Research Update:
Eurasian Development Bank Ratings Affirmed At 'BBB/A-2' On Callable Capital Subscription; Outlook Negative

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Overview

• In July 2014, the council of the Eurasian Development Bank (EDB) increased the bank's charter capital to $7 billion, from the current paid-in capital of $1.5 billion, in the form of callable capital.
• While callable capital can, in principle, enhance the stand-alone credit profile of a multilateral lending institution and achieve a higher issuer credit rating, we factor in no explicit uplift in the case of EDB.
• We are therefore affirming the long- and short-term foreign currency issuer credit ratings on the EDB at 'BBB/A-2'.
• The negative outlook reflects our view that there is at least a one-in-three chance that we could lower the ratings on EDB within the next two years if its financial profile weakens, either due to a deterioration in the loan portfolio or a more significant weakening of the economic environment in the region that we currently anticipate.

Rating Action

On July 24, 2014, Standard & Poor's Ratings Services affirmed the long- and short-term foreign currency issuer credit ratings on the Eurasian Development Bank (EDB) at 'BBB/A-2'. The outlook remains negative. We also affirmed the Kazakhstan national scale rating on the bank at 'kzAA+' and the Russia national scale rating on the bank at 'ruAAA'.

Rationale

The ratings on EDB are based on its strong financial profile and its weak business profile, as our criteria define these terms. Together, these assessments lead to EDB's stand-alone credit profile (SACP) of 'bbb.' Despite the recently approved callable capital subscription, our ratings on EDB do not incorporate any explicit uplift for extraordinary shareholder support in the form of callable capital.

EDB was founded in 2006 by the governments of Russia and Kazakhstan. It is a subregional multilateral lending institution (MLI) comprising six member states, the other members being Armenia, Belarus, Kyrgyzstan, and Tajikistan. EDB has a clearly defined public policy role of supporting regional integration, economic growth, external trade, and economic ties within the countries of the Eurasian Economic Community (EurAsEC).
We assess EDB's business profile as weak. Russia and Kazakhstan continue to dominate EDB in terms of the decision-making process. Voting rights are proportional to capital contributions. As of end-June 2014, Russia held a 65.97% stake, Kazakhstan 32.99%, Belarus 0.99%, Tajikistan 0.03%, Armenia 0.01%, and Kyrgyzstan 0.01%. EDB's operations are primarily located in the member states, mainly Russia and Kazakhstan, which leaves EDB exposed to the economic and financial markets of those countries.

In our view, EDB serves an important regional role that could only be partly played by other domestic public institutions, such as local development banks. However, EDB has a relatively short track-record of fulfilling its public policy mandate, compared to peers. While we do not expect any current member to withdraw, we note that in the current geopolitical environment, it is unlikely that EDB will attract new member states, which remains one of the bank's priorities.

We view EDB's financial profile as strong. Historically, EDB has maintained a high level of capitalization, although this has gradually declined over last two years due to portfolio growth. Its risk-adjusted capital (RAC) ratio was 23% at the end of 2013, down from 31% at year-end 2012. EDB's balance sheet is highly concentrated: most of its exposures are in Russia and Kazakhstan (72%) and the top-10 loans account for 57% of the loan portfolio. After factoring in these concentrations, the RAC decreases to 18%. Amid a worsening macroeconomic environment we observed several loan defaults during 2013, the full provisioning of which resulted in a $72 million loss. We foresee some further deterioration in loan-portfolio quality as the economies of Russia and Kazakhstan slow down. However, we do not expect credit losses and nonperforming loans (NPLs) to exceed 5%-7% of the loan portfolio in 2014.

EDB has a good track-record of successful bond issuance, and we assess its funding and liquidity position as strong. EDB issues several instruments in different currencies (U.S. dollars, Russian rubles, and Kazakhstani tenge) every year; during 2013 it raised $1.3 billion-equivalent. Kazakhstan's 2013 nationalization of its pension funds--previously the largest class of investors in the local capital market--significantly narrowed the liquidity available for buying tenge-denominated bonds. This worsened in early 2014 with the 19% devaluation of the tenge. However, we expect EDB will be able to raise sufficient tenge financing given its tenge-denominated liabilities are only 14% of its total liabilities. Moreover, in case of need, EDB could borrow bilaterally in tenge from the Kazakhstan government. We note that on the back of the growing portfolio and approaching the existing maximum leverage limit of 200%, the council of the EDB has recently approved an increase of the maximum leverage to 300% of paid-in capital.

EDB's liquidity is ample, with $1.5 billion or 48% of the balance sheet held in liquid assets. Similar to other MLIs, EDB depends heavily on wholesale market funding (representing 90% of its liabilities). In our view, this is mitigated by its conservative liquidity policy, slowing loan portfolio growth, and ability to attract bilateral loans--including from its two largest
shareholders—if market access were to worsen.

In July 2014, EDB's council increased the bank's charter capital to $7 billion, from current paid-in capital of $1.5 billion, in the form of callable capital. There is no payment of capital linked to this capital increase; all the newly-subscribed capital is callable. The council's decision is aligned with the bank's strategy for 2013-2017, which it revised at its July 2014 meeting to reflect a more-moderate loan portfolio increase due to the weaker economic growth prospects in member states, particularly Russia and Kazakhstan. The additional stock issued is worth $5.48 billion. Russia, which receives 65.97% of the additional shares, subscribed to an additional $3.6 billion, while Kazakhstan (receiving 32.99% of the additional shares), subscribed to a further $1.8 billion.

While callable capital can in principle enhance the SACP of an MLI and achieve a higher issuer credit rating, we factor in no explicit uplift in the case of EDB, mainly because of its highly idiosyncratic ownership structure. No other rated MLI has a single shareholder owning more than half of the shares, or two shareholders holding almost all of them.

In our opinion, EDB's shareholder composition exacerbates what we refer to as the "principal-agent" problem surrounding capital calls (see "For Development Banks, Callable Capital Is No Substitute For Paid-In Capital," published Dec. 31, 2009, on RatingsDirect). The principal (that is, the shareholder) may not have an interest in capital being called. If the agent (EDB's council) is entirely independent from the principal, the call is likely to be made as appropriate, notwithstanding the principal's preference to the contrary.

Given EDB's skewed shareholder structure, however, we believe that a call for capital could be delayed or not made at all—even if the bank's financial condition warranted it. Under our methodology, we would only count the callable capital of Kazakhstan, as it is currently the only shareholder rated at the level of, or higher than, EDB. With our sovereign credit rating on Russia currently one notch below the SACP of EDB, we view the likelihood of the sovereign facing financial stress and default, while low, as marginally higher than the likelihood of EDB (standing alone) facing a default scenario. Russia's ability and willingness to heed a capital call, should EDB require one, could be considered doubtful, in our opinion. We also believe that, given the top-shareholder concentration, if Russia could not or would not heed a capital call, other shareholders would also be reluctant to pay as requested.

**Outlook**

The negative outlook reflects our view that there is at least a one-in-three chance that we could lower the ratings on EDB within the next two years if its financial profile weakens, due to a deterioration in the loan portfolio or a more significant weakening of the economic environment in the region that we currently anticipate (see "Commonwealth Of Independent States Ratings Trends Mid-Year 2014," published July 18, 2014).
A downgrade could, but would not necessarily, follow a similar action on Russia and/or Kazakhstan, which are both on negative outlook. The ratings on EDB could also be affected positively or negatively by changes in the operating environment in the region. If this became more difficult—for example, if EDB's NPLs rose, shareholder support weakened, or relations between shareholders deteriorated—we could lower the ratings. Conversely, the ratings would be supported by a strengthening in the institutional and governance framework in Russia and Kazakhstan.

Related Criteria And Research

Related Criteria
- Multilateral Lending Institutions And Other Supranational Institutions Ratings Methodology, Nov. 26, 2012
- Principles Of Credit Ratings, Feb. 16, 2011
- Bank Capital Methodology And Assumptions, Dec. 6, 2010

Related Research
- Commonwealth Of Independent States Ratings Trends Mid-Year 2014, July 18, 2014
- Russia Foreign Currency Ratings Lowered To 'BBB-/A-3' On Risk Of Marked Deterioration In External Financing; Outlook Neg, April 25, 2014
- Outlook On Kazakhstan Revised To Negative On Lower GDP Per Capita Growth; 'BBB+' Rating Affirmed, June 13, 2014
- For Development Banks, Callable Capital Is No Substitute For Paid-In Capital, Dec. 31, 2009

Ratings List

Ratings Affirmed

Eurasian Development Bank
Issuer Credit Rating
Foreign Currency BBB/Negative/A-2
Kazakhstan National Scale kzAA+/--/--
Russia National Scale ruAAA/--/--
Senior Unsecured BBB

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.