MOODY'S
INVESTORS SERVICE

Credit Opinion: Banco de Desarrollo de El Salvador - DRAFT - In Progress or Approved Version

Global Credit Research

San Salvador, El Salvador

Ratings

Category	Moody's Rating
Outlook	Negative
Baseline Credit Assessment	ba3
Adjusted Baseline Credit Assessment	ba3
Issuer Rating	Ba3

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Key Indicators

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

	[2]9-15	[2]12-14	[2]12-13	[2]12-12	[2]12-11	Avg.
Total Assets (USD million)	555.3	521.8	540.6	514.5	575.2	[3]-0.9
Tangible Common Equity (USD million)	221.3	218.9	214.9	202.8	203.1	[3]2.2
Tangible Common Equity / Risk Weighted Assets (%)	38.3	41.8	34.4	32.7	41.2	[4]37.7
Net Interest Margin (%)	2.1	2.5	2.3	1.6	1.9	[5]2.1
PPI / Average RWA (%)	1.1	1.6	1.2	0.8	1.4	[4]1.2
Net Income / Tangible Assets (%)	0.8	0.9	0.9	0.9	0.7	[5]0.8
Cost / Income Ratio (%)	47.0	39.1	41.1	54.1	30.6	[5]42.4
Market Funds / Tangible Banking Assets (%)	59.7	57.5	59.3	58.6	64.6	[5]59.9
Liquid Banking Assets / Tangible Banking Assets (%)	30.3	28.4	35.2	39.9	54.0	[5]37.5

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] Basel I & LOCAL GAAP reporting periods have been used for average calculation [5] LOCAL GAAP reporting periods have been used for average calculation

Opinion

SUMMARY RATING RATIONALE

Moody's assigns a Ba3 foreign currency issuer rating, with a negative outlook, 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 Reserva 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 covers 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.

On 20 November 2015, the Ba3 foreign currency issuer rating was affirmed, with the changed to negative from stable, in line with a similar action on El Salvador's Ba3 government bond rating. Please see Moody's Press Release "Moody's affirms the issuer rating of BANDESAL; outlook changed to negative following sovereign action".

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 market funding, though partly mitigated by good liquidity management

- Robust core capitalization

Rating Outlook

The rating outlook is negative.

What Could Change the Rating - Up

Should El Salvador's government bond rating be downgraded, BANDESAL's Ba3 foreign currency issuer rating would be downgraded as well, while the ba3 BCA would be lowered. A significant intrinsic deterioration of the bank's financial fundamentals, especially capital and asset quality, could also trigger a lowering of the BCA even in the absence of a sovereign action.

What Could Change the Rating - Down

Upward pressures on BANDESAL's issuer rating are limited given the negative outlook on the sovereign.

DETAILED RATING CONSIDERATIONS

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 in 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 September 2015, BANDESAL had a preferential creditor status on about 75% of its total portfolio, similar to the figures posted by year-end 2014.

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. As of September 2015, some 60% of total loans were to regulated commercial banks, 17% to non-regulated cajas and cooperatives, 16% to regulated cooperative banks, 5% to government-sponsored funds. Direct lending is still at a modest 5% of total loans. Regarding the final destination of loans, about half of lending was eventually granted to SMEs, followed by self-employed individuals (28%). Loans to medium and large companies were a more moderate 16% and 12% 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. 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 September 2015, loan loss reserves amounted to 2.8% of total loans. Single borrower concentrations are intrinsically high as BANDESAL lends to a limited universe of Salvadoran financial institutions. As of September 2015, the 5 and 10 largest borrowers comprised 57% 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 16% of total loans. Even though about half of the portfolio is devoted to broad segments of the economy such as commerce (27% of loans) and services (16%), we note significant concentrations in riskier sectors such as agribusiness (16%), and housing (14%).

LIMITED EARNINGS GENERATION PRESSURED BY LOW MARGINS AND WEAK EFFICIENCY

BANDESAL's earnings stream has been intrinsically modest. This derives from a 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 48%. We expect the 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.

As of September 2015, BANDESAL posted a net income of USD3.2 million, contracting mildy by 1% from one year before, largely led by a decline in net interest income (-7%) due to higher funding costs from issued debt and a 40% shrinkage in net fees. This has been in part offset by a decline in loan loss provisions to USD531 thousand from USD1.7 million as of September 2014. The NIM shrunk to 2.1% as of September 2015 from about 2.5% as of December 2014. Returns remained modest, with net income standing at about 0.8% total tangible assets.

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 challenging in a scenario of tighter USD liquidity, which can potentially impair BANDESAL's business generation capacity. As of September 2015, lines from commercial banks comprised 34% of assets, while issued debt represented 8%. The remaining of the funding is composed by lines from the Central Bank (15% of assets) and capital (40%)

Funding is medium term in nature, with 73% of it (including capital), being due in more than one year as of September 2015. This allows an adequate match with the longer loan portfolio, 78% of which matures in more than a year. As a result, BANDESAL shows positive cumulative tenor matches over the short term.

Liquidity buffers have remained robust over the past years, with liquid assets comprising around 30% of total assets as of September 2015, though down from 35% and 40% in 2013 and 2012, as the bank used it to partly fund growth. Liquidity is largely invested in securities (80% of liquid assets) as well as bank deposits and cash (20%).

ROBUST CORE CAPITALIZATION

BANDESAL has maintained strong risk-weighted capitalization that allows for a substantial cushion to absorb losses. As of September 2015, Tangible Common Equity represented about 38% of adjusted risk-weighted assets. The dividend payout has remained low at 15.6% of 2014 earnings.

Foreign Currency Issuer Rating

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