

CREDIT OPINION

26 March 2020

Update

✓ Rate this Research

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Banco de Desarrollo de El Salvador

Update following outlook change to positive

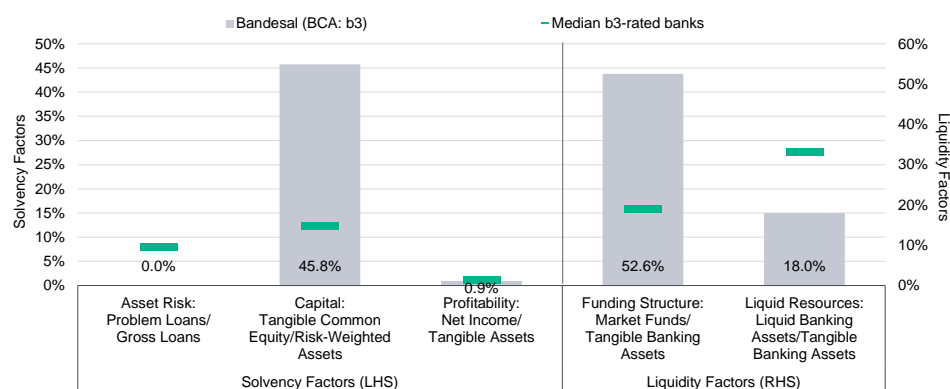
Summary

On 18 March 2020, we affirmed [Banco de Desarrollo de El Salvador's](#) (Bandesal) b3 Baseline Credit Assessment (BCA) and B3 issuer rating, which is in line with the [Government of El Salvador's](#) B3 long-term rating, 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. In addition, on that date we changed the rating outlook for Bandesal to positive from stable, in line with the change in outlook to positive, from stable, on Government of El Salvador's B3 long-term rating.

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, although the latter is primarily sourced from multilaterals, offsetting refinancing and interest rate risks. Additionally, although the full extent of the economic costs related to the coronavirus outbreak will be unclear for some time, we expect it to have a direct negative impact on the asset quality and profitability of banks.

Exhibit 1

Rating Scorecard - Key financial ratios as of December 2019



Source: Moody's Financial Metrics.

For the problem loan and profitability ratios, we review the latest three year-end ratios as well as the most recent intra-year ratio where applicable, and base our starting point ratio on the weaker of the average of this period and the latest figure. For the capital ratio, we use the latest figure. For the funding structure and liquid asset ratios, we use the latest year-end figures.

Source: Moody's Financial Metrics

Credit strengths

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

Credit challenges

- » Modest profitability, given the bank's low net interest margin (NIM) and weak efficiency
- » Challenging operating environment for banks in El Salvador, as captured by its Weak Macro Profile

Rating outlook

The positive outlook on Badesal's ratings considers the expected decrease in risks stemming from the development bank's close managerial and financial linkages with the Salvadoran government, and the resulting improvement in its access to funding.

Factors that could lead to an upgrade

- » In line with the positive outlook, Badesal's will face upward pressure if El Salvador's sovereign rating is upgraded or the country's operating environment continues to improve, provided that the bank fundamentals remain broadly stable or improve.

Factors that could lead to a downgrade

- » A reversal of the improving trend in El Salvador's credit profile, a deterioration on its operating environment or Badesal's fundamentals could lead to a downgrade.

Key indicators

Exhibit 3

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

	12-19 ²	12-18 ²	12-17 ²	12-16 ²	12-15 ²	CAGR/Avg. ³
Total Assets (USD Million)	539.1	531.3	537.6	590.6	560.6	(1.0) ⁴
Tangible Common Equity (USD Million)	253.0	235.6	230.7	227.0	223.2	3.2 ⁴
Tangible Common Equity / Risk Weighted Assets (%)	45.8	42.1	37.9	39.4	40.7	41.2 ⁶
Net Interest Margin (%)	2.6	2.6	2.2	2.2	2.2	2.3 ⁵
PPI / Average RWA (%)	1.8	1.4	1.1	1.1	1.2	1.3 ⁶
Net Income / Tangible Assets (%)	1.0	0.9	0.8	0.8	0.9	0.9 ⁵
Cost / Income Ratio (%)	44.0	45.4	48.1	49.3	46.8	46.7 ⁵
Market Funds / Tangible Banking Assets (%)	52.5	55.0	56.5	61.2	59.7	57.0 ⁵
Liquid Banking Assets / Tangible Banking Assets (%)	18.0	18.2	19.2	28.0	28.8	22.4 ⁵

[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 periods presented for the latest accounting regime. [6]Simple average of Basel I periods presented.

Source: Moody's Investors Service; Company Filings

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 for the most updated credit rating action information and rating history.

Profile

Banco de Desarrollo de El Salvador (Bandesal) 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 December 2019, the bank reported \$540 million of assets.

Recent developments

The global spread of the coronavirus is resulting in simultaneous supply and demand shocks. We expect these shocks to materially slow economic activity, particularly in the first half of this year. The full extent of the economic costs will be unclear for some time. Fear of contagion will dampen consumer and business activity. The longer it takes for households and businesses to resume normal activity, the greater the economic impact. Fiscal and monetary policy measures will likely help limit the damage in individual economies. Policy announcements from fiscal authorities, central banks and international organizations so far suggest that policy response is likely to be strong in affected countries. The coronavirus outbreak will have a direct negative impact on the asset quality and profitability of banks, in some cases in a pronounced manner, for example for undiversified banks with material exposure to high-risk sectors and small and medium-sized enterprises. We also view risks to be elevated for business models reliant on spread income, equity indices and sustained low rates.

Detailed credit considerations

Reliance on wholesale market funding, although mainly sourced from multilateral institutions

Bandesal is 100% owned by the Salvadoran state, and depends entirely on wholesale funding because it cannot take deposits from the public according to the Development Bank Law. Bandesal's refinancing and interest rate risks stemming from its market funding exposure is partly offset by the fact that these funds are mostly sourced from multilateral financial institutions, which are less volatile than other market funding sources. As of December 2019, lines from multilateral financial institutions and foreign development banks comprised about 80% of Bandesal's total funding. Funding is medium term in nature, which allows for an adequate match with its largely long-term portfolio. As a result, Bandesal shows positive cumulative tenor matches over the short term.

Liquid banking assets comprised 18% of tangible banking assets as of December 2019, down from 35% six years ago, 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.

Bandesal's funding and liquidity profiles could deteriorate in case of a 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, since 2017, the bank significantly curtailed its investment portfolio, which was partially used to repay its borrowings.

Modest profitability because of its low NIM and weak efficiency

Bandesal's profitability is low, attributable to a thin NIM, which averaged 2.3% since 2015, the bank's developmental role and its focus on low-yielding lending to other financial institutions (more than 90% of the loan book). Likewise, the bank depends on relatively more expensive funding. Bandesal's operating efficiency is relatively weak, with a cost-to-income ratio of about 44%, even though the bank does not have a branch network. On the other hand, Bandesal benefits from low credit costs, in line with its strong asset quality.

In 2019, the net income-to-tangible assets ratio stood at 1.0%, slightly up from the 0.9% registered in 2018, supported by slight improvements in efficiency and lower credit costs. As such, operating costs decreased to 1.19% of total assets as of December 2019 from 1.22% as of December 2018, while loan-loss provisions declined to 0.5% of gross loans from 0.6% a year earlier.

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 the 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 2019, Bandesal had a preferential creditor status on most of its portfolio.

Although Bandedal has posted zero nonperforming loans since 2006, it constitutes reserves for possible loan losses, which stood at 4.0% of gross loans as of December 2019. 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. Although the bank's loan book concentration is high, the largest exposures are largely devoted to government-owned banks and large domestic private commercial banks.

Robust core capitalization

Historically, Bandedal has maintained strong risk weighted capitalization, which allows for a substantial buffer to absorb losses. As of December 2019, the bank's tangible common equity represented about a high 46% of adjusted risk-weighted assets. Additionally, dividend distribution has been low, averaging 12% of net income in 2015-18, while in 2019 the dividend payment represented 20% of net income.

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

El Salvador has a small economy, which is dependent on remittances and low-value added exports to the US. Economic growth is relatively low, hindered by low investment and low productivity rates. The country has a history of political confrontations between the executive and legislative branches, although recent agreements derived from improved political dynamics have materially reduced refinancing risk and lowered the risk that political brinkmanship would lead to a missed debt payment.

Credit penetration in El Salvador is in line with the average across Latin America and has slightly increased in recent years. Asset risks are mainly driven by banks' sizable retail portfolio – comprised of consumer lending and mortgages, which account for about 50% of total loans – and still-large exposures to government securities. However, nonperforming loans have remained low and stable. Banks are mostly deposit funded and have a relatively low reliance on more volatile 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 the degree of concentration is moderate.

Support and structural considerations

Foreign-currency issuer rating

Bandedal'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.

Bandedal'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 CRRs are positioned at B2/Not Prime

The CRRs are positioned one notch above the Adjusted BCA of b3 and, therefore, above the 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 4

Banco de Desarrollo de El Salvador

Macro Factors						
Weighted Macro Profile	Weak	100%				
Factor	Historic Ratio	Initial Score	Expected Trend	Assigned Score	Key driver #1	Key driver #2
Solvency						
Asset Risk						
Problem Loans / Gross Loans	0.0%	baa2	←→	b2	Sector concentration	
Capital						
Tangible Common Equity / Risk Weighted Assets (Basel I)	45.8%	baa2	←→	b1	Expected trend	
Profitability						
Net Income / Tangible Assets	0.9%	b1	←→	b2	Expected trend	
Combined Solvency Score		baa3		b2		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	52.5%	caa2	←→	b2	Market funding quality	
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	18.0%	b2	←→	b3		
Combined Liquidity Score		caa1		b2		
Financial Profile						
				Adjustment		
Business Diversification				0		
Opacity and Complexity				0		
Corporate Behavior				0		
Total Qualitative Adjustments				0		
Sovereign or Affiliate constraint				B3		
BCA Scorecard-indicated Outcome - 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)	

[1]Where dashes are shown for a particular factor (or sub-factor), the score is based on non-public information.

Source: Moody's Investors Service

Ratings

Exhibit 5

<u>Category</u>	<u>Moody's Rating</u>
BANCO DE DESARROLLO DE EL SALVADOR	
Outlook	Positive
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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