CreditOutlook

Credit Implications of Current Events

2 MAY 2016

NEWS & ANALYSIS

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Corporates

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Apple Boosts Shareholder Payouts, a Credit Negative

Last Tuesday, Apple Inc. (Aa1 stable) expanded its shareholder return program by $50 billion, boosting its total dividend and stock buyback authorization to $250 billion through March 2018. During its fiscal second-quarter earnings call, Apple also acknowledged that the weak global economic environment will continue to negatively pressure its sales performance in the fiscal year ending 30 September 2016. The expansion of the capital return program is credit negative for Apple because it poses incremental credit risk. However, we affirmed Apple's Aa1 senior unsecured rating and stable outlook following the announcement.

Apple has historically funded a large portion of its shareholder return program with additional debt. We estimate that Apple will need $20-$25 billion of external funding or foreign cash repatriation to meet its annual domestic cash needs, including shareholder payouts and acquisitions. Absent Apple repatriating its foreign-held cash, if the company utilizes the full share buyback authorization, its adjusted gross debt balance could approach $120 billion by the end of 2017.

At 26 March, Apple's adjusted long-term debt balance was $77 billion, in addition to about $8 billion of commercial paper issuance that the company uses to manage its liquidity. At its current rating, Apple can accommodate additional borrowings to fund a portion of the newly approved dividend program, provided cash balances continue to well exceed debt levels and credit metrics remain very strong. However, if long-term debt balances and resulting leverage continue to rise, they would likely pressure Apple's credit quality, given that the company operates in a rapidly transforming technology sector.

Apple's 2016 sales will likely be down compared with 2015 levels, amid greater signs of global smartphone saturation, longer iPhone sales cycles and an ongoing decline in iPad tablet unit sales. Apple's slowing sales growth yet healthy cash holdings will likely prompt shareholders to demand an even greater return of capital. We expect the company's foreign cash balances to grow, given the increasing proportion of revenues it generates overseas. Apple has historically funded shareholder payouts over and above domestic cash flow through additional debt.

Apple's liquidity remains extremely strong. It had nearly $233 billion of cash and investments at 26 March, including about $24 billion in the US. Over the past year, its financial leverage increased to about 1.0x debt/EBITDA but its cash and investment balances remain in excess of 2.0x adjusted debt. We expect that Apple will continue to maintain a net cash and investments balance of at least $100 billion and low leverage. Apple's ratings could be downgraded if adjusted debt/EBITDA rises materially above 1.0x, and either its ratio of cash and investments to adjusted debt falls below 2.0x or free cash flow to adjusted debt decreases to below 40%.

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AbbVie Delays Deleveraging to Buy Stemcentrx

Last Thursday, AbbVie Inc. (Baa1 review for downgrade) said that it will acquire privately held Stemcentrx, which is developing a treatment for small cell lung cancer, for approximately $5.8 billion in cash and stock. The deal is credit negative for AbbVie because it will delay the company's deleveraging following its $21 billion acquisition of Pharmacyclics last year. Following the transaction's announcement, we placed AbbVie's ratings under review for downgrade and said we expected an outcome of Baa2 stable.

AbbVie has relied solely on EBITDA growth to steadily deleverage after buying Pharmacyclics. Debt/EBITDA declined to 3.4x at 31 December 2015, down from its peak of 4.4x in May 2015, after the deal closed. But debt/EBITDA has yet to reach the 3.0x level that we consider appropriate for its Baa1 rating. With the Stemcentrx deal, we believe AbbVie will not hit that target until 31 December 2017 at the earliest.

AbbVie will fund the transaction with $2 billion in cash and the rest in stock. But the company expects to complete an accelerated share repurchase of up to $4 billion after the deal closes, so we assume the entire purchase price will require incremental debt. The deal also includes possible future milestone payments of up to $4 billion. The payments, which could begin in 2020, are based on achieving certain regulatory and clinical targets, rather than sales.

Stemcentrx is a development-stage company that will not have revenues until 2018. Its lead late-stage product is Rova-T, for the treatment of small cell lung cancer (SCLC). We estimate multi-billion-dollar sales potential if the product succeeds in clinical testing and receives approval. There are 60,000 new cases of SCLC each year, with a five-year survival rate of 6%. In early trials, Rova-T, which works by killing cancer stem cells, shrank tumors in 44% of patients whose tumors contained a specific protein. Stemcentrx plans to test the drug to treat other cancers, including brain, prostate, pancreatic and colon, and melanoma.

The acquisition will help AbbVie push further into cancer treatments and continue to diversify away from Humira, its blockbuster injectable drug for immunology-based diseases. AbbVie's acquisition of Pharmacyclics last year brought it Imbruvica, which treats several blood cancers. Although AbbVie has yet to justify Pharmacyclics' $21 billion price, Imbruvica has performed well, generating $1.1 billion in revenues since the acquisition closed in May 2015. We expect Imbruvica to generate more than $1.5 billion of sales in 2016.

We also expect AbbVie to remain acquisitive given that Humira will still constitute 55%-60% of the company's revenues in 2016. Humira is facing rising competition from branded drugs, such as Novartis AG's (Aa3 stable) Cosentyx and Eli Lilly and Company's (A2 stable) Taltz for psoriasis, the latter of which Lilly recently launched, and Lilly's baricitinib, an experimental oral drug for the treatment of rheumatoid arthritis, which is pending approval. Biosimilars, or copycat versions, of Humira are another threat, although they are unlikely to launch in the US before 2020.

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Anheuser-Busch InBev Sale of SAB European Assets Dampens Negative Credit Effect of SABMiller Acquisition

On Friday, Anheuser-Busch InBev SA/NV (ABI, A2 review for downgrade) announced that it will offer for sale the Eastern and Central European businesses of SABMiller Plc (A3 review direction uncertain). The sale will dampen the negative effect that the SABMiller acquisition has on ABI's credit quality because it will likely allow for lower leverage at the acquisition's closing, depending on the proceeds the sale ultimately generates. However, the sale will not improve leverage enough to affect the likely rating outcome, which we have indicated through the provisional (P)A3 rating assigned to bonds issued to finance the deal.

ABI will offer for sale SABMiller's assets in Hungary, Romania, Czech Republic, Slovakia and Poland, including a number of top brands in each of the markets. The sale is in addition to the already announced divestment of the Peroni, Grolsch and Meantime brand families and related businesses in Italy, the Netherlands, the UK and internationally. We expect the newly announced sale to receive considerable interest from potential buyers. ABI's commitment to the European Commission to increase its European divestitures is part of the company's efforts to proactively address potential regulatory concerns and obtain clearance in Phase 1 of the regulatory process.

We estimate that the Eastern and Central European businesses contribute approximately $700 million in EBITDA to SABMiller. Depending on the sale multiple, we estimate that the sale of these assets will slightly reduce closing leverage versus our earlier expectation (which already incorporated previously announced divestitures in the US, Europe and China). In our base-case assumption, this would result in pro forma debt/EBITDA leverage of about 5.10x compared with our original expectation of about 5.25x (incorporating our standard adjustments).

However, despite the slightly lower starting leverage, the path to deleveraging will remain relatively long. Our base-case expectations call for debt/EBITDA leverage to return to under 3x only by around 2020. From a qualitative perspective, we do not view the loss of the SAB European assets as particularly negative given that ABI will maintain its already meaningful presence in Europe. Also, the key rationale for the acquisition is to add SABMiller's profitable and high-growth-potential emerging market businesses to ABI's mix.

In January, we assigned a provisional (P)A3 rating on approximately $47 billion of bonds that ABI issued to prefund the SABMiller acquisition. The rating is one notch below ABI's current rating, which remains on review for downgrade until there is greater certainty that the deal will close. The (P)A3 rating primarily reflects the significant debt and resulting high leverage that ABI will incur to fund the deal. The slow reduction in financial leverage is partly a factor of a relatively high dividend payout, which will be offset by the combined company's vast and diverse franchise. ABI's portfolio will include beer brands that have leading market shares, including the top market positions in most of the world's largest and most profitable beer markets.

Although there are integration risks and some uncertainty about the retention of certain owned businesses and business partners, ABI has a long track record of managing acquisitions, which will help to mitigate these risks. Importantly, ABI's senior management has articulated publicly that it will continue to target net debt/EBITDA leverage (by the company's definition) of 2x. These positives help support a relatively high investment-grade rating despite leverage metrics that will be in speculative grade territory for several years.

NEWS & ANALYSIS

Credit implications of current events

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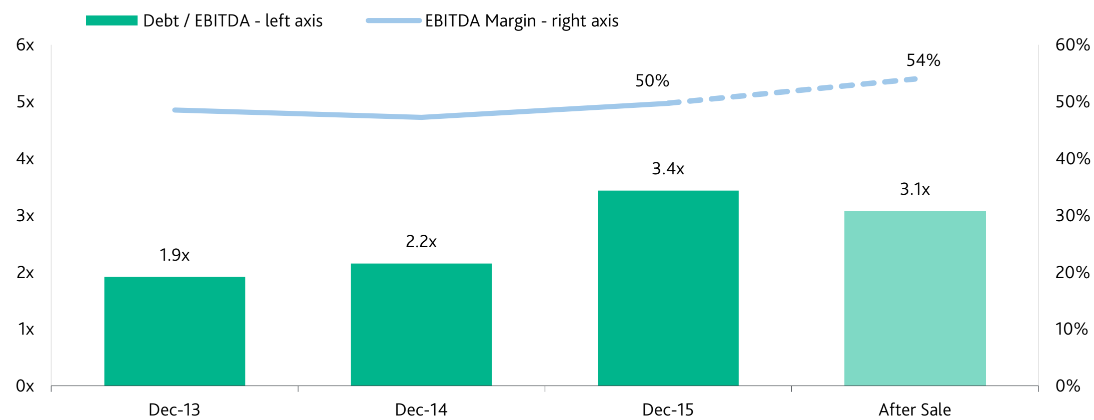
Verisk's Healthcare Sale Is Credit Positive

Last Monday, Verisk Analytics Inc. (Baa3 negative) said that it will sell its healthcare services unit to Veritas Capital for $820 million. The sale is credit positive because it will help Verisk reach its 2.5x debt/EBITDA leverage target for year-end 2016 several months ahead of schedule.

We estimate that Verisk could reach its leverage target by using approximately $445 million of the sale's $600 million in cash proceeds to pay down debt, which would reduce its internally calculated leverage to 2.5x debt/EBITDA from 2.9x at year-end 2015, or to 3.1x from 3.4x on a Moody's-adjusted basis. The company paid down $165 million of revolver debt in the first quarter of 2016, which will allow it to use the balance of the sale's proceeds for acquisitions and share buybacks, if it so chooses.

We expect the sale, which we estimate is priced at 10x-11x EBITDA, to boost Verisk's already-strong margins by as much as four percentage points (see exhibit) because the healthcare unit generates EBITDA margins that are roughly half those of Verisk's core business of providing risk assessment and decision analytics services to US property and casualty (P&C) insurers. Selling the unit, which provides data services, analytics and technology products to public and private healthcare payers such as Medicare and commercial insurers, is strategically sound. The business' customer concentration has increased in recent years as US healthcare reform has led to payer consolidation. Furthermore, the unit is US-centric, which does not fit with Verisk's goal of expanding internationally to increase its geographic diversification.

Verisk's Pro Forma Leverage and EBITDA Margin



Notes: Assumes approximately $610 million in debt reduction using proceeds of $445-$470 million from the sale. All figures and ratios are calculated using our estimates and standard adjustments.
Source: Moody's Investors Service

Verisk is a leading provider of information about risk to the US P&C insurance industry. The publicly traded company also provides risk management analytics to the financial, healthcare, and government industries, and to the energy and commodities sectors.

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Brown-Forman's Acquisition of BenRiach Whisky Brands Is Credit Negative

Brown-Forman Corporation (A1 stable) on Wednesday agreed to buy The BenRiach Distillery Company Limited (unrated), a maker of Scotch whisky, for £285 million ($414 million). The deal is credit negative for Brown-Forman because it will further raise leverage following the company's recent authorization of a new $1 billion stock buyback plan.

We expect Brown-Forman to fund the deal with cash on hand and short-term borrowings, which will increase pro forma debt/EBITDA to slightly above 2.1x as of the fiscal third quarter that ended January 2016. Pro forma leverage rose to slightly above 1.9x from about 1.8x following the company's sale of its Southern Comfort and Tuaca brands for $542 million in March and its decision to return those proceeds to shareholders. Brown-Forman's new share repurchase authorization began on 1 April, following the completion in March of its prior $1.25 billion authorization.

Although metrics will temporarily weaken, we expect that Brown-Forman will maintain leverage of close to 2x within 18-24 months of closing. Brown-Forman has historically operated with leverage of less than 2x.

The acquisition will extend Brown-Forman's presence in the fast-growing single malt Scotch whisky category, and add the BenRiach, Glendronach and Glenglassaugh brands to its portfolio. We expect the Scotch brands to experience significant growth over the next few years because consumers increasingly favor premium brown spirits such as whisky and bourbon over white spirits such as vodka. Euromonitor forecasts premium single malt Scotch to post high-single-digit growth for the foreseeable future.

The addition of a Scotch whisky portfolio will also help Brown-Forman reduce its reliance on its Jack Daniel's family of brands, which produces the bulk of its profits. That reliance only intensified when Brown-Forman jettisoned Southern Comfort, which, along with Jack Daniel's and Finlandia, was one of the company's three largest brands by volume. We also expect Brown-Forman to leverage its network to increase capacity and expand distribution of the Scotch brands.

Based in Louisville, Kentucky, Brown-Forman is a leading American wine and spirits company. Well-known brands in its portfolio include Jack Daniel's, Finlandia, el Jimador, Canadian Mist, Chambord, Woodford Reserve and Sonoma-Cutrer. For the 12 months that ended 31 January 2016, Brown-Forman reported sales of approximately $3.1 billion.

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Avery Dennison's Purchase of Mactac's European Business Is Credit Positive

Avery Dennison Corporation (Baa2 stable) on Wednesday said that it had agreed to acquire Mactac's (unrated) European business for €200 million ($231 million), including assumed debt. The agreement is credit positive for Avery, which will finance the purchase using available cash and credit facilities. Avery says the high-value graphics business will enhance its growth and competitiveness, and increase its presence in Europe and Asia. The Mactac acquisition will begin adding to its earnings in 2017.

Avery, the world's largest producer of printable labels and other pressure-sensitive materials, expects the transaction to close sometime before August, depending on the timing of regulatory approvals. The bolt-on acquisition will have a minimal effect on Avery's 2.2x debt/EBITDA ratio today. Once Avery integrates Mactac and draws a full year's earnings from it in 2017, we expect that the Mactac assets will contribute to Avery's growth and product offerings, and will benefit earnings modestly.

Platinum Equity, a California-based private-equity firm, is selling the Mactac unit, which had run-rate revenues of €147 million in 2015. Avery reported revenues of $6 billion for the 12 months through 2 April 2016, about three quarters of which was from the company's Pressure-Sensitive Materials segment. Most of the remainder was from Avery's Retail Branding and Information Solutions segment, which offers brand differentiation and inventory management mainly to retail customers.

Like Avery, Mactac produces pressure-sensitive materials for graphics, specialty labels, and industrial tapes. Avery believes the Mactac purchase will complement its existing businesses, contribute to its high-value graphics capabilities and expand its global presence. Buying the Mactac unit will give Avery a production facility in Belgium and warehouses in Europe and Asia that reach customers in South America, Asia-Pacific, the Middle East and North Africa.

The acquisition reflects Avery's strategy of bolting on small acquisitions that build its core businesses and grow its higher-margin businesses. We expect that Avery will continue to explore bolt-on acquisition opportunities in a fiscally conservative manner.

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Sanofi's Offer to Acquire Medivation in All-Cash Deal Is Credit Negative

Last Thursday, Sanofi (A1 stable) made a non-binding offer to acquire Medivation Inc. for $52.50 per share in an all-cash transaction that values Medivation at around $9.3 billion. The offer is credit negative for Sanofi because an acquisition would be funded with debt and would lower Sanofi's key ratio of cash flow from operations to debt (CFO/debt) to around 30% pro forma for the acquisition, based on year-end 2015 numbers. Sanofi's CFO/debt was around 40% at 31 December 2015, which is our minimum expectation for its A1 rating.

Sanofi's bid is hostile because Medivation had not been willing to engage in discussions when Sanofi previously approached the company on 25 March and 3 April about a potential takeover. Last Friday, Medivation formally rejected Sanofi's offer. Sanofi has indicated that it would discuss its proposal with Medivation's shareholders. This leaves uncertain the terms of a successful offer, especially given the possibility of other bidders.

Deterioration in Sanofi's post-deal credit metrics would be somewhat mitigated by its €8.7 billion cash position and cash/debt ratio of 38% versus our guidance of more than 20% for its rating. The deterioration in metrics is also mitigated by the potential gross cash inflow of €4.7 billion from an asset swap with Boehringer Ingelheim, although that transaction is still in negotiation.

Medivation is a US-based biotechnology company specialising in the development and commercialisation of drugs for the treatment of cancer. Strategically, Medivation's portfolio would help Sanofi to close its competitive gap in oncology, which the company recently identified as a key focus for the future.

Medivation is already generating revenues of $943 million from the commercialisation of Xtandi, a targeted therapy for the treatment of metastatic castration-resistant prostate cancer. Medivation is also pursuing clinical trials for Xtandi for other forms of prostate cancer and for breast cancer. In addition, Medivation has another targeted therapy drug in phase three clinical trial for breast cancer and a monoclonal antibody for relapsed/refractory diffuse large B-cell lymphoma (an aggressive form of blood cancer) in phase two clinical trial.

Prostate cancer is an attractive oncology therapeutic area with significant unmet medical needs and a sizable patient population because it is the second most common cancer in men behind lung cancer, with one in seven men diagnosed with the disease in his lifetime.

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Fortescue Metals' Note Redemption Is Credit Positive

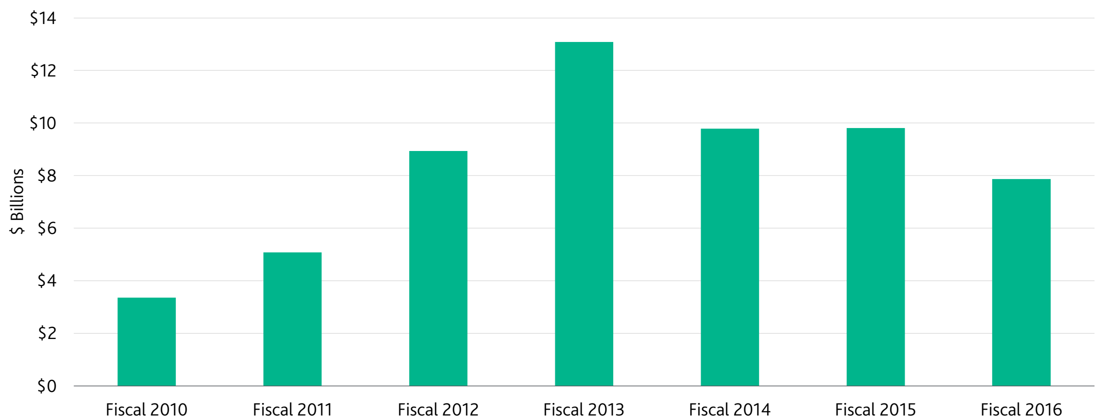
Last Wednesday, Fortescue Metals Group Ltd. (Ba3 negative) announced that it had exercised its call option to repay $577 million of debt by issuing a redemption notice to holders of its 8.25% senior unsecured notes due in 2019. The debt-repayment is credit positive for Fortescue because it reduces the company's total debt by around 7% and provides another indication of the company's commitment to improving its balance sheet and protecting its credit quality in the weak price environment for iron ore.

The 2019 notes, which Fortescue's finance subsidiary FMG Resources (August 2006) Pty Ltd. issued, will be redeemed at par plus a redemption premium of 4.125%. Fortescue will fund the transaction with accumulated cash on hand. The redemption follows $1.1 billion of debt repayments that the company has completed already this year. The redemption will be completed on 1 June 2016.

The redemption would lower Fortescue's reported total debt to around $7.9 billion from around $8.4 billion at the end of March 2016, a nearly 40% reduction from the company's peak debt level of around $12.7 billion in fiscal year that ended 30 June 2013 (see exhibit). We expect the repayment to improve Fortescue's financial leverage, as measured by adjusted gross debt/EBITDA, by 0.2x-0.4x under our base-case iron ore price assumption of $40 per tonne for fiscal 2016. Fortescue's adjusted debt/EBITDA was around 4.0x for fiscal 2015.

Fortescue Metals Group's Debt Levels, $ Billions

The company's debt has declined following its completion of major expansion activities in fiscal 2013.



Note: Fortescue's fiscal year ends 30 June.
Source: Fortescue Metals Group Ltd.

The debt-repayment is an example of Fortescue management's application of excess free cash flow to debt reduction and its focus on achieving a targeted gearing ratio, as measured by book value debt/debt plus equity, of around 40%. This metric was around 52% for calendar 2015, and would improve to around 50% pro forma for the proposed transaction.

The transaction will also lower Fortescue's total interest expense by around $48 million per year, although this will be partially offset in the first year by the approximately $24 million premium paid to redeem the notes. A lower interest cost would slightly improve the company's breakeven costs of production and aid in future free cash flow generation. Additionally, the debt repayment reduces the amount of total debt maturing in 2019 by around 10% to $4.8 billion.

Notwithstanding the credit-positive aspects, the announced offer slightly reduces Fortescue's liquidity cushion at a time when iron prices are low. However, by consistently reducing its unit cash costs and maintaining record production levels, Fortescue has been able to generate positive free cash flow in the lower price environment.

Also, since falling below $40 per tonne in December 2015, iron ore prices have risen to an average of around $51 per tonne year to date 2016. This is around $11 per tonne over our 2016 base-case scenario, which we estimate would result in free cash flow generation of $500-$600 million above of our previous expectations and support the company's ability to fund debt reduction while maintaining solid liquidity levels. Despite the recent increase in iron ore prices, we expect them to migrate toward our base-case scenario owing to the slowdown in steel making in China and overcapacity in global iron ore supply.

Infrastructure

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EPM's Resumption of Operations at Guatape Power Plant Is Credit Positive

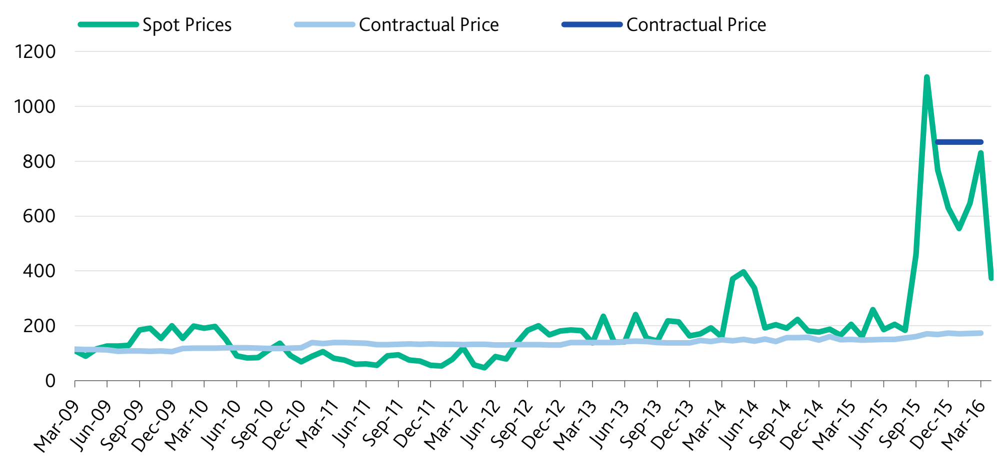
On 23 April, Colombian power company Empresas Publicas de Medellin E.S.P. (EPM, Baa3 positive) resumed operations at two units of its eight-unit, 560-megawatt Guatape hydro-electric power plant, one week ahead of schedule. The resumption of operations is credit positive for EPM because output of three gigawatt-hours per day from these two units will reduce the amount of electric power that EPM currently purchases in the spot power market to about seven gigawatt-hours per day. EPM must purchase this extra electric power to meet its contractual obligations. A fire at an access tunnel affected Guatape's power cables, causing an extended outage at all eight units since 15 February.

The reduced costs of procuring power in the spot market will bolster financial performance. Pending a final assessment after Guatape's last unit becomes operational, which the company expects will occur in September, EPM estimates that the total costs of this incident could be around $200 million, including physical damage of around $25 million. We expect that insurance, including business interruption coverage, will cover the majority of these costs.

The incremental output of the two units, which equals approximately 2% of Colombia's power demand, also helps reduce the volatility of Colombian spot power prices during the tail end of the severe El Niño weather phenomenon. The National Oceanic and Atmospheric Administration predicts the phenomenon will end around June.

As Exhibit 1 shows, Colombian spot power prices began declining in April 2016 after the incident at the Guatape plant prompted the last spike in February 2016. Spot power prices are currently around COP200 per kilowatt-hour. Several factors have contributed to the decline in spot power prices in Colombia, including rainfall that improved reservoir levels in the eastern part of the country, declining power demand, energy imports from Ecuador and the resumption of operations at Unit 4 of Celsia S.A. E.S.P.'s (unrated) 610-megawatt Termoflores plant following an unscheduled turbine outage in February.

EXHIBIT 1
Colombia's Average Spot and Contractual Power Prices, COP per Kilowatt-Hour



Note: Amounts in 2005 pesos, adjusted for inflation.
Source: XM Market Reports

The Colombian government contributed to Colombia's slowing power demand by providing monetary incentives to end users to reduce electric power consumption by at least 400 gigawatt-hours, which equals approximately 5% of the country's power demand. The government implemented these incentives for six weeks starting in mid-March in order to avoid rolling blackouts as a result of the severity of El Niño and extended outages at the Las Flores and Guatape plants that rendered unavailable a material portion of the country's power generation fleet.

Exhibit 2 shows that Colombia's efforts at reducing energy consumption were successful: electricity demand grew by 1.9% between February and March 2016, a modest increase when compared with the growth recorded during the same period in previous years. On 26 April, with the weakening of El Niño and the two units of Guatape back on line, the government canceled these incentives. The government currently estimates the incentives reduced power demand by 1,179 gigawatt-hours over the six-week period.

EXHIBIT 2

Colombia's Monthly Electricity Demand in Gigawatt-Hours

	February	March	Change Between March and February
2016	5,465	5,567	1.9%
2015	5,048	5,533	9.6%
2014	4,902	5,317	8.5%
2013	4,610	5,033	9.2%

Source: XM Market Reports

Banks

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FASB's New Expected Credit Loss Model Aligns with the Economics of Lending and Investing

Last Wednesday, the US Financial Accounting Standards Board (FASB) finalized its controversial and long-awaited expected credit loss model for financial instruments, referred to as the Current Expected Credit Loss model (CECL). CECL better aligns the recognition of credit losses with the economics of lending and investing. Additionally, the overall principle for CECL is easy to understand, reducing complexity in financial statements.

The FASB developed CECL in response to criticism during the 2008-09 financial crisis that accounting rules result in losses being recognized "too little" and "too late." CECL eliminates thresholds to recognizing credit losses and requires the use of forward-looking information when estimating credit losses for loans and debt securities measured at amortized cost.

Although the FASB's new credit loss standard will apply to all companies that report under US generally accepted accounting principles (GAAP), it will have the most material effect on bank financial statements. When a bank first applies the new standard, CECL will result in a significant increase to provisions, reducing bank capital. In subsequent periods, however, provisions will only reflect changes to the bank's estimate of expected credit losses. US regulators have supported CECL throughout its development, but it remains to be seen whether the new rules will affect regulatory capital requirements.

The FASB plans to publish its new credit loss standard in June, after completion of an internal editorial review. For companies that file financial statements with the US Securities and Exchange Commission, CECL will be effective in 2020. Other companies have one more year to implement the new accounting rules. Companies will be permitted to adopt CECL early, but not before 2019.

Below we highlight key items related to the new standard that are relevant to credit analysis of banks.

Incurred versus expected credit losses. An expected credit loss model improves the decision usefulness of information in financial statements for investors. Currently, banks must wait until credit losses are probable or incurred before recognizing contractual cash flows that will not be collected on financial assets. Under CECL, the carrying value reported on the balance sheet will reflect the net amount that a bank expects to collect on a loan or a debt security measured at amortized cost. This will require banks to recognize on the day that they originate or purchase the loan or security a provision in earnings reflecting their expectation of lifetime credit losses. In addition to using historical information, CECL requires banks to use all reasonable and supportable information, including forward-looking information.

CECL has been heavily criticized because it requires a loss to be recognized upon origination or purchase of a financial asset, which many believe is counterintuitive since the credit risk typically is considered in pricing. For credit analysis, however, we believe it is appropriate for banks to recognize losses at loan origination. History has shown that in a pool of performing loans, not all contractual cash flows will be collected.

Detailed and transparent credit quality disclosures. The FASB's new credit loss standard will expand current credit quality disclosures by requiring banks to disaggregate their loans and receivables not only by class and credit characteristics but also by vintage. These disclosures will be particularly helpful in understanding how credit quality has changed from period to period.

US GAAP and International Financial Reporting Standards (IFRS) do not converge, a negative for users of financial statements. Although both CECL and the new impairment model under IFRS are expected credit loss models, their principles are not fully aligned, which does not aid in global comparability of bank financial statements. IFRS 9, the financial instruments standard published in July 2014 by the International Accounting Standards Board,[1] requires recognition of lifetime expected credit losses once financial assets exhibit a significant increase in credit risk. For performing financial assets, an amount equal to 12-month expected credit losses would be recognized. CECL will result in more timely recognition of credit losses on performing loans and debt securities than IFRS 9. In addition, financial reporting under CECL will be easier to understand because provisions in each reporting period will only reflect changes in the bank's estimate of lifetime expected credit losses. Under IFRS 9, provisions will also include a cliff effect for loans that move from performing to exhibiting credit deterioration.

1 See IFRS 9 Gets Green Light to Improve Financial Instruments Reporting in Europe, 21 September 2015.

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US Regulators' Proposed Funding Rule Would Enhance Bank Liquidity

Last Tuesday, the US Federal Deposit Insurance Corporation (FDIC) approved a proposal to implement a net stable funding ratio (NSFR) requirement for large and internationally active US banks. The proposed rule is credit positive because it would enhance and help maintain banks' structural liquidity by limiting their reliance on less stable funding sources, thereby reducing their confidence sensitivity in times of stress.

Beginning in January 2018, the proposed rule would apply to banks that have $250 billion or more in total consolidated assets, or $10 billion or more in total on-balance sheet foreign exposure. For those banks, the proposed rule would also apply to each of their consolidated subsidiaries that are depository institutions with $10 billion or more in total consolidated assets. In addition, the Federal Reserve is proposing a less stringent modified NSFR requirement for banks that have $50-$250 billion in total consolidated assets and less than $10 billion in total on-balance-sheet foreign exposure. As of year-end 2015, 15 banking organizations would be covered by the proposed NSFR and another 20 would be covered by the modified NSFR requirement.

The proposed rule, now in a comment period that ends 5 August, closely follows the NSFR standard that the Basel Committee on Banking Supervision (BCBS) published in October 2014. However, it requires slightly more granular disclosure than the disclosure standards the BCBS published in June 2015. The US-proposed NSFR would measure the ratio of a bank's available stable funding (the numerator) to its required stable funding (the denominator). The numerator would be a weighted measure of the stability of a bank's funding (equity and liabilities) over a one-year time horizon. The denominator would be a bank's minimum level of stable funding calculated based on the liquidity characteristics of its assets, derivative exposures and commitments over the same one-year period. These characteristics would include credit quality, tenor, encumbrances, counterparty type and characteristics of the market in which an asset trades.

The US rule would require a bank to maintain a minimum NSFR of 1.0, or take several steps if its NSFR fell below 1.0. In particular, a bank would be required to notify its appropriate regulator of the shortfall no later than 10 business days following the date of any event that would cause or has caused the bank's NSFR to fall below the minimum requirement. In addition, a bank would be required to submit to its appropriate regulator a plan to remediate its NSFR shortfall.

The proposed rule would also provide a standardized means to measure the stability of a bank's funding structure, promote greater comparability of funding structures across both US and foreign banks subject to similar requirements, and improve transparency through public disclosure requirements. Banks subject to the proposed rule would be required to publicly disclose their NSFR and the components each quarter.

The regulators noted that nearly all of the covered banking organizations would be in compliance with the proposed NSFR or modified NSFR requirement today. They also noted that a few organizations would face an aggregate $39 billion shortfall, equivalent to only 4.3% of their required stable funding. We view this shortfall as being manageable to overcome.

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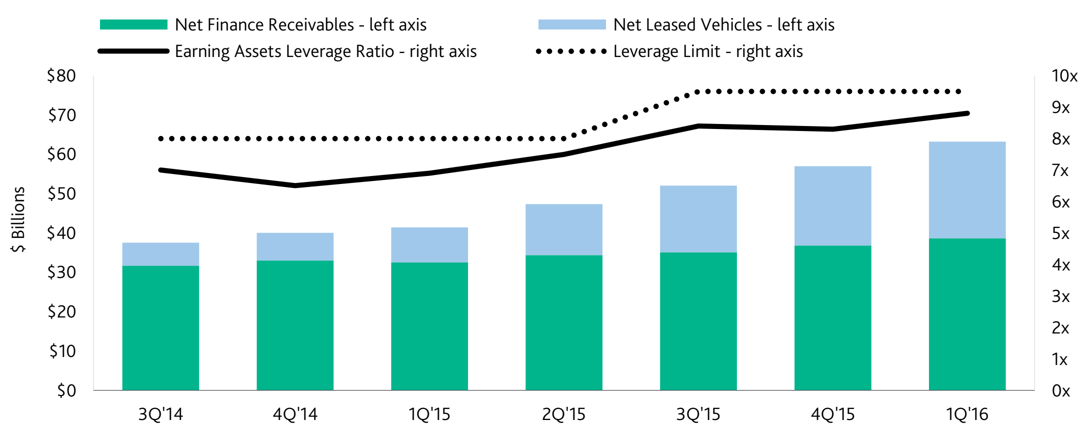
General Motors Financial's Possible Breach of Capital Support Ratio Is Credit Negative

On 21 April, General Motors Financial Company, Inc. (GMF, Ba1 positive) disclosed in its first-quarter 2016 Form 10-Q that it may breach the leverage trigger in its parent support agreement during 2016, but may not call for capital from its parent as permitted in the support agreement. Under the agreement, GMF can require parent General Motors Company (GM, Ba1 positive) to infuse capital to cure a breach of the 9.5x debt/equity leverage ratio threshold. However, based on this disclosure, GMF may briefly operate at a leverage above 9.5x without calling for additional capital, which would be credit negative because it illustrates management's willingness to run the business with leverage higher than we expected.

In 2014, GM and GMF entered into a support agreement aimed at providing increased credit support to GMF. The support agreement requires 100% GM ownership of GMF and limits GMF's leverage, which is defined as net earning assets divided by common equity less goodwill, plus junior subordinated debt. Leverage is limited to 8.0x when earning assets are less than $50 billion, 9.5x at $50-$75 billion, 11.5x at $75-$100 billion and 12.0x at more than $100 billion. As of 31 March 2016, GMF's earning assets were $64 billion.

As shown in the exhibit below, GMF has consistently leveraged its portfolio close to the support agreement limits. Once earning assets reach $75 billion, the leverage limit increases considerably and was structured under the expectation that prime assets would grow to compose a larger portion of the portfolio. In second-quarter 2015, GMF headroom between the actual leverage ratio and the leverage limit shrank, and this occurred again in first-quarter 2016, with the potential for more compression in the next couple of quarters.

GMF's Support Agreement Leverage Limits Have Limited Headroom in This Growth Period



Source: General Motors Financial Company

Using discretion in operating by the terms of the support agreement is credit negative because it raises questions about other scenarios in which the support agreement would be selectively applied that might be more harmful to bondholders. According to GMF, the potential breach this year is a result of a slower-than-expected rate of increase in earning assets, which would prevent the leverage trigger threshold from increasing, and foreign currency translation adjustments of $900 million, which constrained capital growth.

Although the support agreement does not require that GMF request capital and GMF expects that a potential breach in 2016 would be cured in a limited time without support from GM, support agreements also serve to protect bondholders against unexpected and unplanned scenarios. Management's willingness to selectively abide by the terms of the support agreement raises questions about how management would respond to unforeseen circumstances, as opposed to simply living within the terms prescribed by the agreement and therefore expected by market participants.

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Mexican Government's Guarantee on Loans to Cities and States Is Credit Positive for Banks

Last Wednesday, the Mexican government enacted a new financial discipline law that extends an explicit federal government guarantee to certain loans to cities and states, and requires all regional and local governments (RLGs) to follow standardized public reporting guidelines on their financial obligations. The new law is credit positive for Mexican banks because it will allow them to more accurately assess the credit risks associated with lending to RLGs.

The new law calls for the creation of a debt registry controlled by the Mexican Finance Ministry that will contain details such as loan amounts and financing conditions on all RLG obligations, including short-term debt. Any discrepancy between RLGs' reported bank borrowings and banks' reported exposures to RLGs will also be disclosed. Aside from the new reporting requirements, the law also introduces an explicit and full guarantee that will apply to certain new RLG debt that is structured to be repaid by federal government transfers, in an amount up to 3.5% of Mexico's nominal GDP, provided the borrower fulfills certain requirements.

Until now, reporting on RLGs' total outstanding debt levels has not reflected short-term debt levels, increasing the risk that banks have made loans to cities and states with incomplete information about their overall leverage levels. Had this information been available in the past, it might have discouraged banks from lending to certain state and local borrowers whose loans subsequently had to be restructured. Over the past few years, banks have built up large exposures to RLGs, attracted by their low capital usage, with total bank loans to this segment peaking at 60% of tangible common equity as of September 2015.

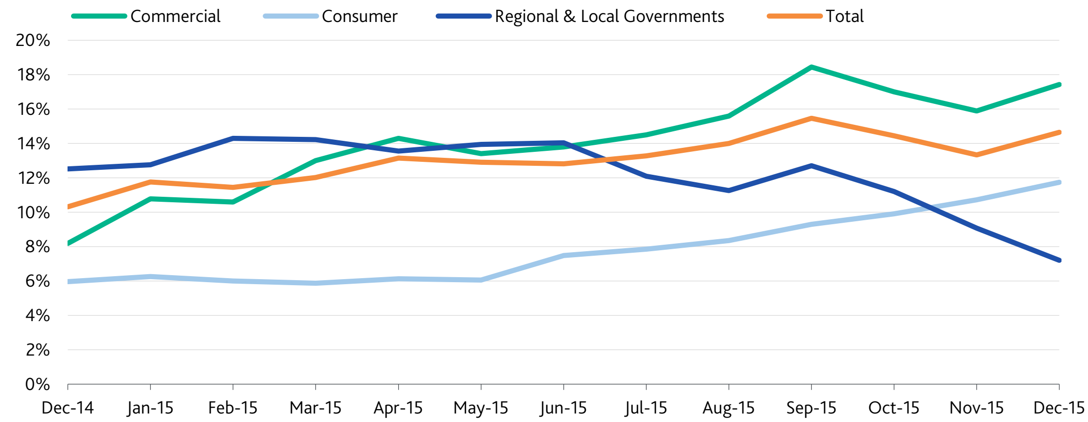
The registry will be updated daily, which will help banks with large RLG portfolios gauge the actual indebtedness of their borrowers in real time. Among the banks to benefit are Banco Interacciones, S.A. (Ba1/Ba1 review for downgrade, ba2 review for downgrade[2]), Banco Mercantil del Norte, S.A. (A3 review for downgrade, baa1 review for downgrade), Banco del Bajío, S.A. (Baa3 stable, ba1) and Banca Mifel, S.A. (unrated).

Although many existing RLG loans are already secured by federal fiscal transfers, the new guarantee provides an additional layer of enhancement from the government, further reducing credit risks. The federal transfers that many RLGs rely on to service their debt are financed by a trust that is funded in part with oil revenues. The size of that trust has been shrinking since 2015 as a result of the drop in oil prices and declining production, although in most cases debt service coverage remains ample.

Banks' growing worry about rising RLG indebtedness is in part evidenced by a sharp slowdown in lending to that segment. As of December 2015, loan growth to RLGs halved to 7% year on year from 15% just six months' earlier (see exhibit below). RLG loans, most of which are secured by federal transfers, currently account for 8% of banks' total loan portfolios.

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

Mexican Banks' Year-over-Year Loan Growth by Type



Source: Mexico's Comisión Nacional Bancaria y de Valores

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RBS Delays Williams & Glyn's Divestment, Adding to Costs, a Credit Negative

Last Thursday, The Royal Bank of Scotland Group plc (RBS, Ba1 positive) said that it was unlikely to complete the divestment of Williams & Glyn (W&G, unrated) by the year-end 2017 deadline as agreed with the European Commission, a credit negative. The delayed divestment could lead the European Commission to impose financial penalties or other punitive actions on RBS, and will increase the costs associated with the W&G separation, which will weigh on RBS' already-weak profitability.

W&G comprises a number of retail and commercial banking branches in the UK, which RBS agreed to divest following the UK government's £45 billion capital injection into the bank at the height of the 2008-09 financial crisis. RBS originally agreed with the European Commission to complete the sale by November 2013 and entered into a sale agreement with Santander UK PLC (Aa3/A1 stable, a3[3]). However, RBS applied for an extension when the deal was cancelled at the end of 2012 after Santander informed RBS that it did not believe the agreed upon conditions would be satisfied by a deadline that Santander would not extend. RBS subsequently decided to dispose its branches through an initial public offering of its W&G entity.

Although W&G accounted for only around 7% of both RBS' loans and deposits at the end of 2015, W&G's divestment has proven operationally complex because of its high degree of integration with the rest of RBS. The separation also requires the setup of an ad-hoc IT platform, which RBS has indicated is the main cause for the delayed separation and shows once again the IT challenges that RBS faces. In recent years, RBS has made sizable IT investments to upgrade and improve its IT infrastructure after years of underinvestment led to a number of high-profile incidents. These included 600,000 failed payments into and out of customer accounts last June and a major IT outage in June 2012 that left RBS unable to update customer account balances, process payments or participate fully in clearing within normal time frames.

RBS announced that it was considering alternative solutions to achieve the W&G separation and has warned that the financial effect from the delayed project is likely to be significantly higher that it had previously indicated. RBS currently employs around 6,000 full-time staff on the W&G separation project at an annual cost of £630 million per year (around 4% of its total costs in 2015), according to RBS. Total costs incurred to December 2015 totalled £1.2 billion.

The delay in the divestment of W&G also underscores the challenges that management faces in achieving its complex multi-year restructuring while dealing with legacy conduct, litigation and operational issues, despite material progress made thus far. RBS' remaining restructuring initiatives continue to pose complex operational challenges related to the reorganisation of its core retail and commercial banking operations, the downsizing of its corporate and institutional banking business and the implementation of structural reforms, such as ring-fencing. These add further complexity to RBS' overall reshaping and consume additional management energy at a time when RBS is still recovering.

[3] The bank ratings shown in this report are Santander UK's deposit rating, senior unsecured debt rating (where available) and baseline credit assessment.

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Bankinter's Placement of Additional Tier 1 Securities Is Credit Positive

Last Thursday, Bankinter, S.A. (Baa1/Baa2 stable, baa3[4]) announced that it had placed €200 million of perpetual Tier 1 securities. The issuance is credit positive for Bankinter because it will offset the negative effect of the bank's recent acquisition of Barclays Bank's retail business in Portugal on Bankinter's regulatory capital, thereby supporting regulatory capital ratios.

Although the securities that Bankinter is issuing are additional Tier 1 (AT1) capital, they will improve the bank's common equity Tier 1 (CET1) ratio. That is because Bankinter has no outstanding AT1 securities, and regulatory deductions now taken against CET1 capital will be taken against the new AT1 instruments that Bankinter will issue. The securities are perpetual, senior only to common shares and callable five years after issuance. They pay an 8.625% coupon, which is non-cumulative and has an optional and a mandatory coupon-suspension mechanism, and will convert into common shares if the bank's transitional CET1 ratio falls below 5.125%. On 25 April, we assigned a provisional (P)Ba3(hyb) rating to the securities.

The issuance of the €200 million of securities would improve the bank's CET1 ratio by approximately 70 basis points. However, Bankinter plans to use the AT1 issuance to offset the negative effects on capital of its acquisition of Barclays Bank's Portuguese retail business. The acquisition, announced in September 2015 but effective since 1 April 2016, consumed around €320 million of capital, of which Bankinter covered €120 million with the bad will generated by the purchase (the price that Bankinter paid was below book value). Bankinter will cover the remaining €200 million with the AT1 issuance.

Bankinter has adequate capitalisation from a regulatory perspective. The bank reported a phased-in CET1 ratio of 11.8% and a total capital ratio of 12.7% as of the end of 2015. These levels are above both the minimum regulatory requirements and the European Central Bank's 2015 supervisory review and evaluation process (SREP), which set a minimum CET1 ratio of 8.75%. Given the more than 300-basis-point difference between Bankinter's CET1 ratio and the SREP requirement, there is a low probability of coupon suspension owing to the restrictions on distributions established by the European Union's Capital Requirements Directive IV.

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

Exchanges

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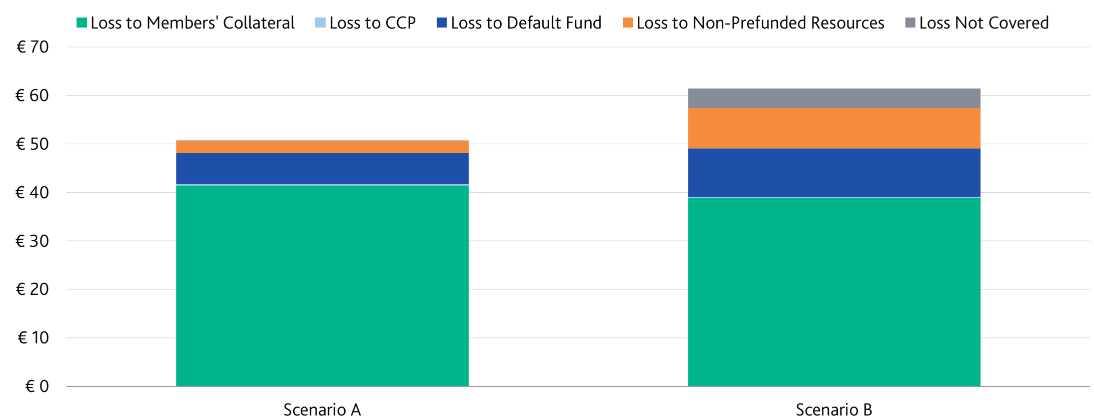
European Central Counterparty Stress Test Shows Resilience to Market Shocks, a Credit Positive

On Friday, the European Securities and Markets Authority (ESMA) published its 2015 European Union (EU)-wide CCP Stress test, which indicated that central counterparty (CCP) operators' were resilient to scenarios of multiple clearing member defaults and simultaneous market price shocks. Major exchange groups that operate stress tested CCPs include CME Group Inc. (Aa3 stable), Intercontinental Exchange, Inc. (A2 stable), London Stock Exchange Group plc (Baa1 positive) and Nasdaq, Inc. (Baa3 positive). The results are credit positive because they demonstrate strong risk management and governance of the exchange groups, a benefit for counterparties and creditors.

A first, ESMA's stress tests outline the effects of multiple scenarios of clearing member defaults in combination with both historical and hypothetical market price shocks. The 17 CCPs involved in the test have an aggregate clearing membership of more than 900 clearing members holding more than €150 billion worth in margin resources.[5]

Although ESMA did not disclose individual CCP results, the stress test showed that the tested EU CCPs' pre-funded resources (these consist of margin resources, CCP skin-in-the-game [capital] and default fund[6] contributions) were sufficient to cover stressed losses for a default scenario of the top two[7] EU-wide member groups[8] at each CCP. However, in a separate scenario where the top two clearing members of each CCP default simultaneously in every CCP, pre-funded resources were deficient at some CCPs, with aggregate uncovered losses across all CCPs ranging from €100 million to €4 billion across the two most severe hypothetical market stress scenarios (see exhibit).

Stress Results for Worst-Case Member Default Scenario Combined with Two Hypothetical Market Stress Scenarios, € Billions



Note: Losses are aggregated across all tested CCPs for the December 2014 stress. The default scenario is the top two clearing members of each CCP defaulting simultaneously in every CCP. The market stress scenarios are ESMA's two most severe hypothetical scaled scenarios.
Source: European Securities and Markets Authority

5 Margin resources are provided by clearing members to absorb losses resulting from the closeout of a member's clearing obligations with the CCP.
6 Default funds are resources provided by clearing members to help absorb losses resulting from the default of a clearing member.
7 As measured by clearing members' relative contribution to a CCP's default fund. Default fund contributions reflect the relative clearing risk brought to the clearinghouse by clearing members.
8 The stress test differentiated between individual clearing members and member groups. Member groups consist of clearing members that may share a similar franchise but operate distinctly as a clearing member.

A material deficiency in pre-funded resources would have been a significant issue for clearing members and CCP creditors, given the risk that members would be unable to support their commitments for unfunded assessments. The scenarios that generate such an outcome are severe, given ESMA's assumption of cross-default across all EU CCPs, which in one instance would result in the simultaneous default of an aggregate 30 members across all CCPs, with one CCP facing losses from the default of 10 members.

To put this in context, cross-border CCPs generally operate on a Cover-2 industry standard, which requires that the CCP hold resources adequate to absorb potential losses from the default of its top two members. Thus, the ESMA stress scenarios reflect stressed defaults of five times the industry standard (10 members default in one CCP in the October scenario indicated in the exhibit). These scenarios demonstrate how resilient the sector is to a combined counterparty credit default and extreme market stress.

Within the stress results, the level of interconnectedness among the 10 largest clearing members and 10 largest CCPs is an issue: with the top 10 clearing member groups composing 50% of EU-wide default funds, the concentration highlights the fragility of the network and reinforces the need for strong CCPs to ensure margin collateral and default fund resources are positioned so default losses[9] largely remain with the defaulting counterparty. In terms of particular member concentrations, the ESMA stress test highlights only a non-systemic risk where a relatively small CCP maintains a significant concentration in its membership base. Across the EU, member concentration is relatively benign.

The ESMA stress test outcome is not entirely a vote of confidence for the sector, however. ESMA does make a few recommendations that point to sector shortcomings. The EU-wide stress test highlights that CCPs should factor into their assessments of member creditworthiness the possible losses to which members would be exposed because of their participation in multiple CCPs. In particular, ESMA's clearing member knock-on analysis pointed to the potential for member losses through pre-funded resources or assessments that could compose more than 50% of the member's Tier 1 capital. This suggests that some members would be unable to support their unfunded commitments.

The stress test results also pointed to weaknesses in the assumptions used by some CCPs. The ESMA test established minimum market stress levels for risk factors (e.g., price shocks) that in some cases are more stringent than the ones used by the CCPs themselves. By setting a level playing field for the sector, ESMA has helped reinforce stress testing practices across the EU CCP sector, well-timed ahead of Europe's clearing mandate,[10] which takes effect in June.

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9 In managing the default of a clearing member, losses may arise in the closeout or auction of defaulting member positions. A defaulting member's margin and default fund resources serve as an initial resource toward absorbing these losses. Such a framework is known as "defaulter pay."

10 The clearing mandate refers to the requirement for select market counterparties to clear mandated instruments (e.g., interest rate swaps) through the CCP rather than on a bilateral basis. Europe's clearing mandate is due to start on 21 June 2016.

Sovereigns

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Delays in Concluding Greece's Bailout Program Review Are Credit Negative

Last Wednesday, European Council President Donald Tusk rejected Greece Prime Minister Alexis Tsipras' request for an emergency meeting of European Union (EU) leaders to revitalise efforts to complete the first review of Greece's (Caa3 stable) third bailout package. The process of completing the review has faltered amid tensions between Greece and its official creditors, notably the European Commission and the International Monetary Fund (IMF). The delays in concluding the current bailout programme's review are credit negative for Greece because they increase the risk of a new liquidity squeeze in the economy and prevent any discussion of debt relief, which will weigh on economic confidence.

Since early February, the government has been negotiating the first review of the €86 billion bailout package with its creditors. The main sticking points include the extent of future IMF participation and the IMF's requirement for debt relief and lower primary balance targets, and continuing (although narrowing) differences between the Greek government and its creditors over social security savings, income tax reform and the establishment of a privatisation fund. Another issue is creditors' demand for contingency budget cuts totalling around €3 billion, or 2% of GDP, that could be triggered if the government falls short of the fiscal targets laid out in its original bailout agreement. That agreement called for Greece achieving a primary surplus of 3.5% of GDP by 2018.

The next disbursement of €5.7 billion under the bailout programme will only take place after the conclusion of a successful review. Consequently, faltering negotiations increase the risk of a liquidity squeeze.

After months of relatively small repayment needs, Greece's amortisation and interest payments from May to December total €7.5 billion. Our estimate is that around two thirds of the total payments (€5.0 billion) are due in June and July alone, and that Greece owes most of that amount to the IMF and European Central Bank. Amortisation payments to the private sector on bonds are fairly limited at less than €100 million in June and July, and approximately €80 million for the remainder of 2016. In addition to the repayments, the government has to pay approximately €1.5 billion in salaries and pensions every month.

Against these payments, the government continues to face a challenging time collecting taxes. Although the Greek government's budget recorded a €215 million surplus against a €1.3 billion deficit target in January through March, the budgetary net revenues continued to underperform by 0.6% versus its target.

Additionally, political uncertainty is again on the rise. The governing coalition of Syriza and Anel holds only a three-seat majority in the 300-seat parliament, and could face difficulties in passing the legislation for the required social security reforms and tax increases. The centre-right opposition party New Democracy (ND), restructured under its new leader Kyriakos Mitsotakis, is now leading in opinion polls and could seek to force new elections. Moreover, Greece's programme review has gradually become entangled with both the EU's refugee crisis, with Greece hosting more than 50,000 refugees, and the UK's (Aa1 stable) 23 June referendum on EU membership, the latter of which threatens to delay Greece's bailout package review until after June.

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UK's Suspension of Aid to Mozambique Is Credit Negative for the African Sovereign

On Thursday, the UK Department for International Development suspended all financial aid to Mozambique (Caa1 stable) after the country acknowledged $1.38 billion (nearly 9% of GDP) of previously undisclosed external debt. The suspension of UK aid follows both the International Monetary Fund's (IMF) and World Bank's earlier suspensions of aid because of hidden debt.

These developments are credit negative for Mozambique and add additional pressure to a country already in a tenuous position. Both the suspension of aid and discovery of hidden debt negatively affect our assessment of the government's financial strength, the intensity of the pressures that Mozambique's balance of payments is experiencing, and the overall strength of the country's institutional framework.

Of all the credit implications, the pressure on the balance of payments and the foreign exchange reserve position of the Bank of Mozambique, the country's central bank, is the most relevant to the sovereign's credit quality. Before the discovery, external pressures were already manifest in a $1 billion drop in Mozambique's foreign-exchange reserves and in our view that the reserves would continue falling in 2016 and 2017. The discovery of new external debt obligations together with the aid suspensions means that there will be more capital and interest payment outflows and less revenue and capital inflow taking place in Mozambique's balance of payments than previously projected, with an equally negative effect on government finances.

The discovery puts at risk the overall support that Mozambique receives from the international community, which contributed roughly 10% of GDP in 2015. Much of Mozambique's support comes in the form of grants and concessional loans to the government, and in an IMF short-term credit facility that was agreed upon in December 2015 and designed to support the central bank's foreign exchange reserves. Under this $285 million facility, $120 million was immediately disbursed in 2015, while $165 million remains available for potential disbursements over 2016-17.

The hidden debt discovery also means that the government will have to service more external debt, with the additional service potentially reaching $250 million annually, according to our estimates. Our estimate assumes that the whole debt was not included in our government debt amortisation profile and that its associated interest was also not included in our assessment of government interest payments. We also assume that the debt is in the form of amortised loans with an average maturity of seven years and average interest rate of 7%.

Because of the hidden debt discovery, the IMF cancelled upcoming discussions with the government of Mozambique aimed at initiating its sixth review under the IMF's policy support instrument and on an existing stand-by credit facility. More importantly, the IMF will likely reassess Mozambique's government debt sustainability, which is key for any future financing programme. The credit risk for private investors is that such a financing programme can come with the condition of private-sector debt restructuring.

All these considerations are to a large extent embedded in our Caa1 rating. In light of the recent debt exchange carried out by the government and the ongoing external pressures, we have seen an increased risk that the Mozambican government may choose a debt restructuring as a means to alleviate external pressures in the future. We viewed the debt exchange as a distressed exchange,[11] allowing the government to postpone external debt service payments until 2023, which was a key driver behind our 15 April downgrade.

[11] See Government of Mozambique – FAQ - Debt Exchange, 20 April 2016.

Sub-sovereigns

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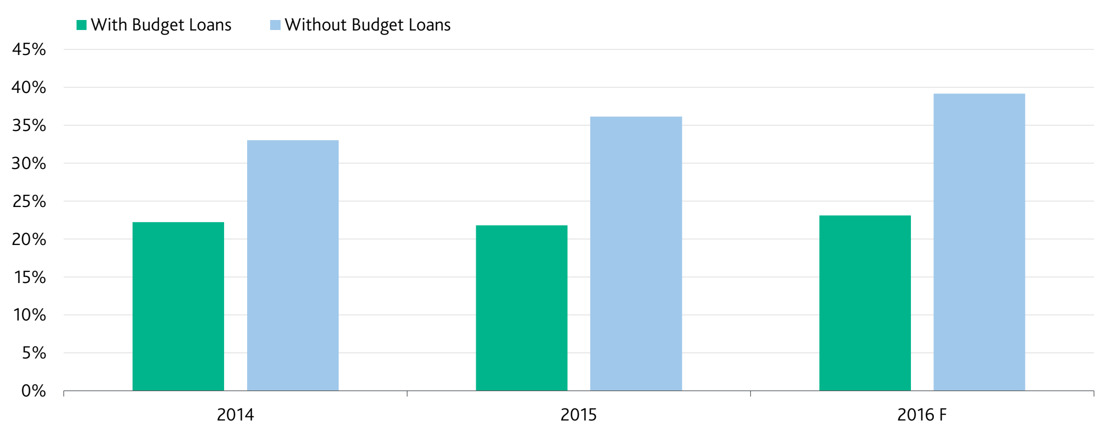
Increase in Russian Government Budget Loans to Regions Is Credit Positive

Last Tuesday, the Russian Ministry of Finance published official statistics showing a 26% increase in federal government budget loans during first-quarter 2016, which resulted in such loans composing a 43% share of Russian regions' debt at the end of March 2016, up from 35% at the end of 2015. Federal government budget loans are low-cost loans issued by the Russian government to regions to cover deficits, refinance market debt and fund infrastructure construction. The increase is credit positive for Russian regions because a greater proportion of these loans positively affects the regions' capacity to service debt and contain growing refinancing risk.

As Exhibit 1 shows, new federal government budget loans will significantly restrict the growth of regions' market debt in 2016, which is relatively short-term (more than 70% is due in the next two years) and is more difficult and more costly to refinance. As a result, market debt as percent of own-source revenue will not grow significantly, meaning that risks from market debt exposure will not materially increase. The Russian government intends to issue RUB310 billion of federal government budget loans in 2016, which will cover the majority of the market debt to be repaid by regions this year. In addition, these loans can be restructured and more easily refinanced by the federal government than market debt.

EXHIBIT 1
Russian Regions' Market Debt as Percent of Own-Source Revenue



Sources: Russian Federal Treasury, Russian Ministry of Finance and Moody's Investors Service calculations and estimates

We expect that the share of federal government budget loans will grow to more than 40% of total direct debt at the end of 2016 and partially contain an increase in interest expense. Russian regions use this debt to refinance costly market debt, which has a 12%-14% higher yield than federal government budget loans, which have an annual yield of 0.1%. We estimate that new federal government budget loans will help the regions save up to RUB35 billion in interest service costs this year.

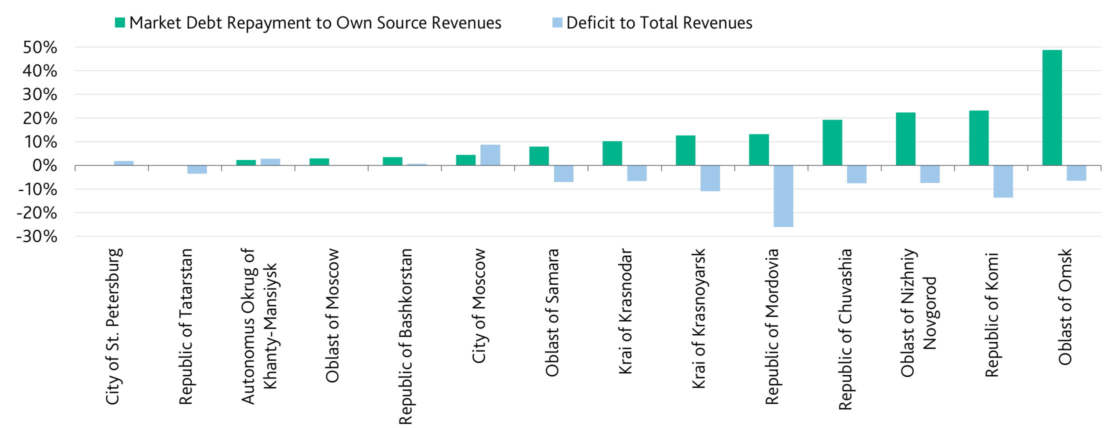
We expect that the regions' ongoing deficits will lead their debt levels to increase 8%-10% this year, and that even with the new federal government budget loans, market debt will likely grow by 7% this year. Such increases expose the regions to elevated refinancing pressure.

As shown in Exhibit 2, the regions with higher refinancing needs this year or lower fiscal performance will have the greatest need for cheaper federal government budget loans. These include Republic of Mordovia (B3 negative), Republic of Komi (B1 negative), Oblast of Omsk (Ba3 negative), Oblast of Nizhniy Novgorod

(B1 negative), Republic of Chuvashia (Ba3 negative) and Krai of Krasnoyarsk (B1 negative). Their higher refinancing needs will lead them to use expensive market borrowings to cover their deficits and refinancing needs.

EXHIBIT 2

Moody's-Rated Russian Regions' Financial and Debt Repayment Positions



Note: Data for 2015 are preliminary. Own-source revenues are total revenues minus federal transfers.

Sources: The regions and Moody's Investors Service

US Public Finance

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Illinois' Stopgap Higher Education Funding Bill Is Credit Positive, but Funding Challenges Persist

Last Monday, Illinois (Baa1 negative) Governor Bruce Rauner signed into law a bill that provides $600 million of stopgap funding to the state's community colleges, universities and financial aid program amid the state's budget stalemate. The stopgap funding relieves some of the immediate liquidity pressures confronting the state's higher education sector, a credit positive.

However, the measure provides only part of the funding that these institutions originally expected in the fiscal year ending 30 June 2016. The sector will continue to confront longer-term funding pressure because the state remains unable to resolve its own severe budget issues and significant pension underfunding. Illinois has not yet passed a budget for fiscal 2016, making the nearly 10-month budget approval delay the longest in state history.

In the absence of an approved fiscal 2016 state budget, the temporary measure draws on the state's Education Assistance Fund (EAF) to provide $356 million to public universities, $169 million of Monetary Assistance Program (MAP) financial aid grants and $74 million to community colleges. The EAF is used for both elementary-secondary and higher education, funded through a share of income tax revenue and riverboat gambling proceeds. Illinois Comptroller Leslie Geissler Munger said that as of 22 April, the EAF had a balance of approximately $354 million and has already begun appropriating funds.

The state expects to immediately start distributing the funds, which amount to less than one third of annual appropriations, and stop distribution by the end of July, nearly one month into fiscal 2017. Still, the measure provides some breathing room, particularly for those schools with the thinnest liquidity, such as Chicago State University (unrated) and Eastern Illinois University (Ba1 negative).

Because the state's public universities rely on state appropriations for a material amount of operating revenue, an average of 37% of total revenue for fiscal 2015, including on-behalf payments with an additional 1%-4% of revenue composed of MAP awards, this measure has a relatively larger effect on public universities than it does on community colleges (see exhibit). State appropriations comprise an average of 13% of community colleges' operating revenue, ranging from 5% to 25% including MAP grants, with the majority having more diversified revenue sources and more options to raise liquidity. State support for community colleges, including on-behalf pension payments, composes an average of 28% of rated community colleges' operating revenue.

EXHIBIT 1

Under Fiscal 2016 Stopgap, Universities Receive Less than One Third of Fiscal 2015 Appropriations

Obligor Name	Senior Lien Rating	Fiscal 2015 State Operating Appropriations $ Millions	EAF Special Appropriation $ Millions	Percent of Fiscal 2015 State Operating Appropriations
University of Illinois*	Aa3 negative	$653.1	$178.7	27%
Illinois State University	A3 negative	$72.2	$20.9	29%
Northern Illinois University	Baa2 negative	$91.0	$26.4	29%
Southern Illinois University	Baa1 negative	$201.2	$57.5	29%
Northeastern Illinois University	Baa3 negative	$36.9	$10.7	29%
Western Illinois University	unrated	$51.5	$14.9	29%
Eastern Illinois University	Ba1 negative	$42.9	$12.5	29%
Governors State University	Baa3 negative	$23.9	$7.0	29%
Chicago State University	unrated	$38.0	$20.1	53%
Illinois Community College Board**		**$335.7**	**$74.1**	**22%**

Notes: *Includes $11.1 million appropriation to the hospital.

** The Illinois Community College Board oversees and distributes funding to the state's 39 community colleges.

Sources: Issuers' audited financial statements, SB 2059 allocations and Illinois Board of Higher Education

NEWS & ANALYSIS

Credit implications of current events

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Strike at San Francisco Community College Signals Credit-Negative Resistance to Budget Cuts

Last Wednesday, the faculty of the San Francisco Community College District (SFCCD, Aa3 stable) conducted a one-day strike to protest management's proposal to reduce expenditures by 26% over the next six years. The strike is credit negative because it sends a strong signal of resistance to the district's plans to reduce costs and maintain structural balance. A failure to maintain balanced operations would impede the district's progress toward full renewal of its accreditation status, which, in turn, would further erode student enrollment and weaken annual revenue support from the state of California.

SFCCD's enrollment has fallen 37% since 2011 as a result of an improving economy luring students back into the workforce and student concerns about the district's accreditation. California community colleges typically reduce their expenditure base when enrollment declines to maintain structural balance. However, SFCCD has reduced operating expenditures by only 15.2% since 2011. The district has been able to stave off deeper cuts through its receipt of enrollment stability funding from the state. Stability funding is a temporary source designed to give districts with flagging enrollment time grow their enrollment to pre-decline levels. If growth does not occur, funding declines to match the new enrollment level. SFCCD will receive $25 million in stability funding for the fiscal year ending 30 June 2017. The district's eligibility to receive stability funds will expire on 1 July 2017, although the state has approved new legislation that will provide additional revenue support to the district even if enrollment declines further.

Stability funds combined with revenue from parcel taxes and increased state support for all California community college districts allowed SFCCD to improve its fiscal profile, including an improvement in total available liquidity to 20% of revenues in fiscal 2015 from 1.7% in fiscal 2012. This increase was key to the district's demonstration of strengthened fiscal management, an area cited as a weakness by the Accrediting Commission for Community and Junior Colleges. A failure to continue to maintain stable finances would jeopardize the district's efforts to clear its accreditation standing during its next review scheduled for January 2017.

The district has proposed reducing costs by cutting staff and class offerings, and implementing a salary structure approximately $10 million lower than what faculty is seeking. The district's proposed salary structure includes a 7.1% raise for faculty over the next two years in addition to a onetime payment of 5.3%. Faculty has requested a 4% raise in each of the next three years, plus annual cost of living adjustments and a restoration a foregone salary increase that was originally scheduled to occur in fiscal 2010.

The strike is the first by faculty in SFCCD's history, and because it occurred at the "fact-finding" stage of negotiations, an early phase of bargaining, it points to the level of entrenchment and distrust between the negotiating sides. Employee efforts to impair the district's flexibility to make expenditure reductions or otherwise maintain structural balance is a credit weakness relative to other districts that do not face such challenges.

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