FITCH UPGRADES INTERNATIONAL INVESTMENT BANK TO 'BBB+'; OUTLOOK STABLE

Fitch Ratings-London-22 November 2018: Fitch Ratings has upgraded International Investment Bank's (IIB)'s Long-Term Issuer Default Rating (IDR) to 'BBB+' from 'BBB'. The Outlook is Stable. The issue ratings on IIB's senior unsecured long-term bonds have also been upgraded to 'BBB+' from 'BBB'. The Short-Term IDR has been affirmed at 'F2'.

KEY RATING DRIVERS

The upgrade of IIB's IDR reflects the improvement in Fitch's assessment of the bank's solvency to 'a' from 'a-'. This in turn results from strengthening in the bank's overall risk profile measured by Fitch following its re-assessment of IIB's exposure to credit risk, increased geographic diversification of its loan portfolio and the strengthening of its risk management framework.

IIB's ratings are driven by its intrinsic features, robust liquidity profile (assessed as 'aa-') and improving solvency assessment ('a'). The bank's 'high-risk' business environment translates into two-notch negative adjustment below our assessment of the bank's solvency, resulting in an intrinsic rating of 'bbb+'.

IIB's solvency assessment of 'a' balances the bank's 'excellent' capitalisation and 'moderate' risk profile. The equity/assets and guarantees ratio, at 31.5% at end-1H18, has remained well above Fitch's 25% threshold for 'excellent' despite a marked increase in the bank's balance sheet (+13% yoy). Fitch expects the capitalisation assessment to remain 'excellent' over the medium term thanks to future capital contributions and internal capital generation. These will largely offset the expected rapid growth in lending (+20% yoy on average).

IIB's overall risk profile has strengthened. Fitch now assesses the average credit quality of the loan portfolio at 'B+' (from 'B-' at the previous review). This improvement primarily reflects the upgrade of the bank's own credit risk assessment system. Fitch now builds on IIB's internal ratings to assess the credit risk of counterparties that do not have a rating by Fitch. The improvement also reflects increased exposure to higher-rated borrowers and a greater share of central and eastern Europe (CEE) in the financing (50.0% as of 1H18 from 37.7% in 1H17).

The bank's loan portfolio has performed well since its relaunch of operations in late 2012 as only two of the new loans have been recorded as non-performing (EUR30 million), representing 3.9% of outstanding loans at end-1H18. The performance of the loan portfolio is partly explained by the limited seasoning of these loans and significant share of credit risk mitigants, including sovereign and quasi-sovereign guarantees. The agency expects non-performing loans to remain close to the current level in the medium term.

Geographically, IIB has continued its diversification, with CEE loans now accounting for 50.2% of total loans (end-2016: 33%).The share of loans to Russian-based entities remains on a downward trend (1H18: 15.7% from 22% at end-2016) and is now matched by Bulgaria (15.7%) and followed closely by Slovakia, Romania, and Mongolia (10%-12% each).

Concentration metrics, as measured by the ratios of top five and single borrower exposure to total portfolio, have deteriorated slightly yoy. At end-1H18 these exposures represented 38.8% (end-1H17: 35.1%) and 11.2% (end-1H17: 7.7%) of the total banking portfolio. Fitch expects concentration risk will remain 'low' as loan growth dilutes existing exposures.

In Fitch's view, the risk management framework has strengthened as evidenced by the implementation of the internal counterparty rating system, which the agency considers conservative. Continued adherence to the bank's strategy and internal limits further support our assessment. The risk profile also accounts for the 'very low' equity risk, with equity participation less than 1% of total banking exposure at end-1H18, 'moderate' risk management policies and 'low' market risks.

IIB has a strong liquidity buffer, comprising bank deposits and securities covering 1.46x short-term debt at end-1H18 (end-1H17: 2x coverage). The credit quality of treasury assets has significantly improved, with 17.9% of the total rated in the 'AAA'-'AA' range as of end-1H18 (end-1H17: 8.7%). We assess access to capital markets and other alternative sources of liquidity as 'moderate', balancing the bank's limited market issuances with its increased diversification of funding sources.

Overall, Fitch assesses IIB's business environment as 'high risk', reflecting a 'high risk' business profile and 'medium risk' operating environment. The business profile is constrained by the bank's small size (total banking exposure was EUR0.8 billion at end-1H18), high share of non-sovereign exposure and 'high risk' strategy associated with the bank's rapid lending expansion. However, risks to the operating environment have continued to reduce, as highlighted by Fitch's upgrades of the sovereign ratings of the following member states since the last rating review: Czech Republic to 'AA-' from 'A+', Bulgaria to 'BBB' from 'BBB-', and Mongolia to 'B' from 'B-'.

Russia (BBB-/Positive) remains the largest and most influential shareholder, as measured by callable capital (end-1H18: 53.2%), voting rights, and loan exposures. However, the share of EU shareholders is expected to continue to increase (end-1H18: 44.1% of callable capital and 48.4% of paid-in) with their respective influence and interest in the institution rising commensurably. Notably, the Prime Minister of Hungary (BBB-/Positive) has proposed relocating IIB's headquarters from Moscow to Budapest. If implemented, the move could contribute to positive pressure on the assessment of the bank's business environment by Fitch.

Another initiative discussed by the bank's shareholders is the creation of a banking group with Moscow-based peer International Bank for Economic Cooperation (IBEC/BBB-/Stable). IIB and IBEC have seven shareholders in common (out of 10) with similar ownership structures.

Fitch does not assign any credit uplift for shareholders' support, assessed at 'bb+'. Support rests on a callable capital mechanism. This callable capital was 53%-owned by Russia at end-1H18. The capacity to support, measured by the rating ensuring coverage of net debt, is currently 'bbb-'. We assess propensity to support as 'moderate', given the small size of the bank in relation to the financing requirements of its member states, and translates into a negative adjustment of one notch.

RATING SENSITIVITIES
The factors that could, individually or collectively, lead to positive rating action are:
A stronger risk profile reflecting continued improvement in credit risk and concentration metrics.
Proven track record of adherence to internal prudential limits.
Improvement in the bank's business environment, as a result of reduced risks on its operating environment and/or strengthening of its business profile.

Conversely, the factors that could, individually or collectively, lead to a negative rating action are:
Deterioration of asset quality metrics, as evidenced by higher than expected impaired loans and/or weakening of credit quality.
Material deterioration in capitalisation, for example following a sharper rise in lending than expected or losses incurred in the loan portfolio.
Marked deterioration in liquidity indicators.

KEY ASSUMPTIONS
IIB will remain compliant with its internal prudential limits.

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- Sources of information - The source(s) of information used to assess these ratings were IIB's financial statements, and other information provided by IIB.

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Additional information is available on www.fitchratings.com

Applicable Criteria
Supranationals Rating Criteria (pub. 24 May 2018)
https://www.fitchratings.com/site/re/10031448