FitchRatings

Fitch Affirms European Bank for Reconstruction and Development at 'AAA'; Outlook Stable

Fitch Ratings - London - 04 December 2019:

Fitch Ratings has affirmed European Bank for Reconstruction and Development's (EBRD) Long-Term Issuer Default Rating (IDR) at 'AAA' with a Stable Outlook.

A full list of rating actions is at the end of this rating action commentary.

Key Rating Drivers

The affirmation reflects the bank's intrinsic credit quality with both solvency and liquidity assessed at 'aaa'. Fitch assesses the business environment in which EBRD operates as 'medium risk', with no uplift made over other intrinsic features.

EBRD has traditionally concentrated its operations in Central and Eastern Europe, with a focus on private sector financing. In 2006 it began to diversify its operations in Mongolia and Turkey in 2009. In 2011, the bank began its expansion into the Southern and Eastern Mediterranean (SEMED) region. Since then, the SEMED portfolio, which includes Egypt (B+/Stable), Jordan (BB-/Stable), Morocco (BBB-/Stable), Tunisia (B+/Negative), and Lebanon (CCC) has grown to EUR3.5 billion or 11.5% of the bank's total banking exposure (TBE) as of end-1H19, while significantly reducing financing to Russia.

As part of a planned review of its strategic and capital framework, EBRD is undertaking analysis on several options regarding its strategic direction. The review should result in the articulation of the framework for 2021-2025 and could lead the bank to venture into new, higher-risk markets. Related to a broader discussion on EU External Financing and the European Financial Architecture, the bank has become a recipient of first-loss guarantees from the EU (AAA/Stable) and is acting as a vehicle to channel EU External Financing.

Fitch does not explicitly incorporate changes to the bank's capital adequacy framework, business profile, or strategic focus in its projections as a result of the ongoing review and would re-asses the bank's solvency and business environment accordingly if these were to materially change.

EBRD's 'aaa' solvency assessment is underpinned by its 'excellent' capitalisation with an equity-to-adjusted-assets and guarantees ratio of 26.8% at end-1H19 and overall 'low' exposure to risks. In line with Fitch's updated Supranationals Rating Criteria, EBRD's capitalisation is now also assessed via Fitch's usable capital to risk-weighted assets ratio, at 39% as of mid-2019, above the threshold for an 'excellent' assessment (35%). Usable equity includes a portion (10%) of callable capital from shareholders rated 'AA-' or above (EUR15.1 billion).

Fitch expects the overall capitalisation assessment to remain 'excellent' over its three-year forecast horizon, driven by a combination of moderate growth in the banking portfolio offset by internal capital generation. Profitability is volatile but remains strong (1H19: EUR627 million net income after allocations) and is expected to continue contributing to the build-up in the bank's equity base. Internal capital generation is key in strengthening the bank's capitalisation, as no capital injection has been received since 1996.

Fitch 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-1H19: 86% of TBE).

Fitch estimates that EBRD's average credit quality of loans was 'B+' as of end-1H19, in line with previous years. EBRD's preferred-creditor status primarily applies to the bank's sovereign loans (end-1H19: 17% of total loans), but Fitch also considers it would provide moderate protection against the imposition of capital controls on its private sector exposures, as was the case in Russia in 1998.

EBRD's NPL ratio decreased to 4.6% of gross loans at end-1H19 from 5.0% of gross loans a year before. The improvement primarily reflects a slight reduction in the stock of impaired loans coupled with an increase in gross loans. While Turkish NPLs increased significantly during 2018, this was partially offset by improvements in the Eastern Europe and the Caucasus and South-Eastern Europe portfolios. Fitch expects the NPL ratio to remain in the 'moderate' risk range (3%-6%) and for the bank to maintain adequate levels of loan loss reserve coverage and conservative provisioning practices (specific and collective provisions accounted for 85% of NPLs at end-1H19).

Fitch considers the risks associated with EBRD's equity participations, representing 16.3% of banking exposures at end-1H19, as 'moderate'. The bank's exposure to Russia (BBB/Stable) in its equity portfolio has decreased to 17% of the total (from 27% two years before) and should remain diluted given the bank's decision in 2014 not to undertake any new investments there. Turkey represents the second-largest source of equity risk for the bank (with 12.7% of the total), followed by Poland (A-/Stable; 11.5%) and Romania (BBB-/Stable; 10.4%).

Fitch assesses EBRD's concentration risk by individual obligor as 'very low' due to the diversification of lending across a large number of private borrowers and compares favourably with 'AAA' rated peers. The five largest banking exposures accounted for 8% of the total at end-1H19. However, the bank remains moderately exposed to Turkey (17.9% of TBE), Poland (8.7%) and Ukraine (6.7%) at the country level, despite improvements in recent years.

In our view, EBRD's 'excellent' risk management policies are a rating strength. In particular, the bank abides by conservative liquidity policies, which ensure that it meets at least 75% of net cash requirements for the next two years. This coverage reached 1.2x at end-1H19. Further, EBRD has a conservative gearing limit, which caps operating assets to 100% of subscribed capital, retained earnings, and reserves.

Fitch assesses EBRD's liquidity profile at 'aaa'. The bank's coverage of short-term debt by liquid assets was 1.7x at end-1H19 and is expected to remain above the 1.5x threshold that we deem as 'excellent' coverage. The quality of treasury assets is 'strong', with the share of treasury assets rated 'AAA'-'AA' at 55% as of end-1H19. In Fitch's view, EBRD has 'excellent' access to capital markets.

We assess EBRD's business profile as medium risk, balancing the high share of non-sovereign financing (86% of the total at end-1H19) and focus on less advanced economies with the high quality of governance of the institution and the importance of its public mandate. In Fitch's view, the bank has successfully grown its shareholding base (from 42 shareholders at inception to 71) and expanded into new geographical regions. 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.

Although this is a secondary rating driver, Fitch assesses shareholders' support 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.

RATING SENSITIVITIES

The Outlook is Stable. Consequently, Fitch's sensitivity analysis does not currently anticipate developments with a material likelihood, individually or collectively, of leading to a downgrade. However, developments that may, individually or collectively, lead to negative rating action include:

- Deterioration in EBRD's capitalisation ratios, potentially stemming from faster than expected growth in banking exposures and/or prolonged and significant losses on equity investments or on lending operations.

- Substantial and protracted credit quality deterioration in a large country of operation, including Turkey, Poland or Ukraine, translating into a marked deterioration of the quality and performance of its banking portfolio.

- A significant loosening of risk management and governance standards and a material change in the bank's prudent strategy.

Key Assumptions

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

RATING ACTIONS

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

Additional information is available on www.fitchratings.com

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Applicable Criteria

Supranationals Rating Criteria (pub. 23 May 2019)

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