CREDIT OPINION
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Update

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Banco de Desarrollo de El Salvador

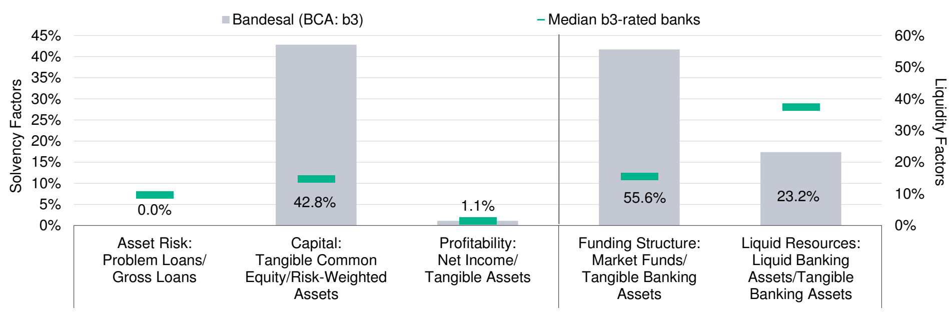
Update to credit analysis

Summary

Banco de Desarrollo de El Salvador's (Bandesal) b3 Baseline Credit Assessment (BCA) and B3 issuer rating are in line with the Government of El Salvador's B3 long-term rating, which reflects our view that the creditworthiness of the bank is intrinsically interlinked with that of the Salvadoran government because its funding, liquidity position and market access are closely tied to El Salvador's own access to market 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.

Exhibit 1
Rating Scorecard - Key financial ratios
Data for Bandesal as of June 2018.



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 funding, which adds to refinancing risks

» Modest profitability, given the bank's low net interest margin and weak efficiency

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

Outlook

The outlook on Bandesal'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

Bandesal's ratings might be upgraded if El Salvador's operating environment improves.

Factors that could lead to a downgrade

If the bond rating of the Salvadoran government were to be downgraded, Bandesal's ratings 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]

	6-18[2]	12-17[2]	12-16[2]	12-15[2]	12-14[2]	CAGR/Avg.[3]
Total Assets (USD million)	533	538	591	561	522	0.6[4]
Tangible Common Equity (USD million)	234	231	227	223	219	1.9[4]
Tangible Common Equity / Risk Weighted Assets (%)	42.8	37.9	39.4	40.7	41.8	40.5[5]
Net Interest Margin (%)	2.5	2.2	2.2	2.2	2.5	2.3[6]
PPI / Average RWA (%)	1.4	1.1	1.1	1.2	1.6	1.3[5]
Net Income / Tangible Assets (%)	1.1	0.8	0.8	0.9	0.9	0.9[6]
Cost / Income Ratio (%)	44.5	48.1	49.3	46.8	39.1	45.6[6]
Market Funds / Tangible Banking Assets (%)	55.6	56.5	61.2	59.7	57.5	58.1[6]
Liquid Banking Assets / Tangible Banking Assets (%)	23.2	19.2	28.0	28.8	28.4	25.5[6]

[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

Banco de Desarrollo de El Salvador 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), Bandesal cannot take deposits.

As of June 2018, the bank reported $533 million of assets.

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 June 2018, lines from commercial banks and the Central Reserve Bank of El Salvador comprised 54% of its total assets, while the bank did not have any debt issuances outstanding.

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

Liquid banking assets comprised about 23% of tangible banking assets as of June 2018, down from 35% and 40% in 2013 and 2012, respectively, as the bank used them to fund growth in the past. The bank's liquidity is largely in the form of 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 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, attributable to thin net interest margins, which averaged a modest 2.3% since 2015, a by-product of the bank's developmental role and a loan book largely devoted to financial institutions (about 93%).

In the first half of 2018, the net income-to-tangible assets ratio stood at 1.07%, up from 0.64% registered in H1 2017, partly reflecting a contraction in low-interest-earning assets. As a result, the net interest margin slightly increased to 2.5% in H1 2018 from 2% in the year-earlier period. Furthermore, profitability was supported by release of reserves.

Although as of June 2017, loan-loss provisions increased 25% from a year earlier, as a percentage of pre-provision income, they remained relatively stable (28%). At the same time, high operating costs continued to exert pressure on returns. As of June 2018, Bandesal, despite not having a branch network, had a high cost-to-income ratio of about 45%.

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. In accordance with 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 June 2018, Bandesal had a preferential creditor status on most of its portfolio.

Although Bandesal has posted zero nonperforming loans since 2006, it constitutes reserves for possible loan losses, which stood at 3.8% of gross loans as of June 2018. 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.

However, 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.

As of June 2018, the loan portfolio decreased 4% from a year earlier, partially because of unfavorable funding conditions in 2017 and loan prepayments in light of higher liquidity in the system. We do not expect significant loan growth for the rest of the year, in line with the soft economy.

Although the bank's loan book concentration is high, with the 20 largest borrowers representing about 1.5x tangible common equity as of June 2018, the 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, which allows for a substantial buffer to absorb losses. As of June 2018, the bank's tangible common equity represented about a high 43% 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 relatively weak growth levels, hindered by low investment and limited productivity gains. Though the country compares favorably with its peers in most governance indicators, political polarization limits policy credibility and effectiveness. Liquidity risks have diminished since the approval of the 2018 budget, but it remains to be seen how easy it will be for political parties to reach new agreements.

Credit penetration is in line with the average across Latin America, although loan growth has lagged regional peers because of lackluster economic growth. Significant growth in consumer lending and large exposure to government securities continue to fuel asset risk. Banks are mostly deposit funded and have a relatively low reliance on market funds. They also have good liquidity buffers, which help compensate for the lack of a lender of last resort in El Salvador because of the full dollarization of the economy. The 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.

Counterparty Risk (CR) Assessment

CR Assessments are opinions of how counterparty obligations are likely to be treated if a bank fails and are distinct from debt and deposit ratings in that they (1) consider only the risk of default rather than both the likelihood of default and the expected financial loss suffered in the event of default, and (2) apply to counterparty obligations and contractual commitments rather than debt or deposit instruments. The CR Assessment is an opinion of the counterparty risk related to a bank's covered bonds, contractual performance obligations (servicing), derivatives (for example, swaps), letters of credit, guarantees and liquid facilities.

Bandesal's CR Assessment is positioned at B2(cr)/Not Prime(cr)

The CR Assessment is positioned one notch above the b3 Adjusted BCA and, therefore, above the issuer rating, reflecting our view that its probability of default is lower. We believe senior obligations represented by the CR Assessment will be more likely preserved to limit contagion, minimize losses and avoid disruption of critical functions.

Counterparty risk ratings (CRRs)

CRRs are opinions of the ability of entities to honor the uncollateralized portion of non-debt counterparty financial liabilities (CRR liabilities) and also reflect the expected financial losses in the event such liabilities are not honored. CRR liabilities typically relate to transactions with unrelated parties. Examples of CRR liabilities include the uncollateralized portion of payables arising from derivatives transactions and the uncollateralized portion of liabilities under sale and repurchase agreements. CRRs are not applicable to funding commitments or other obligations associated with covered bonds, letters of credit, guarantees, servicer and trustee obligations, and other similar obligations that arise from a bank performing its essential operating functions.

Bandesal's CRR is positioned at B2/Not Prime

The CRR is positioned one notch above the Adjusted BCA of b3 and, therefore, above issuer rating, reflecting our view that CRR liabilities have a lower probability of default as they will more likely be preserved to minimize banking system contagion, minimize losses and avoid disruption of critical functions.

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.

Rating methodology and scorecard factors

Exhibit 3

Banco de Desarrollo de El Salvador

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

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	42.8%	ba1	←→	b1		
Profitability						
Net Income / Tangible Assets	0.9%	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				b3		
Business Diversification				0		
Opacity and Complexity				0		
Corporate Behavior				0		
Total Qualitative Adjustments				0		
Sovereign or Affiliate constraint:				B3		
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
Counterparty Risk Rating	1	0	b2	--	--	B2
Counterparty Risk Assessment	1	0	b2 (cr)	--	B2 (cr)	--
Senior unsecured bank debt	0	0	b3	--	--	B3

[1] Where dashes are shown for a particular factor (or sub-factor), the score is based on non-public information.
Source: Moody's Financial Metrics

Ratings

Exhibit 4

Category	Moody's Rating
BANCO DE DESARROLLO DE EL SALVADOR	
Outlook	Stable
Counterparty Risk Rating	B2/NP
Baseline Credit Assessment	b3
Adjusted Baseline Credit Assessment	b3
Counterparty Risk Assessment	B2(cr)/NP(cr)
Issuer Rating	B3

Source: Moody's Investors Service

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