MOODY'S INVESTORS SERVICE

Credit Opinion: Banco de Desarrollo de El Salvador

Global Credit Research - 06 Nov 2013

San Salvador, El Salvador

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating	Ba3

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Key Indicators

Banco de Desarrollo de El Salvador (Consolidated Financials)[1]

	[2]6-13	[2]12-12	[2]12-11	[2]12-10	[2]12-09	Avg.
Total Assets (USD million)	534.1	514.5	575.2	594.2	599.9	[3]-2.9
Tangible Common Equity (USD million)	212.3	202.8	203.1	199.8	200.5	[3]1.4
Net Interest Margin (%)	2.0	1.8	1.9	2.4	2.2	[4]2.1
PPI / Average RWA (%)	3.7	1.9	2.2	--	2.2	[5]2.5
Net Income / Average RWA (%)	2.5	2.0	1.2	--	1.2	[5]1.7
(Market Funds - Liquid Assets) / Total Assets (%)	20.8	18.7	10.6	7.0	12.7	[4]13.9
Tier 1 Ratio (%)	38.1	37.0	48.5	52.0	47.7	[5]44.7
Tangible Common Equity / RWA (%)	127.1	104.8	69.5	28.7	31.3	[5]72.3
Cost / Income Ratio (%)	45.3	54.1	30.6	32.4	31.7	[4]38.8

Source: Moody's

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel I; LOCAL GAAP [3] Compound Annual Growth Rate based on LOCAL GAAP reporting periods [4] LOCAL GAAP reporting periods have been used for average calculation [5] Basel I & LOCAL GAAP reporting periods have been used for average calculation

Opinion

SUMMARY RATING RATIONALE

BANDESAL is El Salvador's sole development bank established to support private sector economic development and investment by lending through the banking system. BANDESAL is 100% owned by the Banco Central de Reservas of El Salvador. The bank was originally established as Banco Multisectorial de Inversiones (BMI) by special legislative act in 1994 and was spun off from the central bank under the aegis of the Inter-American Development Bank (IADB).

As its main activity, the bank lends to private-sector Salvadoran financial institutions, which in turn on-lend the funds to customers engaged in pre-approved private-sector development projects. BANDESAL's original role also include providing advice for project and trade finance, as well as export promotion. BANDESAL's activities also include lending operations to small- and medium-sized companies, as well as fostering exports and job generation.

Moody's assigns a Ba3 foreign currency issuer rating to BANDESAL, in line with the Ba3 sovereign rating for El Salvador.

The country's financial system is fully and legally dollarized, so Moody's does not assign local currency ratings to this issuer.

BANDESAL's issuer rating also derives from Moody's rating methodology for government-related issuers (GRIs) and reflects the following inputs: 1) baseline credit assessment (BCA) of ba3; 2) a systemic support indicator of Ba3; and 3) the assessment of "high" dependence and "high" support that exists between BANDESAL and its shareholder, the Salvadoran government. Our assessments of both a "high" dependence (or default correlation) and "high" support reflect its 100% government ownership and funding support, as well as its preferred creditor status within El Salvador.

The ba3 BCA is essentially the rating of the sovereign, with which BANDESAL is inextricably linked in terms of ownership and funding, sourced largely from the multilateral agencies via the Central Bank. BANDESAL's ratings are underpinned by the following factors: 1) BANDESAL's important mission to promote private-sector economic development; 2) its sole access among domestic financial institutions to long-term funds for project and corporate lending; 3) its legal structure; 4) sound stand-alone creditworthiness; and 5), its unique and legal ability to obtain repayment for its loans by charging the borrowers' Central Bank reserve accounts directly.

Rating Drivers

- The bank is wholly-owned by Banco Central de Reservas; therefore, it enjoys a preferential creditor status, which enables the bank to directly access the reserve accounts of financial institutions in the central bank to reach for resources in the case of non-payment of loans

- Key role in country's economic development program

- Sound legal and financial structure, corporate governance, and conservative management

- Increasing presence of international banks in the country has led to a more competitive environment, which, in turn, has resulted in a smaller loan book, lower margins and weaker recurring earnings power

- The bank operates in a legally dollarized country, which means that there is no true lender of last resort; this situation is partly mitigated by international bank dominance in the sector.

Rating Outlook

The rating outlook is stable.

What Could Change the Rating - Up

An upgrade of the sovereign's ratings would be positive for BANDESAL's rating. Another upward pressure could derive from an improvement in BANDESAL's standalone creditworthiness, which could be manifested in the form of consistent enhancement of financial metrics or reduced funding from the government.

What Could Change the Rating - Down

Downward pressure could come from a lower sovereign rating or from a change in BANDESAL's ownership and/or legal structure. Deterioration in asset quality within the bank's loan portfolio and recurrence of poor financial metrics could affect BANDESAL's rating as well.

DETAILED RATING CONSIDERATIONS

BANDESAL's detailed ratings considerations are as follows:

Baseline Credit Assessment

PROFITABILITY IS LOW, BUT STABLE, IN LINE WITH BANDESAL's ROLE AS DEVELOPMENT BANK

As of June 30, 2013, BANDESAL reported an increase of 13.9% in its loan book to $311.9 million, after a 16.8% growth in the twelve-month period ended in December 2012. As a result, loan income continued to represent a significant contributor to intermediation income, accounting for roughly 67% of interest income and fees together. The investment portfolio represented 31.3% of total assets, compared to 40% in June 2012; while loans increased to 58.4% from 48.4%.

The decline in net interest income and fees to $5.1 million from $7.9 million during the 12-month period is mostly explained by the reduction in revenues from securities and an increase of 4.2% in funding costs. The bank's operating result was also negatively affected by the 17.9% increase in operating expenses, which totaled $2.2 million in June 2013. Despite the reduction in net interest income, BANDESAL reported net profits of $2.05 million compared to $1.8 million in June 2012 (a 13.9% annual increase). As a result, returns on average assets and equity increased slightly to 0.78% and 1.94%, respectively, in June 2013 versus 0.63% and 1.78% in mid 2012.

GOOD DIVERSIFICATION OF LOAN BOOK

Asset quality, liquidity, and capitalization remain BANDESAL's strengths, given the bank's preferred creditor status within El Salvador as well as its well-collateralized loan portfolio and conservative risk-management and reserving practices. The underlying loan portfolio is diversified by both sector and loan type once the loans are on-lent by the financial institutions to their corporate borrowers.

Nonperforming loans have been posted at zero since 2006, when a long-time legacy loan that had been provisioned at 100% was finally paid off. Nevertheless, BANDESAL prudently continues to provision for possible loan losses and also takes provisions against its investment portfolio. The bank's investment strategy is also conservative; having a portfolio of investment grade investments, including Central Bank paper or high-quality US and European names, as well as top tier Salvadoran financial entities.

BANDESAL has a conservative loan-loss reserve policy, including a 1% voluntary reserve in addition to specific reserves, a policy based on forward-looking risk profiles, which has been stricter than the one required by the Superintendent of the Financial System due to the developmental nature of its loan book. In 2007, BANDESAL added a feature to this policy based on the regulator's new reserve-scheduling rules, which are based on days past due, and resulted in an increase in reserves although NPLs remained at zero.

COMFORTABLE CAPITAL POSITION

As a rule, BANDESAL maintains strong risk-weighted capitalization that allows for a substantial cushion to absorb losses. As of June 2013, shareholders' equity represented 38.1% of risk-weighted assets, a still high ratio compared to the minimal capital requirement of 8% present in the bank's by-laws. Nevertheless, the expansion of the bank's loan portfolio has consumed capital and dragged solvency ratio down from hefty 53.5% reported in mid-2011.

Foreign Currency Issuer Rating

Moody's assigns a Ba3 foreign currency issuer rating to BANDESAL. The rating is in line with the Ba3 rating of its ultimate shareholder, the Republic of El Salvador, as well as reflecting our assessment of high dependence and high support.

Foreign Currency Debt Rating

Senior debt issued by BANDESAL would be rated at the same level as the issuer rating.

Bank Financial Strength Rating

Because it is a GRI and does not take deposits, Moody's does not assign BANDESAL a bank financial strength rating.

Global Local Currency Deposit Rating (Joint Default Analysis)

Because it is a US dollar-denominated bank and does not take deposits, we do not assign BANDESAL a local currency deposit rating.

ABOUT MOODY'S BANK RATINGS

Bank Financial Strength Rating

Moody's Bank Financial Strength Ratings (BFSRs) represent Moody's opinion of a bank's intrinsic safety and soundness and, as such, exclude certain external credit risks and credit support elements that are addressed by Moody's Bank Deposit Ratings. Bank Financial Strength Ratings do not take into account the probability that the bank will receive such external support, nor do they address risks arising from sovereign actions that may interfere with a bank's ability to honor its domestic or foreign currency obligations. Factors considered in the assignment of Bank Financial Strength Ratings include bank-specific elements such as financial fundamentals, franchise value, and business and asset diversification. Although Bank Financial Strength Ratings exclude the external factors specified above, they do take into account other risk factors in the bank's operating environment, including the strength and prospective performance of the economy, as well as the structure and relative fragility of the financial system, and the quality of banking regulation and supervision.

Moody's uses the Baseline Credit Assessment (BCA) to map BFSRs onto the 21-point aaa-c rating scale and like the BFSR, it reflects a bank stand- alone default risk. Each point on the aaa-c scale represents a specific probability of default and therefore allows Moody's to use the BCA as an input to Moody's Joint Default Analysis (JDA), described below. The baseline credit assessment reflects what the local currency deposit rating of the bank with the given BFSR would be without any assumed external support from a government or third party.

Global Local Currency Deposit Rating

A deposit rating, as an opinion of relative credit risk, incorporates the Bank Financial Strength Rating as well as Moody's opinion of any external support. Specifically, Moody's Bank Deposit Ratings are opinions of a bank's ability to repay punctually its deposit obligations. As such, Moody's Bank Deposit Ratings are intended to incorporate those aspects of credit risk relevant to the prospective payment performance of rated banks with respect to deposit obligations, and includes: intrinsic financial strength, sovereign transfer risk (in the case of foreign currency deposit ratings), and both implicit and explicit external support elements. Moody's Bank Deposit Ratings do not take into account the benefit of deposit insurance schemes which make payments to depositors, but they do recognize the potential support from schemes that may provide assistance to banks directly.

According to Moody's joint default analysis (JDA) methodology, the global local currency deposit rating of a bank is determined by the incorporation of any external elements of support into the bank's Baseline Credit Assessment. In assigning the local currency deposit rating to a bank, the JDA methodology also factors in the rating of the various potential support providers (parent company, cooperative group, regional or national governments), as well as the degree of dependence that may exist between each one of them and the bank. Moody's assessment of the probability of systemic support (by a national government) is derived from the analysis of the capacity of a government and its central bank to provide support on a system-wide basis. The systemic support indicator is determined for a particular country and serves as an input for all bank ratings in that country. The support indicator can be set at, above or, in rare cases, below the government's local currency bond rating for that country.

National Scale Rating

National scale ratings are intended primarily for use by domestic investors and are not comparable to Moody's globally applicable ratings; rather they address relative credit risk within a given country. An Aaa rating on Moody's National Scale indicates an issuer or issue with the strongest creditworthiness and the lowest likelihood of credit loss relative to other domestic issuers. National Scale Ratings, therefore, rank domestic issuers relative to each other and not relative to absolute default risks. National ratings isolate systemic risks; they do not address loss expectation associated with systemic events that could affect all issuers, even those that receive the highest ratings on the National Scale.

Foreign Currency Deposit Rating

Moody's ratings on foreign currency bank obligations derive from the bank's local currency rating for the same class of obligation. The implementation of JDA for banks can lead to a high local currency ratings for certain banks, which could also produce high foreign currency ratings. Nevertheless, it should be noted that foreign currency deposit ratings are in all cases constrained by the country ceiling for foreign currency bank deposits. This may result in the assignment of a different, and typically lower, rating for the foreign currency deposits relative to the bank's rating for local currency obligations.

Foreign Currency Debt Rating

Foreign currency debt ratings are derived from the bank's local currency debt rating. In a similar way to foreign currency deposit ratings, foreign currency debt obligations may also be constrained by the country ceiling for foreign currency bonds and notes: however, in some cases the ratings on foreign currency debt obligations may be allowed to pierce the foreign currency ceiling. A particular mix of rating factors are taken into consideration in order to assess whether a foreign currency bond rating pierces the country ceiling. They include the issuer's global local currency rating, the foreign currency government bond rating, the country ceiling for bonds and the debt's eligibility to pierce that ceiling.

About Moody's Bank Financial Strength Scorecard

Moody's bank financial strength model (see scorecard below) is a strategic input in the assessment of the financial strength of a bank, used as a key tool by Moody's analysts to ensure consistency of approach across banks and regions. The model output and the individual scores are discussed in rating committees and may be adjusted up or down to reflect conditions specific to each rated entity.

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