MOODY'S
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Credit Opinion: Banco de Desarrollo de El Salvador

Global Credit Research - 05 May 2014

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]**12-13**	[2]**12-12**	[2]**12-11**	[2]**12-10**	[2]**12-09**	**Avg.**
Total Assets (USD million)	**540.6**	**514.5**	**575.2**	**594.2**	**599.9**	[3]**-2.6**
Tangible Common Equity (USD million)	**214.9**	**202.8**	**203.1**	**199.8**	**200.5**	[3]**1.7**
Net Interest Margin (%)	**2.3**	**1.6**	**1.9**	**2.4**	**2.2**	[4]**2.1**
PPI / Average RWA (%)	**1.2**	**0.8**	**1.4**	**1.6**	**1.3**	[5]**1.3**
Net Income / Average RWA (%)	**0.7**	**0.8**	**0.7**	**0.9**	**0.7**	[5]**0.8**
(Market Funds - Liquid Assets) / Total Assets (%)	**24.1**	**18.7**	**10.6**	**7.0**	**12.7**	[4]**14.6**
Tier 1 Ratio (%)	**32.1**	**32.3**	**40.3**	**52.0**	**47.7**	[5]**40.9**
Tangible Common Equity / RWA (%)	**34.4**	**32.7**	**41.2**	**28.7**	**31.3**	[5]**33.7**
Cost / Income Ratio (%)	**41.1**	**54.1**	**30.6**	**32.4**	**31.7**	[4]**38.0**

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

Moody's assigns a Ba3 foreign currency issuer rating and a ba3 baseline credit assessment (BCA) to Banco de Desarrollo de El Salvador (BANDESAL), El Salvador's development bank. BANDESAL is 100%-owned by the Salvadoran State (Ba3, stable) via the Central Bank, Banco Central de Reservas de El Salvador (BCRES).

As its main activity, the bank lends chiefly to Salvadoran financial institutions, which in turn on-lend the funds to customers engaged in pre-approved private-sector development projects. BANDESAL's activities were expanded in 2012 to include direct lending operations to small- and medium-sized companies, as well as fostering job generation. 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

(IDB).

BANDESAL's credit assessment is intrinsically intertwined with that of the sovereign given the close financial and managerial linkages between both, coupled with its relevant mission to promote economic development. Further, the bank benefits from a preferential creditor status, which enables it to directly access the reserve accounts of regulated financial institutions at the BCRES in the case of non-payment of loans. This facility has covered around three-quarters of the loan portfolio.

BANDESAL's issuer rating derives from Moody's rating methodology for government-related issuers (GRIs) and incorporates the BCA of ba3 as well as the assessment of a high probability of support from the Salvadoran government. This assumption is based on the bank's ownership and financial ties as well as its public policy mandate to promote economic growth by financing investment projects at targeted sectors such as SMEs and microfinance. As the country's financial system is legally dollarized, Moody's does not assign BANDESAL local currency ratings.

Rating Drivers

- Preferred creditor status, enabling BANDESAL to directly access the reserve accounts of regulated financial institutions at the Central Bank

- Limited earnings generation pressured by low margins and weak efficiency

- Reliance on wholesale funding, though partly mitigated by good liquidity management

- Robust core capitalization

Rating Outlook

The rating outlook is stable.

What Could Change the Rating - Up

BANDESAL's ratings would benefit from an upgrade of El Salvador's sovereign ratings, in conjunction with enhanced standalone financial fundamentals, including earnings generation and continued strong asset quality.

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, profitability, liquidity or capitalization could also affect the bank's ratings.

DETAILED RATING CONSIDERATIONS

BANDESAL's detailed ratings considerations are as follows:

PREFERRED CREDITOR STATUS, ENABLING BANDESAL TO DIRECTLY ACCESS THE RESERVE ACCOUNTS OF REGULATED FINANCIAL INSTITUTIONS AT THE CENTRAL BANK

Asset quality remains a strength for BANDESAL given its preferred creditor status within El Salvador, coupled with prudent risk-management and reserving practices. Per article 6 of the Development Bank Law (Ley del Sistema Financiero para el Fomento del Desarrollo), BANDESAL can get access to the reserve accounts of regulated banks and some non-banks at Central Bank, to ensure proper and timely payment of a given loan. The portfolio of loans to unregulated saving banks ("cajas"), cooperatives and direct lending is not covered by this mechanism. As of December 2013, BANDESAL had a preferential creditor status on 74% of its total portfolio, relatively similar to the figures posted in 2012 and 2011.

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. By year-end 2013, 62% of total loans were to commercial banks, 21% to cajas and cooperatives, 9% to government-sponsored funds and 5% to a financial services company. Direct lending is still at a modest 3% of total loans, comprised of two loans totaling US$9.5 million. Regarding final destination of loans, 37% of lending was eventually granted to SMEs, followed by self-employed individuals (35%). Loans to medium and large companies were a more moderate 15% and 13% of total on-lending.

The bank's investment strategy is also prudent, with about half of the portfolio comprised of BCRES securities and another half placed at foreign banks, eventually devoted to investment grade securities. BANDESAL constitutes provisions for possible loan and investment losses. The loan-loss reserve policy includes a 1% voluntary reserve in addition to specific reserves, a policy based on forward-looking risk profiles. As of December 2013, loan loss reserves amounted to 2.5% and 6.4% of total loans and investments, respectively (2.4% and 5.4% in 2012).

Single borrower concentrations are intrinsically high as BANDESAL lends to a limited universe of Salvadoran financial institutions. As of December 2013, the 5 and 10 largest borrowers comprised 54% and 77% of total loans. Largest exposures are largely devoted to government-owned banks and large domestic private commercial banks. Particularly, BANDESAL largest loan comprises 17% of total loans and is granted to government-owned Banco Hipotecario de El Salvador. In addition, even though about half of the portfolio is devoted to broad segments of the economy such as commerce (25% of loans) and services (19%), we note significant concentrations in riskier sectors such as housing (17%), agribusiness (15%), and construction (11%).

We have no major concerns regarding the bank's corporate governance. While the entire nine-member board is appointed by the government, and we therefore do not consider it to be independent, the risk of conflict of interest is somewhat muted by the fact that all board members are personally liable to the bank in the case of decisions that cause economic damage to BANDESAL. The Chairman of the Board is appointed by the President of the Republic. Changes in the board composition may occur in the short term, in light of the new National Government that will take office in June 2014.

LIMITED EARNINGS GENERATION PRESSURED BY LOW MARGINS AND WEAK EFFICIENCY

BANDESAL's earnings stream has been intrinsically modest despite recent high loan growth. This derives from thin net interest margins (NIM), which averaged a modest 2% since 2010, a byproduct of the bank's development role and a loan book largely devoted to financial institutions. Moreover, we note the high levels of operating expenses vis-à-vis operating income despite not having a branch network, as evidenced by an average cost-income ratio of 40%. We expect NIM to continue to be affected in the medium term given the increase in USD rates which will push up funding costs as BANDESAL is largely funded with wholesale market funds, with 35% needing to be refinanced during 2014.

As of December 2013, BANDESAL posted a net income of US$4.6 million, similar to year-end 2012's results. Earnings were affected by a significant increase in loan loss provisions (US$1.9 million vs. US$0.1 million), given the sturdy increase in loans to non-regulated financial institutions (26% of total loan growth in 2013) and direct lending (22% of total growth), which require a higher level of provisions than regulated entities. Higher credit costs offset a 35% rise in net interest income fuelled by a 15% loan growth amid a widening of the NIM to 2.3% as of December 2013 from 1.6% in 2012. The more ample NIM is explained by the higher yields on the loan book given the lending to higher margined non-regulated entities. Operating expenses remained flat as a 12% increase in wages was balanced by a 27% contraction in sundry outlays. ROAAs and ROAEs remained stable at a low 0.9% and 2.2%.

RELIANCE ON WHOLESALE MARKET FUNDING, THOUGH PARTLY MITIGATED BY GOOD LIQUIDITY MANAGEMENT

BANDESAL depends entirely on wholesale funding, as it cannot take deposits from the public per the Development Bank Law. The contracting of new credit lines can prove to be more fickle in a scenario of tighter USD liquidity, which can potentially impair BANDESAL's business generation capacity. As of December 2013, lines from commercial banks comprised 60% of liabilities, 62% of which are sourced from multilaterals, bilateral and government agencies. Loans from El Salvador's Central Bank and issued debt represented 30% and 6% of liabilities, respectively.

Funding is relatively medium term in nature, with 63% of total liabilities being due in more than one year. This allows an adequate match with the longer loan portfolio, 80% maturing in more than a year. BANDESAL shows positive tenor matches in all the reported tenor buckets. However, we note that the bank will have to refinance US$106.4 million in credit lines during 2014, representing 35% of total lines. Management expects to renew around 80% of that amount. As of April 2014, BANDESAL had already renewed 18% or US$20 million.

Liquidity buffers have remained robust over the past years, with liquid assets comprising 35% of total assets in 2013, though down from 40% and 54% in 2012 and 2011 as the bank used it to partly fund growth. Liquidity is largely invested in securities (77% of liquid assets), bank deposits (16%) as well as in cash and deposits at the Central Bank (7%).

ROBUST CORE CAPITALIZATION

BANDESAL has maintained strong risk-weighted capitalization that allows for a substantial cushion to absorb losses. As of December 2013, total capital represented 37.5% of risk-weighted assets 98% composed of core capital and well above the 12% established by local regulators. Nevertheless, the expansion of the bank's loan portfolio has consumed capital and dragged solvency ratio down from hefty 48.5% reported in 2011. Dividend payout has remained low being 12.4% for 2013 earnings.

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 from the latter.

Foreign Currency Debt Rating

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

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