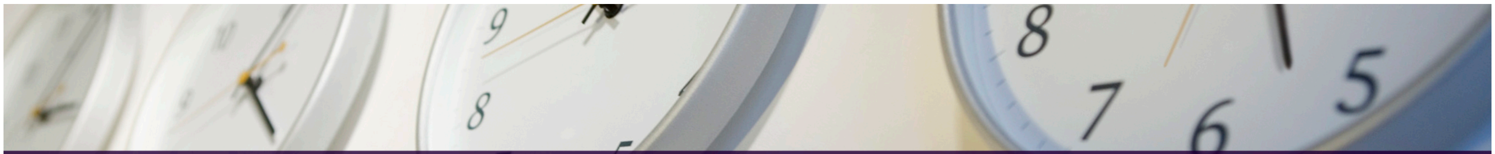

Credit Outlook

23 September 2021

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Lincoln National's $9.4 billion life reinsurance transaction is credit negative

Originally published on 20 September 2021

On 17 September, Lincoln National Corporation (LNC, Baa1 stable) announced that it had signed an agreement to reinsure approximately $9.4 billion of executive benefit and universal life (UL) reserves to Security Life Insurance Company of Denver (SLD, insurance financial strength Baa1 negative), a subsidiary of Resolution Life Group Holdings LP, a private capital-funded aggregator of legacy insurance businesses. The transaction is credit negative for Lincoln because it will give up a low-risk block of stable life insurance business, gain counterparty risk and use most of the released capital for share repurchases.

Lincoln's operating subsidiary, The Lincoln National Life Insurance Company (insurance financial strength A1 stable), will cede to SLD an $8.1 billion block of in-force executive benefit reserves (primarily company-owned life insurance (COLI)/bank-owned life insurance (BOLI)) and approximately $1.3 billion of UL reserves. The transaction, effective 1 October 2021, is subject to usual and customary closing conditions, and is not subject to regulatory approval.

Lincoln indicated the business will generate approximately $1.2 billion in total transaction value, including the release of capital to support the block and a ceding commission paid by SLD. Lincoln intends to use 75% of the generated capital to fund approximately $900 million of incremental share repurchases by the end of first-quarter 2022. The company is monetizing an attractive in-force business to reward equity shareholders, but is giving up a stable earnings stream of around $40 million annually (after tax, net of amortized deferred gain). Balancing this, the remaining proceeds will be used for general corporate purposes, primarily paying down debt. We expect leverage and coverage to be unchanged.

Lincoln will retain account administration and record-keeping of the in-force policies, which will lessen servicing issues with policyholders in the block; SLD will manage the coinsured general account investment portfolio. The agreement is structured as a 90% coinsurance treaty for the general account reserves and a modified coinsurance treaty for the separate account reserves, with counterparty protections including a comfort trust and investment guidelines to meet Lincoln's risk management targets. The transaction adds counterparty risk, which the trust and investment guidelines mitigate.

Although the transaction sheds a portion of Lincoln's life insurance book, the company will continue to sell executive benefits and UL insurance. Lincoln will maintain a balanced business earnings mix with around a 30% contribution from mortality/morbidity risks.

For SLD, the transaction aligns with Resolution Life's strategic build out of its US business platform. Resolution Life acquired SLD at the end of 2020 and the deal is consistent with SLD's current credit profile. We expect Resolution Life through its SLD platform to acquire and reinsure other US life insurance blocks in the coming quarters.

This transaction continues a broad and accelerating industry trend – the participation of private capital firms in life insurance mergers and acquisitions. We expect private capital firms with varying degrees of credit strength will continue to scoop up insurance businesses and participate in the industry's overall consolidation amid low interest rates and plenty of available capital looking for attractive investments (see exhibit).

Private capital-driven life insurance acquisitions accelerated in second half of 2021

Date of Transaction	Buyer/Ultimate Parent	Seller	Type of Business	Motivation	Deal Value (USD Billions)	Reserve Size (USD Billions)	Transaction Type (Stock/Reinsurance)
September-21	Resolution Life	Lincoln National	Life	Private Capital	$ 1.2	$ 9.4	Reinsurance
September-21	Fortitude	Prudential Financial	VA	Private Capital	$ 2.2	$ 31.0	Sale
August-21	Brookfield Asset Management	American National Group	Life	Private Capital	$ 5.1	n.a	Stock
July-21	Blackstone	AIG Life and Retirement	Life	Private Capital	$ 2.2	n.a	Stock
June-21	Constellation Insurance Holdings	Columbian Mutual Life	Life	Private Capital	n.a	n.a	Demutualization
March-21	Wilton Re	Allstate Life Insurance Company of New York	Life & Annuities	Private Capital	$ 0.2	$ 5.0	Stock
March-21	Constellation Insurance Holdings	Ohio National Financial Services	Life & Annuities	Private Capital	$ 1.0	$ 28.9	Stock
March-21	Apollo	Athene	Fixed Annuities	Private Capital	$ 11.0	$ 88.1	Stock
January-21	Blackstone	Allstate Life	Life & Annuities	Private Capital	$ 2.8	$ 23.0	Stock
January-21	Sixth Street	Talcott Resolution Life	VA	Private Capital	$ 3.2	$ 85.0	Stock

Sources: Company filings and Moody's Investors Service

The private-capital transactions tend to be good for the sellers, which, in true sales and certain protected reinsurance transactions, enable the seller to shed high-risk, low-earning and below-scale businesses. However, they also tend to be negative for policyholders of the businesses sold, especially in true sales, since the private-capital buyers are typically less creditworthy insurers and have greater asset risk than those that sold them the policies. If private capital insurers have problems as liabilities accumulate, their reputation risk could potentially transfer to the industry, implying reputation risk for the original sellers and particularly major US life insurers such as Lincoln.

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U.S. Bancorp's acquisition of MUFG Union Bank, despite enhancing scale, poses risks

On 21 September, U.S. Bancorp (USB, A2 negative) announced that it will acquire the regional banking franchise of MUFG Union Bank, N.A. (Aa3/A2 review for upgrade, a3 review for upgrade[1]) for $5.5 billion in cash and $2.5 billion of stock. The bank expects the transaction to close in the first half of 2022.

Although a successful acquisition would enhance USB's scale and market position and provide opportunities for significant cost savings, it is credit negative for USB because of the acquisition's associated operational and integration risks. Additionally, USB will face regulatory risks and profitability pressure arising from a consent order to which MUFG Union Bank is subject. Following the announcement, we changed USB's outlook to negative from stable, and put MUFG Union Bank's ratings on review for upgrade from stable.

The $5.5 billion cash consideration temporarily will reduce USB's capitalization. USB estimates that its Common Equity Tier 1 capital ratio will fall by almost 100 basis points upon close from 9.9% as of 30 June 2021, but will return to its target level of 9% soon thereafter. Our outlook change on USB's ratings considers this temporary decline and that this acquisition may increase USB's capital erosion under stress, although USB does benefit from above-peer stress capital resilience.

As part of the MUFG Union Bank acquisition, USB will acquire assets of $105 billion as of 30 June 2021, loans totaling $58 billion (approximately 16% of the combined entity's loans as of the same date on a pro forma basis) and deposits totaling $90 billion (17% of combined deposits). The transaction excludes MUFG Union Bank's Global Corporate & Investment Bank, certain middle- and back-office functions, and other selected assets. MUFG Union Bank is the bank subsidiary of MUFG Americas Holdings Corporation (MUAH, A3 review for downgrade), which is the US intermediate holding company for Mitsubishi UFJ Financial Group (A1 stable).

Acquiring MUFG Union Bank will enhance USB's scale and market position, particularly in the western US and the attractive California market, while also providing opportunities for significant cost savings. USB historically has been a highly efficient banking franchise, while MUFG Union Bank's cost structure has been elevated for several years, constraining its profitability.

MUFG Union Bank recently became subject to a consent order with the Office of the Comptroller of the Currency because of deficiencies in its technology and operational risk management, which will likely increase its noninterest expenses to remediate. USB management has indicated that it has incorporated the consent order and remediation in its acquisition plan, but there is a risk that the regulatory considerations will add unexpected delays or costs.

With the increased asset size and additional organic growth, USB is likely to become subject to more stringent regulatory requirements as a Category II institution when it exceeds $700 billion of total assets for four consecutive quarters. This would further strengthen its credit profile.

Tempering the risks associated with acquiring MUFG Union Bank are the low risk profile of assets USB is acquiring and the strength of USB's risk governance. USB's governance has been a key support of its high ratings with its very strong risk governance and concentration limit framework, which along with its business diversity, has supported a positive assessment of the company's corporate behavior and an excellent financial track record through economic cycles evidencing exceptional stewardship.

Endnotes

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

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Lufthansa launches €2.1 billion rights issue, a credit positive

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On 19 September, Deutsche Lufthansa Aktiengesellschaft (Ba2 negative) launched a €2.1 billion fully underwritten rights issue to repay state support it has received during the coronavirus crisis. The rights issue is credit positive because it will reduce Lufthansa's reported net debt by slightly more than 10% and contribute to the airline's objective to return to a company-defined net debt/EBITDA (including pension provisions) of less than 3.5x by 2024.

Lufthansa's ratings and outlook remain unchanged because the combination of a sustained improvement in operating performance, free cash flow generation applied to debt reduction and leverage improvements would be required for an outlook stabilisation.

The fully underwritten rights issue of €2.1 billion is being offered at a subscription price of €3.58 per new share, a steep discount of 39.3% to the theoretical ex-rights price. The proceeds will be used to repay the outstanding €1.5 billion silent participation 1 of Germany's Economic Stabilisation Fund (ESF) as soon as October. In a second step, Lufthansa intends to repay the outstanding amount of €1 billion under silent participation 2 and to cancel the €3 billion availability under silent participation 1 by year-end 2021.

The ESF, which holds around 16% of Lufthansa's shares, has committed to start divesting its stake in the airline six months after completion of the capital increase at the earliest and within a 24 months time frame. This commitment is subject to the repayment of silent participation 1 and 2 by Lufthansa. Despite the ownership of the German government through the ESF falling below 20%, we will keep the government-related issuer status for Lufthansa as long as silent participation 1 and 2 have not been fully redeemed and the availability of €3 billion under silent participation 1 has not been canceled.

The rights issue is just one lever to restore Lufthansa's capital structure over time. The impact of the rights issue on the company's Moody's adjusted credit metrics will be relatively limited given the size of Lufthansa's adjusted debt and net debt positions. As at 30 June 2021, Lufthansa had €25 billion of Moody's adjusted gross debt and €13.5 billion of Moody's adjusted net debt outstanding. The rights issue of €2.1 billion will therefore only reduce Lufthansa's adjusted gross debt by around 10% and net debt by around 16%.

However, Lufthansa confirmed good progress on its cost reduction programme during the call on its proposed rights issue. The company has already achieved more than 50% of its €3.5 billion fixed cost reduction programme. It also reported progress on passenger traffic and earnings. Offered capacity during the third quarter (as measured by available seat kilometers) amounted to around 50% compared with 21% in the first quarter of 2021 and 29% in the second quarter, with a load factor reaching 72% in August from 45% in the first quarter. Lufthansa confirmed its fourth-quarter capacity guidance of 60% despite expecting the North Atlantic corridor to open up toward the end of the year versus an earlier expectation of September.

Lastly the company indicated that there would be no cash drain at the operating cash flow level in the third quarter and that it expects to generate positive adjusted net EBIT (excluding restructuring charges) during the quarter.

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Igloo acquisition will strengthen Dometic's positioning in North American outdoor market

Originally published on 20 September 2021

On 17 September, global manufacturing company Dometic Group AB (Ba2 stable) announced it entered an agreement to acquire Igloo, a designer and manufacturer of passive cooling boxes and drinkware in the US and internationally. The total purchase price is $677 million, on a cash and debt free basis. The agreement includes an earn-out element of maximum $223 million to be realized depending on Igloo's future EBITDA development. Pending regulatory approvals, the company expects the transaction to close in the fourth quarter of this year, when Igloo will become part of Dometic's Global Segment.

The acquisition is credit positive because it will expand Dometic's offering in the outdoor segment and decrease the company's exposure to the cyclical recreational vehicle market in the US. However, Dometic's pro forma Moody's-adjusted debt/EBITDA is bound to increase to around 4.1x from 3.9x for the 12 months that ended in June. Balancing the temporary leverage increase with the business profile improvements, the Ba2 rating with a stable outlook remain unchanged.

Texas-based Igloo reported $401 million in revenue with a 10.1% EBITDA margin in the last 12 months that ended July 2021. With Igloo's leading position in the cooling boxes and drinkware market in the US, Dometic is expected to widen its product portfolio of coolers and add production capacity. In addition, Dometic is expected to significantly grow distribution points in the US and inherit long-standing relations with major retailers.

Including the Igloo acquisition, Dometic has made eight acquisitions this year with a combined turnover of $630 million (SEK5.5 billion). Dometic launched a direct share issue of approximately SEK3.4 billion in the second quarter of this year to fund acquisitions, which materially improved its cash position.

On 25 February, we changed Dometic's outlook to stable and affirmed the Ba2 rating. As of second quarter 2021, Dometic had record high net sales with 66% organic growth and a record high order backlog. Profitability was positively affected by sales growth, pricing strategy and cost saving initiatives.

In the longer term, we expect Dometic to deleverage gradually from this acquisition and reach key credit metrics commensurate with the Ba2 rating within the next 18 months, which includes a debt/EBITDA ratio of below 4.0x and a high single-digit free cash flow/debt ratio. We believe the positive current favorable industry trend of outdoor life will continue to benefit the recovery of Dometic's credit profile despite supply chain disturbances in current environment.

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Merger of Indosat Ooredoo and PT Hutchison 3 Indonesia is credit positive for Ooredoo

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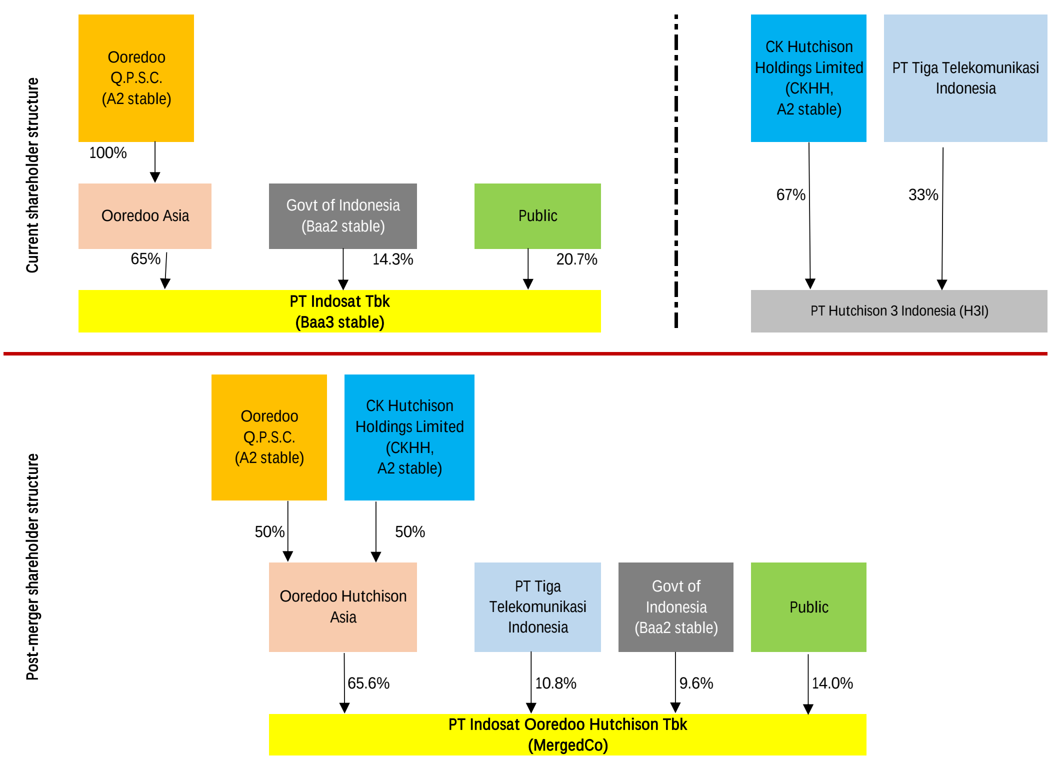
On 16 September, Ooredoo Q.P.S.C. (A2 stable) and CK Hutchison Holdings Limited (A2 stable) announced they will merge their respective operations in Indonesia, PT Indosat Tbk (Indosat Ooredoo, Baa3 stable) and PT Hutchison 3 Indonesia. The merged entity will be called PT Indosat Ooredoo Hutchison Tbk.

The transaction is credit positive for Ooredoo because its net debt to EBITDA will decrease slightly. At the same time, however, Ooredoo will no longer consolidate Indosat in its financial accounts and the transaction will result in Ooredoo having to share control of its Indonesian operations, the second-highest contributor to the group's EBITDA, after Ooredoo Qatar.

On completion of the transaction, Ooredoo will have joint control alongside CK Hutchison of Ooredoo Hutchison Asia, which itself will be the majority owner of Indosat Ooredoo Hutchison with a 65.6% stake (see exhibit). Ooredoo will also receive $387 million in cash from CK Hutchison as part of the transaction.

Ooredoo will control the merged entity jointly with CK Hutchison



Source: Company data

The merged entity will hold a strong second place in the Indonesian market with a market share of around 28%, ahead of XL Axiata but behind Telekomunikasi Indonesia (P.T.) (Baa1 stable), which had around a 48% market share in terms of subscribers as of 30 September 2020. Ooredoo expects the merged entity to benefit from operating expenses and capital spending synergies of $300-$400 million per year, to be realised over the next three to five years. The consolidation in the Indonesian telecom market could lead to Indosat

Ooredoo Hutchison's equity value increasing over time, which would ultimately benefit Ooredoo. Ooredoo expects the transaction to be completed by the end of 2021, subject to regulatory approvals.

While the transaction will mildly improve Ooredoo's net leverage because of the additional cash that it will receive from CK Hutchison, Ooredoo will also relinquish control of its Indonesian subsidiary, which will be jointly controlled with CK Hutchison once the transaction is completed. We expect net debt to EBITDA (on a reported basis) to decrease to 1.6x pro-forma for the transaction as of June 2021, from 1.7x for the last 12 months that ended June 2021. The ratio excludes any potential one-off dividend payment from Indosat Ooredoo following the tower sale and leaseback transaction that was announced earlier this year. We also expect Indosat Ooredoo Hutchison to become a regular dividend payer once the integration is complete and the synergies are realised.

By relinquishing its control of Indosat Ooredoo, Ooredoo will no longer consolidate it in its financial accounts. This will decrease revenue by more than 26% from $4 billion for the first half of 2021 on a consolidated basis. Indosat Ooredoo was the biggest contributor to Ooredoo's revenue in the first half. It was also the second-largest contributor to the group's EBITDA in the first half, making up 29.4% of Ooredoo's EBITDA, a close second behind the Qatari operations. In addition, Indosat Ooredoo's QAR7.9 billion of debt constituted 31% of the group's total debt as of June 2021. This amount will also be deconsolidated once the transaction is completed, and the cross-default provision in Ooredoo's bond documentation toward Indosat Ooredoo's debt will no longer be applicable.

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Indosat's merger with PT Hutchison 3 Indonesia solidifies second-largest position in Indonesian telco market

Originally published on 20 September 2021

On 16 September, Ooredoo Q.P.S.C. (A2 stable) and CK Hutchison Holdings Limited (CKHH, A2 stable) announced that they had entered a binding agreement to merge their Indonesian telecommunications businesses. Ooredoo's 65%-owned PT Indosat Tbk (Indosat Ooredoo, Baa3 stable) and CKHH's wholly owned PT Hutchison 3 Indonesia (H3I) will merge to become the second largest telecommunications company in Indonesia. Pending regulatory and shareholder approvals, Indosat Ooredoo will continue as the surviving legal entity and will be renamed PT Indosat Ooredoo Hutchison Tbk (MergedCo) upon completion of the merger, which is likely to close by year-end. It will maintain its listing on the Indonesia Stock Exchange.

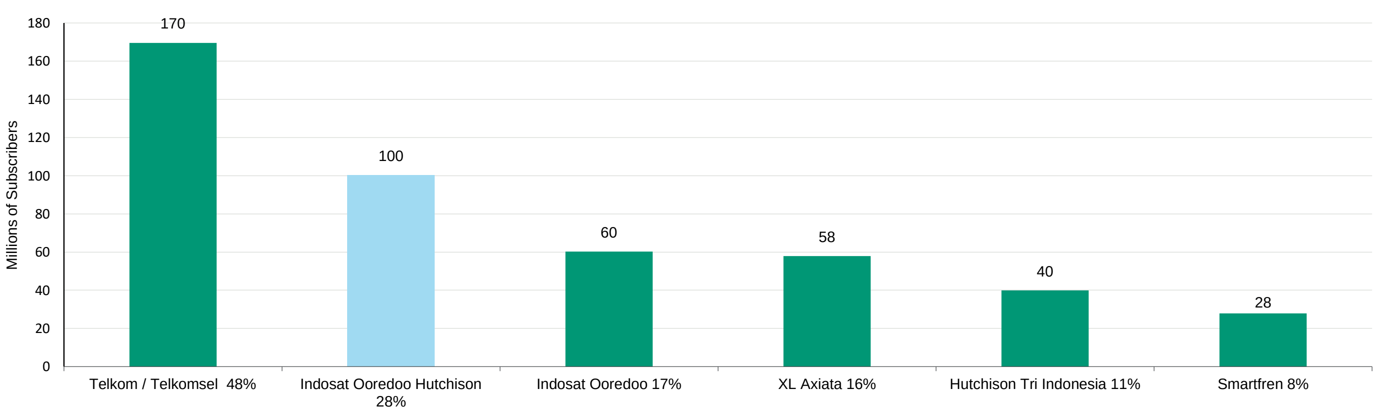
The merger is credit positive because the MergedCo will have the standalone business strengths of both Indosat Ooredoo and H3I, which will strengthen its position in Indonesia's highly competitive telecommunications market. The merger will also enhance network quality and coverage through the consolidation of Indosat Ooredoo's and H3I's telecommunication networks and spectrum holdings.

The MergedCo will be 65.6%-owned by Ooredoo Hutchison Asia, which will be jointly owned by Ooredoo and CKHH. Other shareholders include PT Tiga Telekomunikasi Indonesia (10.8%), the Government of Indonesia (Baa2 stable) (9.6%) and public shareholders (14%).

We estimate the MergedCo will have around a 28% market share (based on number of subscribers of the top five telcos as of year-end 2020). Its market share will be significantly ahead of XL Axiata Tbk (P.T.)'s (Baa3 stable) 16% market share (Exhibit 1), solidifying Indosat Ooredoo's market position as the second-largest telecom company in Indonesia after being level with XL Axiata over the past three years. The reduction in number of telecommunications operators in Indonesia as a result of the merger may alleviate some of the competitive pressure in the market.

Exhibit 1

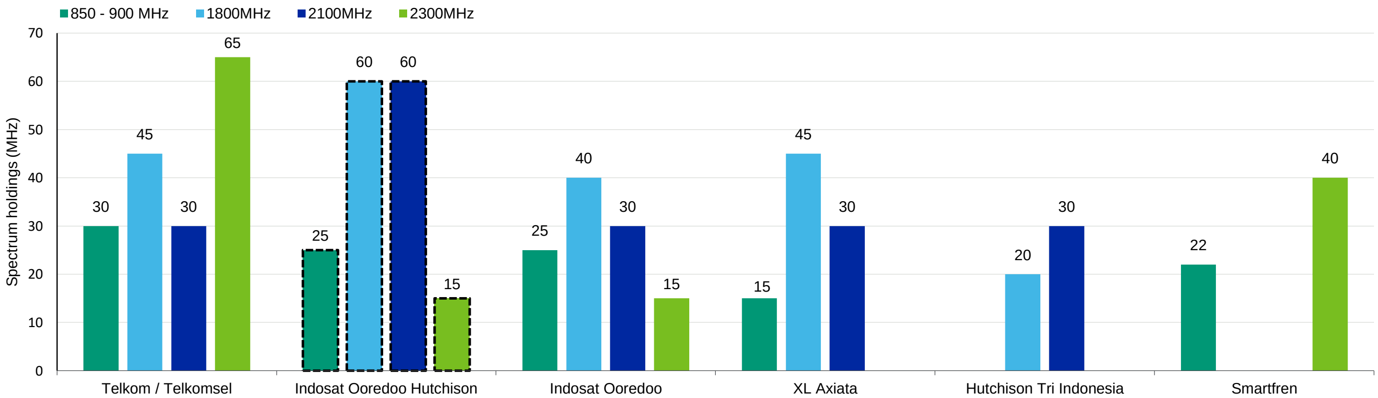
The MergedCo will have second-largest market share based on number of subscribers



Total Subscriber base was 356 million as of December 2020.
Source: Companies' filings

The MergedCo will also have the largest amount of spectrum in both the 1800 megahertz (MHz) and 2100 MHz bands (Exhibit 2), assuming the MergedCo is allowed to retain all of the spectrum under Indosat Ooredoo and H3I. This decision is still subject to approval by the Ministry of Communication and Informatics.

Exhibit 2
The MergedCo will be biggest holder of 1800MHz and 2100Mhz spectrum bands, but Telkom/Telkomsel is the largest spectrum holder



Source: Companies' filings

The companies also expect around $300-$400 million of run rate synergies from decommissioning of duplicate telecom sites, and rationalization of sales and distribution networks, among others. Although these synergies are likely to be realized over several years, they will be partially offset by integration costs.

We do not expect the MergedCo's credit metrics to differ significantly from Indosat Ooredoo before the merger (Exhibit 3). However, the credit effect of the merger also depends on the business strategy, financial policies and dividend policies adopted by the MergedCo. We will also evaluate the extent to which Ooredoo and CKHH support the debt at the MergedCo.

Exhibit 3
The MergedCo's credit metrics unlikely to differ significantly from standalone entities

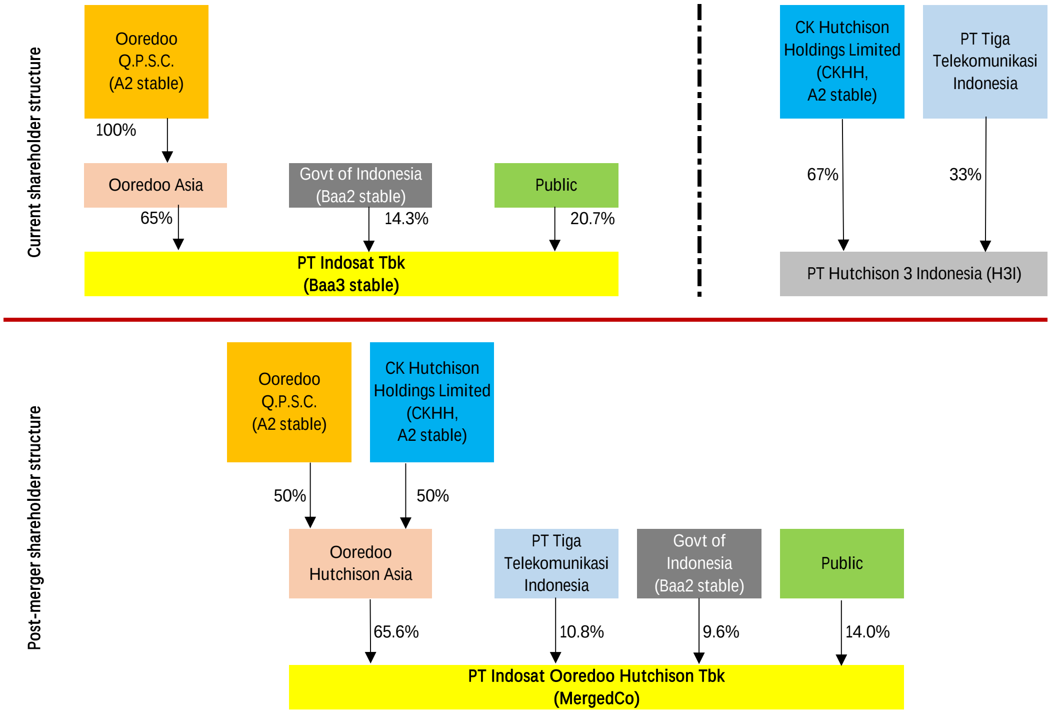
	Prior to merger		After merger
$ millions	PT Indosat Tbk	PT Hutchison 3 Indonesia	PT Indosat Ooredoo Hutchison Tbk (Pro forma)
Revenue	1,944	981	2,926
EBITDA	842	432	1,273
Cash	127	289	345
Debt	1,973	1,157	3,300
EBITDA margin	43%	44%	44%
Debt / EBITDA	2.3x	2.7x	2.6x

[1] Subscribers data as at 30 June 2021. [2] Financials and ratios are based on company's reported numbers for the last twelve months ended 31 March 2021. Pro forma financials do not incorporate any synergies and integration expenses.
Source: Companies' filings

Indosat Ooredoo's Baa3 rating takes into consideration the support Ooredoo is likely to provide to Indosat Ooredoo in times of need, resulting in a one-notch uplift. However it is now unclear if Ooredoo will extend the same level of support to the MergedCo because of its diluted shareholding and control. The MergedCo will not be consolidated into Ooredoo's financials and it will cease to be considered a material subsidiary under Ooredoo's bond indenture. Hence, it is unlikely that the cross-default provisions between Ooredoo's debt and Indosat Ooredoo's debt will remain following the merger. We believe support from CKHH will be even less forthcoming because the MergedCo is unlikely to contribute to a significant portion of CKHH's earnings. However, we expect both companies will provide management and board-level support to the MergedCo (Exhibit 4).

Exhibit 4

Shareholding structure before and after merger



Source: Company information

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Nordea Bank's upcoming shareholder distribution suggests tightening in capital management, a credit negative

Originally published on 22 September 2021

On 16 September, Nordea Bank Abp (Aa3/Aa3 stable, a3[1]) announced that it plans to distribute a total of €4.9 billion to shareholders through dividend payments and a share buyback. The plan suggests Nordea will resume tighter capital management, a credit negative, though we expect it to maintain a solid capital position relative to its risk profile, with significant buffers above the minimum regulatory requirements.

The move follows an announcement by the European Central Bank (ECB) on 23 July to remove restrictions on capital distributions put in place since March 2020 to preserve banks' capital buffers and lending during the coronavirus-induced economic disruption. Starting 1 October 2021, the ECB will return to its usual supervisory practice of assessing banks' capital management plans that are submitted to the authority on a regular basis, including their projected distributions over a three-year period.

Nordea's share buyback of up to €2.0 billion (equivalent to €0.5 per share), which the ECB has approved, will be initiated after the bank reports its third-quarter 2021 results on 21 October, and is still subject to a final decision by the bank's board of directors. The impact of the share buyback on the bank's Common Equity Tier 1 (CET1) ratio, based on the bank's financial position as of 30 June 2021, would be a reduction of around 130 basis points. The remaining dividend distributions of €2.9 billion (equivalent to €0.72 per share) relate to unpaid distributions during 2019 and 2020 (equivalent to 190 basis points) and are already deducted from the bank's CET1 ratio of 18.0% as of June 2021. These will be distributed to shareholders after September 2021.

As a result, the bank's June 2021 CET1 ratio will decline to 16.7%, reverting to pre-pandemic levels – its CET1 ratio as at December 2019 was 16.3%. However, the ratio will remain a comfortable 650 basis points above the bank's minimum CET1 requirement of 10.2%, compared with 780 basis points before the distribution. Nordea's minimum CET1 requirement includes a Pillar 1 and Pillar 2 component (with the total Pillar 2 requirement set at 1.75% by the ECB), a buffer for systemic risk of 2%, a 2.5% capital conservation buffer and a 0.2% countercyclical buffer. The bank's buffer over regulatory requirements will narrow further, but still remain high, following increases in the countercyclical buffer in the main Nordic countries[2] where Nordea operates, and potentially because of macroprudential measures that could apply to Nordea's Norwegian exposures, which the bank estimates would increase its CET1 requirement by up to 95 basis points.

Net of these effects, Nordea's capital metrics will remain comfortably above the minimum requirements, as well as its own capital policy of 150-200 basis points above the minimum CET1 requirement, maintaining its solid capital position relative to its risk profile.

The ECB's approval of the share buyback, making Nordea one of the first banks in Europe to receive such approval since the easing of restrictions, also follows Nordea's resilient performance in the European Banking Authority's 2021 stress test, which included the most severe assumptions since the tests started in 2009. Under the stress test, Nordea showed above-average performance, with its CET1 ratio declining by 370 basis points over the three-year test period (2020-23), compared with the average of 485 basis points for the EU's 50 largest banks that participated. Nordea's capital erosion was also the 16th lowest across the 50 banks.

The ECB will use the results to inform its next reviews of banks' capital buffers, which may lead to adjustments in banks' specific (usually non-disclosed) Pillar 2 guidance (P2G) levels. According to the new methodology – a bucketing framework, which ties the level of P2G to four buckets according to the impact on banks' CET1 under the adverse stress test – and before the application of any qualitative adjustment, Nordea's P2G would be set in the second-lowest P2G bucket range of 0.5%-2% (with the maximum being 4.5%).

The distributions are in line with Nordea's target dividend payout ratio of 60%-70% and the use of share buybacks as a tool to optimise its capital position. While less common for the bank in the past, share buybacks will now be an integral part of Nordea's capital management approach, providing more flexibility in the distribution of its excess capital, which the bank also aims to deploy toward organic growth or strategic business acquisitions. Nordea is already discussing a potential additional buyback programme with the ECB and expects to make a formal application in early 2022. While the bank's capital management is tighter than its large Nordic peers, we expect its capital buffers to remain comfortably above minimum requirements.

Endnotes

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

2 In Denmark the buffer will increase to 1% from the third quarter of 2022 and in Norway to 1.5% from the second quarter of 2022. In Sweden, the authorities intend to increase it to 1% in the third quarter of 2021, with effect in the third quarter of 2022.

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Higher capital buffer requirement is credit positive for Bulgarian banks

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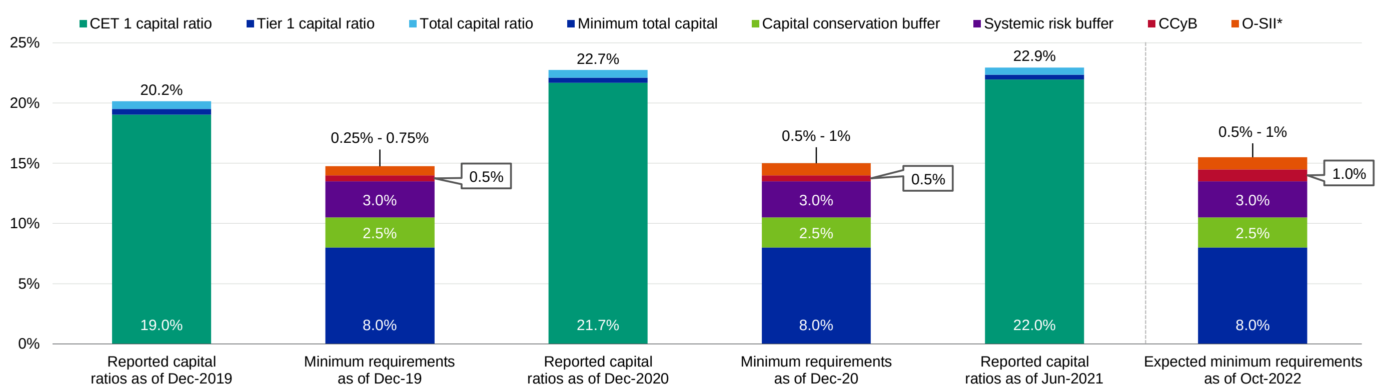
On 16 September, the Bulgarian National Bank (BNB), the central bank, announced an increase in banks' countercyclical capital buffer (CCyB) requirement for credit risk to 1.0% from 0.5% currently, that will take effect in October 2022. The increase, which may be the start of other increases in the buffer requirement, is credit positive for Bulgaria's banks because it will ensure they maintain surplus capital against risks.

We expect that banks will manage to meet the higher requirements while continuing to lend given that they have large capital surpluses. As of March 2021, banks' capital surplus above minimum regulatory requirements and buffers was BGN4.7 billion, and we estimate that the 0.5-percentage-point rise in the CCyB will reduce the surplus by around BGN330 million. Most banks' already-strong capital levels have risen further since the end of 2019 because of earnings retention and changes to the calculation of regulatory capital following the EU's Capital Requirements Regulation (CRR) "quick fix" in June 2020. The CRR changes reduced risk-weighted exposures and, unlike capital retention, did not benefit banks' loss-absorption buffers.

Banks' average Common Equity Tier 1 capital ratio was 22.0% in June 2021 and their average total capital ratio was 22.9%, substantially above current requirements and the planned increase in the CCyB (see Exhibit 1). Requirements include an 8% minimum total capital ratio, a 2.5% capital conservation and 3% systemic risk buffers applicable to all Bulgarian banks, the CCyB, a 0.5%-1.0% buffer for eight systemically important banks and bank-specific Pillar 2 requirements.

Exhibit 1
Bulgarian banks' capital metrics well exceed their minimum requirements
Aggregate reported capital ratios and minimum regulatory requirements

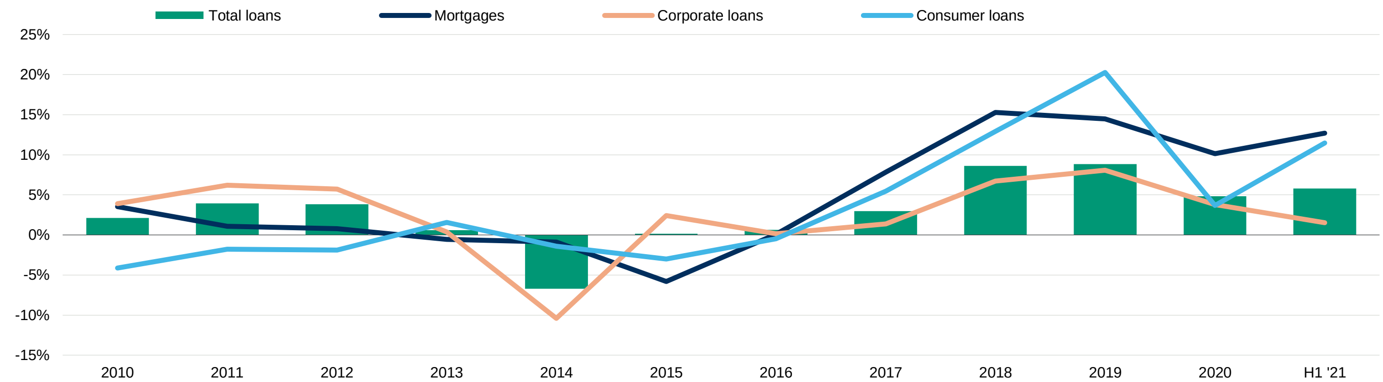


O-SII: Other systemically important institution buffer. Requirements would also include bank-specific PIllar 2 add-ons.
Sources: Bulgarian National Bank and Moody's Investors Service

The hike in the CCyB, which will help preserve more capital at banks once they are again able to distribute profits to shareholders, is the BNB's response to strong lending activity, particularly in residential mortgages. Mortgages grew by an annualised rate of 12.7% in the first half of 2021 (see Exhibit 2), up from a still-robust 10.1% in 2020. Annual house price growth also rose to 7.5% in the first quarter of 2021 from 5.4% at the end of the previous quarter.

Exhibit 2

Mortgage lending growth has been robust in Bulgaria
% growth by loan type



Growth in the first half of 2021 is annualised
Sources: Bulgarian National Bank and Moody's Investors Service

A recovery in GDP following last year's coronavirus-induced contraction, rising household incomes and low mortgage interest rates are driving the increase in mortgage activity. Average wages in the second quarter of 2021 increased 14.1% from a year earlier, largely because of public sector wage rises. The average interest rate on new Bulgarian lev-denominated mortgages declined to 2.73% in June 2021 from 2.91% a year earlier.

Growth in Bulgarian mortgage debt is starting from a low base. Residential loans equalled 11% of GDP in 2019 and overall household debt was 23% of GDP compared with EU averages of 44% for mortgage debt and 50% for overall household debt, according to Eurostat data.

However, Bulgaria's rapid rate of lending growth together with recent house price appreciation risks causing higher indebtedness among individual borrowers and a buildup of risks and asset quality issues during the next downturn. The BNB's higher capital requirements against the emergence of cyclical risks come instead of borrower-based macroprudential measures, such as debt service-to-income or loan-to-value limits that would enforce stricter credit standards.

In March 2020, the BNB cancelled planned increases of the CCyB to 1% in April 2020 and 1.5% in January 2021 and kept the 0.5% buffer rate because of the coronavirus pandemic and to support lending. At the time, the BNB also required banks to fully capitalise 2019 profits that amounted to BGN1.6 billion (around €800 million), and in January 2021 extended the measure to also include 2020 profits.

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Central Bank of Russia will develop carbon transition stress tests, a credit positive

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On 16 September, Central Bank of Russia (CBR) First Deputy Governor Kseniya Yudaeva announced that the CBR is developing long-term stress tests on the effect of decarbonization on the economy and market participants by 2030 and 2050.

The CBR's planned stress testing is credit positive for Russian financial institutions because it will increase understanding and assessment of carbon transition risk for the sector and enhance the climate risk regulatory framework. We expect the regulatory initiative will support financial institutions development of climate risk management practices and ultimately help them reduce carbon transition risk.

The stress-test focused on decarbonization risks follows the CBR's earlier announcement of stress tests to assess the effect of climate change risk on the economy.[1]

The CBR's stress testing will supplement the government's scenario analysis of the impact of carbon transition on the economy. At present, the Ministry of Economic Development's proposed strategy for Russia's transition to a low-carbon economy has four scenarios, as shown in the exhibit.

Russia's proposed carbon transition strategy has four scenarios

Scenario	Emissions reduction goals	Estimated investment for green transition
Inertial	Current goal of 30% net emissions* reduction below 1990 level by 2030	1% GDP
Basic	25% net emission reduction below 2019 level by 2050	1.5% GDP
Intensive	Net zero target in 2060	4% GDP
Aggressive	Net zero target in 2050	more than 4% GDP

*Including absorptive capacity of forests.
Sources: Russia's Ministry of Economic Development and Moody's Investors Service

In 2019, Russia ratified the Paris Agreement, the international climate act that aims to limit global warming to well below 2°C above pre-industrial levels, but has not yet committed to net zero emissions by mid-century. Its current pledged nationally determined contribution under the Paris Agreement is a 30% reduction in greenhouse gas emissions by 2030 from the 1990 level, including the absorptive capacity of forests (the inertial scenario). Increasing the target for emissions reduction and setting a net zero goal under other scenarios would likely place greater scrutiny on the country's carbon-intensive industries and accelerate the introduction of environmental policy initiatives, including financial climate risk regulation.

We assess Russia's carbon transition risk as high because of the important role that hydrocarbons play in exports and government revenue. While global transition toward lower consumption of hydrocarbons will proceed over several decades, Russia is likely to feel the impact in the near term of other countries positioning their economies to reach their own carbon-neutral targets. Vulnerability to global carbon transition risk will put pressure on Russian commodity exporting companies. The CBR will also conduct regular stress testing of exporters amid the implementation of global carbon regulation, including the EU's proposed carbon border tax.

Given the structure of Russia's economy, the country's banks have material exposure to carbon-intensive industries, which makes them susceptible to carbon transition risk. Decarbonization creates risks for banks by weakening the credit quality of carbon-intensive borrowers and cutting the value of carbon-related investments. At the same time, however, it creates commercial opportunities to finance the green transition through lending to new green industries and technologies.[2]

Endnotes

1 See Russia's development of climate-change risk guidelines for financial institutions is credit positive, 9 June 2021.

2 See Decarbonizing finance poses unprecedented challenges and transformative opportunities for financial institutions, 21 September 2021.

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Nigeria's four large banks' Stage 2 loans decline 21% in the first half of 2021, a credit positive

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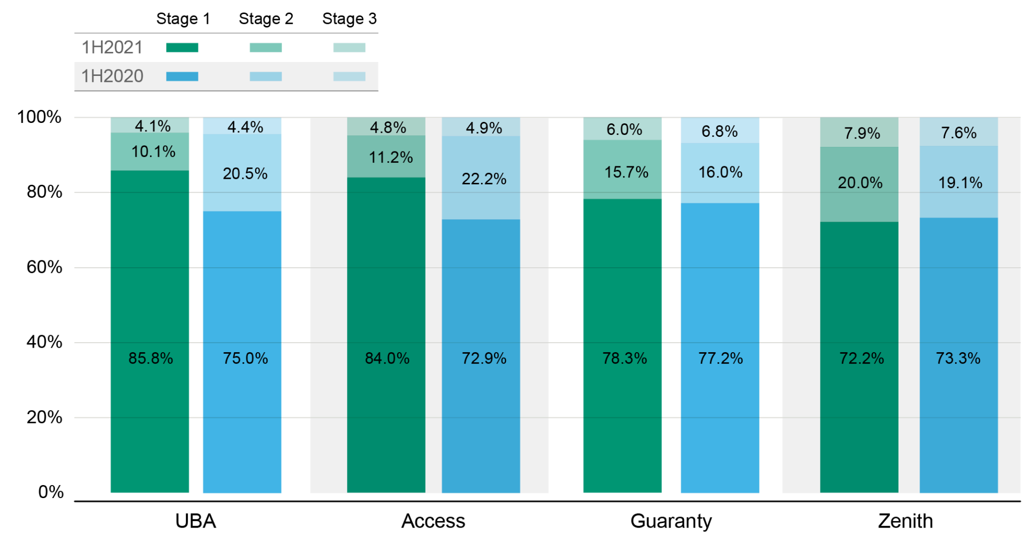
On 16 September, United Bank for Africa Plc (UBA, B2 negative, b2[1]) reported first-half 2021 results, following similar announcements from Zenith Bank Plc (B2 negative, b2), Access Bank Plc (B2 negative, b3) and Guaranty Trust Bank Plc (B2 negative, b2). Combined, the four[2] banks' Stage 2 loans, defined as loans with increased risk of default (rebuttable presumption of more than 30 days past due), declined 21% over the past 12 months, while Stage 3 loans (loans with a significant credit deterioration [rebuttable presumption of more than 90 days past due]) increased by a moderate 7%. Stage 2 and Stage 3 loans comprised 19.6% of total gross loans for these four banks in aggregate, down from 25.8% in June 2020.

The decline in overdue loans is credit positive and indicates improving asset quality for Nigerian banks, although the real extent of problematic loans in Nigeria is masked by still some loan forbearance by the regulator.

The banks' combined Stage 2 loans fell to NGN1.6 trillion in June 2021 from NGN2.0 trillion in June 2020. The volume of Stage 2 loans for Access and UBA declined 41%, but increased by 12% at Zenith. As the exhibit shows, UBA's Stage 2 loans were 10.1% of gross loans in June 2021 (down from 20.5% in June 2020), while Access' ratio was 11.2% (down from 22.2% in June 2020). Zenith's Stage 2 loans rose to 20.0% of its gross loans as of June 2021 from 19.1% a year earlier (see exhibit).

First-half reported asset quality metrics improved for Nigeria's large banks except Zenith Bank



Sources: The banks and Moody's Investors Service

The asset quality improvements reflect the resolution of some problem loans, particularly oil and gas nonperforming loans (NPLs), which are benefiting from current high oil prices. The four banks' oil and gas exposures accounted for around 27% of their loans as of June 2021. Guaranty had the largest exposure to the oil and gas sector at about 43% of total loans as of June 2021, while UBA had the lowest at 19%. In addition, some banks wrote off select NPLs, in line with a Central Bank of Nigeria directive requiring banks to reduce their NPL ratios to below 5%.

The large banks are also benefiting from a decline in foreign-currency loans, which limits their vulnerability to weakness in the domestic currency, the naira. Access reduced its foreign-currency loans to 22% of total loans as of June from 26% at year-end 2020 and 40% in

2019 (the bank now has the lowest level among the large banks). However, Guaranty's foreign-currency loan book is still a substantial 53% of total loans, although down from 55% in June 2020.

Although the banks' reported NPL ratios will continue to improve, their widespread loan forbearance and restructurings mask asset risks. There is limited visibility into banks' treatment of loans under forbearance, and the classification of such loans varies across banks. Banks that have not classified some of these vulnerable loans as Stage 3 or Stage 2 may have rising problem loans if after forbearance lifts, the loans struggle to perform.

As well, the banks' asset quality remains vulnerable to an oil price shock, which in addition to directly affecting the oil and gas sector borrowers, tends to have a generalised negative effect on Nigeria's economic performance. Moreover, some of the banks increased their lending, creating untested loans, including loans to government-prioritised industries that support job creation. This means that loan repayments collection will be challenged if economic growth slows or falters. UBA increased its loans by 19% and Access expanded its loan book by 17%. We expect banks to continue to grow their loan books as they try to satisfy the minimum loan-to-funding ratio of 65%. The banks' average loan-to-deposit ratio was 48% in June 2021.

Endnotes

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

2 **Due to limited disclosure, First Bank of Nigeria Limited (B2 negative, b3) was not included in the analysis.**

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Prudential's planned equity raise will support deleveraging

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On 19 September, Prudential Public Limited Company (A2 stable) announced a share offer to raise up to 5% of its current issued share capital, or around $2.5 billion as of 21 September.The planned equity raise is credit positive for Prudential because the group will be able to redeem high coupon debt, reduce leverage, and gain additional flexibility to invest in its growing operations in Asia and Africa. The offer includes a portion available only to residents of Hong Kong, SAR, China (Aa3 stable), which should help the group broaden its investor base in Hong Kong, the territory of domicile for the Group's designated insurance holding company, and one of its key insurance markets, albeit that the vast majority of its shareholder base will remain UK and US domiciled, even after this offering.

Prudential stated that it would use around $2.25 billion of the proceeds to redeem high coupon debt that is past its first call date, which it expects will save approximately $125 million in interest costs annually. The equity raise and subsequent debt paydown will help the group bring its leverage within its target operating range of 20%-25% for total leverage. Although Prudential's Moody's-calculated total leverage was within this band at 23.6% at year-end 2020, the insurer expects to report a temporary increase to around 30% post demerger of Jackson Financial, which was completed on 13 September. On demerger, Jackson is no longer recognized as a subsidiary, which will have a negative accounting effect on the group's shareholders' equity and increase leverage to around 30%.

Because of lower than expected capitalisation at Jackson, Prudential did not receive an initially planned pre-separation dividend and whilst leverage is expected to reduce below 30% in the near-term due to organic capital generation, Prudential is using the equity raise to expediate a return to its target leverage range of 20-25% and therefore increase financial flexibility. The Group had initially planned to separate from Jackson via an IPO and divesting through a series of subsequent sell downs, but changed course earlier this year to pursue a demerger which would allow the faster completion of a full separation.

Reducing balance sheet leverage will give Prudential additional flexibility to invest in organic and inorganic opportunities, including distribution arrangements, to grow its business in Asia and Africa. Prudential has market-leading positions in nine of the 13 insurance markets in which it operates in Asia. It is well positioned to strengthen its position in these markets, with particular focus on growth in China, India, Indonesia and Thailand. Its product mix in these Asian markets, which is increasingly focused on unit-linked and health and protection products, is relatively capital efficient and has a short payback period that will provide strong returns on additional investment.

Additionally, the capital raise will help Prudential broaden its shareholder base within the Asia-Pacific region, and particularly in Hong Kong. Although the vast majority of its investors will still be based outside of Asia, the planned capital raise will better align the group's investor base with its main markets.

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Bahamas' election outcome is unlikely to materially shift fiscal consolidation

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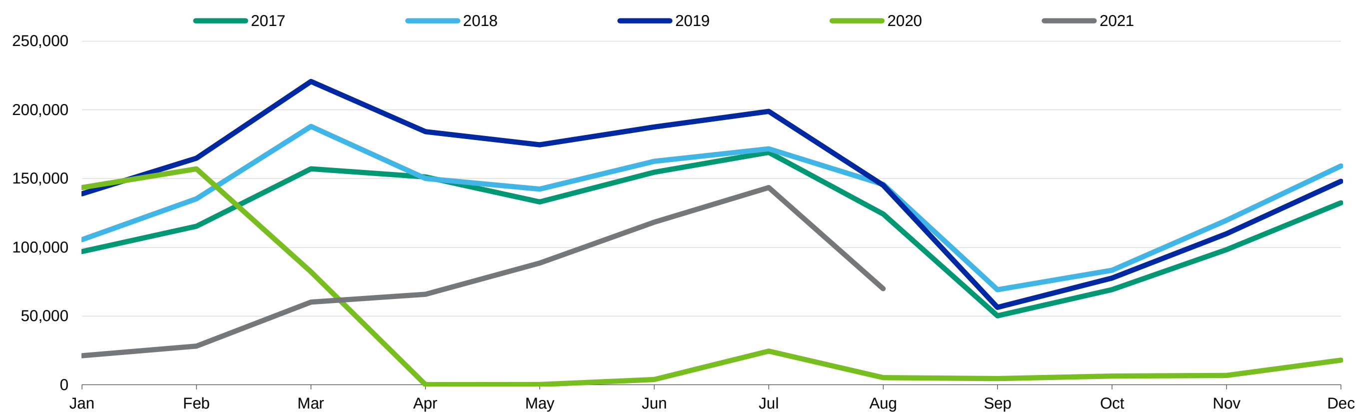
On 16 September, The Bahamas (Ba3 negative) held general elections. The Progressive Liberal Party (PLP) won 32 of the 39 parliamentary seats, ending the five-year term of the Free National Movement party. Despite the transition to a new government, we expect broad policy continuity, particularly in the government's commitment to fiscal consolidation and adherence to its fiscal rule and medium-term debt targets.

The PLP's "Recover, Rebuild, Revolutionize," economic plan emphasizes stimulating growth and boosting resiliency through initiatives ranging from tax measures to support for small businesses and increasing competitiveness. The economic plan focuses on stabilizing public finances and prioritizing increased tax collection in areas such as property taxes.

The Bahamas' growth prospects are tied to tourism activity, which, although improved in recent months, is still well below pre-pandemic levels (see exhibit). Our baseline expectation assumes tourist arrivals – stopover arrivals – remain close to 75% of 2019 levels for the remainder of this year, leaving 2021 tourist arrivals at around 50% of 2019 levels. Assuming continued recovery in 2022, driven mainly by increased vaccinations and greater comfort with international travel, we expect The Bahamas to have another year of very high economic growth rates. We expect GDP growth of 8.0% in 2021 and 7.0% in 2022 after the 14.5% contraction in 2020. We expect stopover arrivals to return to 2019 levels by 2024, while cruise visitors will take longer to recover.

Stopover visitors to The Bahamas strengthened in recent months, continuing a recovery that began in December 2020
Number of stopover arrivals



Sources: Ministry of Tourism and Moody's Investors Service

We expect fiscal policy to be anchored by reforms enacted in recent years to improve the government's institutional and fiscal policy framework. These measures include a set of fiscal rules, improved fiscal data dissemination standards, new procurement guidelines and new debt management legislation. The Fiscal Responsibility Act (FRA) included an original fiscal consolidation program that set a fiscal deficit limit of 0.5% of GDP as of fiscal 2021 (which ended 30 June 2021), in addition to capping the growth of current expenditure to the long-term rate of nominal GDP growth. The FRA sets a long-term objective to reduce the debt/GDP ratio to no more than 50%. The fiscal deficit widened to 12.3% of GDP in fiscal 2021, bringing the debt burden up to 87% of GDP.

While Hurricane Dorian and the coronavirus pandemic have delayed achieving these fiscal targets, we expect the government to remain committed to achieving them over the medium term. Even if the targets are ultimately not achieved, they will serve to anchor fiscal policy.

We expect the PLP-led government to continue to prioritize fiscal consolidation and reducing the government's debt burden over time. Over the remainder of fiscal 2022 and in fiscal 2023, we expect fiscal consolidation driven mainly by the normalization of economic activity (and particularly tourist activity), which will increase revenue, and the removal of pandemic-related spending.

The pace of the economic recovery will directly affect the pace of fiscal consolidation and how quickly debt begins to decline. The reliance on indirect taxation – taxes on goods and services made up 67% of total revenue in fiscal 2019, the last pre-pandemic fiscal year – makes government tax collection more sensitive to the economic recovery than a tax system that relies more heavily on direct taxation. Combined with the high reliance on tourism as a share of GDP and employment, The Bahamas is more vulnerable than other tourism-reliant sovereigns to the pace of tourism recovery.

The economic contraction in 2020 and relatively slow recovery will leave The Bahamas with a significantly higher debt burden compared with its pre-pandemic debt levels and significantly weaker fiscal strength than similarly rated peers. We think it very unlikely that the government will be able to reverse the rise in debt over the past two years, although the debt burden likely peaked in fiscal 2021 and will gradually decline beginning in fiscal 2022.

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Panama's economic recovery supports stabilization of debt metrics after severe deterioration in 2020

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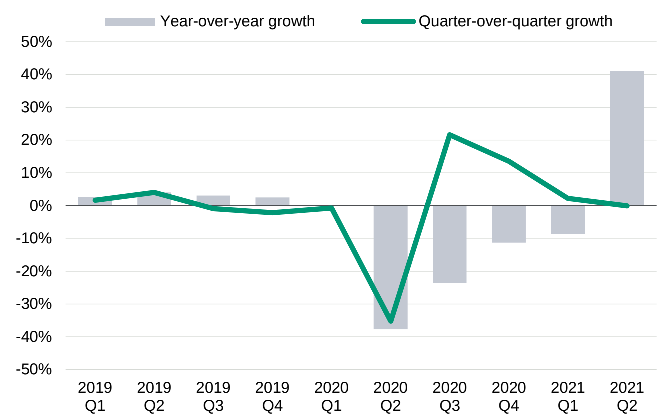
On 17 September, Panama's (Baa2 stable) National Statistics Institute (INEC) reported that second-quarter real GDP grew 40.4% over the same period last year – reflecting the low base – and rose 10% for the year through June from a year earlier (see Exhibit 1). While this points to some upside to our current 2021 growth forecast of about 10%, we continue to expect Panama's GDP to reach its 2019 level by 2023 lagging its Baa-rated peers. Nevertheless, Panama's economic performance is credit positive because it will help stabilize the government's debt metrics after they severely deteriorated in 2020.

In the second quarter on a year-over-year basis, the construction sector was the largest contributor to growth because of the base effect, followed by mining and then the transport sector, which includes the Panama Canal's (A2 stable) activities. The wholesale and retail sector was the fourth-largest contributor. However, on an accumulated basis through June and indexed to the level of activity per sector in the fourth quarter of 2019 (see Exhibit 2), the transport sector is the best performer to date, exceeding the construction, hotels and wholesale and retail sectors, demonstrating that the economic recovery is uneven and gradual, and externally led.

Exhibit 1

Panama's economic activity is rebounding, in line with our expectations...

Real quarterly GDP growth

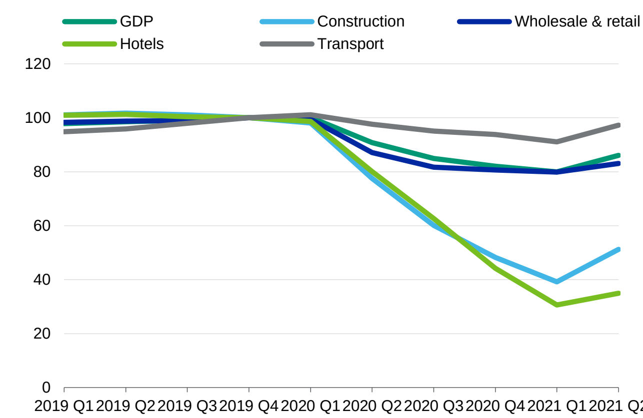


Sources: Haver Analytics, Panama's Instituto Nacional de Estadistica y Censo and Moody's Investors Service

Exhibit 2

...but the external economy is recovering the fastest

Real GDP by sector index (Q4 2019 = 100), four-quarter moving average



Sources: Haver Analytics, Panama's Instituto Nacional de Estadistica y Censo and Moody's Investors Service

Panama's uneven recovery is reflected in the government's numbers: second-quarter revenue at both the central government and nonfinancial public sector (NFPS) level is up compared to 2020 year-to-date second-quarter collections, but down compared to the same period in 2019 (see Exhibit 3). Additionally, social security (CSS) revenue is 12% below what it was through the second quarter of 2019 reflecting the pandemic's toll on formal employment, and expenditures are up compared to both 2020 and 2019 year-to-date second quarter, except for capex compared to the 2019 number. These figures suggest that fiscal consolidation will be gradual, too, highlighting the importance of rising revenue in line with the economy and measures to contain spending beyond 2021 to ensure the stabilization of debt metrics over the next two years. Despite some fiscal risks, including the deterioration of the CSS financial position, a rise in current spending (wages and interest payments) that increases expenditure rigidity, and a narrow revenue base, we believe that the government is on track to meet its 2021 fiscal deficit target of 7.0%-7.5% of GDP.

Exhibit 3

Panama's fiscal position is improving compared to 2020, but still lags year-to-date 2019 performance

Government revenue and expenditures

	Year to date ($ millions)		% change	
	2021 Q2	**2020 Q2**	**2021 Q2 vs 2020 Q2**	**2021 Q2 vs 2019 Q2**
Nonfinancial public sector revenue	$7,759	$6,534	19%	-3%
Cental government revenue	$4,490	$3,599	25%	-10%
Cental government tax revenue	$3,250	$2,883	13%	-22%
Cental government direct tax	$1,989	$1,533	30%	-12%
Cental government indirect tax	$1,262	$1,350	-7%	-33%
Social security fund revenue	$2,444	$2,449	0%	-12%
Nonfinancial public sector expenditures	$11,024	$9,691	14%	2%
Nonfinancial public sector current expenditures	$8,573	$7,771	10%	12%
Nonfinancial public sector interest	$1,271	$1,167	9%	20%
Nonfinancial public sector capital spending	$2,451	$1,919	28%	-22%

Sources: Haver Analytics and Moody's Investors Service

In 2020, Panama's debt/GDP ratio increased 23.4 percentage points to 69.8% from 46.4% in 2019 because the economy contracted 17.9% as a result of the government's coronavirus containment measures. The ratio of government interest payments/revenue also deteriorated, in line with the increase in the debt burden and the loss of revenue. The debt affordability ratio increased to 14.5% in 2020 from 10.2% in 2019. We expect that as the economy and government revenue recover, these debt metrics will remain stable after 2021.

By the end of June 2021, the government had lessened or lifted many pandemic-related containment measures and 23.3% of the population had been vaccinated – as of 21 September 49.4% of the population was fully vaccinated and another 16.7% had received one dose. However, a resurgence in cases in June led the government to reinstate some mobility restrictions, which seems to have affected quarter-over-quarter growth and may pose another risk to our economic and fiscal forecasts.

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Europe will benefit more from US growth than from China's

Originally published on 21 September 2021

Summary

Europe will be a strong beneficiary of continued GDP growth of the world's two largest economies, the US (Aaa stable) and China (A1 stable), which we forecast will post growth of 6.5% and 8.5%, respectively, in 2021. Using a sample of six European countries, we estimate the spillover effects of US and China growth on GDP in Europe, and we discuss the credit-positive benefits for a range of European sectors. Our analysis relies on broad historical patterns, which could change over time, but for the ongoing business cycle it should still generally hold: Europe's strong recovery in 2021 is also driven by the recovery in the US and China.

» **US growth has a much larger effect on Europe than does China growth.** Using a vector autoregression (VAR) model, we estimate that a permanent 1% increase in US GDP will lead to an additional 0.8% rise in GDP in Europe, whereas a 1% increase in China's GDP will boost European GDP by 0.2%. The spillover effects of this growth will be particularly positive for export-oriented sectors. The effects will also be positive for European sovereigns, as higher growth in Europe will translate into higher revenue for governments, while also alleviating some spending needs.

» **The strong spillover effects of US growth derive from trade, financial linkages, and synchronisation of business cycles and policy stances**. Spillover effects are not surprising given the close interconnectivity of the economies, particularly that of the US and Europe. Because the US is Europe's largest trading partner, higher GDP in this country will push up demand for European products and services and other sources of income. Changes in financial conditions in the US are typically correlated with changes in financial conditions in Europe, which have related effects on European growth. The business cycle is also more correlated between the US and Europe.

» **Export-oriented economies in Europe do not benefit more than other economies from growth spillovers**. The large trade powerhouses in Europe, such as Germany (Aaa stable) and the Netherlands (Aaa stable), benefit from US GDP spillovers in the short term more than do the other European economies in the sample. However, these other economies, which are more oriented toward services sectors, catch up with a lag. On the other hand, trade-focused economies benefit less from Chinese GDP growth than do the others in the sample, which may reflect the high level of imports (including commodities, services and other materials) in the trade-focused economies' production mix.

Click here for the full report.

Central banks aim to limit disruption when designing retail digital currencies

Originally published on 21 September 2021

Central banks globally are investigating and developing retail central bank digital currencies, or CBDCs, at an accelerated pace. Rapid digitalization and the development of private stablecoins, which would be more disruptive to the existing payments architecture, are two key drivers for the rise in CBDC development. Financial inclusion, security costs of cash, reducing informality and improving payment efficiency, including the ability to distribute social benefits digitally, are additional drivers, particularly in emerging markets.

A two-tier retail CBDC model using existing market infrastructure is central banks' preference. Based on existing and proposed pilot schemes, CBDC development is being done in conjunction with existing financial market infrastructure, the two-tier model. Under this approach banks and other financial intermediaries would maintain their client-facing roles and would play a part in disseminating CBDCs. Despite this cautious approach, CBDCs have the potential to be highly disruptive.

Disruption to financial institutions will depend on a number of additional key design and policy choices. Central banks have to focus on the precise form of their retail CBDC and on whether it operates on centralised architecture. They would also have to consider holding limits, whether CBDCs bear interest, and the cost of use compared to existing payment rails. If CBDCs are highly integrated with and accessible to market participants, particularly large technology firms, through application software interface (API) technology, it could also cause broader disruption to existing financial institutions. Programmability and the digital currencies' eventual use for cross-border payments could also increase adoption of CBDCs.

For banks, disintermediation and fee loss risks will be heightened as they adapt to CBDCs. Although not meant to compete directly with bank deposits, CBDCs would provide an attractive risk-free alternative, raising bank funding costs, particularly as CBDCs held directly by individuals would not be available for fractional reserve lending and if holding limits are high. CBDCs would enable broad use of risk-free instant payments and may increase the share of payments processed via a likely cheaper central bank operated payment infrastructure. Fee income currently made by banks and other financial institutions from payment processing would decline as a result, further reducing banks' profitability.

Click here to link to the full report.

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