FitchRatings

RATING ACTION COMMENTARY

Fitch Revises EBRD's Outlook to Negative; Affirms at 'AAA'

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Fitch Ratings - London - 03 Dec 2020: Fitch Ratings has revised the Outlook on European Bank for Reconstruction and Development Bank's (EBRD) Long-Term Issuer Default Rating (IDR) to Negative from Stable and affirmed the IDR at 'AAA'.

KEY RATING DRIVERS

The revision of the Outlook to Negative reflects downside risks to EBRD's asset quality and capitalisation resulting from the coronavirus pandemic and the bank's expansion in 'high risk' countries in recent years. Asset quality and capital ratios had deteriorated ahead of the pandemic. Sustained higher non-performing loans (NPLs) or weaker capitalisation in the medium term could lead to a negative revision of the bank's current 'aaa' solvency assessment and in turn a downgrade of its 'AAA' rating.

Historically focused on private sector financing in Central and Eastern Europe (CEE), EBRD has pivoted away from Europe and Russia (BBB/Stable) in recent years towards Turkey (BB-/Negative) and the Southern and Eastern Mediterranean (SEMED) region, which includes Egypt (B+/Stable), Jordan (BB-/Negative), Morocco (BB+/Stable), Tunisia (B/Negative), and Lebanon (RD). The SEMED and Turkish portfolio has grown to EUR10.3 billion or 31% of the bank's total banking exposure (TBE) as of end-June 2020. As part of the recently approved Strategic and Capital Framework for 2021-25, the bank expects to continue to grow its portfolio in these countries.

In Fitch's view, increased exposures to 'high risk' countries, as measured by sovereign ratings, combined with the impact of the COVID-19 crisis result in a significant risk that the NPL ratio will remain above our 6% threshold for a 'high' risk assessment in the medium term. As of end-June 2020, impaired loans, as defined by the bank, were 6.1% of total loans from 4.5% as of end-2019 and 4.9% on average over 2015-2019. The increase was primarily driven by pre-pandemic impairments in Turkey (18% of loans and 32% of total NPLs as of June 2020) and Lebanon (10% of total NPLs despite accounting for only 0.7% of loans). Impaired loans relate exclusively to non-sovereign loans.

Fitch expects the COVID-19 crisis will lead to further pressures on NPLs and the performance of the bank's equity portfolio. The agency estimates that close to 10% of the bank's loan exposures are in countries in which the sovereign rating has been downgraded by one notch since the start of the COVID-19 crisis and 37% are in countries where the Outlook on the sovereign is Negative. While the bank is primarily exposed to non-sovereign risk, the negative sovereign rating actions highlight deterioration in the macroeconomic environment that could affect non-sovereign borrowers and the bank's equity investments.

In Fitch's view, loans subject to payment deferrals also pose risks to NPLs. The bank has extended temporary payment deferrals to borrowers that account for approximately 3% of total loans. While the bank does not consider these exposures as impaired, the agency treats these exposures as 'non-performing' to reflect the risk that the temporary payment relief may only delay loan impairments. This is in line with Fitch's supranationals rating criteria, which considers non-sovereign exposure with a three-month payment delay as 'non-performing'.

There are risks to the bank's capitalisation assessment given limited buffers above Fitch's own thresholds, asset quality risks, and weaker internal capital generation prospects. Capitalisation is assessed as 'excellent', supported by the bank's equity-to-adjusted-assets ratio (25.8% at end-June 2020) and Fitch's usable capital to risk-weighted assets (38.7% at end-June 2020). However, while the two ratios are in the 'excellent' threshold, they are just above the respective thresholds for an 'excellent' assessment of 25% and 35%, respectively.

The agency expects the bank's profitability, the only source of growth in EBRD's own funds, to be weaker in the coming years owing to potential further losses on loan exposures, depressed income from the bank's equity investments and low interest income from its fixed income portfolio. Year-to-date financial losses (net loss of EUR727 million as of 9M20) were mainly driven by negative revaluation of the bank's equity portfolio (12.3% of TBE at end-June 2020, -10% negative re-valuation since end-2019) and loan loss provisions (EUR445 million as of 9M2020).

The latter reflects the bank's estimate of expected credit losses plus an additional management overlay given the magnitude and uncertain duration of the economic crisis. In Fitch's view, the large loan loss provisions only partly mitigate the risk of further credit losses in case NPLs significantly increase.

EBRD's 'AAA' Long-Term IDR reflects the bank's intrinsic credit quality with both solvency and liquidity assessed at 'aaa'. The 'aaa' solvency assessment reflects the bank's 'excellent' capitalisation and 'low' risk profile.

Fitch's assessment of EBRD's 'low' risk profile is supported by the 'very low' obligor concentration metrics, 'excellent' risk management policies and 'very low' market risk exposure. This balances the 'moderate' risk faced in its private sector exposures (end-June 2020: 86% of TBE), which have shifted away from Russia and CEE in recent years towards Turkey and the SEMED region.

Fitch estimates that EBRD's average credit quality of loans and guarantees was 'B+' as of end-June 2020, in line with previous years and despite increased exposure to new markets with on average lower creditworthiness. The resilience can largely be attributed to the diversified nature of the loan portfolio and has been supported by sovereign upgrades across CEE in recent years. However, risks are tilted to the downside given the bank's geographic strategic direction and the large number of sovereigns with Negative Outlooks while none has a Positive Outlook.

EBRD's preferred creditor status primarily applies to the bank's sovereign loans (end-June 2020: 17% of total loans), but Fitch also considers it would provide protection against the imposition of capital controls on its private sector exposures. This leads to a one-notch uplift over the assessment of the average rating of the loan book, to 'BB-'.

EBRD's liquidity is assessed at 'aaa'. The bank's coverage of short-term debt by liquid assets was 1.7x at end-June 2020 and is expected to remain above the 1.5x threshold that we deem as 'excellent' coverage. EBRD operates with a higher level of treasury assets (43% of total assets at end-June 2020) than comparable peers and this positively weighs on our assessment on liquidity. The quality of treasury assets is 'strong', with the share of treasury assets rated 'AAA'-'AA' at 59% as of end-June 2020. In Fitch's view, EBRD has 'excellent' access to capital markets.

The agency assesses EBRD's business profile as medium risk, balancing the high share of non-sovereign financing and an increased focus on less advanced economies with the high quality of governance of the institution and the importance of its public mandate. The latter was illustrated by the bank's response to the pandemic, which played a key role in providing liquidity support and financial advice to its borrowers.

The operating environment is also assessed as medium risk, reflecting the moderate average credit quality and political risk in most countries of operations as measured by the World Bank governance indicators, and strong operational support from member states.

Shareholders support is assessed at 'aa-'. EBRD's shareholders support capacity is based on the weighted average of key shareholders, estimated at 'AA-'. Shareholders' propensity to support is considered 'strong', reflecting the important role played by EBRD in the financing of member countries, despite a limited track record of capital increases unlike multilateral development bank peers.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to negative rating action/downgrade:

- Solvency (Capitalisation): A decline in capitalisation metrics with an equity to assets and guarantees ratio sustained at a level below 25% or a Fitch usable capital to risk-weighted assets (FRA) ratio below 35%. This would affect our 'excellent' capitalisation assessment. This could be driven by further losses, faster-than-expected growth, and/or a significant increase in risk-weighted assets.

- Solvency (Risk): Sustained higher levels of NPLs (above 6%), a breach of preferred creditor status on sovereign loans, or a decline in the average rating of loans and guarantees below 'B+'.

Factors that could, individually or collectively, lead to positive rating action:

- Solvency (Capitalisation): Continued 'excellent' capitalisation metrics with an equity to assets and guarantees ratio sustained at a level above 25% and a FRA ratio above 35%. This could be supported by stronger asset performance than currently anticipated.

- Solvency (Risk): Improvement in the macroeconomic environment across EBRD's countries of operations that reduce downside risks to the performance of banking exposures and prevents further deterioration in the bank's NPL ratio.

ESG CONSIDERATIONS

EBRD has an ESG Relevance Score of 4 for 'Exposure to Social Impacts'. In order to provide temporary liquidity support, the bank has allowed payment deferral for some of its borrowers affected by the coronavirus crisis but that had not experienced payment delays before the deferral was granted. This has a negative impact on the credit profile, and is relevant to the ratings in conjunction with other factors.

EBRD has an ESG Relevance Score of 4 for 'Rule of Law, Institutional and Regulatory Quality'. All supranationals attract a score of '4' as they are neither subject to bank regulation nor supervised by an external authority. Instead, supranationals comply with their own set of prudential limits. Fitch pays particular attention to these internal prudential policies, including the bank's compliance with them. This has a negative impact on the credit profile, and is relevant to the ratings in conjunction with other factors.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [https://www.fitchratings.com/site/re/10111579].

KEY ASSUMPTIONS

Fitch assumes that EBRD will continue to abide by its conservative prudential framework on capitalisation, leverage, liquidity and underwriting

We also assume that the global economy evolves in line with its most recent update of the Global Economic Outlook published on 6 November 2020.

SOURCES OF INFORMATION

The sources of information used to assess these ratings were EBRD's financial statements and other information provided by EBRD.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
European Bank for Reconstruction and Development	LT IDR	AAA Rating Outlook Negative	Affirmed	AAA Rating Outlook Stable
•	ST IDR	F1+	Affirmed	F1+
• senior unsecured	LT	AAA	Affirmed	AAA
• senior unsecured	ST	F1+	Affirmed	F1+

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Supranationals Rating Criteria (pub. 30 Apr 2020) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

European Bank for Reconstruction and Development	EU Issued

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