Research Update:

European Bank for Reconstruction and Development 'AAA/A-1+' Ratings Affirmed; Outlook Stable

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Overview

- The shareholders of the European Bank for Reconstruction and Development (EBRD) have agreed on a €4 billion capital increase, which is expected to raise the paid-in capital by more than 60% by 2029.
- Together with donor guarantees deployed over the past two years, shareholders' commitments to support for Ukraine reaches about €5.5 billion.
- We expect the demonstrated shareholder support will further enhance the bank's ability to fulfil its mandate by increasing its exposure to riskier assets and support Ukraine, which ties back to its original mandate, in our view, and positively affects our assessment of EBRD's overall policy importance.
- Further supporting our view is that the shareholder base continues to expand, with Iraq joining as the 74th member while Benin and Côte d'Ivoire have received pre-membership status.
- We affirmed our 'AAA/A-1+' long- and short-term issuer credit ratings on the EBRD and maintained the stable outlook.

Rating Action

On Jan. 26, 2024, S&P Global Ratings affirmed its 'AAA' long-term and 'A-1+' short-term issuer credit ratings on the European Bank for Reconstruction and Development (EBRD). The outlook is stable.

Outlook

The stable outlook on the EBRD reflects our expectation that, in the next 24 months, the bank will continue receiving strong support from its shareholders that will enable it to fulfil its mandate and provide support to its countries of operation, while mitigating pressure on financial metrics from pressured credit quality in its exposure. Our outlook is further supported by the EBRD's ample 'AAA' callable capital, which could mitigate a significant weakening of its financial profile and support the rating at the current level.

Downside scenario

We could consider lowering the rating if we observed that the quality of the bank's exposure deteriorates more than we currently expect, for example due to a sharp rise in nonperforming loans (NPLs) that was not followed by mitigating risk management actions and shareholder support. We could also consider a downgrade if major shareholders left the bank or significantly reduced their support.

Rationale

The shareholders' decision to increase EBRD's capital stock supports our view of the bank's policy role. In December 2023, the EBRD's shareholders agreed to increase EBRD's authorized capital stock and paid-in capital by €4 billion. The capital increase will be effective from December 2024 and is expected to raise the total paid-in capital stock by more than 60% to about €10.2 billion. This will increase the bank's total authorized capital stock to €34 billion, from the current €30 billion, and increase the share of paid-in capital to 30% of total capital stock from the current 20%. Payments are expected in five annual installments, from April 2025 until April 2029. The additional capital will primarily be used for continued support to Ukraine, both in wartime and reconstruction. At the same time, the capital increase will help mitigate potential pressure on the EBRD's capital position stemming from increased exposure to riskier assets, while allowing the bank to continue fulfilling its mandate. We believe that this, together with the close to €1.6 billion in donor guarantees supporting lending to Ukraine over 2022-2023, illustrates the shareholders' support to the EBRD and the focus on Ukraine is well aligned with its original mandate. We expect that shareholders will remain supportive of the bank's operations, despite the heated political environment exacerbated by the Russia-Ukraine war.

The EBRD's shareholder base is continuing to expand with the recent addition of Iraq. From the original 40 members, the number of the bank's shareholders has increased to 74 countries after Iraq's approval and accession in November 2023. In addition, the first stage of the membership processes for Benin and Côte d'Ivoire have also been approved, but the countries need to meet some pre-membership requests before becoming shareholders. We believe that the expansion will continue, and therefore we could see a further increase in the shareholder base in the coming years, especially in sub-Saharan Africa. Despite the bank's measures, Russia and Belarus, who together hold about 4.2% of the shares in EBRD, have not left the EBRD or diluted their participation in the bank. In fact, no shareholder has left the bank since its inception. The EBRD does not have private sector shareholding. The European Community and the European Investment Bank each hold a 3.0% share.

The EBRD has built a long track record of fulfilling its mandate. The EBRD was established in 1991 to foster the transition toward open-market-oriented economies in central and eastern Europe and the Commonwealth of Independent States by promoting private and entrepreneurial initiatives. Over the past decade, the EBRD has widened its scope and strategically expanded its mandate. The bank has built a strong presence in Türkiye and the southern and eastern Mediterranean region (SEMED), which includes Egypt, Jordan, Lebanon, Morocco, and Tunisia. In 2023, the board of governors agreed to expand the bank's mandate to sub-Saharan Africa and Iraq. In 2014, the EBRD decided that Russia would no longer be a recipient country and stopped approving investments in Russia. The board of governors reinforced this decision in 2017 and further in 2022. In April 2022, after Russia invaded Ukraine, the board of governors decided to also suspend Belarus' access to the bank's resources, due to the country's support of Russia in the war.

We assess the EBRD's governance and management as strong, based on its diversified shareholder base, transparent governance, experienced senior staff, and conservative risk management policy. Management maintains a conservative approach to classify exposure as NPLs and provision for losses. In addition to specific provisions, the bank maintains about €400 million in so-called post-model adjustments to mitigate the increased risk to asset quality, especially in Ukraine. Total impairment provisions in its loan book increased by about €1.4 billion in 2022 but decreased slightly in the first quarter of 2023, partly because exposures guaranteed by donors requires lower provisions. As of the third quarter of 2023, the bank held €2.2 billion in general and specific provisions, €360 million in loan loss reserves, and €306 million in special reserves, which together represent 8.6% of total loan operating assets or 1.1x the gross value of the impaired assets. In addition, we view positively from a risk management perspective the decision for capital injections and that any new exposure in Ukraine in 2022-2023 carried partial donor guarantees.

We consider that the preferred creditor treatment (PCT) awarded on sovereign exposure does not substantially improve the EBRD's enterprise risk profile. Although the EBRD has benefited from PCT, the bank's business portfolio and strategy are more oriented toward the private sector. We reflect it in lower risk weights on its assets in our capital framework. We could reconsider this approach if the EBRD increased its sovereign exposure and had a longer record of keeping it above 25% of its total investments under the mandate. The government of Belarus decreed in April 2022 that it would repay debt to international financial institutions, including that owed to EBRD and to other multilateral lending institutions, in local currency. While we acknowledge the decision was taken due to operational challenges, it constitutes a default under our definitions as well as for the EBRD. Sovereign exposure to Belarus from the EBRD represents about 1.5% of the bank's total sovereign operating assets. As a result, our assumption of the EBRD's loss given default in our risk-adjusted capital (RAC) calculation is 20%, compared with 10% prior to 2022.

Asset quality has deteriorated since the outbreak of the war in Ukraine but prudent risk management mitigates some of the associated risks. NPLs remain relatively high at 7.7% of total purpose-related exposure in the third quarter of 2023, compared with 7.9% at year-end 2022 but 4.9% at the end of 2021. Albeit at the higher end, the bank compared relatively well with 'AAA' rated peers with a similar focus on the private sector. We still see a risk of further deterioration in asset quality, especially in Ukraine, where NPLs already stood at 46% of total exposure to the country in June 2023. Since the outbreak of the war, the bank has provided more than €3 billion in new funding to Ukraine, carrying 50% donor guarantees on average. However, contrary to legacy exposures in Ukraine, which were primarily focused on the broader private sector, the bank primarily disburses new loans to the public sector or affiliated companies supporting critical infrastructure. We expect that these will perform better than the legacy loans. Moreover, we understand that, beyond the warzone, there are some positive trends in NPLs, with recoveries in, for example, Turkiye.

While we see a risk that asset quality may deteriorate further, we estimate that the EBRD will be able to sustain an intrinsic RAC ratio after adjustments above 23% and an NPL ratio broadly in line with its peers. The capital position remains extremely strong and improved to 32.1% as of

June 2023, from 30.2% in December 2022. The improvement primarily reflects a 6.6% increase in total adjusted capital, thanks to a net profit of €1.2 billion in the first half of 2023. The ratio reflects the large geographic and sector diversification in the bank's exposures, and a loss given default assumption of 20%. The EBRD's strong internal capital generation, with the return on equity averaging about 4% over the past five years, supports the capital position. Furthermore, the EBRD's eligible callable capital provides it with an additional buffer against any higher-than-anticipated deterioration of its capital position. More specifically, the EBRD's 'aaa' stand-alone credit profile (SACP) is buttressed by €6.1 billion (about 30% of adjusted common equity) in subscribed callable capital from members rated 'AAA'. Therefore, even if we revised down our assessment of the EBRD's SACP to 'aa+' or 'aa' because of a weakening in its cash capital position, it would probably not affect the issuer credit rating on the bank. In such a scenario, we could factor in shareholder support from eligible callable capital provided by members rated above the SACP, all other things being equal.

The EBRD's funding profile benefits from strong access to capital markets and a diversified investor base. Our funding and liquidity ratios for the EBRD indicate that the bank would be able to fulfil its mandate for at least one year, even under extremely stressed market conditions, without access to capital markets. As of June 2023, our stressed liquidity ratios for the EBRD had increased to 3.1x at six months, from 2.8x per December 2022, and remained stable at 1.9x at 12 months. Moreover, we estimate that the EBRD would not need to reduce the scheduled disbursements of its loan commitments even if it were to draw down half of the total commitments in one year.

Table 1

European Bank for Reconstruction and Development--Selected indicators

	H1 2023	2022	2021	2020	2019
Enterprise profile					
Policy importance					
Total purpose-related exposure (loans, equity, etc.) (mil. €)	40,091	39,177	37,492	35,173	33,383
Public-sector (including sovereign-guaranteed) loans/purpose-related exposure (%)*	34	33	32	32	22
Private-sector loans/purpose-related exposures (%)	66	67	68	68	78
Gross loan growth (%)	8.6	7.3	3.8	5.9	9.8
PCT ratio	0.0	0.0	0.0	0.0	0.0
Governance and management expertise					
Share of votes controlled by eligible borrower member countries (%)	14.5	14.5	14.5	14.5	14.5
Concentration of top two shareholders (%)	18.7	18.7	18.7	18.7	18.7
Eligible callable capital (mil. €)	6,088	6,088	6,088	6,088	6,088
Financial risk profile					
Capital and earnings					
RAC ratio	32.1	30.2	29.7	30.4	30.3
Net interest income/average net loans (%)	7.1	3.9	3.2	2.9	3.3
Net income/average shareholders' equity (%)	12.0	-6.3	12.7	1.0	7.7

Table 1

European Bank for Reconstruction and Development--Selected indicators (cont.)

Impaired loans and advances/total loans (%)	6.2	6.9	4.8	5.5	4.2
Funding and liquidity					
Liquidity ratios					
Liquid assets/adjusted total assets (%)	42.1	42.6	45.4	45.4	46.9
Liquid assets/gross debt (%)	69.2	70.3	69.2	67.5	69.8
Liquidity coverage ratio (with planned disbursements):					
Six months (net derivate payables)	3.1	2.8	2.4	1.8	1.4
12 months (net derivate payables)	1.9	1.9	1.9	1.5	1.2
12 months (net derivate payables) including 50% of all undisbursed loans	1.5	1.5	1.5	1.3	1.2
Funding ratios					
Gross debt/adjusted total assets (%)	60.9	60.6	65.7	67.3	67.2
Short-term debt (by remaining maturity)/gross debt (%)	N.A.	29.6	29.9	30.2	37.4
Static funding gap (without planned disbursements)					
12 months (net derivate payables)	2.7	2.5	2.4	1.9	1.4
Summary balance sheet					
Total assets	73,098	71,625	74,773	69,772	68,201
Total liabilities	52,271	52,289	54,428	51,881	50,371
Shareholders' equity	20,827	19,336	20,345	17,891	17,830

*Excluding committed undrawn loans. H1--First half. N.A.--Not available. PCT--Preferred creditor treatment. RAC--Risk-adjusted capital.

Ratings Score Snapshot

Table 2

European Bank for Reconstruction and Development--Ratings score snapshot

Issuer credit rating	AAA/Stable/A-1+
Stand-alone credit profile	aaa
Enterprise risk profile	Extremely strong
Policy importance	Very strong
Governance and management	Strong
Financial risk profile	Extremely strong
Capital adequacy	Extremely strong
Funding and liquidity	Very strong
Extraordinary support	0
Callable capital	0
Group support	0

Table 2

European Bank for Reconstruction and Development--Ratings score snapshot (cont.)

Issuer credit rating	AAA/Stable/A-1+
Holistic approach	0

Related Criteria

- Criteria | Governments | General: Multilateral Lending Institutions And Other Supranational Institutions Ratings Methodology, Jan. 31, 2022
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Ratings Affirmed	
European Bank for Reconstruction and Development	
Issuer Credit Rating	
Foreign Currency	AAA/Stable/A-1+
European Bank for Reconstruction and Development	
Senior Unsecured	AAA
Commercial Paper	A-1+