MOODY'S INVESTORS SERVICE

Credit Risks in Turbulent Times

SECTOR COMMENT

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Credit Conditions – Global

Coronavirus and oil price shocks: managing ratings in turbulent times

The rapid and widening spread of the coronavirus, the deteriorating global economic outlook, lower oil prices and asset price declines are creating a severe and extensive credit shock across many sectors, regions and markets. The combined credit effects of these developments are unprecedented. At this time, the sectors with the largest exposure are those that are most sensitive to consumer demand and sentiment, including global passenger airlines, lodging and cruises, automotives, and segments of the oil and gas sector that are most affected by the oil price shock. Notwithstanding significant policy support, we expect credit conditions globally to deteriorate and defaults to rise in the coming months.

Our ratings consider numerous factors, including possible downside scenarios in the global economy or within a specific industry or asset class, that are intended to make them robust to a range of possible outcomes. Nevertheless, when we anticipate severe and enduring shifts in credit conditions, we change ratings to ensure the rating system continues to reflect our views on the ordinal ranking of credit risk on a forward-looking basis. Given sharply lower global growth expectations and acute market volatility, we have taken some rating actions in the most affected sectors already and expect to take more in the coming weeks. These actions reflect the breadth and severity of the shock, and the broad deterioration in credit quality that it has triggered.

We have undertaken a globally coordinated exercise to identify and rank order the susceptibility of rated issuers and transactions to current and future risks emanating from the coronavirus outbreak, liquidity and refinancing risk, and the collapse in oil prices. Using this approach, and recognising that there is a range of possible scenarios that could develop as events unfold, we have categorised rated entities across sectors into three distinct categories:

» **"High."** Entities that are highly exposed under our **baseline** macroeconomic and oil price scenario, with potential implications for their credit quality and ratings. Our baseline scenario assumes simultaneous demand and supply shocks to the global economy over multiple quarters, with GDP growth for G-20 countries coming in at around 2% in 2020, the weakest pace of expansion since the 2008-09 global financial crisis. In this environment, financing conditions will start to ease after a temporary but intense turbulent period. Oil prices also will start to rise gradually later this year, from their current levels.

» **"Moderate."** Entities that under our **downside** macroeconomic and oil price scenario would likely be exposed to an extensive and prolonged slump, with potential implications for their credit quality and ratings. In this scenario, a sustained pullback in consumption and extended closures of businesses will hurt earnings, drive layoffs and weigh on business and consumer sentiment, raising the risk of recession. Prolonged asset price volatility would also magnify the economic shock. Financing conditions would likely remain very tight for all but the highest-rated issuers for a prolonged period of time. Oil prices would also remain depressed through much of this year, onto next year.

» **"Low."** Entities with **low or limited** meaningful exposure to their credit quality or ratings under either our baseline or downside macroeconomic and oil price scenarios.

This approach enables a prioritisation of deeper reviews, and potentially, rating actions in a systematic and consistent way globally.

Speculative-grade companies with weak liquidity and refinancing profiles across the most-exposed sectors dominate the higher-risk categories. The modest decline in headline growth we expect under our baseline scenario masks severe retrenchment across many exposed sectors individually. Companies in these sectors will have much less flexibility to adjust to event risks and mitigate negative credit pressures arising from reduced revenue and margins, and from supply chain disruptions. They may also have upcoming refinancing needs at a time when access to capital markets is constrained. Looking through the credit cycle, these issuers are also more likely to have enduringly weaker credit profiles after the global economy has recovered and the pandemic has subsided. As a result, negative rating actions are more likely for issuers rated lower on the scale. Rating transitions could be particularly severe in cases in which we perceive material increases in near-term default risks.

Investment-grade companies on average have less exposure to meaningful changes in credit quality and ratings. These issuers typically have multiple levers that they can pull to address liquidity and refinancing needs, including reducing capital spending, share buybacks and dividends, and increasing asset sales (beneficial for liquidity, although asset sales also reduce future earnings and cash flow). Furthermore, rating actions will be more tempered for higher-rated companies that are likely to benefit from policy intervention or extraordinary government support. Such policy impetus may reduce the severity of rating actions for companies rated investment grade or near investment grade, particularly when policy transparency and predictability and government intentions are aligned to provide support. We view government support as likely for sectors of strategic or significant national importance.

For most global sovereigns, the immediate credit and rating implications will likely be limited as long as the expectation continues that the shock will be severe but short-lived. Governments can weather storms other debt issuers cannot, tapping broad sources of revenue and funding. They also have a unique ability to determine which expenditure obligations they can meet without sanction. However, if sustained, a risk-off environment would have significant rating implications for some lower-rated sovereigns. The more vulnerable sovereigns in this category are likely to be those that rely on external financing with significant financing needs.

Currently, most regulated banks and insurers are well positioned at their rating levels, and their credit profiles will become vulnerable to the extent the economic shock broadens and lengthens relative to our baseline macroeconomic assumptions. The coronavirus outbreak will have a direct negative impact on the asset quality of rated financial institutions and on the underwriting of insurers. Global monetary easing and related initiatives will help to relieve liquidity pressures but will weigh on profitability across the financial sector, and will weaken some insurers' capitalisation. Rated financial institutions particularly at risk include undiversified banks with material exposure to high-risk sectors, life (re)insurers with material exposure to mortality among older people and credit insurers with material exposure to small and medium-sized enterprises (SMEs). Other at-risk sectors include aircraft lessors and other finance entities focusing on fuel and transportation subsectors, service providers with business models reliant on spread income such as independent broker dealers, mortgage servicers with weaker origination platforms, and insurers and other financial institutions whose capitalisation or profitability would be impacted by sustained low interest rates and equity indices.

For structured finance transactions, we will assess performance, structural protections and any impact on sponsors and counterparties as the situation evolves. Although our ratings incorporate forward-looking views and take into account timely information available to us, we will further intensify our efforts to ensure ratings on both new and existing transactions reflect ongoing credit weakening as well as various support that some consumer or corporate obligors and counterparties will receive. The impact will vary by asset type. The direct impact will likely be smaller for transactions backed by consumer assets because they benefit from diversification; also, governments or sponsors may provide support to consumers in the near term. Prime borrowers will likely be more resilient in times of turbulence than will non-prime borrowers. The credit challenges will be more acute for some corporate and commercial assets, in particular those securing aircraft leasing asset-backed securities (ABS), SME ABS, and certain equipment leasing ABS and commercial mortgage-backed securities backed by hotel and retail assets. Collateralised loan obligations (CLOs) are generally very well diversified across many industries. However, they are backed by highly levered and risky borrowers typically rated B2 or B3; therefore they are vulnerable to prolonged credit deterioration. Nonperforming loan transactions are also more vulnerable as they are exposed to investment sentiment and functioning property markets.

While we will endeavour to position and, if necessary, reposition ratings at their appropriate levels as quickly as possible, we also recognise that greater visibility over the depth and length of the current crisis will be necessary in order to fully quantify the impact across some industries. Likewise, the degree of any external intervention (for example, short-term government support measures) may not be immediately known. Such intervention would provide a significant buffer to issuers from the economic fallout. We are therefore likely to put ratings under review for possible downgrade in many industries and asset classes, which will enable us to signal different forms of severity, ahead of ratings settling at their current level, a lower level, or in some cases potentially much lower levels.

Moody's related publications

Sector In-Depth

- Companies – EMEA: Coronavirus will curb profitability and test the liquidity of lower rated companies, March 2020
- Corporates – Global: Heat map: Coronavirus hurts travel-driven sectors, disrupts supply chains, effects compounded with global spread, March 2020
- Corporates – North America: Heat map: Coronavirus will negatively impact corporate credit, effects widen in downside scenario, March 2020
- Insurance – Cross Region: EMEA Heatmap: Low interest rates and market volatility are insurers' key risks, March 2020
- Default Trends – Global: February 2020 Default Report, March 2020
- Global Macro Outlook 2020-21 (March 2020 Update): Coronavirus will hurt economic growth in many countries through first half of 2020, March 2020
- Oil and Gas – Global: Low oil prices heighten financial risks in 2020, March 2020
- Financial Stability – US: FAQ on rising corporate leverage and credit implications for CLOs, December 2019
- Nonfinancial Corporates – US: As low-rated spec-grade universe expands, more rated companies will likely default or be downgraded in the next downturn, September 2019

Topic page

- Coronavirus Effects

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