits held in US dollars) of 54% of total deposits as of February 2021 to increase further. Ultimately, the lira depreciation will dampen portfolio and investment inflows and increases the tail-risk scenario of capital controls resulting from government policies.

These risks are somewhat mitigated by the fact that Turkish banks have adequate foreign-currency liquidity and have generally reduced their reliance on market funding since the country's 2018 currency crisis, as indicated by the banking system's loan-to-deposit ratio improving to 108% in 2020 from 126% in 2017. However, Turkish banks still rely on market funding, with large banks' market funding ranging between 15-32% of tangible assets at December 2020, and are therefore exposed to a shock to investor confidence.



## Kuwait's new insurance regulations are credit positive

Originally [published](#) on 24 March 2021

On 21 March, Kuwait's Insurance Regulatory Unit published new executive directives for insurers and reinsurers. The new directives introduce risk-based capital measures and actuarial-led reserving, as well as other updates around (re)insurers' risk management. The regulations are credit positive for Kuwait's insurers because they will enhance insurers' capital adequacy, reserve adequacy and risk management.

The new financial regulations aim to ensure the stability and sustainability of the insurance industry by improving the market's risk management sophistication around several credit characteristics of insurers, including capital, asset quality and reserve adequacy. Such a setup will encourage insurers to become more sensitive to the risks they underwrite, thereby balancing competitive considerations with the risk undertaken when writing new business and promoting market stability.

The new regulations also encourage a risk-based approach to manage the quality of invested assets. These improvements address previous regulatory shortcomings that led to excessive competition that often hurt the profits and capital of smaller insurers competing in the compulsory segments of motor and medical insurance.

The largest domestic insurers will benefit from the updated regulations because the measures aim to stabilise the market and reduce the aggressive competition from smaller rivals. Large insurers include [Gulf Insurance Group K.S.C.P.](#) (A3 negative) and its main Kuwait-based subsidiary [Gulf Insurance and Reinsurance Company K.S.C.](#) (A3 stable); [Al Ahleia Insurance Co. \(S.A.K.P.\)](#) (A3 stable); [Kuwait Insurance Company S.A.K.](#) (A3 stable); [KFH Takaful Insurance Company K.S.C.](#) (Baa2 stable); [Warba Insurance Company K.S.C.P.](#); and Kuwait Reinsurance Company K.S.C.P. Currently, these groups have self-imposed underwriting discipline and a certain level of risk management but they are nonetheless constrained by aggressive competition.

In addition to existing basic minimum capital requirements, the solvency capital requirements now incorporate premium- and claim-based solvency calculations that vary by lines of business, for example marine and general insurance will require a higher level of capital as compared to life and health. Actuaries will set and monitor reserves, making insurers more sensitive to the risks they underwrite. We expect that these steps will encourage insurers to set premiums in line with underwriting risks and become increasingly selective, which will improve underwriting profitability.

Minimum issued capital stipulated by the law is KWD5 million for standalone property and casualty (P&C) or standalone life insurers, KWD10 million for those that write both life and P&C business and KWD15 million for reinsurers.

Although the regulation will provide a one-year grace period for compliance, enhanced regulations also come with additional costs that we expect will encourage consolidation among some smaller insurers.

The regulations provide guidance on the governance of invested assets, including board-approved investment policies, and cites the related risks that insurers should consider, including credit, liquidity and exchange-rate risk. Although the regulations currently do not stipulate limits for each type of asset class along with the new focus on maintaining good quality assets to aid solvency, we expect there to be a gradual shift to higher quality assets in the market as a result of the new regulations.

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## Surprise firing of Turkey's central bank governor is likely to increase credit pressures

Originally [published](#) on 22 March 2021

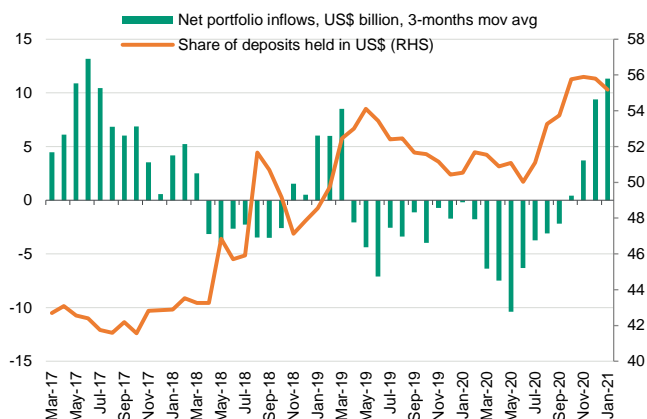
On 19 March, [Turkey's](#) (B2 negative) President Tayyip Erdogan dismissed Central Bank Governor Naci Agbal only two days after the central bank had raised its key policy rate by 200 basis to 19%. The central bank interest rate hike had been a positive move to rein in high and rising inflation and a step towards rebuilding the central bank's credibility.<sup>1</sup> The decision reverses these positive developments and increases the risk of renewed pressure on the exchange rate. The surprise move is also further evidence of the complete lack of policy predictability in Turkey and confirms our view of serious institutional weakening in the country over the past several years.

Last September, [we downgraded Turkey's rating to B2](#) and maintained a negative outlook, because of concerns of a deepening balance-of-payments crisis if economic policies were not changed. Over the past few months – and as a result of the more credible monetary policy under governor Agbal – the currency has stabilised and foreign capital has returned to Turkey.

With Agbal's dismissal, these capital inflows – in particular the \$11.3 billion in net portfolio inflows – will likely reverse again in the near term (see Exhibit 1). At the same time, Turkey's foreign-currency reserves are at a much lower level than last year, at \$53 billion on a gross basis but a negative \$4.5 billion on a net basis, if the required bank reserves at the central bank are deducted, limiting the ability of the central bank to stabilise the currency. A weakening currency will increase already elevated inflationary pressures; in February consumer price inflation stood at 15.6%, compared to 12.4% a year earlier. High inflation in turn erodes confidence of Turkish households and corporates; the level of deposits held in US dollar and gold is high and may well increase further, adding to pressure on lira.

Exhibit 1

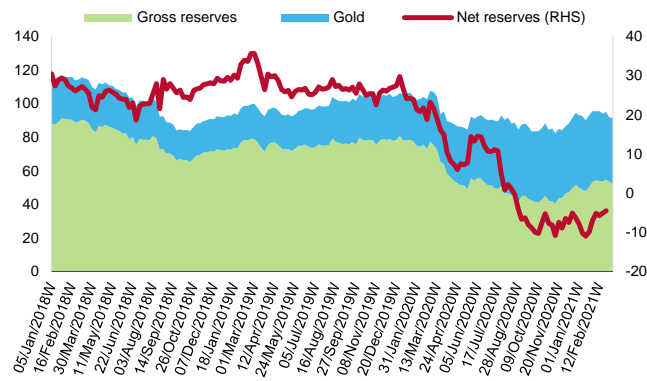
**Dismissal is likely to reverse recent capital inflows and increase dollarisation...**



Sources: CBRT, Haver Analytics and Moody's Investors Service

Exhibit 2

**...putting further pressure on foreign-currency reserves**  
\$ billions



Sources: CBRT, Haver Analytics and Moody's Investors Service

The change in governor signals that further rate increases will no longer be under consideration. Instead the central bank may choose to reduce its policy rate again below the level of inflation to push economic growth. Continued strong credit growth might also be encouraged again. While these policies may indeed provide support to private consumption and investment in the coming quarters, they would also result in higher imports and a larger current-account deficit than expected before the weekend events, which needs to be financed in a less welcoming financing environment. Servicing and refinancing Turkey's large external debt burden will likely become both costlier and more difficult. The private sector has \$117.5 billion in short-term external debt that it needs to roll over, although \$54 billion is in trade credit which is a more stable source of funding. Maturing medium to long-term debt of \$29.4 billion adds to the

private-sector's external funding needs. In addition, the government faces repayment of external debt (principal and interest) of \$11.6 billion between March and December this year.

## Endnotes

<sup>1</sup> See [Turkish central bank's decisive interest rate hike helps to rebuild credibility, a credit positive](#), 19 March 2021.

## Australia's robust employment data signals economic recovery is well underway, supporting credit quality

Originally [published](#) on 19 March 2021

On 18 March, the Australian Bureau of Statistics announced that [Australia's](#) (Aaa stable) seasonally adjusted unemployment rate fell to 5.8% in February, the lowest level since the introduction of pandemic restrictions in March 2020. The fall comes on the back of a rapid recovery in economic growth, and in consumer and business sentiment, collectively signalling a relatively smooth conclusion to the government's JobKeeper wage subsidy scheme, which is due to expire on 28 March. A successful exit from the scheme, in the context of a strong economic recovery, would indicate potential for the fiscal consolidation process to begin, supporting credit quality.

Unemployment rose sharply as the coronavirus pandemic hit Australia's economy, triggering the closure of inter- and intranational borders and the imposition of lockdown restrictions. The unemployment rate peaked at 7.5% in July 2020, the highest level since the 1990s, and up from just 5.2% in March 2020. In response, the government enacted stimulus measures worth around AUD180 billion (\$140 billion), of which the JobKeeper wage subsidy scheme – which has now been in place for 12 months – accounts for about half.

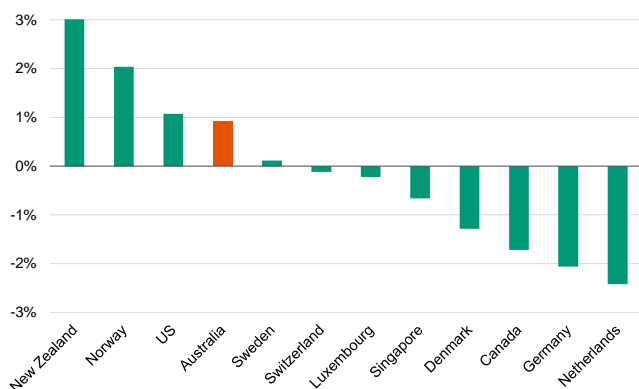
February's data indicates that unemployment is now below the level of 6.0% that the government flagged to begin a policy shift toward fiscal consolidation (see Exhibit 2); it had forecast for this to occur only during the fiscal year ending June 2023 (FY2022/23). However, we do not expect significant fiscal consolidation until the global economic situation strengthens further, especially with federal elections due in the period up to early September 2022.

The rapid recovery in employment comes on the back of a surge in economic sentiment, with both businesses and consumers, as measured by the NAB Business Survey and Westpac-Melbourne Consumer Sentiment Index, becoming increasingly positive since the fourth quarter of 2020. Dwelling prices – a key measure of household confidence – have surpassed pre-pandemic levels in Sydney and are less than 2% below their March 2020 peak in Melbourne. The economic recovery has also benefitted from robust commodity prices, especially for iron ore, which accounted for around 20% of Australia's total exports in 2019.

Together, the forces associated with the pandemic accounted for a GDP contraction of 2.44% in 2020, below Treasury's estimate of 3.75% in the 2020-21 budget. We expect a recovery in GDP growth to 3.5%-4.0% in 2021, above the Aaa-rated median of 3.3%. Significantly, Australia is one of the few Aaa-rated sovereigns for which we expect 2021 real, inflation-adjusted GDP to exceed 2019 levels (see Exhibit 1).

Exhibit 1

**We expect Australia's economy to weather the coronavirus shock better than most other Aaa-rated sovereigns**  
(2021F real GDP, % change from 2019)



Source: Moody's Investors Service

Exhibit 2

**Employment has recovered quickly, overtaking government forecasts**  
(Unemployment rate, %)



Sources: Australian Bureau of Statistics and Moody's Investors Service

While the faster-than-expected economic recovery is likely to bolster revenue and contain social security expenditures, the government has suggested it may introduce smaller, more-targeted programs to offset the termination of JobKeeper. We therefore maintain our forecast for debt at around 65%-70% of GDP over the next three years. This is in line with other Aaa-rated sovereigns such as [Germany](#) (Aaa stable) and the [Netherlands](#) (Aaa stable), and significantly lower than [Canada](#) (Aaa stable) and the [US](#) (Aaa stable).

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# FAQ on US federal fiscal deficits, debt and debt affordability following American Rescue Plan

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Unprecedented fiscal stimulus and extraordinary monetary policy have provided critical support to the [US](#) (Aaa stable) economy throughout the coronavirus pandemic. As the economy begins what we expect to be a very strong recovery from the depths of the crisis, sustained government spending on pandemic relief will drive large fiscal deficits and a rising debt burden. This has raised market concerns about the potential for higher inflation and interest rates, which could weigh on the US' debt affordability. In this report, we answer frequently asked questions related to these dynamics and explain why we expect the sovereign's credit profile to remain resilient over the medium term.

- » **What impact will increased fiscal stimulus spending have on federal fiscal deficits and debt?** We expect the deficit to increase to about 16% of GDP and debt to rise to nearly 108% of GDP in 2021. Over the next two to three years, very strong growth and a recovery in revenue will support deficit reduction and debt stabilization at around 107% of GDP. Over the longer term, we expect federal deficits and debt to gradually rise as GDP growth converges with potential and expenditure pressures increase, driven mainly by higher interest rates and rising age-related entitlement spending. These adverse fiscal dynamics will likely keep the US' fiscal deficit above 5% of GDP for most of the next decade, with the debt burden increasing to around 119% of GDP over the same period.
- » **Does the US have the capacity to improve its fiscal position after the coronavirus pandemic shock?** US federal fiscal deficits have historically narrowed between recessions. Although heightened political polarization will continue to challenge the fiscal policymaking process, policymakers have options to reduce deficits by either raising revenues or reducing long-term entitlement spending. The extent to which they do so, along with debt affordability dynamics, will be important considerations in our credit assessment of the US sovereign as this decade unfolds.
- » **Are rising Treasury yields an imminent threat to the US' debt affordability and fiscal strength?** Despite their recent rise, Treasury yields remain low by historical standards. We expect episodes of heightened financial market volatility to reoccur over the course of 2021 as the economic recovery from last year's recession gains steam, periodically igniting fears of inflation and faster-than-anticipated interest rate increases. In the near term, high GDP growth combined with relatively low interest rates will mitigate the impact of wider federal fiscal deficits on debt affordability. We forecast federal interest payments-to-revenue to remain in the range of around 10%-11% annually through 2023, compared to an average annual ratio of about 15.2% during the 1980s and 16.4% in the 1990s.

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

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