Credit Rating Announcement

17 September 2021

Scope affirms Council of Europe Development Bank's AAA rating with Stable Outlook

Excellent asset quality, very high liquidity buffers and increasing strategic importance for highly-rated shareholders support the rating. High leverage is the key credit challenge.

Scope Ratings GmbH (Scope) has today affirmed the Council of Europe Development Bank's AAA long-term issuer and senior unsecured foreign-currency ratings, along with a short-term issuer rating of S-1+ in foreign currency. All Outlooks are Stable.

For the associated Appendix, click here.

Summary and Outlook

The Council of Europe Development Bank's (CEB) AAA rating reflects the supranational's 'excellent' intrinsic strength and 'high' shareholder support. The CEB's institutional profile benefits from an increasing strategic role for its shareholder governments and excellent governance. Its social mandate, along with shareholders' strong responses and financing demand during the 2015 refugee crisis and the Covid-19 health crisis, supports its unique role among peers.

The CEB's financial profile benefits from excellent asset quality with no non-performing loans (NPLs) and high average borrower quality due to its focus on the public sector, predominantly in Europe. It also benefits from preferred creditor status (PCS) for its sovereign exposures and strong geographical diversification. The CEB's liquidity profile is exceptionally strong, and its funding profile benefits from strong market access. Stable net profits continue to strengthen its capital base. The key rating challenge is the CEB's high leverage.

Finally, the CEB benefits from highly rated key shareholders. The largest European economies – Germany (AAA/Stable), France (AA/Stable), Italy (BBB+/Stable), Spain (A-/Stable), the Netherlands (AAA/Stable), Belgium (AA-/Stable) and Greece (BB+/Stable) – are joined by Turkey (B/Negative) to form the CEB's key shareholders, whose weighted average rating is A. This drives Scope's high assessment of shareholder support. However, at 14%, coverage of outstanding mandated assets by high-quality callable capital is relatively moderate compared to peers.

The Stable Outlook reflects Scope's assessment of the CEB's financial buffers against external and balance sheet-driven shocks. The rating could be downgraded if: i) the CEB records sustained losses leading to a marked deterioration of the capital base; ii) its liquidity buffers are significantly reduced; and/or iii) key shareholders are downgraded.

Rating rationale

The first driver of the CEB's AAA rating is its very strong institutional profile.

This reflects the CEB's high and increasing strategic importance for its shareholders. Both the 2015 refugee crisis and the Covid-19 health crisis have highlighted the unique role of the CEB, its ability to adapt to current social challenges, and shareholder governments' responsiveness to and demand for CEB financing and expertise. The bank's response to the Covid-19 crisis led to higher rates of project approvals (up 50% YoY) and disbursement activity (up 60% YoY) in 2020, with a total of EUR 3.1bn for 21 pandemic-related project approvals in members states[1]. Importantly, roughly one third of project approvals in 2020 were for new customers, establishing future relationships for the bank. Furthermore, increasing cooperation with the European Union (AAA/Stable) strengthens the bank's policy relevance. This includes fiduciary and grant-financing activities, such as the Regional Housing Programme and the Strengthening Health Infrastructure Care for All initiative in Turkey. Lastly, the CEB will be an implementing partner for the social arm of the EU's InvestEU Programme, which will provide guarantees for eligible CEB projects, further enhancing cooperation and its strategic importance.

While the bank has a predominantly social mandate, it also links its activities to environmental sustainability and the Paris Agreement, and provided financing of around EUR 800m in 2020 for climate change mitigation and resilience[2]. In this context, Scope assesses the CEB's potential environmental risk exposure and its environmental policies. This includes the risk of stranded assets and the reputational risk of pursing activities, either directly or through counterparties, that are contradictory to its mandate and environmental objectives. Scope assesses these risks as low compared to peers. This is due to: i) the comparatively low transition and physical risk scores of the CEB's main countries of operation based on Scope's internal assessment; and ii) the CEB's ongoing screening efforts within projects regarding their alignment with sustainable development goals and their environmental impact.

The second driver underpinning the CEB's AAA rating is its excellent financial profile.

The CEB's credit profile is supported by its very strong asset quality. Its loan book is characterised by zero NPLs, high average borrower quality, clear benefits from the PCS of its sovereign exposures, as well as low geographical concentration and low top-10 loan book concentration, in line with its prudent lending policies. The bank's main lending areas are aid to refugees and displaced persons, health care, social housing, regional infrastructure, greening the economy and supporting small- and medium-sized enterprises. The bank lends directly to sovereigns and sub-sovereigns via its Public Sector Finance Facility and via on-lending to commercial and state-owned banks. The bank may also offer guarantees (but currently none are outstanding) and does not invest in equities. Although all member states are eligible to receive financing, the bank's target group is 22 countries in Central and Eastern Europe.

The bank benefits from a loan book with high average borrower quality, which Scope estimates to be in the 'bbb' category before credit enhancements, based on Scope's estimate of the geographical and sectoral distribution of aggregate loans outstanding and Scope's sovereign ratings. The relatively stable operating environment reflects the fact that around 25% of outstanding loans are in France, Germany and Spain, with a recent shift to relatively higher rated countries such as the Netherlands (AAA/Stable) and the Czech Republic (AA/Stable). Turkey (B/Negative) represents the riskiest exposure in the CEB's loan portfolio, accounting for around 8% of total loans. Public sector exposures amounted to around 80% of the CEB's total loan book after credit enhancements, reflecting the bank's mandate to lend mostly to sovereigns, sub-sovereigns and state-owned financial institutions. The overall share of investment grade exposures, as reported by the bank, stood at 87% after credit enhancements[3].

The CEB's loan book benefits from a very high degree of credit protection overall. When it comes to sovereign exposures, the CEB benefits from PCS as evidenced during the default episode of Greece. Scope expects the CEB to continuously benefit from PCS given the high share of public sector exposures and expected reputational concerns among its highly rated borrowers. Looking at the private sector exposure, about 20% of the loan book comprises on-lending to commercial banks. Here, the CEB benefits from the ultimate risk of the borrower being transferred to the implementing bank. Furthermore, counterparties provided collateral or guarantees amounting to EUR 6.8bn at YE 2020, equalling around 38% of the total loan book. In sum, Scope estimates that over 80% of the total loan book benefits from PCS or other credit enhancements.

In addition, The CEB's loan portfolio is well diversified across member states. In 2020, the largest aggregated exposures were in Spain (around 12% of total loans), Poland (10%), Turkey (8%) and France (7%). In terms of sectoral concentration, the loan portfolio is concentrated among sovereigns and sub-sovereigns, and to a lesser degree, financial institutions, in line with the nature of the CEB's lending operations. Further, the CEB actively manages large exposure risks. It has imposed a limit of 25% of prudential equity for any non-sovereign counterparty or connected group of counterparties, equalling around EUR 800m at end-2020. No non-sovereign exposure exceeded that limit at the end of 2020, and the sum of large exposures to non-sovereign borrowers was EUR 3.3bn, or around 19% of gross loans. Overall, these factors increase Scope's assessment of the CEB's portfolio quality after credit enhancements to the highest category of 'very strong'. The bank's excellent portfolio quality is also reflected in a flawless track record of recording no NPLs since 2009 and only one NPL in its entire history.

The CEB's financial profile is further underpinned by its conservative liquidity management and high liquid asset buffers. Internal liquidity guidelines stipulate, among other things, a self-sufficiency period of at least six months. This assesses the bank's ability to cover expected net cash outflows in a severe stress scenario given full operationality without access to funding markets and without selling or repoing its financial assets. In addition, the bank monitors short-term liquidity ratios over different time horizons of up to one year, for which the limit is set at 100%. The same guidelines apply to its liquidity coverage ratio and net stable funding ratio. Finally, the bank stress-tests its contingent liquidity requirements deriving from two-way margin requirements for its derivative contracts. In addition, the CEB hedges all foreign exchange and interest rate risks stemming from its lending, treasury and funding operations.

The CEB's prudent liquidity policies result in a high and stable level of liquid assets, providing a substantial cushion in the context of higher lending volumes due to the bank's Covid-19 response. This enables the CEB to fulfil its mandate, particularly in times of heightened activity and uncertainty. Specifically, Scope estimates total liquid assets at around EUR 8.1bn for end-2020. Conversely, total liabilities maturing in one year or less at YE 2020 and disbursements in 2021, estimated at around 3.5bn, amount to around EUR 7.3bn. Scope uses this as a basis to calculate the bank's liquid assets ratio, which stood at 112% in 2020. This ratio implies that the bank's available liquid assets cover all outstanding liabilities and loan disbursements within 12 months without the need to access capital markets. This is one of the strongest liquidity cushions among supranational institutions.

Another credit strength is the CEB's strong market access. The bank's bond issuances are designated as Level 1 high-quality liquid assets, which are granted a 0% risk weight under the Basel Framework and are eligible for the ECB's asset purchase programmes. This preferential regulatory treatment, along with an established track record on capital markets and a strong shareholder and capital base, underpins the CEB's market access for its annual issuance volumes of around EUR 5bn between 2018-20. Furthermore, the bank's prudent funding strategy is reflected in the roughly six-year weighted average maturity of its issuances, which limits refinancing and maturity mismatch risks. Its diversification in terms of instruments and currencies is shown by bond issuances in six different currencies during 2020. Since 2017, the CEB has issued social bonds that follow the bank's social inclusion bond framework and align with the ICMA's social bond principles. These include bonds issued to fund the bank's Covid-19 activities after it added the health sector to its social bond framework, further underscoring its unique social mandate[4]. Even though the CEB is a relatively small issuer on capital markets compared to peers with AAA ratings, it operates under similar funding conditions.

The third driver of the CEB's AAA rating is its high shareholder support.

The CEB's key shareholder group comprises the largest European economies – Germany (AAA/Stable), France (AA/Stable), Italy (BBB+/Stable), Spain (A-/Stable), the Netherlands (AAA/Stable), Belgium (AA-/Stable) and Greece (BB+/Stable) – and Turkey (B/Negative). This results in a weighted average rating of A based on Scope's sovereign ratings, signalling a strong ability to support the CEB. However, exceptional support in the form of the bank's callable capital, if ever needed, is assessed as relatively moderate compared to peers. High-quality callable capital of shareholders rated AA- or higher amounted to around EUR 2.5bn, or 14% of outstanding mandated assets.

Despite these credit strengths, the CEB also faces the following credit challenges:

The CEB's capitalisation level relative to its outstanding assets is low compared to peers. Scope expects this to remain the case in the coming years given a record-high stock of approved projects to be financed, totalling EUR 9.5bn at the end of 2020. Scope estimates the CEB's equity and reserves at around EUR 3.1bn. The CEB's operational gearing ratio, which limits total loans after swaps and guarantees to 2.5 times its own funds (subscribed capital, reserves and net profits), acts as an operational target that is credibly enforced. This limit stood at around EUR 20bn in 2020. Assuming maximum operations under the gearing ratio limit and the CEB's current capitalisation, results in a capitalisation ratio of about 16%, which is below that of peers, but still higher than the 10% observed for the European Investment Bank (AAA/Stable). The CEB's actual capitalisation ratio, based on disbursed gross loans, is slightly higher at around 18%, also signalling that the bank was operating close to the gearing ratio limit at YE 2020.

At the same time, Scope acknowledges several mitigating factors to the institution's low capitalisation. First, the CEB's track record of ensuring high asset quality protects its capital base. Second, stable levels of profitability enable the bank to continuously retain earnings and build up its reserves and capital base. Scope notes that the CEB has been profitable every year, with average annual returns on equity of 3.5% since 2015 and stable annual earnings of around EUR 105m from 2017-19. The CEB's net income in 2020 of EUR 75m, or 2.4% of equity, was negatively impacted by the Covid-19 crisis via a general increase in the cost of risk due to the worsening macroeconomic environment. Lower returns on its treasury portfolio due to declining long-term interest rates also had a negative impact in 2020.

Finally, the bank's prudential framework ensures capital adequacy and continued operationality. This is highlighted by the bank's reported capital adequacy ratio, which measures its prudential equity (paid-in capital, reserves and net profit) versus its risk-weighted assets. This ratio stood at 27.6% at end-2020, significantly above the internal floor of 10.5% and above the CEB's comfort-zone of over 25%, which is intended to ensure a sufficient buffer. In addition, the bank limits its leverage, or indebtedness ratio after swaps, to 10 times its prudential equity (the actual ratio was 6.9 in 2020).

Factoring of environment, social and governance (ESG)

Scope considers ESG sustainability issues during the rating process as reflected in its supranational methodology. ESG factors are explicitly captured in Scope's assessment of the institutional profile, which Scope assesses as 'very strong' for the CEB.

Scope's supranational scorecard

Scope's supranational scorecard, which is based on clearly defined quantitative parameters, provides an indicative AAA rating for the CEB. Additional considerations allow Scope to incorporate idiosyncratic characteristics that cannot be assessed in a consistent and comprehensive manner across all supranationals, but which may still affect the creditworthiness of the issuer.

For the CEB, no additional consideration has been identified.

A rating committee has discussed and confirmed these results.

For further details, please see the Appendix.

Rating committee

The main points discussed were: i) key shareholders and institutional setup; ii) preferred creditor status and mandated activities; iii) liquidity management and buffers; iv) capitalisation; v) asset quality; and vi) consideration of peers.

Rating driver references

1. Activity Report 2020
2. Sustainability Report 2020
3. Financial Report 2020
4. Social Inclusion Bond Framework

Methodology

The methodology used for these Credit Ratings and/or Outlooks, (Rating Methodology: Supranational Entities, 7 September 2021), is available on https://www.scoperatings.com/#!methodology/list.
Scope Ratings GmbH and Scope Ratings UK Limited apply the same methodologies/models and key rating assumptions for their credit rating services, while Scope Hamburg GmbH's methodologies/models and key rating assumptions are different from those of Scope Ratings GmbH and Scope Ratings UK Limited.
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The Outlook indicates the most likely direction of the Credit Ratings if the Credit Ratings were to change within the next 12 to 18 months.

Solicitation, key sources and quality of information

The Credit Ratings were not requested by the Rated Entity or its Related Third Parties. The Credit Rating process was conducted:

With Rated Entity or Related Third Party Participation	YES
With Access to Internal Documents	YES
With Access to Management	NO

The following substantially material sources of information were used to prepare the Credit Ratings: the Rated Entity and public domain.
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Prior to the issuance of the Credit Rating action, the Rated Entity was given the opportunity to review the Credit Ratings and/or Outlooks and the principal grounds on which the Credit Ratings and/or Outlooks are based. Following that review, the Credit Ratings were not amended before being issued.

Regulatory disclosures

These Credit Ratings and/or Outlooks are issued by Scope Ratings GmbH, Lennéstraße 5, D-10785 Berlin, Tel +49 30 27891-0. The Credit Ratings and/or Outlooks are UK-endorsed.
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