Credit Outlook

17 January 2022

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New stablecoin consortium is credit positive for founding banks

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On 12 January, a group of US community banks launched a consortium to offer their customers a new bank-minted stablecoin, called USDF. Stablecoins are digital assets or a cryptocurrency backed by another asset and designed to have a stable value, such as being tied to the US dollar.

The establishment of the consortium is credit positive for its founding bank members,[1] which include New York Community Bank (A3 stable, baa2[2]), NBH Bank, FirstBank, Sterling National Bank and Synovus Bank (A3 stable, baa2), because it gives them the ability to send and receive payments and other digital assets in real time, facilitating faster, cheaper and more secure money movement than traditional payments systems. This new capability could attract new customers and additional deposits given the recent rapid increase in the use of stablecoins. It also provides bank members with the opportunity to replace legacy payments-related revenue with new revenue sources to the extent newer digital currency payments systems reduce the share of banks' existing payments systems.

USDF will operate on the public Provenance Blockchain and will be redeemable on a 1:1 basis for cash from a consortium bank member with real-time settlement. USDF can supplement customer wire, ACH, SWIFT and interchange payments, and will provide bank members with cross-selling opportunities and support new products, such as digital securities lending, capital call lines of credit, crypto lending and loan servicing, although some of these products may entail greater risk because of their lack of clear regulation and price volatility.

The consortium could bring further stability to, and acceptance of, digital currency payments systems within the regulated banking system, thereby encouraging technology advancements and alleviating some of the competitive threats posed by the currently unregulated stablecoin industry and nonbank digital payments initiatives. USDF will be a bank-minted alternative to Tether's USDT and Circle's USD coin (USDC), the two largest stablecoins by market value.

The consortium will attempt to address the consumer protection and regulatory concerns that have been raised in connection with nonbank issued stablecoins, including the inability to verify the level of collateral reserves that these stablecoins maintain. The alternative financial system around the growing volume of digital payments, transfers and lending activities lacks the traditional banking and payments systems' stronger regulation and risk management frameworks that protect customers, limit illicit activities and control systemic risk. USDF will be unique from existing stablecoins in that the senders and receivers of the digital currency will be highly regulated, FDIC-insured institutions, and transaction activity will be driven by customers who have been through a member bank's regular anti-money-laundering (AML) and know-your-customer (KYC) processes.

USDF should also be compliant with the proposals in the President's Working Group on Financial Markets' (PWG) 1 November 2021 report, which recommends that entities performing critical activities for the functioning of stablecoins, including stablecoin issuers and custodial wallet providers, have appropriate regulatory oversight, strong risk management policies and procedures and be subject to limits on their affiliations with commercial entities. The PWG report also proposed that Congress pass legislation requiring that stablecoin issuers be banks.

The consortium will likely encourage other banks to participate in the cryptocurrency world in some form, with USDF providing banks with a foundation for a broader digital asset strategy.

Despite the benefits to the consortium bank members, the use of stablecoins likely comes with increased operational and regulatory risk related to new customers who will need to be screened for AML/KYC risks.

Endnotes

[1] The online lender Figure Technologies, Inc. and the bank-owned venture fund JAM FINTOP are also founding members of USDF.

[2] The bank ratings shown are the bank's deposit rating and Baseline Credit Assessment.

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Germany's planned increase in capital requirements is credit positive for bank creditors and covered bonds

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On 12 January, German banking supervisory authority BaFin announced[1] its intention to implement a countercyclical capital buffer (CCyB) requirement of 0.75% of domestic risk-weighted assets (RWAs) and an additional 2.0% buffer specific to RWAs from domestic loans backed by residential properties.

The higher capital requirement is credit positive for unsecured and secured creditors of German banks because it encourages banks to hold higher capital ratios and rein in currently dynamic mortgage lending growth. These effects should help moderate growth in property prices and the risk of a significant future price correction. Such developments would support the solid solvency profiles of the German banks and covered bond issuers that we rate.

Germany is aiming for these macroprudential measures to take effect on 1 February 2023. A specific buffer for residential mortgage exposures had previously also been applied by the Swiss Financial Market Authority (FINMA) during the past decade. CCyB's had been introduced or announced by a broad range of European countries, including Germany, prior to the coronavirus outbreak, when most reduced these back to zero. Since then, several have raised their rate again, as Exhibit 1 shows.

Exhibit 1

Overview of European regulators' recent changes in CCyB

Selected countries with CCyB above zero (not all changes listed for the specific country)

Country	Date of Announcement	CCyB rate	Change	Application since	Previous CCyB	Application since
Bulgaria	9/16/2021	1.00	Increase	10/1/2022	0.50	4/1/2020
Czech Republic	11/25/2021	2.00	Increase	1/1/2023	1.50	10/1/2022
Denmark	6/23/2021	1.00	Increase	9/30/2022	0.00	3/12/2020
Estonia	11/30/2021	1.00	Increase	12/7/2022	0.00	1/1/2016
Germany*	**1/12/2022**	**0.75**	**Planned**	**2/1/2023**	**0.00**	**2/1/2021**
Iceland	9/29/2021	2.00	Increase	9/29/2022	0.00	3/18/2020
Luxembourg	12/29/2020	0.50	Confirmation	1/1/2021	0.50	1/1/2021
Norway	12/16/2021	2.00	Increase	12/31/2022	1.50	6/30/2022
Romania	10/15/2021	0.50	Increase	10/17/2022	0.00	1/1/2016
Slovakia	1/26/2021	1.00	Confirmation	2/1/2022	1.00	8/1/2020
Sweden	9/29/2021	1.00	Increase	9/29/2022	0.00	3/16/2020

* 0.75% rate not yet settled; 2% of additional buffer not included in the exhibit.

Sources: European Systemic Risk Board (ESRB) and BaFin

European countries have also adopted specific measures in reaction to dynamic house price and mortgage lending growth, mostly targeting risk model output or new business underwriting, as Exhibit 2 shows. In particular, many countries have set borrower-based lending limits on, for example, maximum loan maturity, loan-to-value (LTV), loan-to-income (LTI) and debt-service-to-income (DSTI) levels. While BaFin has so far refrained from setting lending limits for residential mortgages - a relative credit weakness for German banks and covered bonds - it highlights the option of implementing such measures in the event that loan underwriting discipline starts to deteriorate.

Exhibit 2

Overview of potential measures in relation to house price and lending growth

Selected measures used by other countries	Capital measures		Lending measures	
	Capital requirements	**IRBA floor**	**Credit growth limit**	**Borrower-based limits**
Details	Sectoral CCyB. Set at the individual bank level with the aim of protecting the banking sector from periods of excess credit growth associated with the build-up of systemic risk. Lowered to 0% in response to the pandemic because of risk of the housing market heating up further.	Floor for average risk weights for real estate exposures (residential and/or commercial). Where the exposure-weighted average risk weight is lower than the floor, total risk-weighted assets should be increased correspondingly.	Lending growth for individual customer segments must be below 15% per year. Relevant segments comprise private homeowners, residential rental properties, agricultural properties and other businesses.	For residential mortgage lending, loan size and maturity are limited according to borrower-specific ability to pay. Loan size limits often include a maximum LTV set between 80% and 90%. LTI and DSTI limits are also commonly used.
Examples	Switzerland	Belgium, Finland, Luxembourg, Norway, Sweden	Denmark	Denmark, Estonia, Finland, Ireland, Norway, Poland, Slovakia

Sources: ESRB and FINMA

Germany's announced measures will reduce the pace of mortgage lending growth in particular for the few banks that BaFin identified without naming them as in need of additional capital to comply with future capital requirements. On a systemwide basis, BaFin estimates that the two capital buffers – which by far exceed the 0.25% CCyB first announced in 2019 and which was then withdrawn amid the coronavirus outbreak – will bind around €22 billion of additional core capital in the banking system, €17 billion of which will be from the CCyB and €5 billion from the sectoral systemic risk buffer for mortgage loans. We expect these additional requirements to be covered by current excess capital buffers in the case of the banks we rate in Germany.

At the same time, the measures will influence competitive dynamics in new lending because they will result in residential mortgage and multifamily property lending market share gains for nonbanks, which are not subject to the additional capital requirements. A supplemental 2.75% Common Equity Tier 1 requirement for credit RWAs on newly underwritten mortgage loans significantly adds to an average minimum total capital guidance of around 13% of RWAs which BaFin set for small and midsize German banks it directly oversees after its last stress test just before the pandemic.

Thanks to a lower RWA density on mortgage exposures, banks that use internal rating models to determine credit risk weights will likely benefit when competing with smaller retail banks that apply the standardised approach in RWA-setting. This may in part reverse market share gains in recent years achieved by the cooperative sector's primary banks.

Endnotes

[1] The German-language announcement is available at https://www.bafin.de/dok/17220302.

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Liberty Tire's debt-financed acquisition of Rubberecycle is credit negative

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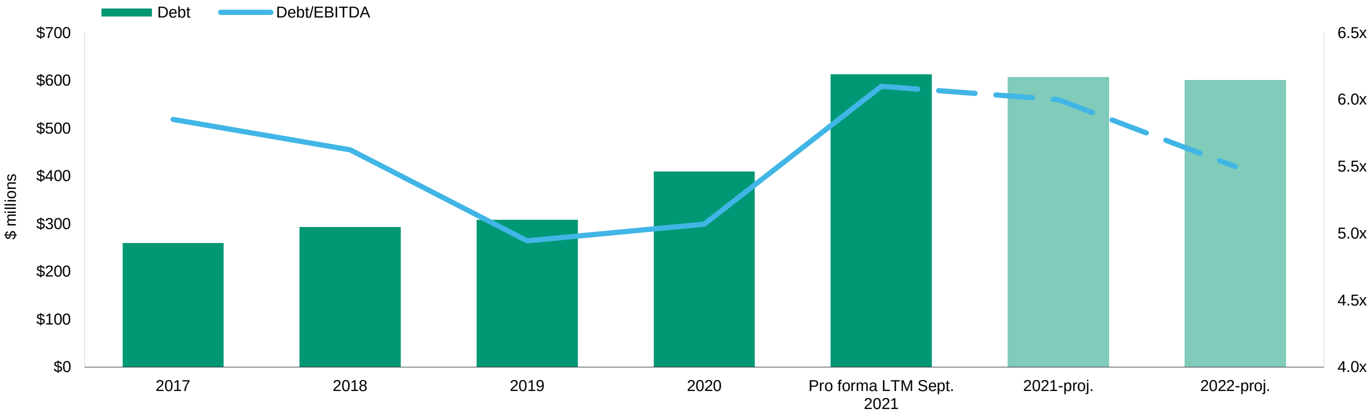
On 11 January, LTR Intermediate Holdings, Inc. (Liberty Tire, B3 stable) announced that it had entered into a definitive agreement to purchase Rubberecycle Corporation, a New Jersey-based manufacturer of reusable rubber products. We view the transaction as credit negative because it will increase Liberty Tire's financial leverage while presenting execution and integration risks.

Liberty Tire will fund the transaction with a $150 million term loan add-on that will be fungible with the company's existing $410 million principal term loan due May 2028, increasing the size of the facility to $560 million. Proceeds from the incremental term loan will be used to fund the acquisition of Rubberecycle, repay $12 million outstanding on the company's revolving credit facility, add a modest amount of cash to the balance sheet, and fund transaction fees and expenses.

Pro forma Moody's adjusted debt-to-LTM EBITDA will rise to roughly 6.1x from 5.2x as of 30 September 2021. Although this is a material increase, we expect Liberty Tire's leverage to improve to around 5.5x by the end of 2022, driven largely by profitability growth.

We expect leverage to improve to around 5.5x by year-end 2022 from the pro forma level



Sources: Moody's Financial Metrics and Moody's Investors Service projections

Despite the increase in leverage, the acquisition of Rubberecycle will significantly increase Liberty Tire's presence in the northeast US, add over 70 million pounds of used tire processing capacity, and strengthen the company's production capabilities and ability to manufacture higher-value and higher-margin rubber tire mulch. Rubberecycle's northeast presence provides logistical advantages, placing the company closer to certain end-customers while providing access to transfer stations in key geographic markets. Rubberecycle also completed a facility upgrade in April 2021 that should enable it to increase its tire recycling capacity.

Liberty Tire's liquidity is expected to remain adequate over the next 12 months, supported by our expectation of free cash flow in the $20-$30 million range and full availability under the $60 million revolving credit facility due 2026. The company will also have $17 million of pro forma cash as at 30 September 2021. The revolving credit facility will likely be used for bolt-on acquisitions, working capital needs and general corporate purposes.

LTR Intermediate Holdings, Inc., through its principal subsidiary, Liberty Tire Recycling Holdco, LLC, provides scrap tire collection and rubber recycling services mainly in the US and in Canada. Its three main revenue streams are inbound collections, or fees received for used tire collections; grade/used tires or the resale of roadworthy tires; and beneficial reuse, or outbound products derived from processing recycled tires into various alternative applications. Revenue was $592 million for the 12 months ended 30 September 2021.

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Royal Philips lowers expectations for 2021 results, a credit negative

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On 12 January, Royal Philips N.V. (Baa1 stable) announced it now expects to generate group sales of approximately €17.2 billion for full-year 2021, a decline of around 1% from the previous year, and a group adjusted EBITA margin (company definition) of approximately 12%. These preliminary results are weaker than the company's previous guidance and lower than we had expected, a credit negative, though the Baa1 rating with stable outlook remains unchanged at this point.

We previously forecast growth of 2% in the company's group sales and a 13.5% adjusted EBITA margin (company definition) for 2021. While we would need a more comprehensive set of results to precisely calculate Moody's adjusted metrics, it is likely that by the end of 2021 the company's debt/EBITDA (Moody's adjusted) will exceed the 3x downgrade trigger we set for the current rating, indicating Philips is weakly positioned in its rating category.

The performance during the fourth quarter of 2021 was weaker than the company previously expected because of intensified global supply chain shortages and the postponement of equipment installations by hospitals, which are struggling with the current surge in COVID infection rates.

Our ratings are forward looking and take into account the trajectory of the operating performance over the next 12-18 months. The company's order intake grew by 4% during the fourth quarter of 2021 compared with the year-earlier period and its order book reached an all-time high level, indicating potential for future growth. Philips' ability to execute its order backlog and generate revenue growth combined with continued positive free cash flow generation over the next quarters will be important drivers of its rating positioning.

Philips also announced that it increased its field action provision by around €225 million to around €725 million. This provision aims at covering the remediation costs (repair, replacement and communication with customers) linked with the product recall initiated in June 2021 of certain of the company's sleep and respiratory care devices. Philips estimates that the field action will be completed in 2022. In our previous forecast, we already included a €700 million field action provision, a more conservative assumption than the €500 million the company initially planned. Hence, the provision increase that was announced on 12 January does not change our previous assumptions.

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Castellum's replacement of its CEO heightens corporate governance risk, a credit negative

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On 10 January, Castellum AB (Baa2 stable), a major listed real estate company in Sweden, announced that its board of directors had appointed current chairman Rutger Arnhult as CEO, replacing Biljana Pehrsson with immediate effect. We understand the decision followed an assessment by the board of what would be required for the successful integration of Kungsleden AB (Baa3 review for upgrade) into Castellum; the board had not agreed with Pehrsson how this work should be executed. Castellum completed its offer for Kungsleden in November 2021. In addition, on 13 January Castellum's CFO, Ylva Sarby Westman, announced that she will also leave the company.

These latest changes of senior management personnel follow significant senior management fluctuations last year, when the preceding CEO and CFO also left the company in quick succession after Arnhult, Castellum's anchor shareholder, took a more prominent position within the group as chairman of the board.

High senior management turnover is adding to existing corporate governance risks that are increasingly weighing on Castellum's credit quality. These changes create additional uncertainties because they come at a time when the group has completed the sizeable acquisition of Kungsleden, which requires dedicated management capacity for a smooth integration. While Kungsleden and Castellum are active in similar subsegments and integration complexity for real estate companies is generally lower than for other companies, the two have followed different strategies when it comes to, for example, asset management.

So far, we have refrained from taking negative rating action, considering the generally positive sector sentiment as well as the company's commitment to prudent financial policies, including keeping the combined group's total debt/total asset ratio well below 45%.

Arnhult's appointment as CEO is also credit negative because it raises a number of additional corporate governance risks, making Castellum vulnerable to event risk. Arnhult owns 17.8% of Castellum and is by far its largest shareholder. He is also a significant owner of another listed real estate company, Corem Property Group AB, with 36% of the votes and 33.36% of the capital. Ownership of two companies raises conflict of interest risks, for example, in the event that both companies compete for the same assets or by allowing the owner access to confidential information relating to the other company that could be used for personal benefit. Both Corem and Castellum have similar portfolios, with offices making up the largest property type by far.

In addition, cross ownership could raise the risk of Arnhult focusing more on protecting Corem's liquidity than Castellum's in the event of a sharp market downturn. It is difficult to know how highly levered the dominant owner's total holdings are. If the equity market dries up, companies would have to raise funds from banks or the bond market, which would increase debt and erode credit quality.

Castellum board member Per Berggren has been appointed chairman of the board until the annual general meeting on 31 March 2022. As well as leaving his position as Castellum's chairman, Arnhult also left the Nomination Committee, but he remains a board member.

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Better-than-expected sales growth is credit positive for China auto, auto-part and auto dealer companies

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On 12 January, the China Association of Automobile Manufacturers (CAAM) released data showing that China's auto unit sales rose 3.8% in 2021 compared with 2020. The growth was higher than our expectation of 1.0% and reflects a better than expected recovery in automobile production, supported by an improvement in the supply of semiconductors (also known as chips) and steady demand for automobiles in China. The development is credit positive for Chinese automakers, auto-part makers and auto dealers because it reflects a greater likelihood of higher auto sales in 2022.

Auto production in China has been hindered by a global shortage of semiconductors. The principal cause of the shortage was a significant downturn in auto sales in the first half of 2020, which led to a severe cutback in chip production. Semiconductor makers subsequently reallocated capacity to consumer electronics because of strong demand for these products. After this significant reallocation of chip production and sales, global auto demand rebounded more strongly than expected in the second half of 2020 and in 2021, resulting in a severe shortage of chips for automakers. We forecast industry growth of around 6% in 2022 and expect a gradual improvement in semiconductor supplies, which will allow for a continued recovery in global auto sales.

China's auto unit sales – defined as unit sales of passenger and commercial vehicles made in China – were 1.6% lower in December 2021 than in December 2020, according to CAAM. This follows declines of 9.1% in November, 9.4% in October and 20% in September compared with the same months in 2020. While December sales were lower than the same period a year earlier, the decline in percentage terms was the smallest since May 2021, when auto sales in China first contracted, a result of a tightening of chip supply globally. The narrowing sales decline was supported by a recovery in auto production, with December 2021 production rising 2.4% compared with the same month a year earlier, the first month of growth since April 2021.

Because of narrowing declines during October-December 2021 and solid growth in the first nine months of the year, China's auto unit sales grew to 26.3 million units in 2021, the first year in which auto sales have expanded since 2017, when sales reached a historic high of 28.9 million. We expect year-over-year auto unit sales growth of 3% in 2022, reflecting a continued recovery in production, supported by improved semiconductor supply and stable demand for automobiles. The likelihood of higher auto sales will increase if the recovery in production – supported by better chip supply – is greater than expected, while demand continues to hold steady.

China's auto unit sales are driven by the country's economic growth, which we expect will be 5.3% in 2022. China's still low vehicle penetration rate – around 199 vehicles per 1,000 people in 2020, according to data from the Ministry of Public Security and National Bureau of Statistics – will continue to support sales growth over the longer term.

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TSMC's robust 2022 revenue growth guidance reflects continued strong demand, a credit positive

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On 13 January, Taiwan Semiconductor Manufacturing Co Ltd (TSMC, Aa3 stable) announced robust 2022 revenue growth guidance, which was above our expectations. The company said its revenue will increase by a mid- to high-20s percentage in US dollar terms – faster than the market's overall growth rate in 2022 – driven by continued demand in its smartphone, high-performance computing, Internet of Things and automotive segments. This strong demand is credit positive because it will drive TSMC's solid earnings growth in 2022.

In announcing its 2021 financial results, which were in line with our expectations, the company said revenue increased 18.5% year on year to NTD1.59 trillion ($56.8 billion), underpinned by strong growth in its high-performance computing segment, which grew 34%. Additionally, revenue in the smartphone segment increased by 8%, in the Internet of Things segment by 21% and in the automotive segment by 51%.

TSMC expects the global market for foundry chipmaking (contract chip manufacturing) to grow 20% in 2022 because of strong demand from fifth-generation (5G) wireless technology-related and high-performance computing-related applications.

We have raised our revenue growth forecast to 25% to NTD1.98 trillion in 2022 from our previous projection of 12.5%. TSMC's solid revenue growth will be supported by strong demand for its advanced nodes (7-nanometer chips and below), especially for its 7-nanometer and 5-nanometer chips, which were introduced ahead of its competitors and have gained significant market share as the most advanced nodes in the industry.

5G wireless technology-related and high-performance computing-related applications will drive semiconductor content enrichment, increasing demand for TSMC's advanced technologies.

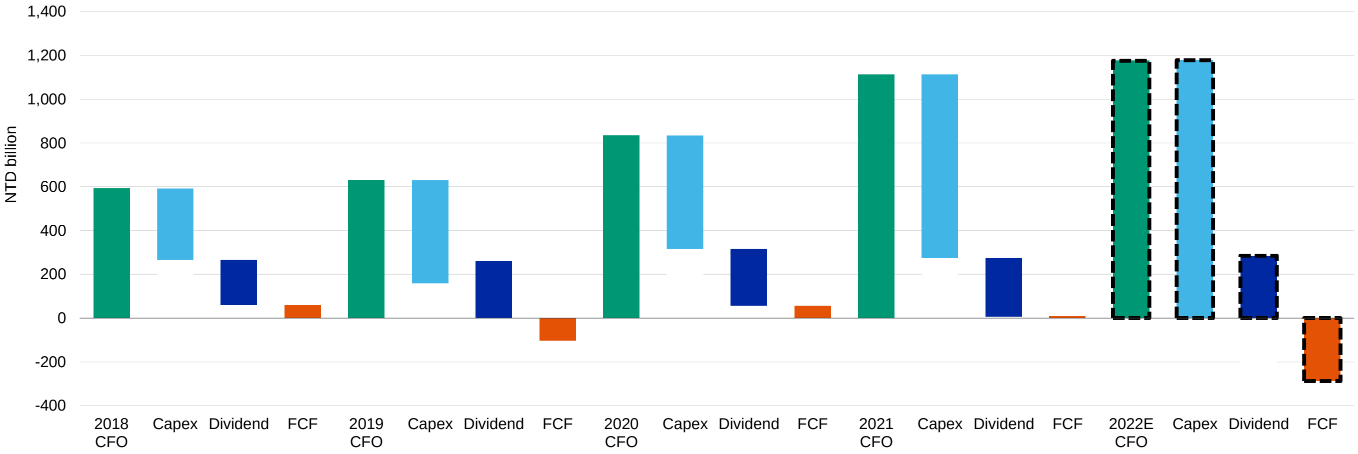
Additionally, TSMC raised its long-term revenue growth rate to a compound annual growth rate (CAGR) of 15%-20% over the next few years in US dollar terms to reflect strong demand from its smartphone, high-performance computing, Internet of Things and automotive segments. This growth rate is above its previous long-term revenue growth guidance for 2020 to 2025 of near the high end of the 10%-15% range.

TSMC's adjusted EBITDA margin declined slightly to 68.3% in 2021 from 68.6% in 2020 mainly because of a weaker gross margin on account of an unfavorable foreign exchange rate and the introduction of 5-nanometer technology, with a weaker gross margin in the early production stage. Its reported gross margin decreased to 51.6% in 2021 from 53.1% in 2020.

We expect the company's adjusted EBITDA margin will remain relatively stable at about 68% in 2022, driven by cost and expense control.

We also expect TSMC to generate negative free cash flow in 2022 (see exhibit) driven by higher capital spending to support its strong revenue growth, meet solid customer demand and maintain its dominant market position over the next few years. The negative free cash flow will be mitigated by strong earnings growth and a relatively stable dividend policy.

TSMC is likely to generate negative adjusted free cash flow in 2022



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

Specifically, we project TSMC will generate negative NTD288 billion ($10.3 billion) in adjusted free cash flow in 2022. Its capital spending will be around $42 billion in 2022, up from $30 billion in 2021, to support advanced technology developments, including 7-nanometer, 5-nanometer, 3-nanometer and 2-nanometer chips, and the construction of its new manufacturing facilities in Arizona, US (Aaa stable) and Japan (A1 stable).

However, we project that the company will maintain a strong net cash position over the next two years, which will provide a strong buffer against industry cyclicality and allow for business expansion. Its strong earnings growth will partially fund its capital expenditure, with its adjusted net cash position set to decrease to NTD138 billion in 2022 from NTD424 billion in 2021.

TSMC is the market leader in pure semiconductor foundry services. The company manufactures products for various platforms, covering a variety of smartphone, high-performance computing, Internet of Things, automotive and digital consumer electronics segments.

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Navient's settlement of state lawsuits reduces legal and regulatory uncertainty, a credit positive

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On 13 January, Navient Corporation (Ba3 stable) announced agreements with 40 state attorneys general to resolve all previously disclosed multistate litigation and investigations. The settlement is credit positive for Navient because it removes a large uncertainty that had weighed on the company's credit profile for many years, and allows the company to focus on its core businesses as well as reduce future legal expenses. The cost of the settlement is limited and equivalent of around one to two quarters of the company's average net income.

In January 2017, several states, along with the US Consumer Financial Protection Bureau (CFPB), filed lawsuits alleging that Navient had violated consumer financial laws. The claims included offering predatory and misleading subprime loans to students as well as failing to help borrowers enroll for and reenroll for Income Driven Repayment plans.

As part of the settlement with the state attorneys general, Navient will cancel approximately 66,000 of legacy private student loans totaling approximately $1.7 billion that were largely originated between 2002 and 2010 to borrowers who subsequently defaulted. The vast majority of borrowers attended certain for-profit schools, such as Corinthian and ITT, which closed years later.

Because these loans defaulted many years ago, Navient has already almost entirely charged off their balance, and with the settlement has taken a $50 million charge for the remaining amount. In addition, the company will make a onetime payment of $145 million to the states, $94 million of which will provide restitution payments to approximately 360,000 borrowers who were placed in certain long-term forbearance programs with the remaining amount to cover the states' legal costs.

As part of the settlement, Navient "expressly denies violating any law, including consumer-protection laws, or causing borrower harm" and agreed to maintain its servicing practices that "support borrower success."

The CFPB lawsuit remains outstanding. While the claims of the CFPB suit are basically the same as the states' claims, the outcome and time for resolution is uncertain. The company believes a trial will not commence in 2022. We expect any cost of the CFPB lawsuit to be limited relative to the company's profits. However, we consider student loan providers to face high social risks. The most relevant social risks for these companies arise from the way they interact with their customers. Costs that materially increase the company's leverage or impair its franchise would be credit negative.

Combined with the 28 September announcement that the company had agreed to transfer to Maximus, Inc. (Ba2 stable) its US Department of Education (DOE) loan servicing contract, the company will be able to increase its focus on its core private student loan origination and servicing business, managing its legacy student loan portfolio that is largely composed of federal guaranteed student loans, and continuing to expand its business services activities, a credit positive.

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Changes to overdraft policies at Bank of America and Wells Fargo are credit positive

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On 11 January, both Bank of America Corporation (A2 positive) and Wells Fargo & Company (A1 negative) announced a number of changes to their consumer overdraft policies, including a reduction in overdraft fees at Bank of America (overdraft fees are charged when the bank pays a check or electronic transaction despite an account having insufficient funds).

The moves are credit positive for several reasons. From a social risk perspective, the changes have the potential to improve customer relations and reduce political and regulatory pressures. From a competitive position, the moves help the banks compete more effectively against financial techology (fintech) challenger banks touting their no-fee deposit accounts as superior to those offered by incumbent banks.

From a financial perspective, overdraft-related charges contribute a relatively small proportion of total net revenues, and the resulting revenue loss will likely be more than offset this year by the positive effect of higher interest rates.

The changes at Bank of America and Wells Fargo follow announcements last year by several other banks to either eliminate overdraft charges entirely, such as Ally Financial Inc. (Baa3 stable) and Capital One Financial Corporation (Baa1 stable), or to adopt policies that make it easier for customers to avoid such charges. They also add to previous customer-friendly steps taken by both banks in this area in recent years. While neither bank has entirely eliminated overdraft charges, both banks appear to have gone further than many of their peers in reducing the burden on customers from these charges.

The changes announced include the following:

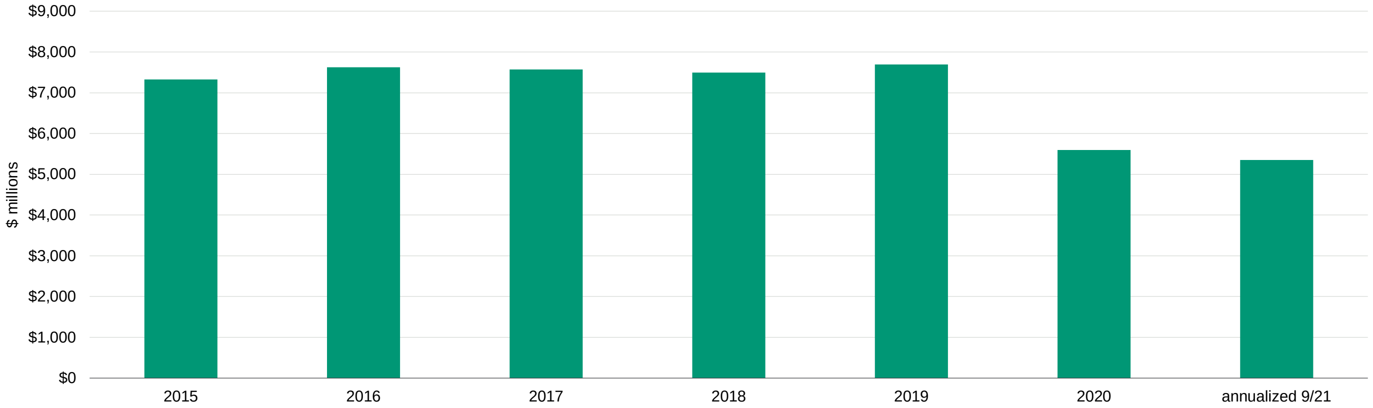
- Eliminating non-sufficient funds fees (charged when a check or electronic transaction is not paid because of a lack of funds) (both banks)
- Eliminating fees on automatic transfers from a linked account to cover an overdraft (both banks)
- Lowering overdraft fees to $10 from $35 (Bank of America only)
- Eliminating a customer's ability to incur an overdraft at an automated teller machine (Bank of America only)
- Introducing a 24-hour grace period for customers to deposit funds to avoid an overdraft fee (Wells Fargo only)
- Offering early access (by two days) to eligible direct deposits (Wells Fargo only)
- Offering a short-term loan of up to $500 to cover an overdraft for a flat fee (Wells Fargo; Bank of America introduced a similar product in 2020)

Overdraft-related charges at the 10 largest US banking groups with a significant retail banking business are down considerably from pre-pandemic levels (see Exhibit 1). In addition to previous changes in overdraft policies, fiscal stimulus has bolstered low- and moderate-income households' finances, helping them avoid these charges. During the first nine months of 2021, overdraft-related charges reported at each group's lead banking subsidiary contributed on average only 1.4% of group-wide total net revenues (see Exhibit 2), but this reliance varies widely. At Bank of America, total overdraft-related charges accounted for 1.2% of total net revenue, while Wells Fargo's reliance was slightly higher at 1.8%.

Exhibit 1

Overdraft-related charges at the 10 largest US retail banks are down 29% from pre-pandemic levels

Aggregate overdraft-related charges at 10 largest US banks with significant retail operations

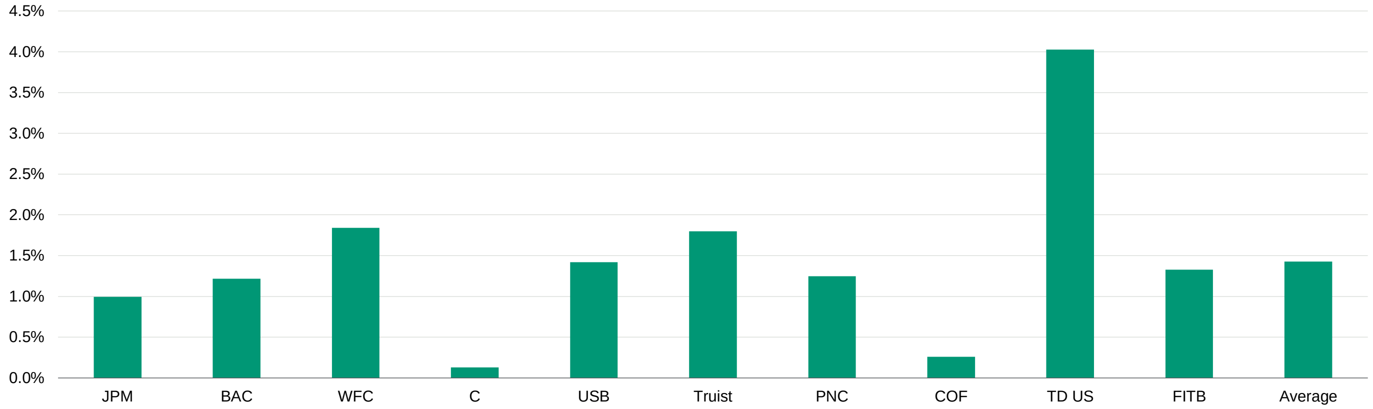


Includes JPMorgan Chase & Co., Bank of America Corporation, Wells Fargo & Company, Citigroup Inc. U.S. Bancorp, Truist Financial Corporation (Branch Banking and Trust Company and Suntrust Bank before December 2019), PNC Financial Services Group, Inc., Capital One Financial Corporation, TD Group US Holdings LLC and Fifth Third Bancorp.
Sources: The banks and Moody's Investors Service

Exhibit 2

Reliance on overdraft-related charges is relatively modest at most large US banks

Overdraft-related charges at lead bank as % of groupwide net revenues, year-to-date September 2021



Key: JPM = JPMorgan Chase & Co.; BAC = Bank of America Corporation; WFC = Wells Fargo & Company; C = Citigroup Inc.; USB = U.S. Bancorp; Truist = Truist Financial Corporation; PNC = PNC Financial Services Group, Inc.; COF = Capital One Financial Corporation; TD US = TD Group US Holdings LLC; FITB = Fifth Third Bancorp
Source: The banks and Moody's Investors Service

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Itaú’s acquisition of digital broker Ideal is credit positive

Originally published on 14 January 2022

On 13 January, Itaú Unibanco Holding S.A. (Itaú, Ba3 stable) announced that it had reached an agreement with Ideal Holding Financeira S.A., a digital broker platform, and its subsidiaries (Ideal) to acquire 100% of Ideal’s equity. The transaction is credit positive for Itaú because it will enable the bank to add to its portfolio of financial products the services of electronic trading and direct market access provided by the cloud-based broker.

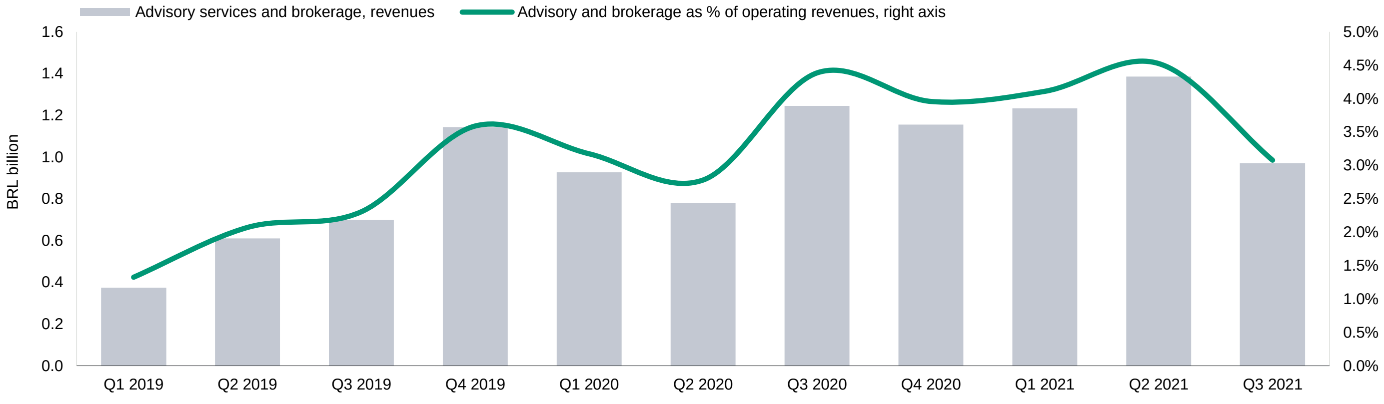
Additionally, Ideal will allow Itaú to increase its origination of fee-based revenue and reinforce Itau's position as stronger competitor against XP Inc. (XP, Ba2 stable) and Banco BTG Pactual S.A. (BTG, Ba2 stable, ba2[1]) in the brokerage and investment services segment focused on retail customers, under the model of Broker as a Service (BaaS). According to Itaú, Ideal is one of the leading brokers by trading volume on B3 S.A. – Brasil, Bolsa, Balcão (Ba1 stable), Brazil's vertically integrated exchange, depository and clearing house.

Ideal’s purchase will be carried out in two phases, with an initial acquisition of 50.1% of the digital broker's voting shares through a primary capital contribution and a secondary share acquisition, which together will total roughly BRL650 million ($117.5 million). After five years, Itaú will have the right to purchase Ideal’s remaining shares. Based on the terms of the deal, the total value of this transaction would be appraised at BRL1.3 billion today, however, the commercial conditions of the acquisition of the remaining shares are not defined yet. The deal is still subject to the analysis and approvals from Brazil's central bank and antitrust authority (CADE).

The initial outlay is small relative to Itaú’s consolidated shareholders' equity of BRL139 billion as of September 2021 and recurring net income of BRL19.7 billion for the first nine months of 2021. By the terms of the agreement, Ideal will remain as a separate operation from the bank, maintaining managerial independence and having no obligation to provide exclusive services to Itaú's customer base.

Itaú reported BRL3.59 billion in revenue from advisory services and brokerage, or 3.9% of operating revenues, for the first nine months of 2021 (see exhibit). The revenue from advisory services and brokerage was 21.65% higher than the year-earlier period, reflecting an increase in the volume of advisory services, mainly fees from merger and acquisitions, and of investments in 2021 amid stronger economic activity. The bank was able to improve revenue origination despite having received earnings from its former stake in XP only up to 31 May 2021, when Itaú spun off its ownership stake in XP.

Ideal's acquisition will improve brokerage revenue origination for Itaú



Itaú had an ownership stake in XP until May 2021. Figures for Q3 2021 exclude any revenue-sharing from XP.
Source: Itaú’s financial statements

From a strategic standpoint, the possibility of boosting the origination of fee-based revenue is more relevant in view of Brazil's slow economic activity and weak macroeconomic conditions for 2022, including high inflation and unemployment, which will likely weigh on revenue generation from lending. Moreover, the deal will also enable Itaú to expand its distribution network through the hiring of independent financial advisors, a model that both XP and BTG have used aggressively in recent years to increase their presence in the segment of retail investment services.

Endnotes

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

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MassMutual's launch of Martello Re reinsurer is credit negative

Originally published on 14 January 2022

On 12 January, Massachusetts Mutual Life Insurance Company (MassMutual, insurance financial strength Aa3 stable) announced that, together with Centerbridge Partners, Brown Brothers Harriman and a group of institutional and individual investors including Hudson Structured Capital Management, it had launched Martello Re, a Bermuda-based life and annuity reinsurer with $1.65 billion of starting capital.

While the transaction may provide growth opportunities for MassMutual's Barings asset manager, a fee-based business less interest-rate sensitive than its core participating whole life insurance business, it is credit negative for MassMutual, which will face reinsurance counterparty risk and greater likely investment risk from Martello Re compared with its own general account.

According to the press release, Martello Re will initially only reinsure business from MassMutual and its subsidiaries – including $14 billion of MassMutual's existing general account liabilities – and future business through a separate reinsurance agreement. Martello Re will then reinsure the liabilities of other, leading life and annuity insurers on a selective basis, which could happen in the near future, given the continuing strong market for private-equity-funded legacy insurance transactions (see exhibit). Martello Re's asset management will be shared between Baring, MassMutual's wholly owned investment manager, and Centerbridge Partners, a leading alternative asset manager. The parties expect both MassMutual reinsurance agreements to close in February subject to regulatory approval.

Low interest rates, abundant legacy business and available capital will continue to drive private-equity-led M&A in 2022
Last 10 transactions in 2021

Date of transaction	Deal value ($ billions)	Buyer/ultimate parent	Target	Target business	PE* buyer/reinsurer? (Y/N)
September-21	$1.2	Resolution Life Group Holdings LP	Lincoln National Corporation	Life	Y
October-21	$2.5	Sun Life Financial, Inc.	DentaQuest	Group Benefits	n/a
October-21	$5.8	Chubb Limited	Cigna's Personal Accident, Supplemental Health and Life Insurance Business	Life	N
October-21		Fidelity & Guaranty Life Insurance Company	Freedom Equity Group, LLC	Life	Y
November-21	$0.0	Cordillera Holdings LLP	Sunset Life Insurance Company of America	Life	Y
November-21		Venerable Holdings	Manulife Financial Corporation	VA	Y
November-21	$0.4	Resolution Life Group Holdings LP	Resolution Life Australasia	Life	Y
November-21	$1.0	Athene Holding Ltd.	Aqua Finance Inc.	Other	Y
December-21	$37.8	Sun Life Assurance Company of Canada	Dialogue Health Technologies Inc.	Other	N
December-21	$4.1	Sixth Street / Resolution Life	Allianz Life	Life	Y
TOTALS	$52.8				

* We use "PE" in the broadest sense of the term, including alternative insurance buyers and investors and asset managers.
Sources: The companies and Moody's Investors Service:

The equity investment will provide MassMutual with the opportunity to expand the private asset origination expertise of Barings to Martello Re, while the reinsurance arrangements will give it greater flexibility to manage the in-force business of its recently acquired Great American Life Insurance Company, reducing liability risk, and help it sell its annuity products more competitively. However, the reinsurance transactions are credit negative for MassMutual because they will subject the insurer to the credit risk of a new, untested offshore counterparty.

While we do not know the projected capitalization of Marcello Re or the makeup of its investment portfolio, the combination of an asset-intensive business, offshore domicile and private-equity ownership will likely result in a higher risk profile relative to MassMutual's well-established onshore business. If Martello Re encounters financial difficulties, MassMutual could be subject to reinsurance losses (or would have to recapture business ceded to the entity) because, as the direct insurance writer, it is required to pay policyholder claims first and collect reimbursement from the reinsurer afterward. The staffing of Martello Re with experienced insurance executives somewhat mitigates this risk.

Martello Re is also likely to expose MassMutual to greater investment risk relative to its own general account portfolio. Given Barings' expertise in private asset origination and that of Centerbridge in alternatives, and the somewhat looser investment guidelines offshore, credit risk and asset impairments (including of the Martello Re investment itself) will be incrementally higher if the reinsurer's assets are invested more aggressively in these asset categories, if the reinsurer encounters financial difficulty, or both. The reinsurance will be structured as a so-called funds-withheld transaction, with MassMutual retaining control of and investing in the assets for the benefit of Martello Re, so this reduces some of the risk.

Life insurers have continued to add less liquid assets, such as commercial mortgage loans and real estate, and higher-yielding alternative assets such as private debt and limited partnerships, to help boost flagging portfolio yields in the still-low interest-rate environment. Investing in a reinsurer that invests in these assets is another way of doing this. Before August 2018, reinsurer Fortitude Re, which is majority-owned by The Carlyle Group and its managed funds, started life as some of American International Group Inc.'s (AIG, Baa2 stable) legacy life and property and casualty business, an exit strategy that has worked well for AIG to date.

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CREDIT IN DEPTH

Growing global carbon transition commitment raises longer-term credit risks for hydrocarbon-reliant nations

Originally published on 11 January 2022

Efforts to arrest the pace of global warming and climate change are gathering momentum. Broader and clearer commitments from governments and businesses to lower carbon emissions, including the pledges surrounding COP26[1], point to the inevitability of an eventual structural decline in global demand for oil and gas. They also increase the likelihood of an accelerated energy transition. Furthermore, climate pledges from financial institutions mean that declines in hydrocarbon demand will likely be accompanied, if not preceded, by weaker demand for hydrocarbon-related financial assets, adding an important credit transmission channel. In this context, we update our previous analysis[2] of the credit implications of carbon transition for hydrocarbon-reliant sovereigns, focusing on the fiscal impact of alternative transition pathways outlined by the International Energy Agency (IEA).

Gathering momentum behind energy transition has intensified spotlight on longer-term credit challenges for hydrocarbon-reliant sovereigns The challenges, proportional to the sovereigns' economic, fiscal and external exposures to lower hydrocarbon demand and prices, will exert negative pressure on the credit profiles in the absence of timely adjustment.

The most likely carbon transition scenarios offer some time for adjustment, with fiscal pressures starting to build mainly in the 2030s In our baseline scenario, consistent with IEA's STEPS[3], carbon transition will remain very gradual, exerting only limited negative pressure on hydrocarbon-reliant sovereigns' credit profiles during the current decade. If all currently announced climate pledges are fulfilled on time and in full, as in IEA's APS, fiscal pressure will increase, but mainly in the 2030s.

However, faster carbon transition pathways would bring forward and intensify credit challenges If global regulation and policies change and/or investors exit the hydrocarbon sector faster than we expect, credit pressures will be particularly large for Iraq (Caa1 stable), Kuwait (A1 stable) and Oman (Ba3 stable), and – longer term – also for Azerbaijan (Ba2 positive), Qatar (Aa3 stable), Abu Dhabi (Aa2 stable) and Saudi Arabia (A1 stable).

Sovereigns with the strongest institutions and largest financial buffers are best positioned to mitigate longer-term carbon transition risks, including credit pressures under faster carbon transition. Abu Dhabi, Qatar and Saudi Arabia have the strongest capacity to adjust policies from an institutional and governance perspective. Kuwait, Abu Dhabi, Qatar and Azerbaijan have the largest sovereign wealth fund assets, which will provide financial means to facilitate and buffer the adjustment.

Click here for the full report.

Endnotes

1 See **Carbon Transition – Global: COP26 pledges point to accelerated energy transition; implementation is key hurdle**, November 2021

2 See our previous analysis in **Sovereigns – Hydrocarbon exporters: Carbon transition manageable for most; significant credit pressure in event of more ambitious transition**, July 2018

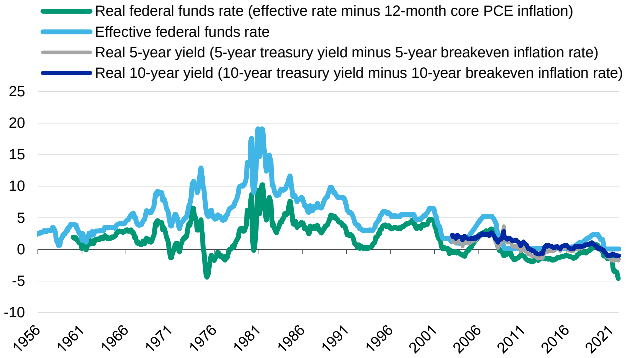
3 The two most likely carbon transition scenarios defined by IEA are STEPS, which captures currently stated and implemented climate policies, and APS, which reflects a hypothetical scenario in which all climate pledges announced to date, including all the net-zero emissions targets, are implemented in full and on time. Details of IEA's alternative carbon transition pathways are described in the Appendix.

US interest rates set to rise despite Omicron surge

Robust consumer spending, a steadily tightening labor market and high inflation implies that current US monetary policy is highly accommodative, particularly given that inflation reached 7.0% in December 2021 and interest rates are deeply negative, as Exhibits 1 and 2 show. The backdrop of elevated inflation and a tight labor market strengthens the case for an earlier and faster normalization of monetary policy. Indeed, notwithstanding the risks to growth posed by the Omicron surge, the Fed is well placed to move to a neutral monetary stance starting in March 2022, and we now expect three US interest rate hikes this year, compared with our November expectation of none until 2023.

Exhibit 1

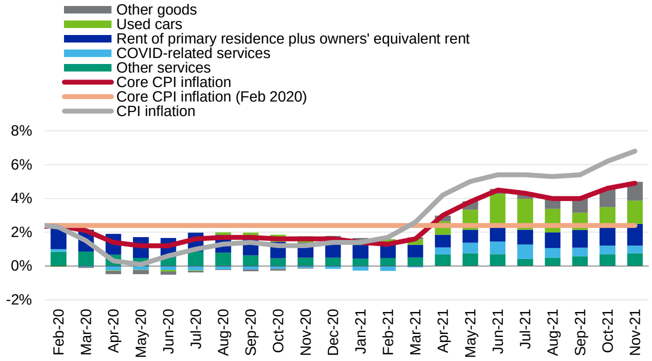
Real interest rates are deeply negative



Source: Haver Analytics and Moody's Investors Service

Exhibit 2

Energy, food and goods prices account for the bulk of US headline inflation so far



Source: Haver Analytics and Moody's Investors Service

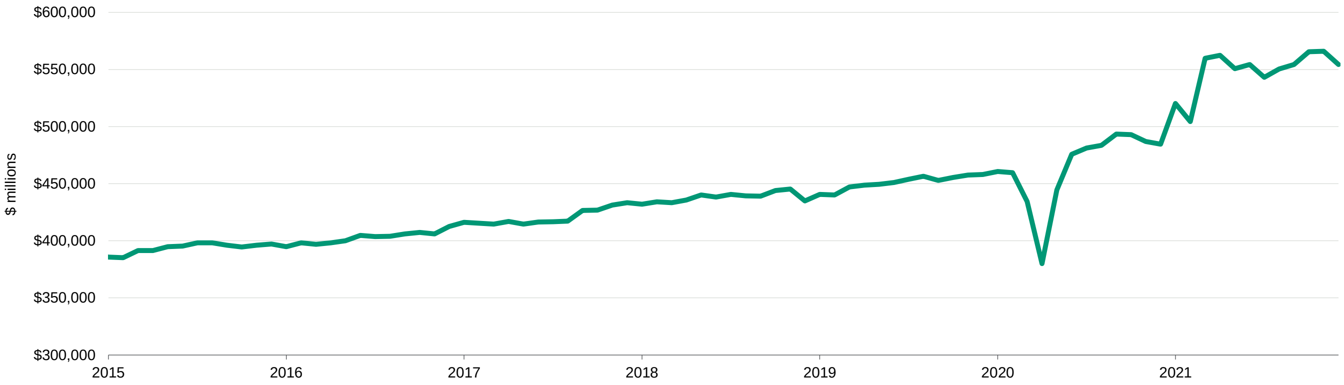
The Federal Open Market Committee (FOMC) shifted its communication on its monetary policy stance at its December meeting and announced an end to asset purchases by March this year. The minutes of that meeting and recent comments by individual members of the FOMC show broad support for both a March rate hike and balance sheet normalization soon after the rate increase cycle begins.

The economy is on a solid expansionary path that the current virus surge is unlikely to derail. In December, retail sales fell by 2.0% from November, but were well above the pre-pandemic trend (Exhibit 3). Even though the highly contagious Omicron variant is creating additional uncertainty about the economic outlook, we are maintaining our 2022 US GDP growth forecast of 4.4%, following an estimated 5.4% growth rate in 2021.

The surge in virus cases will no doubt dampen economic activity in pandemic-sensitive services industries in January, but, as previous virus surges have shown, activity will rebound once the Omicron wave begins to subside. The latest forecasts from the Institute for Health Metrics and Evaluation project that US daily COVID-19 case counts will peak at the end of this month, and that hospitalizations and fatalities will peak in mid-February.

Exhibit 3

December retail sales remained well above the pre-pandemic trend



Source: Haver Analytics and Moody's Investors Service

On inflation, we expect the headline CPI inflation rate to decline from the current level of more than 6% over the course of this year. Inflation at the end of the year is likely to be closer to 3.0%. There is still a high degree of uncertainty in the inflation forecast because the inflation rate will depend on how much the rise in prices of services offsets the likely decline in goods price inflation this year.

We expect that the Fed will provide more concrete guidance at its next January meeting as to when and at what pace it will begin to raise the federal funds rate and reduce the size of its balance sheet. Given the high degree of uncertainty and a strong desire to avoid tightening too much, we expect the Fed to take a measured approach – communicating that higher rates are inevitable, while maintaining some flexibility in both directions depending on growth, employment and inflation data.

While the Fed may not wait long after the first rate hike to begin reducing the size of its balance sheet, quantitative tightening as a separate monetary policy tool to influence long-term rates upward is still untested. Thus, the Fed will likely favor a passive approach to balance sheet normalization, letting the maturing bonds in its portfolio run off at a gradual pace, at least initially. However, if inflationary pressures fail to subside, the Fed could use its balance sheet more actively to influence long-term yields upward, thereby dampening housing and other investment activities.

Fed funds rate hikes together with balance sheet normalization will likely push both short-term rates and long-term yields upward. The low rate environment of the past several years has allowed households and firms to refinance their debt obligations and lock in low rates. The effect of rising rates is likely to be transmitted to the real sector by curbing new lending for consumer goods, autos and homes. Small and mid-size firms, which tend to have shorter debt maturity profiles, will also be affected. Lastly, higher interest rates will weigh on the valuations of risky assets.

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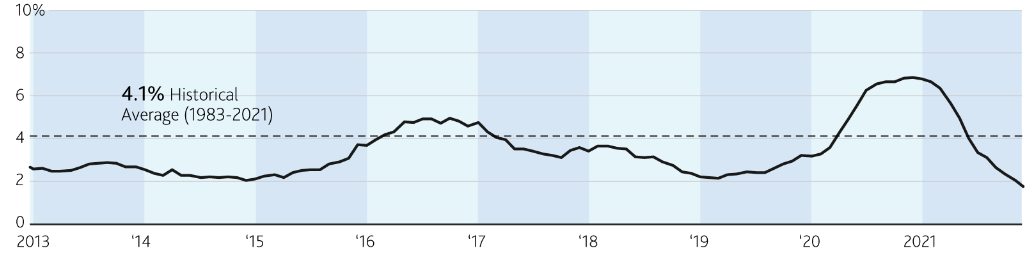
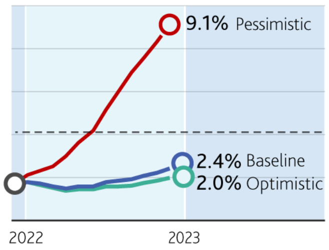
December 2021 Corporate Default Report

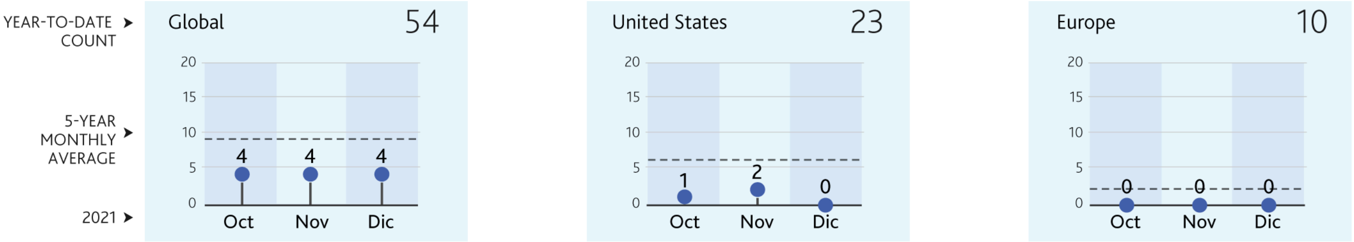
Four Moody's-rated corporate issuers defaulted in December, just as in November. There were 54 total defaults in 2021, down from 216 in 2020 and 105 in 2019, and the lowest since the 53 defaults recorded in 2011. The global economic recovery and ample liquidity kept corporate defaults low, despite the pandemic, supply chain disruptions, labor shortages and inflation. Click here for the full report.

Global Default Rate and Count

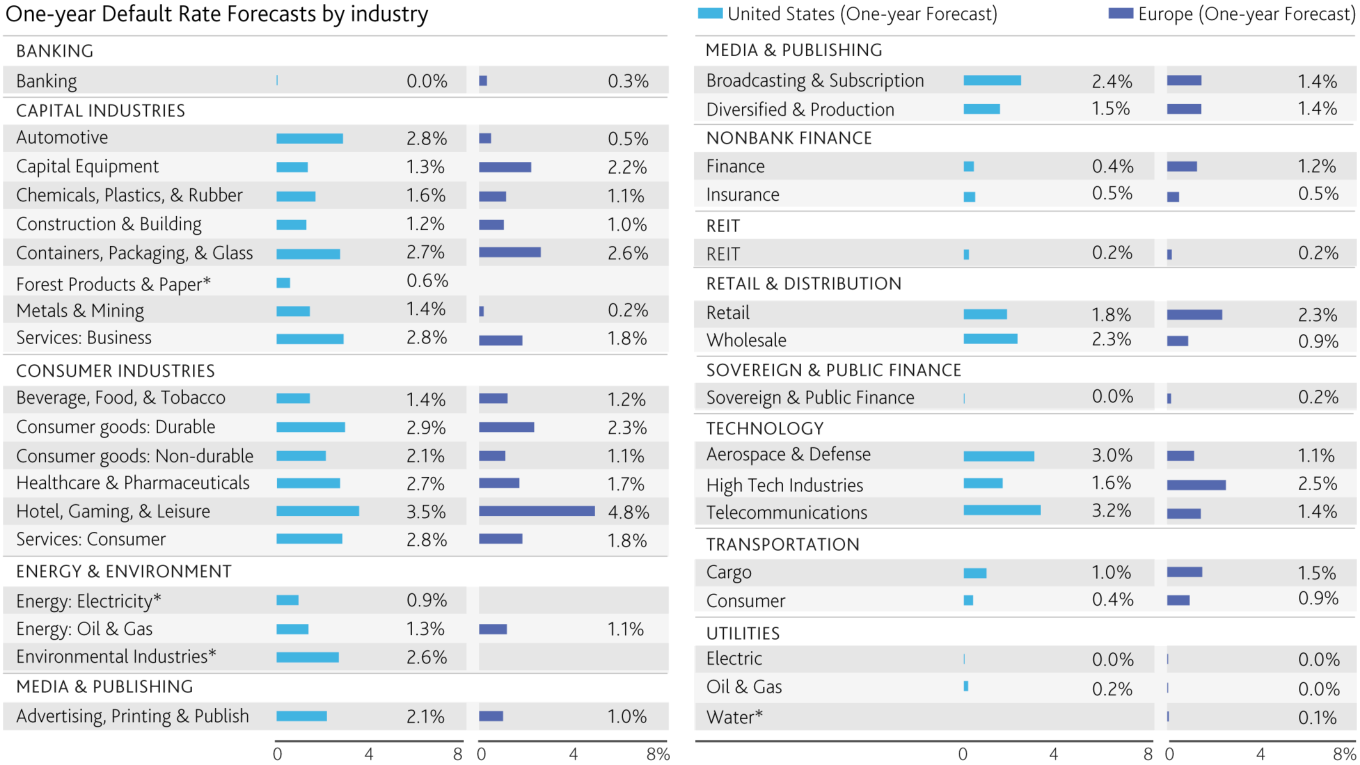


Forecast – January 2022





One-year Default Rate Forecasts by industry



	United States (One-year Forecast)	Europe (One-year Forecast)
BANKING		
Banking	0.0%	0.3%
CAPITAL INDUSTRIES		
Automotive	2.8%	0.5%
Capital Equipment	1.3%	2.2%
Chemicals, Plastics, & Rubber	1.6%	1.1%
Construction & Building	1.2%	1.0%
Containers, Packaging, & Glass	2.7%	2.6%
Forest Products & Paper*	0.6%	
Metals & Mining	1.4%	0.2%
Services: Business	2.8%	1.8%
CONSUMER INDUSTRIES		
Beverage, Food, & Tobacco	1.4%	1.2%
Consumer goods: Durable	2.9%	2.3%
Consumer goods: Non-durable	2.1%	1.1%
Healthcare & Pharmaceuticals	2.7%	1.7%
Hotel, Gaming, & Leisure	3.5%	4.8%
Services: Consumer	2.8%	1.8%
ENERGY & ENVIRONMENT		
Energy: Electricity*	0.9%	
Energy: Oil & Gas	1.3%	1.1%
Environmental Industries*	2.6%	
MEDIA & PUBLISHING		
Advertising, Printing & Publish	2.1%	1.0%
MEDIA & PUBLISHING		
Broadcasting & Subscription	2.4%	1.4%
Diversified & Production	1.5%	1.4%
NONBANK FINANCE		
Finance	0.4%	1.2%
Insurance	0.5%	0.5%
REIT		
REIT	0.2%	0.2%
RETAIL & DISTRIBUTION		
Retail	1.8%	2.3%
Wholesale	2.3%	0.9%
SOVEREIGN & PUBLIC FINANCE		
Sovereign & Public Finance	0.0%	0.2%
TECHNOLOGY		
Aerospace & Defense	3.0%	1.1%
High Tech Industries	1.6%	2.5%
Telecommunications	3.2%	1.4%
TRANSPORTATION		
Cargo	1.0%	1.5%
Consumer	0.4%	0.9%
UTILITIES		
Electric	0.0%	0.0%
Oil & Gas	0.2%	0.0%
Water*		0.1%

Podcasts and Videos

ESG Outlook 2022: Amid new pledges, action on environmental, social issues to rise to the fore - Video, 13 January 2022

Potential action in 2022 on carbon commitments will intensify investor focus on carbon transition and physical climate risk, which could have negative credit implications for carbon-intensive sectors. Policy initiatives and added disclosure obligations will increase attention on social considerations, such as labor issues and gender diversity.

Emerging Markets Decoded - Podcast: China's economic rebalancing will reduce social risks, but transition will be bumpy, 13 January 2022

Lillian Li from the Credit Strategy & Research team and Lina Choi from the Corporates team join host Shirin Mohammadi to discuss how China's common prosperity framework and new antitrust regulations will shape the credit outlook for the sovereign and businesses.

Related reports: *Government Policy – China: 'Common prosperity' agenda will create transition risks, with longer-term benefits if well implemented* and *Technology Services – China: Antitrust regulations limit market-share expansion and reduce earnings growth*

Muniland - Podcast: US state tax revenue growth will slow, ESG exposure remains for state, local governments, 13 January 2022

Marcia Van Wagner of the US Public Finance team discusses reasons behind the falloff in soaring state tax revenue growth, including expired federal pandemic aid and interest rates. Plus, Jennifer Chang, Adebola Kushimo and Coley Anderson weigh in on environmental, social and governance (ESG) issues facing state and local governments and delve into our new simplified way of communicating ESG risks.

Related reports: *States - US: Surge in tax revenue will moderate as pandemic effects evolve*and *Local Government – US: ESG considerations have neutral to low credit impact on most large US cities*

Focus on Finance - Podcast: Global life and P&C insurance outlooks stable as economies recover, 12 January 2022

Frank Yuen and Laura Bazer explain why the outlook for life insurers worldwide is less bleak than it was a year ago. Plus, Bruce Ballentine and Benjamin Serra discuss the strengths that help insulate global property and casualty (P&C) insurers from higher claims as economies reopen.

Related reports: *Life Insurance – Global: 2022 Outlook stable as shift to fee-based models and good capitalization mitigate persistent spread compression (Slides)* and *P&C Insurance - Global: 2022 Outlook stable as economies recover, capitalization is strong (Slides)*

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» Fire at Berlin production site will potentially reduce ASML's revenue growth in 2022

» Indonesia's temporary coal export ban highlights regulatory risk for miners

Infrastructure

» Veolia's acquisition of SUEZ is credit positive

» Zhejiang Provincial Energy's listed power subsidiary issues profit warning for 2021, a credit negative

CREDIT IN DEPTH

» ESG 2022 outlook: amid new pledges, action on carbon, social issues will come to the fore

» For oil and gas firms, market rebalancing will persist in 2022; focus on energy transition slowly picking up

Click here for last Thursday's Credit Outlook.

Editors

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