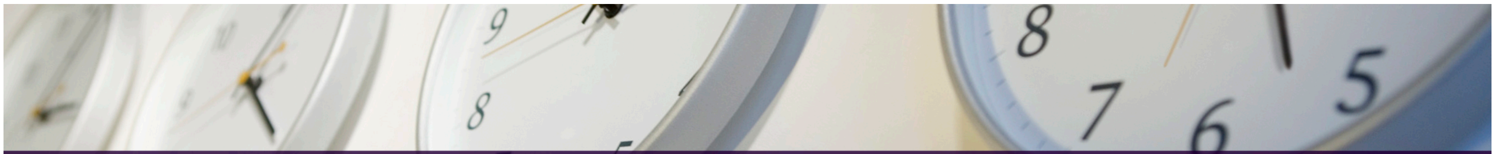

Credit Outlook

7 October 2021

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FAQ on the sovereign credit implications of US government debt limit brinkmanship

Originally published on 05 October 2021

Since the legally binding limit on US (Aaa stable) government debt was reached on 1 August at about $28.4 trillion, the Treasury Department has used “extraordinary measures,” a series of temporary accounting measures that it has used in the past to increase borrowing capacity under the debt limit, to meet its daily financing needs until Congress reaches an agreement to raise or suspend the debt limit. On 28 September, Treasury Secretary Janet Yellen notified Congress that the Treasury would exhaust its extraordinary measures as early as 18 October if the debt limit is not raised. If this occurs, the US government would need to prioritize between debt-service and other payments, raising the possibility of a technical default.

» **What are Moody's assumptions about US debt limit developments?** The stable outlook on the US' Aaa rating reflects our view that the debt limit will ultimately be raised and that the US will continue to meet its debt-service obligations on time and in full. Despite ongoing political polarization and debt limit brinkmanship in the US Congress, we believe the Democratic Party is most likely to use the budgetary reconciliation process to raise the debt limit in time to avoid a missed interest payment.

» **When are the next interest payments due on US government debt and how would a missed interest payment affect the sovereign rating?** The next three interest payments are due on 15 October (in the amount of $4 billion), 1 November ($14 billion) and 15 November ($49 billion). We would classify a missed interest payment as a default. Generally, we would not consider that outcome to be consistent with a Aaa rating and would most likely downgrade the rating for all Treasury securities, barring extraordinary mitigating circumstances. The rating would most likely remain close to the highest level, reflecting our expectation that any default would be cured quickly, with little if any losses to investors. We would, however, likely keep the rating on review until it became clear that a cure would happen.

» **Would Moody's move the rating back to Aaa after a default were cured?** An upgrade back to Aaa would be unlikely while the institution of the debt ceiling, and the political environment that gave rise to the missed payment, remained in place. The lower rating would balance the very small expected loss and the US' exceptional credit strengths. It would reflect the probability, even if very low, of similar events reoccurring in the future.

» **Is there risk of the US defaulting on its principal obligations?** Under the debt limit rules, as principal obligations come due, the Treasury can auction new debts to refund and replace old liabilities and still remain under the existing debt limit. As long as the Treasury auction market is still functioning, the Treasury should always have funds available to meet principal payments on maturing bills, notes and bonds.

» **Would there be rating implications if the US failed to meet its non-debt spending obligations?** No. If the Treasury were to fail to meet some of its non-debt obligations, it would not affect the US sovereign rating because our ratings reflect the risk of default and loss on government debt, not the risk of failed or delayed payment on non-debt obligations.

Click here for the full report.

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FIRST READS

Mexican president's proposal to reform electricity sector is credit negative

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On 30 September, Mexican President Andres Manuel Lopez Obrador submitted a bill to Congress to change three articles of the Mexican constitution related to the energy sector. The initiative is credit negative for the Mexican electricity sector because it would lessen its operating transparency, deter private investment in generation, disincentivize renewable generation and likely increase the overall cost of electricity.

Lopez Obrador's proposal is the government's third attempt to change the way the electricity market operates in Mexico. In 2019, Mexico's Supreme Court ruled that changes proposed to existing energy policies that also aimed to change dispatch criteria were unconstitutional, setting a precedent for coming disputes. An initiative to change the electricity law presented last February and approved by Congress shortly afterward, is now being contested at the Supreme Court.

The initiative proposes eliminating the Comisión Nacional de Hidrocarburos (CNH)[1] and Comisión Reguladora de Energía (CRE),[2] Mexico's independent energy regulators. The existence of these regulators is a key element in the development of Mexico's energy sector, providing assurance and stability among market participants. The elimination of CNH and CRE would undermine investor confidence because it would weaken the sector's transparency and institutional framework.

We cannot rule out that the Lopez Obrador proposal is approved, but this is not the most likely scenario because it would require a two-thirds majority vote in both houses of Congress and a simple majority in the local congresses of Mexico's 32 regional governments. Furthermore, if passed, the proposal would likely trigger international legal disputes, affect foreign investment competitiveness and diverge from agreed regulatory practices. The proposal is currently being discussed at the Lower House of Congress, which has 180 days to approve or reject it.

The proposal aims to strengthen the role of state-owned electric utility Comisión Federal de Electricidad (CFE, Baa1 negative) by reincorporating Mexico's independent system operator Centro Nacional de Control de Energía (CENACE) into it, and by prioritizing dispatch from its generation plants, which include fossil fuel plants, ahead of power from private renewables and combined cycles, which are generally cleaner and cheaper. The move would disincentivize investment in renewable generation, likely pushing up electricity costs. While the Government of Mexico (Baa1 negative) could subsidize increased costs, existing subsidies have risen significantly over the past few years.

The initiative also states that private-sector generation participation would be capped at 46% of total electricity consumption, compared with the current level of 62%. This would be achieved through the cancelation of power-generation permits and power purchase agreements, as well as the invalidation of self-supply plants, independent power producers and plants awarded long-term energy contracts at auction. If the proposed reform passes, CFE would buy the remaining 46% of electricity from existing power plants, according to economic dispatch[3] and would be subject to the reliability of the system, which could displace efficient, renewable, low-cost private generation.

The proposal foregoes new private investment in the electricity sector and companies that own gas-fired power plants, such as Cometa Energía S.A. de C.V. (Baa3 stable) and FEL Energy VI S.a r.l. (Baa3 stable), could be exposed to lower prices and dispatch levels, which could hamper their cash generation capacity. Issuers that operate within an energy self-supply agreement such as Mexico Generadora de Energía S. de R.L. (MGE, Baa2 stable) may face substantial changes in their cash generation model, increasing business risk. However, the potential credit implications are difficult to determine until the regulatory framework is developed further.

The focus on existing fossil fuel-based capacity owned by CFE would increase Mexico's exposure to natural gas prices and availability. According to the Ministry of Energy, fossil fuels accounted for roughly 74% of Mexico's electricity generation in the January-October 2020 period, with natural gas comprising around 81% of that amount. Mexico has been reducing local production of natural gas and imports accounted for 72% of its total gas consumption as of June 2021, according to the Ministry of Energy. The Polar Vortex phenomenon in February 2021 led to a natural gas supply shortfall and a hike in prices, creating a $2.5 billion cost overrun for CFE, half of which the government subsidized through a direct transfer. In the absence of additional subsidies from the federal government, CFE's liquidity will likely weaken further in 2021, because since June 2021 tariffs can, by decree, only be raised in line with inflation and not because of additional costs.

Not only would the reform proposal create a costlier electricity market that would increase the need for subsidies, it would also impede Mexico's progress in achieving its clean energy goals. According to the government's commitments to mitigate and adapt to climate change for the 2020-30 period, Mexico aimed to generate 35% of its power from clean sources by 2024 and 43% by 2030, up from 25.5% in the January-October 2020 period.

While CFE could compensate for some of the lost private investment in renewable energy by replacing some of its polluting, costlier generation, it has not announced any new renewable power plants on top of its investments in existing hydroelectric plants and the construction of a photovoltaic project in the State of Sonora (B1 stable). The proposal mentions "two large clean energy projects," but details are yet to come. Moreover, the proposed amendments include the nullification of clean energy certificates, which would further hinder Mexico's energy transition goals, while eroding investor confidence in local institutions, specifically in the renewable energy sector.

Endnotes

1 CNH's responsibilities include bidding and signing contracts for the exploration and extraction of hydrocarbons.

2 CRE promotes competition in the sector, protects users interests, promotes adequate national coverage and ensures the reliability, stability and security of the supply and provision of services.

3 The procedure through which the utility selects which of its generators to use to meet electricity demand based on lower costs.

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America Movil-VTR deal creates integrated Chilean provider with sound credit quality

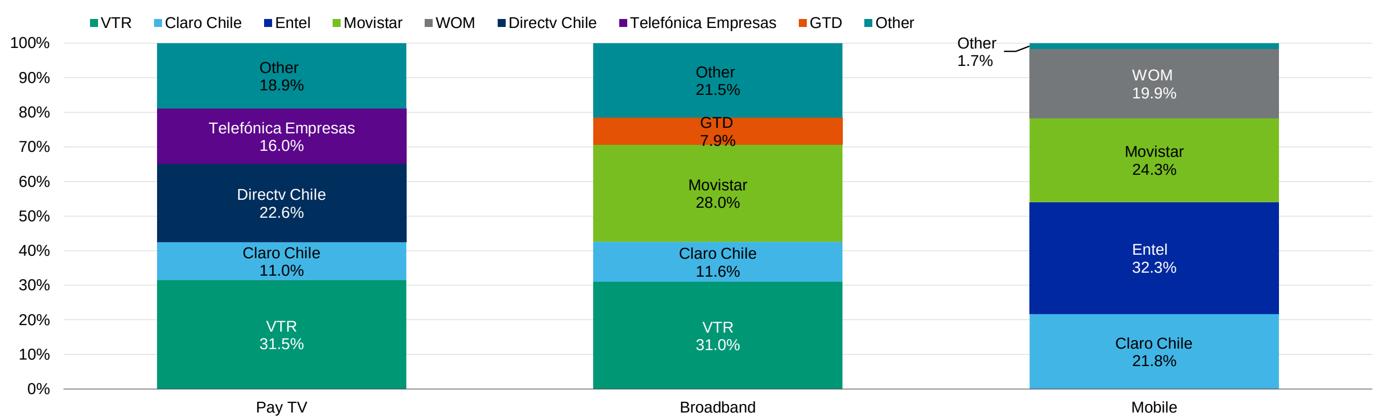
Originally published on 04 October 2021

On 29 September, America Movil, S.A.B. de C.V. (AMX, A3 negative) and Liberty Latin America Ltd (LLA) announced an agreement to combine their Claro Chile and VTR Finance N.V. (Ba3 review for upgrade) operations to create a new Chilean integrated telecom company as a 50-50 joint venture. The new deal comes two weeks after AMX announced a $200 million deal to sell Claro Panama to Cable & Wireless Panama, a subsidiary of Cable & Wireless Communications Limited (Ba3 negative).

While AMX and VTR did not offer details on the joint venture's final capital structure, the deal, if approved as proposed, probably in the second half of 2022, would be credit positive for both backers, creating a new company with strong market share in Chile's fixed broadband and pay TV segments. The joint venture would offer mobile, broadband, pay TV and fixed-line telephone service, allowing the new company to boost its preceding entities' subscriber revenue with cross-selling opportunities, improving its ability to retain customers and optimize capital investments in fiber and 5G expansion.

In the new joint venture, the parties expect to extract $180 million in synergies, roughly 80% of it in the first three years after closing. The companies' businesses will complement each other as well. Today, VTR is focused on the residential pay-TV and fixed-broadband markets, and Claro Chile on the enterprise segment, with a 22% market share in Chile's mobile business. The combination would allow VTR to move away from its current mobile virtual network operator that it offers through third-party infrastructure.

VTR and Claro Chile combined would have much larger share in Chilean telecom market
Market shares of Chilean telecom providers as of June 2021



Source: Subtel

As a result of this transaction, none of the shareholders will consolidate the joint venture's operations. The parties made a commitment to contribute businesses with net debt of CLP1.095 trillion ($1.5 billion) for VTR and CLP259 billion ($400 million) for Claro Chle.

The untested nature of the two companies' joint control of a collaboration poses some credit risk. Even so, AMX's conservative financial policies ease that risk, along with LLA's senior management experience in joint ventures at the Liberty Global plc (Ba3 stable) level, LLA's former parent company, namely VMED O2 UK Limited (Ba3 stable) in the UK and VodafoneZiggo Group B.V. (B1 stable) in the Netherlands.

The companies expect the new group to operate with a net leverage target of 2.8x-3.5x net debt/EBITDA, stronger than VTR's reported 5.1x net leverage, calculated in accordance with its indenture of VTR's 6.375% $550 million senior unsecured notes. Under AMX and

VTR's conservative liquidity management, the joint venture will retain VTR's revolving credit facilities totaling about $260 million and maturing in June 2026.

The transaction also benefits AMX, giving the Mexican telecom conglomerate $100 million that it plans to use to repay debt and further advance toward its net leverage ratio target of 1.50x from 1.64x as of June 2021. Claro Chile currently represents less than 2% of AMX's consolidated revenue. AMX will spin off Claro Chile's towers, along with most of its roughly 36,000 towers in Latin America, probably by early 2022.

We expect that the new company will direct its investments toward improving broadband coverage and service, offering a combination of DSL, HFC and optic fiber. Empresa Nacional de Telecomunicaciones' (Entel, Baa3 stable) broadband service runs mostly on fiber optic but it has only a small market share. Telefónica Chile's fiber network serves about 2.4 million of passed real estate investment units, incorporated with InfraCo, a company 40% owned by Telefonica Chile and 60% by KKR.

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Collapse of a wind turbine near Essen, Germany, is credit negative for Nordex

Originally published on 06 October 2021

On 29 September, a model N149/4500 wind turbine produced by Nordex SE (B3 negative) that had only been in operation since March 2021 collapsed near Essen, Germany. Subsequently, Nordex decided to preventatively take out of operation all 22 turbines with the same configuration, including 17 installed and five under construction in Germany. The company has sold a total of 1,222 turbines of this type worldwide. The reason for the collapse is under investigation. The rating remains unchanged, considering recent performance improvements and improved liquidity following a capital increase. The negative outlook continues to reflect the challenge of sustained performance improvements and a return to break-even free cash flow generation.

The turbine's collapse is credit negative, because it could raise reliability issues for Nordex's flagship Delta4000 turbine platform, and dampen customer confidence and future order intake, particularly if this platform, which includes the N149/4500 turbine, is found to have structural quality problems. In addition, it could lead to substantial one-off costs if the repair of similar turbines becomes necessary.

Nordex is currently weakly positioned in the B3 rating category. The wind turbine collapse puts additional pressure on Nordex's already weak profitability. The company's Moody's-adjusted EBITDA for the 12 months ended June 2021 was negative €139 million. We expect increases in raw material prices and logistics costs to weigh on profitability for at least the next 12-18 months. While Nordex only recently started to increase its prices for new projects, it will have to bear most of these cost increases on projects under construction. Hence, we expect a slower recovery in profitability and free cash flow generation compared to our previous expectations.

Counterbalancing these weaknesses are a strengthening of profitability in the first half of 2021, hinting at healthier margins in the absence of external events and the phasing out of €300 million of one-off coronavirus-related costs booked in the third quarter of 2020. Nordex reported EBITDA of €51 million for the first half of 2021 compared with negative €79 million a year earlier. In addition, the company's successful €585 million capital increase completed in July 2021, including €388 million in cash and €196.6 million by way of a contribution in kind against its existing shareholder loan from Acciona S.A., reduced its net debt substantially. It also provides a liquidity buffer that will support Nordex's growth, and recovery in profitability and free cash flow generation.

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IPO adds financial flexibility to IHS Holding and MTN Group

Originally published on 06 October 2021

On 4 October, IHS Holding Limited (B2 negative), a leading independent mobile tower operator operating in Africa, Latin America and the Middle East, announced it is pursuing an initial public offering (IPO) on the New York Stock Exchange, which is expected to raise up to $432 million of new capital for IHS. The planned IPO is credit positive for IHS because it will provide access to the equity market, strengthen its balance sheet and increase its cash balances toward $1 billion, providing the company with sizeable funds to continue to diversify its business outside of its main market Nigeria (B2 negative). It will also be credit positive for MTN Group Limited (MTN, Ba2 negative), which owns 29% of IHS, because it will allow MTN to achieve its stated objective of reducing its stake in IHS over time, reducing debt and simplifying the group's portfolio.

While IHS's credit metrics and business profile are better than the B2 rating implies, IHS's credit quality is constrained by the sovereign risks of Nigeria, reflected by the B2 government bond rating and foreign currency ceiling of B2. This is because of the high concentration of IHS's cash flow (around 78% of 2020 EBITDA) and the elevated risks associated with operating in Nigeria, such as the repatriation of cash flow offshore, which has been difficult for some companies, at times.

IHS's financial capacity to pursue sizeable acquisitions is already large, with cash balances of $542 million, a $245 million undrawn revolving credit facility and sizeable headroom between Moody's adjusted gross debt/EBITDA of 2.9x as of 30 June 2021 and the downgrade trigger of 5.5x. Following the IPO, the additional equity proceeds will boost the cash balance toward $1 billion. Despite this sizable debt capacity, IHS's financial policy will remain unchanged with the company maintaining its conservative net debt/EBITDA target of between 3x and 4x (2.2x reported as of 30 June 2021, pro forma including acquisitions) and not paying dividends.

The prospectus states that the IPO proceeds would be used for general corporate purposes, including acquisitions, though at present there are none contemplated beyond the recently signed and announced TIM Fiber acquisition in Brazil. Over the past 18 months, IHS has been growing its operational footprint, acquiring tower businesses in Latin America and the Middle East regions, which account for around 8% of pro forma 2020 revenue, followed by 21% from four African operations and 71% from the Nigerian operations.

We expect IHS to continue to focus its attention on expanding its operations in the Latin American and Middle Eastern markets, which will over time reduce its reliance on cash flow from Nigeria, thereby lowering its credit exposure to the country. Such diversification is illustrated by IHS's announcement on 6 October 2021 to partner with the Egyptian Ministry of Communications to potentially roll out up to 5,800 build to suit towers in the country over three years.

For MTN, selling a portion of its 29% stake in IHS over time forms a key part of the company's plan to raise $1.7 billion from asset disposals over the next 3-5 years. At the time of listing, MTN plans to sell a moderate 1.5% of its holding in IHS, which we expect would raise c. $30 million. While the initial amount is immaterial in the context of MTN's asset disposal program, owning a substantial stake in publicly listed IHS will improve MTN's financial flexibility and allow it to sell down more, if and when required to reduce debt and maintain its conservative financial policy while meeting its investment objectives.

As of 30 June 2021, MTN's holding company reported net debt/EBITDA reduced to 1.4x from 2.2x six months earlier, thereby meeting the company's announced aim to reduce holding company leverage below 1.5x. Despite meeting the deleveraging target, we understand the company's near term priority remains to reduce debt further before using excess cash for shareholder returns.

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Singtel's sale of towers is credit positive

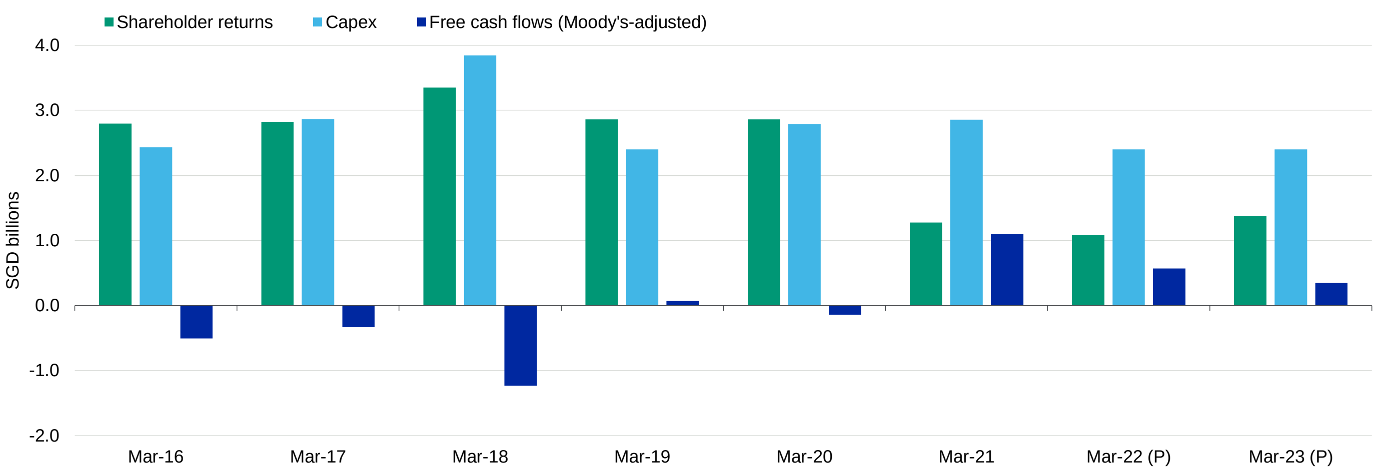
Originally published on 05 October 2021

On 1 October, Singapore Telecommunications Limited (Singtel, A1 stable), announced that its wholly owned subsidiary, Singtel ATN Pte. Ltd. (Singtel ATN), had entered a conditional agreement with AS Infra Tower Pty Ltd to sell a 70% stake in Australia Tower Network Pty Ltd (ATN) for around AUD1.9 billion. ATN operates telecommunications towers for Singtel's Australian telco subsidiary, Singtel Optus Pty Limited (Optus, A3 stable). AS Infra Tower was established by Australian Super Pty Ltd, which is the trustee of Australia's largest superannuation fund. The sale is likely to be completed by the end of October 2021.

The transaction – once concluded – will be credit positive because it unlocks value from Singtel's passive infrastructure and enhances its liquidity buffer. However, we expect Singtel's leverage to remain at 2.5x-2.6x following the transaction.

Singtel will use the proceeds from the sale to accelerate 5G investments in Australia and Singapore. It also plans to invest in other growth areas including data centers. Singtel could also use the proceeds to support its dividends at the higher end of the 60%-80% payout range, which could still keep free cash flow positive over the next two years. Historically, Singtel has paid special dividends on the back of asset sales; any additional dividend payments could lead to pressure on cash flows and leverage for Singtel.

Singtel is likely to generate significant cash flow over next two years despite ongoing shareholder returns and high capital spending



Sources: Company financial statements, Moody's Financial Metrics™ and Moody's Investors Service estimates

Following an internal restructuring by Singtel earlier this year, ATN took ownership of a portion of the mobile tower infrastructure assets, which were previously owned and operated by Optus. The sale proceeds of around AUD1.9 billion include a repayment of AUD500 million of an outstanding loan by ATN to Optus.

The transaction involves 2,312 existing towers at ATN with a tenancy ratio of 1.6x, along with another 565 towers that are in the order book. Optus will remain the anchor tenant of all the towers. Because of capitalization from the leases, the sale of towers will not have a meaningful effect on leverage for either Optus or Singtel. Optus continues to hold some of its towers as strategic assets, and the transaction does not preclude Optus from constructing towers and other infrastructure for future network growth on its own or through other third parties.

Following completion, Singtel ATN will retain a 30% stake in ATN, which will provide it with certain shareholder rights. Importantly, the residual stake allows Singtel to continue benefiting from tower business growth at ATN. However, we do not expect Singtel to receive significant dividends from ATN over the next two years because of the latter's need to service debt undertaken for this transaction. ATN secured additional debt of AUD1.25 billion, which it will use to pay capital returns, repay the loan to Optus and other business needs.

Singtel also announced plans to create a regional data center platform with an initial focus on Southeast Asia. As part of this plan, Singtel has signed a memorandum of understanding with Thailand's Gulf Energy Development PLC to build and develop data centers across Thailand. The company is also in advanced discussions with PT Telekomunikasi Indonesia (Telkom, Baa1 stable) to acquire and build data centers in Indonesia and other countries in the region. This is in line with Singtel's strategy to grow its digital and infrastructure businesses through partnerships.

Singtel plans to grow its data center capacity by 100 megawatts over the next three to four years. The capital outlay will likely be funded jointly by Singtel and its joint venture partners. We estimate annual capital spending of SGD200-SGD300 million and do not expect the data center expansion strategy to have a substantial effect on its leverage.

Although Singtel's data center business is likely to grow rapidly, the effect on its consolidated finances will be manageable. Singtel currently has a combined data center capacity of more than 70 megawatts, which contributes revenue of more than SGD250 million a year. The business generates high EBITDA margins of more than 60%, leading to EBITDA contribution of about SGD150 million.

As an integrated telecom provider, Singtel can also bring benefits to its customers through data center capacity, connectivity, data analytics and cybersecurity.

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XP gains autonomy from Itau as it merges with XPart, a credit positive

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On 1 October, Brazilian online securities company XP Inc. (Ba2 stable) announced that it had approved its merger with XP Participações S.A. (XPart), under which Itau Unibanco S.A. (Itau, Ba2/(P)Ba2 stable, ba2[1]) will effectively transfer its 40.5% ownership stake in XP upon completion of XPart and XP's merger to its own shareholders.

The deal's completion is credit positive for XP because it gives XP autonomy from Itau. XP has increased its voting shares to 68.3% from 55.4% and Itau no longer has veto rights over XP's mergers and acquisitions, nor have rights to a seat on XP's board of directors or any other committee. In substitution, Itausa S.A., Itau's ultimate holding company, has already indicated two board members, including a member of the audit committee. However, Itausa's effective ownership stake is significantly lower now than Itau's was, with a total stake around 8.0% and limited voting shares.

XP can pursue its strategic objectives, including expanding its digital universal banking business model and competing directly with Brazil's five largest banks, which have more than 70% market share of Brazil's loans and deposits.

With total assets under custody of BRL817 billion ($152 billion) as of June 2021, up 88% from a year earlier, XP maintain a leading presence in the online brokerage segment. To continue its expansion, XP is growing its digital banking business, widening its range of services and diversifying into credit, all of which is supported by the Brazil's Open Banking[2] which is launching in phases throughout 2021. In addition, the company will target services including banking and capital raising for small to midsize enterprises and to grow its private pensions business. XP's broad distribution of financial products across its platform is a key competitive advantage that gives it a pricing advantage across divisions and ultimately supports strong profitability, which is reflected in its 3.2% return on average assets as of June 2021. XP's growth in additional business lines will continue to support revenue diversification.

Itau announced its intention to spin off its stake in XP in December 2020 and created a new company, XPart, into which it transferred its 40.5% stake in XP.[3] . Under the terms of XPart merger, Itau shareholders that own American depositary receipts received class A shares issued by XP, and all other Itau shareholders received newly issued XP Brazilian depositary receipts that are now trading on Brazil's stock market and which they are then free to sell.

The spin off of Itau's stake into XPart was approved by Itau's shareholders in February 2021, and the creation of XPart was approved by US Federal Reserve in May 2021 and by the Central Bank of Brazil in July 2021. In December 2020, before the deal, Itau had already sold a 4.4% in XP for BRL4.0 billion ($935 million) through a follow-on offering on Nasdaq.

Itau acquired a 49.9% stake in XP in 2017 for BRL6.3 billion ($1.2 billion). XP listed on the Nasdaq stock exchange in December 2019 and based on its market capitalization as of 30 September, Itau's stake would be worth BRL62.3 billion ($11.4 billion). Itau will acquire a stake of 11.4% in XP, subject to regulatory approval in line with the terms and conditions of its initial stake acquisition in 2017 and we expect this transaction to take place in 2022.[4] The current deal will have no material effect on Itau's credit profile. After the completion of XPart's spin-off on 31 May, Itau received earnings from its stake in XP for only two months in the second quarter. Despite that, Itau reported a 12% growth in total fee income in the quarter reflecting a rise in the volume of its own activities.

Endnotes

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

2 Sponsored by the central bank of Brazil, Open Banking aims to modernize the Brazilian financial system and make it more efficient while promoting the democratization of financial services through technology

3 XPart's sharehodler structured mirrored that of Itau

4 The price it will pay for the stake is a multiple of 19x 2021 net income and we expect that it is well below XP`s current share price.

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Iceland restores countercyclical buffer and introduces debt service cap in mortgages, a credit positive for banks

Originally published on 06 October 2021

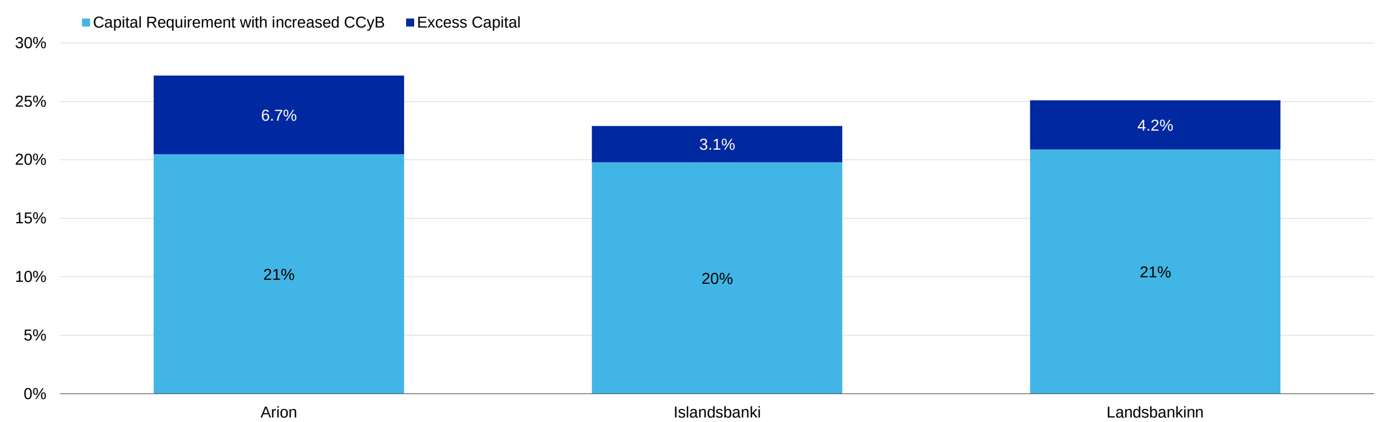
On 29 September, the Central Bank of Iceland announced its intention to restore the countercyclical capital buffer (CCyB) to 2% from 0%, with the increase taking effect in 12 months. The central bank also announced new rules on retail mortgages, capping the debt service-to-income (DSTI) ratio for the first time. Both measures are credit positive for Icelandic banks because they will mitigate the risks associated with rapidly rising asset prices and increasing household debt. Additionally, the measures will support banks' asset quality and reinforce high levels of capital which protect bank creditors from losses.

Iceland's central bank decreased its countercyclical buffer to 0% in March 2020 to provide banks with greater flexibility to continue supporting lending to creditworthy businesses and households during the coronavirus pandemic. The decision to restore the countercyclical buffer to its pre-pandemic level reflects the recovery of the Icelandic economy, which we expect will grow by 3.4% in 2021 following a contraction of 6.6% in 2020 and will return to its pre-pandemic growth level of 5% in 2022. Supporting the economy's rebound is a reopening of the economy and an increase in tourism as a result of Iceland's 80% vaccination rate.

Reinstating the capital buffer also signals a reduction in economic risks and reinforces the buffers that banks must hold against unexpected losses. However, the introduction of tighter underwriting standards indicates that tail risks from asset appreciation persist.

Icelandic banks benefit from strong capital metrics supported by internal capital generation derived from increased lending activity, which we expect will remain intact despite the higher capital buffer requirement. Although banks have 12 months to comply with the increased requirements, all Icelandic banks meet them now (see Exhibit 1).

Exhibit 1
Iceland's systemically important banks already comply with the higher capital requirements
Data as of 31 July 2021



Sources: The banks and Moody's Investors Service

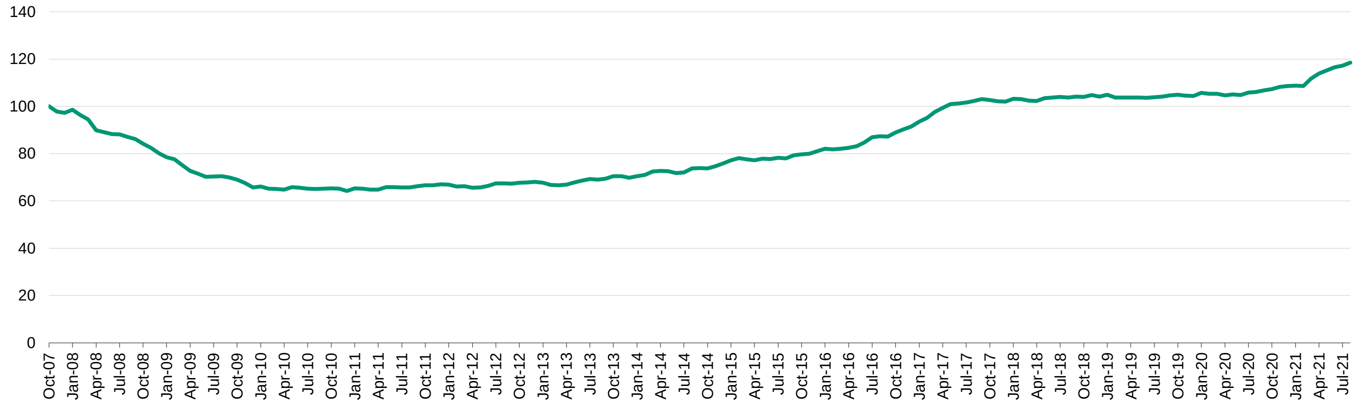
The central bank also introduced a DSTI ratio cap of 35% for new mortgages issued after 1 December 2021, and capped the DSTI ratio for first-time homebuyers at 40%. These rules follow a lowering of the maximum loan-to-value (LTV) ratio to 80% from 85% in June 2021. We expect the DSTI ratio caps to support Icelandic households' debt service resilience and contain house price appreciation, strengthening Icelandic banks' asset quality. Mortgages account for almost 50% of banks' lending operations.

House prices in the greater Reykjavik area have increased this year by 11.6% in real terms to reach record highs, following a 4% rise in 2020 (see Exhibit 2). Although household indebtedness (as measured by household debt over disposable income) has decreased over the past 10 years and at 161% is below the Nordic average of 204%, LTVs have risen over the past 18 months. Furthermore, Icelandic households have taken advantage of all-time low interest rates to swap their fixed rate inflation-linked loans with non-indexed variable loans, increasing their sensitivity to interest rate changes. Non-indexed variable-rate mortgages constituted 32.9% of all mortgages in August 2021, up from 18.5% in January 2020.

Exhibit 2

House prices in greater Reykjavik are at an all time high

Real house prices index in Reykjavik, Index, October 2007=100



Sources: Registers Iceland, Statistics Iceland, Central Bank of Iceland and Moody's Investors Service

Still, Icelandic households have performed well during the pandemic. “Frozen loans”, or loans that are not paid down with contractual installments and can accrue interest, peaked at 2.27% in February 2021, versus 0.91% at the end of 2019. That number has since recovered to 1.62% as of the end of August 2021 because of support measures for pandemic-affected industries.

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Sun Life acquisition of DentaQuest positions it as a leading dental benefits provider, a credit positive

Originally published on 04 October 2021

On 3 October, Sun Life Financial (SLF) announced it had signed a definitive agreement to acquire DentaQuest, a major US dental benefits provider, from CareQuest Institute for Oral Health and Centerbridge for approximately $2.5 billion in cash. The acquisition is credit positive for SLF's US employee benefits (EB) business, whose own dental benefits business will gain scale and market diversity.

DentaQuest is the largest provider of Medicaid dental benefits in the US with a growing Medicare Advantage business - both markets in which SLF's dental benefits business does not currently participate. The acquisition should add earnings and business diversity to the firm's overall EB business in the US, whose primary focus has been on its medical stop loss and group benefits business, while increasing the US segment's contribution to SLF's consolidated "underlying" (i.e., adjusted) earnings from 16% to over 19%. The transaction is expected to close in the first half of 2022, subject to regulatory approvals.

According to terms of the transaction, SLF will finance the acquisition through a combination of cash on hand and the issuance of subordinated debt. As a result, leverage is expected to rise as a result of the transaction but will remain within the range of 25%-30%, which is within our expectations. While the transaction is expected to reduce SLF's LICAT ratio seven percentage points (the redemption of preferred shares on 29 September 2021 impacted the ratio by another three percentage points sequentially for a pro forma LICAT ratio of 137%), we would expect the firm to replenish capital levels within a relatively short period of time following the closing of the transaction.

On the negative side, SLF, a leading commercial EB player serving the private employer/employee benefits segment, has no experience in the government health markets, a highly regulated and complex market. This exposes the company to significant execution and lapse risks, although this is somewhat mitigated by the fact that the DentaQuest is a turnkey operation that includes employees and a proprietary claims system, led by an experienced management team.

In addition, SLF will be exposed to the vagaries and politics associated with the government health markets. In commercial markets, product pricing and costs are, to a large degree, under a provider's control. Conversely, the Medicare and Medicaid programs are highly regulated markets, which use a competitive bidding process for providers.

This transaction continues the M&A trend, adding to the rapidly growing list of transactions in the North American life insurance sector, despite the effect of the coronavirus pandemic (see exhibit). As persistently low interest rates accelerate the life insurance industry's to shift from capital-intensive, spread-based insurance products to fee-based, capital-light ones, like asset management and health insurance, we expect transactions similar to SLF's acquisition of DentaQuest to continue.

Select M&A transactions in North America continue to multiply amid low interest rates

Date of Transaction	Buyer/Ultimate Parent	Seller	Primary Type of Business	Motivation	Deal Value (USD Billions)		Transaction Type (Stock/Reinsurance)
September-21	Resolution Life Group Holdings	Lincoln National	Life Insurance	Private Capital	$	1.2	Reinsurance
September-21	Fortitude Reinsurance Company Ltd.	Prudential Financial	Variable Annuity	Private Capital	$	2.2	Stock
August-21	Brookfield Asset Management	American National Group	Life Insurance	Private Capital	$	5.1	Stock
July-21	Blackstone	AIG Life and Retirement	Life Insurance	Private Capital	$	2.2	Stock
July-21	Great -West Lifeco Inc.	Prudential Financial	Retirement	Scale	$	3.6	Stock / Reinsurance
April-21	Ameriprise Financial	BMO's EMEA Asset Management	Asset Management	Scale	$	0.8	Stock

Source: Company filings and Moody's Investors Service

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Biggest global banks retain competitive advantage, but stiff obstacles loom post pandemic

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Most of the 30 global systemically important banks (G-SIBs, overview page 2) have maintained strong capitalization and liquidity since our September 2020 report on the peer group. This is consistent with our view that the G-SIBs' inherent strengths, flowing from their diversification and scale, have not only armed them against the adverse effects of the COVID-19 pandemic but, in some cases, will allow them to exit the pandemic in a stronger competitive position. These advantages will also help the G-SIBs contend with underlying business model challenges beyond the transitory effects of the pandemic.

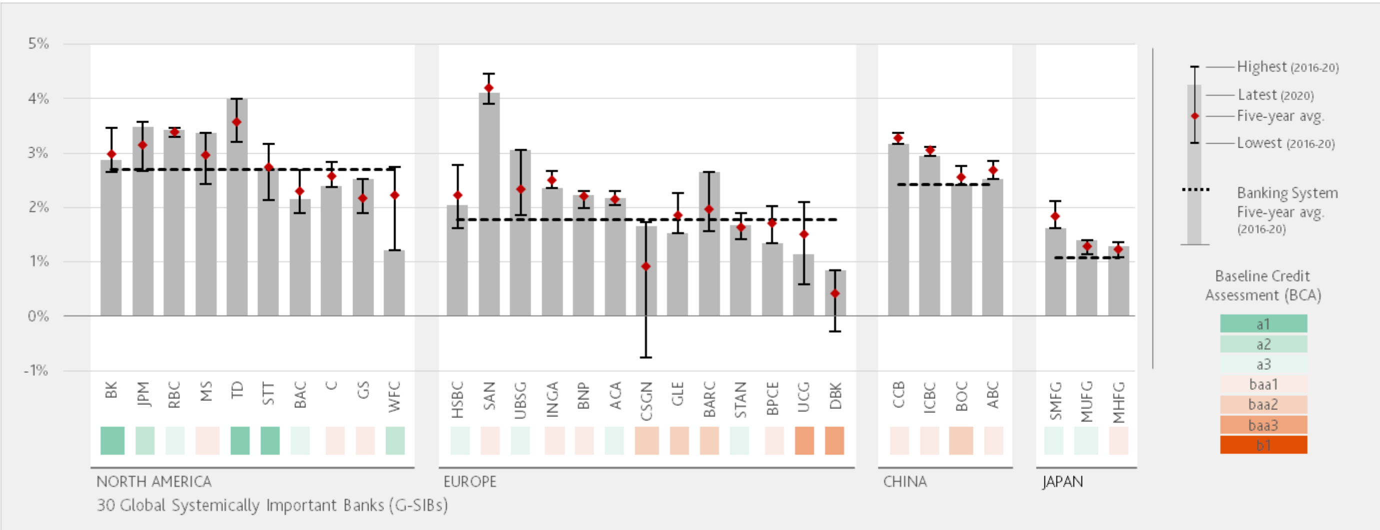
Accommodative policy and regulatory vigilance aided many banking systems and supported the reported capital and liquidity positions of most G-SIBs. In addition to benefiting from these external influences, internally the banks have generally maintained more disciplined risk appetites and risk management practices that they developed in the past decade and that have supported their capital and liquidity.

Diversification and scale of many G-SIBs should drive superior profitability again in 2022, and support through-the-cycle performance. Profitability varies across the group, reflecting local operating conditions, but preprovision returns on risk-weighted assets held up for most G-SIBs during 2020 and first-half 2021, and exceeded their system averages. This reflects several enduring advantages: foremost the G-SIBs' balanced franchises, often anchored in deposit-gathering in a home or specialty market or with diversified earnings from less capital-intensive businesses like asset and wealth management. And, in some cases, scaled and complete global capital markets franchises benefited from exceptional primary and secondary flows. These inherent strengths should allow G-SIBs with more coherent business models to emerge from the pandemic in even better competitive shape.

Capital surpluses will decline as regulators loosen shackles on shareholder distributions. After a year or more of restricted capital distributions, many banks are likely to increase shareholder payouts in 2022. Sustaining profitability will be difficult for some, with earnings muted by compressed yield curves and uneven economic recoveries by region.

As COVID-related risks ebb, underlying competitive challenges will again come to the fore. The G-SIBs' core deposit-taking, payment and lending services face rising threats from technology firms and shadow banks. The banks have formidable defenses in the form of brand, trust, regulatory economies of scale and investable earnings. But as demand for tech skills and intellectual capital rises, and workplace preferences shift, it will be increasingly difficult and costly to recruit and retain staff and build a collaborative, innovative, client-centered culture.

Pre-provision returns on risk-weighted assets vary by region, business model and franchise strength
Range and average of pre-provision income/risk-weighted averages, 2016-20



Key: TD = Toronto-Dominion Bank (The); JPM = JPMorgan Chase & Co.; RBC = Royal Bank of Canada; MS = Morgan Stanley; BK = Bank of New York Mellon Corporation (The); STT = State Street Corporation; GS = Goldman Sachs Group, Inc. (The); C = Citigroup Inc.; BAC = Bank of America Corporation; WFC = Wells Fargo & Company; SAN = Banco Santander S.A. (Spain); UBSG = UBS Group AG; BARC = Barclays PLC; INGA = ING Groep N.V.; BNP = BNP Paribas; ACA = Groupe Credit Agricole; HSBC = HSBC Holdings plc; STAN = Standard Chartered PLC; CSGN = Credit Suisse Group AG; GLE = Societe Generale; BPCE = Groupe BPCE; UCG = UniCredit S.p.A.; DBK = Deutsche Bank AG; CCB = China Construction Bank Corporation; ICBC = Industrial & Commercial Bank of China Ltd.; ABC = Agricultural Bank of China Limited; BOC = Bank of China Limited; SMFG = Sumitomo Mitsui Financial Group, Inc.; MUFG = Mitsubishi UFJ Financial Group, Inc.; MHFG = Mizuho Financial Group, Inc.
Sources: Company reports and Moody's Investors Service

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