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Research Update:

International Investment Bank Upgraded To 'A-' On Stronger Governance Structure; Off UCO; Outlook Stable

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Overview

- International Investment Bank (IIB) has strengthened its governance and management structure by introducing a proportional voting system, diversifying its shareholders, and clearly articulating an expansion strategy, which includes relocating its head office.
- We reviewed the ratings on IIB under our revised criteria for multilateral lending institutions.
- We are raising the long-term issuer credit rating on IIB to 'A-' from 'BBB+', affirming the 'A-2' short-term rating on the bank. We are removing the ratings from under criteria observation.
- The outlook is stable, reflecting our expectation that the recent strengthening of IIB's enterprise risk profile will support future expansion and reinforce the bank's role and public policy mandate.

Rating Action

On March 7, 2019, S&P Global Ratings raised its long-term issuer credit rating on International Investment Bank (IIB) to 'A-' from 'BBB+'. We also affirmed the short-term issuer credit rating on the bank. The outlook is stable.

At the same time, we removed the ratings from under criteria observation, where we placed them on Dec. 14, 2018, after publishing our revised criteria.

Rationale

We base the ratings on IIB on its moderate enterprise risk profile and very strong financial risk profile, according to our revised criteria, "Multilateral Lending Institutions And Other Supranational Institutions Ratings Methodology," published Dec. 14, 2018, on RatingsDirect. We assess IIB's stand-alone credit profile (SACP) at 'a-'. Our ratings on IIB do not incorporate any explicit uplift for extraordinary shareholder support in the form of callable capital.

The improvement in the assessment of IIB's enterprise risk profile reflects the progress that IIB has made in repositioning itself as a diversified European institution. This includes the relocation of its headquarters to Hungary from Russia and the increase in European member countries' shares in both the loan portfolio and paid-in capital. The revised assessment also incorporates the improvement in IIB's governance structure and the continued strong support from its shareholders, demonstrated by the approval of a capital injection of €200 million as part of the capitalization plan for 2020-2022. We no longer incorporate preferred creditor treatment in our assessment of IIB's enterprise risk profile, because the bank fully focuses on private sector lending. However, we do think it will benefit from preferential treatment, such as exemption from capital restrictions and sanctions for all its shareholder members. We incorporate this in our capital framework by applying lower risk weights to corporate and financial institutions exposure.

In December 2018, IIB decided to relocate its headquarters to Budapest from Moscow. IIB signed the host country agreement with Hungary in February 2019 and we expect the new headquarters to be operational this year. IIB's Moscow office will instead operate as a branch. We think this move will help mitigate concerns regarding the impact that sanctions on Russia could have on the bank. We also think it will enable easier access to funding. Furthermore, during 2018, IIB implemented a three-level corporate governance structure--similar to many other multilateral lending institutions--and established two new bodies: the Board of Governors and the Board of Directors. The Board of Governors includes higher representation from its member shareholders, which strengthens the relationship with the shareholders, in our view.

However, IIB's shareholder concentration and small asset size continue to constrain our assessment. Although IIB has nine member state shareholders, four of them--Russia, Bulgaria, Hungary, and the Czech Republic--account for about 83% of paid-in capital. The other shareholders are Cuba, Mongolia, Vietnam, Slovakia, and Romania. In 2018, the Czech Republic contributed €7 million to the paid-in capital and Romania contributed €4 million, as part of the capitalization plan for 2013-2017. This increased the share of European member countries to 50%. Russia continues to dominate the structure with 46% of the paid-in capital, but this has decreased significantly from 58% in 2013. We have a more positive view of governance for institutions with diversified shareholders, particularly among borrowing member states.

IIB is improving its role and competitive position in its member countries, but it still remains very small compared to the economies of its nine members. IIB's loan portfolio increased to €753 million as of end-2018, 13% higher than at end-2017. In line with IIB's strategy, the geographical split of the loan exposure has also changed. Russia's share in the loan portfolio decreased to 13% as of end-2018 from 27% as of end-2017. IIB now has no lending to Russian financial institutions. On the other hand, lending to European countries has increased, with Bulgaria now accounting for 18% of the loan portfolio, followed by Slovakia (12%) and Romania (11%).

IIB was established in 1970 with the aim to promote the social and economic development of its member states. Its credit lending covers lending to small and midsize enterprises, export and import operations, project financing, and mergers and acquisitions. It does this primarily through leading domestic publicly owned banks, development banks, and other financial institutions. The bank was formed by a treaty and it enjoys supranational status. IIB is exempt from custom duties, direct taxes, and restrictions on export and import operations. It is also immune to the sanctions currently imposed on Russia.

We assess positively the stability and strength of the relationship between IIB and its shareholders. For example, the Board of Governors has approved the capital injection of €200 million as part of the 2020-2022 capitalization plan. In the past 16 years, the only change in the number of shareholders has been Hungary's rejoining IIB. The bank is open for new members to join, and aims to expand its shareholder base by one or two countries in the next two years.

IIB's financial risk profile benefits from its very strong capital adequacy and strong funding and liquidity. For the fiscal year ending March 31, 2017, the bank's risk-adjusted capital (RAC) ratio after diversification--which we calculate using the ratings on IIB as of Feb. 18, 2019--increased to 24.8%, up from the 24.1% calculated under our old criteria. This increase stemmed from our standard enhancement of the risk weights on IIB's exposures to financial institutions and corporate entities. We made this enhancement to capture the effects of preferential treatment and the reduction of single name concentration, which, under our new approach, disregards treasury assets. We expect the RAC ratio to decline over the next 12 months, due to further loan portfolio expansion and the negative impact of the adoption of International Financial Reporting Standard 9, which was €27 million as of end-2018. However, we think the ratio will still stay comfortably above 15%, supporting our assessment of the bank's very strong financial risk profile.

We also note IIB's continued improvement in its asset quality. Nonperforming loans (NPLs; loans overdue by 90 days or more) accounted for 2% of the loan portfolio as of end-2018, lower than the 4.5% reported at end-2017. This level is below the peer group average. IIB's re-launch in 2012--when it replaced its entire management team--fundamentally shifted the risk appetite and monitoring of risk at the bank. NPLs made up more than 70% of IIB's gross loan portfolio when the bank was turned over in 2013, and most of its toxic loans were either written off or sold. We view positively that IIB's management is committed to keeping NPLs below 5% of the gross loan portfolio.

The abovementioned portfolio expansion prompted a need to raise significant amounts of new funding in 2017 and 2018. We think IIB benefits from an increased diversification trend in its funding sources. Among new placements in 2018 was a Czech koruna (CZK) denominated debt issue that was listed on both the Prague and Vienna stock exchanges. The total issuance amounted to CZK750 million and was tapped twice. We estimate that IIB's sound funding profile has no gaps for the next five years, excluding loan disbursements. IIB swaps most issues in local currency into dollars or euros, with the exception of its newly developed currency lending, which is increasing from a relatively small base.

Liquidity

Our liquidity ratios for IIB indicate that it would be able to cover all committed lending and debt repayments for at least one year, even under stressed market conditions, without accessing the capital markets. We note that IIB has, for the third year in a row, improved the quality of its treasury portfolio, with the share of 'A' to 'AAA' rated assets increasing to 57% as of end-2018, from 43% in the previous year. The management is committed to increasing the share of 'A' to 'AAA' instruments to 65% by year-end 2020.

Outlook

The outlook is stable, reflecting our expectation that IIB's growth strategy and stronger role and public policy mandate will continue supporting its enterprise risk profile.

Upside scenario

We could consider an upgrade in the next 12-24 months if IIB materially raises and broadens its loan book and further strengthens its shareholder base, following an increase in authorized capital intended to attract new members. For an upgrade to materialize, IIB would also likely need to secure capital sufficient to retain a RAC ratio above 23%.

Downside scenario

We could lower the ratings if the bank falls short of its own expansion plans, which could include a failure to attract new membership. We could view this as a sign of limited policy importance.

Ratings Score Snapshot

Issuer Credit Rating	A-/Stable/A-2
SACP	a-
Enterprise Risk Profile	Moderate
Policy Importance	Moderate
Governance and management	Adequate
Financial Risk Profile	Very Strong
Capital Adequacy	Very Strong
Funding and Liquidity	Strong
Extraordinary Support	0
Callable capital	0
Group Support	0

Holistic Approach	0

Related Criteria

- Criteria | Governments | General: Multilateral Lending Institutions And Other Supranational Institutions Ratings Methodology, Dec. 14, 2018
- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Guidance - Criteria - Governments - General: Multilateral Lending Institutions And Other Supranational Institutions Ratings Methodology, Dec. 14, 2018
- Ratings On 32 Multilateral Lending Institutions And Supranationals Placed Under Criteria Observation On Criteria Update, Dec. 14, 2018
- Supranationals Special Edition 2018: Comparative Data For Multilateral Lending Institutions, Oct. 11, 2018

Ratings List

Upgraded; Ratings Affirmed

	To	From
International Investment Bank		
Issuer Credit Rating		
Foreign Currency	A-/Stable/A-2	BBB+/Stable/A-2

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