



CreditOutlook

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Phillips 66's share buyback increases its leverage

Last Tuesday, [Phillips 66](#) (P66, A3 negative) said that it would repurchase 35 million shares of its common stock from a subsidiary of [Berkshire Hathaway Inc.](#) (Aa2 stable) for \$3.3 billion. The share buyback is credit negative for P66 because it increases the diversified energy company's net debt and signals an aggressive financial policy.

The share repurchase exceeds P66's December 2017 cash balance of \$3.1 billion, and will increase the company's net debt and leverage. Once the company discloses its full-year 2017 financials and announces its financing plans for the share repurchase, we will have more insight into exactly how much the buyback will weaken P66's leverage.

We expect that P66 will generate higher free cash flow in 2018 as it completes its investments in capital projects, and as refining margins continue to rebound. The recent change in US tax law will further boost P66's cash flow as it benefits from higher bonus depreciation, lower taxes on repatriated overseas cash and lower US corporate tax rates. We project that P66's ratio of retained cash flow to debt will improve to more than 20% in 2018 from 17% as of 30 September 2017.

But P66's 2018 free cash flow, combined with any future equity issuance by its master limited partnership subsidiary, [Phillips 66 Partners LP](#) (PSXP, Baa3 stable), is unlikely to cover P66's cash outflows from the new share buyback, which comes on top of ongoing quarterly share repurchases during the year. P66 likely will have to fund the share repurchases partially with debt, thereby reducing some of the deleveraging benefit as earnings grow.

P66 has been shareholder-friendly in recent years, even during a downturn in refining profit margins, buying back more than \$1 billion of common shares annually during 2013-17. The company also generated negative free cash during 2014-17 owing to high capital spending, mainly for chemical and midstream projects, and weak refining margins from the second half of 2015 through 2017. Its debt has increased as a result, and profits from new projects have yet to offset it.

Meanwhile, P66 has been contending with high leverage since 2016, when it increased debt balances to help fund PSXP's growth and continued share repurchases amid reduced cash flow from weak refining margins. P66 in late 2016 raised debt at PSXP to fund a dropdown of assets from P66, giving P66 proceeds to buy back some common shares. Together, these factors drove P66's ratio of retained cash flow to debt to a low of 12% at year-end 2016 from 43% at year-end 2015.

Although P66 indicates that the new buyback does not change its overall strategy, it will delay the consolidated company's deleveraging through organic earnings growth, assuming no further change to its capital spending plans or the existing pace of share repurchases. By distributing a substantial amount of its existing cash cushion to its shareholders, P66 is reducing its own liquidity and will therefore require additional external funding to maintain its current plans.

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For Teva, another approval of a generic form of Copaxone is credit negative

Last Tuesday, Momenta Pharmaceuticals, in collaboration with [Novartis AG](#)'s (Aa3 negative) Sandoz unit, said that the US Food and Drug Administration (FDA) had approved its generic version of Copaxone 40 milligram (mg). Copaxone is an injectable drug for the treatment of multiple sclerosis and is also [Teva Pharmaceutical Industries Ltd.](#)'s (Ba2 stable) largest franchise.

The FDA's approval of Momenta's generic version is credit negative for Teva because the increased competition will erode Teva's earnings and cash flow from branded Copaxone. Teva already faces generic competition for 40mg Copaxone from [Mylan N.V.](#) (Baa3 stable), which launched its version of the drug late last year. The earnings erosion on this drug is faster than we had expected, and will lead to increased negative pressure on Teva's bank covenants in the first half of this year.

We had expected additional generic competition to the 40mg formulation, but not until the second half of 2018. With Momenta's entrance in the 40mg market, we expect further price declines that will drive a faster and steeper erosion in Teva's sales. US sales of Copaxone in 2017 were approximately \$3 billion, mostly in the 40mg dosage, which accounts for more than 85% of total Copaxone prescriptions. We estimate that this year Teva will lose more than 20% of its market share in 40mg Copaxone, which was 83% in January.

Momenta's earlier launch also puts Teva at risk of a covenant breach in the first half of 2018. Although the covenants within Teva's bank credit agreement were amended in January 2018, the company's leverage covenant cushion remains weak. The credit agreement permits maximum net debt/EBITDA of 5.50x in first-quarter 2018 and 5.75x in second-quarter 2018. Teva's leverage was above 5.0x at year-end 2017.

Teva received cash proceeds of around \$1.4 billion from the sale of its women's health business outside of the US and from a onetime working capital settlement with [Allergan plc](#) (Baa3 stable), which will partially offset the weak leverage covenant cushion. However, failure to address the covenants would pressure the company's liquidity.

Teva's credit profile is constrained by its high leverage, which we do not expect will fall below 4.0x gross debt/EBITDA until after 2019. The company has reported debt maturities of approximately \$3.6 billion this year that will constrain its ability to absorb large unforeseen business disruptions or cash needs. Teva is taking major steps to reduce its cost base by \$3 billion over the next two years, which will shore up profitability and support deleveraging. We expect that the company will use the majority of its free cash flow to reduce debt.

It is critical that Teva's cost-restructuring plan boost cash generation to ultimately reduce leverage. Although we believe that Teva's costs will decline, we view the company's timetable as aggressive. The restructuring raises the risk for business disruption, while planned portfolio rationalizations in the generics segment have the potential to harm Teva's relationships with its customers.

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Axtel's potential sale of its mass-market segment would be credit positive

On 13 February, [Axtel, S.A.B. de C.V.](#) (Ba3 negative) said it was carving out, and would consider selling, its mass-market segment, which focuses on fiber-optic service mainly for high-end residential customers of Mexico's biggest metropolitan areas.

A sale of the niche mass-market unit would be credit positive for Axtel, allowing the Mexican company to focus on its core enterprise and government segments, and reduce its leverage well below current levels. A sale of the unit would potentially raise around \$300 million.

Axtel, a niche operator in Mexico's telecom market, is committed to reducing its leverage, aiming to achieve a net debt/EBITDA ratio of 2.5x by 2020. The company's debt/EBITDA ratio peaked in 2016 and was still about 4.1x on a gross debt basis and 3.8x on a net debt basis at the end of 2017, as reported by the company.

Axtel's mass-market segment offers "fiber to the x," or FTTx, services in most of Mexico's wealthiest metropolitan areas; its business supplies some 1.4 million high-end residential households with fiber-optic links for internet, telecom and cable services.

Axtel is a niche residential telecom provider in Mexico, where it accounts for just 4% of the country's fixed voice and broadband subscribers, and less than 2% of its pay-TV subscribers. The telecom giant [Telefonos de Mexico, S.A.B. de C.V.](#) (Baa1 stable) still dominates Mexico's fixed-line market, and [Grupo Televisa, S.A.B.](#) (Baa1 stable) its pay-TV sector. Most of Axtel's work serves enterprise and government contracts, where it benefits from greater scale, stronger market position and operating margins.

Axtel's credit metrics are weak today, with high leverage and low interest cover. But we expect that the company's financial profile will gradually improve, based on continued earnings growth and synergies and investment savings from its merger with Alestra.

Without knowing the price Axtel could eventually get for its mass-market unit, past transactions indicate that it could draw an EBITDA multiple of 8x in the sale, valuing the business at MXN5.2-MXN5.6 billion (\$280-\$300 million), based on annual EBITDA of roughly MXN650-MXN700 million. If Axtel used all proceeds to reduce debt, at that sales price it would reduce its gross debt/EBITDA ratio, not including our standard adjustments, to about 3.4x-3.5x, from 4.1x at the end of 2017.

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Airbus' better-than-expected 2017 results are credit positive, but A320neo engine challenges may weigh on 2018 guidance

Last Thursday, [Airbus SE](#) (A2 stable) published its 2017 results, including company-defined EBIT adjusted of €4.25 billion and free cash flow of €2.9 billion before M&A and customer financing, which were both ahead of the €4.16 billion EBIT adjusted and €1.4 billion free cash flow that we expected. Airbus also confirmed that in 2018 it expects its EBIT adjusted to increase to around €5.1 billion and free cash flow before M&A and customer financing to be similar to 2017, provided that current delivery issues with the A320neo, its narrowbody aircraft, can be solved quickly.

Airbus' stronger-than-expected 2017 results and strong guidance for 2018 are credit positive and support much needed strengthening in Airbus' key credit metrics, which are currently weak for its A2 rating and compared with similarly rated peers. Our provisional calculations for 2017 metrics are that the company's Moody's-adjusted operating profit margins will now be closer to 5%, versus below 5% over the past three to four years. We expect Airbus' 2017 Moody's-adjusted gross leverage, as measured by gross debt/EBITDA, at or just below 3.0x, down from above 3.0x over the same period. We expect 2017 free cash flow of around €1 billion versus the negative €1 billion we had previously forecast.

Airbus' stronger credit metrics are important because its weak financial performance has persisted longer than the 12-18 months that we would typically consider for its A2 rating. Until now, we have made allowances for investments associated with the material ramp-up of its A320 and A350 commercial programs and the negative effect that has had on Airbus' financial metrics. We also considered that the company's duopoly in commercial aerospace, and more specifically its strong market position and order backlog in narrowbody aircraft, would provide stronger free cash flows through 2019-20.

However, engine issues associated with Airbus' A320neo, and in particular the Pratt & Whitney geared turbofan (GTF) engine that is one of two engine options for the A320neo, continue to threaten Airbus' ability to deliver A320 aircraft and achieve its 2018 cash flow guidance. These challenges risk delaying deliveries of around 200 aircraft in 2018, assuming a 52-per-month ramp-up rate, Airbus' target that around two-thirds of its A320 aircraft deliveries would be fitted with neo engines and our assumption that the GTF engines would affect around 50% of total neo deliveries.

Both Airbus and Pratt & Whitney are still assessing the situation, and although there is some flexibility to advance the manufacture of A320XLRs (a version of the aircraft with engines that are not new generation and are less fuel-efficient) in lieu of more fuel-efficient A320neos, we believe this is limited given the pull-forward of its neo aircraft last year.

Besides the ramp-up risk associated with the A320 and A350 (although the latter is progressing well), Airbus continues to face a number of challenges that jeopardize future cash flows. The agreement reached with A400M customers to materially de-risk the program is noteworthy considering management's numerous challenges, but will lead to an additional €1 billion cash drain in 2018 (though this is included in the company's 2018 guidance). Customer financing needs of €100 million in 2017 were inconsequential in the context of the company's total net cash position of €13.4 billion (on a company-defined basis). However, management will also need to resolve restrictions on access to export credit agency financing prior to any weakening in market liquidity.

Airbus faces material fines resulting from ongoing investigations into its filing inaccuracies and fraud, which it self-reported in 2016. Brexit, management changes and the potential for changes in strategy are also material unknowns over the next 12-18 months.

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GKN's strategy update is credit positive

Last Wednesday, GKN, the parent company of [GKN Holdings plc](#) (Baa3 stable), announced an updated strategy that includes a new efficiency programme, the intention to sell several non-core activities, and distribute up to £2.5 billion of cash returns to shareholders over the next three years, subject to maintaining an investment grade rating. The strategy is credit positive because efficiency measures will improve profitability and asset disposals will delever the company. Considering GKN's commitment to maintaining an investment grade rating, we expect that shareholder distributions will not jeopardize the company's Baa3 rating. After the strategy update, [we affirmed GKN's Baa3 ratings](#).

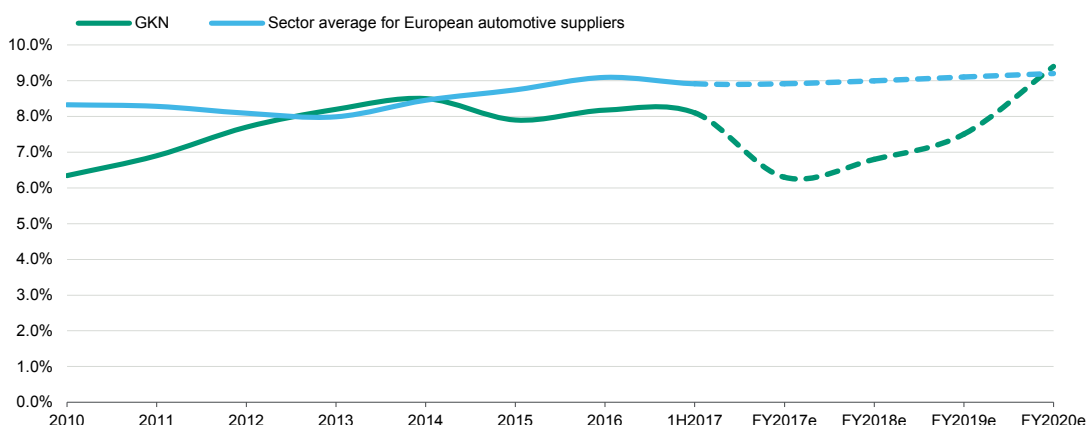
GKN's updated strategy is a response to a hostile takeover bid from Melrose Industries plc, which we previously said could put [GKN's rating under pressure](#). The strategy update comprises three main elements. First it would quantify the newly established efficiency programme, Project Boost, which should deliver recurring annual operating profit contributions of £340 million starting at the end of 2020. Second, GKN intends to sell several non-core activities, including its Powder Metallurgy division, within the next 12-18 months. Then, it would distribute up to £2.5 billion of cash returns to shareholders over the next three years, subject to maintaining an investment grade rating.

The efficiency measures address the company's recently weak operating performance, despite a 10.5% revenue increase in 2017. The aerospace division was particularly weak, with its profit margin (based on management's definition) declining 210 basis points, and profitability in the automotive division declining 70 basis points. Project Boost should improve the company's trading profit margins within three years to more than 10.5% from 7.4% in 2017, which would return the company to the sector average of Moody's-rated automotive suppliers in Europe, the Middle East and Africa (see Exhibit 1).

EXHIBIT 1

Project Boost should improve GKN's profitability

Moody's-adjusted EBITA margins for GKN and European automotive suppliers



Sources: Company data and Moody's Investors Service estimates

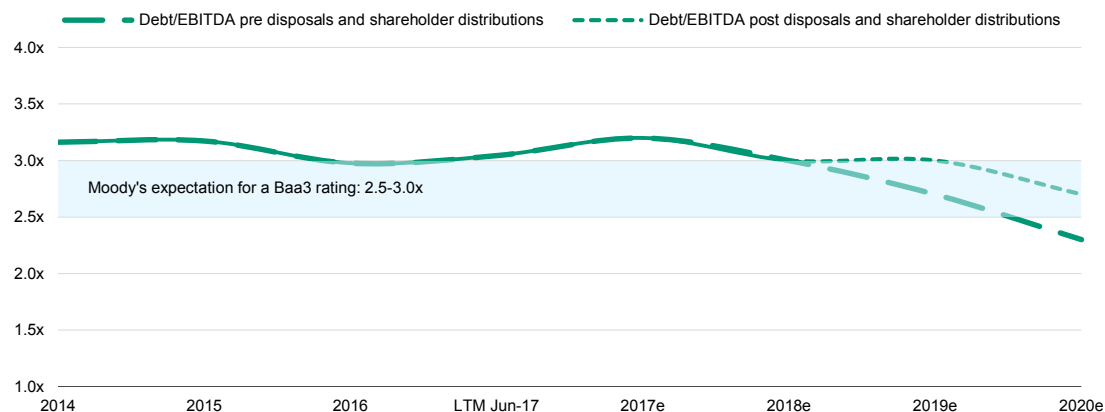
The company's asset disposal plan affects activities equaling £242 million of EBITDA, or 20% of GKN's 2017 EBITDA. Assuming a transaction multiple of 7x-8x indicates potential disposal proceeds of £1.7-£1.9 billion. Assuming Moody's-adjusted gross debt of £3.1 billion at December 2017, the proceeds have the potential to substantially improve GKN's leverage metrics. The company's plan to distribute up to £2.5 billion to shareholders includes disposal proceeds and ordinary dividends, and is subject to maintaining an investment grade rating. Therefore, we expect that distributions will only be made at a point in time and at an amount that will leave credit metrics in line with our expectations for a Baa3 rating, such as a Moody's-adjusted debt/EBITDA maximum of 3.0x (see Exhibit 2).

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EXHIBIT 2

Asset disposals will help keep GKN's leverage consistent with an investment grade rating, despite shareholder distributions



Ratios are on a Moody's-adjusted basis.

Sources: Company data and Moody's Investors Service's estimates

GKN's credit metrics are weak for its Baa3 rating. We expect GKN's Moody's-adjusted gross leverage at December 2017 to be around 3.0x, the same as the last 12 months to June 2017 and might downgrade GKN's rating if leverage were to exceed 3.0x. GKN's metrics may weaken slightly over the course of the coming year because of upfront costs associated with Project Boost, but metrics thereafter should strengthen as the plan takes effect. The ratings may come under negative pressure if the plan proves less successful than the company anticipated, or if management were to make distributions to shareholders at a faster pace or in a larger amount than the improvement in metrics allows.

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New South African leadership is credit positive for gold and PGM mining

Last Friday, at his State of the Nation Address, [South Africa's](#) (Baa3 review for downgrade) newly elected President Cyril Ramaphosa said that he is certain that the impasse between mining companies and the government over the country's revised mining charter would be resolved. Mr Ramaphosa emphasised the need for agreement to a charter that would grow the mining sector, a vital part of South Africa's economy. He also indicated that the Mineral Resources and Petroleum Development Act (MRPDA) amendment bill (supporting legislation for the mining charter) would be reasonably finalised during first quarter of this year. The bill will entrench existing regulatory certainty, provide security for mining lease agreements and establish a framework for investment. Mr Ramaphosa, who was a successful mine labour union leader early in his career and has a strong understanding of the mining sector, said he intends to revitalise the sector and is determined to work with mining companies to attract new investment.

A resolution of the issues around the revised mining charter and the finalisation of the MRPDA amendment bill would be credit positive for [AngloGold Ashanti Limited](#) (Baa3 positive), [Gold Fields Limited](#) (Ba1 positive) and [Sibanye Gold Limited](#) (Ba2 stable). Net investment in South Africa's mining sector has declined 57% over the past decade.

Following the spirit of the State of the Nation Address, South Africa's Chamber of Mines, which represents most mining companies operating in the country, and South Africa's Department of Mineral Resources agreed on Sunday to give negotiations a chance. One issue to which miners object is that the [revised mining charter](#) requires South African mining companies to increase black shareholders' equity holdings to 30% from 26%. Miners would likely have to use cash or raise debt to facilitate the equity transfer. We believe that current shareholders are unlikely to support dilution of their equity interests.

Additionally a number of the revised mining charter's proposals will add to the costs of operating mines and reduce free cash flow generation. One such proposal would require holders of new mining rights to pay a minimum of 1% of annual turnover in a given financial year to these empowerment shareholders, in accordance with legislative solvency and liquidity requirements and partly offset by ordinary dividend payments.

International [investor optimism since Mr. Ramaphosa was elected](#) leader of South Africa's ruling party on 18 December 2017 has contributed to the South African rand's 11.5% appreciation versus the US dollar to date. A stronger rand negatively affects South African gold and Platinum Group Metals (PGM) mining companies because their production and operating costs are mainly denominated in rand, but their revenue is earned in US dollars. Therefore, when the rand appreciates against the US dollar, dollar-denominated operating costs increase relative to revenue streams given that gold, platinum and palladium prices are dollar-denominated. To better assess cash flow generation, we use gold and PGM prices in rand terms which better represent profit margins.

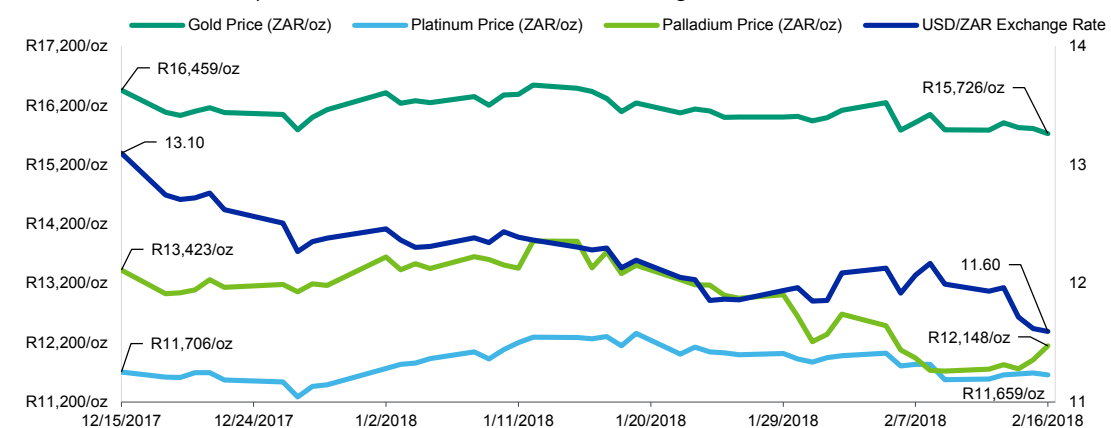
The net effect however appears not to have had too much a damper on profitability for AngloGold Ashanti's remaining South African gold operations, Gold Fields' South Deep gold mine and Sibanye's South African gold and PGM (around half of production is platinum and a third is palladium) operations. Over the same period, the US dollar gold price along with platinum and palladium (referred to as two-element PGM) prices have appreciated as the South African rand has appreciated. This has led to prices in South African rand being broadly stable. Rand gold (down 4.5%), platinum (down 0.4%) and palladium (down 9.5%) prices were down by less than the 11.5 % appreciation in the rand relative to the US dollar (see exhibit).

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Gold, platinum and palladium prices have been mostly stable since 18 December 2017

Gold and two-element PGM prices in South African rand and USD/ZAR exchange rate



Sources: Bloomberg and Moody's Investors Service

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Credit implications of current events

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Nippon Yusen's ¥2 billion charge after embezzlement is credit negative

Last Tuesday, Japanese shipping conglomerate [Nippon Yusen Kabushiki Kaisha](#) (NYK, Baa3 negative) announced that it expects to take a ¥2 billion (about \$18 million) charge related to embezzlement at its Chinese car carrier subsidiary. Additionally, the company has postponed its release of fiscal third-quarter financial results, which it was scheduled to file with the Kanto Local Finance Bureau on 14 February, until 23 March while it determines the financial effect of the embezzlement more definitively.

The ¥2 billion charge is credit negative because it will slow the company's deleveraging process. Assuming the charge is a cash payment, we expect that NYK's ratio of retained cash flow to net debt will be about 10%, just above the single-digit quantitative level that would lead us to consider a downgrade.

Based on the latest guidance, debt/EBITDA would be in the low 7x range for the fiscal year ending 31 March 2018, above the 6.5x level that we expect for the Baa3 rating. Although we anticipate ongoing deleveraging, if debt/EBITDA remains at above 6.5x well into fiscal 2018, which ends 31 March 2019, we would consider downgrading the rating.

If the charge is confined to ¥2 billion, however, it will not on its own materially or immediately worsen the company's financial profile or lead to a downgrade. The company has not made public what the ¥2 billion entails, or whether it is a cash payment. Even if it is a cash payment, the company can comfortably cover it without hindering its liquidity. NYK had ¥95 billion of cash on hand as of year-end 2017.

It appears that one or a few local employees embezzled, as opposed to being a larger, company-wide problem that could become a reputational issue. Nonetheless, the event casts a cloud on NYK's corporate governance.

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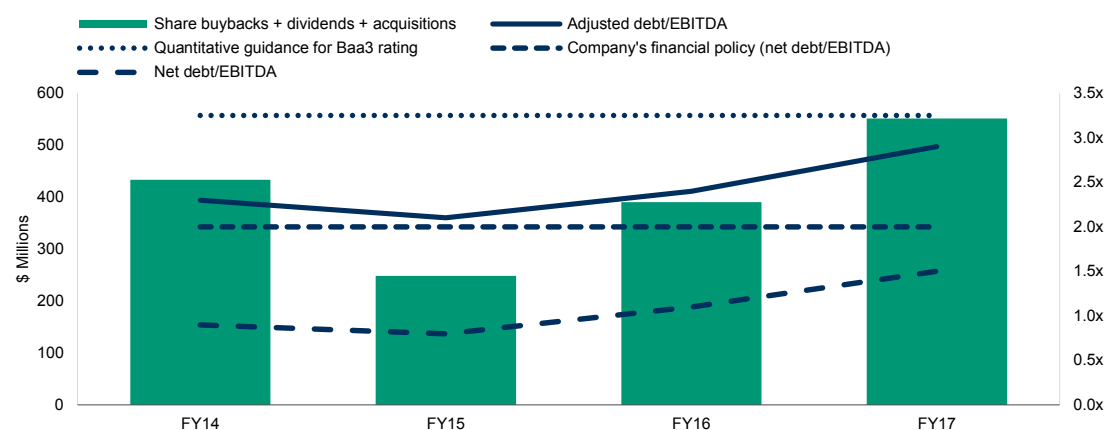
Genpact's increase in dividends is credit negative

Last Monday, Indian IT services provider [Genpact Limited](#) (Baa3 stable) announced a 25% increase in its quarterly cash dividend to \$0.30 per share from \$0.24 per share. The increase in recurring dividends is credit negative because the company is using cash that could otherwise go toward debt reduction or acquisitions that would contribute to future EBITDA growth.

The dividend increase translates to an additional \$11-\$12 million of cash outflow annually. The cash outflow from the incremental dividend is moderate relative to the company's overall cash flow generation. Genpact's new deal wins during 2017 rose 5% from a year earlier to about \$2.8 billion and the company's predictable and recurring cash flow support an improvement in 2018 cash flow.

Genpact's leverage, as measured by adjusted debt/EBITDA, weakened to around 2.9x in 2017 from around 2.4x in 2016 because of debt-funded acquisitions and returns to shareholders in the form of dividends and share buybacks (see exhibit). We expect the company's leverage to remain elevated over the next 12-18 months.

Genpact's leverage is weakening, but remains within our quantitative guidance



Sources: Genpact, Moody's Financial Metrics and Moody's Investors Service forecasts

In 2017, Genpact returned \$220 million to shareholders via share buybacks, with an additional \$46 million in dividends. Coupled with the increase in acquisitions, the company's total adjusted debt outstanding has increased to around \$1.5 billion from around \$1.0 billion in 2015. However, the company held a large cash balance of about \$500 million at the end of December 2017.

Genpact's growth thus far has been from a combination of organic and bolt-on acquisitions. The company's total acquisitions for the 12 months that ended December 2017 totaled \$284 million, a significant increase from \$45 million in 2016. Similar to its industry peers, we expect Genpact to continue to explore mergers and acquisitions to gain competencies to remain competitive.

The company's Baa3 rating incorporates our view that it will maintain a measured approach to growth, adhering to its publicly stated conservative financial policy of maintaining net leverage below 2.0x. Any departure from this approach would weigh on the rating. As of the end of December 2017, net leverage was 1.5x. We expect the company to exercise financial discipline even as it continues to return surplus cash to shareholders and carry out acquisitions, and that its credit metrics will remain within our quantitative guidance.

Infrastructure

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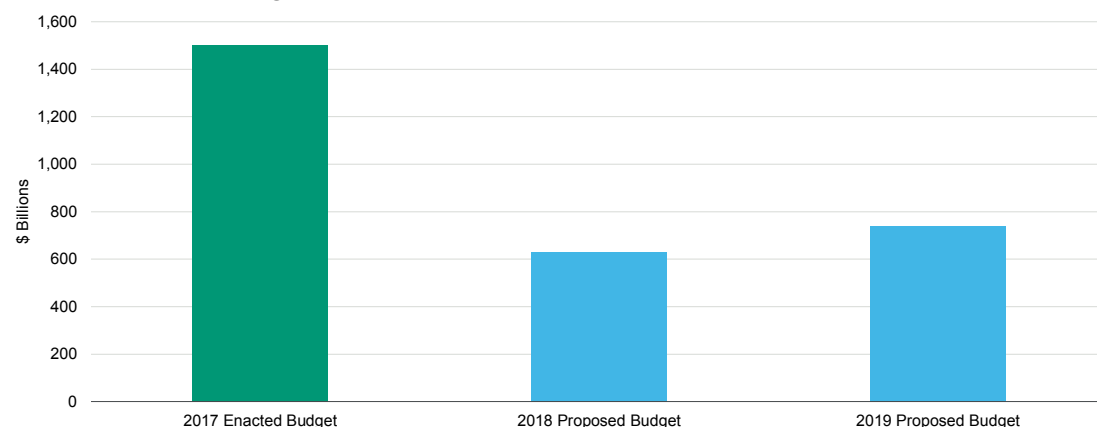
For Amtrak, the Trump administration's proposal to reduce federal funding is credit negative

Last Monday, the Trump administration released its proposed US budget for fiscal 2019 (effective 1 October 2018) and its [infrastructure proposal](#), both of which indicate reduced federal support for [National Railroad Passenger Corp. \(Amtrak\), DC](#) (Amtrak, A1 stable), a credit-negative development for the railroad. While it is by no means certain that the US Congress will approve the administration's spending cuts, if it did, Amtrak would be pressured to reduce long-distance routes that incur substantial operating losses and require considerable federal subsidies, as well as defer additional capital improvement projects. Should federal funding levels decrease substantially, the resulting decrease in service reliability and future capacity will negatively affect Amtrak's ability to offer competitive pricing and will lead to a contraction in ticket sales that erodes its financial position.

In recent years, the US Congress has provided increased funding for Amtrak and Federal Railroad Administration rail grants and is ultimately responsible for deciding Amtrak's funding levels, using the administration's budget proposal as a starting point. That being said, the US Office of Management and Budget proposed a \$738 million budget for Amtrak in fiscal 2019, down nearly 51% from the \$1.5 billion granted in 2017 (see Exhibit 1). For fiscal 2018, the Trump administration proposed a \$630 million budget for Amtrak, but Congressional Appropriation Committees have not yet agreed on a proposed spending package. The administration's proposed reduction in federal funding comes as needed maintenance and repair projects are on the horizon, notably the \$30 billion Gateway Program, a rail investment program aimed at expanding capacity to the busiest 10-mile section of Amtrak's Northeast Corridor.

EXHIBIT 1

Amtrak's federal funding



Source: The Trump administration's budget proposal for fiscal 2019

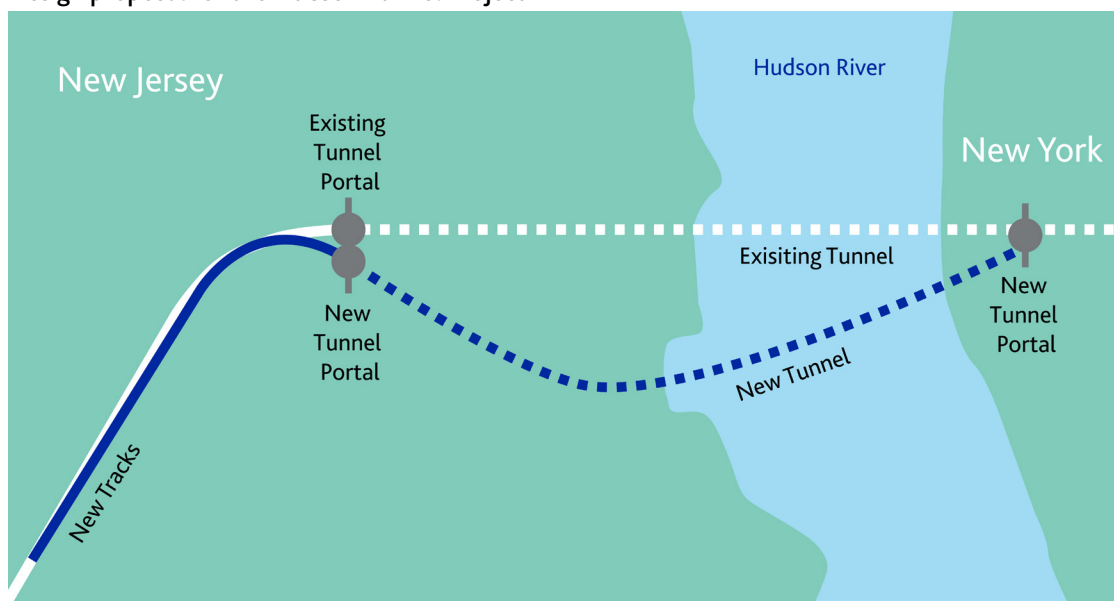
The Gateway Program's largest component is the Hudson Tunnel Project, including a \$13-\$15 billion investment in a new, dual-track commuter rail tunnel between New York's Penn Station and New Jersey to serve Amtrak and New Jersey Transit trains (see Exhibit 2). The Hudson Tunnel Project also includes needed maintenance and rehabilitation of the 107-year-old North River Tunnels that run between Weehawken, New Jersey and New York Penn Station, scheduled to begin in 2026 after the new line is operational. Saltwater flooding during Superstorm Sandy exacerbated a millennia of heavy tunnel usage, damaging key electrical components and leading to system reliability failures, causing significant delays between New York and New Jersey, as well as from Boston to Washington DC.

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EXHIBIT 2

Design proposal for the Hudson Tunnel Project

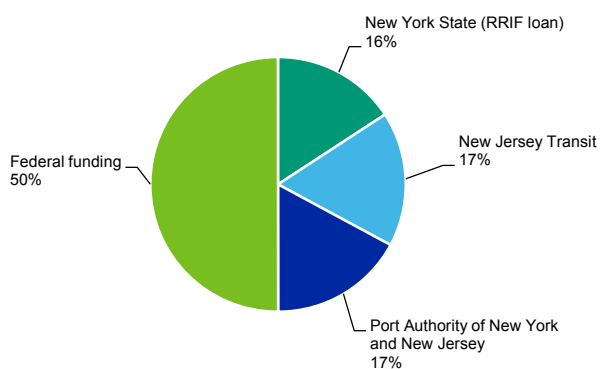


Source: The Gateway Program Development Corporation

The Trump administration's proposed reduction in project-related federal funding caps and increased constraints on eligibility requirements will hinder progress on the Hudson Tunnel Project. The administration's infrastructure proposal aims to leverage state and local government dollars, capping incentive grants at 20% of infrastructure project costs. This new cap on federal funding marks a notable deviation from the 50% federal commitment to the project under a November 2015 framework agreement reached with the previous administration (see Exhibits 3 and 4).

EXHIBIT 3

Funding provisions under the 2015 framework agreement



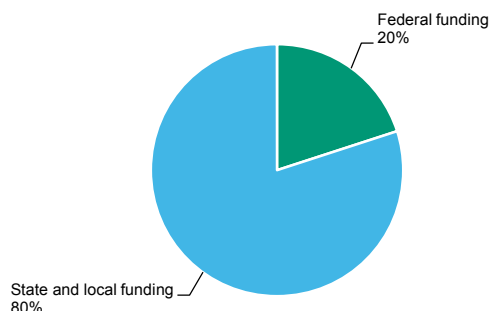
Source: Gateway Program Development Corporation 2017 Annual Report

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Credit implications of current events

EXHIBIT 4

Maximum funding provisions under fiscal 2019 US government budget proposal



Source: The Trump administration's infrastructure proposal

The [State of New York](#) (Aa1 stable), [New Jersey Transit](#) (A3 stable) and the [Port Authority of New York and New Jersey](#) (Aa3 stable) already have a joint agreement to commit their \$5.55 billion half of the project's new-build costs. The administration's budget proposal also outlines funding constraints on the Federal Transit Administration's capital investment grant program (New Starts) to projects with existing full funding grant agreements. With this clause, the much-needed Gateway Program would be ineligible for federal support because the 2015 framework does not constitute a contractual agreement.

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Credit implications of current events

Banks

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Fannie Mae's and Freddie Mac's strong fundamentals offset credit-negative fourth-quarter losses

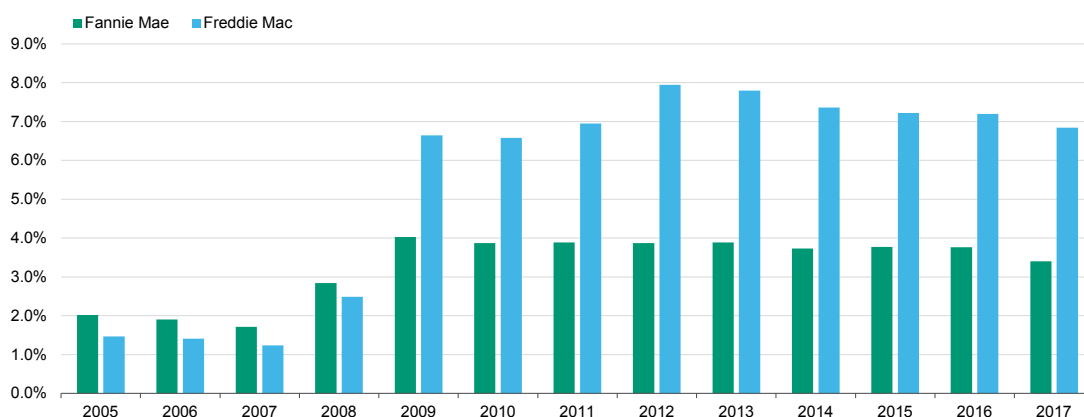
Last Thursday, [Freddie Mac](#) (Aaa stable) reported a \$3.3 billion other comprehensive loss for fourth-quarter 2017, a day after [Fannie Mae](#) (Aaa stable) reported a \$6.5 billion loss for the same period, both the result of impairments of their deferred tax assets (DTA). The DTA impairment is credit negative for the government-sponsored enterprises (GSEs) because it results in their requesting capital from the US Treasury, which in turn reduces their access to capital from the agency.

Before the DTA impairments, Fannie Mae had access to \$117.6 billion of capital under preferred stock agreements (capital agreement) with the US Treasury, while Freddie Mac had access to \$140.5 billion. These amounts decline with any capital request, so Fannie Mae's access to capital will decline to \$113.9 billion and Freddie Mac's to \$140.2 billion. The GSEs' DTA impairment is the result of the Tax Cuts and Jobs Act, which, among other things, lowered corporate income taxes to 21% from 35%.

For 2017, Fannie Mae reported net income of \$2.5 billion and Freddie Mac reported net income of \$5.6 billion. Pre-tax income, which excludes the DTA impairment, was \$18.4 billion for Fannie Mae, versus \$18.3 billion as of year-end 2016. Freddie Mac's pre-tax income was \$16.8 billion at year-end 2017, versus \$11.6 billion the prior year. The strong and consistent pre-tax performance reflects the GSEs' solid business fundamentals, low credit losses and solid margins. We expect these fundamentals to continue this year.

The capital agreement was amended in fourth-quarter 2017 in anticipation of the DTA impairments allowing the GSEs to build capital on their balance sheets up to \$3.0 billion. And, although the funds the GSEs have access to under their capital agreements will decline with their requests, both still have capital at historically high levels (see exhibit). Additionally, their sound business fundamentals make another draw in 2018 highly unlikely. We expect that both Fannie and Freddie will build capital to their \$3.0 billion limit over the next quarter or two.

Fannie Mae's and Freddie Mac's capital ratio



Source: Fannie Mae and Freddie Mac Form 10-K

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Credit implications of current events

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US Bancorp's regulatory agreements are credit negative but move toward closure

Last Thursday, [US Bancorp](#) (USB, A1 stable) announced agreements and monetary penalties with several regulatory agencies regarding previously disclosed deficiencies in its Bank Secrecy Act/anti-money laundering (BSA/AML) compliance program. Settlements were reached with the Office of the Comptroller of the Currency (OCC), the Federal Reserve Board (Fed), the Financial Crimes Enforcement Network, and the US Department of Justice. In total, US Bancorp will pay \$613 million to regulators.

US Bancorp's BSA/AML issue is credit negative because it is a risk management failure. It also came with regulatory sanctions that create uncertainty. The BSA/AML issue stains US Bancorp's relatively clean track record compared with large US bank peers in avoiding risk management failures and regulatory sanctions in the past decade.

The monetary penalties and regulatory agreements are a near settlement of the issue and require USB to demonstrate that it has strengthened its compliance risk management. The monetary penalties it must pay will have a small financial effect on USB's credit metrics: to put things into perspective, the \$613 million charge equals about 1.8% of its Common Equity Tier 1 capital at year-end 2017. Furthermore, USB accrued \$608 million against such a settlement in the fourth quarter of 2017, making the effect on its first-quarter 2018 earnings minimal.

USB has enhanced its compliance risk management, particularly since 2015, when the bank entered a consent order with the OCC to address deficiencies in its BSA/AML compliance program. Bank management has taken multiple actions since 2015 to strengthen its governance and risk management, including new leadership for its compliance program; improved and centralized risk identification, oversight, and reporting functions, including escalation procedures to the board and executive management; and an increase in staff.

None of the additional regulatory actions identified fault with USB's progress or plans in improving its program. Instead, the regulatory actions called for more reporting. For example, the Fed's consent order requires written submission of a plan to strengthen board oversight of BSA/AML compliance and various policies and procedures. It also requires quarterly progress reports from USB's board, which emphasizes a bank board's responsibilities regarding risk management.

USB has entered a deferred prosecution agreement with the US Attorney's Office. The agreement defers prosecution on the criminal charges for two years as long as the company remains compliant with its terms, after which the government will seek to dismiss the charges. Additionally, any other breach of law, even in an unrelated matter, could be deemed a violation of the agreement, which would result in a criminal prosecution and a potentially significant loss of customers and revenue. We expect that USB will be able to address the regulators' concerns. However, the timing of the removal of the regulatory orders cannot be predicted and uncertainty persists until the orders have been formally terminated.

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Credit implications of current events

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Nationstar's merger with WMIH is credit positive for its senior unsecured notes

Last Monday, [Nationstar Mortgage LLC](#) (B2 stable) and WMIH Corp. (formerly Washington Mutual, Inc.) announced their agreement to merge. The merger is credit positive for Nationstar's senior unsecured notes (B2 stable) because WMIH will issue debt to refinance about \$1.9 billion of the notes maturing between August 2018 and June 2022, a lower risk outcome than if the notes were to remain outstanding. The merged entity will be better capitalized, but will have a significantly larger debt burden.

The company also will have the benefit of WMIH's \$6 billion of net operating loss (NOL) carryforwards, although their benefit will be contingent on the company's profitability, which we expect will improve only moderately. We believe the additional debt burden, and consequently higher interest expense, and the uncertainty around profitability over the next several years will present additional risks to noteholders that refinancing avoids.

The merged entity will focus on growing Nationstar's presence in the mortgage industry. Nationstar is now the third-largest residential mortgage servicer and 18th-largest lender in the US. The merged company will continue its strategy of growing Nationstar's servicing portfolio, origination book and real estate services business.

Although we expect that the merged entity will have higher capital and roughly the same net debt to equity ratio of 1.0x, the company will be challenged to improve its profitability and realize the potential benefits of the NOLs. As aggregate consideration, Nationstar shareholders will receive \$1.2 billion in cash and WMIH shares valued at approximately \$700 million. As part of the transaction, WMIH has secured financing commitments of \$2.75 billion and plans to issue that amount in senior unsecured notes to refinance Nationstar's existing notes.

The new debt issuance includes \$826 million of transaction debt, increasing the merged entity's annual interest expense by approximately \$58 million. However, the company's net corporate debt to equity ratio will remain roughly 1.0x because tangible common equity will increase in proportion with the debt to \$2.1 billion. As a result, the company's capital as measured by tangible common equity to tangible managed assets (TCE/TMA) will increase to 11.1% after the merger from 8.8% as of 30 September 2017.

Among the biggest benefits of the merger to Nationstar may be WMIH's \$6 billion of NOLs expiring in 2032, which have no annual use limitations. Because NOLs offset future tax obligations, they will provide the most benefit if the merged entity's profitability is strong. However, Nationstar's profitability has been constrained over the past three years, and likely will improve only marginally post-merger. We expect the firm's operating costs to remain elevated because of ongoing regulatory scrutiny of the industry and lower loan origination volume owing to rising interest rates.

Nationstar's management team will remain after the merger and the company will remain publicly traded, ensuring continuity and continued transparency. The company's board of directors will have seven members, three from WMIH and four from Nationstar. Although, Nationstar will lose Fortress Investment Group LLC, a strong strategic investor that owns 68% of the publicly traded, non-bank mortgage company, it will gain another strong investor in KKR, which will own 17% of the merged entity.

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Credit implications of current events

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Blucora's plan for faster deleveraging is credit positive

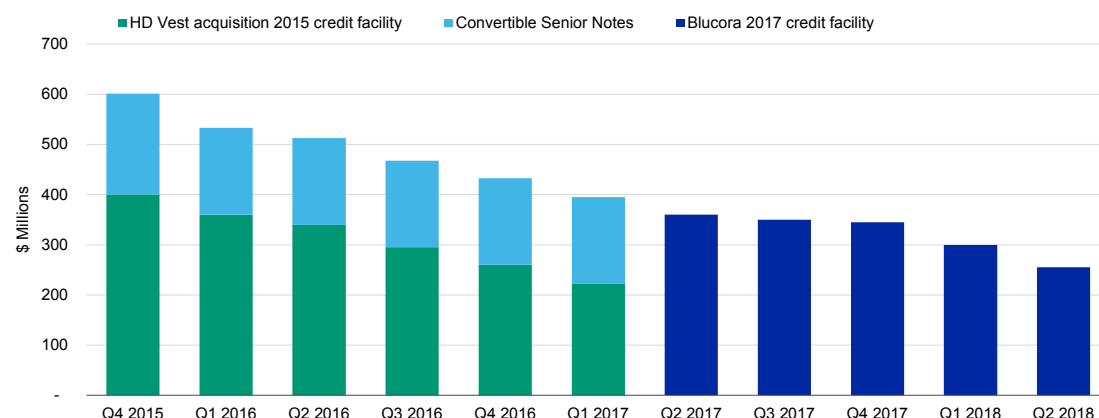
Last Thursday, [Blucora, Inc.](#) (B1 stable) said that it intends to pay down \$80-\$100 million of its \$345 million senior secured credit facility in the first half of this year, faster than previous guidance. The accelerated debt repayment is credit positive because it will help Blucora reduce leverage while maximizing the benefits of its net operating losses (NOLs).

Blucora offers financial advisory products and tax preparation solutions. The firm acquired HD Vest, a wealth management firm, in December 2015 for \$580 million, funding it partly with a \$400 million first-lien term loan. As of year-end 2017, the firm's leverage, as measured by debt/EBITDA, was 4.1x, including our standard adjustments. We estimate that a \$90 million debt reduction (the midpoint of management's guidance) by the end of the first half, would reduce leverage to 3.1x. The additional deleveraging would improve Blucora's debt service capacity, reducing its cash interest expense to \$14 million for 2018 versus \$21 million in 2017. Blucora's focus on faster deleveraging would help it avoid the new US tax law's limitation on interest expense deduction while accelerating its utilization of NOLs.

The firm's NOL carryforwards were \$518 million as of year-end 2017, with \$274 million expiring in 2020 and \$135 million in 2021. The firm's focus on faster debt repayment is to benefit from reduced interest expense and utilize the firm's tax-loss carryforwards in a manner that could minimize cash taxes.

In May 2017, the firm refinanced its 2015 credit facility with a \$375 million first-lien term loan. The company used proceeds from the new loan and company cash to refinance the 2015 credit facility and Blucora's \$172 million convertible senior notes (see exhibit). Although credit negative at the time because of an increase in senior secured debt, the refinancing was facilitated by a series of debt paydowns funded with internally generated cash and proceeds from the sale of non-core operations.

Blucora's total debt balance



First- and second-quarter 2018 are our estimates of total debt balance based on a total of \$45 million debt reduction in each period.

Sources: *The company and Moody's Investors Service*

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Credit implications of current events

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Mercado Libre's new prepaid card is credit negative for Argentina's banks

On 9 February, [Mercado Libre S.R.L.](#) (ML, B1 stable), in partnership with MasterCard Argentina, launched a prepaid card that has no issuance costs or maintenance fees, can be requested online, and will allow customers to withdraw cash through ATMs and make bank transfers. ML's card, which works like a debit card, is credit negative for Argentine banks because it will compete with the banks' debit and credit card offerings. Credit cards currently account for about 28% of banks' lending portfolio and nearly three-quarters of their total consumer finance business.

By making it easier for consumers to get no-fee cards, ML will negatively affect banks' business prospects for cards and deposits, because depositors often open accounts solely to obtain debit cards. ML's move could force banks to reduce card fees, which currently account for 8% of total bank revenue and have been relatively stable. The cards will also negatively pressure bank fees from transfers and current accounts.

The largest credit card issuer in Argentina is Tarjetas Regionales, mostly through its subsidiary [Tarjeta Naranja S.A.](#) (B2 stable), which has issued 9.5 million cards. [Banco Santander Rio S.A.](#) (Ba3/Ba3 stable, b2¹) ranks second, with roughly 4.5 million cards, and [Banco de Galicia and Buenos Aires](#) (B2/B2 stable, b2), Tarjetas Regionales' parent, ranks third, having issued another 3.8 million cards under the Galicia name. Credit cards account for 44% of Galicia's consolidated loan portfolio, including Tarjetas Regionales, and 35% of its revenue.

Although ML's prepaid card business is new in Argentina, the company's popular online platform makes it a potentially tough competitor as customers move toward digital platforms. Although Argentine banks have tried to improve their service by enhancing their digital platforms in response to changing consumer preferences, local banks' digital improvements lag those of international peers. ML already has launched a card in Brazil, where it has 80,000 users, and in Mexico, where it has 200,000 card users. ML is a popular online retail brand in Argentina and is competitively positioned owing to its eBay-like online marketplace, which accounts for most of its operating income.

The prepaid card is not ML's first financial product in Argentina. In 2017, ML partnered with [Banco Patagonia S.A.](#) (Ba3/Ba3 review for downgrade, b2 review for downgrade) to launch a credit card specifically for purchases within ML's online marketplace, which has 180,000 users. A key advantage of ML's own-brand card versus competitors' cards is that it can be tied to ML's own online payment system, Mercado Pago, which is akin to PayPal and an integral part of the company's online marketplace. This link will allow individuals and businesses that sell products through ML's online platform to access their online funds when they use the card offline at other businesses.

The launch of the debit card may be ML's first step in a strategy to start offering credit cards. Last year, ML began offering loans to small and midsize companies (SMEs) that sell products through its marketplace. If it uses the new debit card as a platform to expand its credit origination to individuals as well, the card has the potential to become a significant competitive threat to banks and traditional consumer finance companies. ML is the largest internet retailer in Latin America, with about 9 million merchants or online sellers and seven national websites including in Brazil, Argentina, Mexico and Chile. In Argentina alone, about 80,000 families and small and medium-sized enterprises reportedly rely on ML as their main source of income.

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

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Credit implications of current events

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PTSB's plan to actively reduce its nonperforming assets is credit positive

Last Tuesday, the Irish mortgage lender [Permanent tsb p.l.c.](#) (PTSB, Ba2/Ba3 positive, ba2²) announced that it intends to significantly reduce its nonperforming loan (NPL) ratio over what the bank described as the medium term and in accordance with European regulatory guidance. The reduction would be credit positive for PTSB's risk profile because the bank's large stock of NPLs constrains its standalone credit strength.

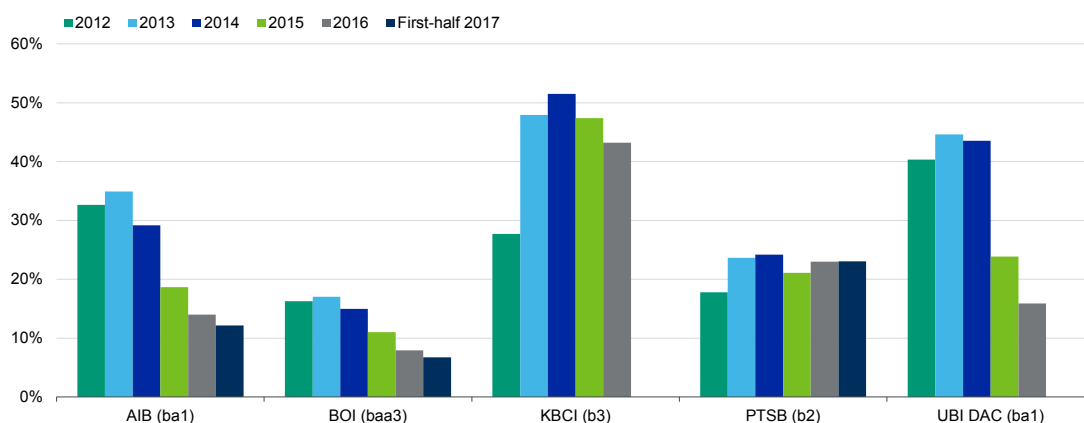
The bank will use various approaches including voluntary surrenders, its mortgage-to-rent program, loan sales, and, where appropriate, legal action to effect its strategy. The bank already has taken some steps with respect to these strategies. Some 1,200 properties have now been voluntarily surrendered under this scheme in the buy-to-let segment.

PTSB estimates that in its mortgage-to-rent program, it may be able to sell up to 1,000 properties to an approved housing body, which would rent the properties back to their current owners, allowing them to remain in their homes. PTSB expects the cumulative effect of these measures to improve the bank's NPL ratio. In addition, the bank instructed accounting firm EY to manage the market engagement for the formal sales process of NPLs, named Project Glas. This plan would demonstrate the bank's ability to accelerate the reduction of its NPL stock by selling the assets as opposed to their gradual reduction.

Overall, the bank's target, as per regulatory guidance, is reducing its NPL ratio to a high-single-digit level over the medium term from 23% as of 30 June 2017. We think this reduction may take several years to accomplish. In addition, PTSB's asset quality metrics compare poorly with its Irish peers, constraining its Baseline Credit Assessment (its standalone credit profile), which is lower than those of the other major Irish banks (see exhibit).

Permanent's nonperforming loan ratio versus selected Irish peers

Irish banks' ratio of problem loans to gross loans



Ratings are banks' Baseline Credit Assessment.

AIB = Allied Irish Banks plc; BOI = Bank of Ireland; KBCI = KBC Bank Ireland plc; PTSB = Permanent tsb plc; and UBI DAC = Ulster Bank Ireland DAC.

Sources: The banks

Over the past couple of years, PTSB has made progress cleaning up its balance sheet and has materially reduced downside risks as a result of deleveraging its non-core (mainly commercial real estate) loan portfolios. The bank also actively engaged in loan restructuring with retail customers. As a result, the bank's impaired loan balances declined 38% to €4.9 billion as of the 30 June 2017, from a peak of nearly €8 billion at the end of 2013.

² The bank ratings shown in this report are PTSB's deposit rating, senior unsecured debt rating and Baseline Credit Assessment.

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Credit implications of current events

In August 2017, we upgraded the bank's ratings and assigned a positive outlook to its long-term debt and deposit ratings, reflecting our expectation that management's focus on an accelerated reduction of NPLs would strengthen asset quality ratios over our outlook horizon. Last week's announcement is in line with these expectations. However, it remains uncertain whether an accelerated reduction in NPLs will lead to additional provisioning requirements and/or write-downs that would negatively affect the bank's profitability and capital. The bank's ability to manage the process of improving its asset quality while maintaining its current capital levels, in our view, remain important credit drivers.

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Credit implications of current events

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German plan to prioritize claims in bank resolution is credit negative for outstanding senior unsecured bank debt

Last Tuesday, the German Ministry of Finance published [draft legislation](#) to implement new European rules on the priority of claims in resolution under the European Union's (EU) Bank Recovery and Resolution Directive (BRRD). The rules would improve the consistency of creditor hierarchies across the EU and allow German banks for the first time to issue plain vanilla preferred senior unsecured bonds. However, the draft law would be credit negative for bondholders of outstanding non-structured senior unsecured debt issued by German banks because it effectively perpetuates their non-preferred status. The draft law likely will take effect on 1 July 2018, but remains subject to amendments before becoming a law.

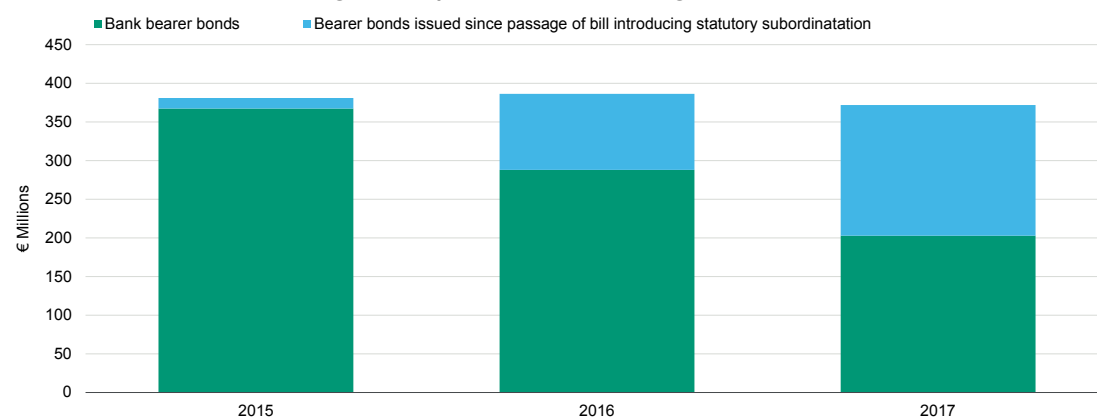
Unlike other EU members, Germany on 1 January 2017 introduced a statutory subordination of all outstanding senior unsecured debt if the particular instrument is a simple, non-structured bond. The move effectively weakened investors' position in a bank resolution owing to the expected higher loss severity for such instruments. Because the draft legislation affirms these instruments' non-preferred position in resolution, they will lose their eligibility as collateral in repo transactions with the European Central Bank (ECB) starting in January 2019, making the instruments less liquid. With the draft legislation, the German government plans to introduce a subordinated (non-preferred or junior) senior unsecured debt class based on contractual subordination that will rank *pari passu* with the current stack of plain vanilla senior unsecured bonds.

The new framework will provide more funding flexibility to banks and ensure future ECB eligibility of the new senior unsecured instruments that banks issue. Additionally, the existing stack of statutory subordinated senior unsecured debt should support competitive pricing of senior unsecured funds relative to other EU banking systems that mostly have considerably smaller volumes of non-preferred debt outstanding. And, German banks are more likely to comply with new rules for the Minimum Requirement for Own Funds and Eligible Liabilities (MREL), which will relieve them from having to issue large, more costly amounts of non-preferred debt.

However, the draft legislation would negatively affect investors in outstanding non-structured German senior unsecured bank bonds. The *pari passu* ranking for outstanding senior unsecured debt with the new contractually subordinated senior class implies that these bonds will remain MREL-eligible, highlighting their elevated risk to being subject to bail-in during a resolution.

As the exhibit below shows, we estimate that more than 40% of currently outstanding senior unsecured German bank debt was issued after German lawmakers in November 2015 passed a bill that introduced the statutory subordination of senior unsecured debt, which applies to all bank resolutions that occur after December 2016.

German banks refinanced a significant portion of outstanding German bearer bonds in 2016-17



Source: Moody's Investors Service estimates based on Deutsche Bundesbank data

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Credit implications of current events

Whereas investors in German senior unsecured bonds currently still benefit from a significant volume of equal-ranking debt, German banks may refinance part of future debt maturities with new preferred senior unsecured instruments. Doing so would decrease the currently sizable volume available to share potential losses among statutorily subordinated senior creditors. However, volume may stabilize ahead of upcoming regulatory MREL requirements that aim to ensure that banks have sufficient equity and debt available for bail-in to absorb losses and assure recapitalization.

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Credit implications of current events

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BNP Paribas' partnership with Paytweak is credit positive

Last Wednesday, [BNP Paribas](#) (Aa3/Aa3 stable, baa1³) announced that it had entered a partnership with financial technology (fintech) company Paytweak to widen its offering of digital services and secured payments for French retailers. The partnership is credit positive for BNP Paribas because it supports its competitive position in France's digital services and payments sector and helps the bank achieve its desired digitalisation strategy.

The service that BNP Paribas will offer in partnership with Paytweak targets French retailers such as artisans that still source a portion of their sales through traditional channels such as phone or mail. The service allows them to make the sales more secure, automate relevant invoices and simplify cash collection from clients. Clients can make payments via credit cards using the electronic payment platform BNP Paribas Mercanet, which they can access through a secure link sent by the retailer via email, SMS or instant message.

BNP Paribas has been an active player in the e-commerce sector since 2000, when it launched BNP Paribas Mercanet, providing services to facilitate electronic purchases and make sales and payment collections more secure and efficient for e-commerce merchants. The Paytweak partnership is one of a number of digital initiatives that BNP Paribas has undertaken as part of its strategic plan to enhance customer experience and ultimately improve its operational efficiency levels by 2020.

The bank is targeting at least 2.5% annual revenue growth, which it expects will generate a return on equity in excess of 10% through 2020. Management also has announced a €3 billion business transformation investment in 2017-19, which it expects will generate €3.4 billion in savings during this period and €2.7 billion in annual recurring savings starting in 2020. The plan includes a number of projects aimed at facilitating customer access to its services, streamlining its operating model, modernising IT infrastructure and better leveraging the use and management of data.

³ The bank ratings shown in this report are BNP Paribas' deposit rating, senior unsecured debt rating and Baseline Credit Assessment.

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Credit implications of current events

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French requirement for banks to keep Livret A deposits is credit negative

Last Monday, after hearing the Conseil d'Etat (Council of State), France's prime minister enacted a [decree](#) to specify the terms and conditions under which the so-called "over-centralisation" of Livret A and Livret de Développement Durable (LDD)⁴ deposits by French banks to government-owned [Caisse des Dépôts et Consignations](#) (CDC, Aa2 stable) will be terminated. The termination will adversely affect banks' profitability since they will no longer be able to transfer or centralise 100% of high-cost funds to CDC, a credit negative.

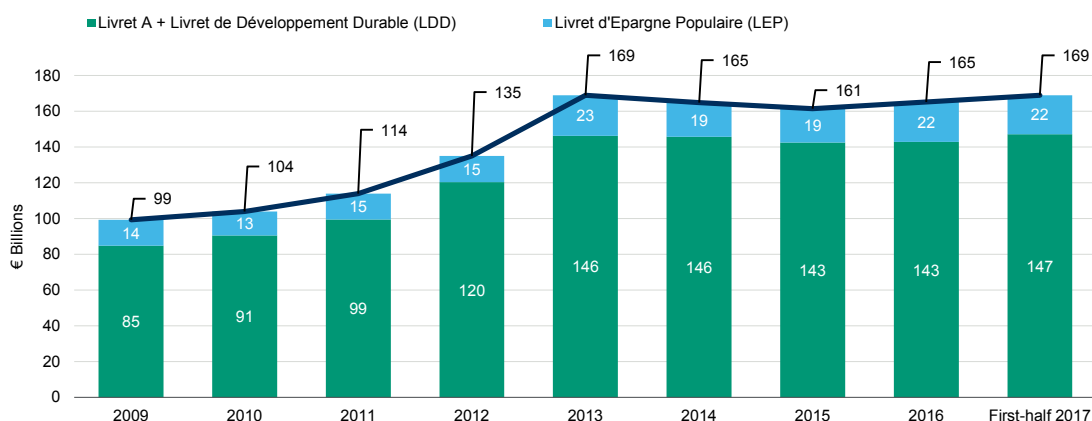
Large French banks collect deposits on CDC's behalf and get a commission on the full amount of collected deposits of 0.3% for the Livret A and LDD and 0.4% for the Livret d'Epargne Populaire (LEP). Banks typically centralise a percentage of these resources to the Direction des Fonds d'Epargne (DFE) at CDC and previously could centralise 100% of these regulated tax-free savings. CDC then recycles the funds to finance social housing and local public-sector investments.

The centralisation rate is set at 65% for the Livret A and LDD, but it may vary with a formula linked to the DFE's financing needs. The centralisation rate is currently about 60% on average, but differs among French banks and will progressively converge between 1 May 2011 and 30 April 2022 to a unique rate for all banks. On average, French banks are allowed to keep around 40% of these regulated savings on their books, for which they have to pay 0.75% of interest annually, as set by the French government. A few years ago, market conditions were such that banks were eager to keep this liquidity, which was not overly expensive. Today, the interest rate paid on these resources is much higher than the average 0.29% paid on ordinary savings accounts as of December 2017. Therefore, it is no surprise that banks were keen to transfer these resources.

Until late 2017, banks had the option to fully centralise the collection of deposits on the Livret A and LDD, thereby sending 100% of the collection to CDC. Many banks started fully centralising their regulated savings during the first half of 2016, sending nearly €30 billion of additional deposits to CDC on top of the usual centralised amount (see exhibit). As these additional flows of expensive deposits dented DFE's profitability, French authorities decided to end the option to fully centralise regulated deposits on 30 December 2017. According to the decree published last Tuesday, CDC will return to banks the deposits they had centralised above the centralisation rate. We estimate the resultant cost that banks will incur at tens of millions of euros.

Evolution of regulated savings accounts kept on French banks' balance sheets (deposits not centralised at CDC)

Livret A, Livret de Développement Durable (LDD) and Livret d'Epargne Populaire (LEP)



Sources: Banque de France and Direction des Fonds d'Epargne

⁴ Livret A and LDDs are tax-free savings accounts guaranteed by the French government. Banks receive a commission on the funds collected by government-owned Caisse des Dépôts et Consignations.

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Credit implications of current events

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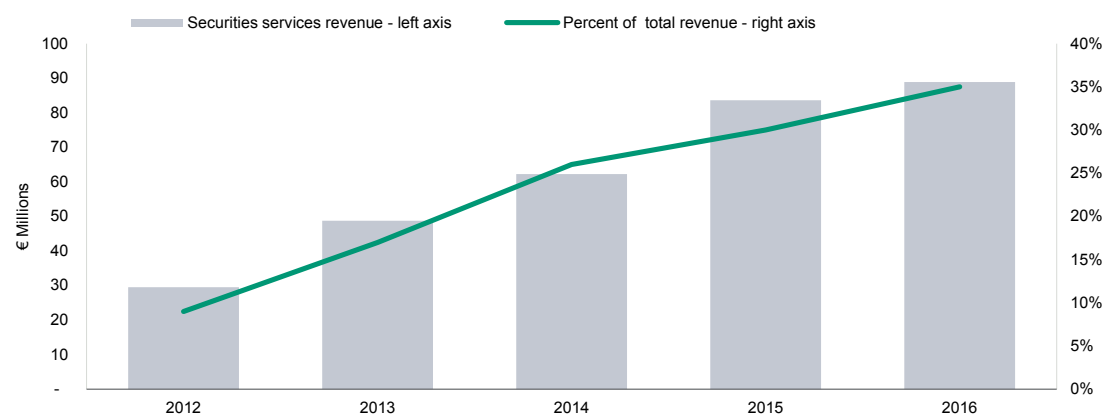
Cecabank expands its securities business franchise with equity clearing, a credit positive

Last Tuesday, [Cecabank S.A.](#) (Baa2 stable, ba1⁵) announced that it had reached an agreement with London Clearing House Limited (LCH) to become a member of EquityClear, LCH's equities clearing service. The agreement is credit positive for Cecabank because it will strengthen the bank's securities business franchise by offering its customers equity clearing services on a variety of international trading venues. Cecabank already is a member of LCH's Repoclear service, and this latest agreement will make the bank EquityClear's first Spanish clearing member.

Cecabank's new role as an equity clearer will strengthen its securities business franchise, which, although significantly strengthened since 2012, still lacks a number of securities-related services. Additionally, the agreement with LCH will allow Cecabank to gain access to 13 European equities trading venues by means of LCH's pan-European equities clearing service. Accessing a variety of clearing providers has become increasingly important in clearing in light of the best-execution requirement under the recently implemented Markets in Financial Instruments Directive II.⁶

Participating in equity clearing will allow Cecabank to increase its recurrent profitability, which over the past few years has become increasingly reliant on securities services (see exhibit). Although Cecabank earns most fees related to securities services from the provision of depositary services, it earns significant fees by providing ancillary services to its securities services customers, which now will include equity clearing. Providing such ancillary services leverages the bank's leading domestic position in providing depositary services, with more than €100 billion of assets under depositary and €125 billion of assets under custody.

Cecabank's securities-services-related revenue



Source: Cecabank's annual reports

⁵ The bank ratings shown in this report are Cecabank's deposit rating and Baseline Credit Assessment

⁶ Best execution is the obligation of a firm, when executing orders on behalf of clients, to take all reasonable steps to obtain the best possible result.

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Credit implications of current events

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Amendments to Egypt's capital markets law are credit positive for banks

Last Tuesday, the Egyptian parliament voted into law amendments in the Capital Markets Act that will deepen the financial markets in Egypt by facilitating sukuk issuance and investors' ability to hedge, making the country a more appealing investment destination to foreign investors. The amendment is credit positive for banks because the increased capital markets activity will raise banks' income from their debt capital markets business while also providing funding options.

The law's amendments include the introduction of futures trading, a commodities exchange, allow the establishment of privately owned stock exchanges, and reduce listing fees to 0.002% from 0.005% to encourage smaller companies to list on an exchange. The amendments also facilitate sukuk issuance, set higher penalties for violations of the law and set up a federation for non-banking financial companies similar to the Federation of Egyptian Banks.

Egypt's capital markets are underdeveloped relative to other African peers. Egypt ranks 14th among the 17 African countries in Barclays Africa Group 2017 Financial Market Index, which uses a variety of parameters, both qualitative and quantitative, to record the openness and attractiveness of countries across the continent to foreign investment.

Government issuance dominates Egypt's debt market and listed equities are few. Listed corporate debt issuance accounted for 0.5% of listed bonds and the market cap of listed corporations accounted for 20% of 2017 GDP. Additionally, only 32 entities were listed on NILEX, the exchange dedicated to small and midsize enterprises (SMEs), as of October 2017. Although Egypt is the largest Arab country by population, the sukuk market is inactive, something the authorities are aiming to address with the revised law.

Increasing the products offered and investors' ability to hedge will increase Egypt's attractiveness to foreign investors, which would provide additional funding options for banks. Currently, Egyptian banks are financed mainly by deposits, which accounted for 71% of non-equity liabilities as of October 2017. Furthermore, the income banks earn from their debt capital markets activity will increase, diversifying their operating income, which is heavily reliant on interest income earned from investment in government bonds. As of October 2017, government bill and bond investments accounted for 31% of banking system assets and contributed more than 41% to banks' interest income.

Although banks likely will lose loan business as some of the country's largest corporates begin to finance their operations through the yet-to-be-developed debt markets, banks' increasing lending to the country's underserved Small and mid-sized enterprises (SMEs) will support loan growth and profitability. Currently, local corporates finance their operations through bank loans, squeezing out SMEs. As of October 2017, loans to corporates accounted for around 82% of total loans. To divert much needed credit to the SME sector, the central bank introduced regulations in 2016 requiring all Egyptian banks to allocate 20% of total loans to SME loans by 2020. Local SMEs, which account for around 80% of GDP and 75% of employment, cite a lack of access to credit as a main impediment to their growth. Despite the central bank's initiative, loans to SMEs remain low at around 10% of total loans, according to our estimates.

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Credit implications of current events

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Saudi Arabia's test of fintech solutions for cross-border payments is credit positive

Last Wednesday, the Saudi Arabian Monetary Authority (SAMA) signed an agreement with US-based financial technology (fintech) company Ripple to offer a pilot program for cross-border payments. Under the agreement, participating Saudi banks can explore a solution for cross-border transactions using distributed ledger technology (DLT, or blockchain), while SAMA and Ripple provide program management, training and other support to banks.

A successful pilot likely will lead Saudi banks to integrate DLT into their existing payment infrastructure, improving payment transparency and efficiency. Saudi banks will potentially improve their profitability on cross-border transactions by reducing the cost of each transaction, while gaining revenue with higher volume as the customer experience improves with the saving of money and time. We estimate that even a 10% reduction in the cost of completing and managing a cross-border transaction will translate to savings of roughly \$200-\$400 million per year system-wide. Saudi Arabia's four largest banks – [National Commercial Bank](#) (A1 stable, baa1⁷), [Al Rajhi Bank](#) (A1 stable, a3), [Samba Financial Group](#) (A1 stable, a2) and [Riyad Bank](#) (A2 stable, baa1) – and [Saudi British Bank](#) (A1 stable, a3) and [Banque Saudi Fransi](#) (A1 stable, a3) have large correspondent banking relationships.

Saudi Arabia, like other Gulf Cooperation Council countries, has a large number of migrant workers who make a large number of low-value transactions when sending remittances to their home countries and DLT could be of particular value in such situations. The World Bank estimates that fees on remittances average a high 7.1% of the transaction volume, and we estimate that cost could fall 50% with DLT.

DLT solutions are still untested on a large scale, but have the potential to address some limitations banks have today. Cross-border payments currently take more than a day, are completed only during business hours, with uncertainty on the total costs and payments as they are routed through multiple banks, causing delays and accruing fees. The current system is not only costly and time consuming for clients, but also costly for banks that spend considerable resources managing liquidity needs and the overall transaction process, given complicated tracking, investigation and repair if needed, or in response to customer enquiries. DLT solutions such as Ripple's can process cross-border payments in seconds, at any time of day, with end-to-end visibility over the payment's journey, combining payments messaging with funds settlement, at a low cost. Payment messaging is currently mainly provided by SWIFT, and is separate from funds settlement.

SAMA is not looking to shake up its financial system, but rather expect DLT solution to act as an intermediary between Saudi Arabia's banks and global banks in the completion of transactions. SAMA is the first central bank to launch such a pilot, which suggests a growing belief among banks that they can leverage DLT to improve the transparency and efficiency of cross-border transactions. Last year, the Bank of England completed a proof of concept with Ripple, broadly concluding that DLT showed promise at enabling two separate real time gross settlement systems (the infrastructure that allows real time payments within a country or a currency block) to communicate and achieve seamless global interoperability.

Even with a successful pilot, we do not expect an imminent widespread use of DLT in cross-border payments, either in Saudi Arabia or globally. The pilot program will test the system with a small number of banks and transactions, and allow banks, regulators and the technology incubators to learn and adjust before ultimately adopting the technology for a wider use.

⁷ The bank ratings shown in this report are the bank's deposit rating and Baseline Credit Assessment.

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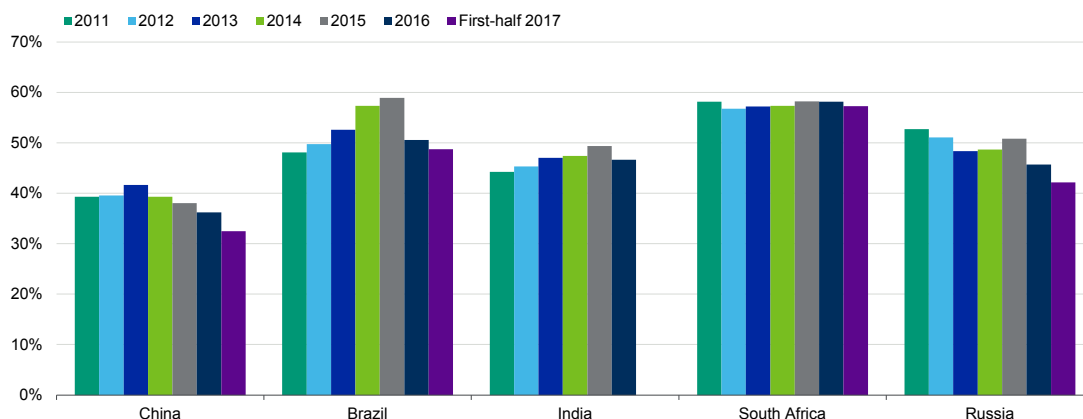
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South Africa launches financial technology program, a credit positive for banks

Last Tuesday, the South African Reserve Bank (SARB) [announced](#) the establishment of the “Financial Technology (fintech) Programme,” a starting point for the central bank to experiment with digital technologies, establish a regulatory framework for virtual currencies and assess the appropriateness of innovation facilitators. The adoption of fintech infrastructure and regulation following these assessments, which are scheduled to conclude this year, will improve efficiency, strengthen anti-money laundering practices and increase South African technologies’ competitiveness globally. These are credit-positive developments for banks that will decrease their transaction costs.

Of the three primary objectives outlined by the SARB, the most pioneering is the experimentation with distributed ledger technologies (DLTs), whose adoption can improve efficiencies in back- and middle-office functions. The cost-to-income ratio of South African banks is higher than that of peers elsewhere (see exhibit), with the improvements in the ratio in recent years also trailing peers. Consequently, adoption of more efficient and less costly processes will help bridge the growing efficiency gap.

Cost to income ratio for Moody's-rated South African banks versus peers



Source: Moody's Financial Metrics

The SARB's aim is to develop a proof of concept in collaboration with the banking industry to trial J.P. Morgan's Quorum blockchain potential in interbank clearing and settlement, with a report explaining the risks and benefits scheduled for release in the second quarter of 2018. To develop the proof of concept, the SARB will partner with ConsenSys, a blockchain software technology company, to replicate the processing of wholesale payments using Quorum, an enterprise-focused version of Ethereum, a distributed public blockchain-based network. Because this initiative, at least initially, emphasises wholesale payments processing, we expect [Nedbank Limited](#) (Baa3 review for downgrade, baa3 review for downgrade⁸) to be best positioned among South Africa's large banks to benefit because of its greater focus on wholesale banking services.

Although the initiative does not imply a radical move to DLT for the country's national payments infrastructure, the SARB's proactive approach toward the potential of blockchain, which follows a fintech working group including South Africa's central securities depository Strate, [Absa Bank Limited](#) (Baa3/Baa3 review for downgrade, baa3 review for downgrade), [FirstRand Bank Limited](#) (Baa3/Baa3 review for downgrade, baa3 review for downgrade), [Investec Bank Limited](#) (Baa3/Baa3 review for downgrade, baa3

⁸ The bank ratings shown in this report are the bank's deposit rating, senior unsecured debt rating (where available) and Baseline Credit Assessment.

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review for downgrade), Nedbank, and [The Standard Bank of South Africa Limited](#) (Baa3 review for downgrade, baa3 review for downgrade), can benefit the banking system.

Despite high initial development costs, DLTs can improve efficiency by speeding up processes and reducing infrastructure costs relating to clearing, settlement, administration, cross-border payments, and collateral management. DLTs also can improve digital security and have the potential to reduce capital requirements through reduced settlement periods.

As part of its objectives, the SARB will take a more hands-on approach with virtual currencies by addressing regulatory issues in a review in the second half of this year. Strengthened regulatory oversight of virtual currencies on matters such as settlement risks, exchange control effects, anti-money laundering activities and cybersecurity will limit the potential prudential risks these digital assets pose.

Finally, by the third quarter of this year, the SARB will have assessed the suitability of innovation facilitators such as innovation hubs and regulatory sandboxes. Fostering innovation and collaboration between the world of finance and technology can increase South African technologies' competitiveness globally, resulting in further efficiency improvements by reducing costs.

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Credit implications of current events

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Australian regulator's proposed changes to capital framework are credit positive for banks

Last Wednesday, the Australian Prudential Regulation Authority (APRA) proposed key revisions to its capital framework for authorized deposit taking institutions (ADIs). The revisions cover the calculation of credit, market and operational risks. These proposed changes are credit positive for Australian ADIs because they will improve the alignment of capital and asset risks in their loan portfolios.

The key proposals are as follows:

- » Revisions to the capital treatment of residential mortgage portfolios under the standardized and advanced approaches, with higher capital requirements for higher-risk segments
- » Amendments to the treatment of other exposures to improve the risk sensitivity of risk-weighted asset outcomes by including both additional granularity and recalibrating existing risk weights and credit conversion factors for some portfolios
- » Additional constraints on the use of ADIs' own risk parameter estimates under internal ratings-based approaches to determine capital requirements for credit risks and introducing an overall floor to risk-weighted assets for ADIs using the standardized approach
- » Introduction of a single replacement methodology for the current advanced and standardized approaches to operational risks
- » Introduction of a simpler approach for small, less complex ADIs to reduce the regulatory burden without compromising prudential soundness

A particularly significant element of the new regime is a reform of the capital treatment of residential mortgages, given that more than 60% of Australian banks' total loans were residential mortgages as of January 2018. The improved alignment of capital to risk for residential mortgages will come from hikes in risk weights on several higher-risk loan segments. APRA proposes increased risk weights for mortgages used for investment purposes, those with interest-only features and those with higher loan-to-valuation ratios (LVR). At the same time, risk weights for some lower-risk segments likely will drop. For example, under the standardized approach, standard mortgages with LVR ratios lower than 80% will require risk weights of only 20%-30%, down from 35% under current requirements.

The higher capital charges on investment loans will better reflect their higher sensitivity to economic cycles. During periods of economic strength investment loans perform well. As Exhibit 1 shows, on a national basis and during a time of strong economic growth, defaults on investment loans have been lower than owner-occupier loans. However, in Western Australia, where the economy has deteriorated following the end of the investment boom in resources, defaults on investment loans have been higher than owner-occupier loans, as Exhibit 2 shows.

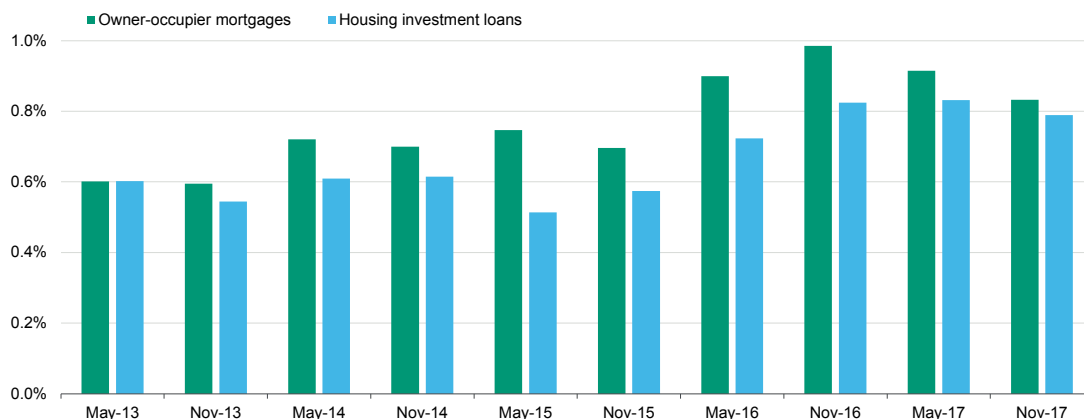
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EXHIBIT 1

Australia's investment housing loan defaults nationwide have been lower than owner-occupier loans during a period of strong economic growth

Australia's mortgage default rates

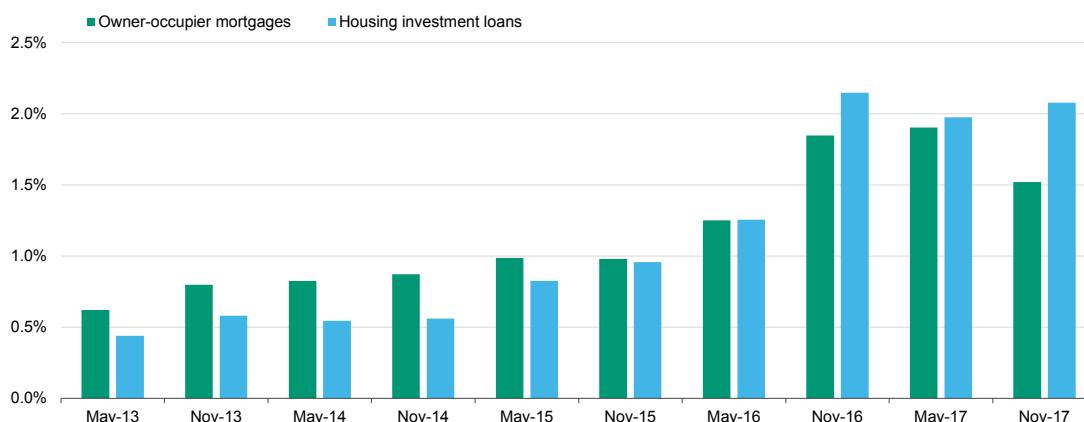


Source: Moody's Investors Service

EXHIBIT 2

Housing investment loan defaults increased in Western Australia after the end of the resources boom

Western Australia's mortgage default rates



Source: Moody's Investors Service

Investment loans also are sensitive to the interest rate cycle. During periods of rising interest rates, investment loans tend to experience higher default rates than owner-occupier loans, as shown in Exhibit 3.

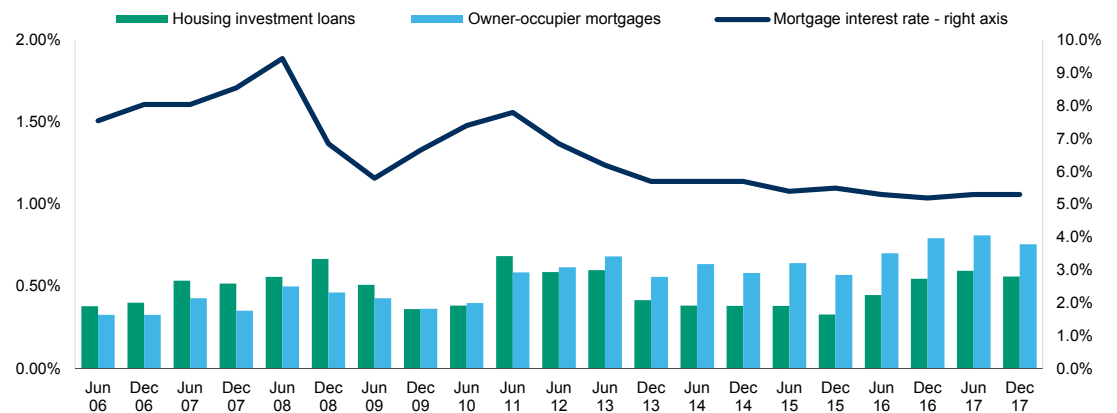
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Credit implications of current events

EXHIBIT 3

Australia's investment loans underperform when interest rates rise

Mortgage default rates



Sources: Moody's Investors Service

The new capital regime has the potential to encourage ADIs to prioritize lending to lower-risk segments of the residential mortgage market in light of the increasing capital intensity for higher LVR loans, investment and interest-only loans.

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Kemper's purchase of Infinity is credit positive for the buyer, negative for target

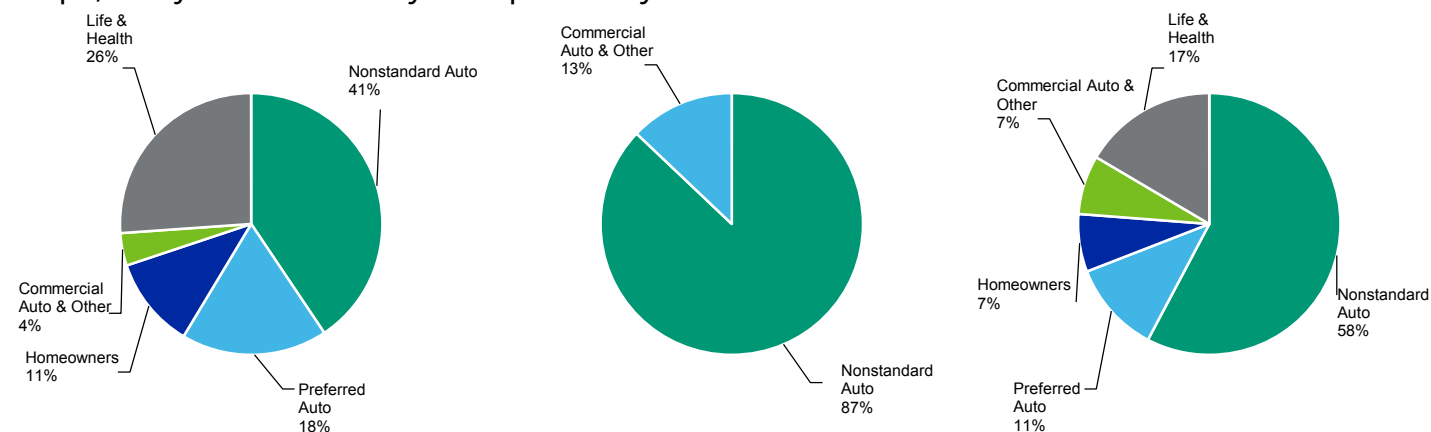
On Tuesday, [Kemper Corporation](#) (KMPR, Baa3 stable) announced plans to acquire [Infinity Property and Casualty Corporation](#) (IPCC, Baa2 review for downgrade) for about \$1.3 billion in stock and cash. Although the transaction will increase Kemper's financial leverage and reduce company liquidity, it is credit positive for Kemper because it enhances the group's position in the nonstandard auto market and adds a solid source of operating profitability. For Infinity, the transaction is credit negative because Kemper could reduce Infinity's capital to help fund the transaction and increase Infinity's investment risk over time. The parties expect the transaction to close in the third quarter of 2018, pending shareholder approvals by both companies and regulatory approvals.

Following the announcement, [we affirmed](#) Kemper's Baa3 rating and the A3 financial strength rating of its lead property and casualty insurance subsidiary [Trinity Universal Insurance Company](#) (financial strength A3 stable), and placed the ratings of Infinity and its principal operating subsidiaries, including [Infinity Insurance Company](#) (A2 review for downgrade), on [review for downgrade](#).

Kemper is a diversified holding company providing both personal lines and life and health insurance products primarily through independent agents. Infinity primarily writes nonstandard private passenger automobile coverage and has developed specific expertise through its focus on urban and Hispanic markets, a specialization that is difficult and costly for competitors to replicate. Kemper has significantly grown its nonstandard auto insurance book in recent years, particularly in California, through organic growth and its 2015 acquisition of nonstandard auto insurer Alliance United. The combined company will be the 14th-largest personal auto insurer, up from 23rd prior to the acquisition, and among the leading US nonstandard auto insurers. On a pro forma basis, Kemper's nonstandard auto business will equal 58% of 2017 earned premiums (see Exhibit 1).

EXHIBIT 1

Kemper, Infinity and combined entity earned premiums by line of business



Sources: Company Financials and Moody's Investors Service

The combined group will also have increased data and technological resources that could lead to better ratemaking, underwriting and claims management capabilities. The acquisition expands the group's nonstandard auto distribution networks. However, the combined organization will have about 53% of P&C premiums in California for the first nine months of 2017 on a pro forma combined basis.

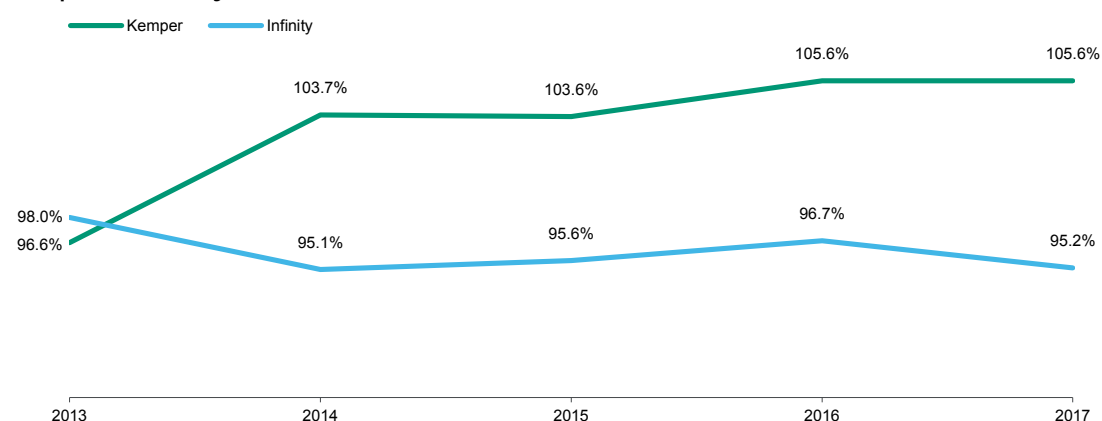
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Kemper has strong capitalization with low 2.5x operating leverage as of year-end 2016 and limited hurricane and earthquake exposure. However, it has struggled with shrinking P&C premiums particularly in its preferred auto and homeowners book, where the company has been challenged with weak underwriting results and a high expense structure. The company's combined ratio has been relatively volatile over the past five years, while Infinity's combined ratio has been relatively stable (see Exhibit 2). Kemper grew its nonstandard auto premiums by 19.2% in 2017 while posting a nonstandard auto combined ratio of 95.5%, well below its preferred auto combined ratio of 110%.

EXHIBIT 2

Kemper and Infinity combined ratios



Sources: Company Financials and Moody's Investors Service

Kemper plans to finance the acquisition through the issuance of about \$762 million of common stock and about \$570 million of cash funded by a combination of cash on hand, other internal resources, and possibly a newly issued term loan. Following the close of the transaction, Infinity shareholders will own approximately 20% of the combined company.

The planned financing is reasonably in line with the company's current capital structure, although we expect financial leverage to rise and holding company liquidity to decline post-transaction. On a pro forma basis, Kemper's financial leverage increases to around 28%, up from about 24%. The acquisition will also lead to higher goodwill on Kemper's balance sheet and higher underwriting leverage. Given the relative size of both organizations, the transaction carries significant execution and integration risks.

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Credit implications of current events

Asset Managers

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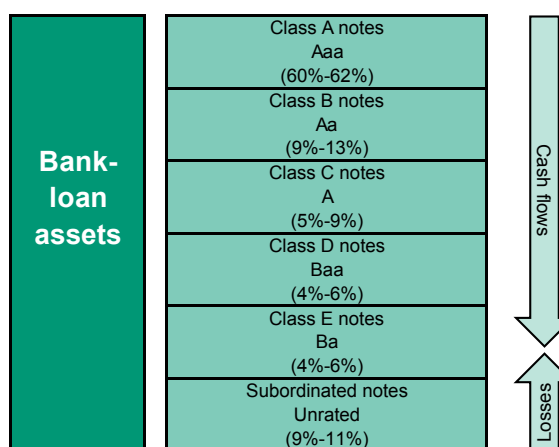
Court ruling on CLOs' risk-retention rule is credit positive for asset managers

On 9 February, the US Court of Appeals for the District of Columbia ruled that sponsors and managers of collateralized loan obligations (CLOs) need not retain capital equal to 5% of their deals. The appeals court determined that asset managers of "open-market" CLOs, unlike originators of loans that directly securitize their production, should not be required to absorb some of the risk in these vehicles. The ruling is credit positive for asset managers such as [Invesco Ltd.](#) (A2 stable) and [Neuberger Berman Group LLC](#) (Baa2 stable) because they will have greater flexibility to manage their equity commitment to the CLOs they sponsor, potentially freeing up capital or allowing smaller, capital-constrained managers to participate in this market.

Since 2014, under regulations that the US Securities and Exchange Commission and US Federal Reserve promulgated pursuant to Section 941 of the Dodd-Frank Act, CLO sponsors have been required to invest capital in the CLOs they manage. Dodd-Frank required any "securitizer" to retain an economic interest in a portion of the credit risk it transfers to a third party. However the court ruled that open-market CLO managers neither originate the loans nor hold them as assets at any point. Instead, the ruling [stated](#), "like mutual fund or other asset managers, CLO managers only give directions to an SPV [special-purpose vehicle] and receive compensation and management fees contingent on the performance of the asset pool over time." The SEC and Federal Reserve have 45 days to appeal the ruling, but are unlikely to do so.

CLOs issue different classes of securities and use the proceeds to acquire loans that typically are of lower credit quality. Interest and loan payments flow to the CLO's noteholders, and residual amounts go to subordinated noteholders, who hold 9%-11% of the liabilities (see exhibit). Managers of open-market CLOs under the 5% retention rule had the option of buying a "horizontal slice" of their CLOs' equity (approximately 60% of the market), or a "vertical slice" of the different classes of notes (40%). This requirement will now lapse with the appeals court's ruling.

Structure of a typical CLO balance sheet



Percentages indicate typical ranges for each class' share in the total liability structure.

Source: Loan Syndications and Trading Association

To fund their requirements, managers created risk retention funds (RRFs), especially for the purchase of the more volatile CLO equity slices. With an RRF, a manager could lay off some of its risk retention requirement to other investors while earning management and performance fees at both the CLO level and the RRF level. CLO equity investors preferred to invest in RRFs, which provided actively managed, diversified exposure to CLO equity returns.

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We expect the removal of capital requirements to increase participation in the CLO sector, increasing assets under management and fees. And, over the next 12-18 months, RRFs will remain in place, continuing to serve their investors according to the terms of their partnership agreements. Some managers will remain active investors, reallocating RRF capital to new equity vehicles that will support future CLOs.

However, technical features of the loan market are driving capital flows and returns, and will ultimately determine sponsors' willingness to absorb risk. CLO issuance has been particularly strong in the low interest rate environment of the past few years as investors sought higher-yielding securities. CLOs have been an important source of demand for private-equity firms' leveraged loans, and it is excess demand for loans that will drive yields lower and eventually constrain new CLO issuance. In response to the demand, leveraged loan spreads have already compressed and CLO sponsors have refinanced or reset the classes of notes to reduce funding costs and maintain spreads.

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Credit implications of current events

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Standard Life Aberdeen will lose Lloyds' £109 billion of assets under management, a credit negative

Last Thursday, [Lloyds Banking Group plc](#) (A3 stable) notified [Standard Life Aberdeen plc](#) (A3 stable) that it will terminate its investment management contract with Lloyds. Under the contract, Standard Life Aberdeen manages £109 billion of assets for Lloyds' insurance subsidiary, Scottish Widows. Lloyds' review of the investment management contract was prompted by Aberdeen's recent merger with insurance company Standard Life, which now makes Aberdeen a direct competitor of Scottish Widows.

The loss of the Lloyds mandate is credit negative for Standard Life Aberdeen because Lloyds is Standard Life Aberdeen's single largest client on the basis of assets under management. Lloyds accounts for 17% of Standard Life Aberdeen's £646 billion assets under management and administration. Standard Life Aberdeen will take a £40 million impairment loss against intangible assets related to the Lloyds customer relationship. The client loss comes at a particularly inopportune time for Standard Life Aberdeen, which is in the throes of its post-merger integration process.

The contract termination is a blow to Standard Life Aberdeen, but not totally unexpected because the Lloyds relationship was at risk following Aberdeen's merger with Aberdeen Asset Management. Although the loss of such a significant client is credit negative, it will have a limited effect on Standard Life Aberdeen's credit profile because the Lloyds assets were low margin (low management fees) and contributed less than 5% to the group's pro forma revenue for 2017. Furthermore, we view this contract termination as a one-off event that is not likely to spill over into Standard Life Aberdeen's other client relationships.

Standard Life Aberdeen's brand names remain strong. Aberdeen Standard Investments has a solid distribution network among institutional clients, while Standard Life's strategic focus on pension and accumulation products strongly positions it among UK retail clients. We expect the group to gradually benefit from a more diverse revenue mix thanks to a broader product offering and enhanced distribution gained through the merger, and as synergies play out from cross-selling opportunities. The group's financial profile also remains strong with moderate leverage at around 1.4x debt/EBITDA and robust cash generation. Given relatively conservative assumptions, we expect the company to deliver on its target of £200 million of pre-tax run-rate cost synergies per year within three years.

Sovereigns

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Escalating political tension in Cameroon's Anglophone regions is credit negative

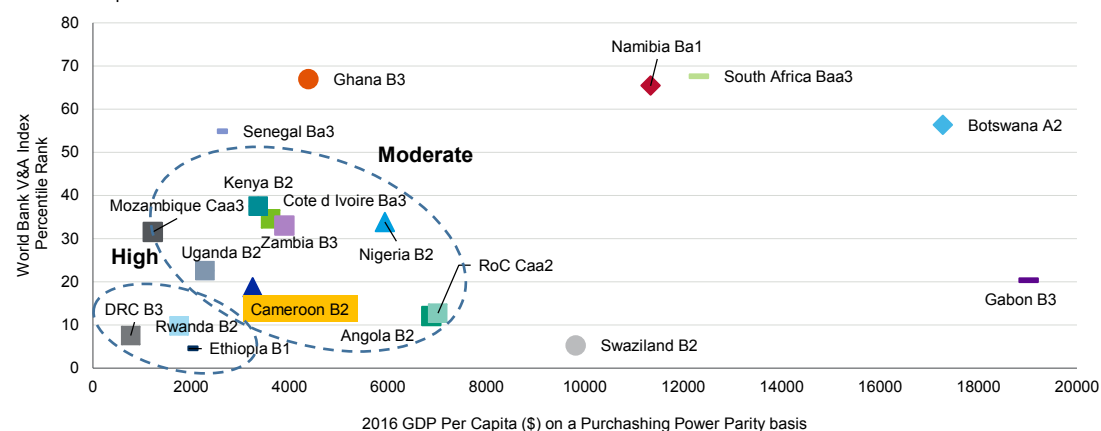
Last Tuesday, the [Cameroon](#) (B2 stable) army announced that it would continue its search for the deputy head of the Anglophone Batibo district, who is missing and was reportedly abducted following violent confrontations between the Cameroon army and separatists in the northwest Anglophone region.

The Anglophone conflict erupted in late 2016 and is progressively becoming an insurgency backed by secessionist forces, a credit-negative development for the sovereign. Since its onset, 43,000 Cameroonians have fled to neighbouring Nigeria, jeopardizing the northwest region's industrial operations. A government-imposed internet outage on the northwest and southwest Anglophone regions in January -- after recurring shutdowns in 2017 cost the country \$38 million over 93 days -- already has cost businesses at least \$1.3 million in direct costs without taking into account indirect effects of disrupted supply chains or missed remittances, according to a coalition of rights groups.

The nascent insurgency so far has been concentrated in the northwest region owing to its higher poverty and the presence of terrorist group Boko Haram. But tensions have started to spread to the resource-rich south. The southwest, an important economic centre for Cameroon, produces about 100,000 tons of cocoa beans, or almost half of national production, and is home to petroleum production and agro-industrial conglomerates such as the Cameroon Development Corporation and PAMOL Plantations Plc. As buyers avoid the region's unrest (heeding several countries' travel warnings for both Anglophone regions) we expect continuing trade disruptions to negatively affect the country's largest source of export proceeds. Additionally, an increase in the intensity of attacks could disrupt the presidential and parliamentary elections scheduled for October, which would increase Cameroon's already elevated political event risk assessment in the regional comparison (see exhibit).

Moody's domestic political risk assessment of Cameroon and other African sovereigns

Cameroon's political risk is moderate



The World Bank Voice & Accountability percentile rank measures a country's relative survey placement among all Moody's-rated sovereigns.

Sources: World Bank Worldwide Governance Indicators, World Bank World Development Indicators and Moody's Investors Service

An increase in Cameroon's political risk could have negative repercussions on its credit strength by adversely affecting production or export capacity, for instance, or reducing its access to funding on favourable terms. The International Monetary Fund has classified Cameroon's external debt as being at "high risk" when measured against the present value of exports. The IMF projects that ratio will exceed 100% by 2021 because of lower export receipts and higher external borrowing on non-concessional terms. A rising share of

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more than 15% of the country's stock of debt, or about 5% of GDP, is now composed of commercial bonds and loans. Since the beginning of the year, foreign banks have lent the government more than \$200 million to fund the construction of public projects.

We expect the conflict between separatists and the government to intensify in the run-up to the October parliamentary and presidential elections, which are subject to significant succession risks. President Paul Biya has led the country and Cameroon People's Democratic Movement party since 1982, and he has yet to declare whether he will run again in the upcoming elections. Although there is an institutional process in place in case the president is unable to discharge his duties, his advanced age (85 years old) and the lack of a named successor reduces visibility about an eventual power handover.

Securitization

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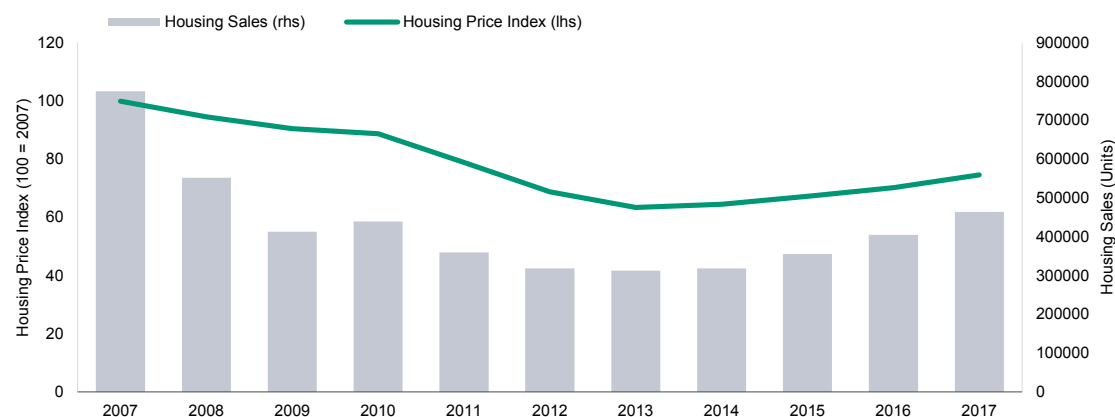
Spain's housing sales hit a 10-year high, a credit positive for RMBS

Last Tuesday, the [Spanish National Statistics Institute](#) released data showing that housing sales in Spain during 2017 reached a record high of 464,423 properties, a 14.6% increase over 2016 and a record number of sales since 2008, when the financial crisis in Spain triggered a construction crash and oversupply issues. This trend is credit positive for Spanish residential mortgage-backed securities (RMBS) because it will ease the sale of properties that issuers repossessed, facilitating a reduction in the stock of unsold properties in RMBS transactions.

Because of illiquid conditions in the real estate market, especially between 2008 and 2015, RMBS issuers, in the absence of third-party bidders at auctions, were forced to repossess most of the residential properties backing defaulted mortgages in their securitized portfolios. The currently improving environment for real estate will benefit recoveries in Spanish RMBS.

Together with higher sales, we expect house prices to rise by approximately 9% in total over the next three years, following a positive year-on-year trend that began in 2014, a turning point after the drastic drop in housing prices during 2007-15 (see exhibit). Improving macroeconomic conditions in Spain are contributing to the recovery of the domestic housing market. Low interest rates along with a declining (although still-high) unemployment rate, which declined to 17% in 2017 from a record 27% in 2013, are supporting housing affordability.

Spain's housing sales and prices are on the rise



The 2017 house price index data is as of third quarter

Source: Spanish National Statistics Institute

Despite these real estate dynamics, the increase is not exclusively fueled by an expansion in mortgage credit. The number of mortgages granted during 2017 was only one-fourth of total mortgages granted during 2007. Moreover, although it is likely that housing sales will exceed 500,000 properties during 2018 for the first time in a decade, this is still far from the nearly 1 million of annual housing sales before 2007. On the supply side, construction activity currently is at 40% of pre-crisis levels in 2007, partially correcting the oversupply in place before the crisis.

Although the improvement we expect for housing sales and prices will benefit RMBS, we do not expect the same level of improvement among repossessed properties in terms of prices. The prices of repossessed properties mainly reflect the forced sale process of distressed properties (i.e., quick sales), as opposed to

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sales between willing market participants. We expect the house price increase for repossessed properties to be lower than that of the overall residential market.

Improved conditions for residential properties also will benefit RMBS because borrowers that may have difficulty repaying their mortgages will find it easier to sell their properties in the market than getting evicted. This will help to reduce the severity for future defaults in existing RMBS transactions.

Most of the real estate recovery corresponds to the sale of second-hand properties, which total 82% of sales. This trend is credit positive because repossessed properties are in this category. Conversely, new construction remains relatively subdued at only 18% of total sales. Before the housing crisis, new properties accounted for more than 40% of total sales.

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- » Packaging Coordinator Midco's planned acquisition of Pharmaceutical Packaging Professionals is credit negative
- » Wereldhave and Citycon lack prime real estate assets to lift performance, a credit negative

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- » Approval of nuclear production tax credit is credit positive for MEAG Power and other Vogtle co-owners
- » China General Nuclear's proposed share offering is credit positive

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- » Bank of Nova Scotia acquires Canadian asset manager, a credit positive
- » Additional criminal charge related to Barclays' 2008 capital raise is credit negative
- » Nordic banking sector, bracing for fintech competition, will explore common payment infrastructure
- » Russian Central Bank presents financial technology strategy for 2018-20, a credit positive for banks
- » Arab Bank's legal case ends, a credit positive
- » Gulf Bank cleans up its loan portfolio ahead of IFRS 9 implementation, a credit positive
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