Fitch Revises Council of Europe Development Bank's Outlook to Stable; Affirms at 'AA+'

Fitch Ratings-Paris-29 July 2020:

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

Key Rating Drivers

The revision of the Outlook reflects Fitch's expectation of downward pressure on the credit quality of CEB's loan portfolio as a result of the economic impact of the global pandemic on the bank's countries of operations. The affirmation and Stable Outlook also reflect our expectation that the bank's ratings will be resilient to this negative shock.

CEB's ratings are driven by its intrinsic credit features and reflect its solvency (assessed at 'aa-'), its liquidity (assessed at 'aaa') combined with its low-risk business environment, which provides an uplift of two notches to the lower of its solvency and liquidity assessments (aa-), resulting in an intrinsic rating of 'aa+'.

The bank has responded to the COVID-19 crisis by re-allocating and expediting planned loan commitments to address the health needs and social impact resulting from the pandemic. We expect the bank's 2020 disbursements to increase to around EUR4.0 billion-EUR4.5 billion (from EUR2.85 billion in 2019) owing to strong demand for financing from its member states. This would be above the levels envisaged in the bank's recently approved strategy for 2020-2022 (EUR3.0 billion-EUR3.5 billion per year).

CEB's capitalisation is assessed as 'strong', which balances a 'moderate' equity-to-assets ratio (12.2% at end-2019) and an 'excellent' Fitch usable capital to risk-weighted assets ratio (FRAR; 40% at end-2019). We expect some deterioration in these metrics, owing to a slight increase in leverage and higher risk-weighted exposures as a result of expected deterioration in the credit quality of the loan portfolio. Part of the increased disbursements in 2020 will be funded by drawing on the bank's ample treasury buffer (33% of total assets at end-2019), limiting the negative impact on capitalisation metrics.
CEB's 'very low' risk profile reflects the bank's 'very low' credit, equity, and market risks. The bank has not recorded any arrears on loan repayments since the onset of this crisis, which highlights the high credit quality of its borrowers.

The average rating of the loan portfolio was estimated at 'A-' as of end-2019. The average has remained unchanged so far despite recent downgrades across a number of the bank's borrowers. However, the economic crisis has affected the credit quality of the loan portfolio and the balance of risks is tilted to the downside. Fitch estimates that 10% of the portfolio has experienced downgrades year-to-date. A further 27% now have Negative Outlooks (including non-sovereign entities located in countries where the Outlook on the sovereign rating is Negative). The average rating of the portfolio would deteriorate to 'BBB+' if these Outlooks materialised into downgrades. There are no sovereign ratings with Positive Outlooks across CEB's member states compared with seven at end-2019.

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 performance of the loan book (zero non-performing loans at end-2019) reflects the high credit quality of the bank's borrowers and the large share of sovereign and public sector exposures (two-thirds of the loan book at end-2019). 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+', the highest across Fitch's multilateral development bank rating coverage.

'Low' concentration risk, as measured by the five largest exposures (25% of total loans at end-2019), 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 (9%) 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-2019). The coverage of short-term debt by liquid assets is expected to remain well above the 1.5x 'excellent' threshold by 2022 (2.4x at end-2019), in line with recent years. CEB's 'strong' access to capital markets has been further evidenced by large subscription rates on its COVID-19 social inclusion bonds.

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. Fitch has revised the assessment of the bank's public mandate importance to 'medium' risk from 'high'. The revision is driven by our view of CEB's increased importance for its member states as evidenced by the role it has played in the response
to Europe's refugee crisis and the COVID-19 pandemic. Participation in the Invest EU scheme, whereby the CEB is set to benefit from guarantees from the European Union (AAA/Stable) is also evidence of increased importance of the bank within the EU's financial framework, in Fitch’s view.

CEB’s ratings do not benefit from credit uplift from shareholders' support. The average rating of key shareholders fell to 'A+' from 'AA-' following the downgrade of Italy's sovereign rating (BBB-/Stable). 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 (Risk): 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.

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

- Solvency (Capitalisation): Stabilisation or improvement in the bank's capitalisation metrics as evidenced by maintenance of the FRAR above the 35% threshold for an 'excellent' assessment and an equity-to-assets 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 and affects our 'strong' capitalisation assessment.

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

- 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

CEB maintains a 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.

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Applicable Criteria
Supranationals Rating Criteria (pub. 30 Apr 2020) (including rating assumption sensitivity)

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