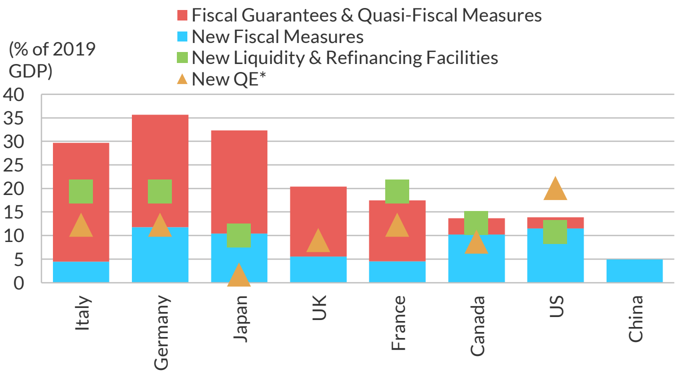
Fitch Ratings' Assessment of Coronavirus Global Policy Responses

Liquidity Provision Critical, but Many Ratings Still Face Longer-Term Pressures

Macro Policy Responses - G7,China



*QE numbers are Fitch forecasts for US, Canada and Japan. Announced/pledged figures from the ECB for France, Italy, Germany. Data as of June 5, 2020.
Source: Fitch Ratings, IMF

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Coronavirus Macro Policy Responses Unprecedented

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Unprecedented Crisis Prompts Unprecedented Policy Responses

Substantial fiscal support measures, including direct fiscal easing and guarantees, have been announced by governments in the world's major economies (G7, plus China) in response to the coronavirus pandemic. More measures may be announced in due course. In Europe, Germany, Italy and the UK have announced more than 20% of GDP overall fiscal support, followed closely by France at 17.5% according to Fitch Ratings.

Central banks are offering support through sovereign and corporate bond-buying and liquidity facilities to inject liquidity into the markets and economy.

Financial and regulatory measures have also been put in place to increase liquidity for banks and provide them with incentives to extend credit to households and businesses through the crisis. Lenders are also encouraged - albeit not mandated - to work with borrowers who are or may be unable to meet their obligations because of the effects of the pandemic.

Fitch evaluates coronavirus-linked policy responses in conjunction with applicable Fitch criteria, many of which incorporate methodologies for estimating expected government support in the normal course of events.

This report explains how Fitch will assess policy responses and support measures in major economies in relation to the ratings for Sovereigns, Financial Institutions, Corporates and Structured Finance and provides some top-line assessments on potential impact on ratings of the parameters of the support programmes.

Common Elements in Coronavirus Policy Responses

Policy responses across major economies have a combination of fiscal, monetary and financial measures, with a few common elements (see the table below).

First, there is a common overarching aim to provide funding and liquidity to businesses and households to prevent a vicious circle of bankruptcies and rising unemployment, and a fall in confidence, consumption and investments, which would hamper resumption in economic activity once lockdown measures begin to ease.

Second, these measures have a more medium-term objective to enable households and businesses to emerge from this initial wave of lockdowns with some ability to resume consumption and production relatively unencumbered.

Fiscal measures include:

- tax measures such as tax breaks and tax credits,
- grants and subsidies, including wage support schemes,
- expansion of unemployment benefits and sick leave provisions,
- direct cash to households,
- loan programmes backed by government guarantees.

Monetary measures include:

- vastly expanded QE programmes to envelop corporate bond purchases in addition to sovereign and municipal and local government bonds,
- reduction in key policy rates,
- expansion of US dollar swap lines,
- central bank liquidity facilities.

Financial measures include:

- easing of regulatory requirements, including capital and liquidity buffers,
- payment moratoriums and payment holidays on consumer credit products and mortgages.

The table on the next page provides a non-exhaustive representation of the various measures under the policy responses and which countries have implemented a form of these.

For brevity and focus we have primarily looked at G7 countries and China as our sample countries for this report. We also bring in examples and refer to a wider set of countries when there is a particular measure that will have a material impact and is not captured by the common parameters of policy responses announced.

G7, China - Summary of Policy Responses by Type of Measures

Fiscal and quasi fiscal measures	China	Japan	EU	France	Germany	Italy	UK	US	Canada
Tax measures	✓	✓		✓	✓	✓	✓	✓	✓
Tax payments and tax return fillings deferred for eligible companies and/or households									
Tax rebates									
Tax credits									
Deferral of social security payments									
Grants & subsidies		✓	EU commission (SURE[b], State Aid Temporary Framework)	✓	✓	✓	✓	✓	✓
Payment protection grants and wage subsidy schemes for companies that retain employees									
Grants for SMEs in distress to top up or substitute loans									
Direct cash and/or expanded unemployment benefits	✓	✓		✓	✓	✓	✓	✓	✓
Direct cash to households									
Expanded unemployment benefit schemes									
Credit guarantees		✓	EU commission (State Aid Temporary Framework)	✓	✓	✓	✓	✓	✓
Government guarantees for low-interest or interest free loans[a] to SMEs and larger companies, via commercial banks									
Expansion of export credit guarantees									
Direct Loans, targeted support			EU commission (State Aid Temporary Framework)	✓	✓	✓		✓	✓
Direct loans to companies or specific industries									
Securing strategic industries									
Monetary									
Central bank asset purchases		✓	✓	ECB	ECB	ECB	✓	✓	✓
Investment grade commercial paper									
Investment grade corporate bonds; primary and secondary markets									
Speculative grade corporate bonds and ETFs (US)									
Purchase of sovereign bonds									
Central bank liquidity support		✓	✓	ECB	ECB	ECB	✓	✓	✓
US - asset backed securities loan facilities (TALF)									
US - Main Street Lending Program									
ECB- Pandemic Emergency Longer Term Refinancing Operation (PELTRO)									

Fiscal and quasi fiscal measures	China	Japan	EU	France	Germany	Italy	UK	US	Canada
Policy rates cuts (basis points)	**30**						**65**	**150**	**150**
(Monetary easing since February 1st 2020)									
USD liquidity swap line arrangements		✓	✓	ECB	ECB	ECB	✓	✓	✓
Financial									
Easing of regulatory requirements									
Use of liquidity buffers	✓	✓	✓	ECB	ECB	ECB	✓	✓	✓
Countercyclical capital buffers easing				✓	✓		✓		
Use of capital buffers		✓	✓	ECB	ECB	ECB	✓	✓	✓
Payment moratoria/payment holidays offered	✓			✓	✓	✓	✓	✓	✓
Discouragement of share buybacks, common dividends for banks			✓	ECB	ECB	ECB	✓		

[a] loan guarantees are off balance-sheet vs direct loans
[b] SURE is a temporary EU instrument that allows for low interest loans to EU Member States to address sudden increases in public expenditure for the preservation of employment and support short-time work schemes and similar measures in Member States
This is not an exhaustive list, although it has tried to capture the major policy responses and place them under the relevant categories/types for major economies (G7, China). This is for illustrative purposes to showcase elements of policy programmes in major economies and provide context for understanding for this report. The examples under each category do not apply to each country listed, but each country listed has implemented its own measures under each category.
Source: Fitch Ratings, IMF Global Financial Stability Report, IMF Policy Responses to COVID-19, official announcements

Sovereigns

Much of the burden of the coronavirus policy response is falling on sovereigns. Fiscal policy is being eased on a scale and across a range of countries that is unprecedented. For the first time, Fitch forecasts that nearly all rated sovereigns will experience an annual fiscal deterioration, running larger deficits or smaller surpluses in 2020 than a year before. Similarly, we project that government debt will increase in almost all countries.

The fiscal response is channelling resources to the healthcare sector and to support for households and businesses facing sudden interruptions in income. In many cases, this support is necessary to save lives, maintain financial stability and prevent a lasting economic depression that could weaken sovereigns' credit profiles over the long term.

Nevertheless, fiscal easing rarely pays for itself. The deterioration in public finances, along with economic downturns and, in some cases, external financing pressure, is putting significant pressure on sovereign ratings. 25 sovereigns have been downgraded so far in 2020, by a total of more than 30 notches, and we expect it to be a record year for downgrades.

Rating Approach to Fiscal Measures

Fitch assigns its sovereign ratings in a two-step process. The starting point is our Sovereign Rating Model (SRM), a proprietary quantitative model that establishes an indicative rating. Qualitative adjustments are then applied by the rating committee to account for factors not adequately captured by the SRM.

The fiscal deterioration will affect the SRM score through four fiscal variables within the model: fiscal balances relative to GDP, government debt stocks relative to GDP, interest payments as a share of government revenue and shares of government debt denominated in foreign currency.

SRM scores based on our latest forecasts are pointing to downgrades for 70 sovereigns in 2020, when compared with end-2019 scores. In 25 of them, deterioration in fiscal metrics alone is enough to push the score one notch lower. However, not all of these sovereigns will be necessarily downgraded, as the SRM score is only the starting point.

Track Record Is Important

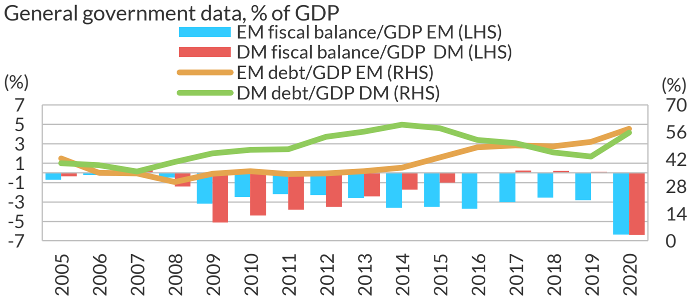
Qualitative assessments of the credit impact of fiscal loosening will evaluate the fiscal starting point – both in absolute terms and relative to rating peers – and whether fiscal measures will have public finance implications through the medium term.

A key component of this assessment will be a government's track record of reining in deficits and lowering debt during good times. On a global basis, the track record since the global financial crisis is not particularly encouraging. Fiscal balances generally narrowed and contributed to higher ratings in the SRM in the years following the global financial crisis, but the global median government debt ratio continued to increase until 2017.

However, the global aggregate masks more positive trends among some sovereigns. Developed-market sovereigns, for example, have been on a broadly improving fiscal trend, albeit with only gradual debt improvements than the overall trend. Emerging market sovereigns' collective fiscal position has been on a more negative trend, due in part to the decline in commodity prices in the middle of the decade. Each sovereign's track record needs to be examined individually.

Developed Market Sovereigns Were on Improving Fiscal Trend

General government data, % of GDP



Source: Fitch Ratings

Fitch may also be more likely to hold off on a downgrade if the bulk of easing is designed to be temporary. Fiscal frameworks with powerful automatic stabilisers will generally be viewed positively in this respect. Automatic stabilisers associated with an economic downturn, such as declining tax revenue and rising unemployment benefits, are inherently cyclical.

Deficit changes driven by discretionary measures tend to be a more significant rating consideration. However, we will also take into account the nature of discretionary programmes. It may be easier to avoid repeating one-off spending packages, such as those composed largely of cash handouts, wage subsidies or tax deferrals or rebates than it will be reverse cuts to tax rates, for example.

Liquidity Support Can Raise Fiscal Risks

Qualitative assessments also have to take into account support measures that affect public finances indirectly. For example, governments have rolled out or enlarged various guarantee schemes to facilitate companies' access to credit. In many major economies, government liquidity support through guarantees, loans and equity injections amounts to more than 10% of GDP, and globally it exceeds the value of direct fiscal stimulus, according to the IMF.

The scale of government liquidity support makes it an important rating consideration. Guarantees typically do not have direct fiscal implications, at least in the short term. Loans and equity injections increase public debt in the near term, but the long-term impact will depend on the performance of the loan/equity stake. Fitch generally expects most of these undertakings to be designed in ways that allow governments to reclaim at least some previously extended support when companies have recovered. We also recognise that liquidity support by the sovereign can aid economic recovery thereby indirectly supporting the sovereign credit profile. However, this may not be sufficient to offset the negative impact of the associated fiscal easing.

The provision of support by central banks via quantitative easing that lowers sovereign bond yields, improves liquidity and lowers interest service costs is credit positive in the short term, but does not provide unlimited support to sovereign ratings, either in terms of a particular rating level or for an unlimited time period.

Nevertheless, these schemes come with fiscal risk. Guarantees can be called, loans can go unpaid and equity stakes can lose value. These are not normally large enough to affect the sovereign ratings, but in cases where the scale is particularly large, Fitch's analysis can include assumptions on the likely eventual fiscal costs of liquidity support, and adjusted fiscal forecasts accordingly. Deeper and more prolonged recession would increase the chances of these risks materialising on government balance sheets.

Off-balance-sheet stimulus can also add to fiscal transparency concerns, particularly in emerging economies with weaker institutions, which may be negative for ratings. In China, for example, our rating assessment will take into account the extent to which measures take place transparently and on budget, as has generally been the case so far, or whether they are accompanied by resurgence in off-budget spending or credit stimulus. A significant acceleration in credit growth is a negative rating sensitivity, see *China NPC Signals Restrained Approach to Policy Stimulus*.

In many countries, banks are being encouraged to increase lending to support government efforts to contain economic damage. This can shift some of the direct burden away from the sovereign, but can also present risks, particularly in countries with weak banking systems that may eventually require government recapitalisation.

Central bank lending initiatives typically do not have direct fiscal implications, although governments may need to compensate for or otherwise recognise any credit losses suffered. For more on the implications of central bank credit losses see *What Investors Want to Know: Central Bank Purchases of Government Bonds*.

Debt Relief for Low-Income Sovereigns

Concerns about the scale of the humanitarian and macroeconomic impact of coronavirus and fears of a destabilising debt crisis have built momentum for debt relief to low-income countries. Many of these countries have lost access to international capital markets, and might otherwise be facing severe liquidity stress.

We do not view debt relief from official sector creditors as a default under our *Sovereign Rating Criteria*, and rating implications would be based on the extent to which the coronavirus shock – the main trigger for the accelerated debt relief – has fundamentally raised credit risk. The inclusion of private creditors in any debt relief initiative would have more direct implications for ratings.

Implications of Debt Relief for Supranational Ratings

Suspension of sovereign debt payments owed to multilateral development banks' (MDBs) would be negative for MDB ratings unless they were fully compensated by their shareholders.

The impairment of an MDB's sovereign loans would constitute a breach of the MDB's preferred creditor status, which gives repayment of loans to MDBs priority. It would also weaken the credit quality of the MDB's loan portfolios and the suspension of debt payments would adversely affect the MDB's cash flows and liquidity.

Related Research

Global Fiscal Deterioration Amid Coronavirus

What Investors Want to Know: Emerging-Market Sovereigns - 2Q20

Fiscal Space Limited for Many Sovereigns

Suspension of Debt Payments to MDBs a Risk to Ratings

What Investors Want to Know: Central Bank Purchases of Government Bonds

China NPC Signals Restrained Approach to Policy Stimulus

Sovereign Defaults Set to Hit Record in 2020

Value of Downgraded Sovereign Debt Not as High as Previous Crises

Financial Institutions

In response to the coronavirus crisis, regulators have released a flurry of rule changes and guidance to give banks the flexibility to manage the broad economic shock and encourage them to lend or intermediate to support the recovery.

Many measures, including central bank actions to shore up financial market liquidity and to support households and corporates, are positive for financial stability and supportive of financial institutions' credit profiles in the short term, particularly for funding and liquidity and for mitigating more acute pressure on asset quality. However, irrespective of some elements of the policy responses, most financial institutions' capital, asset quality and profitability will still weaken over the medium and longer term. There may also be unintended effects, such as reduced transparency eroding investor confidence.

The interplay between asset quality, capital and earnings with the mitigating effects on borrower creditworthiness from fiscal support are among the main rating factors that Fitch will consider. The level of headroom an issuer has at its rating level, risk appetite and the presence of sovereign or institutional support are other key considerations for ratings implications.

Government Guarantees

Most governments have introduced temporary credit guarantees to help banks provide the financing needed to companies. In some key jurisdictions (the US, Germany, France, Italy and the UK), the guarantee covers at least 80% of the loan value to small and medium-sized enterprises (SMEs).

This should reduce banks' expected losses on new lending and, to a lesser extent, support revenue generation. However, heightened credit risks from the crisis means we still expect asset quality to weaken relative to previous expectations and earnings challenges to intensify due to weaker business volumes and rising loan impairment charges.

Lenders could face increased risks on the COVID-19 relief loans if the terms of the partial guarantee programmes are imprecise, as this makes recovery expectations and cost/benefit analysis more difficult. Details, such as how and when banks should foreclose and pursue loan recoveries before seeking state guarantees, could affect banks' responses. Banks are also exposed to reputational, legal and regulatory risks if returns are perceived to be outsized or at the expense of the government's relief efforts.

There are other ways authorities are supporting borrower asset quality. The temporary EU framework for state aid gives authorities greater flexibility in providing direct grants and other aid to borrowers routed through banks. For insurers, some EU states have set up guarantee schemes for trade credit insurers to continue extending cover to coronavirus-hit companies.

In some jurisdictions, an aggressive credit-led policy response could put pressure on our assessment of banks' operating environment and strain bank capital further. For example, there is a risk in China that this could extend to significant restructuring of loans, despite being reported as current. In India, the structure of the liquidity facility to support mutual funds and non-banks places the onus on banks to absorb the associated credit and capital risk. . Fitch can adjust the operating environment or implied asset quality scores to account for such behaviour.

Payment Moratoriums

Banks and certain non-bank financial institutions (NBFIs) will face earnings pressure from any moratoriums on loan payments offered to individuals and corporates facing financial difficulties and from suspending some foreclosures. Some weaker NBFIs, eg non-performing loan purchasers dependent on cash inflows, could also face liquidity pressures. There is a risk this temporary relief and other fiscal measures may not be sufficient to prevent borrower credit deterioration and will only act to delay loan impairments. The deeper the shock and the shallower the recovery, the more likely these payment and foreclosure suspensions will only postpone losses for lenders.

However, these moratoriums can directly limit risks for mortgage insurers to the extent they reduce what would otherwise be heightened foreclosure levels on defaulted mortgage loans. Typically, suspended mortgage payments under these programmes are added at the end of the loan's term, extending the maturity.

Regulatory Forbearance: Loan Impairments

There were significant differences in the way banks provision under expected credit loss (ECL) regimes during 1Q20, depending on their portfolio composition, economic forecasts, and conservativeness and Fitch expects this to continue for 2020. Use of ECL regimes to estimate loan-loss provisions in response to the global coronavirus crisis has raised risks that banks may significantly increase provisions, reducing their capacity to extend credit.

Revised regulatory guidance on setting aside reserves for ECL under current expected credit loss (CECL) and IFRS9 accounting standards, the extent to which provisions would be deducted from regulatory capital, and changes to transition regimes as a result of the coronavirus crisis are aimed at reducing excessive pro-cyclicality in financial statements and regulatory capital.

Rising ECLs reflect the likelihood of increased losses in the future despite current cash flows being unaffected, as the loans are still

Expected Credit Loss Regimes – Key Regulatory Guidance Related to Coronavirus Crisis

	US: CECL	Global (Excluding US): IFRS 9
Provisioning	• Agencies will not direct institutions to automatically categorize loan modifications as troubled debt restructurings • Lenders can delay CECL implementation until the end of 2020 or when the health crisis is declared over, although most financial institutions adopted CECL in 1Q20	The International Accounting Standards Board and the European Commission have guided that: • temporary payment holidays will not automatically lead loans to being measured on the basis of lifetime losses (stage 2), • judgement and flexibility should be used to avoid excessively pro-cyclical assumptions in ECL models, • government guarantees should be factored into ECL estimates. IFRS 9 implementation has been delayed in some jurisdictions, such as India.
Bank Regulatory Capital	Banks are allowed the option to: • fully delay the "day one" impact on regulatory capital ratios for two years and then phase it in over the subsequent three years, • only flow 75% of the incremental reserves beyond the day one impact (i.e. the "day two" impact) through regulatory capital ratios for two years before phasing in over a three-year period.	• Banks are encouraged to implement transitional arrangements that will reduce the impact of IFRS9 ECL provisioning on regulatory capital. • In the EU, Capital Requirements Regulation amendments will permit the full offset of IFRS 9 ECLs on common equity Tier 1 (CET1) during 2020 and 2021.

Source: Fitch Ratings, IASB, EC, Federal Reserve, OCC, and FDIC performing. Actual credit losses may never materialise if the shock is short-lived, triggering ECL reversals.

Nevertheless, given the severity of the shock, we believe that delays in applying ECLs may only postpone the longer-term credit loss impact from the pandemic-induced economic shock. In this case, it will distort profitability and asset quality metrics, while the neutralisation of ECLs from regulatory capital will artificially boost CET1 ratios. This increases banks' lending flexibility, but risks masking economic reality and distorts banks' true underlying solvency.

Fitch can adjust implied capitalisation scores downwards if we believe the headline-reported CET1 ratios used in arriving at an implied score do not accurately reflect true solvency. For asset quality, disclosures on economic assumptions applied to ECL models, the staging of loans under IFRS 9, extent of loans under moratoriums and mitigation under new state guarantees will help inform our views of the extent and duration of the decline in borrowers' credit quality. Our views will evolve in light of how the pandemic develops, and will take account how effective policy measures are in supporting the economy.

The ability to add back ECLs to CET1 capital means banks are less likely to fail due to regulatory capital breaches, but it does not shield them from rating downgrades if their asset quality deteriorates materially or appears likely to do so. However, the ECL waiver for EU banks is positive for additional Tier 1 (AT1) bondholders, as adding back ECLs will increase the buffers that enable AT1 coupon payments.

Regulatory Forbearance: Capital and Liquidity Buffers

Supervisors are encouraging financial institutions to use capital and liquidity buffers as necessary in the wake of the coronavirus crisis, indicating banks will be given a significant amount of time to restore their regulatory ratios to adequate levels. There have been various adjustments to the regulatory calculations to give banks greater flexibility. The Basel Committee has also delayed the implementation of the final Basel III rules by a year.

The use of capital and liquidity buffers by developed market banks to accommodate credit expansion will not necessarily trigger a rating downgrade by Fitch. Bank Issuer Default Ratings could be resilient if reductions in regulatory capital and liquidity ratios are temporary and there is a clear and credible path for restoring them to levels consistent with the rating level within a reasonable timeframe, typically two years or less. However, restoring buffers may not be sufficient to prevent negative rating action where Fitch anticipates a sustained decline in other key rating factors.

A temporary breach of the leverage ratio is a lower rating risk than breaching risk-weighted regulatory capital buffer thresholds. Our primary measure of capitalisation is a bank's risk-weighted CET1 ratio. Absolute capitalisation levels and our expectations for their development relative to the risks a bank faces hold most weight when we assess capitalisation. All else equal, taking on more credit exposure for the same level of capital is a credit negative, unless this exposure is mitigated, for example by fiscal support mechanisms.

Ratings for AT1 instruments would face downgrades at an earlier stage if capital buffers are temporarily breached. Default risk would increase as headroom over relevant coupon omission points is eroded.

Banks have also been permitted to temporarily breach liquidity coverage ratios. We see less ratings pressure from temporary reductions in liquidity coverage ratios below 100% in light of the availability of secondary sources of liquidity from unprecedented levels of government and central bank liquidity support schemes.

Suspension of Dividends and Share Buybacks

Global financial institutions' announcements to suspend share repurchases and dividend payments, sometimes at the advice of the regulator, are supportive of ratings in the near term. They increase financial institutions' capital buffers to absorb shocks from the current crisis. In the longer term, how firms use any additional capital headroom amid a recession and rising credit or investment losses will be key for credit profiles, as will the timing, pace and extent of the eventual economic recovery.

Capital distributions may come under further regulatory or political scrutiny if the recession is deeper and longer, as in Fitch's downside scenario, which could make it more difficult for financial institutions to raise capital in case of need.

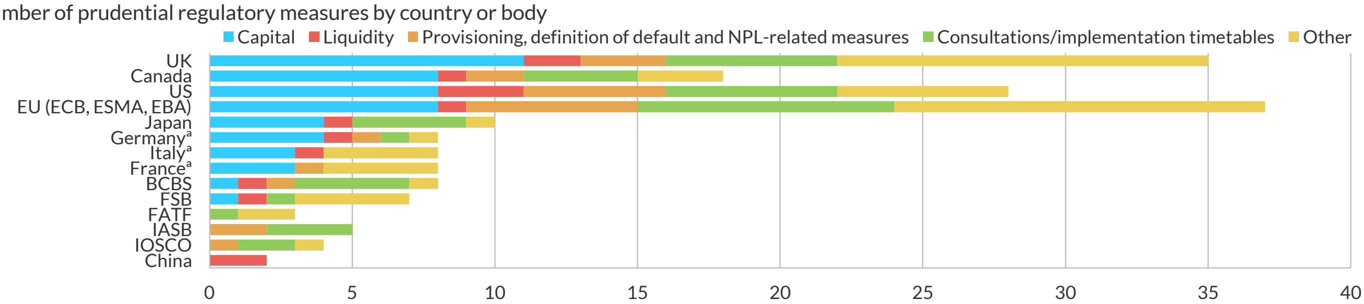
The decision to suspend common dividends on ordinary capital in some jurisdictions does not constrain banks to continue AT1 coupon payments.

Liquidity Provision by Central Banks

The decisive actions by central banks globally in response to extreme market volatility following the onset of the coronavirus crisis are positive for financial stability. The unprecedented

Coronavirus-Related Measures for Banks Have Focused on Capital

Number of prudential regulatory measures by country or body



[a] For Eurozone member states measures are included under EU. These numbers are additional, distinct measures taken by the country or clarifications based on changes by central banks/regulators.
Source: Fitch Ratings, IIF Database of Prudential Regulatory Measures for Banks

liquidity support and asset purchase programmes should reduce funding and liquidity risks for banks and other financial institutions in most jurisdictions. These actions have helped to stem equity market falls and widening spreads in bonds, which reduces valuation pressure on insurers' investment portfolios.

The US Federal Reserve (Fed) has broadened existing dollar swap lines with the ECB, Bank of Japan, and the Bank of England to boost US dollar funding markets in other markets. Supervisors have encouraged banks to use these facilities. In Europe, the ECB has provided banks with daily access to US dollar funding.

Central banks globally have loosened collateral eligibility requirements. In Europe, emergency asset purchase programmes and the extension of extremely cheap funding facilities are likely to lead to greater reliance on central bank funding in some jurisdictions.

Whilst cheaper funding supports financial institutions' liquidity, cuts to policy interest rates in developed and emerging markets will aggravate existing challenges to earnings, especially where profitability is already structurally weak at banks, insurers and NBFIs. Insurers' current spread-widening related to higher new money rates are unlikely to offset these weaknesses on a risk-adjusted basis. Lower interest rates over the longer-term could also cause insurers to increase reserves on long duration policyholder liabilities, as discount rate assumptions are lowered.

Central banks have also provided facilities to support mutual funds, such as the US Fed's Money Market Fund Facility and India's Special Liquidity Facility for Mutual Funds. Fitch estimates this support to be more than USD90 billion, underscoring the potential systemic risks that funds pose since more than globally doubling in size over the last decade. Large redemptions from funds could lead to fire sales of assets and increase financial market volatility. The scale of support is positive for mutual funds, but suggests that fund managers' liquidity management tools may be inadequate in a severe stress.

Related Research

Small Business Loan Program Risks May Impede US Bank Participation

Coronavirus Will Magnify CECL Challenges for US Lenders

Fitch Ratings Maintains EU Bank Capital Approach Despite ECL Waiver

Bank Accounting Rules Blunt Multi-Trillion USD Capital Relief

Temporary EU Regime Cushions Bank Creditors From Coronavirus Fallout

Coronavirus DM Bank Buffer Breaches May Not Trigger Downgrade

EU Banks Key Beneficiaries of Basel III Coronavirus Delay

Bank Suspension of Dividends, Buybacks a Near-Term Credit Support

Fed Actions, US Banks Discount Window Use Prudent Amid Turmoil

Fed's Intervention Stems U.S. Prime MMF Liquidity Strains

USD90bn of Central Bank Support Underscores Mutual Fund Systemic Risks

Corporates

Government support programmes will mitigate some short-term downward pressure on ratings to the extent that it solves an immediate liquidity concern, particularly among speculative-grade issuers. Fitch only incorporates liquidity support that has already been confirmed in its financial analysis. The potential for future support is not factored into forecasts due to meaningful uncertainty around timing, amounts, changing government rules and eligibility.

More broadly, downward pressure is indirectly mitigated, by the backstop these support programmes provide to the overall economy by preventing an even worse recession and larger unemployment.

Loans or Grants, Conditional or Not?

Government support programmes can be differentiated on the basis of the nature of funding being provided to companies. These can take the form of grants, loans or equity commitments that will, together with any conditionality, largely determine the impact on a company's credit profile.

Grants and Subsidies

Schemes such as the UK's Coronavirus Job Retention Scheme, Italy's wage compensation scheme and the US's USD25 billion in payroll grants for airlines (30% of which will be a low interest loan) are examples of important measures to compensate for, but maintain, costs which otherwise would have likely been reduced through staff layoffs. Such grants can help companies rapidly resume operations once lockdowns end as well as reduce the rise in unemployment. The cost base is maintained, and at least a portion of resulting losses is compensated.

Funding via grants is far better for the issuer's profile than via equivalently conditioned loans, both for liquidity and for the post-pandemic leverage profile. Over the medium to long term the impact may be more mixed and will depend on whether there are conditions attached that limit cost-reductions.

Payment Moratoriums

Deferral of rent, mortgages or utilities for a few months helps temporarily reduce cash outflows for companies adopting these measures, notably retailers. These measures can be disruptive to the cash flow of, for example, property owners while the postponement lasts. Fitch's Real Estate analysts note however that this short term cash flow interruption is not going to place downward pressure on our ratings for investment grade commercial real estate issuers in EMEA for instance as property companies rated by Fitch have resilient enough liquidity over 2020 to absorb it, see *What Investors Want to Know: Coronavirus and EMEA Property Company Liquidity*

These measures are, essentially liquidity support, and less likely than grants or subsidies to have a longer-term positive impact as most of the deferred costs eventually need to be paid.

Loans and Loan Guarantees

Most common, and least valuable for medium-term creditworthiness, are loans and loan guarantees. These are widespread and apply to businesses of all sizes, in all major economies. As stated earlier and according to the IMF, in many major economies government liquidity support through guarantees, loans and equity injections amounts to more than 10% of GDP, and globally it exceeds the value of direct fiscal stimulus.

Eligible commercial banks and state development banks are the main conduits of this liquidity to the real economy, with measures in place to incentivize banks to extend credit to businesses.

France has pledged to offer credit guarantees of up to 90% for loans to businesses of a total of EUR300 billion under the auspices of the EU's State Aid Temporary Framework, which significantly expands the flexibility for EU member states to deploy various forms of state aid. Germany has allocated EUR400 billion under its Economic Stabilisation Fund (WSF) for loans with credit guarantees between 80% and 100% and EUR365 billion to expand KfW's federal loan guarantees. For a full list of measures approved under the EU's temporary framework see here.

The US Federal Reserve's Main Street Lending Program worth USD600 billion is designed to provide liquidity to medium-sized business (up to 15,000 employees or USD5 billion of revenues) via three loan facilities (for a detailed analysis of the loan facilities under the US CARES Act see CARES Act's Benefit to U.S. Speculative-Grade Corporates Is Capped by Leverage Restrictions).

In almost all cases, loans incrementally increase an issuer's gross leverage, and treatment of leverage between facilities related to official support programmes and standard credit facilities will not be differentiated.

Compared to grants and deferrals, incremental loans are likely to create the largest hangover effect on post-pandemic credit profiles. On balance, we also expect the net effect of conditionality to be negative – conditionality that cements fixed costs will have a medium-term negative impact on the credit profile; conditionality on share buybacks and dividends will be only moderately supportive of a credit profile, given these will likely be measures than an emergency funding recipient would be considering in any event.

Relative Impact for Corporate Ratings

In the summary table below we offer a broad assessment of what different components of various policy responses may entail in terms of credit impact for non-financial corporates that access them. We do so with the caveat that this is a generalized picture and that the issuer impact will be assessed in line with our ratings criteria and the specific conditions of each issuer.

Policy Responses and Support Measures – Credit Impact Assessment by Type of Support

	Examples of support offered	Short-term credit impact on corporate issuer	Longer-term credit impact on corporate issuer
Tax relief and other tax measures	Japan: Tax payments for individuals and businesses negatively affected by the COVID-19 outbreak deferred by one year France: Deferral for three months of social security and tax payments for companies Germany: Businesses affected by COVID-19 allowed to defer tax payments to end-2020	Positive because it relieves pressure on liquidity	Neutral as these are temporary measures
Grants & subsidies (including wage support schemes)	Canada: Emergency Wage Subsidy: up to 75% of an employee's wages – up to CAD847 per week - for employers of all sizes and across all sectors who have suffered a drop in gross revenues Germany: Kurzarbeit subsidy: state will subsidise wages of workers who cannot work due to the lockdown Japan: Subsidies to firms who maintain employment during scale-down of operations US: Airlines rescue package: up to USD25 billion in grants to cover payroll expenses, on condition the airlines refrain from involuntary furloughs or workforce reductions to September 2020 (30% low-interest loans)	Generally positive on cash flows and operationally positive as this can facilitate resumption of operations	Mixed, depending on conditions that may limit long-term cost reduction ability
Loans and Loan Guarantees	France: State-backed guaranteed loans for businesses of up to 90% of loan value Germany: State-backed guarantees for loans (80%-100%) to companies (SMEs and larger companies) Italy: State guarantees for loans to support businesses and households UK: Coronavirus Business Interruption Loan Scheme for SMEs via British Business Bank US: USD670 billion in forgivable Small Business Administration loans and guarantees to help small businesses that retain workers (Paycheck Protection Program), with the loan converted to a grant if companies use 70% of it to retain staff and pay for utilities or mortgages[a] Canada: Business Credit Availability Program to provide credit facilities to lend to firms under stress	Positive due to liquidity support	Incremental debt that leaves net leverage higher by end-2021 will on balance be negative for profiles
Central bank corporate bond buying programmes	Japan: Bank of Japan temporary increase in the annual pace of purchases of ETFs, J-REITs, and temporary increase in purchases of corporate bonds and commercial paper. Eurozone: ECB expansion of Corporate Sector Purchase Programme UK: COVID-19 Corporate Financing Facility: Bank of England purchase of short-term debt set up by commercial banks US: Primary Market Corporate Credit Facility: Fed to purchase investment-grade and "fallen angel" corporate bonds in the primary market from May 2020 until September 2020 US: Secondary Market Corporate Credit Facility: Fed to purchase investment-grade and "fallen angel" corporate bonds and ETFs in the secondary market from May 2020 until September 2020 Canada: Corporate Bond Purchase Program for investment-grade issuers capped at CAD10 billion	Positive due to liquidity support, lower credit spreads and improved volumes in the primary refinancing market, as well as averting financial market shutdowns	Positive, as credit spreads, access to refinancing and relative financial market stability will benefit the issuer, for its own funding and for wider economic confidence

Policy Responses and Support Measures – Credit Impact Assessment by Type of Support (Cont.)

	Examples of support offered	Short term credit impact on corporate issuer	Longer-term credit impact on corporate issuer
Payment moratoria	France: Deferral of rent and utility payments for affected microenterprises UK: Three-month mortgage holidays for struggling residential mortgage owners (extended by another three months in May 2020) UK: Three-month moratorium against eviction for non-payment of rent for commercial and residential occupants	Positive due to liquidity boost (to the extent applicable to retail and other commercial property renters). Short-term cash flow disruption negative for property investment companies, lessors and utilities	Neutral as these are temporary measures

[a] According to Fitch Ratings PPP funding will be treated as a loan until they are confirmed to be forgiven by the SBA, at which point they will be recognised as a onetime income item (see Fitch Ratings report - CARES Act's Benefit to U.S. Speculative-Grade Corporates Is Capped by Leverage Restrictions, May 2020). Correct as of 15 May
Source: Fitch Ratings, IMF Policy Responses to COVID-19, official announcements

Targeted State Support for Specific Industries or Companies

While various support programmes have on the whole been industry-neutral, there are also cases of more targeted measures for specific industries or companies that are under more pronounced pressure due to the lockdowns. (Noting the exception of significant bolstering for healthcare systems to boost their capacity to fight the pandemic),

This support is in the form of targeted direct loans and loan guarantees, grants and tax programmes for specific industries.

Examples include targeted support for airlines, which according to the International Air Transport Association (IATA) amounts to a total of USD123 billion globally (as of May 2020), support for tourism sectors in various European countries announced or under consideration, while the EU's Temporary State Aid Framework provides EU-wide cover for EU member states to provide direct aid to companies and industries. The EUR7 billion loan and loan guarantees package by the French government for Air France was provided under the EU's state aid temporary framework for example.

A more unique element of targeted state support for a company is state equity stakes. While Fitch Ratings will consider grants, loans and tax relief as explained above, a sovereign taking an equity stake in a company will be an additional consideration.

State equity stakes can be supportive of a company's credit profile in the short term as they relieve an immediate liquidity concern while also not adding to overall debt leverage. Longer term, the picture may be more complex. In emerging markets, our assessment of state-owned entity support can add notches to an issuer's rating, so an increase in ownership may contribute to a more positive view on support. In contrast, in developed markets with strong state aid rules, the state's influence on strategic decision making, notably on personnel, environmental and sustainability targets for instance, may well be a net negative for the rating.

In the table below, we offer a broad assessment of the impact direct state support for an issuer will have on their short- and longer-term credit profiles. Again, this is a generalized picture and the issuer impact will be assessed in line with our rating criteria and the specific conditions of each issuer.

Targeted State Support For Corporates – Credit Impact Assessment by Type of Support

	Short-term credit impact on corporate issuer	Longer-term credit impact on corporate issuer
State equity stake with limited or no conditionality	Positive: liquidity boost, limits debt increase	Positive, though depending on size of the stake the state may influence decision-making
State equity stake with heavy conditionality	Mixed: liquidity boost, limits debt increase but can lead to increased costs	Mixed, depending on long-term costs associated with conditions and potential impact of state's influence on decision-making
Direct state loans with heavy conditionality	Mixed: liquidity boost but conditionality could lead to increased costs	Likely negative, depending on conditionality and impact on long-term fixed costs and on overall leverage
Direct state loans with limited or no conditionality	Positive: liquidity boost	Neutral to mildly positive if it lowers overall borrowing costs

Source: Fitch Ratings

Related Research

What Investors Want to Know: Our Initial Corporate Assumptions for 2021

CARES Act's Benefit to U.S. Speculative-Grade Corporates Is Capped by Leverage Restrictions

Higher US Corporate Revolver Use Is Not Always a Credit Negative

Fitch Takes Rating Actions on North American Airlines

What Investors Want to Know: Coronavirus and EMEA Property Company Liquidity

Structured Finance

Consumer-Focused Forbearance Is Most Impactful Among Policy Measures for Structured Finance

Among the many measures, forbearance of loans to households and SMEs has been adopted in all countries with an active securitisation market. For some sectors, lenders are encouraged – albeit not mandated – to work with borrowers who are or may be unable to meet their obligations because of the effects of COVID-19.

Borrowers will naturally benefit from any support measures easing the burden of reduced income, but the cash flow problem is shifted to any securitization that has been used to finance such loans. Senior costs and senior debt service will still need to be paid, even though the issuer will receive less cash as a result of the underlying assets temporarily providing less income. There is elevated default risk if there is insufficient cash flow or liquidity in the structure to withstand the reduction in cash available.

Fitch is incorporating consumer- and SME-focused payment holidays announced as part of COVID-19 policy responses in its ratings analysis across global Structured Finance. Loan forbearance will help reduce ultimate losses on securitised assets, but will inevitably delay the recognition of losses caused by the scale of coronavirus-related economic disruption in many markets.

In particular, Fitch takes into account these holidays in its analytical approach for the credit card, auto loan/lease, equipment lease and student loan sectors within ABS, and for RMBS transactions.

Fitch analyses borrower eligibility criteria and coverage periods for payment holidays, the expected holiday take-up and government plans to fully or partially cover the missed payments.

Transactions affected by measures available to a wide group of borrowers and not based on a borrower vulnerability assessment are most exposed to interest deferral risk. We also consider transaction specifics when determining if a Rating Watch or downgrade is warranted including the level of liquidity protection, whether interest can be deferred for certain classes and the expected duration and recovery of deferred amounts.

Low unemployment before the start of the coronavirus outbreak means that many non-legacy transactions will have started the crisis with full reserve funds, mitigating the effect of borrower non-payment.

Interest Deferral Analytical Approach Driven by Class Seniority

Most transaction documents allow for the deferral of interest payments on subordinated notes if collections plus additional available liquidity are insufficient for full interest payments. The unpaid interest portion will either be added to the principal balance or become payable once sufficient funds are again available.

We assign ratings in the 'Asf' and 'BBBsf' categories if interest can be deferred for short periods as long as these amounts are recovered well in advance of the final legal maturity of the notes and the option to defer interest is clearly evident to noteholders. We do not expect the non-payment of interest on subordinated deferrable classes to lead to downgrades provided the deferral is temporary and recoverable.

Subordinated notes often do not benefit from dedicated reserve accounts or liquidity facilities. However, transactions may avoid deferring subordinated note interest payments even if there is very high take-up of payment holidays if there is liquidity support from the servicer or sponsor, there are general reserves that have not been depleted, where excess spread is high, and/or interest payments are low.

In contrast to subordinated notes, non-deferrable senior notes often benefit from reserve accounts and liquidity facilities, which are usually sized to cover one to three months of senior fees and interest in a stabilized interest rate scenario assuming no collections. The low interest rate environment means that in-place liquidity can support senior interest payments over a significantly longer period than normal as long as reserve funds and liquidity facilities can be used for any cash flow disruption.

Fitch tests the impact of payment holidays on liquidity for senior notes in several sectors across EMEA (credit cards, auto loans/leases, equipment leases) and APAC (credit cards, auto loans/lease) and liquidity for all notes in EMEA and APAC RMBS. For EMEA RMBS transactions, the various government support measures are explicitly considered as mitigating factors when setting future portfolio default assumptions.

However, we do not assign 'AAAsf' or 'AAsf' category ratings to notes that we project will defer interest in our corresponding rating stresses. We would therefore consider downgrades to classes below the 'AAsf' category if any material interest deferral, even if permitted by the transaction documents, would occur.

US RMBS Payment Holiday Assumptions Vary by Product Type; Criteria Exposure Draft Published

In a US residential mortgage backed security (RMBS) Exposure Draft published 15 April 2020, Fitch introduced a new forbearance delinquency cash flow scenario by product type to reflect expected utilization of payment holidays. During the exposure draft period, Fitch will apply to new ratings the exposure draft assumptions related to payment holidays set out below. Fitch began applying the Payment Holiday Liquidity Stress in April 2020 to coincide with the expected start of the payment holidays.

These payment holidays are envisioned to be finite and therefore Fitch will begin stepping down the stress in October 2020 and remove it completely by January 2021 under the new base-case assumption. Fitch may decide to extend the payment holidays for longer than six months and/or may change the utilization rate if evidence shows utilization of payment holidays for longer periods or a greater number of borrowers utilizing payment holidays as a result of the health and subsequent economic crisis caused by the coronavirus.

Fitch is distinguishing between loans reported as delinquent due to forbearance/payment holiday and those due to credit concerns by adjusting its loss expectations in its surveillance criteria where applicable.

Non-Qualified Mortgage Treatment More Stressful than Prime Jumbo

For Non-Qualified Mortgage (NQM) and non-prime RMBS, Fitch is assuming 30% of borrowers will receive a payment holiday for six months. While we believe that self-employed borrowers, who can constitute 70%–75% of some of these pools, may be more vulnerable than salaried borrowers who can continue to work remotely, we do not expect delinquencies to rise to the level observed by legacy Alt-A collateral.

We expect NQM loans to perform better due to stronger federal consumer lending laws instituted post-GFC. NQM loans require lenders to document income and demonstrate ability to pay. Alt-A loans consist of primarily stated-income loans, which are currently prohibited by federal law.

The underwriting quality and large liquid transaction reserves are likely to cushion the number of borrowers needing payment holidays despite these documentation programmes resembling legacy Alt-A collateral. Most NQM RMBS provide for six months of advancing, have payment waterfalls that direct subordinated principal to pay timely interest to the 'AAAsf' and 'AAsf' bonds and have excess spread to absorb a rise in delinquencies.

Fitch assumes 25% of the collateral for prime jumbo RMBS will receive payment forbearance for six months before reverting to its standard liquidation timelines. We do not expect any impact on ratings for prime RMBS due to the advancing of delinquent principal and interest by the servicers and the back-up advancing by highly rated master servicers as long as the advances are deemed recoverable. In our view, these advances should be recoverable as long as the payment holiday does not result in a permanent loan modification with forborne principal.

If the duration or take-up rate of payment holidays is greater than initially assumed, Fitch may assume higher utilization rates or longer payment holiday durations when applying liquidity stress analysis. Additional payment holiday liquidity stresses may result in ratings impact on tranches originally rated 'Asf' or lower that were upgraded to 'AAAsf' or 'AAsf' if they are expected to experience recurring interest shortfalls as a result of the stress. Fitch will not assign 'AAAsf' or 'AAsf' category ratings to notes that we expect would defer interest under stress scenarios associated with those ratings, even if permitted under the terms of the documents. Lower-rated tranches could be affected if additional payment holidays result in increased realized losses.

The payment liquidity stress is designed to test the ability of the RMBS transaction structure to withstand a spike in payment forbearance or payment holidays available to borrowers. Forbearance in RMBS can either refer to a temporary (or "payment") forbearance, or it may refer to principal forbearance that results from a loan modification. Fitch believes that payment holidays will function as a temporary or payment forbearance. The magnitude of the assumptions is based on delinquencies for predominant borrower types in each product based on post-crisis or recent natural disaster performance.

Student Loan Treatment of Payment Holidays

Fitch is re-evaluating current sustainable constant default and prepayment rate assumptions for all US student loan transactions in surveillance. For new ratings it will continue to benchmark base-case default assumptions to recessionary performance while other assumptions, such as forbearance, will reflect changes to servicing policies.

Government Support Measures Have Limited Direct Implications on Analytical Approach for CMBS and CLOs

Fitch is not explicitly taking into account government support programs for CMBS transactions. Fitch's analysis is based on long-term sustainable income and/or value, which we do not believe will be materially affected by government support programmes, whether they are tenant payment holidays, grants or loans provided to tenants.

One of the key rating drivers for CLOs is the underlying asset quality (i.e. Issuer Default Rating) of the issuer of loans within the transaction. The impact of government support programmes would be reflected in the ratings provided by Fitch's Corporates teams.

Rating Implications of Policy Responses Depend on Sector

The rating impact of policy responses, in particular payment holidays, is mixed for structured finance transactions.

Interest payments on subordinated notes with weak liquidity provisions may be deferred if there is a high take-up of payment holidays for an extended period due to the coronavirus outbreak. Over the longer term, payment holidays may mask performance deterioration stemming from the economic shock caused by COVID-19 and containment measures. If this delays recognition of defaults and the start of provisioning mechanisms, senior noteholders would not benefit from a build-up of credit enhancement that would help insulate the transaction from further deterioration.

However, in some sectors transactions with low liquidity protection could withstand significant reductions in loan interest receipts. The eventual rating impact will depend on how widely payment holidays are used.

In addition, the language on payment holidays within transaction documents could have implications for servicer advancing. For example, in US RMBS, forbearance and realized losses are typically defined terms in the transaction documentation. "Payment forbearance", "payment holidays" and "payment deferral" are not typically defined in the transaction documents. Treatment for terms or plans not defined in the transaction documents is subject to the servicer's interpretation of the documentation.

Government-Sponsored Enterprises (GSEs) Credit Risk Transfer structures within RMBS are not adversely affected by the payment holiday delinquency stress. The GSEs advance both principal and interest to the bonds during the forbearance period and during repayment. The only potential impact is that the payment forbearance is counted as delinquent, which could result in a significant spike in delinquencies that could trip certain delinquency triggers.

If the triggers are tripped, only scheduled principal is paid to the subordinate bonds. To the extent that a material amount of payment holidays occur and result in permanent modifications to help bring the borrower current, the bonds could be vulnerable to write-downs. The structures write down the bonds for any modification loss amounts, including lost interest. While this amount is not expected to result in defaults in and of itself, it would be an additional challenge to future rating performance.

Government support that increases credit availability could reduce SME equipment leases' propensity to default on securitized rents and could also increase their ability to acquire financed equipment by monetizing the residual value at the end of the lease term.

Fitch acknowledges that government support initiatives may provide some relief for US student loans. However, this will only partly offset a rapid spike in unemployment and reduced income. Fitch will monitor additional developments and consider implications as more information becomes available. The student loan interest waiver and other payment relief initiatives in the CARES Act for all federally held student loans are not applicable to privately held student loans.

Related Research

Structured Finance's Forbearance Challenges Go Beyond Liquidity (May 2020)

Vulnerable Consumers Not Immune Despite UK Credit Card Payment Holiday (April 2020)

Exposure Draft: U.S. RMBS Coronavirus-Related Analytical Assumptions (April 2020)

RMBS Liquidity Protection, Loan Reporting Key to UK Payment Holiday Impact (April 2020)

Dutch RMBS Resilient to Higher Foreclosures and Price Declines (April 2020)

Japan's State of Emergency to Have Limited Impact on Auto ABS (April 2020)

Liquidity in Mexican SF Transactions Mitigates Initial Coronavirus Payment Holidays (March 2020)

Italy Payment Holiday Take-Up Rate Key to RMBS, CVB Impact (March 2020)

Coronavirus Payment Holidays Could Delay Subordinated SF Interest (March 2020)