

## Scope assigns Council of Europe Development Bank AAA/stable first-time credit rating

**Highly rated shareholders, strong liquidity position and asset quality, and increasing strategic importance support the rating; challenges relate to high leverage and shareholder concentration.**

### Rating action

Scope Ratings GmbH has today assigned the Council of Europe Development Bank first-time **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 supranational scorecard, [click here](#).

### Summary and outlook

The **AAA** rating assigned to the Council of Europe Development Bank (CEB) reflects the supranational's highly rated key shareholders, a strong liquidity position, very high asset quality and its increasing strategic importance particularly for EU member states. The CEB's counter-cyclical mandate to provide lending for projects with a social and/or environmental focus in its member states as well as its role in the context of the coronavirus pandemic, raises the strategic importance of the bank for its key shareholders, resulting in a very supportive political environment. At the same time, Scope notes that the institution's high leverage compared to other supranational peers and its reliance on few shareholders for exceptional support, if ever needed, remain challenges. A downgrade of its key shareholders coupled with a deterioration of the bank's operational performance pose medium-term risks to the **AAA** rating. The Stable Outlook reflects Scope's assessment of the CEB's financial buffers to withstand external and balance-sheet-driven shocks.

### Rating-change drivers

The rating could be downgraded if: i) key shareholders are downgraded; ii) liquidity buffers were significantly reduced; and/or iii) the CEB experienced a marked deterioration of its capital base relative to its lending activities.

### Rating rationale

The CEB's **AAA** rating is supported by the institution's highly rated shareholders, with 26 EU member states accounting for 89% of the share capital<sup>a</sup>. The four largest euro area member states – France (**AA**/Stable), Germany (**AAA**/Stable), Italy (**BBB+**/Negative), and Spain (**A-**/Negative) – together account for 61% of total capital contributions to the bank. On this basis, the CEB's key shareholder rating of A+, representing 75% of cumulative share capital when starting with the largest shareholder reflects i) the ability of its shareholders to provide the CEB with a strong framework ensuring preferential treatment for and investor acceptance of its debt instruments and ii) the strong commitment of shareholders with a high willingness and ability to provide the bank with additional financial support if ever needed.

From this starting point, the CEB's rating is further underpinned by its strong institutional setup, including its adequate capitalisation level under the assumption of full leverage. Scope estimates the CEB's available and credible capital resources at around EUR 5.5bn. These include paid-in capital (EUR 0.61bn), accumulated reserves and retained earnings (EUR 2.48bn) plus the callable capital of shareholders rated AA- or above who can directly benefit from the Bank's activities (EUR 2.4bn). Dividing these resources by the maximum potential liabilities as defined by the maximum volume of debt outstanding set by the Administrative Council

at 10 times its prudential equity<sup>b</sup> (EUR 31.7bn), results in a ratio of around 17.3%.<sup>c</sup> This implies that if the CEB were to operate at full capacity as allowed under its framework, its institutional set-up can ensure that available and credible resources would cover around one-fifth of all potential liabilities. While the CEB's shock-absorption capacity is thus among the lowest of AAA-rated supranationals, Scope notes positively that the bank's prudential institutional framework also defines additional, more stringent ceilings for its actual operations, such as a maximum gearing ratio for the volume of outstanding loans (EUR 20.1bn in 2019).

In addition, in line with most multilateral development banks, the CEB's loan portfolio benefits from preferred creditor status (PCS) as evidenced during default episodes in the case of Greece and Former Yugoslavia. Scope expects that the CEB will continuously benefit from PCS given the high share of public sector exposures and expected reputational concerns among its highly rated borrowers. Here, Scope notes that the CEB benefits from its mandate to finance most of its projects by lending directly to sovereigns or sub-sovereigns with a maximum cap of 25% of its exposure to the private sector via on-lending through banks. At end-2019, the bank's weighted average borrower quality for its ten largest country exposures, based on aggregate loans granted and Scope's sovereign ratings, stood at A+, up from A in 2018 and 2017. This relatively stable operating environment reflects the fact that around 25% of outstanding loans are located in France, Germany and Spain as well as a more recent shift to relatively higher rated countries such as the Netherlands (AAA/Stable) and the Czech Republic (AA/Stable). Turkey (B+/Stable) represents the riskiest exposure in the CEB's loan portfolio, accounting for around 9% of the total loan portfolio. Overall, its highly rated key shareholders, the mandate for lending activities only to member states, and preferred creditor status provide the CEB with a strong institutional set-up in line with other AAA-rated institutions.

The CEB's AAA rating is further underpinned by the bank's conservative liquidity management. Internal liquidity guidelines stipulate i) a Self-Sufficiency Period (SSP) of a minimum of six months, which assesses the ability of the bank to cover stressed expected net cash outflows under a severe stress scenario given full operationality without access to funding markets and without selling or repoing its financial assets; and ii) a Survival Horizon assessment, which follows a similar rationale as the SSP calculation but allows for selling or repoing of financial assets. The minimum is set at 12 months and the bank reported a level of 19 months at end-2019, within its stated comfort zone between 18 and 24 months. 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.

It is Scope's view that the CEB's prudent liquidity policies result in a high and stable level of liquid assets, providing a substantial cushion in the context of increased lending volumes due to the bank's Covid-19 response and allow the CEB to fulfil its mandate especially in times of heightened activity and uncertainty. Specifically, to calculate the CEB's liquid assets, Scope considers cash and advances (EUR 2.85bn), other financial assets excluding loans maturing in 12 months or less (EUR 2.42bn), and financial assets with a longer maturity rated AA- or above by the bank (EUR 3.3bn). This results in total liquid assets at around EUR 8.6bn for end-2019. Conversely, the CEB's liabilities due within one year amounted to around EUR 4.2bn and loan disbursements in 2020 are projected at EUR 4.5bn, a significant increase over 2019's disbursements due to the bank's Covid-19 response. Thus, total liabilities and disbursements due within one year amounted to around 8.7bn at end-2019. On this basis, Scope calculates the liquid assets ratio for the years 2017-19 which declined to 98.2% at end-2019 from 113.7% in 2018, because of higher expected loan disbursements in 2020. The three-year average between 2017-19 was 103.4%, which implies available liquid assets cover all outstanding liabilities and loan disbursements within 12 months without the need for the CEB to access capital markets. This is one of the strongest liquidity cushions among supranational institutions.

This estimate is conservative given that for the calculation of the liquid assets ratio, Scope uses the CEB's loan disbursements in 2020 at EUR 4.5bn, significantly higher than 2018/19 levels of around EUR 2.8bn. In response to the Covid-19 economic shock and subsequent healthcare measures in member states, the CEB

reacted by approving around EUR 3bn of loans to finance sovereigns' healthcare measures<sup>d</sup>. In addition, the bank has implemented waivers for the usual 50% limit of CEB loans relative to total project volume. Through July 2020, the bank has approved a total amount of around EUR 5bn for disbursements, which compares to a volume of EUR 4bn in 2019 and a similar pre-crisis target as defined by the bank's 2020-2022 strategy<sup>2</sup>. Scope considers the bank's available resources and conservative risk management policies as prudent and adequate to maintain its strong creditworthiness despite higher expected lending activities in an uncertain economic environment.

Another factor supporting the CEB's AAA rating is its strong capital market access. The CEB's bond issuances are designated as Level 1 HQLA assets, granted a 0% risk weight under the Basel framework and are eligible for the European Central Bank's asset purchase programmes. This preferential regulatory treatment, an established track record of capital market presence and its strong shareholder and capital base underpin the CEB's market access for its annual issuance volumes of around EUR 4.5bn over the years 2017-19<sup>3</sup>. Furthermore, the bank's prudent funding strategy is reflected by 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 2019. After swaps, all funding was conducted in euro. Since 2017, the CEB has issued social bonds that follow the bank's social inclusion bond framework and align with ICMA's Social Bonds Principles. The bank issued social bonds worth EUR 500m in 2017, 2018 and 2019 alongside two additional social bonds with a volume of EUR 1.45bn in 2020 to fund its activities related to the Covid-19 shock. Even though the CEB is a smaller issuer on capital markets compared to its AAA-rated peers, the bank preserves similar funding conditions as its larger peers.

Scope also identifies the CEB's well-diversified loan portfolio with a high average borrower quality and strong asset quality as a core credit strength. The bank's main lending areas are aid to refugees and displaced persons, social housing, regional infrastructure, greening the economy and support to small- and medium-sized businesses (SMEs). The bank lends directly to sovereigns or sub-sovereigns via its Public Sector Finance Facility and provides loans via on-lending to commercial banks. Lending volumes are usually capped at 50% of total project cost. The bank also offers guarantees and does not invest into equity. All member states are eligible to receive financing, however the bank has a target group of 22 countries in the Central and Eastern European (CEE) region.

The bank's loan portfolio is well diversified across member states, which limits concentration risk. In 2019, the largest aggregated exposures were located in Poland (12.6% of total), Spain (12.1%), Turkey (9.3%), and France (7.8%). In terms of sectoral concentration, the loan portfolio is concentrated among sovereigns and sub-sovereigns, and to a lesser degree to financial institutions, in line with the nature of the CEB's lending operations. At the same time, concentration risks are mitigated by the fact that the bank mainly lends to highly rated public sector entities and that direct risk to other borrowers is mitigated by the on-lending principle to commercial banks. This is also reflected in the flawless track record of recording no non-performing loans since 2009 and only one in its entire history<sup>7</sup>. While in the context of the Covid-19 crisis asset quality could deteriorate, Scope does not expect the crisis to have a long-lasting material impact on the quality of the bank's lending portfolio.

Finally, Scope notes positively that the CEB has been profitable every year with average annual returns on equity of 3.38% since 2015 and with stable annual earnings of around EUR 105mn over the past three years. These are fully retained and thus contribute to the CEB's accumulated reserves, and in turn its capitalisation as well as its lending capacity. The CEB's net income in 2019 was EUR 105mn, which corresponds to a return on equity of 3.4%.

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

First, Scope notes the CEB's high leverage, which is expected to remain elevated in 2020 due to higher lending, ending a deleveraging phase that had resulted in the reduction of the leverage ratio by around 33pp

from 2015-2019. At end-2019, the CEB's leverage ratio stood at 687% and its three-year weighted average was 670% for 2017-2019, one of the highest among supranationals.

At the same time, Scope acknowledges several mitigating factors to the institution's high leverage. First, the CEB's track record of ensuring high asset quality protects its capital base. Second, its track-record of maintained levels of profitability enable the bank to continuously retain earnings and build up its reserves and capital base. Reserves stood at around EUR 2.5bn in 2019, up from EUR 2bn in 2015 and combined with paid-in capital of EUR 612m, constitute the bank's equity of around EUR 3.1bn, which stood against EUR 21.2bn of debt issued at end-2019. Finally, the bank's prudential framework ensures capital adequacy and the continued operationality of the bank, as highlighted by the bank's reported Capital Adequacy Ratio which measures the bank's prudential equity (paid-in capital, reserves and net profit) versus its risk-weighted assets. At end-2019 the ratio stood at 30.3%, significantly above the internal floor of 10.5% and a target of above 25% to ensure a sufficient buffer. Second, the bank has an internal gearing ratio, which limits the volume of total loans outstanding after swaps and guarantees to 2.5 times its own funds. For end-2019, the bank's maximum lending capacity given this gearing ratio was around EUR 19.8bn, while loans outstanding amounted to EUR 15.4bn, implying a ratio of 1.92. In addition, the bank limits its leverage, or Indebtedness Ratio after swaps, to ten times its prudential equity (actual ratio was 6.42 in 2019). Finally, the bank limits the size of its treasury portfolio to 5 times its prudential equity (ratio at 2.68 at end-2019).

Second, despite the benefits afforded by the callable capital of its highly rated shareholders, the CEB's shareholder base is highly concentrated compared to other supranationals, which increases its dependence on any one shareholder's ability to honour capital calls. Also, the institution's key shareholder rating is vulnerable to the rating instability of very few countries. A downgrade of either Belgium, Italy or Spain (all with a Negative Outlook assigned by Scope) would lower the key shareholder rating of the CEB by one notch. At the same time, the high and increasing political importance of migration and environment-related projects could further substantiate the strategic relevance of the CEB for its member states and lead to rising government demand for the bank's services, further supporting the willingness of its shareholders to provide financial support if ever needed. The growing importance of the CEB is also shown by its future role as an implementing partner of the InvestEU Fund from 2021 onwards, allowing the bank to substantially increase its guarantee portfolio.

### **Factoring of Environment, Social and Governance (ESG)**

Scope considers ESG sustainability issues during the rating process as reflected in its supranational methodology. Governance-related factors are implicitly captured in Scope's assessment of the 'fundamental rating', which Scope assesses for the Council of Europe Development Bank with a 'AA-'. Additional negative adjustments to governance issues are addressed under the additional considerations in the methodology. In line with peers, the CEB's governance is strong and transparent.

Environmental and social factors are considered during the rating process, including the risk to 'stranded assets' and the benefits from issuing green and/or social bonds, but these had no impact on this rating action. At the same time, Scope acknowledges the strong increase of sustainability-linked bonds and the standard-setting transparent impact reporting for the use of proceeds across issuance instruments. Scope also notes the CEB's increasing issuance of social bonds with strong investor demand, signalling sustained demand for these products. In comparison to other supranationals, the nature of the CEB's lending operations combines environmental and social objectives, compliant with the EU's "do no significant harm" (DNSH) principle laid down in the taxonomy for sustainable finance, which raises the eligibility of CEB projects for sustainability-linked bond issuances in the future.

### **Scope's supranational scorecard**

Scope's supranational scorecard, which is based on clearly defined quantitative parameters, provides an indicative 'AAA' rating for the Council of Europe Development Bank. 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 considerations have been identified.

A rating committee has discussed and confirmed these results.

For further details, please see the Appendix.

### **Footnotes**

<sup>a</sup>Austria is the only EU member state that has not signed-up for membership.

<sup>b</sup>Own funds are defined as the sum of paid-in capital, reserves and net profit (CEB Financial Report, 2019<sup>1</sup>, p. 37).

<sup>c</sup>See CEB Annual Report 2001<sup>4</sup>, p. 8, CEB Annual Report 2004<sup>5</sup>, p. 8, and CEB Annual Report 2013<sup>6</sup>, p. 40

<sup>d</sup>CEB Projects approved by the Administrative Council

### **Rating driver references**

- 1 [CEB Financial Report, 2019](#)
- 2 [CEB 2020-22 Strategy](#)
- 3 [CEB Activity Report 2019](#)
- 4 [CEB Annual Report, 2001](#)
- 5 [CEB Annual Report, 2004](#)
- 6 [CEB Annual Report, 2013](#)
- 7 [CEB Financial Statements 2009](#)

### **Methodology**

The methodology used for this rating and rating outlook, 'Supranational Entities' 4 November 2019, is available on <https://www.scooperatings.com/#!/methodology/list/5>. Information on the meaning of each rating category, including definitions of default and recoveries can be viewed in the "Rating Definitions - Credit Ratings and Ancillary Services" published on <https://www.scooperatings.com/#!/governance-and-policies/rating-scale>. Historical default rates of the entities rated by Scope Ratings can be viewed in the rating performance report on <https://www.scooperatings.com/#!/governance-and-policies/regulatory-ESMA>. Please also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA): <http://cerrep.esma.europa.eu/cerrep-web/statistics/defaults.xhtml>. A comprehensive clarification of Scope's definitions of default and rating notations can be found at <https://www.scooperatings.com/#!/governance-and-policies/rating-scale>. Guidance and information on how Environmental, Social or Governance factors (ESG factor) are incorporated into the rating can be found in the respective sections of the methodologies or guidance documents provided on <https://www.scooperatings.com/#!/methodology/list>. The rating outlook indicates the most likely direction of the rating if the rating were to change within the next 12 to 18 months.

### **Solicitation, key sources and quality of information**

The rating was not requested by the rated entity or its agents. The rating process was conducted:

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

The following substantially material sources of information were used to prepare the credit rating: public domain. Scope considers the quality of information available to Scope on the rated entity or instrument to be satisfactory. The information and data supporting Scope's ratings originate from sources Scope considers to be reliable and accurate. Scope does not, however, independently verify the reliability and accuracy of the information and data. Prior to the issuance of the rating or outlook action, the rated entity was given the opportunity to review the rating and/or outlook and the principal grounds on which the credit rating and/or outlook is based. Following that review, the rating was not amended before being issued.

### **Regulatory disclosures**

This credit rating and/or rating outlook is issued by Scope Ratings GmbH, Lennéstraße 5, D-10785 Berlin, Tel +49 30 27891-0.

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The ratings/outlooks concern a financial instrument, which has been rated by Scope for the first time.

### **Potential conflicts**

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