RATING ACTION COMMENTARY

Fitch Revises Outlook on Council of Europe Development Bank to Positive; Affirms at 'AA+'

Mon 26 Jul, 2021 - 09:03 ET

Fitch Ratings - Frankfurt am Main - 26 Jul 2021: Fitch Ratings has revised the Outlook on the Council of Europe Development Bank's (CEB) Long-Term Issuer Default Rating (IDR) to Positive from Stable and affirmed the IDR at 'AA+'.

KEY RATING DRIVERS

The revision of the Outlook reflects resilience in the bank's solvency profile, which was on a positive trend pre-pandemic. Capitalisation and asset quality metrics have remained robust despite the Covid-19 crisis. CEB's ratings are driven by its Standalone Credit Profile (SCP), assessed at 'aa+'. The SCP reflects the lower of our solvency (aa-) and liquidity (aaa) assessments, adjusted upwards by two notches as a result of the bank's low-risk business environment.

Unlike other multilateral development banks (MDBs) with large non-sovereign operations, CEB has not recorded any non-performing loans (NPLs), maintaining its excellent asset quality record. Contrary to our previous expectations, the weighted average rating of loans (WARL) was also unchanged at 'A-' as of end-2020. Fitch expects continued excellent loan repayment performance and only a marginal decline in borrower creditworthiness in the loan portfolio despite the present downside risks, as
evidenced by the Negative Outlooks on some sovereign ratings of the bank's countries of operations.

CEB received strong demand from member states in 2020 to provide funding to governments to address the health needs and social impact resulting from the pandemic, in line with the bank's social mandate. The bank approved and disbursed a record level of loans in 2020 at EUR6.0 billion and EUR4.5 billion, respectively, compared with EUR4.0 billion and EUR2.9 billion in 2019.

CEB's 'aa-' solvency assessment balances the bank's 'strong' capitalisation assessment and 'very low' risk profile.

CEB's 'strong' capitalisation balances a 'moderate' equity-to-assets (e/a) ratio and an 'excellent' Fitch usable capital to risk-weighted assets (FRA) ratio. The large increase in loan disbursements was partially funded via increased borrowings and a reduction in treasury assets. The former led to an increase in leverage, as reflected in the decrease in the e/a ratio to 11.7% at end-2020 from 12.1% at end-2019, but remained consistent with a 'moderate' e/a ratio (8-15%).

The FRA ratio also marginally declined to 38.6% at end-2020 from 39.6% at end-2019. This decline exclusively reflected the increase in leverage as the sovereign ratings of borrowing countries have been broadly stable since last July.

Fitch expects a decline in loan disbursements in 2021 but for levels to remain above the pre-pandemic trend until 2023, when the agency anticipates a decline in the annual level of lending growth. Despite continued strong demand for CEB lending, weaker internal capital generation, fuelled by the continued low interest rate environment, and prudential leverage constraints should arrest the recent and expected rise in leverage. Overall, we expect a slightly weaker but continued 'strong' capitalisation assessment.

CEB's 'very low' risk profile reflects the bank's 'very low' credit, equity, and market risks.

CEB continues to boast one of the highest credit quality loan portfolios across MDBs rated by Fitch. The WARL was unchanged at 'A-' at end-2020 compared with end-2019. Similarly, the loan performance continues to be excellent with zero NPLs as the bank has not experienced any delays in loan repayments.

The bank has never suffered a loss on sovereign exposures and the last non-sovereign exposure in arrears was resolved in 2012, with the resulting loss accounting for less than 0.1% of the loan portfolio. The loan book performance reflects the high credit quality of the bank's borrowers and the large share of sovereign and public sector
exposures. We assess the bank’s preferred creditor status (PCS) as ‘strong’, which translates into a two-notch uplift over the average rating of loans to 'A+'.

Despite the resilience in the WARL and continued strong loan performance, downside risks remain, with over a quarter of total loan exposures located in countries in which the Outlook on the sovereign is Negative. This is broadly consistent with a year prior and remains in contrast with the pre-pandemic trend of net positive sovereign rating actions across CEB's member states. However, Fitch expects the WARL to prove resilient to downward pressure, even if a proportion of the sovereign ratings with Negative Outlooks are ultimately downgraded.

'Low' concentration risk, as measured by the five largest exposures (23.5% of total loans at end-2020), has continued to improve and further contributes to our assessment of the bank's 'very low' risk profile. Exposure to the Turkish sovereign (BB-/Stable) represents the single largest exposure (7.6%) and is the only exposure rated below investment-grade out of the 20 largest exposures.

CEB's 'aaa' liquidity assessment reflects the bank's excellent liquidity buffers and strong credit quality of its treasury portfolio (54% rated above 'AA-' at end-2020). We expect coverage of short-term debt by liquid assets to remain well above the 1.5x 'excellent' threshold by 2023 (2.5x at end-2020), in line with recent years.

CEB's 'low' risk business environment translates into a two-notch uplift over its solvency assessment. The business environment assessment balances the 'low' risks of its operating environment, including the high credit quality and low political risk in the countries of operations, and CEB's 'medium' risk business profile. In Fitch's view, CEB's public mandate has been enhanced in recent years by the role the bank played in the migrant crisis in Europe and during the Covid-19 pandemic. The greater interest in social investments further supports demand for CEB financing and bonds.

CEB's ratings do not benefit from credit uplift for shareholders' support. The average rating of key shareholders is 'A+', unchanged from a year ago. The lack of paid-in capital injections from shareholders in the last two decades and no coverage of net debt by callable capital translate into a 'weak' assessment of the propensity of shareholders to provide support.

**RATING SENSITIVITIES**

Factors that could, individually or collectively, lead to positive rating action/upgrade:
Solvency (Risks): Improvement in the macroeconomic environment across CEB's member states that reduces downward risks to the credit quality of the bank's borrowers and prevents deterioration in the average rating of the loan portfolio below the 'A-' level as of end-2020.

- Solvency (Risks): Continued strong performance of the bank's loan book that leads to maintenance of the bank's 'very low' NPL ratio (below 1%).

- Solvency (Capitalisation): Stabilisation or improvement in the bank's capitalisation metrics as evidenced by maintenance of the FRA ratio above the 35% threshold for an 'excellent' assessment and an e/a ratio within the range recorded in recent years (11%-13%).

Factors that could, individually or collectively, lead to negative rating action/downgrade:

- Solvency (Capitalisation): A large increase in leverage or increased exposure to borrowers with weak credit quality, potentially caused by faster than expected loan growth, that reduces the bank's capital buffers, including a deterioration in the FRA ratio to below 35%, and affects our 'strong' capitalisation assessment.

- Solvency (Risks): A revision of our 'very low' credit risk assessment, caused by either large declines in asset quality metrics, resulting from multiple negative sovereign rating actions, from rising exposure to the private sector, or from an increase in NPLs.

- Liquidity: Evidence of a large decline in the bank's liquid-assets-to-short-term-debt ratio to below the 150% 'excellent' threshold or a marked deterioration in the asset quality of treasury assets, which could lead to the revision of our assessment of the bank's 'aaa' liquidity assessment.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used
to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

**KEY ASSUMPTIONS**

The global economy will develop in line with Fitch's Global Economic Outlook published on 15 June 2021.

CEB maintains and abides by its conservative risk management framework.

**SOURCES OF INFORMATION**

The sources of information used to assess these ratings were CEB’s financial statements, and other information provided by CEB.

**REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING**

The principal sources of information used in the analysis are described in the Applicable Criteria.

**ESG CONSIDERATIONS**

CEB has an ESG Relevance Score of ‘4[+]’ for Human Rights, Community Relations, Access & Affordability. The CEB provides grants funded by its member states to support policies in favour of migrants and refugees. It also subsidises certain loans to its most vulnerable borrowers to support social development, including social housing, education, and healthcare. This supports the policy importance of the bank. This has a positive impact on the credit profile, and is relevant to the ratings in conjunction with other factors.

CEB has an ESG Relevance Score of ‘4’ for Rule of Law, Institutional & Regulatory Quality. All supranationals attract a score of ‘4’. Supranationals are neither subject to bank regulation nor supervised by an external authority. Instead, supranationals comply with their own set of rules. Fitch pays particular attention to internal prudential policies, including compliance with these policies. This has a negative impact on the credit profile, and is relevant to the ratings in conjunction with other factors.
Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

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**FITCH RATINGS ANALYSTS**

**Malgorzata Glowacka**
Associate Director
Primary Rating Analyst
+49 69 768076 279
malgorzata.glowacka@fitchratings.com
Fitch Ratings – a branch of Fitch Ratings Ireland Limited
Neue Mainzer Strasse 46 - 50 Frankfurt am Main D-60311

**Enrique Bernard ez**
Director
Secondary Rating Analyst
+44 20 3530 1964
enrique.bernardez@fitchratings.com
Tony Stringer
Managing Director
Committee Chairperson
+44 20 3530 1219
tony.stringer@fitchratings.com

MEDIA CONTACTS

Peter Fitzpatrick
London
+44 20 3530 1103
peter.fitzpatrick@thefitchgroup.com

Additional information is available on www.fitchratings.com

APPLICABLE CRITERIA

Supranationals Rating Criteria (pub. 20 May 2021) (including rating assumption sensitivity)

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