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Research Update:

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

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Table Of Contents

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Overview

- Inter-American Development Bank (IADB) experienced its first sovereign nonaccrual status since 2001 when on May 14, 2018, Venezuela surpassed 180 days on some of its payment obligations.
- While negative for the bank, we believe the impact is contained considering its limited exposure to the sovereign and expect no contagion risk.
- We are affirming our 'AAA/A-1+' ratings on the bank.
- The stable outlook reflects our expectation that IADB's financial profile will remain very strong, that most of its stock of 'AAA' rated callable capital will be intact, and that IADB's sovereign borrowers will continue to treat it as a preferred creditor.

Rating Action

On June 22, 2018, S&P Global Ratings affirmed its 'AAA/A-1+' long- and short-term issuer credit ratings on Inter-American Development Bank (IADB). The outlook is stable.

Rationale

The ratings on IADB reflect our assessment of the bank's very strong business profile and financial profile, resulting in an 'aa+' stand-alone credit profile (SACP). Our rating is uplifted by one notch to 'AAA' when incorporating the extraordinary shareholder support it receives through callable capital.

Venezuela entered into a nonaccrual status with IADB on May 14, 2018, (see " Inter-American Development Bank Affirmed At 'AAA/A-1+' After Venezuela Enters Nonaccrual Status; Outlook Stable", published on May 18, 2018) after surpassing some of its payment obligations by more than 180 days.

Venezuela started defaulting to its commercial creditors on its foreign currency denominated debt in November 2017 (see "Venezuela Long-Term Foreign Currency Rating Lowered To 'SD'," published Nov. 13, 2017, and "Venezuela Long-Term Foreign Currency 'SD' Rating Affirmed," published Feb. 15, 2018) and all its outstanding foreign currency bonds carry a 'D' rating (default). However, since then, it continued to make payments to multilateral lending institutions, including IADB. We believe Venezuela has demonstrated a willingness to pay IADB but has run out of capacity to stay current. While U.S. sanctions on Venezuela contribute to a very difficult environment in which to make payments and find alternative solutions to raise funds, we believe they are not the main reason for the nonpayment.

The affirmation reflects our view that while this is negative for IADB, the ultimate impact on the bank's financials and business performance will be limited, given the bank's limited exposure to the sovereign. Venezuela's total outstanding balance represents about 2.6%, excluding concessional loans, of IADB's sovereign loan portfolio. This was IADB's first instance of a sovereign nonaccrual since 2001 when Suriname was overdue on its payments. This frequency is in line with that of some of its main peers. We expect the event to be isolated, since the vast majority of sovereigns in the region are on an upward macroeconomic trend, and the rest of IADB's sovereign borrowers continue to afford preferred credit treatment (PCT) to the bank.

The financial impact on IADB is in our view relatively small and any forgone cash flows will not affect liquidity meaningfully enough to change our assessment. We further expect a small effect on our risk-adjusted capital (RAC) ratio as we already incorporated the severe stress Venezuela was undergoing into the ratio. The two bilateral exchange exposure agreement (EEA) transactions with International Bank for Reconstruction and Development and African Development Bank did not include Venezuela.

IADB's capital position is robust. The RAC ratio was 24% at year-end 2017 after adjustments incorporating parameters as of June 15, 2018. (The criteria correction explained in "Criteria For Assessing Bank Capital Corrected," published on July 11, 2017, is not factored into the RAC ratio after diversification. The impact of the correction on the ratio is not material to the rating.)

Further, under our liquidity stress scenario at all horizons up to one year IADB would fully cover its balance-sheet liabilities without market access. For year-end 2017 data, liquidity ratios including collateral held against derivative exposures were 1.7x at the one-year horizon without loan disbursements and 1.4x with scheduled loan disbursements. However, when taking into account undisbursed loans in a stress scenario (beyond those planned in the next 12 months), we estimate IADB may need to spread out potential disbursements.

Our very strong assessment of the business profile is informed by our view of the bank's role, public policy mandate, and governance. It also reflects solid membership support and our expectation that the bank will continue to receive PCT, an internationally recognized practice of excluding multilateral lending institutions (MLIs) from restructuring or rescheduling of sovereign debt.

Founded in 1959, IADB is the oldest regional multilateral development finance institution (MDFI). It has 48 country members--26 borrowing member countries in Latin America and the Caribbean and 22 nonborrowing members (the U.S., Canada, and 20 nonregional countries). The bank lends mostly to central governments in Latin America and the Caribbean to promote economic development and to expand opportunities for the poor. IADB's role in Latin America is unparalleled as evidenced by its outstanding loan stock representing approximately 50% of total MLI loan stock in the region and 75% of net flows in 2017. We believe it cannot be replaced by any other MLI or commercial bank.

Shareholders have been supportive since inception, and IADB concluded its ninth general capital increase in 2017. The GCI-9 included $1.7 billion of paid-in capital as well as $68.3 billion in callable capital. Two of the 48 member countries (the Netherlands and Venezuela) did not participate in the capital increase, and their shares were reallocated to other members.

Over the past decade, IADB strengthened its financial and risk management 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 an aim of facilitating the bank's ability to lend countercyclically in times of stress while preserving an 'AAA' rating.

Half of IADB's voting members are borrowing members and, as such, have important influence over decision-making. This affects our assessment of the bank's business profile because the interests of borrowing members could differ from those of creditors. However, IADB implemented structures that would make it difficult to make decisions not based on sound risk principles and in line with its framework. In addition, it can increase earnings capacity as needed. Unlike many other MLIs, it 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. A more established track record of adherence to them could lead to improved assessment of the bank's governance and business profile.

In addition to the importance of callable capital to the institution's franchise value, we quantify the support it provides by adding callable capital to the numerator of the RAC ratios. The RAC ratios with callable capital from 'AAA' rated shareholders translated into an extremely strong financial profile. Based on this, the issuer credit rating on IADB is 'AAA', one notch higher than the 'aa+' SACP. IADB's largest 'AAA' rated shareholders include Canada, Germany, and the Nordic countries combined.

Outlook

The stable outlook reflects our expectation that the nonaccrual situation with Venezuela will not have any contagion effect and that other sovereign borrowing members will continue to treat IADB as a preferred creditor. We will continue to monitor the situation in Venezuela with regard to IADB's treatment relative to other creditors. The stable outlook also incorporates our expectation that will retain its role as the main supplier of developmental financing in the region while applying sound governance. We also assume IADB will maintain its liquidity to remain independent from markets for 12 months. Finally, the outlook assumes that IADB's stock of 'AAA' rated callable capital will be largely intact.

We could downgrade IADB if nonaccruals spread to other borrowers, indicating a weaker PCT. A significant deterioration in IADB's funding and liquidity assessment could also have a negative impact on the ratings as well as a reduction in IADB's 'AAA' rated callable capital due to downgrades.

Related Criteria

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- Criteria - Governments - General: Multilateral Lending Institutions And Other Supranational Institutions Ratings Methodology, Nov. 26, 2012
- Criteria - Financial Institutions - Banks: Multilateral Lending Institutions Capital Methodology And Assumptions, Dec. 6, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Inter-American Development Bank Affirmed At 'AAA/A-1+' After Venezuela Enters Nonaccrual Status; Outlook Stable, May 18, 2018

Ratings List

Ratings Affirmed

Inter-American Development Bank	
Issuer Credit Rating	AAA/Stable/A-1+
Senior Unsecured	AAA

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.