

CREDIT OPINION

9 August 2021

Update

 Rate this Research

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Banco de Desarrollo de El Salvador

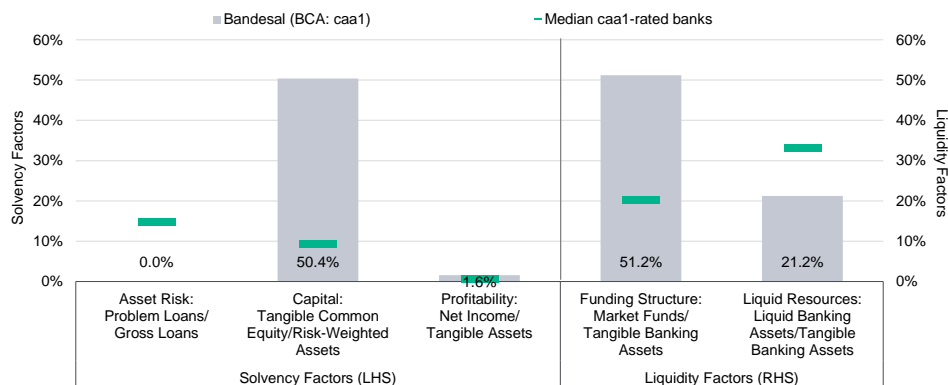
Update following downgrade to Caa1; outlook negative

Summary

[Banco de Desarrollo de la República de El Salvador's](#) (Bandesal) caa1 Baseline Credit Assessment (BCA) and Caa1 issuer rating, are in line with the [Government of El Salvador's](#) Caa1 bond rating. Bandesal's credit profile is supported by its good asset quality metrics, which benefit from its preferred creditor status as the government development bank in El Salvador. Asset risk metrics remained sound throughout 2020 and the beginning of 2021 amid the economic implications of the pandemic and the bank's adequate level of provisions to absorb potential credit losses. The bank's strong capital is also a key strength and provide a sizeable buffer to absorb losses and support loan growth. These strengths are partially counterbalanced by the bank's high dependence on market funding, although the latter is primarily sourced from multilaterals, which partially offset refinancing and interest rate risks.

Bandesal's ratings are however constrained by El Salvador's sovereign rating, reflecting our view that the creditworthiness of the bank is intrinsically interlinked with that of the government. The interlinkages are mainly related to the impact of the sovereign credit profile on banks' operating environment and potential funding pressures for banks that could arise from a deterioration of El Salvador's own access to market funding. However, Bandesal does not have direct exposure to sovereign debt or loans to the government, as these exposures are prohibited by the Salvadoran Development Bank Law. The negative outlook on the bank's ratings are driven by rising uncertainties about El Salvador's government finances, which could potentially drive a weaker operating environment for banks.

Exhibit 1

Rating Scorecard - Key financial ratios as of March 2021


Source: Moody's Financial Metrics.

Credit strengths

- » Strong asset quality, supported by Bandedal's preferred creditor status
- » Robust core capitalization
- » Support from El Salvador's government given the bank's strategic developmental role, although the bank's ratings do not benefit from support due to the weak credit profile of the sovereign

Credit challenges

- » Challenging operating environment for banks in El Salvador, as captured by its Very Weak + Macro Profile
- » Reliance on wholesale funding, although primarily sourced from multilaterals, which partially offset refinancing and interest rate risks
- » Modest profitability, although recently improving, given the bank's low net interest margin (NIM) in comparison with private banks and relatively high operating costs

Rating outlook

The outlook of Bandedal's ratings is negative, in line with the outlook of El Salvador's sovereign rating, reflecting the latter's potential negative impact on banks' operating environment.

Factors that could lead to an upgrade

An upgrade is unlikely for Bandedal at this time because the ratings are currently on negative outlook. However, the outlook could be changed to stable following a stabilization of the Government of El Salvador's sovereign ratings outlook, provided that operating conditions for the bank stabilized and its financial profile remained sound.

Factors that could lead to a downgrade

Downward pressure on the bank's ratings would arise following a further downgrade of the sovereign rating, that could reflect into potential pressures on the bank's operating environment in light of the high interlinkages between bank's creditworthiness and that of the government.

Key indicators

Exhibit 2

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

	03-21 ²	12-20 ²	12-19 ²	12-18 ²	12-17 ²	CAGR/Avg. ³
Total Assets (USD Million)	598.5	548.3	539.1	531.3	537.6	3.4 ⁴
Tangible Common Equity (USD Million)	263.7	261.9	253.0	235.6	230.7	4.2 ⁴
Tangible Common Equity / Risk Weighted Assets (%)	50.4	3870.3	45.8	42.1	37.9	809.3 ⁶
Net Interest Margin (%)	3.5	3.3	2.6	2.6	2.2	2.8 ⁵
PPI / Average RWA (%)	4.3	2.3	1.8	1.4	1.1	2.2 ⁶
Net Income / Tangible Assets (%)	2.6	1.8	1.0	0.9	0.8	1.4 ⁵
Cost / Income Ratio (%)	46.2	44.0	44.0	45.4	48.1	45.6 ⁵
Market Funds / Tangible Banking Assets (%)	54.6	51.2	52.5	55.0	56.5	54.0 ⁵
Liquid Banking Assets / Tangible Banking Assets (%)	19.0	21.2	18.0	18.2	19.2	19.1 ⁵

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

Sources: Moody's Investors Service and 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 la República de El Salvador (Bandesal) is a development bank fully owned by the Salvadoran government. The entity has autonomous control over its administration and it does not depend on government funds to conduct its operations. 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 Banco de Desarrollo de la República de El Salvador), Bandesal cannot take deposits. As of March 2021 the bank had \$598.5 million total assets.

Detailed credit considerations

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 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. The bank also holds additional guarantees on a significant part of its loan portfolio. As of March 2021, Bandesal had a preferential creditor status on most of its portfolio.

Despite Bandesal posting zero nonperforming loans since 2006, it constitutes reserves for possible loan losses, which stood at 3.4% of gross loans as of December 2020. 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. The bank's indirect lending, for which it has a preferred creditor status and comprise most of its loan book, also leads to significant borrower concentrations.

Bandesal's loan growth has been contained in recent years, and its total loan book shrank 4% in 2020, with a total loan book of \$405 million at the end of the year. We expect the bank to increase lending going forward given its developmental role amid the economic impact of the pandemic, and also supported by a recent modification of the Development Bank Law, which enables the bank to increase both its indirect and direct lending, which will in turn drive an increase in loan delinquencies. The bank is also responsible for managing a series of trusts that aim at providing credit to different segments and sectors of the economy, which had consolidated assets of \$3.7 billion as of March 2021.

Robust core capitalization

Bandesal has historically maintained a strong risk weighted capitalization, which allows for a substantial buffer to absorb losses and support loan growth. The bank's tangible common equity represented an average 41% of adjusted risk-weighted assets in the last five years and it has reached 50% as of March 2021. Capital stability and its recent growth have been supported by the bank's earnings and contained dividend payments, which were 11% in 2020 and have averaged 14% of net income between 2015 and 2019.

High reliance on wholesale market funding, although mainly sourced from multilateral institutions

Bandesal 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 expensive and volatile than other market funding sources. As of March 2021, lines from multilateral financial institutions and foreign development banks comprised about 85% 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 19% of tangible banking assets as of March 2021 in line with its level a year earlier. Bandesal's funding profile could deteriorate in case of a further deterioration in the sovereign's credit profile because we consider the bank's market access to be tied to the government's own funding and liquidity profiles.

Modest profitability because of its low margins and high operating costs

Bandesal's profitability is low -although improving since 2020- attributable to a thin net interest margin when compared to commercial bank peers, reflecting the bank's developmental role and its focus on low-yielding lending to other financial institutions (more than 90% of the loan book), coupled with its reliance on market funding, which in turn leads to relatively more expensive funding costs. As of March 2021, the net income-to-tangible assets ratio stood at 2.6%, up from the 1.3% registered in the same period last year, mainly supported by lower funding costs. Despite its operations being centralized -the bank does not have a branch network-

the bank's cost-to-income ratio has historically been high when compared to other development banks in the region (at 46% as of March 2021). On the other hand, Bandedal benefits from low credit costs, in line with its strong asset quality.

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

El Salvador has a relatively small economy, which is dependent on remittances and low-value added exports to the US. Economic growth has been relatively low even before the pandemic, hindered by low investment and low productivity rates. The country has a history of political divergence between the executive and legislative branches, which risks preventing progress on needed reforms to address economic and fiscal challenges. Government liquidity risks are high, reflecting the sovereign's significant borrowing needs, tightened funding conditions and limited sources of financing, which have all been negatively impacted by the pandemic.

Credit penetration in El Salvador has increased in recent years and is currently slightly above the Latin American average. Asset risks are mainly driven by banks' sizable retail loan portfolio – at about 53% of total loans considering consumer loans and mortgages as of March 2021– and large exposures to government securities, which have grown since 2020 in line with the government's increasing financing needs. Nonperforming loans have increased due to the end of flexibilities of the pandemic as of March 2021 and the deterioration on borrower's repayment capacity. 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 Caa1 foreign-currency issuer rating, with a negative outlook, is in line with El Salvador's Caa1 government bond rating, also with a negative outlook.

Counterparty Risk (CR) Assessment

Bandedal's CR Assessment is positioned at B3(cr)/Not Prime(cr)

The CR Assessment is positioned one notch above the caa1 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)

Bandedal's CRRs are positioned at B3/Not Prime

The CRRs are positioned one notch above the Adjusted BCA of caa1 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 3

Banco de Desarrollo de El Salvador

Macro Factors

Weighted Macro Profile	Very 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%	ba1	↔	b2			
Capital							
Tangible Common Equity / Risk Weighted Assets (Basel I)	50.4%	ba1	↔	b1			
Profitability							
Net Income / Tangible Assets	1.6%	b2	↔	b3			
Combined Solvency Score		ba2		b2			
Liquidity							
Funding Structure							
Market Funds / Tangible Banking Assets	51.2%	caa2	↔	caa2			
Liquid Resources							
Liquid Banking Assets / Tangible Banking Assets	21.2%	b3	↔	caa1			
Combined Liquidity Score		caa1		caa2			
Financial Profile				b3			
Qualitative Adjustments				Adjustment			
Business Diversification				0			
Opacity and Complexity				0			
Corporate Behavior				0			
Total Qualitative Adjustments				0			
Sovereign or Affiliate constraint				Caa1			
BCA Scorecard-indicated Outcome - Range				b3 - caa2			
Assigned BCA				caa1			
Affiliate Support notching				0			
Adjusted BCA				caa1			

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	b3	-		B3
Counterparty Risk Assessment	1	0	b3 (cr)	-	B3(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 4

Category	Moody's Rating
BANCO DE DESARROLLO DE EL SALVADOR	
Outlook	Negative
Counterparty Risk Rating	B3/NP
Baseline Credit Assessment	caa1
Adjusted Baseline Credit Assessment	caa1
Counterparty Risk Assessment	B3(cr)/NP(cr)
Issuer Rating	Caa1

Source: Moody's Investors Service

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