CreditOutlook

Credit Implications of Current Events

14 MAY 2015

NEWS & ANALYSIS

RECENTLY IN CREDIT OUTLOOK

Click here for *Weekly Market Outlook*, our sister publication containing Moody's Analytics' review of market activity, financial predictions, and the dates of upcoming economic releases.

Corporates

John Rogers
Senior Vice President
+1.212.553.4481
john.rogers@moodys.com

Francois Lauras
Vice President - Senior Credit Officer
+44.20.7772.5397
francois.lauras@moodys.com

Syngenta's Takeover Bid for Monsanto Raises Credit Risks for Both Agribusiness Giants

Last Friday, Syngenta AG (A2 negative) rejected a $45 billion unsolicited takeover bid from Monsanto Company (A3 negative), its US agribusiness rival. The takeover bid, although rejected, is credit negative for both Monsanto and Syngenta.

Monsanto faces high event risk because it will likely continue to pursue this transaction, and have to increase its bid and raise a significant amount of equity and/or sell assets to secure the deal and remain investment grade. Indeed, the effort to buy Syngenta led us to change the outlook on Monsanto's long-term rating to negative from stable on 8 May. Meanwhile, the very fact of Monsanto's takeover attempt implies greater strain on Syngenta's credit because it will increase pressure on Syngenta for shareholder-friendly (and credit-negative) efforts to fend off the bid.

Monsanto's offer would have paid $20 billion of the price in cash, with the remainder in shares for a total value of CHF449 (about $482) each. From a business profile standpoint, Monsanto combining with Switzerland-based Syngenta would create an extremely large, geographically diversified company in the agricultural chemical and seeds market with nearly three times the sales of its nearest competitor – even assuming that regulators would force the combined company to sell certain assets or license technologies to other competitors.

Yet because of the size of the deal, Monsanto would have to issue a substantial amount of additional equity and sell assets to fund the cash portion of the transaction to keep the combined group's credit quality from slipping considerably. Monsanto as of 31 March 2015 had a net debt/EBITDA ratio of 1.6x, while Syngenta's was 1.2x. But if Monsanto only raised debt to finance the cash consideration of the merger, the company's leverage ratio would deteriorate significantly to more than 4.0x, a level that would not support its investment-grade status.

If Syngenta had accepted the initial offer, the combined company would have roughly $32 billion of balance sheet debt (including our adjustments and excluding any additional equity issued or assets sold), assuming that 90% of the cash required is funded with debt and 10% from existing cash balances. But the combined group would have only about $8 billion in EBITDA, assuming more than $500 million of synergies. Regardless, the combined group would display much higher financial leverage than Syngenta's current standalone leverage even if Monsanto funded part of the cash component through an equity rights issue.

Syngenta's unequivocal rejection of Monsanto's initial offer suggests that the US company will have to increase its bid to secure the agreement of Syngenta's board, which has focused on its growth prospects and integrated strategy, strong product pipeline and ongoing efficiency program. But the Monsanto bid raises the risk that Syngenta's management feels increasing pressure to raise cash returns to shareholders to fend off Monsanto's approach. The need to boost shareholder returns further weakens Syngenta's credit quality.

Banks

Felipe Carvallo
Vice President - Senior Analyst
+52.55.1253.5738
felipe.carvallo@moodys.com

Colombia Proposal to Require Loss-Absorption Features for Tier 2 Bank Debt Is Credit Positive

On Monday, the Colombian Ministry of Finance and Public Credit issued a request for comment on a proposal to establish more stringent requirements for bank debt to be eligible as Tier 2 capital.[1] All subordinated debt issued after 30 April 2016 would be required to provide loss absorption through write-off or conversion into common equity Tier 1 (CET1) in order to be eligible as Tier 2 capital, triggered when a bank's CET1 ratio falls below 5.125%. The new rules are credit positive for banks' senior bondholders and depositors because if the new instruments work as intended, banks will be more likely to avoid liquidation or the need for government support.

The banks whose senior creditors will most benefit are those that rely most heavily on Tier 2 capital, and specifically on subordinated debt, such as Bancolombia S.A. (Baa2/Baa2 stable, baa3[2]) and Banco Davivienda S.A. (Baa3/Baa3 stable, ba1).

The regulations will be a further step toward Basel III capitalization guidelines and possibly to the eventual establishment of an operational regime for going-concern bank resolution. Although the new regulations are a positive step, it is unclear if these instruments will convert to equity in time to avoid liquidation or the need for government support. We view a CET1 ratio of 5.125% as being very close the point of non-viability.

Banks will need to raise new Tier 2-eligible debt to replace existing debt as it amortizes. In addition, as banks continue to expand rapidly and regulators establish additional Basel III-like norms, we expect Colombian banks to increase their sale of Tier 1 or Tier 2 securities to fulfill their capitalization requirements.

Despite a probable increase in the cost of Tier 2-eligible capital because of the new requirements, we expect that banks will continue to favor these instruments over CET1 capital in order to avoid dilution. Although Colombia currently has minimum CET1 and total capitalization requirements, the regulator has not yet established a minimum Tier 1 ratio or specific capitalization buffers above the minimums, which would encourage banks to issue Additional Tier 1-eligible instruments such as preferred shares or hybrid securities sanctioned in Decree 1648 of October 2014.

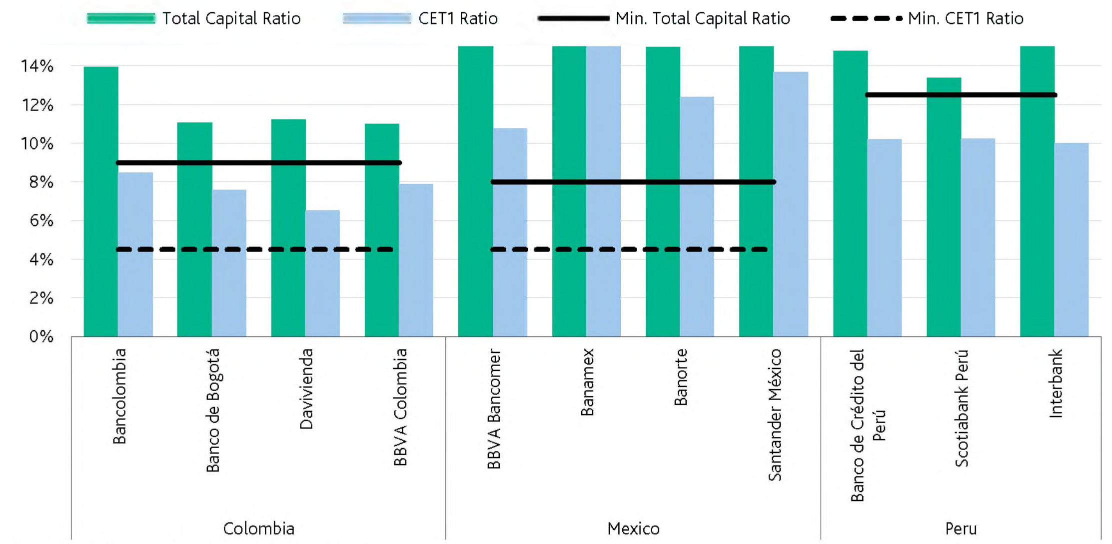
Given their low levels of common equity, Colombian banks in general rely more heavily on Tier 2 capital than other Latin American banks to meet total capital requirements. Although rated Colombian banks' average Tier 2 ratio is 4.5%, Mexican banks' average is 2.1% and Peruvian banks' is 4.4%. Consequently, Tier 2 capital and subordinated debt play a more important role in Colombian banks' loss absorption than elsewhere in Latin America. Nevertheless, Colombian banks' total capitalization levels remain lower than those of their peers (see exhibit).

---

1 In Colombia, common equity Tier 1 is known as Relación de Solvencia Básica or Patrimonio Básico Ordinario, Additional Tier 1 Capital is known as Patrimonio Básico Adicional and Tier 2 Capital is known as Patrimonio Adicional. Total Capital Ratio is known as Relación de Solvencia Total or Patrimonio Técnico.

2 The bank ratings shown in this report are the bank's deposit rating, senior unsecured debt rating (where available) and baseline credit assessment.

Comparison of Colombian Banks' Capitalization with Mexico's and Peru's
Select rated bank solvency ratios versus local regulatory minimums in Colombia, Mexico and Peru, as reported at year-end 2014.



Note: Peru has not established a minimum CET1 ratio.
Source: Moody's Banking Financial Metrics

Despite lacking loss absorption, BBVA Colombia S.A.'s (Baa2 stable, baa3) issuance on 8 April of plain vanilla subordinated debt[3] will be grandfathered as Tier 2, although its eligibility will be amortized over 10 years. The capital eligibility of outstanding subordinated debt issued before 31 March will be amortized over the last five years until maturity, but those issued between 31 March and 30 April 2016 will be amortized either over 10 years or over the last five years until maturity, whichever finishes sooner.

[3] See Moody's Rates Baa3 BBVA Colombia's Proposed Foreign Currency Subordinated Debt Issuance, 8 April 2015.

Oscar Heemskerk
Associate Managing Director
+44.20.7772.5532
oscar.heemskerk@moodys.com

Giovanni Fontana
Vice President - Senior Analyst
+44.20.7772.1475
giovanni.fontana@moodys.com

Sweden's Bank Capital Requirements Are Credit Positive

On Monday, Finansinspektionen, Sweden's banking regulator, published an update on capital requirements for the country's 10 largest banks. The requirements provide more clarity on the Pillar 2[4] capital calculation methods for credit-related concentration risk, interest risk in the banking book and pension risk. Although we do not expect these requirements to trigger additional capital raising because banks already have high capital levels, the announcement is credit positive because it mandates additional capital buffers for some banks and provides enhanced transparency.

Of the 10 largest banks in Sweden, SBAB Bank (publ) (A2/A2 stable, baa2[5]) has the highest additional requirement at nearly 4.5% (versus the previous standard of 2.0% of risk-weighted exposures), the effect of which is credit positive because SBAB must maintain full compliance with this increased level. Meanwhile, Nordea Bank AB (Aa3/Aa3 review for downgrade, a3), Kommuninvest i Sverige Aktiebolag (Aaa stable) and Länsförsäkringar Bank AB (publ) (A3/A3 review for upgrade, baa1) have the lowest estimated requirements (less than 1% versus the previous 2.0% standard), reflecting the three banks' lower exposure to the specific risks.

The new calculation methods take effect in the third quarter of this year and Sweden's four major banks must meet these requirements with at least 74% of common equity Tier 1 (CET1) capital, while the minimum for the other banks is 65% of CET1 capital. Those four major banks are Nordea Bank, Svenska Handelsbanken AB (Aa3/Aa3 review for upgrade, a3 review for upgrade), SEB (A1/A1 review for upgrade, baa1 review for upgrade) and Swedbank AB (A1 review for upgrade /A1 review direction uncertain, baa1 review for upgrade). The published requirements are generally in line with Finansinspektionen's preliminary assessment and below the standard 2.0% Pillar 2 requirement currently in effect. However, the estimated requirements differ significantly among the 10 largest Swedish banks, providing a more accurate allocation of capital buffers based on the type and amount of risk each institution faces.

Finansinspektionen has not yet published calculation methods for all the risks considered under Pillar 2. As such, Pillar 2 capital requirements for some Swedish banks could increase further as Finansinspektionen assesses additional risks. Higher capital buffers based on a more precise risk calibration will positively affect the stability of Sweden's financial system by increasing banks' loss-bearing capacity and improving the transparency of calculation methods.

4 Pillar 2 requirements follow a supervisory review and include a range of components.
5 The bank ratings shown in this report are the bank's deposit rating (issuer rating in the case of SBAB), senior unsecured debt rating (where available) and baseline credit assessment.

Sherry Zhang
Associate Analyst
+852.3758.1392
sherry.zhang@moodys.com

Winnie Tang
Associate Analyst
+852.3758.1326
winnie.tang@moodys.com

Minyan Liu
Associate Managing Director
+852.3758.1553
minyan.liu@moodys.com

China's Interest Rate Reduction Is Credit Negative for Banks

Last Monday, the People's Bank of China (PBOC) reduced both the benchmark deposit and lending rates by 25 basis points, and relaxed the cap on deposit rates to 150% of the benchmark deposit rate from 130%. This is the PBOC's third rate cut since November 2014 to counteract decelerating economic growth and reduce corporate borrowing costs. These developments are credit negative for Chinese banks because they will further narrow the spread between lending and deposit rates and reduce banks' profitability.

The new higher deposit rate cap will give banks enough pricing freedom under normal circumstances to compete against alternative cash investments, attract deposits and stabilize their deposit base. Although this change will enhance banks' liquidity, it will also heighten competition on deposits that will pressure margins. The latest increase follows the PBOC raising the cap to 130% from 120% in March.

The higher cap on deposit rates together with the deposit insurance scheme suggest that China is accelerating its pace of deposit rate liberalization. According to the PBOC, the number of institutions that price their deposits at the cap has declined, and the central bank expects that financial institutions will not utilize the cap to its fullest. Nonetheless, the higher cap may still be relevant for some small and marginal banks, especially when liquidity tightens again.

We expect overall loan rates to fall more than overall deposit rates, which will further squeeze banks' interest margins. We estimate that the interest rate spread between loan and deposit rates will narrow to 1.95%, from 2.10% currently, on the assumption that deposit rates will rise to 140% of benchmark rates, which will lower bank profitability (see Exhibit 1).

EXHIBIT 1

People's Bank of China Benchmark Rates Since 2012

	5 July 2012	22 November 2014	1 March 2015	11 May 2015
Changes in Benchmark Rates				
One-Year Loans	6.00%	5.60%	5.35%	5.10%
One-Year Customer Deposits	3.00%	2.75%	2.50%	2.25%
Interest Rate Deregulation				
Loans	0.7x floor	NA*	NA*	NA*
Deposit Cap as Percent of Deposit Benchmark	110%	120%	130%	150%
Deposit Cap as Interest Rate	3.30%	3.30%	3.25%	3.38%
Loan-to-Deposit Spread	2.70%	2.30%	2.10%	1.73% **

Notes: * With the exception of housing loans, lending rates have been liberalized since 20 July 2013.
** Interest rate spread between loan and deposit rates would narrow to 1.95% if deposit rates only rise to 140% of benchmark rates, rather than 150%.
Source: People's Bank of China

As Exhibit 2 shows, commercial banks' first-quarter 2015 net interest margin fell by 17 basis points on a quarter-to-quarter basis and by five basis points year on year following rate cuts in November 2014 and March 2015.

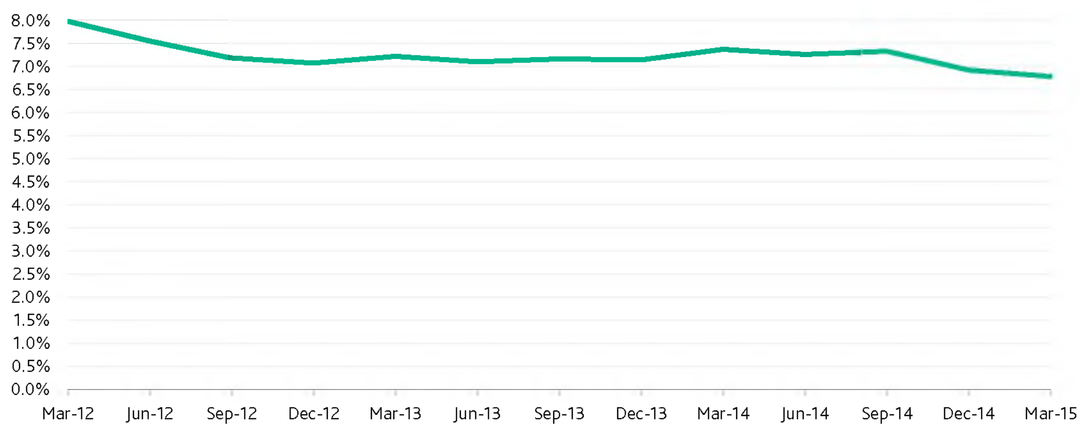
EXHIBIT 2
Chinese Commercial Banks' Net Interest Margins

Source: China Banking Regulatory Commission

Small and midsize banks are most vulnerable to this margin compression because deposits at smaller banks tend to be more price-sensitive. These banks' weaker deposit franchises suggest that they are more likely to have to offer higher rates to attract deposits. Overall, banks' deposit costs are unlikely to decline as sharply as their lending rates, which could further squeeze their interest rate margins.

The effect on bank asset quality is mixed. The reduction in loan rates from the PBOC's action will reduce repayment burdens, which are substantial and have not reflected the full magnitude of the interest rate cuts so far. According to the PBOC, average corporate loan rates fell to 6.78% as of first-quarter 2015 from 7.33% in third-quarter 2014, before the start of the current easing cycle (Exhibit 3). Additionally, consumer price inflation averaged 1.3% between January and April this year, down from 2% for full-year 2014, which suggests that real borrowing costs have not come down nearly as rapidly as the nominal rate cuts would imply. Provided that inflation stabilizes at its current pace, the latest rate cut will more directly reduce real borrowing costs.

EXHIBIT 3
Chinese Banks' Weighted Average Lending Rate Remains Elevated



Source: People's Bank of China

There is a risk that lower loan rates and margins will increase banks' appetite to expand their lending to high-risk borrowers such as small and midsize enterprises because of the higher yield these loans offer to compensate rising margin pressure. This would likely raise asset-quality risk for banks without an expertise in this area.

Insurers

Scott Robinson
Senior Vice President
+1.212.553.3746
scott.robinson@moodys.com

Genworth's Partial Sale of Australian Insurance Subsidiary Is Credit Positive

On Monday, Genworth Financial Inc. (unrated), the ultimate parent of Genworth Holdings, Inc. (Ba1 negative), announced that it had sold a 14.2% stake in its Australian mortgage insurance business for approximately $220 million. The sale includes main Australian operating subsidiaries Genworth Financial Mortgage Insurance Pty Ltd. (Genworth Australia, finance strength A3 negative) and Genworth Financial Mortgage Indemnity Ltd. (Genworth Indemnity, financial strength A3 negative). The transaction is credit positive because it will raise funds to ensure that Genworth Financial's US mortgage insurance operations comply with revised regulatory counterparty capital requirements. We also expect the company to use some of the proceeds to reduce debt.

Somewhat offsetting these benefits is that the sale will shrink the dividends the holding company receives from Genworth Australia to service its debt. However, the dividend cut will be modest because Genworth Financial will retain a 52% stake in the Australian operations following both this most recent sale and a partial initial public offering in May 2014. Genworth Australia (as well as the company's Canadian mortgage insurance operations) paid $109 million in dividends during 2014, and Genworth Financial has cash needs of approximately $350 million per year for interest and other corporate expenses, according to our estimates.

Based on the US government-sponsored enterprises' (GSEs) April 2015 finalized capital requirements for mortgage insurers under the private mortgage insurer eligibility requirements (PMIERs), Genworth Mortgage Insurance Corporation (financial strength Ba1 positive), Genworth's flagship US mortgage insurer, estimated that its available assets fall short by $500-$700 million. The company has stated that it is evaluating measures to address the shortfall, including reinsurance and additional cash contributions from the holding company.

Genworth Financial's partial sale of its stake in its Australian mortgage insurance is part of a plan to provide additional capital to Genworth Mortgage Insurance and pay down debt. Genworth Financial is also facing a number of challenges in its life insurance business, in part because of its exposure to a large legacy block of underperforming long-term care policies. In discussing its first-quarter 2015 results, Genworth Financial updated the status of a strategic review aimed at enhancing shareholder value. Although the company has made no decisions, one scenario involves shrinking its life insurance operations, including potentially selling Genworth Life and Annuity Insurance Company (financial strength Baa1 negative). Management also said they it intended to sell the company's lifestyle protection insurance (book value of $758 million as of first-quarter 2015).

Prudent management actions have improved Genworth Financial's capital resources, including insurance company capital levels and cash on hand, offsetting some of the negative developments in long-term care and the effect of a potential downside scenario, such as a reserve increase. Capital restructuring, such as the partial sale of its stake in Genworth Australia, could have been credit negative had the company used the proceeds to repurchase shares. Historically, as in this case, the company has balanced the competing interests of these two stakeholders.

US Public Finance

Ted Hampton
Vice President - Senior Credit Officer
+1.212.553.2741
ted.hampton@moodys.com

Illinois Court's Rejection of Pension Benefit Cuts Is Credit Negative

Last Friday, the Supreme Court of Illinois (A3 negative) unanimously ruled that 2013 pension reform legislation violates the state constitution. This development is credit negative for the state because the reforms would have reduced Illinois' reported pension liability by about $21 billion. Rejection of the pension benefit legislation puts the state under increased pressure to devise a way to pay for liabilities created through decades of insufficient contributions.

The reforms included measures to reduce the state's accrued pension liability on its largest pension plans through cost-of-living adjustment reductions, caps on final salary for benefit calculation and higher minimum retirement ages. The state, which operates under a 1970 constitution that includes a specific protection for public pension benefits, argued that even if such measures amounted to benefit cuts, they were legally justified to avert a fiscal crisis and maintain core services.

In its opinion, the seven-member court rejected the notion that the state had a legal basis to break a contractual commitment to public pension participants, upholding a November 2014 lower court ruling that invalidated the reforms. This ruling was widely expected following comments last summer by the state's highest court in a case that dealt with healthcare benefits provided through the pension systems.

Illinois Governor Bruce Rauner has proposed alternate legislation to reduce pension costs as a part of his plan to address a general fund deficit of $6.7 billion in the fiscal year starting 1 July. The governor's approach, which has yet to be incorporated in legislation, would force employees' future benefit accruals to follow a less-generous plan devised for workers who were hired after 2010. Although Mr. Rauner asserts that these pension plan changes would not violate the state's constitutional protections, we believe they will at least be subject to litigation and delay. Moreover, the court's latest ruling raises doubt that they can be implemented at all.

Given these facts, the state will come under increasing pressure to manage its pension liabilities through other means. One initiative the state has already considered is shifting the funding burden for teachers and public university employees to their employers, a strategy that is likely to be controversial. A funding burden shift to school districts and universities would alleviate the pension burden on the state, which now shoulders the bulk of employer contributions for school teachers outside Chicago and for university employees statewide. A shift in the funding burden would be negative for the credit standing of state universities and for many local governments, which would have to bear a much greater share of the employer contributions for their workers.

Another approach to satisfying the state's outsize pension liabilities is cutting spending on other services or raising taxes to pay for the growing funding requirements. To date, the state has not tried to orchestrate a funding strategy that assumes it will need to satisfy the existing pension liabilities over an extended period.

NEWS & ANALYSIS

Credit implications of current events

Edna Marinelarena
Associate Analyst
+1.212.553.1383
edna.marinelarena@moodys.com

Anne Cosgrove
Vice President - Senior Analyst
+1.212.553.3248
anne.cosgrove@moodys.com

Volvo's Expansion Plan Is Credit Positive for South Carolina and Berkeley County

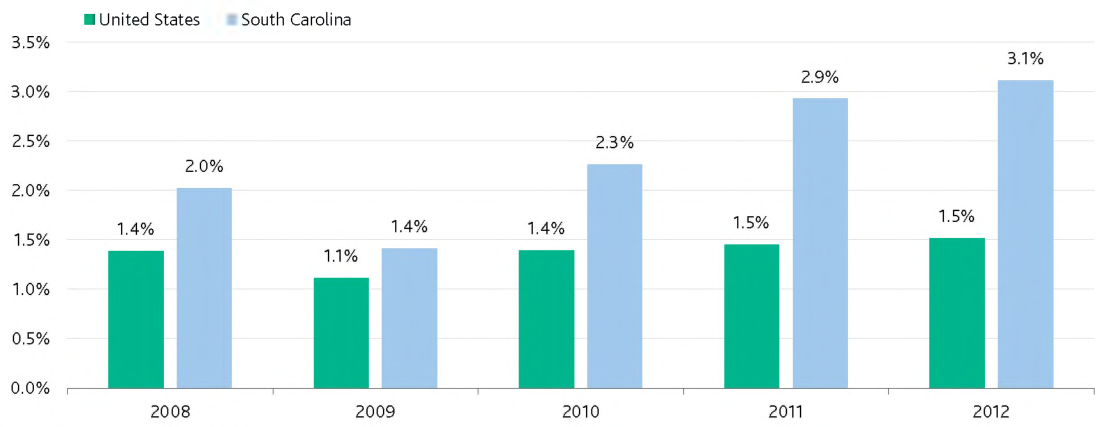
On Sunday, Volvo Car Corp. announced that it had chosen Berkeley County, South Carolina (general obligation Aa2), as the location of its first US factory, where it will invest $500 million in a facility to produce up to 100,000 cars a year. The announcement is credit positive for South Carolina (Aaa stable), Berkeley County and other local governments in the region where the factory will add 2,000 new jobs. The factory will contribute $4.8 billion in economic output per year, according to the state's analysis.

A College of Charleston study estimates that the expansion will generate $11.3 million annually in state and local taxes starting in the fiscal year ending 30 June 2017, rising to $72.3 million upon completion of the project's first phase, which will be no later than 2024, and then doubling to $144.7 million by 2028 once the plant doubles in size.

Construction is scheduled to begin in fall 2015, with the factory to open in 2018; Volvo estimates the factory could expand operations to employ up 4,000 people by 2030. This further strengthens South Carolina's already healthy auto manufacturing sector, which accounts for 3.1% of state GDP, and continues a recent trend of automaker initiatives in the state. BMW AG operates a plant in Spartanburg County (general obligation Aa3) that employs 8,000 people, and recently announced a $1 billion expansion to its plant, the fifth expansion since it opened in 1994, to produce 450,000 vehicles per year (up from 300,000) and to grow its force at the site by 800 new jobs. In March 2015, Daimler AG announced a $500 million expansion near Charleston (general obligation Aaa stable) that will employ 1,300 workers to manufacture work vans.

Volvo's announcement comes as many global carmakers are building new factories in Mexico rather than the US to take advantage of lower labor costs and low export costs through free trade agreements. However, South Carolina is bucking this trend with auto manufacturing growth that has outpaced the national rate since 2008 (see exhibit), in part owing to its low unionization rate, willingness to provide economic incentives and attractive transportation infrastructure. Moody's Analytics reports that South Carolina's employment recovery is outpacing that of the nation and deems the state one of the top performers in employment growth in the South.

Comparison of US and South Carolina's Auto Manufacturing as a Percent of GDP



Source: US Bureau of Economic Analysis

The Volvo facility will be located along Interstates 26 and 95, providing easy access to the Port of Charleston and Georgia's Port of Savannah, a major driver behind Volvo's choice to expand operations in South Carolina. To attract Volvo, we expect the state to provide $120 million of funding for transportation infrastructure, environmental mitigation and site work. The funding is likely to be financed as state general obligation debt through the State Economic Development Bond Act, subject to approval by legislative committee and the State Budget and Control Board. The county incentives include a fee-in-lieu-of-taxes agreement that excludes the plant from property taxes through 2018, and further local tax breaks if the plant meets its investment target of $600 million.

Berkeley County's primary revenues come from property taxes (39.6% of general fund revenues) and sales taxes (17.6%), both of which have been growing modestly in recent years because of tax-base expansion (a five-year average growth rate of 3.0%) and population growth (9.1% increase since 2010). Although the increased activity in the county will immediately benefit sales taxes, Berkeley's property taxes will not be affected for the first three years, and thereafter will vary based on Volvo's level of investment in its plant. An additional benefit for the county is that it will provide water and sewer service to the factory and expects $1.34 million per year in additional operating revenue for the utility starting in 2018, as well as a total of $10 million in impact fees.

RECENTLY IN CREDIT OUTLOOK

Select any article below to go to last Monday's Credit Outlook on moodys.com

NEWS & ANALYSIS

RATINGS & RESEARCH

EDITORS

News & Analysis: Jay Sherman and Elisa Herr

PRODUCTION ASSOCIATE

Amanda Kissoon