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Research Update:

Inter-American Development Bank 'AAA/A-1+' Ratings Affirmed; Outlook Stable

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Overview

- In January 2017, the concessional loan window, Fund for Special Operations (FSO) transferred its assets and liabilities to the ordinary capital resource (OCR) of the Inter-American Development Bank (IADB), thereby boosting the OCR's equity by \$5.2 billion.
- This increases IADB's risk-adjusted capital ratio (21% at year-end 2016) by about 350 basis points, but we need to see a longer track record of stronger capital to consider changing our assessment of IADB's financial profile.
- Nevertheless, we consider that there is potential for IADB to receive extraordinary shareholder support, owing to callable capital from 'AAA' rated sovereigns.
- We are affirming our 'AAA/A-1+' long- and short-term issuer credit ratings on IADB.
- The stable outlook reflects our expectation that IADB's financial profile will remain very strong, most of its stock of 'AAA' rated callable capital will remain intact, and its sovereign borrowers will continue to treat it as a preferred creditor.

Rating Action

On June 30, 2017, S&P Global Ratings affirmed its 'AAA/A-1+' long- and short-term issuer credit ratings on the Inter-American Development Bank (IADB). The outlook remains stable.

Rationale

The ratings on IADB reflect our assessment of the bank's business and financial profiles as very strong, and the extraordinary shareholder support the bank receives through callable capital.

As of Jan. 1, 2017, the assets and liabilities of IADB's concessional window, Funds for Special Operations (FSO), were transferred to IADB's ordinary capital resource (OCR), significantly increasing IADB's equity position. Net assets of \$5.2 billion gave rise to a matching increase in equity, boosting the capital base to \$31.6 billion. The resulting estimated effect on our risk-adjusted capital (RAC) ratio, after adjustments we apply to multilateral lending institutions (MLIs), is slightly above 350 basis points, raising it above 24% from 21% at year-end 2016, all else equal. This indicates a robust capital position and we believe the bank's capital adequacy framework can accommodate some additional leverage in terms of new loans.

The G-20 (group of 20 nations) has asked MLIs to optimize their available resources and exploit opportunities, including integrating concessional loan windows, to make more efficient use of all capital resources. With the FSO transfer achieving a

substantial equity increase for the OCR (fully in line with the G-20 agenda), we believe there might be some subsequent pressure on IADB to put the new capital to use in the developmental lending. However, IADB has now achieved full funding of its capital buffers, which limits the potential lending growth after the equity increase. Because the bank's ninth general capital increase (GCI-9) has fully concluded in 2017, we don't expect it will have additional sources of equity other than net income in the coming two years.

Considering all aspects, we expect the RAC ratio will decline somewhat from the forecast 24%; therefore we would consider whether the bank can sustain its capital levels before incorporating it in our assessment of its financial profile.

IADB's RAC ratio, coupled with its funding and liquidity profile, underpins its very strong financial profile. The bank's RAC ratio improved further following the upgrade of Argentina (see "Argentina Long-Term Rating Raised To 'B' On Improvement In Economic Policy; Outlook Stable," published April 4, 2017). However, the ratio could still come under pressure from other sovereigns IADB lends to in South America, namely Venezuela and Brazil. Last year, IADB posted a \$0.8 billion gain in comprehensive income, down from \$1.2 billion in 2015, but this was owing to market-value movements in both treasury and pension plan assets. In fact, operating income was stronger than the previous year. In 2010, the shareholders initiated discussions to increase IADB's capital through a general capital increase, which has been completed with all paid-in capital contributed and all callable capital having become effective.

We base our assessment of IADB's very strong business profile on our view of the bank's role, public policy mandate, and governance. In addition, we see IADB receiving solid membership support and expect the bank will continue to receive preferred creditor treatment (PCT), an internationally recognized practice of excluding MLIs from restructuring or rescheduling of sovereign debt. IADB's PCT track record is slightly weaker than that of some MLIs, but stronger than many others. There have been recent instances demonstrating PCT, as in the case of the selective default of Belize (February 2017) when IADB continued receiving timely payments. In fact, the last time a sovereign was in arrears with IADB for more than six months was in 2000, when Suriname was in non-accrual status for 175 days (in total 355 days late on its payments) when it brought its loan payments to IADB up to date in December 2000. We assume Venezuela, a significant borrower with a loan balance of \$2.1 billion as of year-end 2016, will remain current on all installments due to the IADB. We assume no change in borrowers' repayment track record with the bank following incorporation of the FSO, despite the FSO's concessional focus. Countries currently borrowing under the FSO also borrow from IADB's OCR, and there are cross-default clauses between the loans.

Over the past decade, IADB has strengthened its financial and risk management framework, as well as its governance standards. The revised policies include the capital adequacy framework, liquidity policy, the investment authority, the asset and liability management framework, and an income management model. In 2014, the bank further updated its capital adequacy framework, which mandates the creation and

building of capital buffers with the aim of facilitating countercyclical lending in times of stress, while preserving a 'AAA' rating.

The bank also introduced a single-borrower limit for sovereign-guaranteed borrowing, which, over time, could help further diversify the portfolio. In late 2015, rules for the revised income management model, to support the building of capital buffers under the capital adequacy framework, took effect. The liquidity policy, which targets at least 12 months of debt repayments and loan disbursements, and considers liquidity haircuts, went into effect in March 2015.

Half of IADB's voting members are borrowing members and, as such, have an important influence over decision-making. In our view, this weighs on the bank's business profile because the interests of borrowing members could differ from those of creditors. That said, IADB has implemented financial and risk management policies to avoid decisions that are not based on sound risk principles and in line with its operating framework. In addition, it has shown an ability to increase earnings capacity to generate capital as needed at the expense of borrowing members. Unlike many other MLIs, IADB can adjust charges on its entire sovereign-guaranteed loan book to generate additional interest revenue and, in essence, raise internally generated capital. The various steps taken by IADB to strengthen its policies are noteworthy.

Continued adherence to the bank's revised financial and risk management framework could result in an improved assessment of the bank's governance and business profile.

Our RAC ratio for IADB is constrained by the bank's concentration in sovereign exposures, but is somewhat offset by our expectation of IADB continuing to receive PCT. The five largest exposures as of year-end 2016 were to Brazil, Mexico, Argentina, Colombia, and Ecuador, which together accounted for 67% of total loans and guarantees exposure; over the past 10 years, the top five exposures accounted for 67%-73% of loans and guarantees.

In December 2015, IADB entered two bilateral exchange exposure agreement transactions to mitigate some of its single-name concentration. It did so with the International Bank for Reconstruction and Development and the African Development Bank for \$4.9 billion (or 4.1% of its total exposure at default) and took on exposure with Africa, Asia, Europe, and the Middle East. We note that these transactions do not involve any direct exchange of credit exposures or loans--all aspects of the client relationship remain with the originating MLI--but the bank benefits from some diversification of its sovereign single-name diversification.

IADB's lending is predominantly sovereign or sovereign guaranteed, accounting for an average 93% of its loan portfolio during the past five years. In the coming years, IADB's non-sovereign-guaranteed portfolio is set to decline. At the annual shareholder meetings in March 2015, the boards of governors of IADB and sister institution Inter-American Investment Corp. (IIC) passed a resolution, "Delivering the Renewed Vision: Organizational and Capitalization Proposal for the IDB Group

Private Sector Merge-Out" that entails a \$2.03 billion capitalization of IIC over the next 10 years to support consolidation of the group's private-sector lending at IIC. That amount includes distributions from IADB's earnings, subject to annual approval, totaling \$725 million from 2018 to 2025. The resolution indicates that IADB's transfers are conditional on its updated capital adequacy policy, which is aimed at building and maintaining capital buffers.

Our funding and liquidity assessment reflects IADB's prudent treasury operations and asset and liability management. Our funding ratios as of year-end 2016 indicate that IADB does not have a static funding gap for the next two years (excluding undisbursed loans). Moreover, IADB is a frequent issuer across global markets, with a strong reach and significant benchmark bonds outstanding.

The bank's liquidity position has strengthened over the past several years, particularly at the beginning of 2014, partly owing to its transition to the revised liquidity policy it adopted in 2015. The new policy incorporates the stressed value of liquid assets, and its objective is to enable IADB to stay out of the capital market for a minimum of 12 months. That said, IADB still has somewhat lower liquidity ratios than some other MLIs, although those institutions also tend to have smaller balance sheets.

Under our liquidity stress scenario, at all horizons up to one year, IADB would fully cover its balance-sheet liabilities without market access. Using year-end 2016 data, the liquidity ratios were 1.95x at the one-year horizon without any loan disbursements and 1.5x with scheduled loan disbursements. However, when taking into account undisbursed loans in a stress scenario (beyond those currently planned in the next 12 months), we estimate IADB may need to spread out potential disbursements.

In addition to callable capital's importance for the institution's franchise value, we quantify the support it provides by adding callable capital to the numerator of our RAC ratio. IADB's RAC ratios with callable capital from 'AAA' rated shareholders translate into an extremely strong financial profile. Given the stronger RAC ratio, less 'AAA' callable capital is needed for the uplift. Based on this, our issuer credit rating on IADB is 'AAA', one notch higher than its 'aa+' stand-alone credit profile. IADB's largest 'AAA' rated shareholders include Canada, Germany, and the Nordic countries combined.

Outlook

The stable outlook reflects our expectation that, over the next two years, IADB's internal capital generation will continue, but be slightly outpaced by loan growth. However, considering IADB's consolidation of the FSO, capital levels are robust, and we could reconsider revising our assessment of the bank's financial profile to extremely strong under a more established track record indicating capital levels are sustainable. We also assume IADB will maintain sufficient liquidity to remain independent from market funding for 12 months, and that IADB's sovereign borrowers will continue treating it as a preferred creditor, regarding both debt servicing and

public support. Finally, we assume that IADB's stock of 'AAA' rated callable capital will remain largely intact.

We could lower the ratings if these assumptions do not hold true.

Related Criteria And Research

Related Criteria

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings - April 07, 2017
- Criteria - Governments - General: Multilateral Lending Institutions And Other Supranational Institutions Ratings Methodology - November 26, 2012
- Criteria - Financial Institutions - Banks: Bank Capital Methodology And Assumptions - December 06, 2010
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009

Related Research

- Credit FAQ: Key Considerations For Supranationals' Lending Capacity And Their Current Capital Endowment - May 18, 2017
- How Brexit Could Impact Ratings On Supranational Institutions - April 10, 2017
- Introduction To Supranationals Special Edition 2016 - September 29, 2016
- How An Erosion Of Preferred Creditor Treatment Could Lead To Lower Ratings On Multilateral Lending Institutions - August 26, 2013

Ratings List

Rating		
	To	From
Inter-American Development Bank		
Issuer Credit Rating		
Foreign Currency	AAA/Stable/A-1+	AAA/Stable/A-1+
Senior Unsecured		
Foreign Currency	AAA	AAA
Short-Term Debt		
Foreign Currency	A-1+	A-1+

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