CREDIT OPINION

14 November 2016

Update

Rate this Research

Contacts

Georges Hatcherian 52-55-1555-5301
Analyst
georges.hatcherian@moodys.com

Vicente Gomez 52-55-1555-5304
Associate Analyst
vicente.gomez@moodys.com

Felipe Carvallo 52-55-1253-5738
VP-Senior Analyst
felipe.carvallo@moodys.com

Banco de Desarrollo de El Salvador

Update Following the Recent Downgrade to B3 Negative

Summary Rating Rationale

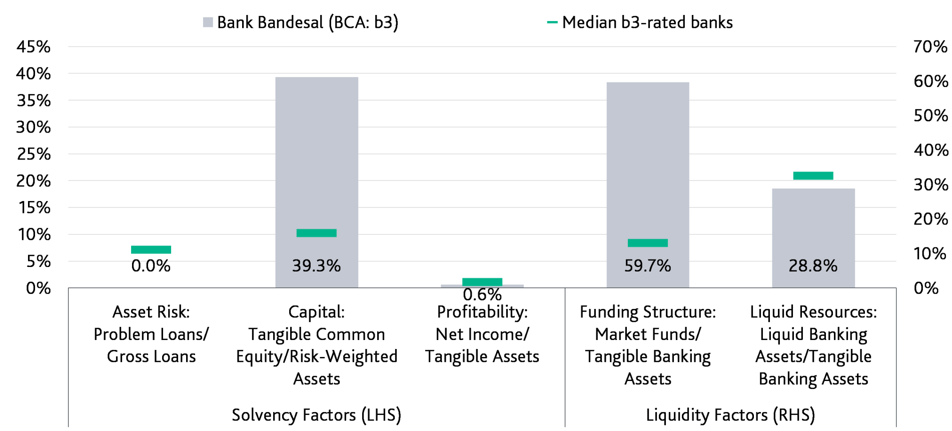
On 9 November, Moody's downgraded to B3, from B1, the long-term foreign currency issuer rating of Banco de Desarrollo de El Salvador (Bandesal), the country's development bank. The bank's standalone baseline credit assessment (BCA) was also downgraded to b3, from b1.

These rating actions follow Moody's downgrade of El Salvador's government bond rating to B3, from B1, with a negative outlook. For details on the rating action on El Salvador please refer to Moody's press release "Moody's downgrades El Salvador's government bond ratings to B3 negative, concluding review for downgrade," published on 7 November 2016.

The lower BCA reflects our view that the creditworthiness of the bank is intrinsically interlinked with that of the Salvadoran government, as its funding, liquidity position and market access are closely tied to El Salvador's own liquidity pressures.

Exhibit 1

Rating Scorecard - Key Financial Ratios



Source: Moody's Financial Metrics

Credit Strengths

» Strong asset quality supported by Bandesal's preferred creditor status

» Robust core capitalization

Credit Challenges

» Reliance on wholesale market funds adds to refinancing risks

» Weakening profitability due to rising funding costs

» Bandesal's BCA is constrained by El Salvador's "Very Weak +" Macro Profile

Rating Outlook

The outlook on Bandesal's long-term foreign currency issuer rating is negative in line with the negative outlook on El Salvador's government bond rating

Factors that Could Lead to an Upgrade

Because Badesal's financial strength is limited by the creditworthiness of the Salvadoran government, there is no upward pressure at this juncture. However, the outlook is likely to be stabilized if and when the outlook on the government bond rating returns to stable.

Factors that Could Lead to a Downgrade

If El Salvador's government bond rating is downgraded further, Bandesal's ratings and assessments are likely to be downgraded again as well.

Key Indicators

Exhibit 2

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

	6-16[2]	12-15[2]	12-14[2]	12-13[2]	12-12[2]	Avg.
Total Assets (USD million)	588.1	560.6	521.8	540.6	514.5	3.4[3]
Tangible Common Equity (USD million)	224.2	223.2	218.9	214.9	202.8	2.5[3]
Tangible Common Equity / Risk Weighted Assets (%)	39.2	40.7	41.8	34.4	32.7	37.8[4]
Net Interest Margin (%)	2.0	2.2	2.5	2.3	1.6	2.1[5]
PPI / Average RWA (%)	1.0	1.2	1.6	1.2	0.8	1.2[4]
Net Income / Tangible Assets (%)	0.6	0.9	0.9	0.9	0.9	0.8[5]
Cost / Income Ratio (%)	53.6	46.8	39.1	41.1	54.1	46.9[5]
Market Funds / Tangible Banking Assets (%)	61.6	59.7	57.5	59.3	58.6	59.3[5]
Liquid Banking Assets / Tangible Banking Assets (%)	29.1	28.8	28.4	35.2	39.9	32.3[5]

[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

Source: Moody's Financial Metrics

Detailed Rating Considerations

RELIANCE ON WHOLESALE MARKET FUNDS ADDS TO REFINANCING RISKS

Bandesal depends entirely on wholesale funding as it cannot take deposits from the public as per the Development Bank Law. As of June 2016, lines from commercial banks comprised 44% of its total assets, while issued debt represented 2.5%. The remainder of the funding is composed by lines from the Central Reserve Bank of El Salvador (13% of assets) and shareholders' equity (38%).

Funding is medium-term in nature, with the majority of it being due in more than one year as of June 2016. This allows an adequate match with the longer loan portfolio, as 77% of it matures in more than a year. As a result, Bandesal shows positive cumulative tenor matches over the short term.

Liquid assets comprised around 29% of total assets as of 2016, down from 35% and 40% in 2013 and 2012 as the bank used it to fund growth. Liquidity is largely invested in Salvadoran government securities (70% of liquid assets) as well as bank deposits and cash (30%).

However, if the Salvadoran government continues to rely on short-term debt financing due to its inability to recur to long-term indebtedness, Bandesal's funding and liquidity profile could deteriorate as the bank's liquidity position and market access are closely tied to the government's own funding and liquidity profile.

WEAKENING PROFITABILITY DUE TO RISING FUNDING COSTS

Bandesal's profitability has historically been modest, with return on assets consistently below 1%. This derives from thin net interest margins, which averaged a modest 2% since 2010, a by-product of the bank's developmental role and a loan book largely devoted to financial institutions.

As of June 2016, the net income to tangible assets hit a historic low at 0.6% reflecting the increase in funding costs given higher international dollar rates amid a deteriorating sovereign creditworthiness. The consequential increases of the bank's funding costs have not been transferred to its loan book, given its public policy mandate. At the same time, high operating costs continued to erode returns. As of June 2016, Bandesal, despite not having a branch network, had a cost-income ratio of a high 55%. We also note that Bandesal had to pay a new special tax to fund public safety.

STRONG ASSET QUALITY SUPPORTED BY BANDESAL'S PREFERRED CREDITOR STATUS

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 have access to the reserve accounts of regulated banks and some non-banks at the 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 June 2016, Bandesal had a preferential creditor status on about 85% of its total portfolio, similar to the figures posted by the same date last year. Nonperforming loans have been posted at zero since 2006.

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 June 2016, the fifth and tenth largest borrowers comprised 53% and 76% of total gross loans. Largest exposures are largely devoted to government-owned banks and large domestic private commercial banks. Bandesal direct lending encompasses only 6% of its total gross loans.

ROBUST CORE CAPITALIZATION

Bandesal has maintained strong risk-weighted capitalization that allows for a substantial cushion to absorb losses. As of June 2016, Tangible Common Equity represented about 39.3% of adjusted risk-weighted assets.

BANDESAL'S BCA IS CONSTRAINED BY EL SALVADOR'S "VERY WEAK +" MACRO PROFILE

El Salvador has a small economy with weak growth prospects, weighed down by low investment and limited improvements in productivity. Although dollarization has helped keep inflation low, it has also limited the economic policy tools available to local authorities to spur greater economic growth. In addition, the country has a fragile rule of law and suffers from widespread security problems. Credit penetration is in line with the average across Latin America, although loan growth has lagged other regional peers as a result of the country's lackluster economic expansion. Asset risks related to exposures to short-term government securities (LETES) have risen this year as a result of the government's liquidity strains. Further, consumer lending growth has accelerated in recent years, leaving banks more susceptible to asset quality problems in the event of a more pronounced downturn in the economy, or a decline in remittances. The Salvadoran banking system is largely foreign owned and moderately concentrated.

Rating Methodology and Scorecard Factors

Exhibit 3

Banco de Desarrollo de El Salvador

Macro Factors		
Weighted Macro Profile	**Very Weak +**	**100%**

Financial Profile						
Factor	**Historic Ratio**	**Macro Adjusted Score**	**Credit Trend**	**Assigned Score**	**Key driver #1**	**Key driver #2**
Solvency						
Asset Risk						
Problem Loans / Gross Loans		ba1	←→	b1		
Capital						
TCE / RWA	39.2%	ba1	←→	ba1		
Profitability						
Net Income / Tangible Assets	0.6%	caa1	←→	caa1		
Combined Solvency Score		ba2		b1		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	59.7%	caa2	←→	caa3		
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	28.8%	b3	←→	b3		
Combined Liquidity Score		caa1		caa2		
Financial Profile				b2		
Business Diversification				0		
Opacity and Complexity				0		
Corporate Behavior				0		
Total Qualitative Adjustments				0		
Sovereign or Affiliate constraint:				WR		
Scorecard Calculated BCA range				b2-caa1		
Assigned BCA				b3		
Affiliate Support notching				0		
Adjusted BCA				b3		

Instrument Class	**Loss Given Failure notching**	**Additional notching**	**Preliminary Rating Assessment**	**Government Support notching**	**Local Currency rating**	**Foreign Currency rating**

Source: Moody's Financial Metrics

Notching Considerations

Foreign Currency Issuer Rating

Bandesal's B3 foreign currency issuer rating, with a negative outlook, is in line with El Salvador's B3 government bond rating, also with a negative outlook. It also reflects our assessment of a high probability of extraordinary public support to the bank in the case of need, though this assessment does not yield in a rating uplift at this time.

About Moody's Bank Scorecard

Our Scorecard is designed to capture, express and explain in summary form our Rating Committee's judgment. When read in conjunction with our research, a fulsome presentation of our judgment is expressed. As a result, the output of our Scorecard may materially differ from that suggested by raw data alone (though it has been calibrated to avoid the frequent need for strong divergence). The Scorecard 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.

Ratings

Exhibit 4

Category	Moody's Rating
BANCO DE DESARROLLO DE EL SALVADOR	
Outlook	Negative
Baseline Credit Assessment	b3
Adjusted Baseline Credit Assessment	b3
Issuer Rating	B3

Source: Moody's Investors Service

REPORT NUMBER 1049841

Contacts

Georges Hatcherian 52-55-1555-5301
Analyst
georges.hatcherian@moodys.com

Vicente Gomez 52-55-1555-5304
Associate Analyst
vicente.gomez@moodys.com

CLIENT SERVICES

Americas	1-212-553-1653
Asia Pacific	852-3551-3077
Japan	81-3-5408-4100
EMEA	44-20-7772-5454