Credit Outlook

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Southwest Airlines expects 4Q loss after holiday travel meltdown, but credit effect will be manageable

On 6 January, Southwest Airlines Co. (Baa1 stable) said in a regulatory filing with the Securities and Exchange Commission that it expects to report a net loss in 4Q 2022, “driven by a preliminary estimated pre-tax negative impact in the range of $725 million to $825 million,” after its cancellation of more than 16,700 flights from December 21-31 because of the severe winter storm between 22 and 25 December.

Although the 4Q loss is negative, we believe the credit effect will be manageable because of Southwest's very strong liquidity, the loyalty of a majority of its customers and continuing demand for air travel.

Southwest was affected more than other airlines by the storm. By way of comparison, Delta Air Lines Inc. (Baa3 stable), the second most affected airline, canceled 1,913 flights, or 7% of its schedule, because of the storm.

The massive cancellations are a major embarrassment for Southwest and highlight significant shortcomings in its flight crew and aircraft scheduling and dispatching systems and procedures. Airline operators must be able to locate their pilots and flight attendants, know where they need to be and get them there in a timely manner. But Southwest was unable to do this. As severe storms moved across much of the country, impacting operations at 23 of Southwest's 25 largest markets, the airline lost the ability to assign aircraft and crews to maintain the integrity of its daily flight schedule. The weather, regulated flight duty times and the inability to effectively maintain communications with crew members, also curtailed Southwest's ability to quickly restore its daily flight operations once the worst of the storm passed by 25 December.

Still, we believe the effect on Southwest's credit will be modest. Southwest will compensate travelers whose plans were disrupted and invest in fixing its systems to avoid similar meltdowns in the future. Southwest has $13 billion of cash on its balance sheet, versus $10 billion in debt, which gives it significant cushion to manage the costs and to invest in its operations without raising new debt. We expect Southwest will continue to pay cash for its aircraft deliveries, which trail their originally scheduled delivery dates because of ongoing challenges in the aerospace supply chain. We also expect Southwest to hit its capacity forecast this year, barring another significant, broad-reaching storm, before it completes necessary system improvements. The company indicated during its recent investor day that it expects its daily flight operations in Q4 2023 to be about 115% of their level in Q4 2019.

While the holiday travel meltdown has tarnished Southwest's brand for now, it will not permanently damage it. Southwest offers competitively priced, generally reliable service across a large part of its network, as well as significant convenience for a large portion of its customers. For existing and new members of its loyalty program, these factors will outweigh the potential for travel disruptions, which will remain a possibility until the company demonstrates that major storms will not cripple its operations when booking trips. The costs of switching to other airlines, with the possibility of higher fares, flights that originate further from home with less schedule frequency and more fees or restrictions (fees for bags, seat assignments and changes to itineraries) also lower the probability that many Southwest customers will defect from the airline. Southwest, which carries about 20% of US domestic and near international (Caribbean and northern Latin America) demand, will also benefit from the remaining rebound and ongoing growth in air travel demand. We believe that the effect on Southwest's passenger volumes and finances will barely be noticeable by this spring and beyond.

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Regulators' warnings on cryptoasset risks have implications beyond credit positive for banks

On 3 January, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency (collectively, the agencies) issued a cautionary joint statement on cryptoasset risks to banking organizations. The statement, notable for its bluntness, comes after a sharp drop in cryptoasset valuations over the past year and several negative crypto market events, including massive investor losses from fraud at a once-leading centralized cryptocurrency institution. The risks cited by US regulators echoed similar highly cautionary guidance by several global counterparts including the European Central Bank (ECB), Bank for International Settlements (BIS) and the Bank of England (BoE) in recent weeks.

The statements are credit positive for banks because they signal regulators' heightened vigilance, which will encourage caution among banks, foster a more stable operating environment and reduce principal risks to banks from a highly volatile and operationally complex asset class and ecosystem. The traditional banking industry is neither accustomed to the irrevocable instantaneous settlement of assets nor the custodianship of a digital bearer instrument, which are both defining features of decentralized cryptocurrencies.

The heightened regulatory scrutiny combined with a collapse in crypto-valuations and perceived profit opportunities is likely to lead banks to more carefully assess the risks of investing in business operations involving cryptoassets and cryptoasset-related businesses, and will likely reduce capital spending and investment in the sector. Because very few banks currently derive significant revenue from cryptoassets, tighter regulation of banks' crypto activities will have nearly no effect on their earnings.

In their statement, the US agencies identified multiple risks associated with cryptoassets and cryptoasset sector participants, including fraud, legal uncertainties, misrepresentations, risk management deficiencies, poor governance and volatility. The statement encouraged banks to take a cautious approach to cryptoasset-related activities, citing concerns about risks to banking organizations as well as a desire to ensure that risks do not migrate into the banking system. The agencies said they are continuing to assess how current and proposed crypto-related activities can be conducted in a manner consistent with safe and sound banking practices and in compliance with relevant laws and regulations.

The agencies are particularly focused on cryptoassets stored on or using open, public decentralized networks, typically permissionless blockchains. According to the joint statement, holding as principal cryptoassets that use an open permissionless blockchain is “highly likely to be inconsistent with safe and sound banking practices.” Private, or permissioned blockchains, were not specifically mentioned, but have their own efficacy hurdles and governance risks.

The ECB has issued similar warnings cautioning the financial industry about customer relations risks and reputational damage from participating in such assets which, in its view, are “neither suitable as a payment system nor as a form of investment.” The US agencies additionally warned that they have “significant safety and soundness concerns” with business models that are concentrated in this space. The US regulators’ and ECB’s stance is even more conservative in tone than the Basel Committee on Banking Supervision (BCBS) capital standard, which proposed higher capital requirements only on riskier cryptoasset exposures in excess of 1% of a bank's Tier 1 capital. However, the BCBS standard also allowed for capital requirement add-ons for any observed infrastructure weakness, risks that were highlighted as a particular concern in the US agencies joint statement.

The regulators' stance is likely to slow the pace of development of the crypto industry and capital investment into cryptoassets by both traditional banks and venture capital firms. However, the operating models of highly decentralized open blockchains, most notably Bitcoin, have functioned as intended throughout the past year's turmoil, a resiliency that combined with more isolation from traditional finance could allow truly permissionless blockchains to organically develop at a slower, but more sustainable pace.

Notwithstanding recent failures in crypto, governments continue to pursue ways to improve and streamline payments and to update money for today’s digital age. In the US, which bears high payment costs (largely unnoticed by consumers because they are embedded into the price structure), the research continues for a digitally native dollar that is not burdened by current legacy frictions and limitations. Globally, there is continued interest in public digital money among central banks including the BoE and the ECB. In a recent

speech, Deputy Governor at the Bank of England Sir Jon Cunliffe noted that as our lives grow ever more digital, the continuing lack of public digital money is driving BoE research into a CBDC. Echoing that view, last week, ECB Executive Board member Fabio Panetta said that "to build solid foundations for the digital finance ecosystem, we need a risk-free and dependable digital settlement asset, which can only be provided by central bank money." Most recently, India launched trials for a digital rupee, despite already having an advanced, low-cost public instant payments system. Meanwhile, US agencies' cautious approach to cryptoassets increases the likelihood that should the US money and payments system evolve, it will more likely take the form of a state solution implemented alongside or integrated with the current banking system, rather than as a private cryptocurrency solution.

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Regulator's final rate case order for Georgia Power is credit positive

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On 30 December, the Georgia Public Service Commission (GPSC) issued a final order on Georgia Power Company's (Baa1 stable) latest alternate rate plan (ARP) proposal/request, approving an estimated $996 million base rate revenue increase over the three-year period 2023-25. The final order reflects the settlement agreement, as modified by the GPSC, filed on 14 December 2022 that Georgia Power reached with several key intervening parties including Americans for Affordable Clean Energy, ChargePoint, Inc., Commercial Group, EVgo Services, LLC, Georgia Association of Manufacturers, Metropolitan Atlanta Rapid Transit Authority, United States Department of Defense and all other Federal Executive Agencies and Utility Management Services.

The rate case order is credit positive for Georgia Power because it will increase the company's revenue and cash flow and it supports our view that the company operates within a credit supportive regulatory environment.

The revenue increase is premised upon the same allowed return on equity (ROE) of 10.5% and equity ratio of 56% that were established and have been in place since Georgia Power's last rate order of December 2019. Earnings will be evaluated against a retail ROE range of 9.5%-11.9%. Retail customers will receive 80% of earnings the company realizes above 11.9%, half of which will be applied to reduce regulatory assets and half will be directly refunded to customers.

The multistep (non-fuel) base revenue increase includes a $216 million increase on 1 January 2023, an estimated $376 million increase on 1 January 2024, and an estimated $403 million increase on 1 January 2025 (see exhibit). The multistep nature of the rate increase mitigates some of the immediate rate impact on customer bills, which we view as particularly important in the current high inflationary environment. The authorized revenue increase includes the vast majority of Georgia Power's initial request of $1 billion based on an allowed ROE of 11% and 56% equity ratio filed by the company on 1 July 2022. The revenue increase enables Georgia Power to recover expenditures related to closing its coal ash ponds through an environmental compliance cost recovery charge as well as demand side management costs. Georgia Power is required to file its next general rate case by 1 July 2025.

Estimated revenue increases by year
($ in millions)

	2023	2024	2025
Traditional Base	$194	$275	$315
Environmental Compliance Cost Recovery	-$21	$66	$81
Demand Side Managemet	$37	$27	-$2
Municipal Franchise Fee	$6	$9	$9
Total [1]	**$216**	**$377**	**$403**

[1] Totals are rounded.
Source: SEC filings

The rate order is important because it is an indication of continued state regulator support, particularly as Georgia Power's business risk remains elevated while the company completes the construction of Plant Vogtle Units 3 & 4. The company aims to place Unit 3 and 4 into service by March and December of this year, respectively. The elevated business risk has been mitigated by a supportive regulatory and political environment as well as continued co-owner support, notwithstanding pending litigation with two co-owners regarding the level of certain costs being shared. On 14 October 2022, Georgia Power announced that fuel loading had begun on Unit 3, the most important remaining milestone before start-up testing and commercial operation, after receiving Nuclear Regulatory Commission authorization to load fuel in August.

The company's current financial profile is weaker than it has been in recent years, primarily due to the deferral of higher fuel costs. Georgia Power's ratio of cash flow from operations pre-working capital changes (CFO pre-W/C) to debt was 14.2% for the 12-months ended 30 September 2022, which is lower than the low-20% range the company has exhibited historically. The company expects to

address recovery of its deferred fuel cost balance with state regulators in the near future. However, last week's supportive rate order on Georgia Power's ARP and successful start-up and operation of Vogtle Units 3 and 4 should position the company to improve its financial profile including a ratio of CFO pre-W/C to debt approaching 20% by the end of this year.

Georgia Power Company is a regulated vertically integrated utility subsidiary of The Southern Company (Baa2 stable), providing electricity to retail customers within Georgia and to wholesale customers in the Southeast. Georgia Power serves over 2.7 million customers, has over 14,500 MW of nameplate generating capacity, and operates within the Southern power pool. Georgia Power is Southern Company's largest utility subsidiary and is regulated by the GPSC and the Federal Energy Regulatory Commission.

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Administrative Law Judges' proposed decision on Oncor's pending rate case would be credit negative

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On 28 December 2022, the Texas Administrative Law Judges (ALJs) issued a proposed decision in connection with Oncor Electric Delivery Company LLC's (A2 stable) pending rate case. After considering Oncor's request to increase (net) its retail base rate revenue requirements by around $251 million or about 4.5%, the ALJs instead proposed a $60.6 million rate reduction. The implementation of the ALJs' recommendation would likely result in a material deterioration in the utility's financial metrics and credit quality. The Public Utility Commission of Texas' (PUCT) final decision on the rate case is expected before the end of the first quarter of 2023.

The ALJs' proposed decision also raises questions around the supportiveness of the regulatory environment in Texas. The level of uncertainty surrounding Texas utility regulation had already been elevated given the complete turnover of the PUCT following the electric grid disruption caused by severe winter weather in February 2021. We cited Oncor's rate case as one of several rate cases that we are closely monitoring following changes in the Texas regulatory commission and increasingly challenging industry business conditions including high natural gas prices, inflation and interest rates.

We estimate that a lower return on invested capital drives around 53% of the gap between the revenue requirements embedded in the ALJs' proposed decision and Oncor's request. This difference in the revenue requirements of around $165 million largely results from lower regulatory parameters and, to a lesser extent, from a reduction in the assumed rate base by nearly $900 million to $17.8 billion (or around 5%). Higher accumulated depreciation of around $680 million embedded in the ALJs' proposed decision largely results in the lower rate base.

The utility had requested an increase in its authorized return on equity (RoE) to 10.3% from 9.8% while the ALJs would reduce it to 9.3%, at the level previously recommended by the PUCT Staff. Such a reduction would be credit negative, particularly considering the recent rapid rise in interest rates, which could continue. The ALJs also recommended maintaining Oncor's current equity layer of 42.5% compared to the utility's request to increase the ratio to 45%. We note that the authorized equity layers of Texas transmission and distribution utilities, including Oncor, are relatively thin compared to other jurisdictions. All else equal, higher equity layers typically allow utilities to produce stronger financial metrics and enhance their financial flexibility, particularly if they are pursuing elevated capital expenditure programs.

Lower assumed administrative and general (A&G) costs account for around $128 million (or around 41%) of the revenue requirement difference. The majority of the reduced A&G costs are associated with certain regulatory assets, particularly items related to Oncor's self-insurance storm reserve (SIR) of $588.5 million. Specifically, the ALJs recommend a proposed 10-year amortization period of the balance compared to the utility's request for five years and the reduction in requested annual accruals by around $32 million to $90 million.

Oncor's prolonged rate case stay-out period, including a postponed base rate case filing in 2021, along with the aforementioned changes at the PUCT highlight the importance of the outcome of this rate case to the utility's credit quality. This has only increased since the rate case was filed in May 2022, given higher inflation and interest rates.

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Entergy's regulatory and financial risks increase with Louisiana regulator's motion to clarify subsidiary's refunds

On 3 January, the Louisiana Public Service Commission (LPSC) and two other state utility commissions filed an Emergency Motion with the Federal Energy Regulatory Commission (FERC), requesting it to issue a statement clarifying the amount of refunds that Entergy Corporation (Baa2 negative) should make to customers through its System Energy Resources, Inc. (SERI, Baa3 negative) subsidiary. The filing reflects growing tension between Entergy and the LPSC, weakening the predictability and stability of future cost recovery for the Entergy utility system.

The motion specifically seeks to clarify the amount of refunds required by a 23 December FERC Initial Order that declared aspects of SERI's rates to be unjust and unreasonable. In the order, the FERC determined that SERI's customer rates were unnecessarily high in two material areas: its accounting for nuclear decommissioning costs, the subject of the LPSC's 3 January filing; and charges related to the extension of a 2015 sale-leaseback transaction for roughly 12% of the Grand Gulf nuclear generation plant in Mississippi. The approximately 1,400 megawatt Grand Gulf unit, SERI's only asset, sells power to four affiliate utilities in Mississippi, Arkansas, Louisiana and the City of New Orleans.

The initial order did not specify the amount of refunds required as a result of Entergy's accounting for nuclear decommissioning costs. This accounting saved Entergy near-term cash tax payments by creating uncertain tax positions and accumulating deferred tax liabilities while the company continued to charge customers for the tax expense. In a 26 December press release, Entergy said that the FERC order required no incremental refunds to customers because it had settled the matter with the Internal Revenue Service and SERI refunded $25 million to customers in 2021. In response, the LPSC issued its own press release on 28 December arguing that the total amount of refunds to be distributed to customers in Louisiana, Arkansas and New Orleans was around $600 million and that "Entergy is attempting to mislead its consumers, investors and the public regarding the consequences of FERC's findings of unjust and unreasonable conduct by SERI" according to then Chairman Lambert Boissiere."

Acrimony appears to be increasing between Entergy and the LPSC, its most important regulator, following comments by an LPSC commissioner in December in which it posited that some of Entergy's restoration costs for 2021's Hurricane Ida were imprudent and should not be recovered through storm cost securitization. In June 2022, Entergy Louisiana, LLC (ELL, Baa1 negative) successfully securitized around $3.5 billion of past storm costs, including roughly $1.0 billion for Ida, and the company is seeking to securitize the remaining $1.6 billion of Ida recovery expenses through a final securitization. The matter has been supported by LPSC staff but has yet to be approved by the five-member commission, which declined to vote for financing authority on 15 December. It is now expected to do so on 18 January.

Should Entergy have to materially delay or forego recovery of Ida storm costs, this would be significantly negative for ELL and Entergy because the credit of both companies is underpinned by the strong precedent in the state for the securitization of severe storm costs. ELL and Entergy service territories are located along the Gulf of Mexico, and are consequently subject to increasingly frequent and severe storm events such as Hurricanes Laura and Ida, which caused more than $5.0 billion of damage in 2020 and 2021. As such, the physical asset risks for these companies are higher than for most industry peers. Louisiana's history in respect of storm cost securitization has been an important risk mitigant supporting the credit profiles of both Entergy and ELL.

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Overhaul of New Mexico commission raises prospect of more consistent regulation of state's utilities

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On 30 December, New Mexico Governor Michelle Lujan Grisham named three new members to the state's Public Regulation Commission (NMPRC), completing the commission's transition from an elected body to an appointed one. New Mexico's regulatory environment has historically been less predictable and less credit-supportive than most other regulatory jurisdictions across the US. However, the complete overhaul of the commission and its change to a governor-appointed three-member commission from an elected five-member commission could result in more stability and greater consistency in regulatory decisions.

Such changes would be credit positive for regulated utilities in the state, particularly Public Service Company of New Mexico (PNM, Baa2 stable), the largest investor-owned utility in the state and the principal operating subsidiary of PNM Resources Inc. (PNMR, Baa3 stable). More supportive regulation would also be positive for Southwestern Public Service Company (SPS, Baa2 stable), the third largest utility subsidiary of Xcel Energy Inc. (Baa1 stable), which has roughly 30% of its retail electricity customers in the state, as well as El Paso Electric Company (Baa2 stable), which generates about 20% of its revenue there. However, any potential improvement in the credit supportiveness of New Mexico's regulatory environment will depend on the newly appointed commission's actions over time.

As a result of previous regulatory outcomes in the state, we view the New Mexico regulatory framework as inconsistent and less transparent than other jurisdictions. One of the NMPRC's most surprising recent actions was its December 2021 rejection of PNMR's planned merger with Avangrid Inc. (Baa2 stable) after 23 of the 24 intervening parties, including the state's attorney general, had either supported or not opposed the merger agreement. That same month, the NMPRC denied PNM's Four Corners coal-fired plant sale and abandonment application, as well as the corresponding request for securitization financing for the remaining book value of those assets. PNM contends that the NMPRC misinterpreted and improperly applied the tenets of the state's 2019 Energy Transition Act (ETA) in the regulators' decision. Both of these decisions are currently being appealed to the New Mexico Supreme Court.

In addition, recent NMPRC decisions on general rate case applications over the last two years provide further evidence of the previous commission's inconsistency. Last February, the NMPRC initially rejected SPS' rate case settlement agreement despite a hearing examiner's recommendation for approval a few months earlier. However, after key intervening parties did not unanimously support commission modifications to the agreement, the NMPRC eventually reconsidered its order and approved the initial stipulated agreement without modifications.

In June 2021, El Paso Electric also filed an appeal to the state Supreme Court in response to a rate order issued by the NMPRC that called for an approximately $4.3 million rate revenue reduction based on an authorized return on equity (ROE) of 9% and equity ratio of 49.21%. In the appeal, the utility argued that its revised authorized ROE level was considerably lower than the utility's previous authorized ROE of 9.48% and the average for electric companies within the sector.

In 2019, Lujan Grisham signed into law a bill calling for the conversion of the elected NMPRC into an appointed commission beginning in January 2023. The governor selected the three new commissioners from a group of nine individuals vetted and submitted by a NMPRC nominating committee. Gabriel Aguilera, a Democrat, has worked for the Federal Energy Regulatory Commission since 2007 and has a four-year term. Brian Moore, a Republican, is a former state legislator who represented eastern New Mexico counties, served on the state's Renewable Energy Transmission Authority Board and is currently the president of a local supermarket chain. He has a two-year appointment. Patrick O'Connell, also a Democrat, is a professional engineer with more than 28 years of experience working at New Mexico utilities, including time at PNM. He was appointed to a six-year term.

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Tariff increase and bond issuance limit increase are credit positive for KEPCO

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On 1 January, Korea Electric Power Corporation (KEPCO, Aa2 stable) increased tariffs KRW13.1/kWh. The increase, announced 30 December, mainly reflects surging fuel costs and higher environmental compliance costs. This increase follows the National Assembly's approval on 28 December of a revision of the KEPCO Act to increase the company's bond issuance limit to a maximum of 6x its standalone equity (excluding additional paid in capital and other capital surplus) until December 2027, from 2x.

The two developments are credit positive because they are likely to lead to a recovery in KEPCO's financial metrics beginning this year and prevent its funding options from narrowing. Higher levels of internal cash from the tariff increase along with the revised KEPCO Act will allow the company to maintain financing sources for its capital spending and operating costs.

Because of the tariff increase, we expect KEPCO's funds from operations (FFO)/adjusted debt will recover to a low- to mid-single-digit percentage this year and high-single-digit to low-teen percentages in 2024-25 from a negative percentage in 2022. The recovery in financial metrics is also being assisted by additional tariff increases in 2022. These consisted of a KRW6.9/kWh rise in April 2022 and KRW7.4/kWh increase in October 2022 for all residential, commercial and industrial customers, with an additional KRW4.5/kWh–KRW9.2/kWh increase for commercial and industrial users. There was also a KRW5.0/kWh increase in July 2022 for all end-users.

Our FFO/adjusted debt projections only incorporate already approved tariff increases (including this latest increase); KEPCO's financial metrics will improve further if there are additional tariff increases in 2023.

We expect KEPCO to record an FFO of KRW3-KRW12 trillion over the next 12-18 months, which would be a strong turnaround from FFO of negative KRW13 trillion for the 12 months to September 2022. The approved increase in bond issuance limits under the revised KEPCO Act will allow the company to continue issuing bonds into domestic and international capital markets, while mitigating a significant erosion of its equity base from likely huge losses for 2022.

The tariff increase is not sufficient to fully compensate for a surge in fuel costs since the first quarter of 2021 because the series of tariff increases since April 2022 are still lower than the rise in KEPCO's input costs. KEPCO's unit power generation cost from coal increased around KRW52/kWh and from liquefied natural gas KRW120/kWh in January-September 2022 over the same period in 2021. KEPCO's unit power purchase costs from private independent power producers also rose KRW101/kWh during the same period.

In our view, the tariff increase along with the increase in KEPCO's bond issuance limit indicate the Korean government's commitment to preventing the company's financial metrics from remaining weak for a sustained period and to making sure the company maintains strong funding channels, which are in line with our base-case assumptions.

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Chile's new fintech law is credit negative for incumbent banks and other lenders

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On 4 January, Chilean President Gabriel Boric signed into law measures that allow regulation of technology-enabled financial companies (fintechs) and that establish rules for all financial entities to access borrowers' financial information with privacy standards (open banking). Such rules are significant because Chile's credit bureau is limited only to bank and other regulated firms' data, with information gaps mainly from unregulated finance companies.

At 92%, Chile already has one of the highest commercial and retail loan-to-GDP ratios versus an average of 50% in Latin America as of December 2021. Therefore, open banking and the regulation of fintechs will increase competition for incumbent banks and other lenders. Upon the request of customers, the new law will require banks to share financial information with other market participants, allowing fintechs to offer lower cost services, which will reduce lending spreads and the price of banking services, reducing banks' profitability.

Large Chilean banks, such as Banco Santander-Chile (A2/A2 stable, baa1[1]), Banco de Chile (A2/A2 stable, a3) and Banco de Crédito e Inversiones (Bci, A2/A2 stable, baa1), are actively preparing for new entrants by introducing innovative digital accounts, e-wallets, payments systems and loyalty programs to make banking and payments more attractive for clients. The banks are also offering in-house fully digital banks (neobanks).

Smaller consumer-focused lenders, including Banco Ripley (Baa3 stable, baa3), Coopeuch (A3 stable, baa1) and Caja Los Andes (Baa3 negative), have also begun to offer digital payments, e-commerce debit cards and neobanks amid increased customer demand for digital services and growing interest from new entrants' growing interest in the segment, considering its high spreads.

The new law regulates various services that are today mainly provided by banks and their subsidiaries, such as payments, brokerage and investment consulting. It also regulates the custody of financial instruments, routing, crowdfunding and credit risk assessment. The law establishes minimum requirements for corporate governance, anti-money-laundering standards, cybersecurity, risk management, financial information reporting, and capital and data security that are similar for banks and nonbank lenders. As a result, the law allows a larger number of counterparties to work with fintechs, which we expect will increase the confidence of potential investors and users.

The law allows the differentiated regulation of smaller, less sophisticated fintechs that may not pose a threat to financial stability. However, all entities, including foreign fintechs, must be registered with the regulator, Comisión del Mercado Financiero (CMF), have a domicile in Chile and meet data privacy norms. The CMF will now have intervention powers over these entities.

With the new law, Chile joins other Latin America countries, including Brazil, Colombia and Mexico, that since 2020 have announced the implementation of open banking, and which have created a regulatory framework for fintechs to foster innovation and financial inclusion. Brazil is the most advanced, having announced open finance in 2020 with a wider scope that includes exchange services, investment, insurance and pension fund products. However, Brazilian implementation of open finance is being phased in, which has not resulted in meaningful compression of commission income stemming from increased competition for clients. Banks in Brazil will likely show a more noticeable effect on profitability from competition as individuals are able to migrate savings and investments directly from apps.

Because the regulation under the new law must be implemented within a maximum period of 18 months from its publication, the CMF has already presented a plan to issue follow-on norms, which include meetings and public consultations with regulated industries and fintech associations. During the first quarter of this year, the plan will focus on service registration standards, and in the second quarter, on standards related to open banking systems.

Endnotes

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

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Huatai Securities' planned rights issue is credit positive

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On 30 December, Huatai Securities Co., Ltd. (Baa1 stable) announced that its board of directors approved a rights issuance plan to raise up to RMB28 billion in equity capital from existing shareholders. Issuance proceeds will be used mainly for developing Huatai Securities' capital-based intermediary business, expanding the scale of its investment and trading business, increasing investments in its subsidiaries, enhancing information technology and content operation, as well as replenishing its working capital. The plan remains subject to shareholder and regulatory approvals and timing is uncertain.

The proposed rights issue is credit positive because it would strengthen Huatai Securities' capital base, improve the quality of its funding and support its already sound liquidity. The company has rapidly expanded its financial investments mainly on the back of short-term fundings since 2019. Consequently, its leverage ratio, measured as total assets/equity attributable to holders of ordinary shares, increased to 6.0x as of 30 September 2022 from 3.6x at year-end 2018. The proportion of long-term funding (including shareholders' equity, long-term bonds and borrowings) as a percentage of total equity and liabilities excluding segregated cash also decreased to 40.9% from 54.8% during the same period. Following the rights issue, if fully issued, the pro forma leverage ratio will improve to 5.2x and the long-term funding ratio will improve to 43.1%, based on financials as of 30 September. Huatai Securities' leverage will remain low by global standards and the quality of its funding will remain moderate compared with domestic peers.

We do not expect the additional rights issuance to significantly change Huatai Securities' shareholding structure, its strategic importance to the Jiangsu government, or its leading position in the Chinese securities industry. As of 30 September, Huatai Securities was about 28% controlled by the Jiangsu state-owned Assets Supervision and Administration Commission through Jiangsu Guoxin Investment Group Limited and other provincial state-owned enterprises. Jiangsu Guoxin, the largest shareholder of Huatai Securities with 15.13% as of 30 September, will make a public commitment to subscribe to a certain number of rights issued before the Huatai Securities shareholders general meeting.

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Revised Medi-Cal contract still positive for Molina and negative for Centene

On 30 December, California's Department of Health Care Services (DHCS) revised the Medicaid contract awards it announced last August. The revised contract awards are credit positive for Molina Healthcare, Inc. (Ba3 stable) and credit negative for Centene Corporation (Ba1 stable), but to a lesser extent than the original contract awards.

In the earlier version, Molina was slated to gain approximately 1.2 million members from a new contract in Los Angeles and expanded contracts in San Diego and Sacramento. Centene Corporation (Ba1 stable) stood to lose approximately 1 million members as a result of lost contracts in Los Angeles and Sacramento, which more than offset an expanded contract in San Diego and retention of its contracts in several other counties.

Under the revised awards, Centene will effectively keep half of the Los Angeles contract and retain its contract in Sacramento. However, Centene did not get a contract in San Diego this time. Overall, as shown in the exhibit, we estimate that Centene will lose approximately 725,000 members under the revised contract, instead of 1 million members in the original contract. For Molina, the revised contract awards remain a significant win. Under the revised awards, Molina received contracts in Riverside, Sacramento, San Bernadino and San Diego, as it did the first time. In Los Angeles, Molina won an award as a subcontractor but was guaranteed to share the membership equally with Centene. Overall, under the revised awards, Molina's Medi-Cal membership will still grow by 600,000. Although this is less than the projected 1.2 million increase under the original award, it is still a 12% increase in total membership.

Revised Medi-Cal awards are still a boost to Molina and headwind for Centene

	Revised award		Original award	
(Membership in '000s)	Centene	Molina	Centene	Molina
Medicaid members - 30 September 2022	15,698	4,667	15,698	4,667
Projected change due to Medi-Cal	-725	600	-1,013	1,200
Change as % of Medicaid members	-4.6%	12.9%	-6.5%	25.7%
Pro-forma Medicaid members	14,973	5,267	14,685	5,867
Total membership - 30 September 2022	22,576	5,175	22,576	5,175
% change to total members	-3.2%	11.6%	-4.5%	23.2%
Pro-forma total membership	21,851	5,775	21,563	6,375

Total membership excludes prescription drug plan members for Centene.
Sources: Company filings and Moody's Investors Service

Molina expects to increase its California Medicaid revenue by approximately $2 billion to $3.9 billion from $1.9 billion. We estimate, based on management's guidance, that the benefit from this contract plus other new contract wins in Iowa and Nebraska will boost total revenue by $4.2 billion and pre-tax income in the range of $250 million to $300 million, which equates at the midpoint to approximately 25% of last 12 months (as of 30 September 2022) pre-tax income of $1.1 billion. In addition, DHCS awarded Molina a contract to serve dual special needs (D-SNP) individuals in Los Angeles, which could add another $500 million in revenue and was not part of the original contract award.

Given Centene's better outcome in the revised contract awards, we project a 2% negative impact on EBITDA, amounting to a decline of $115-$120 million, compared with our original estimate of a modest decrease of about 3%.

We note that Centene's scale – it has leading national market shares in Medicaid and the individual market and a top six position in Medicare Advantage – mitigates the effect of the reduced contract awards. In addition, Centene's value creation plan should generate $400 million in savings this year, mostly from real estate reduction, and another $300 million in 2024. However, Centene faces additional headwinds over the next two years. We expect the resumption of Medicaid eligibility redeterminations to begin early this year, perhaps in February. Management now forecasts a $7.5-$8.0 billion adverse effect on revenue (revenue in the 12 months to 30 September 2022 was $142 billion). Centene also faces a headwind in Medicare Advantage for 2024 because of a poor performance in

the recently released 2023 star ratings. For 2023, few of Centene's members are in plans with a rating of 4 stars or higher, well below the national average of 51%. Plans below 4 stars get lower reimbursement from the government.

Molina, which is even more heavily concentrated in Medicaid than Centene, will also be significantly affected by the resumption of eligibility redeterminations. However, we estimate the revised Medi-Cal contract alone will basically offset the effect of the eligibility redeterminations. In addition, Molina will benefit from significant embedded earnings from the integration of recent acquisitions. Molina will also generate additional savings by shrinking its real estate footprint in the post-pandemic work world.

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Egypt's currency depreciation weakens debt affordability and external debt-service capacity

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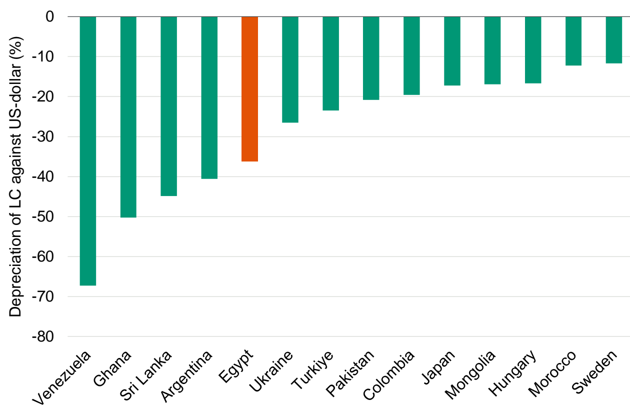
On 4 January, the Egyptian pound depreciated by about 6.5% to EGP26.5/USD1.0, bringing its cumulative depreciation against the US dollar to more than 40% since 1 January 2022. The pound's depreciation last year was one of the sharpest globally (see Exhibit 1). Notwithstanding the broad realignment of the real effective exchange rate with fundamental values after its most recent devaluation in October, parallel exchange rate developments point to further currency weakness ahead.

The most recent drop in the currency follows the government's commitment to exchange rate flexibility agreed under the new IMF $3 billion 46-month Extended Fund Facility approved in mid-December and reflects FX demand for the clearing of the remaining import backlog of over $5 billion amid tight foreign currency liquidity in the monetary system, including the central bank and commercial banks. As a result, we expect a further increase in inflation readings from the 18.8% year-over-year recorded in November, followed by additional policy rate hikes after the 300 basis point hike on 23 December to 16.25%, and implying higher than previously anticipated borrowing costs for the government, a credit negative (see Exhibit 2).

Exhibit 1

The Egyptian pound ranked among most depreciated currencies in 2022

(Local currency depreciation versus US dollar between December 2021-22)

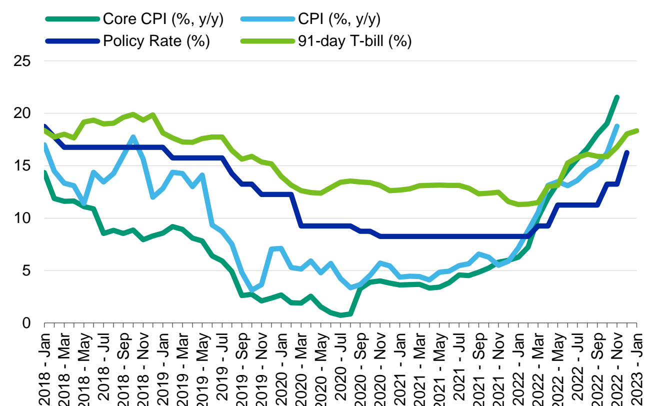


Sources: Haver Analytics and Moody's Investors Service

Exhibit 2

Accelerating inflation will lead to higher policy rates and borrowing costs

(Core and headline inflation, %, y/y; policy rate (%); T-bill yield, %)



Sources: Central Bank of Egypt, Haver Analytics and Moody's Investors Service

Although increased exchange rate flexibility contributes to rebalancing external accounts and helps preserve foreign exchange reserves, pressure on inflation and domestic borrowing costs weakens the government's debt affordability as measured by interest payments/revenue. For fiscal 2023 (ending in June), we estimate debt affordability at over 43%, from about 40% in fiscal 2022, which was among the weakest of Moody's-rated sovereigns. The most recently available budget execution data for July and August 2022, confirm a deteriorating trend in the debt affordability ratio versus the previous year.

Egypt's interest bill is already high at 7.5% of GDP, with 90% allocated to local currency debt service. The average maturity of Egypt's domestic debt is below four years, which is short and increases the sovereign's credit profile's sensitivity to a sharp increase in domestic borrowing costs because the debt stock quickly reprices at higher costs. In turn, the high and higher interest bill crowds out government spending for items such as social support measures and public investment and weighs on the government's capacity to produce continued primary surpluses.

A weaker currency also reduces the government's external debt service capacity by increasing the valuation of foreign currency debt, raising the debt/GDP ratio. All else being equal, a change in our exchange rate assumption to EGP29/USD1 at the end of June 2023 from the previous EGP25/USD1 assumption implies an increase in the debt/GDP ratio to more than 90% from our previous forecast at 86.6%, delaying the previously projected reduction in the debt ratio toward 80% of GDP by fiscal 2026.

Egypt's fiscal challenges are partially balanced by the large and dedicated domestic funding base via the banking system with assets at about 128% of GDP at the end of fiscal 2022. Domestic banks hold the majority of local currency government debt amounting to about 57% of GDP and absorb the bulk of the government's annual gross funding needs at over 30% of GDP, albeit at increasingly higher yields. However, commercial banks' focus on funding the government crowds out lending to the private sector. In addition, banks have started to offer one-year savings certificates at 25% to depositors in order to incentivize continued deposit stability in local currency.

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Italy's extraordinary measure will improve debt affordability for mortgage borrowers

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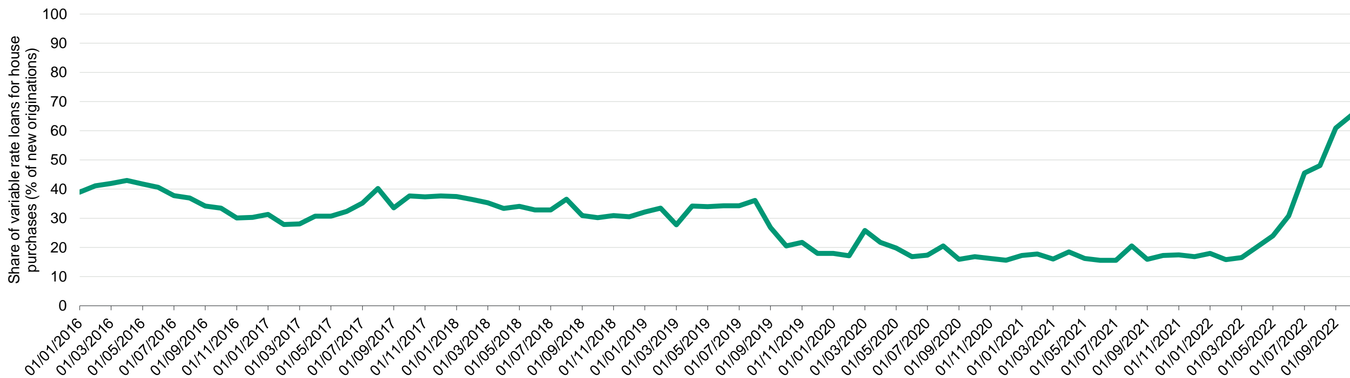
On 1 January, Italy's budget law, legge di bilancio, took effect. The law includes a support measure to allow residential mortgage borrowers to switch their mortgages to a fixed interest rate from a floating rate throughout 2023. The performing borrower must meet certain eligibility conditions such as having a maximum equivalent economic situation Indicator (ISEE) of €35,000 and maximum original loan amount of €200,000.[1]

Changing to a fixed-rate mortgage will improve debt affordability and sustain structured finance mortgage portfolio performance in a rising interest rate environment. Although fixed-rate mortgage origination increased steadily from 2016 in the low interest rate environment, loan originations in 2022 showed an increase in variable-rate mortgages to just above 60% of Italy's total mortgage loan originations as of 31 October 2022, from 17% in October 2021 (Exhibit 1).

Exhibit 1

Recent originations show an increase in variable-rate residential mortgages

Variable rate mortgage loans as a percentage of total mortgage originations for house purchases



Source: European Central Bank

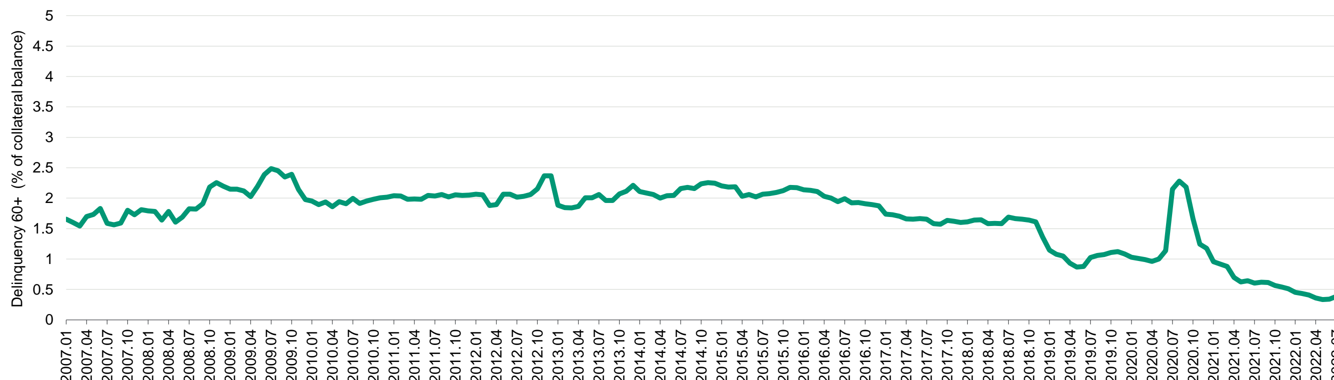
A higher proportion of fixed-rate mortgages will sustain Italian structured finance mortgage portfolio performance by improving debt affordability for borrowers in a rising interest rate environment. Although borrowers can always refinance their loans throughout the life of the loan, the new measure incentivises eligible borrowers to switch to fixed-rate mortgages by minimising the time and cost of refinancing to a fixed-rate mortgage from a floating-rate mortgage.

Performance has been good and stable so far for both residential mortgage-backed securities (RMBS) deals and covered bonds (Exhibit 2). Fixed-rate mortgages comprise around 50% of Italian pools for covered bonds as of Q3 2023 and, on average, more than 30% for RMBS. The vast majority of the fixed-rate mortgage loans in Moody's-rated deals are fixed for life.

Exhibit 2

Performance of Italian residential mortgage portfolios has been stable

Overall delinquency ratio of Moody's-rated Italian RMBS deals defined as 60+ days past due based on the collateral balance



Sources: Moody's Investor Service and performance reports

The share of borrowers that switch to fixed-rate mortgages is uncertain, but we expect the effect on covered bonds and RMBS deals to be limited given the borrowers' prime nature, fairly long seasoning and overall low loan-to-value (LTV) ratios. We expect borrowers with high LTVs to be more incentivised to take advantage of this measure.

The effects on specific deals will depend on several aspects, including the particular deal's hedging structure, excess spread dynamics and interest rate mismatch between assets and liabilities.

Endnotes

1 The measure reinstates the extraordinary measure approved in law no. 70 of 2011.

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Editors

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