Research Update:

Eurasian Development Bank Outlook Revised To Stable; 'BBB-/A-3', 'kzAA', and 'ruAAA' Ratings Affirmed

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**Table Of Contents**

- Overview
- Rating Action
- Rationale
- Outlook
- Related Criteria And Research
- Ratings List
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Eurasian Development Bank Outlook Revised To Stable; 'BBB-/A-3', 'kzAA', and 'ruAAA' Ratings Affirmed

Overview

• In the first half of 2016, the Eurasian Development Bank (EDB) staunched the deterioration of its loan portfolio and returned to profitability.

• EDB also closed a structural funding gap in Kazakhstani tenge.

• We are therefore revising our outlook on EDB to stable from negative and affirming our 'BBB-/A-3', 'kzAA', and 'ruAAA' ratings.

• The stable outlook is premised on our expectation that EDB's risk-adjusted capital ratio will remain in its current 15% to 23% range and the bank will resume being a net contributor of funds to the region. We see less than a one-in-three possibility that we will move our rating on EDB up or down during the next two years.

Rating Action

On Oct. 3, 2016, S&P Global Ratings revised its outlook on Eurasian Development Bank (EDB) to stable from negative and affirmed its 'BBB-/A-3' long- and short-term foreign currency issuer credit ratings on the bank. At the same time, we affirmed our Kazakhstan national scale rating on EDB at 'kzAA' and the Russia national scale rating at 'ruAAA'.

Rationale

Our ratings on EDB incorporate our assessments of the bank's financial profile as strong and business profile as weak. These profiles combine to make a stand-alone credit profile (SACP) of 'bbb-'.

The outlook revision reflects our assessment that downside risks to our rating on EDB have abated. We find that the new management's actions have stabilized EDB's asset quality and, consequently, led to a return to profitability. We also note that our risk-adjusted capital (RAC) ratio for EDB, after adjustments specific for the multilateral lending institution (MLI) asset class, has improved. In addition, the bank has closed its open Kazakhstani tenge funding position.

After a US $144 million loss in 2015, partly owing to US$150 million allocated to loan loss provisions, EDB returned to profitability in the first half of 2016. It reported earnings of US$41 million during this period, with loan loss provisions falling to US$11.7 million. Nonperforming loans have stayed stable at US$60 million (representing 3.7% of the balance portfolio), and management has enhanced the quality of one large impaired loan to Belaz, a state-owned Belarussian manufacturer of moving equipment, by obtaining a central government guarantee. We expect EDB's profits for the second half of the year will exceed first-half levels, with
allocations either remaining low or even resulting in a release of provisions to income.

Although all of EDB's member countries, and Russia and Kazakhstan in particular, are suffering from the direct or indirect effects of a severe terms-of-trade shock, we believe macroeconomic conditions in the region may have bottomed out. On Sept. 16, 2016, we revised the outlook on our sovereign rating on the Russian Federation (which owns 66% of EDB) to stable from negative (see Related Research below for our recent action on Russia and related rating actions and our updated Banking Industry Country Risk Assessments).

The return to profitability and a contraction in EDB's loan portfolio has strengthened the bank's RAC ratio, after adjustments specific for MLIs, to 22% on June 30, 2016, from 18% on Dec. 31, 2015. EDB's capital is denominated in U.S. dollars and its capitalization vis-à-vis its Russian ruble and tenge loan portfolios has improved with the depreciation of CIS currencies. This effect, plus some loan prepayments, caused EDB's current investment portfolio to shrink to US$2.1 billion on June 30, 2016, from a peak of US$3.2 billion on Dec. 31, 2014. In our view, management's strategy to grow its loan book to US$2.9 billion by the end of 2016 is ambitious.

The 2015 reform of the Kazakh private pension system resulted in a marked contraction of the tenge bond market, affecting firms reliant on wholesale funding, including EDB. It had tapped this market to fund its tenge loan portfolio. The market contraction left EDB with a structural open tenge position. Management has closed this position by obtaining from the National Bank of Kazakhstan (NBK) a three-year term repo (repurchase) facility through which EDB posts U.S. dollar-denominated securities in exchange for tenge advances. Currently US$50 million, the facility will likely be increased this year to US$200 million. The NBK prices the advances at one-half of its base rate.

Notwithstanding management's loan targets, loan demand is weak. Many borrowers in the Commonwealth of Independent States (CIS) do not have foreign exchange earnings that would make dollar funding prudent. Nor do they have the domestic pricing power to make attractive borrowings in CIS currencies, which carry high nominal interest rates. Accordingly, we expect little debt issuance from EDB this year.

EDB's funding position is helped by its ample liquidity cushion, with liquid assets exceeding gross debt as of June 30, 2016. We believe that under stressed conditions, EDB could stay out of the market for two years while making its debt repayments and scheduled loan disbursements.

Established in 2006 by an intergovernmental agreement, EDB is owned by the Russian Federation (66%), Kazakhstan (33%), Belarus (1%), Armenia (0.01%), Tajikistan (0.03%), and Kyrgyzstan (0.01%). It is the key MLI for the Eurasian Economic Union and manages a separate US$8.5 billion fund for balance-of-payment support. We see some pressure on EDB's ability to serve as a countercyclical lender, given the contraction of its balance sheet. We also note some instances in which it was not
treated differently from commercial entities. Its bonds held by Russian banks are 100% weighted for capital charges, for example, and the NBK repo facility took some time to negotiate. As with other subregional development banks, there is an unavoidable regional concentration of the loan portfolio and all shareholders are borrowing members.

Our ratings on EDB do not incorporate any uplift for 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 EDB's case. This is mainly because of EDB's highly idiosyncratic ownership structure, which exacerbates the principal-agent problem related to capital calls.

**Outlook**

The stable outlook reflects our expectation that EDB's RAC ratio will remain in its current 15%-23% range and the bank will resume being a net contributor of funds to the region. We see less than a one-in-three possibility that we will upgrade or downgrade EDB in the next two years.

Upward ratings potential could build if EDB strengthens its mandate through catalytic lending while improving its capital position.

We could consider a negative rating action if EDB's asset quality deteriorates, if it relapses into losses, or if it is unable to act as a countercyclical lender.

**Related Criteria And Research**

**Related Criteria**

- General Criteria: S&P Global Ratings' National And Regional Scale Mapping Tables - June 01, 2016
- General Criteria: National And Regional Scale Credit Ratings - September 22, 2014
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers - May 07, 2013
- Criteria - Governments - General: Multilateral Lending Institutions And Other Supranational Institutions Ratings Methodology - November 26, 2012
- Criteria - Financial Institutions - Banks: Bank Capital Methodology And Assumptions - December 06, 2010
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009

**Related Research**

- Supranationals Special Edition 2016: Five-Year Comparative Data For Multilateral Lending Institutions - September 29, 2016
- Russian Federation Outlook Revised To Stable From Negative On Abating External Risks; Ratings Affirmed - September 16, 2016
- Republic of Kazakhstan Ratings Affirmed At 'BBB-/A-3'; Outlook Remains Negative - September 9, 2016
- Republic of Belarus 'B-/B' Ratings Affirmed On Continued Russian Support; Outlook Stable - April 8, 2016
Ratings List

<table>
<thead>
<tr>
<th>Rating</th>
<th>To</th>
<th>From</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eurasian Development Bank</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Issuer Credit Rating</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign Currency</td>
<td>BBB-/Stable/A-3</td>
<td>BBB-/Negative/A-3</td>
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<td>Kazakhstan National Scale</td>
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<td>kzAA/--/--</td>
</tr>
<tr>
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<td>ruAAA/--/--</td>
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<tr>
<td>Senior Unsecured</td>
<td></td>
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</tr>
<tr>
<td>Foreign Currency</td>
<td>BBB-</td>
<td>BBB-</td>
</tr>
</tbody>
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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. 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 S&P Global Ratings' public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings 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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