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Research Update:

Multilateral Lender Council of Europe Development Bank 'AA+' Ratings Affirmed; Outlook Remains Positive

Primary Credit Analyst:

Gabriel Forss, Stockholm (46) 8-440-5933; gabriel.forss@spglobal.com

Secondary Contact:

Maxim Rybnikov, London (44) 20-7176 7125; maxim.rybnikov@spglobal.com

Research Contributor:

Harshleen K Sawhney, CRISIL Global Analytical Center, an S&P Global Ratings affiliate, Mumbai

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Overview

- Responding to increasing demand, the Council of Europe Development Bank (CEB) has meaningfully stepped up its lending activity over the past three years.
- As governments increasingly address notable backlogs in social investment, demand for CEB funds is intensifying. In this context, we continue to believe that CEB could cement its position as a favored and relevant funding contributor, adding momentum to its overall business profile and ratings.
- We are affirming our 'AA+' ratings on CEB.
- The outlook remains positive, reflecting our view that CEB's lending activity will keep increasing over the next few years, signaling its strengthening role as a favored funding contributor to social investments and sustaining its funding relevance through the cycle. Combined with continued shareholder commitment, this could strengthen our assessment of its business profile and lead us to upgrade CEB.

Rating Action

On June 28, 2018, S&P Global Ratings affirmed its 'AA+' long-term and 'A-1+' short-term issuer credit ratings on multilateral lending institution (MLI) Council of Europe Development Bank (CEB). The outlook remains positive.

Rationale

The ratings on CEB reflect our assessment of its business and financial profiles as very strong. These assessments underpin our view of the bank's stand-alone credit profile (SACP), which we assess at 'aa'.

We base our assessment of CEB's business profile on the bank's governance, role, and public-policy mandate. CEB was established in 1956 as the Council of Europe Resettlement Fund for National Refugees and Over-Population in Europe, with a mandate to help refugees and other displaced persons after World War II. Today, CEB supports social infrastructure investment in Europe. In operational terms, this involves loans to support job creation in small and midsize enterprises, vocational training, social housing, health care,

environmental projects, correctional facilities, natural catastrophe relief, and educational reform. In 2017, CEB approved €3.9 billion for projects, of which about €1.2 billion was for facilities for the long-term integration of migrants and refugees and €1.5 billion for micro, small, and medium enterprises. The remainder was for investments in education, improving living conditions, energy efficiency in housing, and local infrastructure.

Over the past three years, CEB has increased its efforts to broaden its activities. In sharp contrast with its lackluster activity levels after the 2007 financial crisis, the bank is now responding swiftly to high demand for investments in the social sphere. Although the higher disbursements in 2017 were offset by almost equally high scheduled reimbursements, leaving the overall loan book rather flat, we observe an ongoing positive trend in the bank's activity levels. In particular, last year and continuing into 2018, we observe continued momentum in CEB's disbursements and project approvals. Both have achieved record highs, and we expect them to increase further still. Specifically, approvals of €3.9 billion in 2017 compared to the bank's aim of €3.5 billion, and the number of projects approved was up by 13% on 2016. We believe this robust momentum will continue.

To cater for significantly heightened demand in non-target countries in Northern Europe--to finance facilities and activities related to migrant and refugees--the bank has relaxed the 60/40 stipulation that favored its traditional target countries so that it can ramp up its lending to social integration activities in non-target countries. In 2017, it increasingly geared its project approvals toward non-target countries, for education and social infrastructure for migrants and refugees. We expect funding demand from refugee-hosting communities to persist and note positively that the bank's 2017-2019 development plan provides flexibility to support further growth in those areas, notably through the introduction of cross-sectoral loans and the medium- to longer-term integration of refugees and migrants in host countries.

With its broadening mandate and increasingly tangible role as a social investor in member countries' budgets, CEB continues to scale-up its operations. In addition, there is scope to cement its longer term funding relevance with the upcoming EU 2021-2027 budget. The EU is set to include a specific social investment window in its structural funds deployment, which we believe could help CEB further improve its mandate fulfillment and lending footprint. In the near term, we expect disbursements to increase to €2.5 billion for 2018, from €2.3 billion in 2017, and gradually approach €3.0 billion through 2020 as the bank translates its comprehensive stock of approved projects into disbursements. Although we do not measure relevance by numbers alone, we believe future loan growth in core operating areas would need to be sustained at these higher levels, through the cycle, to demonstrate CEB's increased importance.

In 2015, CEB responded to the migrant crisis in a timely manner. It initiated and secured shareholder grant funding for its Migrant and Refugee Fund (MRF), to finance the immediate supply of essential facilities in refugee reception centers. It signed almost the full amount of the MRF in the first six months

of the crisis. To date, more than €25 million of contributions have been made to the fund by 21 CEB member states of which Germany (€5 million), the European Investment Bank (€5 million), and CEB itself (€5 million), and the contributions have been converted into €22 million of financing commitments so far. Although its size remains very limited, the MRF was funded and deployed swiftly in 2015 amid the refugee influx.

We think CEB has the opportunity to increasingly step into the forefront as one of the preferred lenders under its mandate. Even though its niche lending mandate, and its relatively small balance sheet compared with other highly rated peers, limits its role as a contra-cyclical lending contributor, the institution is a relevant preferred lender, particularly for social projects in some of the bank's smaller member countries where alternative financing solutions are more scarce. A significant portion of CEB's lending focuses on projects in target countries where the associated project costs, loan sizes, and business expertise deter many other institutions (both commercial and other government-owned). Compared to highly rated peers that are more project-finance heavy, the average loan size for CEB is significantly smaller. Moreover, CEB offers additional expertise in a number of social domains (such as housing and education), technical design support, and technical assistance through the project cycle. Its policy importance is enhanced by its engagements in partnerships and cooperation with the EU and other international institutions.

We view the bank's policy of not paying dividends as a sign of ongoing shareholder support, and we expect this to continue. In this vein, in 2012 the CEB benefited from member countries' additional capital subscriptions linked to its latest capital increase approved on Feb. 4, 2011. This increase required no disbursement of cash from member countries and had no effect on adjusted shareholders' equity. While windfall capital improvements, from stronger credit quality of exposures and dynamics surrounding the high scheduled repayments, have reduced the imminent need for a capital increase from shareholders, we believe sustained longer-term growth would likely prompt a medium-term build-up in financial capacity. Tangible shareholder support in the form of a capital increase would strengthen our assessment of the bank's relationship with its shareholders, and of its policy relevance. In the shorter term, we anticipate that the expansion of CEB's lending activity could likely enhance operational capacity in terms of more staff and increased investments in systems and processes.

We assess CEB's financial profile as very strong. We notably factor in our calculation of the bank's risk-adjusted capital (RAC) ratio of 22% at year-end 2017 (42% before adjustments for concentration risk and preferred creditor treatment), compared with 21% (38% before adjustments) a year earlier, as well as its funding and liquidity. In 2017, borrowers located in Poland accounted for 15% of all disbursements, followed by Germany (15%), Spain (14%), and France (10%). This increased concentration had a limiting effect on the CEB's RAC after MLI adjustments. Even though we expect the bank to disburse around €2.4 billion in 2018, the high €1.8 billion of reimbursements this year will continue to limit the loan book's net growth. Moreover, we expect CEB's

disbursements in 2018 to increasingly focus on highly rated Northern European countries, positively influencing the risk weighting of its assets. Therefore, we forecast that CEB's rate of internal capital generation will help sustain its capital ratios over the next few years. This is despite our expectation that CEB's net earnings will likely remain muted in the low interest rate environment, and thanks to its policy of not paying dividends.

Our funding ratios indicate that CEB is structurally able to cover its scheduled short-term debt repayments and loan disbursements without recourse to new issuance. Owing to a de-leveraging initiative, which has reduced the amount of treasury assets as well as more pronounced loan disbursement commitments, CEB's liquidity ratios have decreased compared with our assessment of one year ago. However, we note that it still keeps high liquid assets relative to its total exposures, compared with many other highly rated MLIs. In our liquidity stress scenario, the bank would be able to continue comfortably fulfilling its mandate, even under extremely stressed market conditions, without access to the capital markets for one year, even though its buffers have decreased compared our previous assessment. That said, we believe that CEB's conservative financial management will secure comprehensive liquidity levels, and the bank will adjust them in tandem with upcoming debt redemption and loan disbursement schedules. We consider CEB's strong liquidity position to be important considering its intended move to two-way credit support annexes (CSAs) on its derivatives counterparty portfolio. Moving to bilateral CSA agreements for collateral posting will affect its liquidity and funding strategy. We expect CEB will appropriately adapt its asset-liability management and size up its liquidity portfolio accordingly to balance the potential liquidity need stemming from additional collateral postings.

Incorporating CEB's callable capital from 'AAA' and 'AA+' rated shareholders into its equity base leads us to revise up our financial profile assessment to extremely strong. Accordingly, we add one notch of uplift to the issuer credit rating from the SACP. Currently, CEB has eight 'AAA' shareholders and one 'AA+' shareholder.

The criteria correction explained in "Criteria For Assessing Bank Capital Corrected," published on July 11, 2017, is not factored into the RAC ratio after diversification. The impact of the correction on the ratio is not material to the rating.

Outlook

The positive outlook reflects our view that CEB's public-policy role and mandate fulfillment is steadily strengthening on the back of its increased lending activity, and clear relevance. We believe that CEB could cement its position as the financier of choice within the social investment sphere--where demand is strong--by replicating and furthering 2017's robust project approval rates and disbursement levels over the next few years. Combined with its excellent financial risk profile and apparent shareholder commitment, this could strengthen our assessment of its business profile and possibly lead to

an upgrade.

We could raise the long-term rating over the next two years if CEB's increasing activity under its mandate became such that its public-policy role strengthened sustainably. In addition, if we observed CEB's shareholders responding encouragingly to the expected significant increase in the bank's activity, in the form of tangible support, then positive rating and business profile momentum would build.

We could revise our outlook to stable if CEB proved unable to cement such a position, leading it to return to lower disbursement and project approval levels. Moreover, if we observed that shareholders were reluctant to tangibly support the bank, ratings momentum would diminish.

Related Criteria

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- Criteria - Governments - General: Multilateral Lending Institutions And Other Supranational Institutions Ratings Methodology, Nov. 26, 2012
- Criteria - Financial Institutions - Banks: Multilateral Lending Institutions Capital Methodology And Assumptions, Dec. 6, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Introduction To Supranationals Special Edition 2017, Oct. 20, 2017
- Supranationals Special Edition 2017: Comparative Data For Multilateral Lending Institutions, Oct. 20, 2017
- Council of Europe Development Bank, Aug. 1, 2017
- Multilateral Lender Council of Europe Development Bank Outlook Revised To Positive On Strengthening Mandate Fulfillment, June 30, 2017
- Credit FAQ Discusses MLIs' Lending Capacity And Current Capital Endowment, May 18, 2017
- How Brexit Could Impact Ratings On Supranational Institutions, April 10, 2017

Ratings List

Ratings Affirmed

Council of Europe Development Bank
Issuer Credit Rating
Foreign Currency AA+/Positive/A-1+

Senior Unsecured	AA+
Commercial Paper	A-1+

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.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website 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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