Credit Outlook

28 October 2021

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Financial Stability Oversight Council recommendations promote focus on addressing and mitigating climate risks

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On 21 October, the Financial Stability Oversight Council (FSOC) released a report on climate-related financial risk that identifies climate change as an emerging and increasing threat to US financial stability. The report makes several recommendations to expand efforts to address climate-related financial risks, develop climate-related data and methodologies, enhance climate-related disclosures and continue to assess and mitigate climate-related risks that threaten financial system stability.

The recommendations are credit positive for US banks because they facilitate the creation of standards and best practices for climate risk identification, disclosure and management. The recommendations encourage US banks to integrate climate risk considerations into strategic decisions, business processes, governance and risk management frameworks.

The report focuses on the need for better data, disclosure and methodologies that include scenario analysis to address and mitigate climate-related risks to the financial system and support an economy-wide transition toward net-zero carbon emissions. The report directs the regulatory agencies that are FSOC members to assess climate-related financial risks and consider changes via new regulation or guidance to address these risks. The FSOC's recommendations also leverage many existing efforts. These efforts include using scenario analysis that builds on the work of the Network for Greening the Financial System (NGFS) and work at the Financial Stability Board, as well as enhancing climate risk disclosures building on the efforts of the Task Force on Climate-related Financial Disclosures (TCFD). The report instructs FSOC members to develop consistent data standards, definitions and relevant metrics, and coordinate as they identify, address and fill data gaps and issues.

The report and recommendations were prompted by President Joseph Biden's climate-related financial risk executive order in May. The report also calls for the creation of two new committees: the Climate-related Financial Risk Committee (CFRC) to ensure that addressing climate-related financial risk remains a priority area; and the Climate-related Financial Risk Advisory Committee (CFRAC), which will include private sector members and report to the CFRC, to help gather information and analysis of climate-related financial risks.

Chaired by the secretary of the US Treasury, the FSOC includes representatives from the Federal Reserve, Office of the Comptroller of the Currency (OCC), Securities and Exchange Commission (SEC), Federal Deposit Insurance Corporation, Consumer Financial Protection Bureau, Commodity Futures Trading Commission, Federal Housing Finance Agency and National Credit Union Administration. The coordinated efforts to manage climate-related financial risk will help US banks better assess the potential consequences of climate change for their business and develop important climate risk management capabilities.

Climate risk disclosure is on many countries' regulatory agendas. We expect improvements in banks' disclosures about these risks in response to growing investor demand that banks meet carbon transition goals in their role as capital providers. However, standardized reporting of climate-related risks and estimates of financial effects remain an ongoing effort.

As the race to net-zero carbon emission accelerates, the credit impact of carbon transition will materialize. Financial firms that adopt a rapid but predictable shift toward climate-friendly finance will best preserve their credit quality. In this scenario, financial firms integrate climate risk considerations into their strategic decisions, business processes, governance structures and risk management frameworks, while setting out clear goals for reaching net zero in their financed emissions.

Megan Fox, *Vice President - Senior Analyst*
Moody's Investors Service
megan.fox@moodys.com
+1.212.553.4986

Carola Schuler, *MD-Banking*
Moody's Investors Service
carola.schuler@moodys.com
+49.69.70730.766

Andrea Usai, *Associate Managing Director*
Moody's Investors Service
andrea.usai@moodys.com
+1.212.553.7857

Cyberattack highlights cyber risks for Tesco and the retail sector

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On 24 October, Tesco Plc (Baa3 stable) said its online store, including Tesco.com and its app, had experienced a service outage over the weekend that lasted around 48 hours after being hit by an attempted hack that affected the company website's search function. The attempt to interfere with Tesco's systems resulted in customers not being able to book or amend their deliveries over the weekend.

While Tesco's website and app are again operational, and costs in terms of lost revenue are likely to be limited to a Moody's estimated £20-£30 million for the two-day period, and are therefore relatively immaterial for Tesco's debt metrics, the hack is credit negative. The cyberattack illustrates the vulnerability of large organisations such as Tesco to such incidents, but also reflects Tesco's resilience in being able to act swiftly to resolve them.

In 2016, a cyberattack at Tesco Bank resulted in the theft of £2.3 million from 8,000 customer accounts. Tesco Bank quickly reimbursed the affected customers but was fined £16.4 million in 2018 by the UK's Financial Conduct Authority (FCA) for shortcomings related to this cyberattack.[1]In 2014, Tesco experienced a cyberattack in which customers' login details were posted online, forcing the company to deactivate customers' online accounts.

Although the cyberattack's financial effect will be limited, hackers' improving capabilities illustrate the risk posed by further attacks with a greater magnitude. Indeed, the risk of more damaging cyberattacks is increasing across most sectors as online sales grow, and a more severe attack could significantly affect Tesco's debt metrics. Our issuer cyber survey indicates that nearly 50% of the respondents reported a cybersecurity event to their board of directors in the past twelve months, pointing to the prevalence and materiality of these events.

Still, the long record of cyberattacks against the retail sector appears to have lead to a healthy adoption of cyber mitigation practices including sustained cyber budgets of roughly 6% of IT spend, in line with investments in other corporate sectors like technology and media (Exhibit 1). Nearly all retail sector respondents said they have also implemented an Incident Response Plan and about two thirds carry out tabletop simulation exercises. Adoption of more sophisticated practices such as red team testing is in line with corporate peers but trails the banking sector, which we view as amongst the most advanced in terms of cyber mitigation practices.

The retail sector's cyber practices keep pace with other corporate sectors but trail banking

	Retail	Technology	Media	Telecom.	Banking
% of IT budget allocated to cybersecurity in 2020	6%	6%	6%	7%	7%
% that have an Incident Response Plan	95%	97%	93%	94%	97%
% that have completed a tabletop simulation in last 12 months	69%	83%	73%	75%	91%
% that have completed a red team test in the last 12 months	58%	57%	52%	63%	83%
% with stand-alone cyber insurance	93%	77%	80%	78%	76%

Issuer survey results reflect medians for each question
Sources: Company data and Moody's Investors Service

We do not expect Tesco's leverage, measured in terms of Moody's-adjusted gross debt to EBITDA, to be meaningfully affected by the outage. We estimate that Tesco's Moody's-adjusted gross debt to EBITDA was around 3.9x as of 28 August, based on Moody's-adjusted gross debt of £16.3 billion and EBITDA of £4.2 billion. And, despite recently announced buybacks, we expect that leverage will remain around current levels over the next 12-18 months because the buybacks will be funded through available cash, leaving the company well positioned in the Baa3 rating category. At 3.9x, leverage is close to the lower point of the 3.75x-4.5x range that is our quantitative guidance for the current rating.

In fiscal 2021, which ended in February 2021, Tesco reported a 77% year-on-year increase in online sales to £6.3 billion (incl. VAT) within UK and Ireland, accounting for an estimated 12% of its total net retail revenue.

Endnotes

1 Issuer Comment on Tesco Bank's 2016 cyberattack and subsequent fine imposed by the FCA.

Roberto Pozzi, *Senior Vice President*
Moody's Investors Service
roberto.pozzi@moodys.com
+44.20.7772.1030

Stefan Trinkl, *Associate Analyst*
Moody's Investors Service
stefan.trinkl2@moodys.com
+44.20.7772.5695

Richard Etheridge, *Associate Managing Director*
Moody's Investors Service
richard.etheridge@moodys.com
+44.20.7772.1035

Crestwood's acquisition of Oasis Midstream is credit positive

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On 26 October, Crestwood Equity Partners LP announced it will acquire Oasis Midstream Partners LP (B2 review for upgrade), which will add scale to Crestwood's strategically core Williston Basin assets and boost cash flow in an essentially leverage neutral manner. The acquired operations strengthen Crestwood's competitive position in the basin and have the longer-term benefit of enhancing its ability to be a consolidator there.

The transaction almost doubles Crestwood's inventory of what it describes as tier 1 drilling locations dedicated to its systems to approximately 1,200 locations, and more than triples its dedicated acreage to 535,000 acres. However, the acquired acreage in the more western and northern portions of the basin is more prospective than Crestwood's existing acreage.

In addition to adding a substantial amount of crude, produced water and natural gas gathering assets, Crestwood gains flexibility to accommodate future growth in that the Oasis processing assets are utilized at rates significantly below those of its Bear Den plant. The good operational and geographical fit of Oasis's assets provides meaningful synergy opportunities, which Crestwood estimates to be more than $25 million annually.

The Oasis acquisition is valued at $1.8 billion, including Oasis's outstanding debt. The transaction will predominantly be equity funded. Crestwood will fund the $160 million cash component by borrowing from its revolver. Oasis's debt included in the purchase price totaled $660 million as of 30 September 2021 and consisted of $450 million of senior unsecured notes due 2029, with the remainder being revolver borrowings. Although the immediate effect of the combination of the two companies will be modestly leveraging to Crestwood, taking debt/EBITDA to 3.5x from 3.4x, successful implementation of cost cutting and operational efficiency efforts should return leverage to its pre-acquisition level and position the company for further deleveraging.

The transaction is subject to regulatory approval and Oasis Midstream shareholder approval. Crestwood expects the transaction to close in the first quarter of 2022.

John Thieroff, *VP-Sr Credit Officer*
Moody's Investors Service
john.thieroff@moodys.com
+1.212.553.7853

Sreedhar Kona, *VP-Senior Analyst*
Moody's Investors Service
sreedhar.kona@moodys.com
+1.212.553.4199

Steven Wood, *MD-Corporate Finance*
Moody's Investors Service
steven.wood@moodys.com
+1.212.553.0591

Biscuit International's acquisition of Continental Bakery will likely increase debt

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On 22 October, Biscuit International, a pan-European private-label biscuits producer and owner of subsidiary Cookie Intermediate Holding II SAS (Biscuit, B3 stable), announced an agreement to acquire Continental Bakeries, a bakery group headquartered in the Netherlands specialized in the production of biscuits, bread replacements and toasts.

Although the company has not yet disclosed the details of the transaction, including the purchase price and financing, we view it as credit negative because it is a relatively large acquisition that adds to a number of acquisitions that closed in 2019 and 2020 and could slow the deleveraging trajectory, depending on the funding mix. Biscuit's underlying operating performance has been weaker than we expected when the rating was assigned in early 2020.

While the price paid and financing have not been disclosed, we understand that management and the sponsor will look to maintain pro forma financial leverage broadly in line with the current level. However, pro forma leverage will likely include a number of additional cost savings and synergies that will materialize over time, exposing any future deleveraging to execution risks. Failure to achieve such synergies could eventually put pressure on the rating.

The agreement to acquire Continental Bakeries follows the acquisition of Dan Cake in early 2021. Frequent acquisitions complicate the monitoring of Biscuit's underlying performance as we need to rely on pro forma accounts. In addition, Continental Bakeries is a relatively sizeable company, generating €400 million in revenue in 2020, operating 13 factories in Western Europe and employing more than 2,300 staff. It is not much smaller than Biscuit, which generated €527 million of pro forma revenue in 2020 and which operates 20 factories and employs 2,600 workers. The integration of Continental Bakeries will also require significant management attention at a time when the company's underlying performance is below our expectations and its financial leverage is high for its rating. Financial leverage stood at 8.8x in December 2020 on a Moody's adjusted gross debt to EBITDA basis, against a maximum of 7.0x allowed by the rating.

Biscuit's ratings are weakly positioned because the company's 2020 profit was depressed by lockdown measures imposed as a result of the coronavirus pandemic and a number of restructuring costs. The company's financial leverage as of year-end 2020 was well above our previous expectations, and we were expecting a degree of recovery in its key credit metrics in 2021 and 2022. The acquisition of Continental Bakeries might slow the deleveraging process and, as we indicated earlier in the year, failure to show a significant reduction in financial leverage in 2021 could result in negative pressure on the rating.

On the positive side, the company's underlying performance showed a degree of stabilisation in the second quarter of 2021 and we expect some improvements in the second half of the year, including initial progress on cost savings following the acquisition by Platinum Equity at the beginning of 2020. In addition, the eventual integration of Continental Bakeries will provide for better geographic and product diversification, partially compensating for these weaknesses.

Biscuit International is the parent company of Cookie Intermediate Holding, one of the largest European manufacturers of private-label sweet biscuits based in France. The company produces and distributes traditional biscuits, nutrition biscuits, waffles and other sweet products across Europe. During 2020, the company sold 175 kilotons of biscuits, generating €527 million of revenue and €77.5 million of EBITDA pro forma for the Dan Cake acquisition.

Paolo Leschiutta, ***Senior Vice President***
Moody's Investors Service
paolo.leschiutta@moodys.com
+39.02.9148.1140

Ivan Palacios, ***Associate Managing Director***
Moody's Investors Service
ivan.palacios@moodys.com
+34.91.768.8229

Ambra Cortesi, ***Associate Analyst***
Moody's Investors Service
ambra.cortesi@moodys.com
+39.02.9148.1144

Takeover of Deutsche Industrie will strengthen CTP's operations and be leverage neutral

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On 26 October, Dutch real estate company CTP N.V. (Baa3 stable) announced that it intends to acquire full ownership of Deutsche Industrie REIT (DIR) for around €800 million in cash and stock. The purchase is credit positive for CTP because it will strengthen CTP's business profile over time and give it access to the German market without weakening its solid financial position.

DIR is a German-listed REIT that owns a diversified logistics/light-industrial portfolio valued at around €790 million as of June 2021 and yields gross rental income of €59 million at an 88% occupancy.

CTP's offer includes two payment options, a cash offer of €17.12 per share that implies a small premium over DIR's closing stock price as of 25 October or a share-based offer equal to 1.25 new CTP share in exchange for one DIR share. On the latter's basis, CTP said it would be paying the equivalent of a 48% premium to DIR's closing price as of 25 October.

With a deal likely, DIR shareholders have a strong economic incentive to accept CTP's offer of shares as payment considering that CTP's share price traded at a premium of around 2x the company's European Public Real Estate Association's net total assets metric as of June 2021. If DIR shareholders opt for CTP shares, the purchase would involve limited cash.

Moreover, DIR's capital structure, which had a loan-to-value (LTV) ratio of 41.4% as of 30 June 2021, resembles CTP's own conservative financial profile at around 40% LTV. Similar ratios mean the transaction will be leverage neutral and in line with CTP's financial policy.

Although DIR's portfolio quality is less than that of CTP and its occupancy is notably lower than CTP's across Central and Eastern Europe, acquiring DIR would give CTP access to Germany, a highly liquid investment market with a high demand for logistics space, at a reasonable financial cost. Germany would become CTP's third-largest market, with the potential of further growth in terms of value and rental income.

Additionally, the acquisition would create opportunities to launch asset management initiatives aimed at ramping up occupancy rates and make capital investments to upgrade properties' quality, enhance ESG credentials and develop a 2.3 million-square-meter land bank that would accompany the purchase. CTP also would be able to leverage is track record in asset management and development projects with a broader tenant base, creating cross-leasing opportunities in both Central and Eastern Europe and Germany.

Some 56% of DIR's shareholders support the transaction, limiting execution risks. The parties expect to complete the transaction early next year, after which DIR will be delisted.

Overall we positively acknowledge CTP's enhanced financial strength and access to public capital following its initial public offering (IPO) in March 2021. Proceeds from the IPO support the company's growth and regional diversification plans while also preserving its conservative capital structure, commensurate with its investment-grade rating.

Ana Luz Silva, CFA, *Vice President - Senior Analyst*
Moody's Investors Service
ana.silva@moodys.com
+49.69.70730.914

Anke Rindermann, *Associate Managing Director*
Moody's Investors Service
anke.rindermann@moodys.com
+49.69.70730.788

State regulator's final rate case approval is credit positive for Florida Power & Light

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On 26 October, the Florida Public Service Commission (FPSC) unanimously approved Florida Power & Light Company's (FPL, A1 stable) multiyear rate settlement agreement, approving an up to $1.5 billion base rate revenue increase over the four-year period 2022-25. The settlement was agreed with key intervening parties including the state's consumer advocacy group, Florida Office of Public Counsel, the Florida Retail Federation, the Florida Industrial Power Users Group and the Southern Alliance for Clean Energy. The rate case approval is credit positive for FPL because it will increase the company's revenue and cash flow and allow it to maintain its robust financial profile.

The increase is premised on an allowed return on equity (ROE) of 10.6%, up from 10.55% previously, and the continuation of an equity ratio that FPL has consistently maintained at about 60%. The allowed ROE range is 9.7%-11.7%, which allows FPL to effectively earn up to an 11.7% return. The multiyear base revenue increase, the increase in allowed ROE and maintenance of FPL's equity ratio support our view that FPL operates in a credit supportive regulatory environment.

The multiyear base revenue increase includes a $692 million increase on 1 January 2022 and a $560 million increase on 1 January 2023. FPL is also eligible to receive base rate increases for the addition of up to 894 megawatts annually of new solar generation through a solar base rate adjustment mechanism in each of 2024 and 2025. The base rate adjustments could be up to $140 million each year (see exhibit). The multistep nature of the rate increase mitigates some of the immediate rate effect on customers. The authorized revenue increase includes the majority of FPL's initial request filed by the company on 12 March 2021 for up to approximately $2 billion based on an allowed ROE of 11.5% and maintenance of its 60% equity ratio. The revenue increase supports FPL's long-term investments to upgrade its infrastructure, including for resiliency and grid hardening, in response to increasing occurrences of climate-change-related extreme weather events, such as hurricanes.

Exhibit 1

Estimated revenue increase by year ($ in millions)

	2022	2023	2024	2025
Traditional base ($ millions)	$692	$560	-	-
Solar base rate ($ millions)	-	-	Up to $140	Up to $140

Source: SEC filings

The settlement agreement also supports FPL's "30-by-30" plan to install 30 million solar panels in Florida by 2030. Continued investments will also expand FPL's SolarTogether community solar program, including the installation of 16 million solar panels across more than 50 new sites. FPL is authorized to implement solar base rate adjustments with the commercial operation of up to 1,788 megawatts of solar generation projects to be constructed in 2024 and 2025, subject to a cap on installed costs of $1,250 per kilowatt.

Before this proceeding, FPL's last rate case order was in 2016, when the FPSC authorized a multiyear revenue increase of $811 million based on a 10.55% allowed ROE, within a range of 9.6%-11.6% based on an equity ratio that FPL has consistently maintained at about 60%. In response to the December 2017 federal tax reform legislation, FPL was authorized to use the federal tax savings arising from tax reform to replenish its depreciation surplus reserve, which the company used to offset approximately $1.3 billion of storm restoration costs derived from Hurricane Irma in September 2017.

Headquartered in Juno Beach, Fla., Florida Power & Light Company is one of the largest regulated electric utilities in the US and the principal subsidiary of NextEra Energy, Inc. (NEE, Baa1 stable), one of the largest power and utility holding companies globally. FPL serves 5.6 million customer accounts, or more than 11 million residents, across more than half of Florida and has about 31.2 gigawatts of generation capacity. FPL accounts for about 70% of NEE's consolidated EBITDA and ended 2020 with about $61.6 billion of assets.

Jeffrey F. Cassella, *VP-Sr Credit Officer*
Moody's Investors Service
jeffrey.cassella@moodys.com
+1.212.553.1665

Jayce Kim, *Associate Analyst*
Moody's Investors Service
jayce.kim@moodys.com
+1.212.553.6836

Michael G. Haggarty, *Associate Managing Director*
Moody's Investors Service
michael.haggarty@moodys.com
+1.212.553.7172

Jim Hempstead, *MD - Global Infrastructure & Cyber Risk*
Moody's Investors Service
james.hempstead@moodys.com
+1.212.553.4318

Origin Energy's sale of 10% interest in APLNG is credit positive

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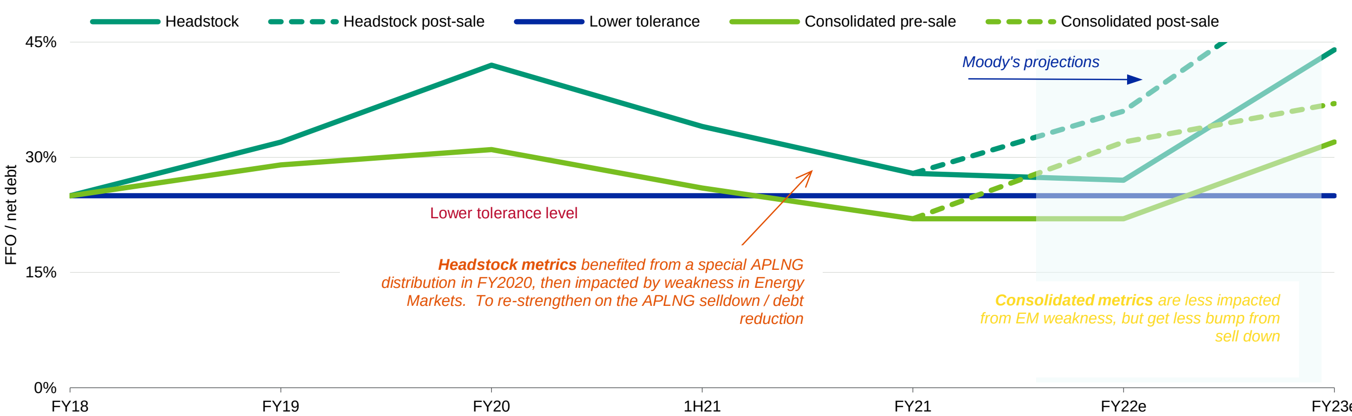
On 25 October, Origin Energy Limited (Baa2 stable) announced that it had sold a 10% equity interest in Australia Pacific LNG Pty Ltd (APLNG, Australia Pacific LNG Processing Pty Ltd (Baa2 stable) to Energy Infrastructure Group for approximately AUD2 billion after adjustments and transaction costs. The proceeds will result in an immediate debt reduction, but will also will increase flexibility for shareholder distributions and growth projects. Based on Origin's track record of commitment to its Baa2 rating and challenging energy market conditions, Origin is likely to prioritise debt reduction. As such, the transaction is credit positive for Origin because it strengthens its credit metrics.

After the sale, Origin will hold a 27.5% interest in the project, remain the upstream operator and retain its existing seats on APLNG's board. The sale is not likely to result in any substantial changes to APLNG's capital structure, management or strategy.

Origin reiterated that its cash flow guidance from APLNG for the fiscal year ending 30 June 2022 (fiscal 2022) is unchanged at greater than AUD1 billion, net of Origin oil hedging with the dilution in its interest being counterbalanced by escalating oil-linked LNG prices.

Before the sell down, we expected Origin's credit metrics – as measured by projected funds from operations (FFO)/net debt – to be at the lower end of its rating parameters because of a weak electricity market and an adverse gas price review that will raise its costs of supply by AUD60 million-AUD80 million in fiscal 2022 and fiscal 2023.

Origin's credit metrics to strengthen on the APLNG sell-down and debt reduction



Headstock metrics take into account cash distributions from APLNG; Consolidated metrics proportionately consolidate Origin's 37.5% interest (reducing to 27.5% on the sell down). Consolidated metrics are shown on the basis that Origin's APLNG interest is of strategic importance to the company, and so there is a raised likelihood that it would support the asset in a financially difficult situation.
Sources: Moody's Financial Metrics™ and Origin Energy

The transaction, which is expected to complete by the end of 2021, is subject to fellow APLNG stakeholder, ConocoPhillips (A3 positive) being reasonably satisfied that EIG is capable of satisfying its obligations under the shareholders agreement. Origin has agreed to guarantee EIG's obligations to satisfy any future cash calls made by APLNG, with an entity controlled by EIG indemnifying Origin with respect to that guarantee. We assess such a guarantee as unlikely to be called given the strong cash generative position of APLNG and EIG's reported track record of investment and financial position, the latter including USD38 billion in committed capital. Consequently, this obligation is not currently treated as debt for analytical purposes.

The sell down and debt reduction demonstrates Origin's willingness to adopt strong countermeasures to shore up its financial position as projected earnings from its core Energy Markets division remain volatile in the face of evolving operating conditions.

The sell down also reduces the company's exposure to oil price volatility because APLNG's LNG export revenue is linked to oil prices, and to environmental and social risks associated with APLNG's gas production from onshore wells.

The credit quality of APLNG Processing, the downstream gas liquefaction plant owned by APLNG, is not immediately affected by the sell down given our aforesaid expectations that the sale is unlikely to result in any substantial changes to APLNG's capital structure or management, while Origin will remain the upstream operator and maintain a 27.5% interest in the project. As such, the project continues to exhibit a strong alignment of interests across the project's key stakeholders.

Nicholas Chapman, CFA, *VP-Senior Analyst*
Moody's Investors Service
nicholas.chapman@moodys.com
+61.2.9270.8191

Arnon Musiker, *Senior Vice President/Manager*
Moody's Investors Service
arnon.musiker@moodys.com
+61.2.9270.8161

Sarah Xie, *Associate Analyst*
Moody's Investors Service
sarah.xie@moodys.com
+61.2.9270.1419

Towngas China's expansion into the smart energy business is credit negative

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On 25 October, Towngas China Company Limited (TCCL, Baa1 stable) entered into a subscription agreement with Clean Energy Ecosystem Pte. Ltd. Under the agreement, Clean Energy Ecosystem will invest about HKD2.8 billion ($360 million) into TCCL, comprising around 116.8 million new shares and convertible bonds with a principal amount of around RMB1.8 billion ($280 million), to be convertible into about 350.5 million new shares within five years after issuance. Clean Energy Ecosystem's equity stake in TCCL will be 13.3% of the company's enlarged share capital upon full conversion of the convertible bonds. TCCL will use the proceeds from the issuance of new shares and convertible bonds for general corporate purposes, including investment in the smart energy business.

The agreement is credit negative for TCCL in the medium term because its increased exposure to the less regulated smart energy business will increase its overall risk profile compared with its existing regulated city gas businesses in China. At the same time, the company's capital spending will increase because of the investment in the smart energy business.

The transaction signals a change in TCCL's business direction in the medium term. Specifically, management believes the smart energy business, in particular rooftop solar projects for commercial and industrial users, will complement its existing city gas distribution business and offer strong growth prospects. Such a business strategy is also in line with the Government of China's (A1 stable) decarbonisation plan. TCCL aims to derive about half of its profit from the smart energy business by 2025. Management's commitment to this new initiative is further evidenced by the impending change of the company's name to "Towngas Smart Energy Company Limited".

The actual impact on TCCL's credit quality will depend on, among other things, the pace of the smart energy business expansion; its capability to manage the associated risks; and ongoing support from The Hong Kong and China Gas Company Limited (A1 stable), its parent.

Clean Energy Ecosystem is ultimately controlled by Affinity Asia-Pacific Fund V, a private-equity fund managed by Affinity Equity Partners group.

Boris Kan, *VP-Sr Credit Officer*
Moody's Investors Service
boris.kan@moodys.com
+852.3758.1539

Ceci Wong, *Associate Analyst*
Moody's Investors Service
ceci.wong@moodys.com
+852.3758.1495

Ning Loh, *Associate Managing Director*
Moody's Investors Service
ning.loh@moodys.com
+852.3758.1668

Terry Fanous, *MD-Public Proj & Infstr Fin*
Moody's Investors Service
terry.fanous@moodys.com
+65.6398.8307

Russian central bank's latest pandemic-related measures support banks' asset quality

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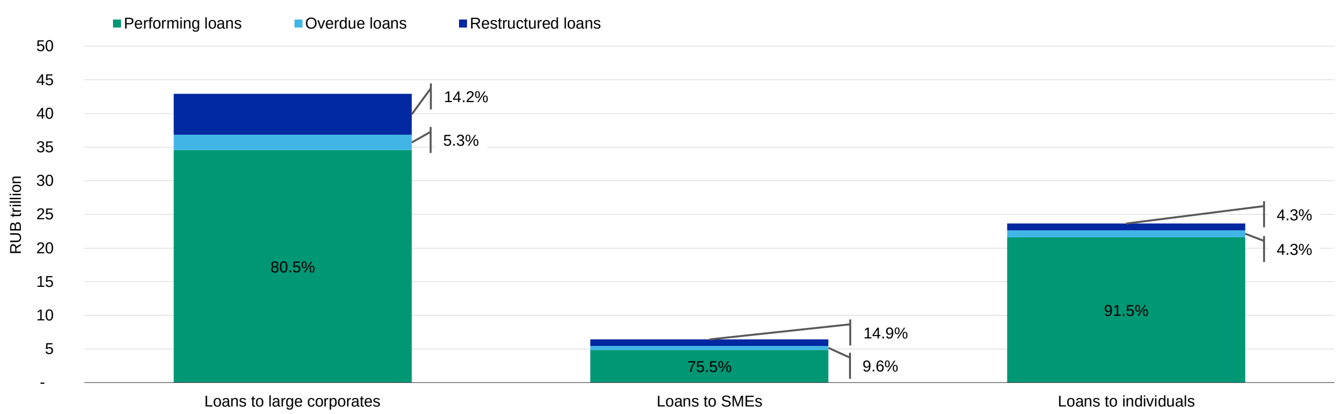
On 22 October, the Central Bank of Russia (CBR) renewed its recommendation that banks restructure loans to individuals and small and medium-sized entities (SMEs) hit by the spike in coronavirus infections that began in October. The recommendation follows the announcement of a countrywide lockdown from 30 October to 7 November, with some regions ordering even longer lockdowns. The latest restrictions will mostly affect SMEs and employees in the service sector. In addition, beginning 1 November and through year end, CBR will provide banks RUB60 billion in cheap financing to extend concessional loans to SMEs.

The CBR's measures support banks' asset quality by giving borrowers the flexibility to weather temporary pandemic-related problems and accumulate resources to return to normal debt servicing. CBR stopped its pandemic-related loan restructuring recommendation 1 October after extending it several time since first offering it March 2020. According to data as of 29 September, 14.9% of bank loans to SMEs and 4.3% of loans to individuals have been restructured since March 2020 (see exhibit). The CBR estimated in January that only 20%-30% of restructured loans would slip into a problematic category.

Restructuring loans allowed banks to avoid sharply increased loan delinquencies
Russian banks' overdue and restructured loans as % of total loans, by loan segment, as of 29 September 2021



Overdue loans are overdue more than 90 days.
Sources: Central Bank of Russia and Moody's Investors Service estimates

While still recommending that banks restructure pandemic-affected SME and individual's loans, the CBR stopped offering banks regulatory forbearance as of 1 July. Since then, banks have classified any newly restructured loans as problem loans and put in place associated loan loss reserves. The proper classification makes banks true asset quality transparent since forbearance provisions do not mask problem loans, and expected credit losses immediately appear in the banks' books.

We forecast that the banking sector credit losses under local GAAP will be 1.0%-1.5% of average gross loans in 2021, a material reduction from the 2.4% ratio in 2020. The systemwide pre-provision profitability, which benefits from a roughly 4% net interest margin and ample transactional fee and commission income, can absorb the expected credit losses without any regulatory forbearance.

Another CBR measure for SMEs is a new credit facility for concessional lending, whereby the CBR offers banks funding at 4% per annum, which they can then lend to SMEs at 8.5% per annum, or one percentage point above the CBR's 7.5% key interest rate. The CBR's new facility is RUB60 billion. Although the facility equates to only around 1% of the sector's aggregate SME loan portfolio, it adds to the CBR's RUB500 billion SME concessional loan facility in place since March 2020 and complements the government's support package announced 20 October to provide subsidies and concessional loans to SMEs affected by the latest wave of the pandemic.

Victoria Voronina, *Associate Analyst*
Moody's Investors Service
victoria.voronina@moodys.com
+7.495.228.6113

Olga Ulyanova, *VP-Sr Credit Officer*
Moody's Investors Service
olga.ulyanova@moodys.com
+7.495.228.6078

Russia proposes tightening consumer lending regulations, a credit positive for banks

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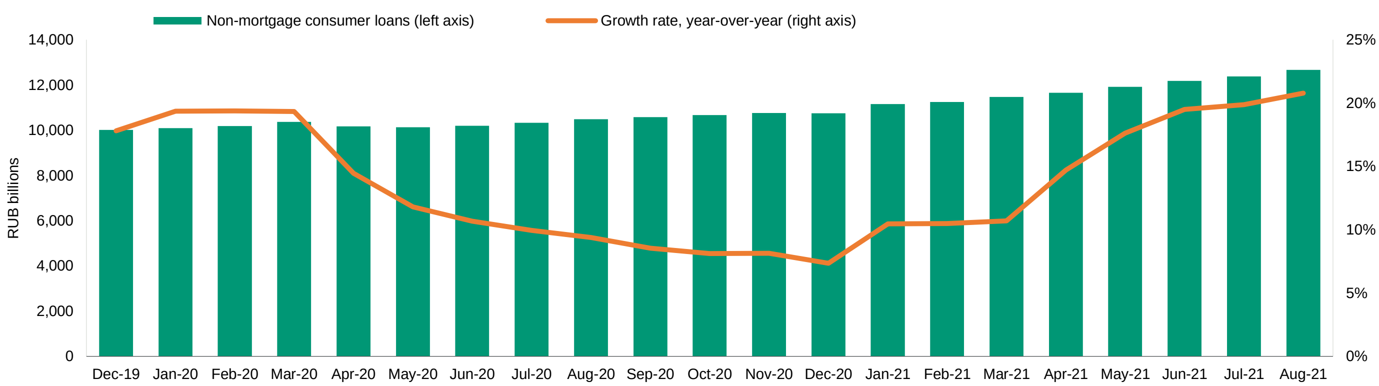
On 21 October, the State Duma, the lower chamber of the Russian Parliament, approved at the first reading a bill allowing the Central Bank of Russia (CBR) to limit the volume of unsecured loans provided by banks and microfinance organizations to households. The new limitations would set a maximum share of certain loan types as a percent of total loans issued during a quarter. The new measure is credit positive for Russian banks because it will expand the toolkit available for the CBR to slow excessive growth in unsecured consumer lending amid subdued household real disposable income. Additionally, the measure will incentivize banks to significantly reduce or discontinue making loans to individuals with high payment-to-income (PTI) ratios.

The new regulation will slow the loan book and net revenue growth of banks focused on the consumer lending segment, including Post Bank, Home Credit & Finance Bank and Tinkoff Bank (Ba2/Ba2 positive, ba3[1]), as well as large universal banks with sizable consumer loan portfolios, including Sberbank (Baa3/Baa3 stable, ba1) and Bank VTB, PJSC (Baa3/Baa3 stable, b1).

Since the end of last year, year-over-year consumer loan growth has accelerated, reaching 21% in August 2021 from 7% in December 2020 (see Exhibit 1). Driving the surge are relatively low interest rates and strong demand from borrowers whose cash flows were hit in 2020 because of the coronavirus pandemic. Household income was particularly hard hit by pandemic-related unemployment last year that has not yet returned to pre-pandemic levels (see Exhibit 2).

Exhibit 1

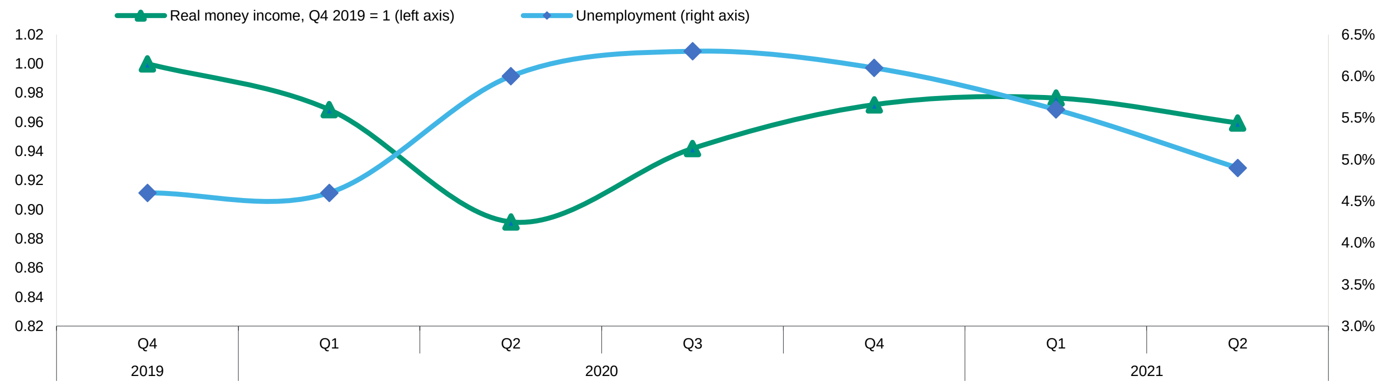
Consumer loan growth in Russia has accelerated this year



Source: Central Bank of Russia

Exhibit 2

Russian household income and unemployment rates have not yet returned to pre-pandemic levels



Source: Russia's Federal State Statistics Service (Rosstat)

Accelerated consumer lending led to overleveraging in some Russian households, as reflected in higher PTI ratios. Earlier this year, CBR Governor Elvira Nabiullina disclosed that the share of high-risk loans provided to borrowers with PTI ratios of more than 80% increased to 30% of all issued loans in the second quarter of 2021 from 23% in early 2020 before the pandemic.

To counter the risk of households becoming overleveraged, the CBR has taken several steps to tame excessive loan growth by encouraging consumer lenders to set aside more capital against those loans. In April and July 2021, the CBR announced higher risk-weight requirements for risky consumer loans with high annual percentage rates (APRs) and loans issued to borrowers with high PTI ratios. Those new requirements applied to loans issued from 1 July for high APR loans and 1 October 2021 for loans to borrowers with high PTI ratios. Nevertheless, year-over-year growth rates have still exceeded 20%.

Endnotes

1 The ratings shown in the report are the banks' deposit rating, senior unsecured debt rating and Baseline Credit Assessment.

Petr Paklin, *VP-Senior Analyst*
Moody's Investors Service
petr.paklin@moodys.com
+7.495.228.6051

Victoria Voronina, *Associate Analyst*
Moody's Investors Service
victoria.voronina@moodys.com
+7.495.228.6113

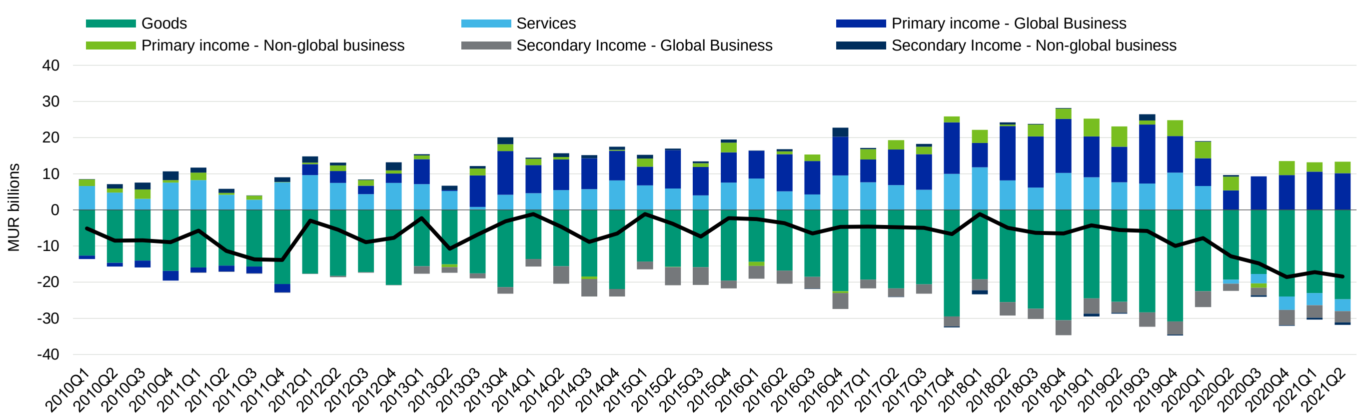
Mauritius' removal from FATF grey list will ease external vulnerability risks

On 21 October, Mauritius (Baa2 negative) was formally removed from the Financial Action Task Force's (FATF) list of jurisdictions for increased monitoring, after being placed on the so-called grey list in February 2020 because of deficiencies in its anti-money-laundering and combating the financing of terrorism (AML CFT) regimes. Removal from the grey list removes a significant risk for local banks' foreign activities and encourages capital flows into the country, ensuring Mauritius's reputation as an attractive, low-cost international financial center for Africa-focused investors. As an off-shore financial center, Mauritius's confidence-sensitive off-shore deposits influence its external position.

Maintaining competitiveness in a strict global regulatory environment is paramount for the country's economic recovery. We forecast 2022 GDP will accelerate to 6.7% from around 5.0% in 2021, and that the current account deficit will narrow.

With business flows likely to remain stable or improve, we expect the current account deficit will improve to 7.6% in 2022 from an average of 11.6% for 2020-21. Global business corporation (GBC) flows historically comprise the majority of net inflows in the country's current account (see exhibit), and play an important role in the economy and the external sector.

Global business flows are a major source of net inflows
Current account balance



Sources: Statistics Mauritius and Moody's Investors Service

Mauritius's exit from the FATF list also demonstrates the government's responsiveness to addressing challenges for the off-shore banking sector and the economy. The government worked with FATF to review and amend applicable policies. After the country was placed on the grey list, the government agreed to a detailed action plan and remedied 39 of the 40 regulatory gaps that FATF identified.

In May 2020, the EU also placed Mauritius on its blacklist of high-risk countries with strategic deficiencies in their AML-CFT Framework. Inclusion on the blacklist subjects financial transactions to enhanced due diligence and potentially discourages new GBC flows. Once the European Commission reviews FATF's information, we expect Mauritius will also be removed from the EU blacklist.

The government recognizes the need to adapt the offshore sector's focus to higher value-added sectors such as treasury management and trade finance and away from a sole focus on tax treaty advantages, particularly amid international tax transparency challenges. As part of its longer-term strategy, the government continues to pursue its Africa Strategy, which positions Mauritius as the link between Asia (China and India) and Africa. As part of that effort, for several years it has pursued a strategy to establish Mauritius as a fintech hub in Africa, leveraging its legal and financial regulatory regime to foster fintech activity. In 2016, the government introduced a regulatory sandbox licensing framework to support the development of fintech activities. A post-work study visa is available for three years after completing undergraduate degree in fields such as information and communication technology, fintech, artificial intelligence and biotechnology.

David Rogovic, *VP-Senior Analyst*
Moody's Investors Service
david.rogovic@moodys.com
+1.212.553.4196

Matt Robinson, *Associate Managing Director*
Moody's Investors Service
matt.robinson@moodys.com
+44.20.7772.5635

Domenico Barbieri, *Associate Analyst*
Moody's Investors Service
domenico.barbieri@moodys.com
+1.212.553.9567

Concessional and market-based financing vastly undershoots emerging market countries' climate-resilience funding needs

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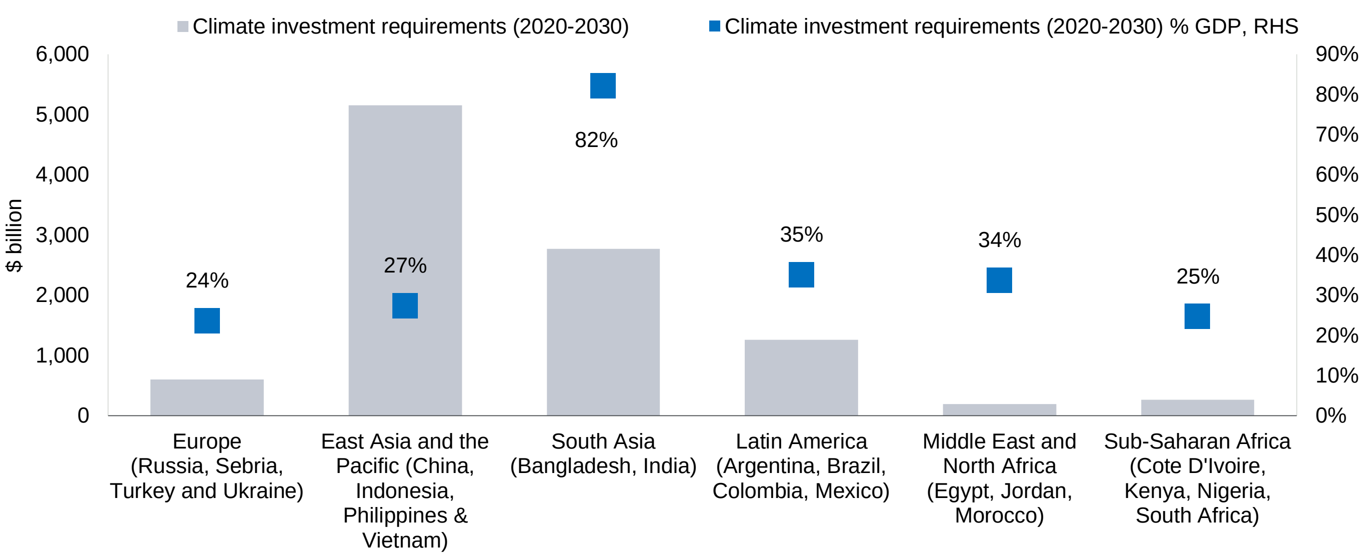
The capital investment needed by emerging market (EM) sovereigns to meet their climate-transition goals is significant. Based on national climate-change commitments and other policies of 21 EMs,[1] the International Finance Corporation (IFC) identified $10 trillion in green-investment opportunities between 2020 and 2030.[2] The International Energy Agency (IEA) estimates that EMs will need to increase their spending on clean-energy initiatives sevenfold to more than $1 trillion annually, or 3% of their GDP by the end of this decade to remain on track for net-zero emissions by 2050.[3] The OECD estimates an annual figure of around $4.1 trillion would be needed to address climate-change mitigation and adaptation as well as other environmental issues in EMs between 2015 and 2030.[4] In this report, we proxy the green-financing requirements of 21 EMs on the IFC's 2020 green investment opportunity estimates. Relative to GDP, these investment requirements vary significantly by region, from around 20% in Europe to around 80% in South Asia.

At the same time, the capacity of EM governments to invest in green initiatives is constrained, especially in the midst of the pandemic when almost all EM governments have seen a significant decline in fiscal revenue and an intensification in their spending pressures.

Exhibit 1

Green investment requirements vary by region, but are highest relative to GDP in South Asia



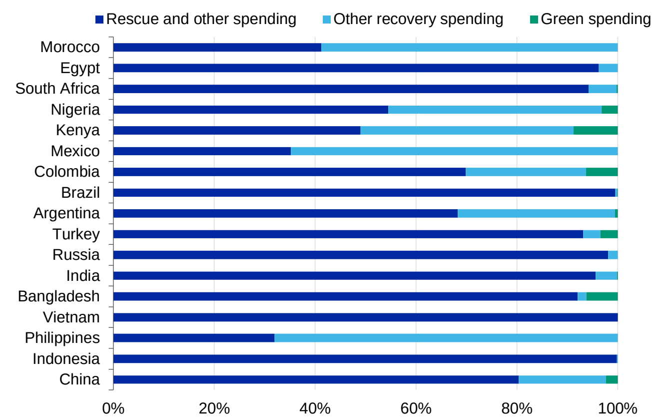
We proxy the green-financing requirements of 21 EMs based on the IFC's 2020 green investment opportunity estimates.
Sources: International Finance Corporation, Haver Analytics and Moody's Investors Service

For the 21 EM countries referenced in this report, government spending on green initiatives has fallen to $54 billion since on the onset of the pandemic or $5 billion if China is excluded, which accounts for 5% of the estimated average annual investment requirements for the 21 EMs covered in this report (see Exhibits 2 and 3). We expect advanced economies will commit to increasing bilateral support from the $28 billion they provided to EMs in 2019,[5] but high government debt levels are a legacy of the coronavirus crisis and are likely to weigh on any sizeable increases going forward. As a result, we expect public spending will fall well short of EMs' estimated investment needs.

Multilateral development banks (MDBs) are playing a critical role in closing this investment gap, especially in places where private investment has been limited to date. In 2020, they committed $66 billion in climate finance globally, with around $38 billion directed to EMs. MDBs have also pledged to increase this figure to $50 billion by 2025. The Africa Development Bank for example will increase its climate finance target to $25 billion for 2020-25, double the $13 billion it spent between 2015 and 2020 (for details see appendix).

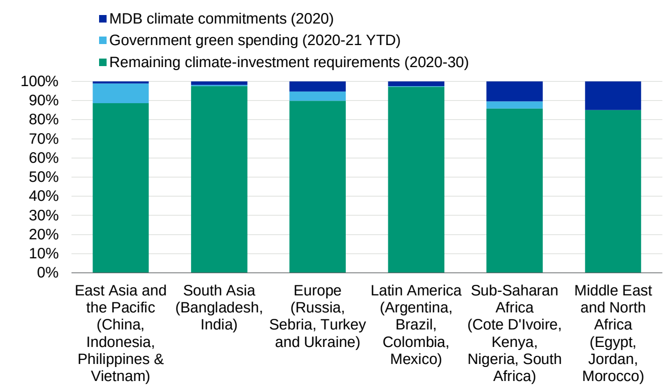
However, apart from a small number of African and European countries, the size of MDBs commitments falls well short of most countries' climate-investment requirements. Collectively, MDBs and EM public investment in 2020 accounted for around 10% of the IFC's $1 trillion figure. As a result, absent a significant increase in government spending, private-sector finance will need to play a major role in closing the gap. In fact, the IEA estimates[6] over 70% of clean energy investment will need to come from private capital.

Exhibit 2
Green recovery spending only accounts for 2% of total EM government spending to counter the pandemic
% of total government recovery spending since the pandemic



Source: The Global Recovery Observatory

Exhibit 3
MDB commitments and government green recovery spending accounted for a fraction of climate-investment requirements in 2020



Sources: International Finance Corporation, Joint report on multilateral development banks, and Moody's Investors Service

The capacity of domestic markets to fund these kinds of investment varies. According to the IFC estimates made in 2016 when a country-level breakdown was last available, South Africa (Ba2 negative), Kenya (B2 negative), Vietnam (Ba3 positive) and Brazil (Ba2 stable) had the highest level of climate investment required relative to their national savings rates. Argentina (Ca stable), Kenya and Egypt (B2 stable) had much larger climate investment requirement compared with domestic market funding capacity (see Exhibit 4).

The potential for external private investment is much larger, but EM issuance of green bonds had hovered around $50-60 billion pre-pandemic before falling to $40 billion in 2020. That said, the number of EMs tapping sustainable debt markets has more than doubled over the last decade, with issuers from India and Brazil raising $33 billion and $31 billion, respectively. We expect private investment to flow into countries with the strongest policy environments. MDBs will play a crucial role by helping EMs build relevant policy frameworks to attract private-sector finance and demonstrating the viability of green solutions.[7] For example, private-sector co-financing in green EM initiatives alongside MDBs was $85 billion in 2020 alone.

Across the 21 EM countries covered in this report, countries in Latin America, Southern Asia and Sub-Saharan Africa face the most significant financing gaps given the size of their investment requirements relative to GDP, constraints on government balance sheets and the relatively limited involvement of private-sector investment to date (see Exhibit 4). In Latin America, heatmap indicators for MDB funding, fiscal space and domestic funding capacity are the lowest among the 21 EMs covered in this report. In African countries, relatively shallower domestic funding markets and tight fiscal space still pose challenges towards climate financing despite greater support from MDBs. They also face some of the highest exposure to environmental risks, as assessed by our Environmental Issuer Profile scores.[8]

By contrast, East Asian countries have more fiscal space given relatively lower government debt levels and interest payments relative to government revenue. They also have higher national savings rates and relatively developed capital markets, which will support domestic funding capacity, especially in countries with relatively smaller investment need. Lastly, even for emerging European countries, which are generally in better position thanks to their relatively lower climate investment need, ample fiscal space, sizeable domestic capital and banking market, there is still a significant gap to close over the coming decade.

Exhibit 4

Most EMs face significant funding shortfalls in meeting their climate-investment needs over the coming decade

		Investment requirement*		Funding capacity									Environmental risk
				MDB funding	Fiscal space		Domestic funding capacity			External funding capacity			
		Total climate investment requirement (2016-2030, $ billion)	Avg. annual investment requirement 2016-2030 (% 2021 GDPe)	MDB climate commitments % avg. annual climate investment requirement (2020)	Govt debt level % GDP (2021)	Gen. gov. interest payments % gov. revenue (2021)	Avg. annual investment requirement % gross national savings (2019)	Avg. annual investment requirement % domestic credit to private sector (2019)	Avg. annual investment requirement % domestic capital market (2020)	Avg. annual investment requirement % FDI (2019)	Green bond issuance % GDP (2020)	Green bond issuance % GDP (2021)	Environmental issuer profile score
East Asia and the Pacific	China	15000	5.9%	0.2%	45%	5%	13%	4%	6%	534%	0.15%	0.25%	E-3
	Indonesia	274	1.6%	4.8%	44%	21%	5%	4%	6%	73%	0.23%	0.07%	E-3
	Philippines	115	1.9%	10.1%	51%	9%	8%	4%	6%	88%	0.22%	0.53%	E-4
	Vietnam	753	13.5%	1.3%	38%	7%	44%	11%	n.a.	311%	n.a.	0.05%	E-3
South Asia	Bangladesh	138	2.6%	13.2%	35%	22%	9%	7%	n.a.	482%	n.a.	n.a.	E-5
	India	2100	4.6%	2.4%	89%	26%	16%	10%	13%	277%	0.03%	0.18%	E-4
Europe	Russia	313	1.3%	n.a.	20%	2%	5%	2%	5%	65%	n.a.	n.a.	E-3
	Serbia	9	1.0%	55.7%	60%	5%	5%	3%	n.a.	14%	n.a.	1.90%	E-3
	Turkey	270	2.4%	9.1%	39%	8%	9%	4%	11%	194%	0.01%	0.16%	E-3
	Ukraine	73	2.8%	18.6%	56%	7%	29%	11%	n.a.	83%	n.a.	n.a.	E-3
Latin America and the Caribbean	Argentina	338	5.5%	4.7%	92%	11%	33%	31%	20%	338%	n.a.	n.a.	E-3
	Brazil	1300	5.4%	1.5%	84%	14%	43%	7%	4%	125%	0.08%	0.03%	E-3
	Colombia	195	4.2%	6.2%	68%	11%	24%	8%	12%	91%	n.a.	n.a.	E-3
	Mexico	791	4.2%	1.6%	42%	12%	20%	11%	8%	180%	0.07%	0.02%	E-3
Sub-saharan Africa	Cote d'Ivoire	10	0.9%	51.1%	42%	13%	5%	6%	n.a.	79%	n.a.	0.17%	E-3
	Kenya	81	5.0%	10.1%	71%	24%	58%	17%	n.a.	405%	n.a.	n.a.	E-4
	Nigeria	104	1.4%	7.2%	30%	35%	7%	13%	n.a.	301%	0.03%	n.a.	E-5
	South Africa	588	9.6%	0.7%	79%	17%	66%	8%	13%	766%	n.a.	n.a.	E-3
Middle east and north africa	Egypt	174	2.9%	12.1%	90%	48%	20%	16%	n.a.	129%	0.19%	n.a.	E-4
	Jordan	23	3.4%	25.0%	113%	18%	23%	4%	n.a.	186%	n.a.	n.a.	E-4
	Morocco	48	2.5%	26.4%	77%	9%	9%	3%	n.a.	186%	n.a.	n.a.	E-4

*We proxy the green financing requirements of 21 EMs on IFC's 2016 green investment opportunity estimates between 2016 and 2030, where the latest country level estimates from IFC are available. The total estimate of investment opportunity was $23 trillion for the period between 2016 and 2030. Because these estimates do not take into account investments made during 2016 and 2020, they are different from numbers presented in Exhibit 1 and 3, with major differences arising from East Asia. MDBs' climate commitments are sourced from 2020 joint report on multilateral development banks. Environment issuer profile scores (IPS) measure the exposure of an issuer or transaction to environmental considerations. We score sovereigns' environmental IPSs on a scale of E-2 (Neutral-to-Low) to E-5 (Very Highly Negative).

Sources: International Finance Corporation, Joint report on multilateral development banks, Haver Analytics, Dealogic Analytics and Moody's Investors Service

Exhibit 5
MDB climate finance targets for 2020s

Multilateral development banks	Climate-finance targets	2020
African Development Bank	A doubling of climate finance to US$ 25 billion for the period 2020-25, giving priority to adaptation finance.	$2.1 billion
Asian Development Bank	By 2024, 65% of the number of its committed operations will address climate change, and for the period 2019-24 the ADB will provide US$ 35 billion for climate finance from its own resources. By 2030, at least 75% of the number of its committed operations will be supporting climate change mitigation and adaptation. Climate finance from the ADB's own resources will reach US$ 80 billion for the period 2019-30.	$5.3 billion
AIIB	Reflecting its commitment to support the Paris Agreement, the AIIB will aim to reach or surpass by 2025 a 50% share of climate finance in its actual financing approvals.	$1.1 billion
European Bank for Reconstruction and Development	Green finance is to account for more than 50% of total annual EBRD investment by 2025, including both mitigation and adaptation.	$2.3 billion
European Investment Bank	The EIB will gradually increase the share of its financing dedicated to climate action and environmental sustainability to exceed 50% of its operations in 2025.	$3.2 billion
Inter-American Development Bank Group	Projects supporting climate change mitigation and/or adaptation for 2020-23 above 60% of operations.	$2.5 billion
Islamic Development Bank	The IsDB is committed to a climate finance target of 35% of total financial commitment by 2025.	$0.2 billion
World Bank Group	The WBG announced a target for an average of 35% of its financing to be climate finance over the period, from 26% for 2016 and 2020.	$21 billion

Source: Joint report on multilateral development banks

Endnotes

1 These countries represent 62% of the world's population and 48% of global emissions.

2 Investment opportunities are based on available policies that are pave the way to net-zero. They use bottom-up approach, estimating investment for key sectors including renewable energy, distributed generation and storage, buildings, transport, waste, agriculture, carbon capture, airlines and shipping. for details, see A green reboot for emerging markets, IFC.

3 See Financing clean energy transitions in emerging and developing economies.

4 See Green finance and investment: mobilising resources for sustainable development and climate action in developing countries.

5 See Climate Finance Provided and Mobilised by Developed Countries: Aggregate Trends Updated with 2019 Data.

6 See Financing clean energy transitions in emerging and developing economies.

7 The IFC has outlined a range of measures that it believes it will help crowd-in private finance, like effective and transparent business taxation, regulation, legal enforcement of property rights, frameworks for public-private partnerships, and proactive investment policies all help to build investor confidence. It also pointed out that the relative newness of the green investment sector in many EMs meant financial incentives may be needed to address the associated risks for firms and all segments of the financial sector.

8 Environment issuer profile scores (IPS) measure the exposure of an issuer or transaction to environmental considerations. We score sovereigns' environmental IPSs on a scale of E-2 (Neutral-to-Low) to E-5 (Very Highly Negative). For more details, see General principles for assessing Environmental, social and governance risks methodology

Ruosha Li, *AVP-Analyst/CSR*
Moody's Investors Service
ruosha.li@moodys.com
+44.20.7772.8638

Claire Li, *AVP-Analyst/CSR*
Moody's Investors Service
claire.li@moodys.com
+1.212.553.3780

Colin Ellis, *MD-Credit Strategy*
Moody's Investors Service
colin.ellis@moodys.com
+44.20.7772.1609

Higher inflation will not undermine US banks' profitability if managed effectively

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Summary

US banks are in good shape to maintain their profitability through the current period of elevated inflation, which in our base case will subside in 2022 but settle a little above 2%, on average, long-term. But if high inflation persists beyond this time frame, the potential for credit negative responses by banks will rise. As a whole, the banking system's historical profitability has not been directly correlated with inflation, though banks particularly exposed to interest rate risk have suffered when rates spiked to combat inflation. Notably, the last period of high inflation several decades ago precipitated significant interest rate hikes, as well as regulatory and business model changes that contributed to a later wave of bank failures.

» **Continued strong economic growth and firmer inflation, currently concentrated in the goods sector, will likely prompt a rise in interest rates.** We expect price pressures to show up in the services sector as the pandemic recedes, with consumers and businesses flush with cash from historic levels of fiscal and monetary support. Meanwhile, goods sector inflation will depend on whether supply chain issues are soon resolved. We expect benchmark short-term interest rates will increase, likely beginning in 2023.

» **Elevated inflation has not previously led to a direct decline in US banks' profitability or an immediate rise in bank failures.** We found no direct correlation between inflation and profitability, or the failure rate, in the US banking system as a whole. However, the Federal Reserve responded to the last extended spike in inflation by sharply raising interest rates, which hurt the economy and induced subsequent destabilizing business model and regulatory changes, particularly at thrifts.

  – Further, if rising inflation leads to higher interest rates but does not weigh on the ongoing expansion, that will unlock the value of banks' huge core deposit franchises, a boost to profitability.

  – Moreover, loan loss provisioning has shown no historical correlation with inflation, often because subsequent interest rates hikes have been gradual, giving banks and borrowers time to adjust. However, a sudden and significant increase in rates would likely lead to elevated loan delinquencies and provisions.

» **How banks respond to persistently high inflation will influence the ultimate impact on their profitability.** Because bank management teams have had no experience operating in a persistent inflationary environment, their strategic responses in that scenario could have unintended, credit negative implications.

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