08 Sep 2020 | Upgrade

Fitch Upgrades International Investment Bank to 'A-'; Outlook Stable

Fitch Ratings-Paris-08 September 2020:

Fitch Ratings has upgraded International Investment Bank's (IIB) Long-Term Issuer Default Rating (IDR) to 'A-' from 'BBB+'. The Outlook is Stable.

A full list of rating actions is at the end of this rating action commentary.

Key Rating Drivers

The upgrade of IIB's Long-Term IDR to 'A-' reflects an improvement in our assessment of the bank's business environment, reflecting the ongoing diversification of the bank's operations across the EU following the relocation of its headquarters to Budapest from Moscow. As well as the more symbolic change of its head office, underpinning this move is a shift in the bank's lending operations and shareholding structure, focussing on a larger share of lending in the EU and increased share of EU shareholders in the bank.

Fitch does not expect a material change in the bank's strategy as a result of the pandemic, including no increase in the bank's leverage. Unlike multilateral development banks with a clear counter-cyclical mandate, IIB has not announced any COVID-19 response package and the bank will not deviate from its established business plan.

Compared with other geographic regions, the ratings of IIB's shareholders have so far been relatively resilient to the COVID-19 crisis. Of the eight shareholders rated by Fitch, there has been only one sovereign downgrade (Slovakia; A/Stable) and only one shareholder, Romania (BBB-Negative) currently has a Negative Outlook. Following a revision of the Supranationals Rating Criteria, the average credit quality of the bank's countries of operations at 'BBB-' is now consistent with a 'low' risk assessment versus a 'medium' assessment at the previous review.

IIB's ratings are driven by its intrinsic features, with solvency and liquidity assessed at 'a' and 'aa-', respectively. The principal driver of the upgrade is the revision to our assessment of the business environment, which now translates into one-notch negative adjustment (from two-notches previously) below our assessment of the bank's solvency, resulting in an intrinsic rating of 'a-'.

Fitch has revised upwards its assessment of the bank's strategy risk to 'medium risk' from 'high risk', as in Fitch's view, the bank has been successful in the relaunch strategy it embarked on in 2012 and has made significant progress in diversifying its lending towards more highly-rated borrowers in EU countries (EU share of loans represented around 57% of total loans at end-August 2020 from 50% in 2018). Furthermore, the pledge by shareholders to continue to support the institution with fresh capital through 2022 is evidence of the renewed importance of the bank for its member states, with Russia (BBB/Stable) and Hungary (BBB/Stable) having already contributed to this capital injection in 1H20, ahead of the bank's expectation.

While Russia remains the largest and most influential shareholder, as measured by its share in the bank's capital (end-1H20: 45.4% of paid-in), EU shareholders now account for over 50% of the bank's paid-in capital and voting rights, with Hungary's share rising to 17% of the total as of end-June 2020 from 9% when it re-joined the bank in 2014. In Fitch's view, the move to Budapest and renewed engagement with Hungary is consistent with the bank's lending and funding shift to Central and Eastern Europe. Although we expect Russia's large ownership stake in the bank's capital to continue to decrease, our assessment of the bank's governance would be sensitive to any change in our perception of the country's influence on IIB's policy direction.

IIB's solvency assessment of 'a' is unchanged from last year and balances the bank's 'excellent' capitalisation and 'moderate' risk profile. The equity/assets and guarantees ratio, at 26.6% at end-1H20, remains above Fitch's 25% threshold for 'excellent', and the Usable Capital/ Risk-Weighted Assets ratio remains above the 35% threshold that is consistent with an 'excellent' assessment. Both capitalisation metrics are expected to remain close to or above the 'excellent' thresholds following the receipt of fresh capital as part of the ongoing EUR200 million capital increase. Fitch expects IIB's internal capital generation to remain low (around 1%) and this represents a relative weakness compared with rated peers.

IIB's risk profile is expected to remain at a 'moderate' level. Since the last review, there have been a number of positive developments. Most notably the average rating of loans and guarantees has improved to 'BB-' at 1H20 from 'B+', owing to the ongoing lending focus on EU-based borrowers, a trend which we expect to continue over the medium term.

Geographically, EU loans continue to account for over 50% of the total (57% at end-August 2020), in line with the bank's targets, with around 16% of the total portfolio now disbursed to highly rated western countries, including Luxembourg (AAA/Stable), Netherlands (AAA/Stable), Spain (A-/Stable), US (AAA/Negative) and Germany (AAA/Stable). However, the majority of EU exposures are to borrowers in lower rated, albeit still investment grade EU countries. Concentration risk is assessed as 'low' with the five largest exposures accounting for 28.7% of the total. Fitch expects concentration metrics to continue to improve over the forecast period but to remain within the 'low-risk' range (20%-40%).

Impaired loans represented 1.5% of total loans at 1H20, a 'low' level. As at 1H20, as per the bank's own definition, it had not incurred any new impaired loans in the first half of this year and there has been no increase in Stage 2 or Stage 3 loans, as per IFRS 9 accounting standards. However, Fitch expects the loan impairment ratio to increase significantly in the short term, to close to 10% of the portfolio by end-2020, based on its own definition of impaired loans.

IIB has allowed payment deferrals until 2021 for some of its borrowers affected by the COVID-19 crisis. IIB does not define these exposures as 'impaired' and Fitch notes that a significant share are to counterparties that benefit from a sovereign guarantee. However, Fitch treats these exposures as non-performing, in line with its supranational rating criteria that considers non-sovereign exposure with a three-month payment delay as 'non-performing', and to reflect the risk that the temporary payment relief may only act to delay loan impairments, in our view. By the end of the forecast period (2022), Fitch expects the impaired loan ratio to stabilise at a moderate level (between 3%-6%).

IIB has a strong liquidity buffer, comprising bank deposits and securities covering 1.4x short-term debt at end-1H20 and this is expected to increase above 1.5x through 2022, in line with recent years. The credit quality of treasury assets has remained relatively stable since last year, with the share of 'AAA'-'AA' rated assets rising to 29% at end-1H20 from 28% a year before. 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. In 1H20, the bank registered its first MTN programme, with a EUR1.5 billion envelope, and to date two transactions have been successfully executed under the programme.

Fitch does not assign any credit uplift for shareholders' support, assessed at 'bbb'. Support is based on Russia's sovereign rating, given its share in the bank's capital. 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

Factors that could, individually or collectively, lead to positive rating action/upgrade:

- Solvency (Risks): A stronger risk profile reflecting improvement in credit risk, particularly an improvement in the bank's non-performing loan rate relative to Fitch's current expectations, to a level commensurate with a 'low' assessment and/or multi-notch improvement in the average rating of the lending portfolio.

- Business Environment: Stronger assessment of the business environment driven by an improved business profile or operating environment. This could reflect greater-than-expected diversification of IIB's operations to higher rated EU countries and/or improvement in our assessment of the importance of the bank's public mandate for its shareholders.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

- Solvency (Risks): Deterioration of asset quality metrics, as evidenced by higher than expected impaired loans and/or weakening in the credit quality of IIB's loans. This could occur if the macroeconomic impact of the COVID-19 crisis on the bank's asset quality is worse than currently expected.

- Solvency (Capitalisation): Material deterioration in capitalisation, for example following a sharper rise in lending than expected, losses incurred in the loan portfolio, and/or material delays in receipt of capital payments from member states.

- Business Environment: Weakening in our assessment of the business environment, which could, for example, result from a change in the direction of lending policy towards borrowers in lower rated countries.

Best/Worst Case Rating Scenario

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [https://www.fitchratings.com/site/re/10111579].

Key Assumptions

The global economy will develop in line with Fitch's Global Economic Outlook published on 7 September 2020, including a deep but short-lived recession in 2020 due to the pandemic. There is an unusually high level of uncertainty around these forecasts and risks are firmly to the downside. Fitch expects eurozone GDP to contract by 9% in 2020 and recover thereafter to 5.5% in 2021.

Fitch assumes that all of IIB's shareholders who have subscribed in the capitalisation programme will participate in the capital increase with regular paid-in capital disbursements. IIB will remain compliant with its internal prudential limits.

Sources of Information

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

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING
The principal sources of information used in the analysis are described in the Applicable Criteria.

International Investment Bank; Long Term Issuer Default Rating; Upgrade; A-; RO:Sta
----; Short Term Issuer Default Rating; Affirmed; F1
----senior unsecured; Long Term Rating; Upgrade; A-
----senior unsecured; Short Term Rating; Affirmed; F1

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Additional information is available on www.fitchratings.com

Applicable Criteria

Supranationals Rating Criteria (pub. 30 Apr 2020) (including rating assumption sensitivity)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form

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