Research Update:

Eurasian Development Bank Downgraded To 'BBB-/A-3' And 'kzAA' On Weakening Funding Profile; Outlook Neg

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Overview

- Eurasian Development Bank (EDB)'s ability to attract financing in dollars and tenge has deteriorated, and there is little progress on bilateral loans from Kazakhstan's authorities.
- Impaired loans increased to 18% of the gross loan book in the first half of 2015 from 5% at year-end 2014, weighing on EBD's internal capital generation capacity and financial profile.
- We are therefore lowering our ratings on EDB to 'BBB-/A-3' and 'kzAA' from 'BBB/A-2' and 'kzAA+'.
- The negative outlook indicates that there is at least a one-in-three likelihood that we could lower the ratings on EDB within the next two years should its financial profile weaken further.

Rating Action

On Oct. 9, 2015, Standard & Poor's Ratings Services lowered its long- and short-term foreign currency issuer credit ratings on Eurasian Development Bank (EDB) to 'BBB-/A-3' from 'BBB/A-2'. The outlook remains negative.

At the same time, we lowered our Kazakhstan national scale rating on the bank to 'kzAA' from 'kzAA+', and affirmed the Russia national scale rating at 'ruAAA'.

Rationale

Our ratings on EDB reflect our view of the bank's strong financial profile and weak business profile, as our criteria define these terms. These assessments, together with EDB's deteriorating funding profile, lead to a stand-alone credit profile (SACP) at 'bbb-'.

Similar to other multilateral institutions (MLIs), EDB depends heavily on wholesale market funding, which represents about 90% of its liabilities. Over the past one and a half years, we have observed a significant drop in EDB's bond issuance to only $0.3 billion in 2014 from $1.3 billion in 2013, and no new issuance outside Russia in the first nine months of 2015. The decrease stemmed from slow portfolio growth; no need for U.S. dollar-denominated funding; and deteriorating conditions in local markets, with higher costs of funding and reduced liquidity.
However, in our view, EDB's ability to attract financing denominated in tenge and U.S. dollars has deteriorated. This has led us to reassess EDB's funding profile, taking into account two key assumptions:

- Long-term funding in tenge will likely remain tight over the next one to two years, further straining EDB's ability to place sufficient bonds to support tenge-denominated loan generation. We base this expectation on our observation of continuous delays in the National Bank of Kazakhstan's provision of local currency funding to EDB through bilateral loans. Moreover, most of the government aid, including from the Single Accumulative Pension Fund, the only long-term investor in local currency, is now channeled to local banks. Inability to attract tenge funding would increase EDB's tenge funding gap, constraining its capacity to lend in local currency; and

- No tangible plans for EDB to issue dollar-denominated bonds next year, due to substantial devaluation of local currencies and lack of borrowers' interest in dollar-denominated debt. Moreover, the Central Bank of Russia has recently proposed an amendment to banks' capital adequacy calculation that would lead to EDB's foreign currency denominated bonds being weighted at 100%. In our view, such regulation, if approved, would put additional pressure on EDB's ability to place new Eurobonds, while narrowing its investor base.

We believe that EDB's public policy mandate suffers not only from stressed market conditions and limited access to the capital markets, but also from the bank's pro-cyclical lending. EDB's loan portfolio has shrunk since year-end 2014, due to currency devaluation and loan repayments exceeding $300 million. At the same time, it signed only two new loans over that period for an equivalent of $23 million.

Our view on EDB's liquidity position remains unchanged because the liquidity cushion is ample, with $1.8 billion of liquid assets that cover 87% of the bank's gross debt as of midyear 2015.

Even though we continue to view EDB's financial profile as strong, we observe increasing pressure on asset quality and internal capital generation capacity. EDB's risk-adjusted capital (RAC) ratio increased to 27% as of midyear 2015, from 23% at year-end 2014, due to contraction of risk-weighted assets as the loan portfolio declined by about 10%. EDB's balance sheet remains highly concentrated. Most of its loans to customers are in Russia and Kazakhstan (72.5%), and the 10 largest loans account for 52.8% of the purpose-related loans. After factoring in these concentrations, the RAC ratio at midyear 2015 decreases to 19%.

Amid a worsening macroeconomic environment, the bank posted a loss of $148 million for the first half of 2015, which was due to a significant rise in provisions by about $180 million. The increase stemmed from reserves for specific loans and the overall portfolio for higher risks in countries of operations, and from foreclosed collateral assets under nonperforming loans.
(NPLs) where the ability to fully recover losses is doubtful.

The deterioration in loan portfolio quality as the Russian and Kazakhstan economies slow down has been faster than we previously anticipated. As of midyear 2015, NPLs (loans overdue more than 90 days) accounted for 2.4% of EDB’s loan portfolio, down from 4.9% at year-end 2014, and credit costs had reached 6.6%. We note that the reduction in NPLs reflected substantial write-offs ($163 million over the past 18 months) and restructuring of problem loans. Therefore, total impaired loans over the first half of 2015 were up to $360 million from $116 million at year-end 2014, and the ratio of potential problem loans had soared to 18% of the loan portfolio from 5.3%.

Our ratings on EDB do not incorporate any explicit uplift for extraordinary shareholder support in the form of callable capital. Although callable capital can, in principle, enhance an MLI’s SACP and result in a higher issuer credit rating, we factor in no explicit uplift in the case of EDB. This is mainly because of EDB’s highly idiosyncratic ownership structure, which exacerbates the principal-agent problem related to capital calls. Also, our assessment of EDB’s SACP is now higher than the rating on one major stakeholder.

**Outlook**

The negative outlook reflects that there is at least a one-in-three likelihood that we could lower the ratings on EDB within the next two years, should its financial profile weaken. This could result, for example, from further deterioration of EDB’s funding profile or asset quality, as well as from more significant weakening of the economic environment in the region than we currently anticipate.

A downgrade could, but would not necessarily, follow the lowering of our ratings on Russia or Kazakhstan, both of which have negative outlooks. The ratings on EDB could also be affected by changes in the operating environment in the region.

For example, if conditions became more difficult and EDB’s NPLs rose significantly, shareholder support weakened, or relations among shareholders deteriorated, we could lower the ratings on EDB.

Conversely, we may revise the outlook to stable if EDB’s financial profile were to stabilize, notably its funding and asset quality.

**Related Criteria And Research**

**Related Criteria**
- National And Regional Scale Credit Ratings, Sept. 22, 2014
- Standard & Poor’s National And Regional Scale Mapping Tables, Sept. 30, 2014
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- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Multilateral Lending Institutions And Other Supranational Institutions Ratings Methodology, Nov. 26, 2012
- Bank Capital Methodology And Assumptions, Dec. 6, 2010

Related Research
- Republic of Kazakhstan 'BBB/A-2' Ratings Affirmed on Strong Fiscal and Debt Position; Outlook remains Negative, Sept. 11, 2015
- Commonwealth Of Independent States Ratings Trends Mid-Year 2014, July 18, 2014
- Ratings on Russia Affirmed On Moderate Debt Burden; Outlook remains Negative, April 17, 2015
- For Development Banks, Callable Capital Is No Substitute For Paid-In Capital, Dec. 31, 2009

Ratings List

Downgraded

<table>
<thead>
<tr>
<th>Eurasian Development Bank</th>
<th>To</th>
<th>From</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issuer Credit Rating</td>
<td>BBB-/Negative/A-3</td>
<td>BBB/Negative/A-2</td>
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<tr>
<td>Foreign Currency</td>
<td>kzAA/--/--</td>
<td>kzAA+/--/--</td>
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<td>Kazakhstan National Scale Rating</td>
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<td>BBB</td>
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<td>Senior Unsecured</td>
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Ratings Affirmed

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<tr>
<th>Eurasian Development Bank</th>
<th>ruAAA/--/--</th>
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<tbody>
<tr>
<td>Russia National Scale</td>
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Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.
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