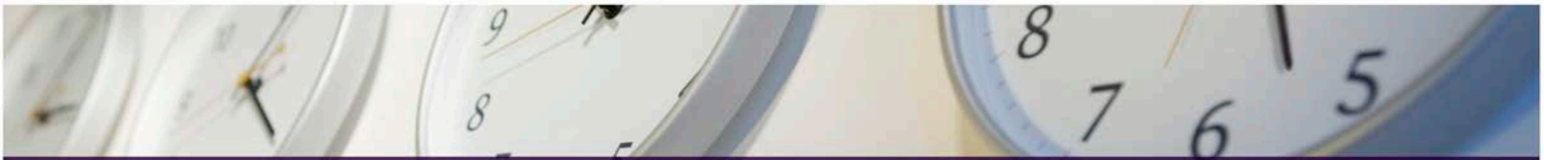

CreditOutlook

Credit Implications of Current Events

9 MARCH 2017

NEWS & ANALYSIS

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US Healthcare Legislation

Proposed American Health Care Act Would Be Credit Positive for Insurers

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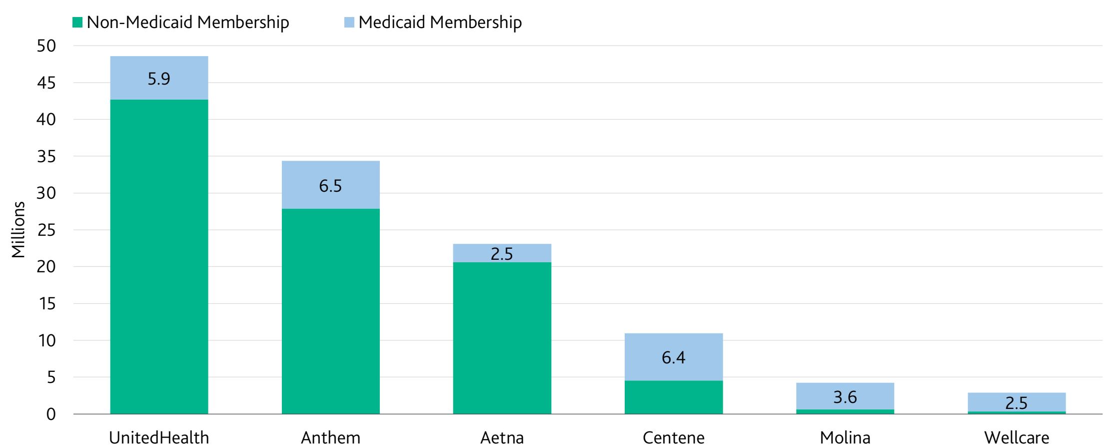
On Monday, Republicans in the US House of Representatives unveiled their proposed American Health Care Act of 2017 (AHCA) to replace the Affordable Care Act (ACA). The proposal is credit positive for health insurers because it should provide a better risk pool by improving incentives for younger and healthier people to enroll and move the most costly patients into federally funded high-risk pools. Under the ACA, the enrollees in the individual markets were sicker, older and far more costly than had been originally forecast. AHCA should create a more profitable enrollment pool.

The proposal is also credit positive for companies that specialize in Medicaid (see Exhibit 1). Previously, we believed that Medicaid expansion under ACA, which added approximately 11 million members to Medicaid, would be eliminated, but in the AHCA proposal Medicaid expansion remains in place until 2020, and is then frozen. Additionally, the proposed funding mechanism for Medicaid should benefit health insurers. We believe that Medicaid membership could grow over the next three years, which should help boost earnings of Medicaid insurers.

EXHIBIT 1

Top US Insurers' Medicaid and Non-Medicaid Membership as of 31 December 2016



Sources: The companies and Moody's Investors Service

The health insurance industry has lost billions on the ACA exchanges since 2014, and we estimate that the total losses exceeded $3 billion through 2015, with the losses trending lower in 2016 owing to higher premiums, revised plan designs and more selective participation by insurers in the exchanges. A smaller and sicker enrollment than government officials initially expected caused the losses. The US Department of Health and Human Services has estimated that year-end 2016 enrollment on the ACA exchanges was 10 million, while 10.7 million eligible people were not enrolled, despite 84% of them being eligible for subsidies.

Young and healthy individuals have not enrolled in the ACA in large numbers because of cost, and their absence has skewed the risk pool. The ACA required that all policies eligible for subsidies include 10 essential health benefits, several of which, including maternity coverage, were not needed or wanted by many consumers, but increased cost. Also, the ACA required that older people not be charged more than 3x the amount of younger people. Before the ACA, the band had averaged 5 to 1. In effect, the law required younger people to subsidize older people.

The AHCA addresses these issues. Young people will be able to buy lower-cost plans and still qualify for a tax credit. The bill also restores the cost band between young and old to 5 to 1, which should also help lower the cost of plans for young people. There will be a continuous coverage requirement, which should incentivize all ages to maintain coverage. For those who maintain coverage, the cost of coverage will not reflect any pre-existing conditions. Those who enroll after getting sick will face higher costs, at least for a specified time period. Overall, these changes should help create a more balanced risk pool and help improve the profitability of the individual market. Finally, the establishment of high-risk pools will take some of the most costly members out of the individual market.

The second positive is the preservation of Medicaid expansion until 2020. After 2020, Medicaid expansion will be frozen with no new enrollment permitted. And, Medicaid, which is currently an unlimited cost-sharing arrangement between the states and the federal government, will shift to a per-capita grant system. States will get an annual grant based on the number of enrollees. This fixed pot of money will further encourage states to use managed care, which currently covers two thirds of all Medicaid enrollees, but, according to industry executives, the remaining one third tend to be in in higher-cost programs. Overall, the proposed Medicaid expansion rules, which we had expected would be credit negative, should be credit positive, at least through 2020. Exhibit 2 compares the ACA with the AHCA.

EXHIBIT 2
Comparison of the ACA with the AHCA

	ACA	AHCA
Individual Mandate	Yes	No, but continuous coverage incentive
Old/Young Premium Ratio	3:1	5:1
Required Coverage of Essential Health Categories	Yes	No
High-Risk Individuals	Enrolled in ACA exchanges or Medicaid	Encourage states to establish high-risk pools aided by federal funding Insure people with pre-existing conditions if they maintain continuous coverage
Assisting Lower-Income Individuals	Subsidies to reduce premiums vary with income. Also expanded Medicaid eligibility	Refundable tax credit tied to age and income
Health Savings Accounts	Limited	Yes
Expanded Eligibility for Medicaid	Yes	Extended until 2020
Federal Medicaid Financing	Shares costs with the states. Pays half for traditional Medicaid and 90% of Medicaid expansion costs	Per capita grants

Sources: "Introducing the American Health Care Act," House Republican Document, Budget Reconciliation Recommendations Relating to Repeal and Replace of the Patient Protection and Affordable Care Act, Healthcare.gov

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Legislation to Repeal Parts of US Affordable Care Act Is Credit Negative for Hospitals

On Monday, the US House of Representatives released legislation to repeal and alter aspects of the Affordable Care Act (ACA). The legislation contains proposals that will affect hospitals, many of which are credit negative because they would reduce the number of people with health insurance and increase bad debt and uncompensated care costs. However, some elements of the legislation, such as preserving federal funding for Medicaid expansion for several years, have no immediate credit effect, while others, such as eliminating scheduled Disproportionate Share (DSH) cuts for states that did not expand Medicaid, are credit positive.

Components of the legislation most likely to negatively affect hospitals are the Medicaid expansion freeze in 2020, transitioning federal Medicaid payments to a per-capita payment to the states and changes to how subsidies are calculated for people who buy coverage on the exchanges. Restoring DSH cuts to non-expansion states is credit positive for hospitals in those states. Repealing the individual mandate to obtain health insurance and replacing it with a "continuous coverage" requirement will only modestly increase insurance coverage.

Importantly, the legislation does not repeal Medicaid expansion; states would be allowed to maintain expanded Medicaid eligibility, but they would bear a greater share of the costs starting in 2020. Expansion of Medicaid eligibility has been the single largest driver of insurance coverage gains under the ACA. Starting in 2020, federal support for Medicaid would involve per-capita payments indexed to inflation (currently, federal Medicaid payments are not capped and rise or fall with state expenditures on Medicaid). We expect that federal payments will grow more slowly than Medicaid program costs, forcing states to make changes that would likely be credit negative for hospitals, including lowering payments to hospitals and other providers, reducing coverage or benefits and reducing targeted payments to safety-net hospitals. States that have not expanded Medicaid would still have the ability to do so before 2020.

Eliminating cuts to Medicaid DSH (payments to hospitals that care for a disproportionately large share of uninsured individuals) for the 19 states that did not expand Medicaid would be credit positive for hospitals in those states, particularly for safety-net providers.

Changes to subsidies available to people purchasing insurance on the exchanges would be credit negative for hospitals because they would reduce the subsidy available to many people, prompting them to drop insurance coverage. Subsidies under the legislation would be based on age, with no subsidies available to people who exceed the income threshold. The legislation would also allow insurers to charge up to 5x more for older people than younger people, versus 3x today. This would lower costs for younger enrollees, encouraging more of them to purchase insurance and contributing to stability on the exchanges.

However, this will also raise costs for older enrollees, causing more of them to drop coverage, which is credit negative for hospitals. We believe that the effect of older enrollees losing coverage will outweigh the positive effect of younger people gaining coverage given that older people have greater healthcare needs and as they lose coverage, hospitals would incur greater uncompensated care and bad-debt costs.

Repealing the individual mandate would be credit negative for hospitals because some individuals would drop insurance coverage if they no longer face a financial penalty for not purchasing insurance. However, the credit effect on hospitals is not material given that the current financial penalties for not purchasing insurance are too small to compel many young and relatively healthy people to buy insurance. Likewise, the discontinuation of the mandate is not as material proportionately because the proposed changes to Medicaid expansion are responsible for the majority of insurance gains since the passage of the ACA.

The House legislation replaces the individual mandate with a continuous coverage requirement to incentivize people to purchase coverage. Under continuous coverage, insurers cannot deny coverage to anyone (regardless of pre-existing conditions) so long as they have maintained continuous coverage. If coverage has lapsed, insurers must charge rates that are 30% higher than they would otherwise charge. The ability of the continuous coverage requirement to keep people from dropping insurance coverage in the absence of an individual mandate will depend on the prices of available health plans and the level of subsidies available to offset premiums. However, we do not believe that the threat of a rate increase in the future will be enough to entice relatively healthy people to purchase insurance if they believe they do not need it.

Corporates

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GM's Sale of European Operations to Peugeot Is Credit Positive

On Monday, General Motors Company (GM, credit facility Baa2 stable) announced that it had reached an agreement to sell its European operations, Opel, to Peugeot S.A. (PSA, Ba2 stable) for approximately $700 million of net cash and $700 million of warrants to purchase Peugeot shares. The sale is credit positive for GM, which is disposing of a business that posted more than $5 billion in losses over the past five years and is unlikely to achieve breakeven performance until 2018 or later.

The sale allows GM to devote managerial and financial resources to more promising areas, including preserving the company's strong returns in North America and China and pursuing long-term prospects in vehicle electrification, ride sharing, autonomous vehicles and connectivity.

GM will retain approximately $7 billion in pension obligations relating to retired European workers and issue approximately $2.8 billion in debt to fund its compensation-payment to PSA for taking on unfunded pension liabilities for active employees that manufacture GM's European brands Opel and Vauxhall. This will increase funded debt to approximately $14.1 billion from $11.3 billion, but GM will be freed from the approximately $2.8 billion in pension liabilities that are included in our standard debt adjustment.

As a result, the added debt will be largely balance-sheet neutral. However, these obligations will also be easier for the company to service after eliminating the European business' operating losses. This should contribute to a modest improvement in debt/EBITDA, which was 2.2x at year-end 2016. GM will also be absolved from having to invest in technology to meet strict European emission requirements.

GM can reduce its minimum cash threshold to $18 billion from $20 billion after the deal, since it will no longer need to hold approximately $2 billion in cash to fund the European business' working capital and operating requirements, or to provide a liquidity cushion against cyclical downturns. However, the automaker plans to use this freed up cash to repurchase shares after the transaction's close, partially mitigating the sale's positive aspects. GM will also lose some scale and cost absorption, primarily for research and product development, associated with manufacturing about 1.2 million Opel and Vauxhall vehicles. And, GM removes itself from the third-largest automotive market.

Despite these negative factors, the sale is a net positive that allows GM to deal with plateauing auto demand in North America, where demand has been supported by accommodative financing that could be imperiled by rising interest rates, more subprime lending and leasing, and more incentives to reduce substantial inventory. Failure to address these issues could move the industry in the direction of excessive discounting, steep declines in residual values and a pull-forward of future demand.

In conjunction with the sale, the European finance business of General Motors Financial Company, Inc. (GMF, Baa3 stable) will be sold to a joint venture between PSA Group and BNP Paribas for €900 million. The sale is consistent with GMF's strategy of supporting GM sales and its exit from this market. However, the disposition could weaken GMF's overall credit quality if it cannot increase prime loan originations in other markets to support overall asset quality.

NEWS & ANALYSIS

Credit implications of current events

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Ardagh's IPO Launch Is Credit Positive

On Monday, glass and metal container producer Ardagh Packaging Group Ltd. (B2 stable) announced that it had launched an initial public offering that will float around 7% of the company on the New York Stock Exchange and raise up to $372.6 million. If successful, the company will use the net proceeds to reduce operating company debt, with the company's intention being to repay its euro-denominated 4.25% senior secured notes due in 2022, a credit positive.

Ardagh aims to sell 16.2 million Class A common shares at $17-$20 per share. Additionally, the underwriters will have the option to purchase up to 2.43 million additional common shares, according to a filing with the US Securities and Exchange Commission. The public listing of a portion of the company's common equity will diversify its shareholder base and provide some liquidity for the equity. The announcement follows the company's audited 2016 financial results, which were in line with expectations and published at the end of February 2017.

Ardagh's B2 ratings and stable outlook are not affected. Execution of the IPO is subject to equity market volatility and Ardagh's rating remains constrained by its high level of adjusted leverage, which, even after the expected reduction in debt, we expect will remain around 7.0x through 2017.

Given that Ardagh is currently weakly placed in the B2 rating category, any material deterioration in its business may result in a rating or outlook downgrade. Among the factors that can affect Ardagh's operating environment are the macro-economic outlook of faster-growing markets in which the company operates, increases in raw material prices, or a weakening of operating margins owing to competition. Ardagh produces packaging for leading food, beverage and consumer brands, and operates 109 facilities in 22 countries. It had global sales of approximately €7.7 billion for 2016.

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Court Judgment Against Parkson Retail Group Is Credit Negative

On Monday, Parkson Retail Group Limited (PRG, B3 negative) announced that a Chinese court had ruled as void PRG's 2004 purchase agreement for a 51% stake in department store operator Anshan Parkson, and that PRG must return the stake. The ruling, which PRG can appeal, is credit negative because Anshan Parkson was profitable (it had RMB38.5 million in net profits in 2016) and helped offset losses in PRG's 50-store network. The legal proceedings create uncertainties regarding PRG's earnings and cash flows.

Before PRG bought the stake in 2004, Anshan Parkson had been 51%-owned by Shenzhen Xinhui Industrial Company Limited (unrated) and 49% by an independent third party. PRG acquired Xinhui's stake through its wholly owned subsidiary Hefei Parkson, and in 2007 purchased the remaining 49% stake from the third party, making Anshan Parkson a wholly owned PRG subsidiary.

However, Dalian Tianhe Building Company Limited (unrated), the 40% owner of Dalian Tianhe Parkson (a PRG related party owns the remaining 60%), alleged that Xinhui held the 51% stake in Anshan Parkson as Dalian Tianhe Parkson's nominee and that Dalian Tianhe Parkson had not given its consent to Xinhui's stake disposal. The Dalian Intermediate Court in 2014 ruled in favor of PRG, but Dalian Tianhe Building Company appealed and the case was retried in the same court last December. The new judgment ruled in favor of Dalian Tianhe Building Company and ordered Hefei Parkson to return the 51% stake in Anshan Parkson to Xinhui.

PRG can appeal the judgment. However, there is now legal overhang over the stake in Anshan Parkson, which contributed approximately 4.25% of PRG's revenue but generated RMB38.5 million in net profit in 2016, a significant amount given that PRG generated an operating loss of RMB201.9 million. In addition, Dalian Tianhe Building Company may also initiate separate legal proceedings to make other claims.

PRG's credit metrics are weak. We estimate that its adjusted debt/EBITDA will be around 9x in 2017 and adjusted EBIT/interest expense will be 0.5x-0.6x. The company had cash deposits totaling RMB5.2 billion at the end of 2016, and it has a $500 million (around RMB3.3 billion) bond due in May 2018, as well as RMB539 million in short-term debt. An adverse outcome in the legal proceedings will create further negative pressure on the company's metrics and liquidity.

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PTT's Bond Buyback Offer Is Credit Positive

On Monday, PTT Public Company Limited (Baa1 stable), Thailand's national oil and gas company, offered to buy back up to $450 million of its outstanding senior unsecured bonds. The buyback is credit positive for PTT because it will lower gross leverage and reduce interest payments. The move also demonstrates PTT's commitment to maintaining a conservative capital structure.

The tender offer encompasses two longer-dated notes that have high nominal interest rates, including a 5.875% $350 million bond due in 2035 and up to $100 million of a 4.5% $600 million bond due in 2042. If the company redeems the full $450 million of these senior unsecured bonds, PTT's total adjusted debt will decrease to THB693.2 trillion ($19.3 billion) from THB709.4 trillion ($19.7 billion) at 31 December 2016. As a result, on a pro forma basis, we expect that its leverage (as measured by retained cash flow to adjusted debt) will improve to 32% from 31% at 31 December 2016.

The bond redemption also will reduce PTT's annual interest burden of THB28.9 billion ($800 million) by around THB900 million ($25 million), thereby strengthening its cash-flow generation. We project that PTT's adjusted EBITDA/interest expense ratio will improve to 9.4x from 9.2x at 31 December 2016.

PTT plans to fund the bond buyback with cash on hand. Assuming full participation, we estimate that the transaction will cost $470 million. PTT's current liquidity position is strong, as reflected by its sizable cash balance of THB215.6 trillion ($6.0 billion) and short-term investments of THB176.8 trillion ($4.9 billion) at 31 December 2016.

The bond buyback is in line with PTT's objective of prudent capital management to weather continued volatility in oil markets. The company's total borrowings declined 6% year on year to THB709.4 billion at 31 December 2016. PTT also demonstrated strong investment discipline in 2016 through a 30% cut in its capital expenditure program.

Infrastructure

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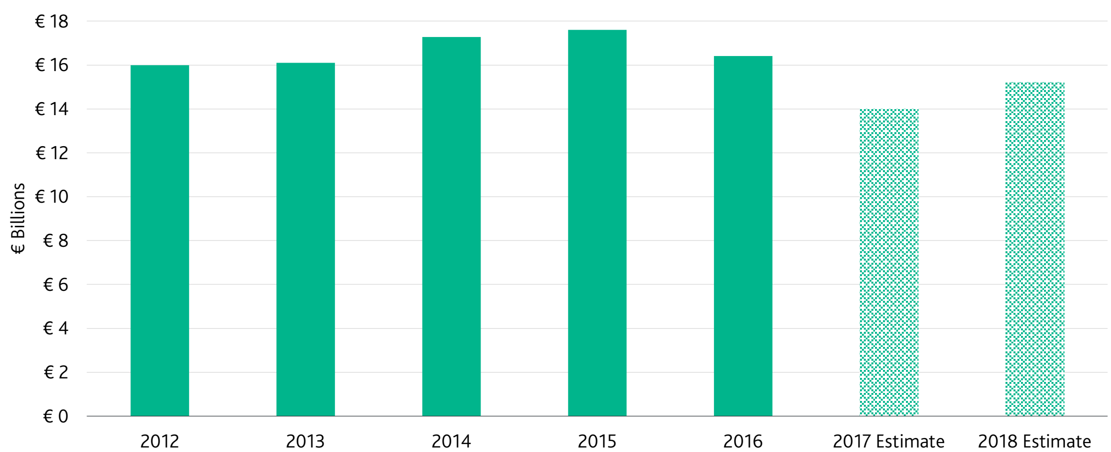
Electricité de France's Capital Increase Is Credit Positive

On Tuesday, Electricité de France (EDF, A3 stable) announced that it was launching a €4 billion share capital increase, the proceeds of which France's incumbent electricity supplier will use to finance its material investment programme and support its financial profile. The announcement is credit positive for EDF because the capital increase, which the company expects to complete by the end of March, will result in an 11% reduction in EDF's reported net debt, which totalled €37.4 billion at year-end 2016.

Pro forma for the capital increase, we estimate that EDF's ratio of funds from operations (FFO) to net debt would be around 19%, versus approximately 18% at year-end 2016. In conjunction with EDF's announcement, the French government, EDF's majority shareholder with a 85.6% stake, has confirmed that it will subscribe to €3 billion of shares, equivalent to 75% of the company's planned capital increase.

EDF's capital increase is part of a broader previously announced action plan, which includes a €1 billion reduction in annual operating expenditures during 2015-19; lowering annual net investments to €10.5 billion by 2018 from €12.4 billion in 2015; disposing of €10 billion in assets during 2015-20; and proposing that shareholders receive dividends for 2016 and 2017 in shares. EDF's action plan was prompted by persistently low power prices, which we expect will exert negative pressure on the company's cash flows (see exhibit).

EDF's EBITDA Will Decline in 2017-18 as Hedges Roll Off



Sources: Electricité de France and Moody's Investors Service estimates

The EBITDA decline comes at a time when EDF faces a substantial long-term capital expenditure programme, notably because of the large investment required to maintain and upgrade France's nuclear fleet and distribution network. Other main projects include the £18 billion construction of a new nuclear power plant at Hinkley Point C in the UK; a 1.6 gigawatt Flamanville 3 nuclear plant, whose start has been delayed to late 2018; the €4.5 billion Linky smart meter project during 2014-21; and a buildup of renewable capacity.

Banks

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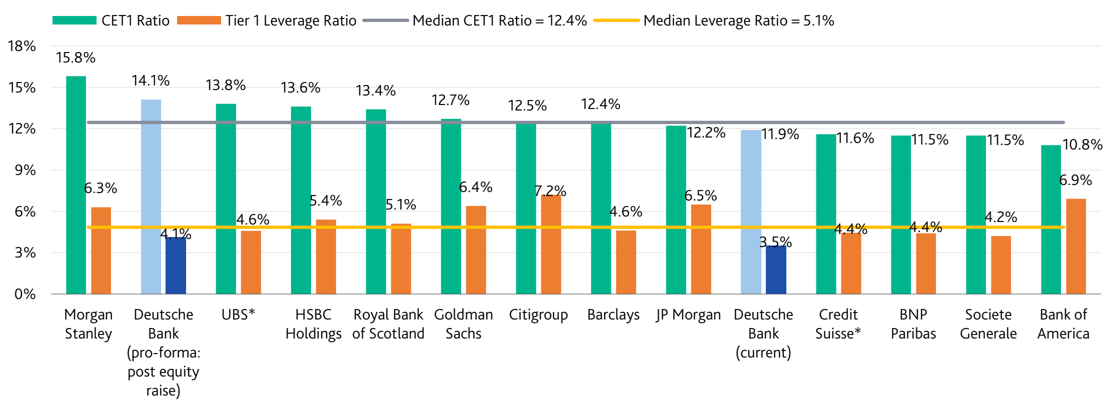
Deutsche Bank's €8 Billion Capital Raise and Strategic Course Corrections Are Credit Positive

On Sunday, Deutsche Bank AG (DB, A3/Baa2 stable, ba1[1]) announced an €8 billion fully underwritten common equity capital raise and some major course corrections to its 2020 strategic plan. These measures, on top of the firm's progress in de-risking its balance sheet, are positive for DB bondholders. Most importantly, the capital raise gives DB more time and financial leeway to achieve the revised 2020 plan, although sustainable improvement to the bank's credit strength and ratings will depend on the success of its ongoing reengineering. With plenty for management still to do, capital and liquidity protection and strong strategic execution will continue to drive DB's creditworthiness this year.

The fully underwritten €8 billion equity capital raise will increase DB's fully loaded common equity Tier 1 ratio by about 200 basis points to more than 14% pro forma as of year-end 2016, significantly improving its capital position relative to its closest global investment bank peers (see Exhibit 1), especially considering the reduction in tail risk resulting from a settlement with the US Department of Justice announced in late 2016.

EXHIBIT 1
Global Investment Banks' Fully Loaded Common Equity Tier 1 Ratios and Tier 1 Leverage Ratios as of Year-End 2016
Deutsche Bank's equity raise significantly strengthens its capital position compared with peers.



Note: * BIS definition CET1 ratio and leverage ratio on a look-through/fully-loaded basis.
Sources: The banks

The capital raise is a powerful response to the challenges DB faced in 2016, and will allow the bank to pursue business and revenue growth more assertively following losses in 2016 that hindered efforts to strengthen and stabilize profitability and led to some customer and counterparty attrition. The settlement with the Justice Department has helped alleviate concerns, and momentum has picked up in many businesses this year, aided by improved market conditions.

Along with the capital raise, DB announced five key components to the latest recalibration of its strategic plan. They are the following:

[1] The bank ratings shown in this report are the bank's deposit rating, senior unsecured debt rating and baseline credit assessment.

- Retain, rather than dispose of, Deutsche Postbank AG (A3 stable/(P)Baa2, ba1) and merge it with DB's domestic operations, thereby eliminating the Postbank ring-fencing, which would make retail liquidity more fungible and increase the potential for cost efficiencies
- An initial public offering of a minority stake in Deutsche Asset Management to provide a new share currency that DB can use for retention and recruitment of investment management talent and for potential expansion
- Reconfigure the existing Global Markets, Corporate Finance and Transaction Banking businesses into a single Corporate and Investment Banking division to generate additional cost savings and pursue a strategy more focused on cross-selling to real economy corporate clients
- Some senior management changes, including the creation of two deputy CEO positions
- Board approval of upcoming Additional Tier 1 coupons and an intention to reinstate the common dividend at a rate of €0.11 per share in May 2017

Management indicated further restructuring costs of approximately €2 billion through 2020 and a plan to establish a legacy portfolio of approximately €46 billion of risk-weighted assets, mostly in the form of legacy rates and credit positions and other non-core assets. The updated financial targets are outlined in Exhibit 2.

EXHIBIT 2
Deutsche Bank's Strategy 2020's Current and Revised Targets

	Current Targets		Revised Targets	Credit Implications
	2018	2020		
CET1 Ratio	> 12.5%		>13%	Positive
Tier 1 Leverage Ratio	4.5%	5.0%	4.5%	Negative
Post-tax Return on Tangible Equity	> 10%		No Target	
Adjusted Costs, € Billions	<€22.0		€'22.0 (2018) & €21.0 (2021)	Positive
Cost-Income Ratio	~70%	~65%	No Target	
Risk-Weighted Assets,€ Billions	~€320	~€310	No Target	

Source: Deutsche Bank

The decision to retain, rather than dispose of, Postbank is a major strategic reversal. If approved by regulators, the plan to integrate Postbank into DB's existing German private and commercial banking and wealth management businesses may eventually bring bondholder benefits in the form of fungible liquidity across the bank, and a greater contribution of earnings from German retail banking, bringing more balance to the business mix. Streamlining and refocusing these businesses will help DB build leaner, more profitable franchises that more closely match its long-term strategic goal to simplify and de-risk the bank while revitalizing its operating platform and processes.

At this stage, however, we think large cost savings will prove difficult to achieve. In 2016, DB reported an 84% cost-to-income ratio for Postbank and an 83% cost-to-income ratio for the Private, Wealth & Commercial Clients segment, illustrating the formidable execution challenge the bank will face to reach its 65% target. The task is further complicated by the fact that Postbank owns BHW, a savings and loan association whose business model is particularly challenged by the low interest rate environment.

This is an excerpt from a longer article that can be found here.

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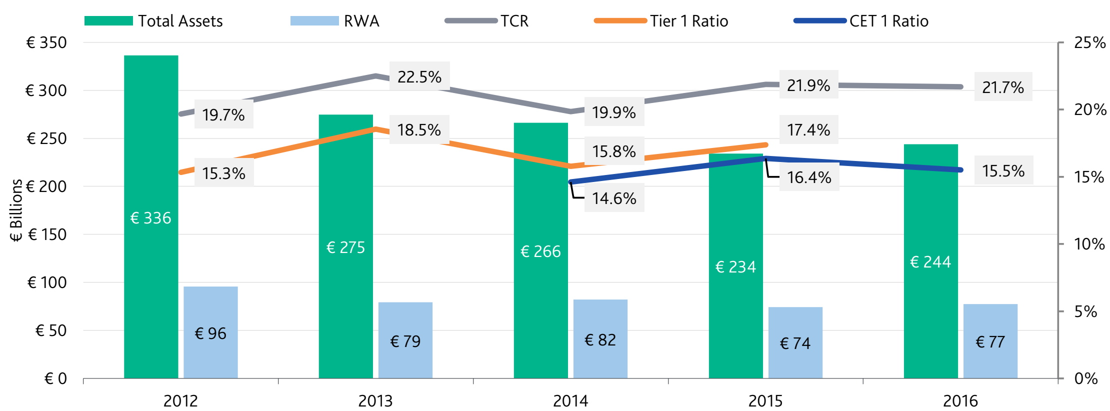
LBBW's Intention to Fully Distribute Its 2016 Profit Is Credit Negative

Last Thursday, Landesbank Baden-Wuerttemberg (LBBW, Aa3/A1 stable, baa3[2]) announced that it would propose a full distribution of its €219 million 2016 profit (based on German local GAAP) to its owners. The proposal is credit negative because it will reduce the bank's regulatory capital ratios as the bank's balance sheet grows.

Increasing risk-weighted assets of €3 billion with no profit retention will weaken LBBW's 2016 transitional common equity Tier 1 capital (CET1) ratio by 90 basis points to 15.5%. LBBW's chairman said that the bank had completed its financial-crisis-driven balance-sheet downsizing and will now focus on new business opportunities. We think that the plans will provide for a lower capital buffer because the bank will focus on lending growth.

LBBW's capital remains well above the required total regulatory ratio of 11.58% (see exhibit), as determined by the regulator following the supervisory review and evaluation process in November 2016. However, its reported capital ratios continue to benefit from support measures initiated by the bank's owners in 2009 following the financial crisis. LBBW's fully loaded Basel III CET1 ratio is around 13.5%, excluding the remaining guarantee's ratio-positive risk-weighted-asset effects and based on numbers as of June 2016.

Landesbank Baden-Wuerttemberg's Regulatory Capital



Note: Data for 2012-13 reflect Basel II requirements; for 2014 and beyond, data reflect Basel III capital ratios shown under transitional rules.
Sources: The bank and Moody's Investors Service

Profit retention is essential for LBBW to stabilize or increase its capital ratios for two reasons. First, because the bank is partially state-owned,[3] it became more difficult to execute external capital injections by its co-owners because of the introduction of the European Union's Bank Recovery and Resolution Directive, which has limited state support of banks. The second reason is that we expect implementation of the Basel Committee's proposal to restrict the use of banks' internal models to lower capital ratios. As of September 2016, more than 70% of LBBW's risk-weighted assets related to credit risk were measured using the internal-ratings-based approach.

We expect some additional capital challenges given the effects of the upcoming International Financial Reporting Standard No. 9, which requires a more comprehensive recognition of expected losses for a broader range of assets. Furthermore, LBBW's capital-retention capacity will be vulnerable to the persistent low-yield environment and weak cost structure negatively affecting all German banks' earnings.

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2 The bank ratings shown in this report are LBBW's deposit rating, senior unsecured debt rating and baseline credit assessment.
3 The Land of Baden-Wuerttemberg (Aaa stable) has a 24.988% direct and 15.546% indirect stake in LBBW, and the City of Stuttgart (unrated) has an 18.932% share.

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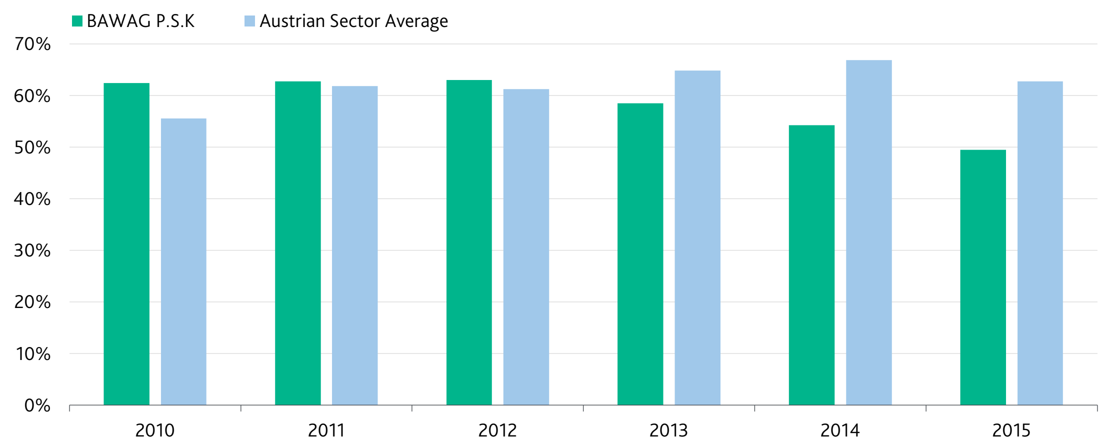
BAWAG's Acquisition of Paylife's Consumer Business Is Credit Positive

On Tuesday, Austrian bank BAWAG P.S.K. (A3/A3 positive, baa2[4]) said that it had agreed to acquire SIX Group Ltd.'s (unrated) Paylife-branded Austrian credit and debit card issuing business for an undisclosed amount. The acquisition is credit positive for BAWAG because it will strengthen the bank's presence in the domestic and adjacent German-speaking retail banking markets.

We expect that BAWAG will be able to expand its superior operational efficiency in its home market. Over the past years, BAWAG's management has proven its ability to set the benchmark in operational efficiency in Austria's retail banking sector, as reflected in a cost-to-income ratio that outperforms other Austrian banks (see exhibit).

BAWAG's Cost-to-Income Ratio versus Other Moody's-Rated Austrian Banks



Sources: Company reports and Moody's Investors Service

Paylife is one of Austria's leading merchant acquirers and payment transaction processors, but BAWAG is only acquiring the consumer-focused card-issuing business, which has been Austria's leading card issuer with 1.7 million debit and credit cards outstanding currently, according to SIX. Its closest rival is card complete Service Bank AG (Baa1 stable, ba1), which had 1.5 million cards in circulation as of year-end 2016.

We expect that the acquisition will follow a similar pattern as that of start:Bausparkasse (unrated) and IMMO-BANK (unrated), which BAWAG closed in 2016. In both cases, BAWAG acquired specialized companies with the aim to apply its own streamlined processes to the acquisition targets, while benefitting from the specific knowledge of the acquired sector specialists.

The parties aim to complete the acquisition in the second half of 2017, with retroactive effect as of 28 February 2017. BAWAG in its 7 March joint press release with SIX said that the card-issuing business will be profitable from day one. We believe Paylife's issuing business' results are likely to have been negatively affected by a decline in fee income in 2016 following a reduction in handling (interchange) fees in Austria for card transactions. By contrast, the interchange fee reduction is likely to have benefitted the 2016 results of the merchant acquiring segment that SIX is keeping owing to lower fee payment obligations.

When it released its full-year results preview last month, BAWAG announced that it plans to retain its €484 million 2016 full-year profit and significant future cumulative net income of €1.5-€2 billion over the next

4 The bank ratings shown in this report are the banks' deposit ratings and outlook, senior unsecured debt ratings (where available) and outlook and their baseline credit assessments

three years. This additional capital cushion will allow the bank to pursue additional and larger acquisition targets in Austria, Germany and Switzerland, the markets where BAWAG identifies growth opportunities. Based on recent transactions, including the Paylife purchase, in which BAWAG acquired either smaller firms with niche sector expertise or static mortgage loan portfolios in Western Europe, we do not expect future large transactions to deviate significantly from these patterns.

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Slovakia's New Mortgage Lending Rules Are Credit Positive for Banks

On 1 March, National Bank of Slovakia's (NBS) new mortgage lending rules for banks took effect. The credit-positive rules, which come at a time of high growth in mortgage credit and weakening underwriting practices, aim to guard against the buildup of risk among banks amid historically low interest rates. Slovak banks will benefit because the rules will protect them from asset quality erosion. Exhibit 1 describes the new lending rules.

EXHIBIT 1
National Bank of Slovakia's New Mortgage Lending Rules

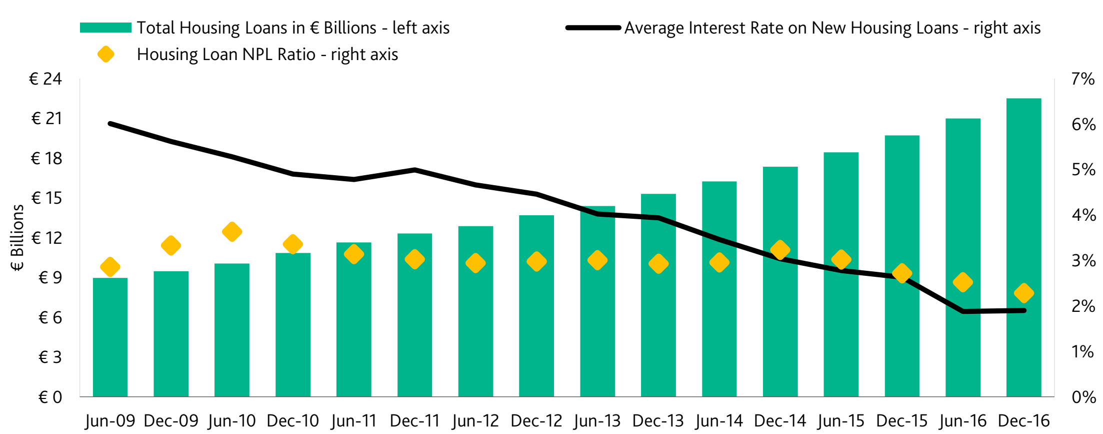
The share of mortgages with loan-to-value ratios above 80% should be limited to 50% of all new mortgage originations, falling to 40% starting in July 2017.
When estimating a borrower's disposable income, lenders should calculate and deduct a minimum living wage for the borrower and his dependents and a 5% reserve, increasing to 20% starting in July 2018.
Borrowers' payment capacity should be stress tested with a 2% increase in their borrowing rates.
Maximum mortgage maturity is 40 years, and mortgages with maturities in excess of 30 years should be limited to 10% of new originated mortgages.

Source: National Bank of Slovakia

Under the new rules, NBS lowered loan-to-value (LTV) limits on mortgages. Mortgages are the largest component of Slovakian household debt, and shortened loan maturities will curb chronic household indebtedness, a threat to borrowers' financial health. Haver Analytics data show that Slovak households' debt-to-income ratios rose to 68% in third-quarter 2016 from 53% at year-end 2012. Although the debt-to-income ratio is moderate compared with the euro-area average of 94%, it is rising fast. NBS' guidance on the prudent disposable income calculation and stress testing households' debt-servicing capacity at higher interest rates will ensure that borrowers can withstand any short-lived adverse changes in household income and a prolonged increase in borrowing rates. Household consumption plays an important role in Slovakia's economy, accounting for around half of GDP, mitigating a decline in export demand and contributing to the stability of banks' operating environment.

Mortgage lending rates in Slovakia have declined by 372 basis points since year-end 2009, helping to fuel an average annual growth rate for mortgages since then of 13% (see Exhibit 2). As a result, mortgage loans constitute the largest share of banks' loan books at 44%, equal to 29% of Slovakia's GDP. Mortgage loans have also helped banks maintain a ratio of nonperforming loans to gross loans of 2.3% as of year-end 2016.

EXHIBIT 2
Slovak Mortgage Loan Stock and Performance, Lending Rates and Real Estate Prices



Source: National Bank of Slovakia

NBS' new mortgage lending rules follow its 2014 recommendations, which set a 100% LTV ratio cap on mortgages and a 10% limit on the share of new originations with LTVs of 90% starting in January 2017. Banks reduced the portion of loans with LTVs above 90% to 6% as of third-quarter 2016, from 23% in fourth-quarter 2014. The new rules also come as Slovakia phases in a 0.5% countercyclical capital buffer in August 2017.

According to NBS, loans with LTVs of more than 80% accounted for 48% of newly originated loans as of third-quarter 2016, below the 50% limit that took effect in March, but up from 43% in 2014. The 10-percentage-point reduction in this limit to 40% in July is a step in the right direction, although it is still looser than Slovakia's peers.[5] A slow recovery in real estate prices is positive, but we note that property values remain lower than before Slovakia's recession in 2009. As a result, lower LTV limits would ensure that banks achieve higher recoveries in foreclosures, especially in a more prolonged economic downturn in which real estate prices decline further, thereby exacerbating banks' losses.

Mortgage originations in 2015 with LTVs in excess of 80% at Vseobecna uverova banka, a.s. (A2 stable, baa2[6]), Tatra banka, a.s. (Baa1 stable, ba1) and Ceskoslovenska obchodna banka (Slovakia) (Baa1 stable, ba1) were slightly below the 47% market average and we understand that level has declined further in 2016. As a result, the banks will only have to fine-tune their growth aspirations and lending practices to comply with the new rules.

5 In the Czech Republic, the maximum LTV is set at 90% and 15% of new originations can be at 80%-90%, while in Poland the maximum LTV is set at 80%, with an exception granted at 90% LTV if the portion that exceeds 80% is insured.

6 The bank ratings shown in this report are the banks' deposit ratings and their baseline credit assessments.

Sovereigns

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Kazakhstan's Constitutional Reforms Strengthen Institutional Framework

On Monday, Kazakhstan's (Baa3 negative) parliament approved a series of constitutional reforms that President Nursultan Nazarbayev announced earlier in the year that transfer some presidential powers to the parliament and the government, supporting the development of checks and balances in the political system. The reforms are credit positive for Kazakhstan because they will support political accountability, provide a framework for policy negotiation and reduce the risk of a disorderly transition of power, thereby strengthening the country's institutional framework.

Under the amended constitution, the formation of a new government will require parliamentary approval and the government will be accountable to both parliament and the president. The president will no longer be able to repeal government decrees or issue decrees with the power of law. And, the president will now have the power to appoint directly only the ministers of defense and foreign affairs.

Reliance on one key decision-maker combined with an untested succession process had increased the risk of a sudden political vacuum. A more powerful parliament reduces the probability of a disorderly presidential succession. Additionally, increasing parliamentary authority is part of a more general plan to make the government more accountable to the people. Greater political accountability is correlated with more effective policymaking to promote economic growth and build strong institutions.

Kazakhstan's politics are characterized by growing differences in policy objectives among an increasing number of constituencies, and a high dependence on a president capable of balancing disparate political interests. Although Mr. Nazarbayev enjoys wide support, he is 76 years old and has no successor in place. The lack of a succession plan harms the sovereign's credit quality by elevating the political risk of a potential disorderly presidential succession should Mr. Nazarbayev suddenly become incapacitated. A disorderly presidential succession, in turn, would likely damage economic and fiscal strength.

Transferring more power to parliament is one step toward creating a more institutionalized mechanism for resolving policy differences. Moreover, as parliament becomes more powerful, the political event risk around succession to one key decision-maker, the president, diminishes.

Increasing the power of parliament is also part of Mr. Nazarbayev's reform plan to increase government accountability and transparency. This is the fifth reform area within the "100 concrete steps" plan unveiled in May 2015. Strengthening public councils, including at the regional and town levels, is a step toward increasing political accountability, one of several governance factors in which Kazakhstan lags its rating peers. Over time, improved accountability and transparency is likely to be associated with more effective governance at all levels, which should enhance economic and fiscal policymaking, reduce corruption and increase economic and institutional strength.

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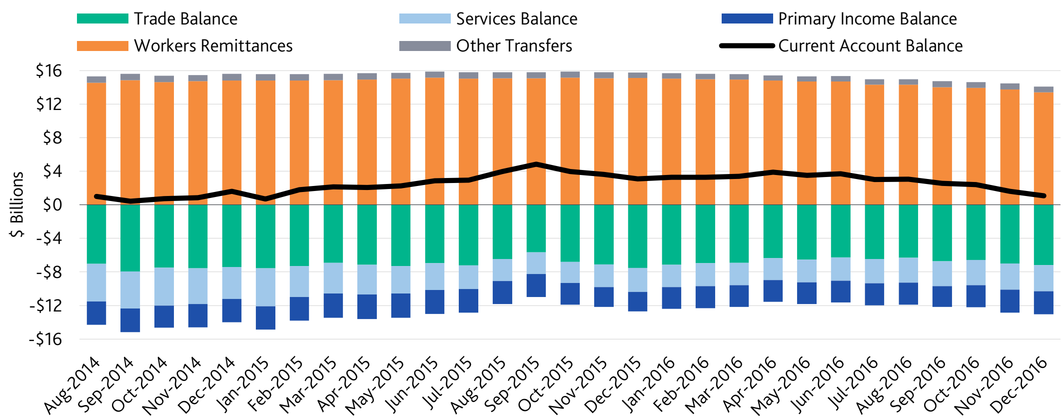
Bangladesh's Remittances Slowdown Will Weigh on Balance of Payments and Growth

Last Thursday, Bangladesh's central bank, Bangladesh Bank, released data showing that remittances, money transferred home by overseas migrant workers, declined to $936.2 million in February, a 17.6% decline from a year earlier and the lowest level of monthly inflows since November 2011. The remittance slowdown is credit negative for the Government of Bangladesh (Ba3 stable) because it weakens the country's external payments position and weighs on GDP growth through a moderation in private consumption.

At around 7% of GDP in 2015, remittance inflows are large relative to the overall size of the Bangladeshi economy. They are also an important stabilizing force for Bangladesh's external account, constituting around 30% of current account receipts in 2015 and more than offsetting a trade deficit (see Exhibit 1). The moderation in remittances will reduce this positive contribution to the balance-of-payments and foreign-currency reserves accumulation.

EXHIBIT 1
Bangladesh's Current Account, 12-Month Moving Sum, $ Billions

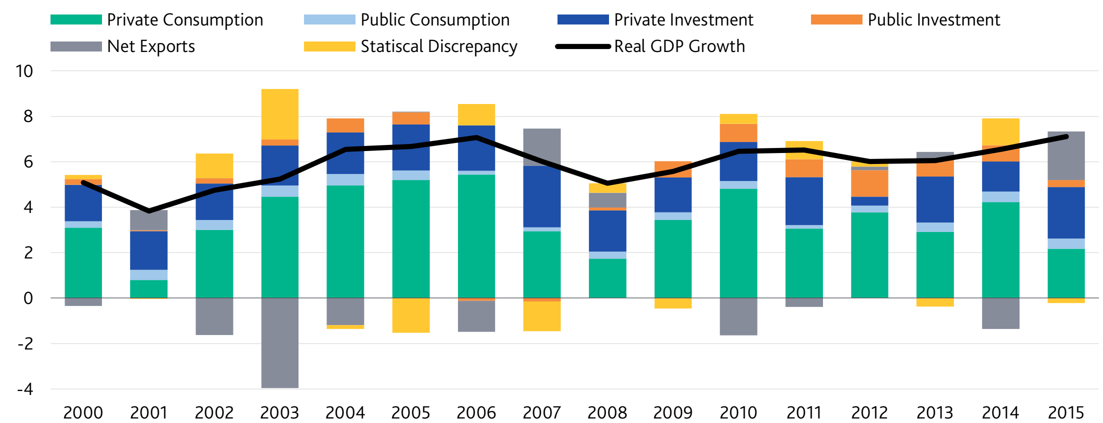


Sources: Bangladesh Bank and Moody's Investors Service

Combined with a recent slowdown in garment exports, which account for around 70% of the country's goods exports, we expect Bangladesh's current account balance to slip into deficit this year. Although foreign-exchange reserves remain high at around $30 billion as of January 2017 (enough to cover almost nine months of goods imports and more than enough to cover external debt repayments), reserves will rise more slowly, marking a departure from Bangladesh's long stretch of building resilience to balance-of-payment shocks.

Remittances are also a major contributor to household income, and, as a result, are a determinant of private consumption. Private consumption accounts for about 70% of GDP and is a major driver of fluctuations in GDP growth (see Exhibit 2). A prolonged decline in remittances will detract from headline GDP growth as households dependent on remittances temper consumption.

EXHIBIT 2
Contributions to Bangladesh's Real GDP Growth, Percentage Points

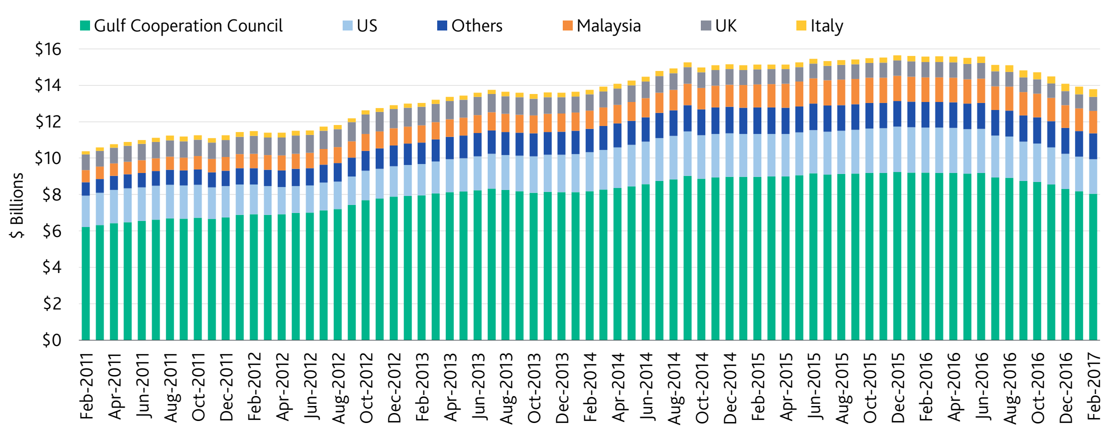


Sources: Bangladesh Bureau of Statistics, Haver Analytics and Moody's Investors Service

To a smaller extent, weaker consumption also threatens to impinge on fiscal strength via reduced government revenues. At only 10.2% of GDP in fiscal 2016 (which ended 30 June 2016), the government's weak revenue base, one of the lowest among Moody's-rated sovereigns, is a credit constraint. Low government revenues limit the sovereign's resources and capacity to spend on infrastructure and other development needs, and have contributed to persistent fiscal deficits averaging 3% of GDP over the past 10 years.

The recent decline in remittances started during the second half of 2016, primarily because of slowing economic conditions in the Gulf Cooperation Council (GCC), where the prolonged period of low oil prices has prompted fiscal tightening and reduced opportunities for migrant labor. Around 60% of Bangladesh's total remittances originate from GCC economies (see Exhibit 3). Given our assumptions that oil prices will not increase significantly over the next two years, we expect that many of these countries will undergo lasting economic adjustments that will continue to weigh on employment trends and remittance outflows from the region.

EXHIBIT 3
Remittance Inflows to Bangladesh by Source Country, 12-Month Moving Sum, $ Billions



Sources: Bangladesh Bank, Haver Analytics and Moody's Investors Service

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