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CREDIT IN DEPTH

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The European Parliament election outcome is credit negative for France and Greece, but positive for Italy. The rise of Eurosceptic parties in France and Greece could prompt both governments to consider easing budgetary consolidation, which would address voters’ austerity fatigue, but permit wider deficits than currently planned.

RATINGS & RESEARCH

Rating Changes

Last week, we upgraded International Paper, Starbucks, AXA Insurance, Banco Mercantil del Norte, China Merchants Bank, the government-guaranteed debt of Allied Irish Banks, EBS, Bank of Ireland and Permanent; MBIA Inc, National Public Finance Guarantee, Philippine National Bank, the government-guaranteed debt of Caixa Geral de Depositos, Banco Espirito Santo, and BANIF-Banco Internacional do Funchal; Uruguay, Metropolitan Atlanta Rapid Transit Authority and 188 US RMBS tranches. We downgraded PGE Polska Grupa Energetyczna, African Bank, First Citizens Bank and Presence Health, Provena Health and Resurrection Health Care (all of Illinois).

Research Highlights


RECENTLY IN CREDIT OUTLOOK

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

Credit-Positive Beats Acquisition Brings Subscriptions to Apple’s Music Mix

Last Wednesday, Apple Inc. (Aa1 stable) announced plans to acquire Beats Electronics, LLC (B2 review for upgrade) for $3.0 billion, including $2.6 billion in cash at closing and $400 million that will vest over time. The acquisition is credit positive for Apple because after it combines with Beats, Apple will have the broadest streaming and download rights of any online music service. The acquisition is also credit positive for Beats and we put its ratings on review for upgrade.

Although the acquisition is priced at a high multiple, it will not strain Apple’s liquidity. The company’s cash and investments balances were $151 billion at 29 March 2014, augmented by $12 billion from a recent debt issuance and first-time commercial paper borrowings. We expect Apple to fund a portion of the purchase price with overseas cash.

Beats is the leading player in the aftermarket headphone market, but its subscription music service and related applications present Apple with a greater opportunity for revenue growth and product expansion. Apple has a dominant position in the downloaded music segment, but changing consumer preferences toward streaming and subscription services have contributed to a slowdown in iTunes’ music download revenues. In late 2013, Apple launched its free iTunes Radio service in order to take on segment leader Pandora. By acquiring Beats, Apple now adds a subscription service to its music mix.

By combining with Beats, Apple also adds recording-industry veteran Jimmy Iovine and rap star Dr. Dre to its senior management ranks, which will deepen the company’s relationships with the music industry. This, combined with offering better payment terms and a share of advertising revenues to record labels and artists in exchange for rights to their music, will help ensure priority access to new releases and help Apple maintain the deepest music catalog. And because Beats Music is available on Android and Windows mobile devices, it will give Apple a platform to expand its offerings to a larger audience. We also expect Apple to broaden Beats Music’s audience by leveraging its iTunes stores and its rights to music around the world.

The Beats headphones business is a weaker strategic fit for Apple, although Apple could modestly increase the operation’s revenues by selling the headphones in new markets. But we believe the greatest benefit would come from Apple improving the headphones business’ cost structure by integrating it into its world-class supply chain.

Beats’ headphones business generated $1.1 billion in revenues from zero in four years, largely because of its positioning as a premium fashion brand, which we expect to continue under Apple. Apple already sells Beats and competitors’ products in its online and retail stores, and it is unlikely that Apple will move to exclusively sell Beats products following the acquisition. Under its previous licensing deal with HTC Corp. (unrated), Beats included its branded headsets with HTC phones, and we expect Apple to provide a similar bundling with its products.

We also expect Apple to leverage Beats’ products and technologies into its development of wearable devices and in-home technologies. For example, Beats’ wireless speakers can be engineered to seamlessly connect to Apple’s AirPlay wireless technology, and provide a much better user experience than connecting to third-party devices. We expect Beats’ product portfolio to play a prominent part in Apple’s efforts to roll out more devices that control the in-home environment. We also expect Beats to help Apple deliver an integrated communication and audio platform to automakers and help Apple better compete against Google Inc.’s (Aa2 stable) Android and Microsoft Corporation (Aaa stable) in the battle to establish a new standard in automotive communications and control.
Boeing’s Dreamliner Long-Distance Travel Approval by the US FAA Is Credit Positive

Last Tuesday, the US Federal Aviation Administration (FAA) approved The Boeing Company’s (A2 stable) 787 Dreamliner aircraft for additional extended operations (ETOPS) of up to 330 minutes, joining the Boeing 777 as the only twin-engine jets to have secured such certification. We expect that this credit-positive development will reinvigorate the Dreamliner’s already robust sales effort and large order book because it further enhances route options and operating efficiency for Boeing’s airline customers that currently and prospectively use the 787 airframe.

The approval allows the 787-8 to fly more direct and longer routes, operating up to as long as 5½ hours from a suitable landing field, versus its previous maximum allowance of just three hours. This allows for incremental market opportunities by expanding potential 787 operations to include a wider range of trans-Atlantic and trans-Pacific flights, and enhances customers’ ability to use the airframe in a manner more consistent with Boeing’s original intentions. The 787-8 model was engineered for long hauls, boasting an effective range of 7,850 nautical miles, while the upcoming 787-9 model, which should be similarly ETOPS certified shortly after introduction and will be in even higher demand, has a maximum range of more than 8,000 nautical miles.

The 787’s heavy use of composite plastics in the airframe, coupled with new fuel-efficient engines, materially enhances its operating efficiency, a key selling point. The 787’s ability to fly longer direct flights without having to maintain closer proximity to alternate safe diversion airports in case of emergencies should further enhance the aircraft’s fuel efficiency and related appeal to carriers. We believe other regulators will quickly follow the FAA’s action, as is normally the case, which would give Boeing a competitive advantage over existing equipment and should stimulate incremental demand.

We expect the FAA’s approval to have a bigger effect on future orders and deliveries because most routes in use for the approximate 150 787-8s in service today are not necessarily constrained by the former ETOPS-180 certification. There will be opportunities for some route modification, which will further enhance the airframe’s operating cost benefit relative to alternative equipment. But we expect the real benefit to come as the 787-9 becomes more mainstream starting in 2016. In particular, the ETOPS-330 approval should afford Boeing the immediate opportunity to enhance its position in the high-growth Asia-Pacific region: The company has almost 900 orders on which it has yet to deliver, and more than 200 of those orders originated from customers in Asia or Oceania.

Although we expected ETOPS-330 approval, the FAA’s action marks a significant reliability milestone and a vote of confidence that should mitigate any lingering questions related to the program’s widely reported grounding in January 2013. Large-scale order cancellations never materialized in response to the Dreamliner’s various developmental problems, including two very visible lithium ion battery failures, but the FAA grounding increased reputational risk and caused some incremental cash burn, including estimated disruption-related customer expense of about $100 million in 2013. Less quantifiable (and perhaps more significant) was the effect the controversy would have on customer confidence during a period of heightened competitive intensity. However, it now appears more likely that the Dreamliner’s growing pains will prove to have been little more than a series of modest distractions, and that Boeing has an opportunity to improve its cost structure and realize a decent return on its substantial investment.
McDonald’s Plan to Return Up to $20 Billion to Shareholders Is Credit Negative

Last Tuesday, McDonald’s Corporation (A2 stable) said it planned to return $18-$20 billion to shareholders between 2014 and 2016 through a combination of dividends and share repurchases that the company will partially fund with additional debt. We view this plan as a more aggressive financial policy toward shareholders and credit negative because it will raise debt levels, weaken credit metrics and limit its cushion within the A2 rating category.

McDonald’s debt/EBITDA, which has held steady over the past several years at around 2.4x as earnings kept pace with debt levels, will likely rise to 2.5x-2.6x over the next 12-18 months. At the same time, we believe McDonald’s has sufficient cushion within its current rating to absorb some additional debt to support its plan, based on our expectations for operating performance and credit metrics. Consequently, we affirmed all of McDonald’s ratings, including its A2 senior unsecured and P-1 short-term commercial paper rating.

Although we expect the company’s earnings to remain strong, its results will likely be hampered by soft comparable restaurant sales as consumer spending remains challenged and intense competition persists. For full year 2013, global comparable restaurant sales increased by only 0.2%, which included negative comparable quest counts of 1.9%.

Last year, several missteps caused in part by the rollout of new products and greater competition resulted in operating inefficiencies at the restaurant level and led McDonald’s to post a 0.2% decline in comparable US restaurant sales and a 1.6% decline in comparable guest counts. Although we expect earnings to remain strong, comparable restaurant sales have been soft for the past several quarters as consumer spending remains soft, promotional activity by competitors remains high and the company laps strong prior-year results.
PetroLogistics’ Sale to Flint Hills Dissolves Its Master Limited Partnership Structure, a Credit Positive

On Wednesday, PetroLogistics LP (B1 review for upgrade) said it had agreed to be acquired by Flint Hills Resources, LLC (FHR, A1 stable) for what FHR indicated was $2.1 billion in cash. The takeover is credit positive for PetroLogistics, which would go private and dissolve its master limited partnership (MLP) structure.

The removal of the MLP structure relieves PetroLogistics of the obligation to make quarterly distributions to partners, eliminating a drain on cash, and improving its liquidity and growth prospects. The takeover also places PetroLogistics under the control of FHR, a company with far stronger credit quality. The favorable credit implications of the deal led us to place PetroLogistics’ ratings on review for upgrade.

We expect the $2.1 billion transaction, including $365 million in assumed debt, to close by year-end. FHR’s offer includes the cash acquisition of PetroLogistics’ public common units for $14 each, an 8% premium to the market price, and its non-public common units held by Lindsay Goldberg LLC, York Capital Management, and PetroLogistics’ executive chairman and president/chief executive officer for $12 each.

PetroLogistics’ variable distribution MLP structure requires the company to spend virtually all of its cash on quarterly distributions to unitholders. Ending the MLP structure supports PetroLogistics’ ability to repay debt and to grow. Removing these distributions to shareholders will greatly improve PetroLogistics’ cash and debt metrics, reversing its retained cash flow/debt from negative 1.5% to more than 30% annually.

PetroLogistics owns the largest propane dehydrogenation facility in the world and the only one in the US, with a capacity of 1.45 billion pounds. We expect the market for propylene, the key product of propane dehydrogenation, to remain tight in North America through 2015. Low propane prices have supported PetroLogistics’ unusually high EBITDA margin, above 30%, but rising propane prices in the first quarter and further increases in propane exports will reduce its margins this year.

PetroLogistics’ positive credit attributes also include multi-year contracts with large customers, a favorable geographic location and ample pipeline connectivity at the site location. The company’s limited operating history, its single site location on the Houston, Texas ship channel and the potential for volatile quarterly earnings are credit risks factored into the rating.

For the refining and marketing company FHR, this acquisition, its largest ever, is credit neutral. Buying PetroLogistics expands and diversifies FHR’s presence in petrochemicals, and provides certain synergies with a number of FHR’s existing assets. The equity financing of the acquisition and the benefits of the synergies will offset the high operating and margin risk associated with buying PetroLogistics. Moreover, PetroLogistics’ future sales should generate healthy margins and returns amid tight propylene supply and fairly low propane prices in North America.

FHR plans to finance the cash portion with proceeds from the liquidation of various financial investment strategies held on FHR’s balance sheet that the company targeted to provide liquidity to fund acquisitions and capital asset investment in excess of operating cash flow.

The acquisition will increase FHR’s leverage only modestly. The assumption of $365 million in PetroLogistics debt will more than double FHR’s debt levels, but FHR will maintain credit metrics in the top range of its peers, with debt/EBITDA below 0.5x.
Westlake's Geographic and Product Diversity Broadens with Credit-Positive Vinnolit Acquisition

Westlake Chemical Corporation (Baa3 stable) on Wednesday said it would spend €490 million in cash to acquire Germany’s Vinnolit Holdings (unrated), a leading European producer of PVC plastics, from Advent International (unrated), a private equity firm. The deal is credit positive for Westlake, and will help its global business profile by incrementally improving its operational, geographic and product diversity—without placing its credit profile under significant strain.

Westlake said it would finance the acquisition through existing cash and its revolver; however, we expect the company will not need to draw on its revolver. Despite a cash outlay of around $670 million for Vinnolit, and our projected capex spend of around $300 million in 2014, we expect Westlake’s liquidity over the coming quarters to remain strong. This primarily reflects the company’s current cash and equivalents balance of approximately $776 million as of 31 March; a capital raise of $225-$275 million from the recent initial public offering for limited partner interest in a fixed-distribution, master limited partnership structure; and cash flow from operations that we project at around $500 million this year.

The deal greatly expands Westlake’s reach by widening its previously US-only footprint to include Europe. Based outside of Munich, Vinnolit generated €917 million in revenues in 2013 almost exclusively from Europe. Vinnolit has six production sites in Europe (five in Germany and one in the UK) and six sales offices dotted across western and Eastern Europe. The increased reach of the combined group will provide unique cross-selling opportunities, especially to global customers that, prior to the combination, were unique to either Westlake or Vinnolit.

Vinnolit’s products serve many custom applications across a few non-construction European industries, including the European automotive industry. Vinnolit has a solid European position in emulsion PVC plastics, a higher-performance niche of the PVC marketplace. As a result, the acquisition broadens product exposures considerably for Westlake (see Exhibit 1, below), whose revenues were about $3.9 billion in the 12 months that ended 31 March 2014, and EBITDA of about $1.2 billion. On a pro forma basis for the 12 months that ended 31 March, we estimate the combined entity’s revenues will be close to $5 billion ($3.9 billion from Westlake and $1.2 billion from Vinnolit).

EXHIBIT 1
Westlake 2013 Revenues and Pro Forma Including Vinnolit

Source: Company filings and Moody’s Investors Service estimates
The Vinnolit acquisition will dilute Westlake’s profitability margins over the near term (see Exhibit 2, below). Vinnolit’s exposure to the European commodity PVC market poses some risk, based on Europe’s weak economic activity and volatile ethylene feedstock prices, and Vinnolit lacks significant backward integration into ethylene.

**EXHIBIT 2**

Vinnolit’s Ethylene Feedstock Costs Will Reduce Westlake’s Overall Margins

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<tbody>
<tr>
<td>Westlake Overall</td>
<td>31.0%</td>
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<tr>
<td>Westlake US PVC</td>
<td>17.2%</td>
</tr>
<tr>
<td>Vinnolit European PVC &amp; Specialty PVC</td>
<td>10.0%</td>
</tr>
<tr>
<td>Pro Forma Combined</td>
<td>25.8%</td>
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*Source: Company filings and Moody’s Investors Service estimates*

Even so, buying Vinnolit entails a constructive and strategic deployment of cash, helping Westlake improve its resilience.
Brazil Imposes Antitrust Fine on Country's Top Cement Producers, a Credit Negative

Last Wednesday, Conselho Administrativo de Defesa Econômica (CADE), Brazil’s government antitrust authority, imposed a $1.4 billion (BRL3.1 billion) fine on six of the country’s cement producers after finding that they ran a cartel that controlled prices and volumes in the country’s cement and concrete markets. The fine is credit negative for Brazil’s biggest cement companies, including market leader Votorantim Cimentos S.A. (Baa3 stable), which has a 36% market share and whose fine is the largest among the cement companies at around $705 million.

The penalty will pressure the companies’ liquidity and their cash flow generation because, in addition to the fine, it requires asset divestitures in the ready-mix concrete segment, and sales of minority equity stakes in concrete and cement companies. Requiring asset divestitures as part of a penalty for an antitrust violation is unprecedented in Brazil. The companies involved constituted 73% of Brazil’s cement production capacity in 2013. The companies can appeal the decision.

Asset divestiture requirements are smaller than the penalty that CADE recommended in its preliminary decision in January, which would have forced Votorantim Cimentos to divest 35% of its assets. The final penalty will have a smaller effect on Votorantim Cimentos’ cash flow generation, affecting less than 5% of its total annual EBITDA.

Earlier this year, CADE found that Brazil’s top cement producers qualified as a cartel and had controlled prices and volumes and set regional quotes in 2005 and earlier, which hindered competition in Brazil’s ready-mix cement and concrete markets. Along with the fine, CADE is demanding that the companies divest their ready-mix concrete assets, which equals 20% of total installed capacity, in areas where they have more than one plant within a 50-kilometer radius. These assets may be sold individually or as a group to any company not named in the suit. The penalty also requires the companies involved to sell their minority interests in cement and ready-mix concrete companies in Brazil.

With Votorantim Cimentos responsible for $705 million of the fine, the remaining $680 million fine will be spread among Brazil’s smaller (and unrated) companies: Intercecm Brasil, Cimpor Cimentos do Brasil, Holcim Brasil, Cia de Cimento Itambé and Itabira Agro Industrial.

We note that Votorantim Cimentos has a strong market presence and geographic diversification, with 40% of its installed capacity outside Brazil in North America, Africa, Europe and Asia. The company had a cash balance of around $796 million at the end of March, or 1.1x the total amount of its share of the fine, and easy access to banks and debt markets, which would allow it to settle the fines. Votorantim Cimentos has formally announced its intention to appeal the decision, which may delay any liquidity pressure in the short term.

Furthermore, CADE may allow the companies to pay the settlement with a combination of upfront payments and installments, which would allow Votorantim Cimentos to accommodate its payment with virtually no effect on its current liquidity position and future cash flow generation.
Russia’s Tube and Steelmakers Will Benefit from Gazprom’s Deal to Export Gas to China

On 21 May, OJSC Gazprom (Baa1, review for downgrade) announced that it had signed a deal with China National Petroleum Corporation (CNPC, Aa3 stable) to export 38 billion cubic meters per annum (bcm/pa) of gas to China. The deal is credit positive for Russia’s steel makers, tubular goods and large-diameter pipemakers OAO TMK (B1 stable), Severstal OAO (Ba1 positive), Magnitogorsk Iron and Steel Works (MMK, Ba3 stable), Chelyabinsk Tube Pipe Works (CTPW, unrated) and United Metallurgical Company (UMC, unrated).

The deal entails developing two gas fields and building a 4,000 kilometre pipeline. The project will require substantial quantities of oil country tubular goods pipes (OCTG) and large-diameter pipes (LDP). The demand will positively affect TMK, which is exposed both to OCTG and large-diameter pipes; Severstal, through large-diameter pipes; and MMK, which produces and sells steel plates ultimately sold to pipemakers; and CTPW and UMC.

Gazprom will develop the Yakutia and Irkutsk region gas fields (i.e., the Chayanda deposit in the Far East of Russia and the Kovykta deposit in Eastern Siberia, respectively), which are estimated to jointly produce up to 60 bcm/pa; and it will build a 4,000 kilometre Power of Siberia trunk pipeline to bring the extracted gas to China. The main part of the pipeline connecting the Chayanda deposit with Vladivostok and the by-passes to China at the border will be built between 2014 and 2018. The second 800 kilometres of the pipeline connecting the Kovykta deposit with the main part of the pipeline will be built over 2018-20. We estimate that the total project investment will exceed $55 billion over 2014-19. Gas delivery will start in 2018-20.

TMK estimates the tenders will begin in the third quarter of this year for OCTG and large-diameter pipes, with lead time for actual delivery around two months. This will have a fairly prompt positive effect on companies’ near-term orders backlogs, but the companies credit metrics are unlikely to improve enough to affect their ratings. We expect TMK will be the biggest winner from this deal because it is likely to win the tenders to deliver both its higher-margin OCTG pipes (gross margin for seamless pipes was around 24% in first-quarter 2014) and large-diameter pipes (gross margin for welded pipes was about 9% in first-quarter 2014).

If Gazprom’s $50 billion South Stream project gains full steam, it and the Power of Siberia pipeline construction might force TMK to increase its large-diameter longitudinal mill capacities because they would be fully utilised compared with current capacity utilisation of around 60%-70%. Despite expected improvements in capacity utilisation, the company had fairly sizeable total debt of around $3.6 billion as of 31 March with Moody’s adjusted debt/EBITDA of around 4.0x as of year-end 2013; furthermore, material deleveraging seems unlikely over the next one to two years. MMK’s large-diameter mill 5000 plate sales were about 8.5% of the company’s domestic sales in fourth-quarter 2013, while Severstal’s LDP Izhora plant contributed around 6% to the company’s Russian steel division revenue in 2013.

TMK estimates the project’s main parameters as follows:

» Around 1 million tonnes of OCTG and line pipes over the next four to five years to develop the deposits (TMK estimates its annual shipments of OCTG pipes to the Russian market at around 1 million tonnes)

» 2.6 million tonnes of LDPs are likely to be supplied for the gas trunk pipeline over 2014-20 (TMK expects to secure 20%-25% share of shipments, with the rest split between Severstal, CTPW and UMC)

» TMK will purchase pipe plate for LDPs from MMK and other Russian and possibly international producers
Lafarge Sale of Ecuador Operations Is Credit Positive

Last Tuesday, French building materials manufacturer Lafarge SA (Ba1 review for upgrade) announced that it had sold its Ecuador operations to Union Andina de Cementos S.A.A. (unrated) for an enterprise value of €405 million. The transaction, which is subject to customary closing conditions, is credit positive for Lafarge because the company will use the proceeds to reduce net debt and leverage.

The sale is another step in Lafarge’s substantial non-core asset disposal program, which will help the company achieve its target of reducing net debt to less than €9.0 billion by year-end from €10.3 billion at year-end 2013. The sale proceeds from the Ecuador operations, along with €380 million of asset disposals in the first quarter, brings the total raised from asset sales this year to close to €800 million. At the end of the first quarter, Lafarge reported net debt of €9.9 billion, versus €11.2 billion a year earlier.

These sale proceeds, along with Lafarge’s target to generate at least €600 million of EBITDA from cost reductions and innovation measures this year, will help bring credit metrics somewhat closer to appropriate levels for its current rating. This includes Lafarge’s retained cash flow/net debt ratio rising toward 15% this year from 8.3% at year-end 2013 and 9.4% as of 31 March.

Lafarge’s sale of its Ecuador operations is not related to the disposal plan resulting from Lafarge and Holcim Ltd.’s (Baa2 negative) merger, which would form the world’s largest cement and aggregates producer, with pro forma sales of CHF33 billion (€27 billion) and EBITDA of CHF8.0 billion (€6.6 billion). As a condition of regulatory approval, Lafarge and Holcim must dispose of assets comprising an international portfolio in developed and emerging markets that generated around CHF6.0 billion in revenues and an EBITDA of around CHF1.0 billion in 2013. The scale of such asset disposals is unprecedented in the global building materials sector, and achieving attractive valuations will be a major challenge.
NYK’s Investment in Liquefied Natural Gas Tankers Is Credit Negative

Last Tuesday, Nippon Yusen Kabushiki Kaisha (NYK, Baa2 negative) announced that it had successfully contracted two new liquefied natural gas (LNG) tankers through a joint venture with TS Shipping Invest AS (unrated) of Norway. NYK’s plans to increase its LNG fleet and the associated investments are credit negative for NYK because any incremental debt to fund these purchases will increase its already high leverage.

The two vessels will be delivered in 2016, and NYK and TS Shipping will charter them to Spanish energy company Gas Natural SDG, S.A. (Baa2 stable) on a 20-year contract. We estimate that these types of tankers cost roughly ¥20 billion each.

With about ¥1.2 trillion of balance sheet debt as of 31 March, the new vessels individually will not significantly increase the company’s debt burden, even if NYK assumes part of the cost or provides guarantees. However, these purchases are part of a number of investments in LNG vessels over coming years, which collectively will slow NYK’s deleveraging efforts if funded with debt. NYK plans to add 33 LNG tankers by the fiscal year ending 31 March 2019.

NYK’s adjusted financial leverage, as measured by debt/EBITDA, for the fiscal year ended 31 March was in the low 8.0x range, versus 9.8x a year ago, based on its preliminary earnings report. With leverage already at such a high level, any additional debt from funding a growing LNG tanker fleet will weigh on the company’s financial profile until revenues start to flow and the company has recovered the additional capex.

NYK has disclosed little of its financing plans for the two new vessels. It said five Japanese and European banks will provide the financing, but did not disclose the amount, timing to incur the debt or whether it and TS are jointly and severally liable.

Once the vessels begin to generate revenue, this transaction will lead to stable profits for NYK. Unlike containerships that rely on short-term contracts, LNG contracts tend to be long, which helps to stabilize the earnings volatility inherent to the shipping sector.

We expect the availability and growth of global LNG trade to lead to heightened investment in LNG tankers by other shippers such as Mitsui O.S.K. Lines, Ltd. (Baa3 negative) and Kawasaki Kisen Kaisha, Ltd. (Ba2 stable), which aim profit from Japan’s demand for new energy sources following the Fukushima nuclear accident in March 2011.
Banks

Mexico’s New Regulations for Stock Exchanges Are Credit Positive for BMV and MILA

Last Tuesday, Mexico’s government published a request for comment in the Comisión Federal para la Mejora Regulatoria (Cofemer) detailing the process for regulatory approvals for the Mexican stock exchange to enter partnership agreements with foreign exchanges. The new regulations are credit positive for Bolsa Mexicana de Valores (BMV, unrated), the Mexican stock exchange, because they mark the final step for BMV to join the Latin American cross-country stock exchange Mercado Integrado Latinoamericano (MILA), which BMV has been trying to do since MILA launched.

The parties expect to complete their partnership agreement by the first quarter of 2015. MILA, composed of the stock exchanges of Santiago, Chile; Bogotá, Colombia; and Lima, Peru, 1 has enabled investors to more easily trade stocks listed on any of the three exchanges by harmonizing trading practices, standards and market regulations. BMV joining MILA will enhance the franchises of all four exchanges by boosting their liquidity and increasing the range and geographic diversification of products available for investors in each market, thereby facilitating a more efficient allocation of capital across the region.

BMV will double MILA’s market cap, allowing the exchanges to more effectively compete against BM&FBovespa for investors and issuers. Together, MILA and BMV constitute 50% of Latin America’s market cap, versus BM&FBovespa’s 49% as of April 2014.

Latin American Stock Market Capitalizations

The MILA accord has led several brokerage houses to establish a regional presence in MILA markets in order to take advantage of these countries’ high growth and synergies. In 2012, Banco de Crédito del Perú (Baa2 stable, C-/baa2 stable) 2 acquired Colombian broker-dealer Correval in April and Chilean investment

1 According to World Federation of Exchanges April 2014 data, Bolsa de Comercio de Santiago, Bolsa de Valores (unrated) in Santiago, Chile had a market cap of $256 billion, while Bolsa de Valores de Colombia S.A. (unrated) in Bogotá, Colombia had a market cap of $205 billion, and Bolsa de Valores de Lima S.A. (unrated) in Lima, Peru had a market cap of $77 billion.

2 The bank ratings shown in this report are the banks’ deposit ratings, standalone bank financial strength ratings/baseline credit assessments and the corresponding rating outlooks.
bank IM Trust in July, while Brazil’s Banco BTG Pactual S.A. (Baa3 stable, D+/baa3 stable) acquired Chilean broker-dealer Celfin Capital (which also has operations in Peru and Colombia) in February and Colombian broker-dealer Bolsa y Renta in December.

The latest round of expansions include an announcement in December 2013 by Itaú Unibanco’s investment banking arm Banco Itaú BBA S.A. (Baa2 stable, C-/baa1 stable) of its intention to open a broker-dealer in Mexico, following BTG Pactual’s opening of a broker-dealer in Mexico in October. We expect BMV’s partnership with MILA to further this trend.
Lloyds’ Plan to sell 25% of Its TSB Shares in IPO Is Credit Positive

Last Tuesday, Lloyds Banking Group plc (A2 negative) announced its intention to sell approximately 25% of its ordinary shares of TSB Banking Group Plc (unrated) through an IPO. The plan is credit positive for Lloyds’ bondholders since it reduces the ongoing costs and remaining execution risks related to the divestment. Furthermore, the sale is a significant milestone in completing the European Commission mandate that Lloyds dispose of a portion of its retail business as part of the aid package it received from the UK government.

In December 1995, Lloyds Bank and TSB merged to form Lloyds TSB. TSB currently has 4.5 million customers, £19.7 billion in loans (plus beneficial title to £3.3 billion non-TSB branded mortgages) and £23.3 billion of deposits (about 4% and 5%, respectively, of Lloyds’ loans and customer deposits), and 631 retail branches across the UK that were rebranded and now operate as a separate entity to ready them for disposal. Although TSB’s valuation remains uncertain, we expect it to be relatively close to its £1.5 billion book value. Hence, the possible one-off loss (given downside risks from current market conditions) would not be significant and, in any case, the value would clearly be much higher than the £750 million sale price Lloyds initially agreed to sell TSB to the Co-Operative Bank plc (Caa2 negative, E/ca stable3), before Co-Operative was exposed to capital deficiencies and decided to retract its bid.

To attract and retain retail investors, they will be given one free share for every 20 shares to which they subscribe (up to £2,000) and hold for at least a year. This benefit partially compensates for TSB’s lack of dividends until at least 2017 and its plan to invest all of the next few years’ earnings back into the business.

Lloyds is required to put its remaining TSB stake on the market by the end of 2015. The group has already incurred TSB’s separation costs of roughly £1.6 billion, while Lloyds has estimated £200 million in additional costs for 2014 for the completion of the TSB float and an additional £150 million related to running and transaction costs. Eliminating this drag on Lloyds’ profitability is credit positive because the only outstanding costs will be those related to putting the remaining stake onto the market by the end of 2015 and those related to the transitional services agreement and long-term services agreement.

Despite losing approximately 4.3% of its 29% current account market share (shown below) as a result of TSB’s full IPO, which will reduce net interest income figure and slightly increase the group’s loan-to-deposit ratio, we believe that Lloyds will maintain its dominant position as the largest retail bank in the UK.

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3 The bank ratings shown in this report are the bank’s deposit rating, its standalone bank financial strength ratings/baseline credit assessments and the corresponding rating outlooks.
Lloyds Bank Market Share

Note: Excludes TSB Banking Group Plc.
Source: Lloyds
Historically Low Mortgage Interest Rates Are Credit Negative for Czech Banks

On 21 May, Czech mortgage data provider Hypoindex announced that the country’s average new mortgage offer rate fell to 2.88% last month, an historic low. The rate decrease stems from intense competition in the mortgage market, which grew 6.7% year-on-year in first quarter of this year. Because mortgages account for 30% of the banking sector’s total gross loans, we expect this to negatively affect the profitability of all Czech banks. Ceskoslovenska Obchodni Banka, a.s. (CSOB, A2 negative, C-/baa1 stable4), for which mortgages constitute approximately 46% of lending to households and non-financial corporations, will be most affected.

Czech mortgage rates have been falling since late 2009 (see Exhibit 1). The drop reflects banks’ continued appetite for mortgage lending as they face low growth in their corporate lending books (+0.6% year-on-year in first-quarter 2014). The three largest banks — CSOB, Ceska Sporitelna, a.s. (A2 negative, C-/baa1 stable) and Komercni Banka a.s. (A2 negative, C-/baa1 stable) — commanded 67% of the mortgage market as of the end of the first-quarter. These banks’ mortgage loan portfolios had grown between 8.2% and 10.8% year-on-year as of the end of the first-quarter, exceeding the market average. Also, net interest margins are hurt by the low interest rate environment (e.g., the Czech National Bank lowered the two-week repo rate to a record low of 0.05% in 2012). This low-rate environment is reflected in declining net interest margins (Exhibit 2).

EXHIBIT 1

Czech Mortgage Loans and Interest Rates

Source: Czech National Bank

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4 The bank ratings shown in this report are the banks’ deposit ratings, their standalone bank financial strength ratings/baseline credit assessments and the corresponding rating outlooks.
Banks’ profitability is further negatively pressured by continued competition in the term deposit market, which constituted 37% of the sector’s deposit funding as of April 2014. Although rates on demand deposits have declined gradually in line with market interest rates, interest rates on the stock of household term deposits have remained stable at around 1.85% since 2010.
BPM’s €500 Million Capital Increase Is a Crucial Step in Reducing Risk to Bondholders

On 23 May, Banco Popolare di Milano S.C.a.r.l. (BPM, B1 negative, E+/b2 stable⁵) announced that the €500 million capital increase it launched on 5 May was 99.48% subscribed, primarily by retail investors. Full subscription of BPM’s equity issue is credit positive and a crucial step for the bank to reduce its risk of failing to meet new regulatory capital thresholds and to pass the European Central Bank’s (ECB) comprehensive assessment.

The capital raise increases BPM’s regulatory capital above the minimum 8% threshold set by the ECB for its assessment, and, more importantly, strengthens a possible partial or full removal of the risk-weighted assets (RWA) add-on that the Bank of Italy (BoI) has applied to BPM. Moreover, the capital raise proves that a midsize Italian bank with vulnerable credit fundamentals and a strong employee-dominated governance structure can successfully tap the equity markets.

After BPM repaid its Tremonti bonds⁶ in June 2013, the bank had one of the lowest capitalisations among its domestic peers. The capital increase will raise BPM’s common equity Tier 1 ratio to about 8.46% from 7.30% reported at the end of first-quarter 2014, improving its loss-absorption capacity. However, even with this higher capital, BPM has little leeway for covering a capital shortfall resulting from the ECB’s assessment, highlighting the importance of the BoI reducing the RWA add-on in order to increase regulatory capitalisation sufficiently above the 8% threshold.

In April 2011, BPM disclosed that a regulatory inspection unveiled serious deficiencies in corporate governance, organisation, risk management, control and group structure. This prompted BoI to require that BPM increase its RWA with an add-on on some assets (Exhibit 1), which we consider an indirect request to increase the bank’s capitalisation (Exhibit 2).

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**EXHIBIT 1**

Banca Popolare di Milano’s Risk-Weighted Assets, 2010 to First-Quarter 2014

<table>
<thead>
<tr>
<th>Year</th>
<th>Risk Weighted Assets</th>
<th>Add-On</th>
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</thead>
<tbody>
<tr>
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</tr>
<tr>
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<tr>
<td>1Q2014</td>
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</table>

Source: The bank and Moody’s Investors Service

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⁵ The bank ratings shown in this report are the banks’ deposit ratings, its standalone bank financial strength rating/baseline credit assessment and the corresponding rating outlooks.

⁶ Hybrid notes subscribed by the government in 2009 and recognised as core Tier 1 capital.
EXHIBIT 2
Banca Popolare di Milano’s Solvency Ratios, With and Without the Add-on, First-Quarter 2014

<table>
<thead>
<tr>
<th>Solvency Ratios</th>
<th>Solvency Ratios Without Add-On</th>
<th>Solvency Ratios with Capital Increase and Without Add-On</th>
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</thead>
<tbody>
<tr>
<td>Common Equity Tier 1</td>
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<td>10.1%</td>
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<td>14.5%</td>
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</table>

Note: Ratios do not incorporate first-quarter 2014 profits and other extraordinary items. According to the bank, if these were included along with the capital increase and the add-on removal, BPM’s common equity Tier 1 ratio would rise to 11%.

Source: The bank and Moody’s Investors Service

BPM hopes that its resolution of its deficiencies prompts regulators to allow for a partial or full removal of the add-on. The bank will formally submit a request for relief sometime this month. However, we note that BPM continues to face corporate governance challenges, as the influence of BPM’s shareholders/employees has not changed since the regulatory inspection, despite the various attempts by management to institute reforms. If the BoI rejects BPM’s request, the bank’s capital ratios would be close to the minimum required under the ECB’s comprehensive assessment.

BPM is the second bank to tap equity markets in 2014, following Banco Popolare Societa Cooperativa’s (Ba3 negative, E+/b3 positive) €1.5 billion rights issue in April. With Italian banks planning to raise €9 billion of fresh capital,7 BPM’s fully subscribed equity suggests investor support.

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7 See Italian Banks: recent capital increases are credit positive ahead of the AQR, 16 April 2014.
**Suncorp’s AUD500 Million Write-Down of Goodwill and Intangibles Is Credit Negative**

Last Tuesday, **Suncorp Group Limited** (SUN, A2 stable) announced it would take an AUD500 million write-down of intangible assets in the group’s life insurance subsidiary, **Suncorp Life & Superannuation Limited** (Suncorp Life, unrated), whose claims and lapse experience continue to be higher than the company’s assumptions, which is credit negative.

The write-down consists of approximately AUD350 million of goodwill and intangibles and AUD150 million of loss recognition on some products and reserving adjustments to policy liabilities. The write-down has no immediate effect on the consolidated group’s ratings as the much larger non-life insurance and banking businesses continue to perform in line with expectations, which underpin the group’s ratings. We expect the group’s business diversification will provide positive benefits while the life business will remain challenged by the operating environment.

Suncorp Life’s write-down, which follows the 25 October 2013 **AMP Life Limited** (Aa2 stable) announcement of reserve strengthening and a revision to lapse assumptions, confirms that operating conditions in Australia’s life insurance industry remain difficult. The industry faces a number of structural and cyclical challenges, which have led to elevated policy claims and lapses.

Product design and pricing, and advisor remuneration are the primary drivers of the structural challenges facing Australia’s life insurance industry. Life insurance products with annual premiums have been structured such that premium levels step up when the policyholder reaches a specified age, generally 45, which has led to policyholders letting their policies lapse instead of renewing at the higher premium rate. Additionally, advisors receive large upfront commission payments on sold policies and are therefore incentivized to churn policies between insurance companies, which has also led to increased lapse rates as policies move between providers. These two factors have resulted in more policy lapses than life insurance companies had budgeted.

Life insurance companies bear the cost of writing life insurance upfront, while profits are realized over the life of the policies, which can be long term. Because claims and policy lapses surpass expectations and will lead to lower-than-expected profitability, SUN and AMP have written down goodwill and deferred acquisition costs and increased reserves.

Suncorp Life has materially revised its assumptions, with claims assumptions set to increase by 20% and lapse assumptions increasing by 2.5% before reverting down to lower levels in 2018, by which time the firm expects some of the structural and cyclical issues will be resolved.

The increase in loss assumptions will lead to reduced margins and profits in the next 12 months. However, we expect these to stabilize before improving as the group takes action to remedy its claims and lapse experience. Suncorp Life is taking a number of actions to improve its policy claims and lapses: repricing policies appropriately for risk; improving its customer retention practices; leveraging the non-life insurance businesses claims management expertise to reduce claims-handling times and ultimately the cost of claims; and reviewing its advisor panel and the remuneration structure to ensure their alignment with the advisors that provide the best value to the company.
Sovereigns

Argentina’s Accord with Paris Club Signals Greater International Financial Integration, a Credit Positive

Last Thursday, Argentina (Caa1 stable) announced it had reached an accord to repay over the next five years $9.7 billion in defaulted Paris Club debt. Argentina has remained in default to the Paris Club, a group of bilateral official lenders, since its 2001-02 crisis. The agreement with the Paris Club will not, by itself, necessarily result in greater capital inflows. But with Argentina’s official reserves decreasing dramatically in recent years, the accord demonstrates the government’s interest in normalizing its foreign currency funding options and opens the door for greater multilateral and bilateral funding that was previously held back by the unresolved Paris Club default, a credit positive for the sovereign.

The agreement backloads payments, with only $1.15 billion due in 2014 and 2015, and carries a modest 3% interest rate, limiting the cash effect on official reserves. Argentina retains the right to extend the five-year repayment schedule by two years, which would raise the interest rate by 1%, but provide the country additional payment flexibility.

Argentina has no access to international capital markets and official reserves remain the main source for international debt repayments. Falling trade surpluses8 and persistent capital flight have eroded international reserves for years (see exhibit), with reserves dropping to $28 billion in April 2014 from $52 billion in April 2011, despite a recent uptick.

Argentina’s International Reserves Have Declined Since 2011

We estimate that Argentina faces dollar debt payments of more than $20 billion in 2014 and 2015, with private creditors and international (multilateral and bilateral) financial institutions owed $9.3 billion this year and $12.5 billion next year, although the final numbers could be higher. The recently finalized agreement with Spanish oil company Repsol S.A. (Baa2 stable)9 to compensate it for the 2012 nationalization of its ownership in YPF Sociedad Anonima (Caa1 stable), Argentina’s largest oil producer,

8 See Argentina’s Trade Surplus Continues to Fall, Negatively Pressuring International Reserves, 27 March 2014.
9 See Repsol Compensation Agreement over YPF Is Credit Positive for Both Companies, 3 March 2014.
could add another $1.5 billion in payments over the next two years. To meet all these obligations, Argentina today relies solely on its stock of international reserves because it lacks other external funding options.

The agreement with the Paris Club will have credit positive knock-on effects for Argentine banks because it will reduce country risk, making Argentina more attractive for foreign investments and creating business opportunities that will boost banks’ ability to generate earnings. It will also increase the likelihood of getting foreign funding to deepen foreign trade business, and it will reduce banks’ funding costs for their current credit facilities.
Securitization

Peer-to-Peer Loan Securitizations Pose Well-Understood Credit Risks

Peer-to-peer (P2P) lending on the Internet is growing quickly, and we expect issuers will attempt to tap the rated asset-backed securitization (ABS) market in the near future. At least one financial intermediary has aggregated and securitized P2P loans, and we expect rated securitizations to follow.

Tapping the rated securitization market would increase the scale of P2P lending and allow investors who are prohibited from investing directly in P2P loans to invest in them indirectly. Securitization would also allow investors to use leverage to increase their exposure to the loans. Although aspects of P2P business models are novel, the P2P loan securitization credit drivers are similar to those of other consumer loan securitizations.

We highlight four main credit considerations for P2P loan securitizations: historical loan performance, underwriting and origination, servicing and regulatory risks.

P2P loans have a limited performance history. As with other types of new consumer lending programs, forecasting performance of P2P loans is challenging because of limited performance data. And, performance history is a key credit consideration for P2P securitizations. However, potential issuers of P2P loan ABS could mitigate some of the risk associated with the lack of historical data by selecting and securitizing a P2P company’s loans that have the most favorable and predictable credit characteristics. Potential ABS issuers can also provide more detail about borrower attributes than what consumer loan ABS transactions typically disclose.

Underwriting criteria and origination practices. P2P companies have revised their underwriting criteria to better predict losses, but their latest formulas have not been tested during times of heavy economic stress. To moderate performance risks, however, ABS issuers could apply their own loan selection criteria to the borrower attributes collected by the P2P companies in order to choose the loans with the most predictable performance.

Fraud and misrepresentation risks are also inherent in P2P platforms, but focusing on fraud detection during the underwriting process and including seasoned loans in the ABS pools would help alleviate these risks. Although P2P companies invest heavily in fraud prevention technology, sole reliance on online platforms in consumer lending has historically yielded high losses even for creditworthy obligors.

Addressing servicing arrangements and operational risk in the securitizations. Loan servicing by P2P companies poses high operational risk because P2P companies are weak financially, owing to their relatively small size and short operating histories. Issuers in other ABS asset classes have diminished servicing risk by arranging for a strong third-party servicer, or by setting up an effective back-up servicing arrangement. An issuer could also set up a servicing arrangement specific to a securitization, as opposed to an arrangement covering the P2P company’s entire portfolio, to make it easier for ABS investors or the securitization’s indenture trustee to replace a nonperforming servicer.

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In other ABS asset classes, issuers have taken steps to protect funds that borrowers remit in the event that the originator files for bankruptcy. To lessen risk, ABS issuers have directed borrowers to pay directly to a securitization account or separate securitization funds from non-securitization funds. For further details, see Moody’s operational risk guidelines.

P2P companies could become subject to additional regulatory oversight. P2P companies also face the risk of regulatory uncertainty as they grow and evolve. Although P2P lending, specifically when funded through a bank, must comply with a variety of regulations, P2P companies themselves are not currently subject to explicit oversight by any one federal or state agency. As loan origination in this industry grows rapidly, however, P2P companies could face additional oversight and regulatory requirements by the Consumer Financial Protection Bureau or other federal agencies.

This article summarizes an article that can be found here.
Amendments to French Covered Bond Law Are Credit Positive

Last Wednesday, the French government amended the legal framework applicable to French covered bond issuers to reduce losses or disruption in case of the default of the sponsor bank, a credit-positive development for covered bondholders.

The amended framework increases covered bondholders’ legal protections through more stringent over-collateralisation requirements, a new maturity test, limiting intra-group exposures in the liquidity test and establishing a servicing transfer plan.

The amendments make two important changes in the amount and definition of the minimum level of over-collateralisation that the covered bond issuer must maintain.

First, the minimum required over-collateralisation increases to 5% from 2%, which will likely increase the value of collateral after a covered bond anchor event (i.e., the sponsor ceasing to make payments to the covered bond issuer). Most covered bond issuers typically include additional assets that push collateralisation well above the legal minimum, but such voluntary over-collateralisation may be removed prior to an anchor event. Consequently, we consider the sponsor’s rating and contractual commitment to maintain the over-collateralisation and sometimes give limited or no value to these additional assets.

Second, the definition of legal over-collateralisation has also been refined, making the legal over-collateralisation test stronger. When intra-group loans in the cover pool exceed 25% of the issuer’s non-privileged liabilities (i.e., typically the issuer’s share capital or any subordinated bonds), a portion of such loans will be excluded from the cover pool for the purpose of calculating the over-collateralisation test. This adjustment is credit positive because it limits the risk that covered bond issuers rely on assets directly exposed to the credit quality of their parent or any of their affiliates. Upon a covered bond anchor event, these assets are likely to have limited value because of a high default correlation within the sponsor group.

Beginning 31 December 2015, all covered bond issuers must comply with a new maturity test: at any time, the remaining average life of the cover pool assets must not exceed that of the covered bonds by more than 18 months. Cover pool assets included in this test are only those that are strictly necessary to satisfy the minimum legal over-collateralisation requirement of 105%. This new test supplements the pre-existing general maturity matching principle. By clarifying the definition of the maturity-matching requirement, the updated framework requires issuers to reduce liquidity and refinancing risks because better maturity matching between assets and liabilities reduces the risk of an asset fire-sale upon a covered bond anchor event.

The existing liquidity requirement – to cover at any time any cash flow needs in the next 180 days – is amended to limit covered bond programmes’ reliance on bank loan facilities. This assessment takes into consideration principal and interest on assets, any substitute assets and any repo-eligible assets. However, following the amendments, any additional facility agreement, whether intra group or not, cannot be included in this assessment. This amendment is credit positive because it reinforces the 180-day liquidity test by effectively limiting intra-group facility agreements as a source of liquidity.

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12 Decree no. 2014-526 dated 23 May 2014 and ministerial order dated 26 May 2014 relating to the prudential regime of sociétés de crédit foncier and sociétés de financement de l’habitat amend the French covered bond law for these issuers.

13 For more details on our approach for analysing voluntary over-collateralisation, see Appendix F3 of Moody’s Approach to Rating Covered Bonds.
Finally, the amendments contain general provisions to mitigate operational risks upon sponsor default. In particular, the issuer must identify the necessary resources to service the cover pool and include a description of the procedures for transferring the servicing activities to another entity in the sponsor bank’s recovery plan and provide that to the regulator on an annual basis.
Accounting

New Global Standard for Revenue Accounting Improves Comparability

On Wednesday, the US Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) jointly released a single global revenue recognition model, replacing the hundreds of accounting standards that currently exist in US generally accepted accounting principles (US GAAP) and converging US and international revenue accounting standards.

Once adopted, the new standard applies a single five-step model to all companies, improving comparability cross-industry, as well as cross-border. Existing revenue reporting is one of the most divergent areas of accounting. US GAAP is composed of hundreds of pieces of literature, primarily industry-based and very prescriptive, while International Financial Reporting Standards include limited guidance with broad principles applied to all industries.

Disclosure requirements in the new standard are a significant improvement versus existing reporting. Increased interim disclosure will help with timely identification of trends in the revenue line. Applying the one-model approach will introduce more judgment than previously required in US GAAP. Because revenue accounting is historically the leading cause of restatements, increased disclosure of significant judgments made by management in applying this new standard will be important for financial statement users.

As is the case with adoption of all new accounting standards, we don’t expect the changes to affect credit ratings because a change in reporting does not change underlying financial conditions. But if increased disclosure in the new accounting standards reveals additional information not previously considered in our analysis, ratings could be affected.

Also, how some companies respond to the accounting rule could have an effect on their credit quality and ratings if business practices evolve in response to the new standard, causing changes to a company’s results and financial condition. For example, telecommunication and software companies burdened by existing accounting for sales of bundled goods and services, which was difficult to understand and delayed revenue recognition, will more easily recognize revenue on separate components under the new standard. This could change pricing and bundling offerings for future products industry-wide. Additionally, we expect companies to include more variable revenue terms in future sales contracts, because the new standard allows for accelerated recognition.

Reporting under the new revenue model will begin in 2017. The long time frame between the standard release and adoption allows companies time to assess the new model’s effect and communicate that to investors. Companies’ transparency and communication about the effects of adopting the standard will be key to analysis through the transition.

This new standard is one of the convergence projects the two boards took on to align US and international accounting standards and the first major project that they have completed. The US Securities and Exchange Commission has reported that progress toward the development of joint standards is one item necessary in their consideration of incorporating International Financial Reporting Standards in US financial reporting. Although issuance of this standard is a significant milestone in global accounting convergence, progress on other joint standards has stalled.

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European Parliament Election Outcome Is Credit Negative for France and Greece but Positive for Italy

Last week, a wide range of populist parties across the 28 member states of the European Union won around 20% of the seats in European Parliament elections, up from 13% in the 2009 elections. Eurosceptic parties did particularly well and became the leading parties in four EU countries, as shown in the exhibit below. For example in France, the Front National won 25.0% of the vote, and in the UK, the UK Independence Party (UKIP) won 26.8%, positioning each of them ahead of the incumbent mainstream parties.¹⁵

For the European Union (EU) as a whole, the strengthened representation of Eurosceptic parties in the new European Parliament (EP) is credit neutral because they are unlikely to reverse recent institutional reforms to enhance the governance of the monetary union’s economic, fiscal and financial market policy framework. Institutions or structures created over the past four years, such as the Single Supervisory Mechanism or the European Stability Mechanism, will be unaffected.

¹⁵ However, the success of populist fringe parties was not uniform, with the Dutch far-right Partij voor de Vrijheid and the British National Party both recording a steep drop in their votes compared with the 2009 EP elections.
Although the growing voter sentiment in favour of preserving the sovereignty of EU member states may lead to slower policy integration, the continued dominance of pro-integration centrist parties in the EP will ensure there are no comprehensive reforms to scale back the drive towards EU integration. Regardless of whom the centrist parties select as the next European Commission president, he or she is likely to cooperate closely with the other large centrist groups to maintain the pro-integration agenda. Moreover, because many returning parliamentarians are from the large traditional parties, they have a significant advantage -- at least early on in the parliamentary term -- of accounting for the majority of experienced legislators.

At the country-specific level, the EP election outcome is credit negative for both France and Greece because the rise of Eurosceptic parties in those countries increases the downside risk that both governments may consider easing fiscal consolidation, which would address voters’ austerity fatigue, but would permit wider deficits than currently planned.

In France, the right-wing, nationalist Front National garnered a record-high 25% of votes in the country’s EP elections, putting the centre-right opposition party, the Union pour un Mouvement Populaire, in second place with 20% and President François Hollande’s ruling centre-left Parti Socialiste party third with 14%. Although Prime Minister Manuel Valls from the Parti Socialiste has ruled out any policy changes as a result of the election outcome, we believe that the Front National could challenge the government’s five-year “roadmap,” the pace of which the government may now choose to slow. More importantly, the Front National could weaken France’s role in Europe (alongside that of Germany) as a key driver of integration initiatives.

In Greece, the far-left Syriza won almost 27% of the vote compared with the combined 30% of the two-party governing coalition. In addition, the far-right Golden Dawn party, which has steadily grown in popularity over the course of the crisis, received the third-highest number of votes, with more than 9% of the vote. Despite Syriza’s assertion that the vote reflected the electorate’s rejection of government policies and its call for immediate general elections, our base-case scenario is that the EP election outcome will not affect the current government’s fiscal consolidation programme, although it increases the risk of slippage. However, Greece still faces the possibility of destabilizing early parliamentary elections given the fragile and shrinking majority of the governing coalition. Moreover, because it is the weakest sovereign in the euro area, it poses the greatest systemic risk to the rest of the monetary union, although the risk of Greece causing a systemic problem is less than it was at the height of the euro area sovereign debt crisis.

Contrary to the situation in France and Greece, the EP election outcome in Italy is credit positive given that the centre-left Partito Democratico of prime minister Matteo Renzi won more than 40% of the country’s votes, effectively securing a fresh mandate for its reform agenda. The anti-establishment Movimento Cinque Stelle won a significant but lower-than-expected 21.2% of the vote, while the right-wing Eurosceptic Lega Nord received 6.2%. These outcomes dispel pre-election concerns that the rise of populist parties might threaten Mr. Renzi’s government.

The EP election outcome is credit neutral for the remaining 25 EU countries given the continued strength of the centrist pro-integration parties in those countries’ votes. For example, in both Spain and Germany,

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16 This centrist political bloc accounts for more than 60% of the EP’s seats. It comprises the Christian Democrats (European People’s Party, which won around 28% of seats), Social Democrats (Socialists & Democrats, with 25%), and Liberal Democrats (Alliance of Liberals and Democrats for Europe, with 8.5%).
the ruling coalitions suffered losses but still maintained comfortable overall majorities. Spain’s votes for the conservative ruling Partido Popular and the Partido Socialista Obrero Español fell to a combined 50% from more than 80% in 2009. In Germany, Angela Merkel’s ruling Christlich Demokratische Union Deutschlands and its sister party, the Christlich-Soziale Union in Bayern, together recorded their lowest-ever vote with 35.3%, down from 37.9% in 2009. The rise of Eurosceptic parties in both countries, most notably Germany’s Alternative für Deutschland (7%), and Spain’s Izquierda Comunista de España (10%) and newcomer party Podemos (8%), will have a negligible effect on domestic policymaking.

The rise of the Eurosceptic UKIP is also credit neutral for the UK and will not have any significant immediate effect on domestic policy formation in the run-up to the 2015 general election, although it is likely to have a significant effect on the major mainstream parties’ manifestos, campaign rhetoric and the policy mix after the general election. UKIP attained a greater share (26.8%) of the vote than the mainstream parties, with Labour receiving 24.7%, the Conservatives 23.3% and the Liberal Democrats an unexpectedly low 6.7%. In response to the apparently strong support for UKIP’s anti-EU message, British Prime Minister David Cameron is likely to step up his calls for the reform of EU institutions in order to enhance EU members’ autonomy and flexibility, particularly with regard to issues such as immigration.
### Corporates

**AmSurg Corporation**

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<tr>
<td>30 May '14</td>
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The review follows AmSurg’s announcement on 29 May that it has entered into an agreement to acquire Sheridan Holdings, Inc. in a transaction valued at $2.35 billion. The review will focus on the expected performance of the combined entity, the proposed capital structure and strategy for deleveraging, the timing and magnitude of synergies realized and the combined entity’s free cash flow capabilities and liquidity.

**Deutsche Lufthansa Aktiengesellschaft**

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The outlook change reflects improvements in the company’s credit metrics in 2013 and operating profitability in Q1 2014, as well as our expectation that the SCORE project will continue to benefit its operating performance.

**Express Scripts Holding Company**

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<td>14 Nov '11</td>
<td>Baa3</td>
<td>Stable</td>
</tr>
<tr>
<td>30 May '14</td>
<td>Baa3</td>
<td>Positive</td>
</tr>
</tbody>
</table>

The outlook change reflects our view that Express Script’s renewed focus on organic growth, following its challenging transition to a single operating platform, will likely help it improve retention rates and new customer wins. It further reflects our view that the company will be able to maintain strong cash flow and will not engage in a large transforming acquisition over the next 12 to 18 months.

**International Paper Company**

<table>
<thead>
<tr>
<th>Date</th>
<th>Rating</th>
<th>Outlook</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Apr '10</td>
<td>Baa3</td>
<td>Stable</td>
</tr>
<tr>
<td>28 May '14</td>
<td>Baa2</td>
<td>Stable</td>
</tr>
</tbody>
</table>

The upgrade reflects International Paper Company’s sustained deleveraging and our expectation of improvements in its financial and operating performance going forward.
Sheridan Holdings, Inc.

<table>
<thead>
<tr>
<th>Corporate Family Rating</th>
<th>4 Dec '13</th>
<th>30 May '14</th>
</tr>
</thead>
<tbody>
<tr>
<td>B2</td>
<td>B2</td>
<td>Review for Upgrade</td>
</tr>
</tbody>
</table>

Outlook

Stable

The review for upgrade follows the company’s announcement on 29 May that it has entered into an agreement to be acquired by AmSurg Corporation, in a transaction valued at $2.35 billion. The proposed acquisition, which has been approved by the boards of AmSurg and Sheridan, is expected to be funded though the issuance of $1.7 billion of new debt and $615 million of common equity. The transaction is expected to close in the third quarter of 2014, and at its closing we expect that all of Sheridan’s outstanding debt will be retired and that Sheridan’s ratings will be withdrawn.

Starbucks Corporation

<table>
<thead>
<tr>
<th>Senior Unsecured Rating</th>
<th>25 Nov '13</th>
<th>29 May '14</th>
</tr>
</thead>
<tbody>
<tr>
<td>Baa1</td>
<td>A3</td>
<td>Upgrade</td>
</tr>
</tbody>
</table>

Outlook

Positive

Stable

The upgrade reflects Starbucks global brand strength, dominant position in the US specialty coffee segment, global diversification, meaningful scale, solid credit metrics and strong liquidity. The stable outlook reflects our view that greater customer focus, new product offerings and disciplined restaurant growth both in the US and internationally should continue to strengthen the Starbucks brand and drive further improvement in earnings, cash flows and debt protection metrics.
RATING CHANGES
Significant rating actions taken the week ending 30 May 2014

Infrastructure

Envestra Limited

<table>
<thead>
<tr>
<th>19 March ‘10</th>
<th>30 May ‘14</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issuer Rating</td>
<td>Baa2</td>
</tr>
<tr>
<td>Outlook</td>
<td>Stable</td>
</tr>
<tr>
<td></td>
<td>Developing</td>
</tr>
</tbody>
</table>

The outlook change follows the company’s announcement that its independent board has unanimously recommended a cash offer from Cheung Kong Group (unrated) to acquire all of Envestra’s shares. The developing outlook reflects a degree of uncertainty associated with Envestra’s credit profile, given the multiple competing bids, as well as the limited information about the strategic intentions of Cheung Kong, should it emerge as the successful bidder.

PGE Polska Grupa Energetyczna, S.A. (PGE)

<table>
<thead>
<tr>
<th>02 Sept ‘09</th>
<th>26 May ‘14</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issuer Rating</td>
<td>A3</td>
</tr>
<tr>
<td>Outlook</td>
<td>Stable</td>
</tr>
<tr>
<td></td>
<td>Stable</td>
</tr>
</tbody>
</table>

The downgrade reflects the execution risk associated with PGE’s investment plans and the related funding requirements in the context of weak wholesale power prices and uncertainty around the development of energy markets in Poland.

Topaz Power

<table>
<thead>
<tr>
<th>04 Feb ‘13</th>
<th>29 May ‘14</th>
</tr>
</thead>
<tbody>
<tr>
<td>Senior Secured Credit Facilities</td>
<td>B1</td>
</tr>
<tr>
<td>Outlook</td>
<td>Stable</td>
</tr>
</tbody>
</table>

The negative outlook is driven by Topaz’s recent and near-term expected financial performance, which has been significantly below management’s assumptions at the time of the 2013 refinancing. Debt repayment via excess cash flow generated in 2013 was therefore also significantly below management’s expectations, while we expect excess cash flow generation to remain anemic in 2014.
Financial Institutions

**Abanka Vipa d.d.**

<table>
<thead>
<tr>
<th>Rating Category</th>
<th>Rating Before</th>
<th>Rating After</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank Financial Strength/Baseline Credit Assessment</td>
<td>E/caa3</td>
<td>E/caa3 Review for Upgrade</td>
</tr>
<tr>
<td>LT Bank Deposits (Domestic)</td>
<td>Caa2</td>
<td>Caa2 Review for Upgrade</td>
</tr>
</tbody>
</table>

The review for upgrade reflects our expectation of improvement in Abanka’s standalone financial strength, following the bank’s recapitalization and balance sheet cleanup.

**African Bank Limited**

<table>
<thead>
<tr>
<th>Rating Category</th>
<th>Rating Before</th>
<th>Rating After</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank Financial Strength/Baseline Credit Assessment</td>
<td>D+/ba1</td>
<td>D/ba2</td>
</tr>
<tr>
<td>LT Bank Deposits (Foreign/Domestic)</td>
<td>Baa3</td>
<td>Ba1</td>
</tr>
<tr>
<td>Senior Unsecured (Foreign)</td>
<td>Baa3</td>
<td>Ba1</td>
</tr>
</tbody>
</table>

The downgrade reflects greater-than-expected deterioration in the bank’s asset quality, which resulted in a net loss over the six months ended March 2014.

**AXA Insurance Ltd**

<table>
<thead>
<tr>
<th>Rating Category</th>
<th>Rating Before</th>
<th>Rating After</th>
</tr>
</thead>
<tbody>
<tr>
<td>Insurance Financial Strength/Outlook</td>
<td>A2 Stable</td>
<td>A1 Stable</td>
</tr>
</tbody>
</table>

The upgrade follows our upgrade of Ireland’s government bond rating to Baa1 from Baa3 and of Ireland’s country ceilings to Aa3 from A2, which resulted from: (1) a step change in future debt levels, with the government’s debt metrics on a steeper-than-expected downward path; (2) a very sharp reduction in off-balance sheet exposures; and (3) an improved credit position relative to peers’. Improvements in Ireland’s macroeconomic fundamentals and credit profile positively affect AXA Insurance Ltd’s asset quality, capital adequacy, profitability and financial flexibility.

**Banco Mercantil del Norte, S.A.(Cayman I)**

<table>
<thead>
<tr>
<th>Rating Category</th>
<th>Rating Before</th>
<th>Rating After</th>
</tr>
</thead>
<tbody>
<tr>
<td>Senior Unsecured (Foreign) / Outlook</td>
<td>A3 Stable</td>
<td>A2 Stable</td>
</tr>
</tbody>
</table>

The upgrade reflects both the improvement in the bank’s baseline credit assessment and a higher probability of support from the Mexican government in a stress situation, given the bank’s growing systemic importance as a leading deposit-taker and lender in the local market.
RATING CHANGES

Significant rating actions taken the week ending 30 May 2014

### BB&T Corporation

<table>
<thead>
<tr>
<th>Date</th>
<th>Action</th>
<th>Rating</th>
<th>Outlook</th>
</tr>
</thead>
<tbody>
<tr>
<td>4 May '13</td>
<td>Long-Term Rating</td>
<td>A2</td>
<td>Negative</td>
</tr>
<tr>
<td>23 May '14</td>
<td></td>
<td>A2</td>
<td>Stable</td>
</tr>
</tbody>
</table>

The outlook change reflects our view that BB&T’s risk profile remains superior to that of most regional bank peers and supports its above-average ratings. It also takes into account improvements in BB&T’s capital-planning process, as reflected in the recent Federal Reserve CCAR results, with the Fed not objecting to BB&T’s capital plan.

### China Merchants Bank

<table>
<thead>
<tr>
<th>Date</th>
<th>Action</th>
<th>Rating</th>
<th>Credit Assessment</th>
</tr>
</thead>
<tbody>
<tr>
<td>5 May '07</td>
<td>Upgraded</td>
<td>D/ba1</td>
<td>D+/baa3</td>
</tr>
<tr>
<td>19 May '14</td>
<td>Long-Term Bank Deposits (Foreign/Domestic)</td>
<td>Baa3</td>
<td>Baa1</td>
</tr>
</tbody>
</table>

The upgrade reflects our raising of the bank’s standalone bank financial strength rating/baseline credit assessment to D+/baa3 from D+/ba1, as well as the likelihood that the bank will receive strong systemic support in the event of stress.

### Credit Suisse AG

<table>
<thead>
<tr>
<th>Date</th>
<th>Action</th>
<th>Rating</th>
<th>Outlook</th>
</tr>
</thead>
<tbody>
<tr>
<td>21 Jun '12</td>
<td>Long-Term Rating</td>
<td>A1</td>
<td>Stable</td>
</tr>
<tr>
<td>20 May '14</td>
<td></td>
<td>A1</td>
<td>Negative</td>
</tr>
</tbody>
</table>

The outlook change reflects the risks to Credit Suisse’s creditors stemming from the bank’s settlement of charges of tax evasion with the US Department of Justice, as well as the potential for client defections and lost revenues resulting from the criminal plea.

### First Citizens Bank Limited

<table>
<thead>
<tr>
<th>Date</th>
<th>Action</th>
<th>Rating</th>
<th>Credit Assessment</th>
</tr>
</thead>
<tbody>
<tr>
<td>28 Mar '14</td>
<td>Bank Financial Strength/Baseline Credit Assessment</td>
<td>C-/baa1</td>
<td>D+/baa3</td>
</tr>
<tr>
<td></td>
<td>LT Bank Deposits (Domestic)</td>
<td>A2</td>
<td>Baa1</td>
</tr>
<tr>
<td>23 May '14</td>
<td></td>
<td>Multiple</td>
<td>Stable</td>
</tr>
</tbody>
</table>

The downgrade reflects the flaws that recent events have revealed in the rules governing the bank’s IPO completed last September, as well as potential shortcomings in First Citizens’ governance and operational risk controls. It also reflects the weakening of the bank’s profitability indicators over the past three years as a result of declining net interest margins and rising operating costs. The outlook change reflects our
expectation that the bank’s credit strengths, including robust capitalization and stable funding from retail and public-sector deposits, will remain over the medium term.

**Irish Banks’ Government-Guaranteed Debt Ratings Upgraded to Baa1 from Baa3**

27 May ‘14

We have upgraded to Baa1 from Baa3 the government-guaranteed debt ratings of four Irish banks: Allied Irish Banks, p.l.c., EBS Ltd, Bank of Ireland and Permanent tsb p.l.c. The upgrade follows the upgrade of Ireland’s government bond rating to Baa1 from Baa3 and the change in outlook on this rating to stable from positive.

**MBIA Group Upgraded to Ba1 from Ba3; National Public Finance Guarantee Upgraded to A3**

21 May ‘14

We have upgraded the insurance financial strength rating of National Public Finance Guarantee Corporation to A3 from Baa1, and the senior debt rating of MBIA Inc., the group’s holding company, to Ba1 from Ba3. The upgrades reflect the positive effect that recent settlements of significant commercial real estate exposures and ongoing portfolio runoff has had on MBIA group’s capital adequacy and liquidity profile. They also reflect National’s improving prospects for generating new insurance in the municipal market.

**Outlook on 82 Long-Term European Bank Ratings Revised to Negative**

29 May ‘14

We have revised the outlook to negative on 82 long-term ratings of banks in the EU, Norway and Liechtenstein. The outlook change follows the recent adoption of the Bank Recovery and Resolution Directive and the Single Resolution Mechanism regulation in the EU. It also reflects our view that the balance of risk for banks’ senior unsecured creditors has shifted to the downside as a result of the new resolution framework.

**Philippine National Bank**

<table>
<thead>
<tr>
<th>Upgrade/Outlook Change</th>
<th>Bank Financial Strength/Baseline Credit Assessment</th>
<th>Outlook</th>
</tr>
</thead>
<tbody>
<tr>
<td>20 May ‘14</td>
<td>D-/ba3</td>
<td>Positive</td>
</tr>
<tr>
<td>22 Mar ’12</td>
<td>E+/b1</td>
<td>Multiple</td>
</tr>
</tbody>
</table>

The upgrade reflects improvement in the bank’s financial profile with regards to asset quality and its capital buffer, following the merger with Allied Banking Corporation. The outlook change reflects ongoing improvements in the bank’s credit profile, as well as our expectation that further improvements in its financial performance will likely bring its credit profile in line with the industry average over the next 18-24 months.
Portuguese Banks’ Government-Guaranteed Debt Upgraded to Ba2 from Ba3 and Placed on Review for Upgrade

19 May ’14

We have upgraded to Ba2 from Ba3 the government-guaranteed debt ratings of three Portuguese banks: Caixa Geral de Depositos, S.A., Banco Espirito Santo, S.A., and BANIF-Banco Internacional do Funchal, S.A. At the same time, we placed on review for upgrade the ratings on the banks’ government-guaranteed debt. The upgrades follow the upgrade of Portugal’s government bond ratings to Ba2 and our placement of those ratings on review for further upgrade on 9 May 2014.

Qatar International Islamic Bank (Q.S.C.)

<table>
<thead>
<tr>
<th></th>
<th>Outlook Change</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1 Jun ’11</td>
</tr>
<tr>
<td>Long-Term Rating</td>
<td>A3</td>
</tr>
<tr>
<td>Outlook</td>
<td>Stable</td>
</tr>
</tbody>
</table>

The outlook change reflects: (1) the expansion of the bank’s Islamic franchise, particularly in the retail segment; and (2) recent improvements in the bank’s asset-quality metrics.

Rizal Commercial Banking Corporation

<table>
<thead>
<tr>
<th></th>
<th>Outlook Change</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>5 Sep ’13</td>
</tr>
<tr>
<td>Long-Term Rating</td>
<td>Ba2</td>
</tr>
<tr>
<td>Outlook</td>
<td>Stable</td>
</tr>
</tbody>
</table>

The outlook change recognizes ongoing improvements in the bank’s credit profile, as well as our expectation that it will continue to improve, particularly once the bank implements its capital-raising plan.
RATING CHANGES
Significant rating actions taken the week ending 28 March 2014

Sovereigns

**Mongolia**

<table>
<thead>
<tr>
<th>Rating</th>
<th>B1</th>
<th>B1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gov Currency Rating</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign Currency Deposit Ceiling</td>
<td>B2</td>
<td>B2</td>
</tr>
<tr>
<td>Foreign Currency Bond Ceiling</td>
<td>Ba3</td>
<td>Ba3</td>
</tr>
<tr>
<td>Local Currency Deposit Ceiling</td>
<td>Ba3</td>
<td>Ba3</td>
</tr>
<tr>
<td>Local Currency Bond Ceiling</td>
<td>Ba3</td>
<td>Ba3</td>
</tr>
</tbody>
</table>

Outlook: Stable

Outlook Change
26 May ‘14

The outlook change was driven by a rise in Mongolia’s external debt burden in recent years, a sharp fall in foreign-exchange reserves and escalating credit growth since 2013. These developments increase the possibility of a currency or external payments crisis over the next few years. At the same time, elevated inflation and rapid credit growth threaten banking system stability, and could have negative feedback effects on the balance of payments.

**Uruguay**

<table>
<thead>
<tr>
<th>Rating</th>
<th>Baa3</th>
<th>Baa2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gov Currency Rating</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign Currency Deposit Ceiling</td>
<td>Baa3</td>
<td>Baa2</td>
</tr>
<tr>
<td>Foreign Currency Bond Ceiling</td>
<td>A2</td>
<td>A2</td>
</tr>
<tr>
<td>Local Currency Deposit Ceiling</td>
<td>A2</td>
<td>A2</td>
</tr>
<tr>
<td>Local Currency Bond Ceiling</td>
<td>A2</td>
<td>A2</td>
</tr>
</tbody>
</table>

Outlook: Positive

Outlook Change
29 May ‘14

The upgrade was driven by the strengthening of Uruguay’s sovereign credit profile, as reflected by the convergence of fiscal and debt metrics with the medians for the Baa peer group; an overall government debt profile that is currently associated with moderate credit risks; and the country’s reduced vulnerability to regional and commodity shocks.
US Public Finance

**Metropolitan Atlanta Rapid Transit Authority, Georgia**

<table>
<thead>
<tr>
<th></th>
<th>10 Aug '12</th>
<th>27 May '14</th>
</tr>
</thead>
<tbody>
<tr>
<td>Third Indenture Sales Tax Revenue Bonds</td>
<td>A1</td>
<td>Aa3</td>
</tr>
<tr>
<td>First Indenture Sales Tax Revenue Bonds</td>
<td>Aa2</td>
<td>Aa2</td>
</tr>
<tr>
<td>Second Indenture Sales Tax Revenue Bonds</td>
<td>Aa2</td>
<td>Aa2</td>
</tr>
<tr>
<td>Outlook</td>
<td>Stable</td>
<td>Stable</td>
</tr>
</tbody>
</table>

The upgrade reflects the restructuring of a formerly outsized variable rate debt and swap portfolio; growth in pledged revenues after multiple years of contraction; improvement in MARTA’s cash position; a relatively low additional bonds test mitigated by sufficient debt service coverage; and easing pressure on the system’s operations, as evidenced by its $9 million fiscal 2013 budgetary surplus.

**Philadelphia (City of) Pennsylvania Gas Works**

<table>
<thead>
<tr>
<th></th>
<th>14 Feb '13</th>
<th>29 May '14</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gas Works Revenue Refunding Bonds, Twentieth Series (1975 General Ordinance)</td>
<td>Baa2</td>
<td>Baa2</td>
</tr>
<tr>
<td>Gas Works Revenue Refunding Bonds; Eighth Series A (1998 General Ordinance)</td>
<td>Baa2</td>
<td>Baa2</td>
</tr>
<tr>
<td>Gas Works Revenue Bonds, Eighteenth Series (1975 General Ordinance)</td>
<td>Baa2</td>
<td>Baa2</td>
</tr>
<tr>
<td>Gas Works Revenue Bonds, Seventeen Series (1975 General Ordinance) Senior</td>
<td>Baa2</td>
<td>Baa2</td>
</tr>
<tr>
<td>Outlook</td>
<td>Stable</td>
<td>Positive</td>
</tr>
</tbody>
</table>

The outlook change comes in recognition of PGW’s improved financial position, which is expected to continue due to supportive rate regulation. This further strengthens PGW’s rate base and cash funding of ongoing capital expenditures and reduces its long-term reliance on debt to fund these costs.
Presence Health, Provena Health and Resurrection Health Care (All of Illinois)

<table>
<thead>
<tr>
<th>Downgrade/Outlook Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>23 Aug '13</td>
</tr>
<tr>
<td>Series 2009 Fixed Rate Bonds</td>
</tr>
<tr>
<td>Resurrection Health Care System Series 1999 A &amp; B</td>
</tr>
<tr>
<td>Revenue Bonds, Series 2010A</td>
</tr>
<tr>
<td>Revenue Bonds, Series 2009A</td>
</tr>
<tr>
<td>Outlook</td>
</tr>
</tbody>
</table>

The downgrade reflects sizable volume declines for two consecutive years, which contributed to a sharp decline in operating performance in fiscal 2013, with operating losses exceeding management expectations and representing a marked variance from budgeted and revised expectations, despite an improved run rate in the last quarter of fiscal 2013. It also incorporates a change in certain core strategies suggested by initiatives that may result in the realignment or divestiture of certain ministry assets as management endeavors to stabilize the system’s financial platform.
Structured Finance

**Moody’s Takes Action on $2 Billion of Subprime RMBS Issued 2005-2007**

We have upgraded the ratings of 53 tranches and downgraded the ratings of two tranches from 22 subprime RMBS transactions, affecting $2 billion. The upgrades reflect the improved performance of the related pools and/or the faster paydown of the bonds resulting from high prepayments and faster liquidations. The downgrades of Cl. AF-2 and Cl. AF-6 from J.P. Morgan Mortgage Acquisition Trust 2006-CH2 reflect the change in principal priority for the Group 1 senior bonds from sequential pay to pro-rata pay upon the recent depletion of the Group 1 mezzanine classes.

**Moody’s Takes Action on $2.2 Billion of Subprime RMBS**

We have upgraded the ratings of 85 tranches and downgraded the ratings of four tranches from 32 subprime RMBS transactions affecting $2.2 billion. The upgrades reflect the improved performance of the related pools and/or the faster paydown of the bonds resulting from high prepayments and faster liquidations. The downgrades reflect deteriorating performance and/or structural features resulting in higher expected losses for the bonds than previously anticipated.

**Moody’s Takes Action on $1.19 Billion of Subprime RMBS Issued 2003 to 2007**

We have upgraded the ratings of 35 tranches from 18 transactions and downgraded the ratings of three tranches from one transaction, all backed by subprime mortgage loans, affecting $1.19 billion. The upgrades reflect the improved performance of the related pools and/or the faster paydown of the bonds resulting from high prepayments and faster liquidations. The downgrades reflect the change in principal priority for senior bonds from sequential pay to pro-rata pay upon the depletion of the mezzanine classes.

**Moody’s Upgrades 10 RMBS Deals of Bank of Tokyo-Mitsubishi UFJ**

We have upgraded the ratings of 10 mezzanine beneficial interests in 10 transactions backed by fixed-rate residential mortgages originated by The Bank of Tokyo-Mitsubishi UFJ, Ltd, affecting JPY49.1 billion. The upgrades reflect increased credit enhancement, which is due mainly to the increased subordination from the paydown of the senior beneficial interests and the rise in the cash reserves for excess spread to cover the transactions’ credit risk.

**Moody’s Upgrade Five and Affirms Eight Classes of ML-CFC 2007-5**

We have upgraded the ratings on five classes and affirmed the ratings on eight classes of ML-CFC Commercial Mortgage Trust, Commercial Mortgage Pass-Through Certificates, Series 2007-5, affecting $3.45 billion. The upgrades reflect an increase in credit support resulting from loan paydowns, liquidations and amortization. They also reflect lower expected losses resulting from strengthening real estate markets.
Corporates

US Consumer Durables Outlook Stays Positive as US Housing Market Improves, Albeit at An Uneven Pace

We expect operating profit to rise 5%-5.5% over the next 12 to 18 months, slightly down from our prior forecast due to rising food healthcare costs, financial volatility and the uneven housing market recovery. Though choppy, the housing recovery is however still sufficiently strong to benefit home products companies, which generate about half the sector’s revenue and operating profit.

Global Aerospace and Defense: Shrinking Defense Spending to Weigh on Profits; Commercial Growth to Remain Strong

Record-high order backlogs for commercial jets will support higher production rates and rising deliveries in the aerospace sector, but defense contractors will continue to contend with declining military spending, heightened competition and government affordability initiatives that will continue to weigh on revenue and, over time, increasingly curtail profitability and margins.

Global Independent Exploration and Production: Steady Commodity Prices Fuel E&P Industry

The sector’s growth trend will continue over the coming 12-18 months, with no obvious catalyst for a slowdown. Stable oil and natural gas prices will enable E&P companies to continue to invest, driving confidence, and so earnings, higher. We expect EBITDA growth in the mid- to high-single digits.

Infrastructure

Korean Electricity Industry

Power reserve margins in Korea will surpass 15% in 2015-16 for the first-time since 2004, as generation capacity additions outpace electricity demand growth. The additional generation will increase competition among power generating companies, reduce wholesale power prices and subsequently compress generators’ operating profits, particularly for gas-dependent power generators.
Financial Institutions

Reassessing Systemic Support for EU Banks
The new Bank Recovery and Resolution Directive and Single Resolution Mechanism regulation have negative credit implications that exceed the benefits of improved stability for senior unsecured creditors of EU banks. As a result, we have changed the outlook to negative on 82 banks’ supported debt and deposit ratings. These outlook changes reflect our view that the balance of risk has shifted to the downside for banks’ senior unsecured creditors.

Korea Banking System Outlook
The stable outlook for the Korean banking system reflects our expectation of economic growth gradually gaining momentum while systemic support remains strong. Pressure on asset quality could moderate toward the end of the outlook horizon. Korean banks’ historical dependence on wholesale funding for foreign currency has lessened, reflecting the country’s strengthened external position. Bank profitability is low in Korea, but could improve somewhat in 2015 as policy rates rise.

Malaysia Banking System Outlook
The stable outlook for the Malaysian banking system reflects our expectation of a stable operating environment that will allow banks to maintain resilient asset quality, as well as strong capitalization levels and funding profiles. We expect that the measures taken by the Malaysian government to implement fiscal reform and consolidation will moderate the pace of economic growth over the outlook horizon.

FAQ on Key Credit Issues Regarding Basel III Subordinated Debt Issued by Russian Banks
Russian banks’ issuance of Basel III-compliant subordinated debt is growing. We expect that Russian banks will issue more such subordinated debt instruments over the next three to five years to replace legacy subordinated debt, which will be progressively phased out. Basel III-compliant subordinated debt is riskier for investors than legacy subordinated debt because their contractual terms explicitly state that the instruments absorb losses at or close to the point of non-viability of the bank.

Measuring the ‘Credit Gap’: Estimates Risk Providing Misleading Signals
With many countries shifting towards more directive macroprudential policy regimes, particular attention has fallen on policymakers’ ability to curb the credit cycle, restraining booms in credit and cushioning busts. However, the capacity to predict or even gauge credit booms and busts in real time is far from certain. This report investigates one proposed indicator – the so-called credit gap – and demonstrates that it can give misleading signals.

Potential Changes to India’s Bank Resolution Framework Could Increase Risks for Creditors
Recently proposed modifications to India’s bank resolution framework would increase risks for many creditors of Indian banks, including holders of both senior and subordinated debt. Although the final resolution framework remains unknown, any changes that come into effect will affect assumptions of government support and hence our ratings of relevant securities.
Korean Life Insurance Industry Outlook

Our outlook for the Korean life industry remains stable. We expect that favorable economic fundamentals and demographic trends will strongly support insurers’ business franchises in the coming 12-18 months. However, a low interest rate environment will continue to pressure profitability because of the high weighting of domestic bonds in life insurers’ investment portfolios.

Q1 2014 US Mortgage Insurance Earnings Comment

All Moody’s-rated US mortgage insurers reported profits in Q1 2014 for the first time since early 2007. Incurred losses for the cohort declined by approximately 47% over Q4 2013, owing mainly to favorable seasonal trends and lower levels of reported new delinquencies. Furthermore, new insurance written declined again this quarter, by 26% year over year.
RESEARCH HIGHLIGHTS
Notable research published the week ending 28 March 2014

Managed Investments

**US Leveraged Closed End Funds – Q1 2014: As Rates Stabilize, Leverage and Asset Coverage Improve**

Leverage and asset coverage for municipal closed-end funds improved for the second consecutive quarter in Q1 2014. Funds’ net asset value has increased 5% on average since year-end, reflecting a stabilization of rates and renewed investor confidence in the asset class. This improvement follows a period in Q2 and Q3 2013 during which a 77 basis point rise in long-term interest rates led to an average 10% decline in municipal closed-end funds’ net asset value.

Sovereigns

**Bermuda Analysis**

On 19 May, the rating of the government of Bermuda was downgraded to A1 from Aa3 and the outlook was changed to stable from negative. The downgrade reflects the deterioration in the government’s balance sheet, as reflected in the rise in the ratio of debt to GDP due to ongoing economic weakness. The stable outlook reflects the expectation that, despite ongoing economic weakness, fiscal metrics will stabilize in the coming years.

**Croatia Analysis**

We assigned a negative outlook to Croatia’s Ba1 sovereign rating in March 2014 to reflect our expectation that its recovery from recession would be delayed and weak, owing to competitive challenges, continued deleveraging and efforts to reduce the fiscal deficit. As weak growth will hinder fiscal consolidation efforts, government debt is likely to remain above the median for Ba-rated countries over the outlook horizon. The negative outlook also incorporates balance of payments risks arising from Croatia’s large external debt burden.

**Mongolia: Key Drivers Behind the Negative Outlook**

On 26 May we affirmed Mongolia’s government bond rating at B1, but changed its outlook to negative from stable. The outlook change reflects emerging pressures stemming from rising external debt; heightened strains on the country’s external liquidity position; and rapid loan growth, which is increasing banking system vulnerabilities.

**Sharjah Analysis**

Sharjah’s A3 rating is supported primarily by the emirate’s very strong fiscal and government debt position, characterized by small fiscal deficits, low levels of government debt and manageable wider public-sector debt. The emirate’s government finances benefit significantly from membership in the federation of the United Arab Emirates, given that the federal Ministry of Finance funds a large portion of public services for UAE nationals directly from its own budget.
Sub-sovereigns

**All That Glitters Is Not Gold - English Housing Associations and Outright Market Sales**

English housing associations in our rated portfolio are increasingly expanding into the development of units for outright sale in order to cross-subsidize the development of social housing. Although by doing so housing associations can benefit from significantly enhanced income, outright sales also introduce a number of vulnerabilities to their credit profiles. As this trend develops, we expect outright sales to become a credit differentiator, both with regard to housing associations’ level of exposure and their ability to minimise exposure to the risks involved.

**French Local Sector Likely to Increase Debt as Government Cuts Transfers Deeply**

In April 2014, the Government of France provided details on its €50 billion savings plan, to be implemented by 2017. The plan gradually reduces the level of transfers to regional and local governments by €11 billion between 2014 and 2017, or a 25% reduction from current levels.

Structured Finance

**Structured Thinking: Asia Pacific (Newsletter) - May 2014**

Key topics in this issue include the Australian Prudential Regulation Authority’s recently released discussion paper on its proposed changes to the regulatory framework for securitizations, as well as the China Bank Regulatory Commission’s issuance of additional risk management requirements that will help improve the operational strength of securitizations.

**Global Auto ABS: Steadying Employment and Strong Borrower Credit Will Support Performance**

The performance of auto loan ABS in North America, South America, Europe and Asia Pacific will remain steady throughout 2014, helped by improved economic conditions. However, delinquency and default rates have begun to rise marginally in some markets amid the easing of underwriting standards that has accompanied the economic recovery. Nevertheless, losses in US auto loan ABS will remain relatively low because loans to borrowers with very strong credit profiles still make up a large proportion of securitizations.
RECENTLY IN CREDIT OUTLOOK

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

NEWS & ANALYSIS

Corporates
» Sanchez Energy Purchase of Eagle Ford Assets Will Boost Production and Reserves at Low Cost
» Nokia Redeems €800 Million Senior Notes, Improving Its Credit Metrics
» Link REIT’s Sale of Four Hong Kong Malls Is Credit Positive
» Sunac Plan to Acquire a Stake in Greentown Is Credit Negative

Banks
» Tatra banka’s Proposed 2013 Profit Distribution Is Credit Negative
» Thailand’s Coup Is Credit Negative for Banks
» Sri Lanka Guarantee on Pawning Loans Is Credit Positive for Banks

Insurers
» RSA Insurance Group’s Sale of Canadian Broker Noraxis Is Credit Positive

Sovereigns
» Thailand’s Coup Will Neither Restore Investor Confidence nor Help Economy

Sub-sovereigns
» Russian Government Plan to Ease Regions’ Refinancing Pressure Is Credit Positive
» Development of China’s Local Bond Market Is Credit Positive

US Public Finance
» North Las Vegas, Nevada, Adopts a Balanced Budget for 2015, a Credit Positive

RATINGS & RESEARCH

Rating Changes

Research Highlights
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