Tax Reform – US

Corporate tax cut is credit positive, while effects of other provisions vary by sector

Summary

A sharply reduced statutory corporate tax rate is the centerpiece of the wide-ranging tax legislation that the US Congress passed on December 20. The cut to 21% from 35% will boost corporate cash flow, a broad credit positive. But the sweeping tax legislation makes many changes to the tax code, some of which will be credit negative for certain sectors.

» US sovereign. The legislation is credit negative owing to a $1.5 trillion deficit impact over 10 years that will make federal debt reduction even more challenging. The tax cuts will contribute only modestly to aggregate economic growth, in the range of one-tenths to two-tenths of a percent of GDP, due mostly to higher household consumption rather than an increase in business investment.

» Non-financial companies. The corporate tax rate cut and full upfront deductibility of capital spending will outweigh the cost of a limitation on interest deductibility for all but a handful of investment-grade US companies. Limits on interest deductibility will leave many highly leveraged companies worse off.

» Utilities. The legislation is credit negative for investor-owned utilities because a lower tax rate will reduce the difference between the amount that utilities collect from rate payers to cover taxes and their payments to tax authorities, reducing cash flow.

» Financial institutions. A reduced corporate tax rate will lead to a net reduction in banks’ tax liabilities and an associated improvement in profitability, which will mostly benefit shareholders. Write-downs in the value of deferred tax assets could have some modest impact on banks’ reported capital ratios. The tax bill is net positive for most asset management firms, with potentially greater benefit for those with foreign earnings. It is also a net credit positive for insurers, but impacts are company specific.

» Public finance. The new $10,000 limit on state and local tax deductions will blunt the effect of lower federal rates for many taxpayers; reduce governments’ financial flexibility by increasing anti-tax sentiment; widen tax rate disparities among states and metro areas; and, in conjunction with a higher standard deduction and a limit on the mortgage interest deduction, reduce the tax incentive for home ownership.

» Structured finance. Generally lower tax obligations for US corporations and individuals will support debt service capacity for both groups of obligors; however, the legislation also will likely result in credit negative tax increases on a subset of obligors, and create risks in certain sectors, such as via negative effects on home prices.
Tax bill will have a modest impact on growth, but will support equity prices

We expect the US economy to grow by around 2%-2.5% in 2018-19, with some potential upside suggested by the recent strong performance. These forecasts incorporate our view that the contribution of the tax cuts to aggregate economic growth will be modest, in the range of one-tenth to two-tenths of a percent. The marginally stronger growth will be driven mainly by somewhat higher household consumption resulting from individual tax cuts. We do not believe that the corporate tax cuts will meaningfully increase business investment spending. The tax changes will be modestly positive for stock prices, given the resulting higher after-tax corporate earnings.

<table>
<thead>
<tr>
<th>Sector</th>
<th>Key Takeaways</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal government</td>
<td>Tax cuts will increase deficits, adding to an already rising sovereign debt burden, a credit negative for the sovereign.</td>
</tr>
<tr>
<td>Non-financial companies</td>
<td>Corporate tax rate cut and full upfront deductibility of capital spending will benefit most investment-grade US companies while limits on interest deductibility will leave many highly leveraged companies worse off. Changes to taxation of multinationals are positive for US-based corporations with foreign operations. However, provisions intended to curb companies’ ability to shift taxable income outside the US could introduce costs to companies with non-tax business reasons for global corporate integration.</td>
</tr>
<tr>
<td>Public finance</td>
<td>The bill is broadly negative for municipal bonds. Limits on state and local tax deductions will reduce governments’ financial flexibility and widen tax rate disparities among states and metro areas. Other provisions will be negative for non-profit hospitals and healthcare systems, housing finance agencies, and private colleges and universities.</td>
</tr>
<tr>
<td>Utilities</td>
<td>The lower statutory corporate tax rate and loss of bonus depreciation will negatively impact the cash flow of investor-owned regulated utilities.</td>
</tr>
<tr>
<td>Structured finance</td>
<td>Tax cuts for US corporations and individuals will generally boost debt service capacity for both groups of obligors, supporting the performance of underlying assets. However, the benefits of tax cuts will differ based on factors such as income, location and family size, creating greater risk of negative effects for certain sectors or specific transactions.</td>
</tr>
<tr>
<td>Financial institutions &amp; Insurance</td>
<td>The reduction in the corporate tax rate will generally result in lower tax liabilities for most financial institutions including banks, asset managers and insurers, boosting profitability. The impact on asset risk will be mixed. Lower top corporate and individual rates will be positive for asset managers. The repeal of the Affordable Care Act’s individual mandate will be negative for health insurers with exposure to the individual marketplaces.</td>
</tr>
</tbody>
</table>

We believe the impact of the tax cuts on economic growth is likely to be modest for the following key reasons. First, while corporate tax cuts could raise business investment on the margin, nonfinancial corporates that have held back investment in this low interest rate environment may not plow back the windfall from a lower tax rate into investment, instead choosing to either pay down debt or engage in share buybacks. Second, the income tax cuts will be proportionally larger for higher-income households, which have a relatively lower propensity to spend and therefore will be more likely to save a large part of the cuts. Third, any government spending cuts undertaken to pay for the tax cuts could actually lower growth.

About this report

This report sets forth our preliminary assessment of credit implications of the tax legislation for different sectors of the US economy. We have focused on the main provisions that we think are most relevant for credit quality in specific sectors. Given the complexity of the bill and uncertainty as to how issuers will respond to the changes, it is difficult to assess the legislation’s net credit effect. Further, a degree of uncertainty remains as the Department of the Treasury and Internal Revenue Service will take time to write rules, especially regarding international taxation; various provisions including those on individual taxation will change or phase out over the next decade; and there may be some technical corrections to the legislation.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moodys.com for the most updated credit rating action information and rating history.
We expect that with above-trend growth and full employment, in part related to the tax cuts, inflation measures will strengthen over time, eventually stabilizing around the US Federal Reserve’s inflation target of 2%. This momentum will bolster the Fed’s confidence to raise the fed funds rate two to three times in 2018. The higher debt trajectory resulting from any unfunded element of the tax cuts is likely to push interest rates up somewhat in the medium term. While we expect that the 10-year yield will gradually rise to around 3% by the end of 2018, similar to our pre-tax-cut view, we forecast that it will be about 15 basis points higher than previous estimates by 2022, at slightly above 4%. Should the tax cuts have a larger positive impact on growth than we expect, consequent inflationary pressures would likely contribute to a faster withdrawal of monetary policy accommodation.

All else equal, the tax bill will have a regionally uneven effect on the housing market in the short term. Since the tax law reduces the value of the mortgage interest deduction and property tax deductions, house price growth may slow in areas with high property taxes. Overall, however, the positive impact of higher household after-tax income and higher wealth effect from higher stock prices on housing demand should offset any negative impact of smaller property-related deductions on the housing market.
Tax cuts will increase deficits, adding to an already rising sovereign debt burden

On balance, the new legislation is negative for the credit strength of the US sovereign (Aaa stable). Given the modest growth impact, we do not believe that the tax reform will be self-financing. We also think it is unlikely that tax cuts will be offset by equivalent cuts to spending in the near term. At only 3.2% of GDP in 2017, potential reductions in discretionary spending would be too small to finance the planned cuts. And mandatory spending largely consists of entitlements, where cuts will be politically challenging, particularly given the upcoming midterm elections and the 51-49 split of the Senate as of the beginning of 2018. The challenge of financing the tax cuts will be compounded if, as typically has been the case in the past, some of the temporary tax cuts, particularly those on household incomes, are extended by a future Congress.

Absent other measures to finance the tax cuts, we believe that the deficit will rise by at least $1.5 trillion over the coming 10 years on a dynamic basis. Our estimate of the cost of the bill assumes that some of the temporary tax cuts will be extended. Higher deficits will exacerbate pressures on the federal government’s finances that are already likely to arise in the coming years from the rising cost of entitlements. Over the longer term, unless the course of fiscal policy is changed through revenue-increasing or expense-reducing measures (and, for the reasons noted above, both are likely to be needed to meaningfully reduce the debt burden), we believe that the federal government’s debt-to-GDP ratio will rise by more than 25 percentage points over the next decade, to above 100%. Combined with rising interest rates, debt affordability will weaken significantly.

Worsening debt metrics will accentuate the importance for the US’ credit profile of its extraordinarily high economic strength, and the unrivalled capacity to issue debt conferred on the US government by the benchmark status of US Treasury instruments and the reserve status of the US dollar.

Exhibit 3
Tax bill accelerates expected deterioration in US government fiscal metrics
% of GDP or revenue

Sources: Moody’s Investors Service, Congressional Budget Office
Key provisions of tax bill benefit all but highly leveraged non-financial companies

Most US non-financial companies will benefit from the tax overhaul, except those that are highly leveraged. We think the corporate tax rate cut and full upfront deductibility of capital spending will outweigh the cost of a limitation on interest deductibility for all but a handful of investment-grade US companies. Based solely on these three factors, a disproportionate share of speculative-grade companies will see their tax liabilities rise relative to current law. Those effects are concentrated among companies rated single-B and below, with less than 7% of Ba-rated companies worse off under the earlier House and Senate plans.1

Exhibit 4

Net effect of initial tax proposals most punitive for sectors with high leverage

Note: Percentage of companies worse off (tax position is more burdensome) under House and Senate proposals when combining the effects of (1) cut in the tax rate to 20%, (2) limits on interest deductibility and (3) full capex deductibility.
Source: Moody’s Investors Service

Sectors with high leverage and with significant leveraged buyout activity such as technology, healthcare and aerospace & defense have the highest percentage of companies worse off (see Exhibit 4). The bite from interest deductibility limitations is mitigated for capital-intensive industries because of the ability to fully deduct capital expenditures in the year spent. However, the phase-out of upfront deductibility of capital spending after five years will leave more speculative-grade companies worse off unless future legislation extends the benefit or companies diminish their use of debt to lower interest costs.

Exhibit 5

Net effect of initial tax proposals benefits almost all investment-grade companies

Note: Percentage of companies worse off (tax position is more burdensome) under House and Senate proposals when combining the effects of (1) cut in the tax rate to 20%, (2) limits on interest deductibility and (3) full capex deductibility.
Source: Moody’s Investors Service

As a consequence of the limits on interest deductibility, defaults for lower-rated issuers could increase in a downturn. Shifting to an earnings-based limit on interest deductibility will make companies more vulnerable to an earnings downturn because interest will comprise a higher percentage of a declining amount of pre-tax income. Some companies could find themselves in the unenviable position of having a positive cash tax burden but negative free cash flow. This is more likely to occur among less capital-intensive...
industries, where there is less ability to preserve cash through reductions in capital spending. However, companies and industries subject to continual competitive pressure from technology advances and secular shifts have less flexibility to pull back on investment spending and research and development because doing so would negatively affect their market position.

The private equity buyout model will become less attractive due to interest deductibility limits. The loss of interest deduction infringes on the underpinnings of the private equity strategy to acquire portfolio companies through highly levered transactions, as it will increase the cost of capital. As a result, it will weaken private equity firms’ ability to compete for assets, particularly against companies with increasing cash flow as a result of the lower tax rate.

**Major changes to taxation of multinationals increase tax base and lower tax rate, overall net credit positive**

The tax legislation incorporates three major changes to taxation of multinational corporations. The bill outlines a new territorial-based tax system, which supersedes the prior taxation of US corporate earnings from foreign subsidiaries upon repatriation. It imposes a one-time transitional tax on previously deferred foreign income. New anti-base-erosion measures are intended to challenge the ability of US and foreign multinationals to shift taxable income outside the US.

The new US territorial-based tax rules, consistent with tax systems in most major economies, will generally benefit US multinationals, a credit positive. Instead of paying tax on their worldwide profits, multinationals with US parents will benefit from a 100% deduction of their foreign-source dividends. Additionally, taxation of direct investment in US property by subsidiaries of US multinationals has been repealed. This shift could have an important impact on the future financial management of US multinationals, which have accumulated large offshore cash balances while often incurring domestic debt to finance US investments, stock repurchases and shareholder payouts.

The bill also outlines a transitional tax on previously untaxed foreign earnings. Multinationals’ share of all accumulated foreign earnings will be charged a 15.5% tax rate for liquid and 8% for certain illiquid assets, payable in installments over eight years. Those companies that otherwise would have repatriated earnings at a 35% tax rate will benefit from the lower rate, a credit positive.

The anti-base-erosion measures aim to reduce the incentive to shift profits abroad to foreign affiliates in lower-tax jurisdictions. The legislation introduces a tax on expensed payments by US corporations to foreign affiliated companies. Additionally, a new tax is imposed on excess returns on asset investments in foreign subsidiaries, aimed at capturing profits accruing to highly mobile, intangible capital. Along with other measures, these provisions may be effective in curbing tax base erosion by multinationals. The measures will also introduce real costs to those multinationals with non-tax business reasons for global corporate integration. These changes are complex and may have mixed credit implications.

**Tax bill has negative credit implications for investor-owned utilities**

Within the investor-owned utilities sector, the just-passed tax legislation will have an overall negative credit impact on regulated operating companies and their holding companies. Although the regulated utility sector is carved out in terms of the treatment of interest deductibility and expensing of capital expenditures, from an earnings perspective, the effect on regulated entities is neutral because savings on the lower tax expense are passed on to their customers as required by regulation. However, from a cash flow perspective, the legislation is credit negative.

Investor-owned utilities’ rates, revenue and profits are heavily regulated. The rate regulators allow utilities to charge customers is based on a cost-plus model, with tax expense being one of the pass-through items. In practice, regulated utilities collect revenues from customers based on book tax expense but typically pay much less tax in cash due to tax deferrals. The consolidated entity's cash tax obligation may be even less because, among other things, the utility holding company can claim holding company interest and expenses as deductions. Most utility holding companies paid little or no cash taxes in 2017.
With the lower tax rate and the loss of bonus depreciation treatment, utility cash flows will be negatively affected by three tax dynamics:

» A fall in the tax rate means that regulated entities will collect less revenue from customers for the purpose of tax expense compensation. Going to a tax rate of 21% from 35% represents about a 40% fall in revenue collection related to tax expense. Although this revenue is ultimately paid out as an expense, under the new law utilities will lose the timing benefit, thereby reducing cash that may have been carried over many years.

» Lowering the tax rate also means that utilities will have over-collected for tax expense in the past because they charged for future tax expense assuming a 35% tax rate. As utilities refund the excess collection to customers, it will reduce cash flows, likely spread out over 20 years.

» The loss of bonus depreciation treatment means that most utilities will start paying cash tax in 2019 or 2020, earlier than under the current tax law. The loss of bonus depreciation treatment means that utilities can claim less in depreciation expenses and will therefore have higher taxable income. We still expect utilities to pay little or no cash tax in 2018 because most have significant accumulated net operating losses driven by past claims of bonus depreciation.

Based on our preliminary analysis, all else being equal, the fall in cash flows is significant for many companies. Out of our portfolio of 215 regulated utilities and their holding companies, we expect that up to 20% of them will see meaningful declines in key financial metrics. As shown in the table below, for this subset of most exposed companies, we estimate that the ratio of cash flow from operations pre-working capital (CFO pre-WC) to debt will on average fall about 133 basis points. If not addressed, this could lead to negative rating actions.

### Exhibit 6
Credit statistics for utilities most exposed to tax legislation

<table>
<thead>
<tr>
<th>Entity Type</th>
<th>Avg Rating</th>
<th>CFO pre-WC to debt (avg 2018 and 2019 forecast)</th>
<th>Difference (bps)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Current Tax Law</td>
<td>Under New Tax Law</td>
</tr>
<tr>
<td>Holding Companies</td>
<td>Baa2</td>
<td>14.3%</td>
<td>13.1%</td>
</tr>
<tr>
<td>Gas Distribution</td>
<td>A2</td>
<td>18.7%</td>
<td>16.9%</td>
</tr>
<tr>
<td>Transmission and Distribution</td>
<td>A2</td>
<td>18.6%</td>
<td>17.0%</td>
</tr>
<tr>
<td>Vertically Integrated</td>
<td>A3</td>
<td>18.8%</td>
<td>17.6%</td>
</tr>
<tr>
<td>Grand Total</td>
<td></td>
<td>16.9%</td>
<td>15.6%</td>
</tr>
</tbody>
</table>

Source: Moody’s Investors Service

**Tax bill will overall be credit positive for US banks**

Changes to the corporate and individual tax codes present a complex set of positive and negative effects on US banks’ profitability and asset risks. But overall, they are positive for bank creditworthiness.

There will be losses of some deductions to taxable income including the phasing out or elimination of deductions for FDIC premiums, depending on a bank’s size by assets. Write-downs in the value of deferred tax assets could have some modest impact on banks' reported capital ratios. Even with these changes, the reduction in the corporate tax rate will lead to a net reduction in banks’ tax liabilities and an associated improvement in profitability.

We do not expect these gains to result in immediate increases in paid-in capital, with higher profits likely benefiting shareholders more than creditors as dividends or share buybacks increase commensurately. The lower tax burden will, however, provide greater protection to capital in the event of increased credit or other costs.

Implications of “second order” effects of the tax bill for banks’ exposures, credit demand and financial market dynamics are more difficult to discern at this stage.
With regard to retail exposures and activity, overall, the increase in individuals’ after-tax income is credit positive. However, for certain borrowers, the reduction or elimination of their ability to deduct state and local taxes or interest on outstanding mortgages could have some impact on credit demand and borrower creditworthiness, particularly with regard to mortgage exposures.

For corporate banking, changes to interest deductibility could lead to reduced demand for loans, with companies possibly opting for leases for some capital purchases, for example. In addition, since a disproportionate share of highly leveraged companies are likely to face higher tax bills than under current law, as noted above, some corporate borrowers could find themselves with positive cash tax burden but negative free cash flow. This could also lead to an increase in defaults for more highly leveraged borrowers in a downturn.

In terms of capital markets activity, the cut to the corporate tax rate will support equity valuations. This could, in turn, support IPOs. Conversely, debt capital markets could see some adjustments, with changes to interest deductibility leading to lower levels of issuance for non-investment grade debt.

**Lower tax rate is positive for US-based insurers, partly offset by new revenue-raising measures**

For domestic insurers, the tax bill is net credit positive, largely because most US-based insurers currently pay an effective tax rate higher than the proposed 21% tax rate. While the legislation is a net positive for the overall insurance sector, taxes are complex and the credit impact on individual insurers will be specific to their circumstances.

The benefit of lower corporate tax rates is at least partially offset by new taxes for insurers. For life insurers, beyond the lower corporate rate, the implications of the legislation will depend on a range of factors including product mix and balance sheet characteristics. For example, the restatement of tax reserves equal to the greater of net surrender value or 92.81% of statutory reserves increases cash taxes but also could clarify the calculation of tax reserves for products affected by the new principles-based statutory reserving methodology.

The lower tax rate will also likely lead to write-downs of net deferred tax assets (DTAs) and the need to recognize an immediate associated loss on a GAAP and potentially a regulatory basis. Also, the higher deferred acquisition cost capitalization charges would increase cash taxes but extend the amortization period. Insurers may not fully realize the financial benefit on newly written business, especially in competitive product lines, since prices will likely quickly adjust to the new tax environment. Lastly, NAIC risk-based capital (RBC) ratios for life insurers would decline (beyond the DTA implications). For some firms, the decline could be meaningful, as much as 100 basis points on their RBC ratios, even with the same investment risk, assuming tax rates used in the calculation are adjusted.

US-based property and casualty (P&C) (re)insurers, particularly those with primary sources of business in the US that have been paying meaningfully higher effective tax rates than 21%, would likely become more competitive with their global counterparts. These benefits would be partially offset by higher taxable income related to a change in the loss reserves discounting rule. The new rule extends payout patterns of insurers’ long tail lines to all lines, prescribes a new interest rate and repeals the use of insurers’ own loss payout patterns.

Municipal bonds have been an attractive asset class for many US-based P&C insurers. Given the lower tax rate and the higher proration factor, there could be lower demand from P&C firms for these bonds, which could lead to a decline in value. However, P&C (re)insurers generally hold investment-grade municipal bonds in their investment portfolios, hold them to maturity and could withstand volatility in market prices. Over time, (re)insurers with concentrations in municipal bonds could shift investment allocations away from such assets, given the reduced tax benefits.

Insurers and reinsurers that cede meaningful US business to their non-US affiliates in lower-tax jurisdictions will be negatively affected by the new tax law. Under the base erosion provision2 in the bill, such (re)insurers will face higher taxes on premiums ceded to non-US affiliates (e.g. 5% in 2018, 10% in 2019 to 12.5% in 2025). This provision could lead US (re)insurers with non-US parents to reconsider their strategies, depending upon the profitability of the underlying business, potentially retaining more business in the US and building capital over time or writing more business directly offshore.

For most for-profit health insurers, the lower tax rate outweighs other factors given that current effective tax rates range from 31%-39%, making the reduced tax rate a significant credit positive. This is partly offset by the repeal of the Affordable Care Act’s individual mandate, which will likely reduce stability and raise costs in the individual market for those companies that remain.
Asset management firms to benefit from changes to the corporate and individual tax codes

The tax bill is net positive for most asset management firms, with potentially greater benefit for those with foreign earnings. Asset managers will benefit from the new 21% corporate tax rate, which is well below the 30%-35% effective rate that we estimate for our rated asset management firms. Asset managers could use cash generated by the reduction in the statutory rate to fund operational improvements and growth initiatives, a credit positive.

Asset management firms that derive a large share of their pretax income abroad are likely to benefit from the changes to taxation of multinational corporations. For those that have previously accumulated profits overseas that are yet untaxed in the US, the one-time tax of 15.5% on repatriated foreign cash represents a large discount to the prior 35% rate. These same asset managers will not be taxed on much of their future foreign earnings either.

However, asset managers will be subject to anti-base-erosion measures to deter shifting taxable income abroad, which could be negative for some. Asset managers that have been unable to defer their prior foreign earnings from US taxation will be less directly affected by the international provisions, as the rules requiring current US taxation of certain passive foreign income remain mostly unchanged.

The lowering of the top personal tax rates and changes to the alternative minimum and estate taxes will enable individuals to invest more of their income and inherited wealth in managed accounts and funds, helping retail and high net worth managers grow assets and related fees. Of the total assets managed by a select group of large global asset managers that we rate, approximately 30% is managed on behalf of retail clients. As this figure excludes assets managed on BlackRock’s iShares platform ($1.6 trillion as of September 30, 2017) and those managed on behalf of high net worth clients, it understates the scope of the potential benefit to such managers.

For private equity firms, the leveraged buyout model will become less attractive as highly leveraged portfolio companies will be subject to a limit on interest deductibility. The interest deductibility limit could slow private equity deal flow and crimp investor returns, particularly in a rising interest rate environment.

Tax bill is negative for state and local governments, non-profit hospitals, housing finance agencies and private colleges

The net impact of the enacted bill is negative for state and local governments, even though a modest expected boost to GDP and employment would be positive.

While the new $10,000 limit on state and local tax (SALT) deductions does not directly impact state or local tax receipts, it will blunt the effect of lower federal rates for many taxpayers, reduce governments’ financial flexibility by increasing anti-tax sentiment and widen tax rate disparities among states and metro areas. The SALT change plus the higher standard deduction and tighter limit on the mortgage interest deduction also reduce the tax incentive for home ownership, which is likely to slow home construction and sales, and moderately suppress home values and property tax growth in higher-price markets.

State and local taxes paid in 2015 (the most recent year available) totaled $1.5 trillion, according to the US Census Bureau, and SALT deductions totaled $550 billion. Nationwide, 30% of tax returns use the SALT deduction; in high-wealth and high-tax states such as Connecticut, Maryland and New Jersey, the number is greater than 40%. The average SALT deduction in those states ranges from $12,000 to $19,000; New York’s average SALT deduction is the highest in the nation at $22,000 (see Exhibit 7). Taxpayers with adjusted gross incomes between $100,000 and $500,000 account for 16% of all returns filed, but nearly 50% of all SALT deductions.
Significantly limiting the SALT deduction raises the effective cost of these taxes and will offset much of the federal rate cut for many taxpayers. New York, Connecticut and New Jersey have the highest state and local tax burdens, according to the Tax Foundation, and limits on federal deductibility of those taxes could push some of the wealthiest taxpayers to consider relocating to lower-tax states. Those higher effective tax costs also will constrain governments’ revenue flexibility by increasing political resistance to tax increases in states and municipalities. In addition, if larger federal deficits caused by the tax cuts result in attempts to cut entitlement spending, states will be pressured to backfill cuts to federal funds from their own budgets.

The new law also has negative credit implications for non-profit hospitals and healthcare systems, housing finance agencies and private colleges and universities. For hospitals, the repeal of the individual insurance mandate will increase the uninsured population and raise uncompensated care costs, hurting operating margins and cash flow. Housing finance agencies can expect reduced equity investment in multi-family projects due to the corporate tax rate reduction because investors will have less incentive to buy the tax credits that help finance them, making these projects more challenging. Private colleges will see a negative effect on alumni giving due to the increased standard deduction available to individuals and modifications to the estate tax. Some estates have structured their philanthropy to limit the estate tax, but with fewer estates liable for the tax, that planned giving may disappear. In addition, the wealthiest universities will also see a 1.4% tax on endowment earnings that inhibits the long-term growth of financial resources.

New limits on tax-exempt advance refundings are a negative for all governmental and other issuers of tax-exempt debt; these financings have been used extensively to take advantage of lower interest rates and reduce long-term borrowing costs. The decrease in the corporate income tax rate also makes tax-exempt bonds a less attractive investment for banks and other financial institutions, which will weaken demand, especially for direct bank loans and private placements. In high-tax states, demand could increase from individual investors, who have lost other ways to offset tax burden with passage of the bill.

Bill is positive overall for structured finance, but some transactions may experience negative impacts

Overall, generally lower tax obligations for US corporations and individuals will support obligors in both groups’ debt service capacity; however, the legislation also will likely result in credit-negative tax increases on a subset of obligors, and create risks in certain sectors, such as via negative effects on home prices.

Collateralized loan obligations (CLOs) are mainly backed by loans to highly leveraged companies, a meaningful share of which will likely see their tax obligations rise as a result of new limits on interest deductibility. (See discussion on corporate issuers above.) More than half of CLOs issued since 2010 have obligors with weighted average ratings of B2 or below, underscoring how the CLO market is at risk from this dynamic. Furthermore, the negative effects on CLOs could be exacerbated during economic downturns as lower earnings reduce companies’ ability to deduct interest. CLO obligors are also more concentrated in industries that are more vulnerable to net negative effects from the curbing of interest deductibility and less concentrated in capital-intensive industries that could benefit from full deductibility of capital spending.
Tax cuts for individuals will be credit positive for US residential mortgage-backed securities (RMBS) and consumer asset-backed securities (ABS). However, the effects of the tax cuts on the overall performance of the underlying assets will be modest, owing to the limited size of the savings for many borrowers and the fact that other borrowers will face higher taxes, as Exhibit 8 shows. The repeal of the mandate that consumers buy health insurance will leave some consumers with more resources to service their debt; however, the repeal is also expected to boost insurance costs for other individuals and will likely result in many borrowers forgoing health insurance, which will leave them more susceptible to health-related financial shocks, one of the biggest causes of consumer defaults.

Exhibit 8
Most American taxpayers will enjoy tax cuts in 2018 but some will face hikes
Effects from major provisions on different income quintiles

<table>
<thead>
<tr>
<th>Share with tax cuts</th>
<th>Average size</th>
<th>Share with tax increase</th>
<th>Average size</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lowest</td>
<td>53.9%</td>
<td>$130</td>
<td>1.2%</td>
</tr>
<tr>
<td>Second</td>
<td>86.8%</td>
<td>$480</td>
<td>4.6%</td>
</tr>
<tr>
<td>Middle</td>
<td>91.3%</td>
<td>$1,090</td>
<td>7.3%</td>
</tr>
<tr>
<td>Fourth</td>
<td>92.5%</td>
<td>$2,070</td>
<td>7.3%</td>
</tr>
<tr>
<td>Top</td>
<td>93.7%</td>
<td>$8,510</td>
<td>6.2%</td>
</tr>
</tbody>
</table>

Source: Tax Policy Center

Further, the benefits of tax cuts will differ based on factors such as income, location and family size, creating greater risk of negative effects for certain sectors or specific transactions. For example, homeowners whose mortgages are included in post-crisis RMBS backed by prime jumbo loans may disproportionately face higher tax bills, owing to their relatively high incomes and propensity to live in areas with high state and local taxes whose deductions against federal tax obligations will now be limited. To be sure, the negative effects on post-crisis jumbo RMBS will be mitigated by the deals including extremely strong borrowers and well underwritten loans in general. These borrowers may also benefit from positive effects on the value of their investments.

We also expect various aspects of the legislation to constrain home prices, resulting in slower growth or even modest declines in values in some areas. Either scenario would be negative for RMBS because recoveries on defaulted loans would be lower and, potentially, borrowers could be less willing to repay their mortgages. The provisions include the rough doubling of standard deductions, which would sharply reduce the number of taxpayers who itemize, lowering the value of mortgage interest deductions and hence the economic value of homeownership versus renting. New $10,000 caps on deductions for any combination of property, income and sales tax on the state and local level could also reduce the attractiveness of homeownership, and thus possibly homeownership rates. Meanwhile, lawmakers’ decision to lower the size of mortgages eligible for interest deductions to $750,000 for new loans from $1 million also will be negative for higher-priced housing segments.

Post-crisis prime RMBS transactions had an average exposure at issuance of roughly 3.4% to the 20 counties facing the largest hits to home prices based on Moody’s Analytics analyses of the initial House and Senate bills, compared with an average exposure of roughly 2.1% for Fannie Mae and Freddie Mac credit-risk transfer RMBS. The prepayment speeds of jumbo transactions could also slow down as a result of the grandfathering of current mortgage interest deductions caps for outstanding loans.

Finally, although the provision limiting corporate interest deductibility and another one narrowing the availability of so-called like-kind exchanges to only real estate assets may carry implications for securitizations backed by automobile and equipment leases, rental cars and vehicle fleets, we don’t expect those provisions to directly affect the credit quality of outstanding transactions. The provisions could, however, negatively affect the economics of issuing new ABS backed by such assets and raise tax obligations for sponsors.
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Government of United States of America: Higher interest rates, rising debt, and lower revenue to weaken debt affordability, 3 August 2017

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

This report was included in ResiLandscape: January 2018 & CLO Interest: January 2018
**Endnotes**

1. We have performed an analysis of the impacts of each of the most recent proposals from the House and Senate, separately. While the final bill includes a slightly higher corporate tax rate—21% rather than 20%—and applies this to EBITDA for the first four years and then EBIT for each year subsequently, the data provided here should provide an indicative view of the relative implications for investment-grade and speculative-grade corporations.

2. Base erosion generally refers to premium or other consideration paid or accrued in reinsurance contracts by the insurer that reinsures business to a related or affiliated non-US entity.

3. As of September, the median weighted average ratings factor for CLO 2.0s was 2829, translating to a rating slightly lower than B2.

4. Based on the plan initially passed by the House -- which used an EBITDA-based interest deductibility calculation that the final bill adopted for the first four years before switching to the EBIT-based calculation included the initial Senate bill -- we estimated that roughly 27% of B2 rated companies and 50% of B3 rated companies would face net tax increases, when considering just the benefits from the base rate cut and full upfront capex deductibility and the costs from limiting interest deductibility. The shares increase at lower rating categories and decrease at higher rating categories. For additional caveats around these calculations, see Non-Financial Corporates - US Debt and Taxes: Latest proposals benefit all but highly leveraged issuers, December 12, 2017.

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**Tax Reform – US:** Corporate tax cut is credit positive, while effects of other provisions vary by sector.