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Rating Action: Moody's affirms the Eurasian Development Bank's Baa1 rating, stable outlook

Global Credit Research - 13 Oct 2017

Singapore, October 13, 2017 -- Singapore, <Rating Date Pending> -- Moody's Investors Service has today affirmed the long term Baa1 issuer and senior unsecured ratings, the (P)Baa1 senior unsecured MTN program rating, the Prime-2 short-term issuer rating, and the (P)Prime-2 other short term rating of the Eurasian Development Bank (EDB). The outlook remains stable.

The key drivers underpinning the Baa1 rating affirmation and stable outlook are:

1) A mixed assessment of capital adequacy given strong metrics balanced by weak asset quality;

2) A relatively strong liquidity position offset by uncertain access to funding;

3) Constraints to the financial capacity of members to support EDB in the event that support would be needed.

RATINGS RATIONALE

The Baa1 rating incorporates the EDB's "Medium" capital adequacy and liquidity positions, and "Low" strength of member support.

STRONG CAPITAL ADEQUACY METRICS BALANCED BY WEAK ASSET QUALITY

The first factor underpinning EDB's Baa1 rating is a "Medium" capital adequacy that reflects strong ratios balanced by weak asset quality, the EDB's allocation of loans that point to potential recurrent losses, and treasury assets invested in relatively weaker securities compared with some other Multilateral Development Banks (MDBs).

A high Asset Coverage Ratio (ACR), which compares the entity's usable equity with assets that can incur losses, supports the EDB's capital adequacy. The ACR has edged higher for the past three consecutive years, and stood at 98.1% as of end June 2017, a high level compared to other MDBs. This improvement was accounted for by a marked deceleration in loan growth. As loan growth picks up from lows seen in 2015, the ACR will likely deteriorate, although we do not anticipate such a deterioration to be sharp.

Leverage, measured as outstanding debt relative to usable equity, stood at 99.8% as of end June, in line with other A and Baa-rated MDBs. Leverage could also edge higher as the borrowing environment improves and the bank takes on more debt, although we do not expect a marked deterioration in this ratio either.

Against these relative strengths, about 40% of EDB's treasury assets, which in turn account for 40% of total assets, are invested in non-investment grade securities, a lower credit quality than for many other MDBs.

The EDB's provisioning policy appears sound, but asset quality is weak, with non-performing loans (NPLs) rising to 5.9% of gross loans, which we define as loans and advances to banks and customers, net of provisions, as of end 2016 from 4.0% in end 2015. Although NPLs edged slightly lower by end June 2017 to 5.1%, this level still remains high relative to the MDBs that Moody's rates. EDB's lending to sectors such as mining that are undergoing marked structural adjustments and are vulnerable to sudden changes in global prices indicates that NPLs are likely to recur.

Furthermore, a weak operating environment for the economies in the Commonwealth of Independent States (CIS) will likely continue to be a drag on asset quality and overall capital adequacy. While these economies are on the mend driven in part by the recovery in commodity prices, we do not expect EDB's largest borrowing members -- Russia and Kazakhstan -- to return to the growth rates experienced prior to the fall in oil prices.

RELATIVELY STRONG LIQUIDITY POSITION, OFFSET BY WEAK ACCESS TO FUNDING

The EDB's liquidity position, measured by its debt service coverage for maturing long-term debt and short-term debt relative to discounted liquid assets, is very strong, at 6.3% at end--June 2017. Moody's considers a ratio
of below 50% as very high liquidity coverage. In fact, this ratio has remained below 30% since EDB's inception, and on average in 2014-2016 the ratio stood at just 15.5%.

However, this strong liquidity position is offset by uncertain access to funding given the nature of the markets that EDB relies on. In order to match the distribution of currencies in its loan portfolio, EDB raises debt in local markets, primarily Russia and Kazakhstan. The relatively shallow nature of these markets, with episodes when market liquidity significantly tapered off, weighs on our assessment of EDB's overall liquidity.

LOW MEMBER SUPPORT BECAUSE OF CAPACITY CONSTRAINTS

We assess the strength of the EDB's members support to the bank as 'Low' because of the possibility that, in the unlikely scenario that financial support is needed, EDB's key members would themselves be under financial stress.

Since the introduction of callable capital in 2014, the EDB benefits from very high contractual support. EDB's debt amounted to 82% of discounted callable capital available from investment-grade members in 2015. This ratio fell to zero in 2016, when the outlook on Kazakhstan's Baa3 rating was changed to negative. With the stabilization of the outlook on Kazakhstan's rating earlier this year, the ratio will increase to over 100%.

Meanwhile, although we assume a high willingness by its shareholders to provide extraordinary support, the ability to support EDB is low. We gauge the ability of members to provide extraordinary support by the average median weighted shareholder rating. At Ba1, this measure of support capacity continues to be lower than before oil prices started to fall markedly in mid-2014, following the downgrade of Russia's issuer rating to Ba1 from Baa3 in 2015.

Other credit weaknesses in this area include the high correlation between the bank's members and its assets, a low number of members and high economic and financial linkages between the shareholders. In stress scenarios, it is less likely that some can fulfill their callable capital commitments and support EDB even if others are not.

RATIONALE FOR THE STABLE OUTLOOK

The outlook on EDB's Baa1 rating is stable, reflecting a tentative recovery in the operating environment balanced by potential further occurrence of NPLs given the bank's lending decisions. An expansion in the balance sheet could pose risks to EDB's asset quality and liquidity metrics, although we think it unlikely that EDB's metrics would change significantly and suddenly.

WHAT COULD MOVE THE RATING UP

Upward rating pressure could come from a reduction in risks to asset quality, including through a track record of sound lending policies resulting in lower NPLs. A diversification in the EDB's funding profile towards more liquid markets, and indications of stronger member support than we currently assess would also be credit positive.

WHAT COULD MOVE THE RATING DOWN

Conversely, downward pressure on EDB's rating could come from NPLs continuing to trend at current high levels, signaling a less vigilant lending policy than we currently assess; a deterioration in liquidity or capital adequacy, which could, for instance, be caused by a weakening of loan or treasury asset quality; or a significant weakening of the credit profiles of EDB's major borrowers or shareholders.

The principal methodology used in these ratings was Multilateral Development Banks and Other Supranational Entities published in March 2017. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

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