

## CREDIT OPINION

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Update

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# Banco de Desarrollo de El Salvador

Update following upgrade to B3, outlook remains stable

## Summary

On 28 February 2018, we upgraded to B3, from Caa1 the long-term foreign currency issuer rating of [Banco de Desarrollo de El Salvador](#) (Bandesal), El Salvador's development bank. The bank's standalone Baseline Credit Assessment (BCA) was also upgraded to b3 from caa1.

The rating action followed the [Government of El Salvador's](#) bond rating [upgrade](#) to B3 from Caa1 with a stable outlook.

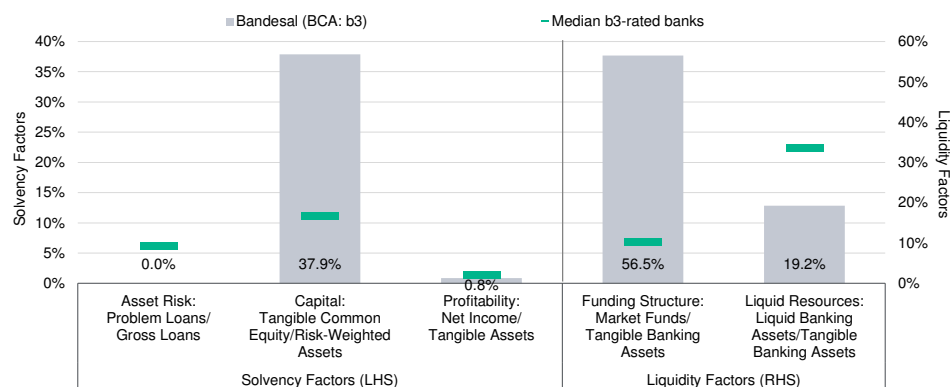
The upgrade of Bandesal's BCA and issuer rating reflects the decreasing risks from the bank's close managerial and financial links with the Salvadoran government, and the resulting improvement in its access to funding. Bandesal's ratings are also supported by its relatively good asset quality, which benefits from its preferred creditor status in El Salvador, coupled with prudent risk management and reserving practices. The bank's profitability is low as a result of its developmental role and focus on low-yielding lending to other financial institutions, coupled with its dependence on more expensive market funding.

For details on this rating action, please refer to Moody's news release [Moody's upgrades Salvadoran banks' ratings; outlook is stable](#).

Exhibit 1

### Rating Scorecard - Key financial ratios

Note: Data for Bandesal as of December 2017



Source: Moody's Financial Metrics

## Credit strengths

- » Strong asset quality, supported by Bandedal's preferred creditor status
- » Robust core capitalization

## Credit challenges

- » Reliance on wholesale market funding, which adds to refinancing risks
- » Modest profitability, because of low net interest margin and weak efficiency
- » Challenging operating environment for banks in El Salvador, as captured by its "Very Weak+" Macro Profile

## Rating outlook

The outlook on Bandedal's long-term foreign-currency issuer rating is stable, in line with the stable outlook on El Salvador's government bond rating.

## Factors that could lead to an upgrade

The ratings might be further upgraded if El Salvador's operating environment continues to improve.

## Factors that could lead to a downgrade

If the bond ratings of the Salvadoran government were to be downgraded, Bandedal's rating would be downgraded as well. A severe deterioration in the bank's capital, asset quality or profitability could also exert downward pressure on its ratings.

## Key indicators

Exhibit 2

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

	12-17 <sup>2</sup>	12-16 <sup>2</sup>	12-15 <sup>2</sup>	12-14 <sup>2</sup>	12-13 <sup>2</sup>	CAGR/Avg. <sup>3</sup>
Total Assets (USD million)	538	591	561	522	541	-0.1 <sup>4</sup>
Tangible Common Equity (USD million)	231	227	223	219	215	1.8 <sup>4</sup>
Tangible Common Equity / Risk Weighted Assets (%)	37.9	39.4	40.7	41.8	34.4	38.8 <sup>5</sup>
Net Interest Margin (%)	2.2	2.2	2.2	2.5	2.3	2.3 <sup>6</sup>
PPI / Average RWA (%)	1.1	1.1	1.2	1.6	1.2	1.3 <sup>5</sup>
Net Income / Tangible Assets (%)	0.8	0.8	0.9	0.9	0.9	0.8 <sup>6</sup>
Cost / Income Ratio (%)	48.1	49.3	46.8	39.1	41.1	44.9 <sup>6</sup>
Market Funds / Tangible Banking Assets (%)	56.5	61.2	59.7	57.5	59.3	58.9 <sup>6</sup>
Liquid Banking Assets / Tangible Banking Assets (%)	19.2	28.0	28.8	28.4	35.2	27.9 <sup>6</sup>

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel I; LOCAL GAAP [3] May include rounding differences due to scale of reported amounts [4] Compound Annual Growth Rate (%) based on time period presented for the latest accounting regime [5] Simple average of Basel I periods presented [6] Simple average of periods presented for the latest accounting regime.

Source: Moody's Financial Metrics

## Profile

Bandedal is a Salvadoran development bank 100% controlled by the government. The bank is primarily focused on indirect lending via other financial institutions to micro and medium-sized enterprises, while the share of direct lending in its loan book is low. In accordance with the Development Bank Law ([Ley del Sistema Financiero para el Fomento del Desarrollo](#)), Bandedal cannot take deposits.

As of December 2017, the bank reported \$538 million of assets.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on [www.moody's.com](http://www.moody's.com) for the most updated credit rating action information and rating history.

## Detailed credit considerations

### Reliance on wholesale market funding adds to refinancing risks

Bandesal depends entirely on wholesale funding because it cannot take deposits from the public according to the Development Bank Law. As of year-end 2017, lines from commercial banks and the Central Reserve Bank of El Salvador comprised 55% of its total assets, while the bank did not have any debt issuances outstanding.

Funding is medium term in nature, with the majority of it due in more than one year as of year-end 2017. This allows an adequate match with its largely long-term portfolio. As a result, Bandesal showed positive cumulative tenor matches over the short term.

Liquid assets comprised about 20% of total assets as of year-end 2017, down from 35% and 40% in 2013 and 2012, respectively, as the bank used them to fund growth in the past. Liquidity is largely invested in Salvadoran government securities, as well as bank deposits and cash.

Consequently, Bandesal's funding and liquidity profiles could deteriorate in case of a resumed deterioration in the sovereign's credit profile because the bank's liquidity position and market access are closely tied to the government's own funding and liquidity profiles. However, in 2017 the bank significantly curtailed its investment portfolio, which was partially used to repay its borrowings.

### Modest profitability because of low net interest margin and weak efficiency

Bandesal's profitability has historically been modest, with return on assets consistently below 1%. This is owing to thin net interest margins, which averaged a modest 2.2% in 2015-17, a byproduct of the bank's developmental role and a loan book largely devoted to financial institutions (about 93% as of December 2017).

In 2017, net income-to-tangible assets ratio remained stable at 0.8%, reflecting a moderate 3% increase in loan portfolio and a contraction in low-interest-earning assets. As a result, net interest margins slightly increased to 2.24% in 2017 from 2.16% in the previous year.

Further, profitability was supported by higher fee and commission income and lower provisioning, as the ratio of loan-loss provisions to pre-provision income decreased to 40% in 2017 from 55% in 2016.

At the same time, high operating costs continued to exert pressure on returns. As of year-end 2017, Bandesal, despite not having a branch network, had a high cost-to-income ratio of about 48%.

### 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, Bandesal can access 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 year-end 2017, Bandesal had a preferential creditor status on most of its portfolio.

Although Bandesal has posted zero nonperforming loans since 2006, it constitutes provisions for possible loan losses that stood at 3.6% of gross loans, above the previous three-year average of 3.0%. The bank's loan-loss reserve policy includes a 1% voluntary reserve in addition to specific reserves, a policy based on forward-looking risk profiles.

Still, we expect asset risk to gradually increase as the bank strategically targets non-regulated financial institutions to expand in specific sectors, and widens direct lending, largely devoted to energy efficiency and industrial reconstruction. Loan growth is likely to remain slow at a maximum of 5%, in line with the soft economy.

Although the bank's loan-book concentration is high, with the 20 largest borrowers representing about 1.6x tangible common equity as of September 2017, largest exposures are largely devoted to government-owned banks and large domestic private commercial banks.

### Robust core capitalization

Historically, Bandesal has maintained strong risk-weighted capitalization that allows for a substantial buffer to absorb losses. As of December 2017, the bank's tangible common equity represented about a high 38% of adjusted risk-weighted assets. Additionally, dividend distribution has been low, averaging 15% of net income in 2014-17.

### Challenging operating environment for banks in El Salvador, as captured by its "Very Weak+" Macro Profile

El Salvador has a small economy with weak growth prospects, weighed down by low investments 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 overall loan growth has been relatively low, in line with modest performance of the economy. Asset risks for banks are fueled by hefty retail lending and still-large exposure to government securities. Consumer lending growth contributed 42% of loan growth since year-end 2015, and consumer loans now account for 35% of total loan portfolio, leaving banks more susceptible to asset-quality problems in the event of a more pronounced downturn in the economy, or a decline in remittances. Total investment portfolios, although declining, are still very high (44% of shareholders' equity), significantly allocated to government-related securities, exposing the banks to a resumed deterioration in the sovereign's credit profile. The Salvadoran banking system is largely foreign owned and moderately concentrated.

### Support and structural considerations

#### Foreign-currency issuer rating

Bandesal's B3 foreign-currency issuer rating, with a stable outlook, is in line with El Salvador's B3 government bond rating, also with a stable outlook.

#### About Moody's Bank Scorecard

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## Rating methodology and scorecard factors

Exhibit 3

### Banco de Desarrollo de El Salvador

#### Macro Factors

Weighted Macro Profile	Very Weak +	100%
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Factor	Historic Ratio	Macro Adjusted Score	Credit Trend	Assigned Score	Key driver #1	Key driver #2
Solvency						
Asset Risk						
Problem Loans / Gross Loans	0.0%	ba1	← →	b2		
Capital						
TCE / RWA	37.9%	ba1	← →	b1		
Profitability						
Net Income / Tangible Assets	0.8%	b3	← →	b3		
Combined Solvency Score		ba2		b2		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	56.5%	caa2	← →	caa3		
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	19.2%	caa1	← →	b3		
Combined Liquidity Score		caa2		caa2		
Financial Profile						
Business Diversification				0		
Opacity and Complexity				0		
Corporate Behavior				0		
Total Qualitative Adjustments				0		
Sovereign or Affiliate constraint:				B3		
Scorecard Calculated BCA range				b2-cao1		
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
Senior unsecured bank debt	0	0	b3	--	--	B3

Source: Moody's Financial Metrics

## Ratings

Exhibit 4

Category	Moody's Rating
<b>BANCO DE DESARROLLO DE EL SALVADOR</b>	
Outlook	Stable
Baseline Credit Assessment	b3
Adjusted Baseline Credit Assessment	b3
Issuer Rating	B3

Source: Moody's Investors Service

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