



RATING ACTION COMMENTARY

Fitch Revises CDB's Outlook to Negative; Affirms at 'AA+'

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Fitch Ratings - London - 03 Mar 2021: Fitch Ratings has revised the Outlook on Caribbean Development Bank's (CDB) Long-Term Issuer Default Rating (IDR) to Negative from Stable and affirmed the IDR at 'AA+'.

KEY RATING DRIVERS

CDB's 'AA+' Long-Term IDR reflects its intrinsic credit profile, underpinned by liquidity and solvency assessments of 'aaa' and 'aa+', respectively. The revision of the Outlook to Negative reflects downside risks to the performance of the bank's loan book due to the impact of the coronavirus pandemic on the creditworthiness of the bank's borrowing member countries (BMCs).

In Fitch's view, the creditworthiness of CDB's BMCs significantly weakened in 2020. Based on the bank's own estimates, regional GDP fell by 12.8% in 2020,

while average government debt to GDP rose to 79.5% from 66.5% in 2019. The contraction in economic activity and rising government debt burdens in the BMCs highlights one of CDB's main rating weaknesses: the concentration of its loan portfolio to Caribbean sovereigns whose economies are highly reliant on international tourism.

The risk of sovereign arrears to CDB in the short term is limited, owing to the bank's financial assistance to BMCs, including a debt service support initiative for seven sovereign borrowers. As of end-2020, these seven countries accounted for 37% of total loans outstanding (and the initiative covered 19% of total loan receipts in 2020 and is expected to cover 23% of the total in 2021). While the debt service support has been granted to sovereigns that were current to the bank in 2020, in Fitch's view the continued performance of the sovereign loan book may in part be driven by the debt service support initiative. There is therefore an increased risk of sovereign arrears over the medium term, despite strong commitments from BMCs to honour their obligations to the bank.

Uncertainties around the timing and the scale of the economic recovery in the region, which is contingent on a resumption of international travel, could further weaken the creditworthiness of some of the bank's sovereign borrowers. In Fitch's view, some BMCs have limited fiscal financing flexibility and are relying heavily on support from CDB and other development partners. The debt service support initiative will continue to provide liquidity to seven BMCs in 2021 and could be extended beyond. However, in Fitch's view, there are limits to the support that the initiative can provide, including the availability of concessional funds and the need to continue to allocate concessional resources to fund investment projects and other BMCs.

CDB's solvency assessment is supported by the bank's 'excellent' capitalisation and 'low' risk profile. The equity-to-adjusted-assets and guarantees ratio was 46% at end-September 2020 and is expected to remain well above the 25% threshold for an 'excellent' assessment over the medium term owing to the bank's conservative leverage limit of 1.65x and moderate growth lending targets. Fitch's usable capital to risk-weighted assets ratio was 70% as of end-September 2020, also comfortably above 35% threshold for an 'excellent' assessment.

The bank has responded to the coronavirus pandemic by redirecting its financial resources to support BMCs with liquidity support and technical assistance. Emergency and policy-based loans accounted for 41% of total approvals in 2020, highlighting the demand for liquidity support and the importance of the bank to its BMCs.

CDB's 'low' risk profile is driven by the bank's 'very low' non-performing loan (NPL) ratio (0.2% of gross loans at end-September 2020) and 'excellent' preferred creditor status. The bank's 'very low' equity risk (no equity participations), 'very low' market risk, and 'excellent' risk management policies also support our assessment of 'low' solvency risks. This balances the bank's 'moderate' concentration risk and the weak credit quality of borrowers.

The 'very low' NPL ratio is exclusively driven by one private sector loan as there have been no arrears on the sovereign loan book (94% of total loans as of end-September 2020). Fitch expects an increase in private sector NPLs but for the overall NPL ratio to remain 'very low' (less than 1%), assuming a fully performing sovereign loan book, despite increased credit risk. Fitch expects a decline in the average rating of the portfolio to 'B-' and for sovereign repayment performance to be contingent on the resumption of tourism activity and financial support to BMCs from international partners. However, a potential default by a BMC is a key downside risk to our NPL forecast, and drives the Negative Outlook.

The debt service support has been provided in the form of the bank extending new concessional loans through the bank's donor-backed unlevered Special Development Fund (SDF). These loans were provided to BMCs from the SDF in order to meet debt service obligations due to the bank's Ordinary Capital Resources (OCR) for four quarters in 2020 and 2021. This has provided liquidity relief to these BMCs while insulating the bank's OCR from arrears.

In Fitch's view, the recourse to the debt service support initiative highlights increased pressures faced by BMCs to meet their debt obligations to the bank, given liquidity constraints and debt sustainability issues. The support was provided in order to enable BMCs to meet health and social expenditures related to the pandemic following a precipitous fall in revenues. Fitch notes that borrowers that benefit from the scheme tend to have the weakest credit profiles

among the BMCs, with an average rating of these exposures at 'CCC' compared with the weighted average rating of loans and guarantees of 'B' as of end-September 2020. These calculations are based on CDB's internal rating and Fitch's where available.

Concentration risk is the main rating weakness. CDB's top five largest borrowers accounted for 55% of total banking exposures at end-September 2020 compared with 57% at end-2019. This is a 'moderate' level based on Fitch's Supranational Rating Criteria. However, Fitch notes that concentration risk is inherently higher than peers with comparable metrics, given the geographical proximity and correlation between BMCs' economies.

Exposure to Barbados (NR) will remain elevated in the near term (21% of total loans at end-September 2020) but should gradually decline over the medium term to closer to 15%. The bank aims to continue to diversify its loan book by expanding operations in countries where it has limited exposure.

Fitch assesses CDB's liquidity at 'aaa'. This is driven by the 'excellent' credit quality of the bank's treasury portfolio, conservative policies on asset-liability management, and the long-term and staggered structure of its borrowings. Fitch expects the coverage of short-term debt by liquid assets to remain well above the 1.5x threshold it deems as 'excellent' over the forecast period. Despite infrequent debt issuances, Fitch views CDB's access to capital markets and alternative sources of liquidity as 'strong'

CDB's overall business environment is assessed as 'medium risk', which does not translate into an adjustment from Fitch's solvency assessments of 'aa+'. The 'medium risk' business profile balances the bank's moderate risk strategy and small size of the institution's banking portfolio against the strong importance of the bank's public mandate. The latter was illustrated by the bank's response to the pandemic, when it played a key role in providing liquidity support to its borrowers. CDB's operating environment is constrained by the relatively weak credit quality of borrowers in its countries of operations and the region's vulnerability to adverse weather events.

Consistent with Fitch's Supranationals Rating Criteria, extraordinary support from shareholders is currently not a key factor in the overall rating, as the extraordinary support assessment is 'bbb', lower than the bank's intrinsic rating of 'aa+'. The support assessment is based on the weighted average rating of key shareholders of 'BBB' and our view of shareholders' 'strong' propensity to support the institution. As of end-September 2020, net debt was covered by callable capital from shareholders rated 'A+' or above. However, Fitch expects the coverage to fall to 'BB+' by 2023 in line with the projected rise in the bank's net debt.

ESG CONSIDERATIONS

CDB has an ESG Relevance Score of '3' for 'Exposure to Environmental Impacts'. Environmental risk is a key risk to CDB's borrowers but this is actively managed by the bank. CDB has set up (with other partners, such as the World Bank) an insurance vehicle against natural disasters and requires its sovereign borrowers to acquire minimum insurance cover. CDB has never suffered a loss due to the realisation of environmental risk.

CDB has an ESG Relevance Score of '4[+]' for 'Human Rights, Community Relations, Access & Affordability'. CDB provides grants funded by donor contributions and that are a significant part of the bank's business model. CDB has also acted as a lender of last resort to countries that had lost market access. This supports CDB's policy importance. This has a positive impact on the credit profile, and is relevant to the ratings in conjunction with other factors.

CDB has an ESG Relevance Score of '4' for 'Rule of Law, Institutional and Regulatory Quality'. All supranationals attract a score of '4'. Supranationals are neither subject to bank regulation nor supervised by an external authority. Instead, supranationals comply with their own set of rules. Fitch pays particular attention to internal prudential policies, including compliance with these policies.

CDB has an ESG Relevance Score of '4' for 'Policy Status and Mandate Effectiveness'. Geographically concentrated exposure to small Caribbean islands with economies largely interconnected and highly vulnerable due to large

tourism exposure and risk of natural disasters. This has a negative impact on the credit profile, and is relevant to the ratings in conjunction with other factors.

Except for the matters discussed above, the highest level of ESG credit relevance, if present, is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or to the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING SENSITIVITIES

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

- Solvency (Risk): An increase in credit risk potentially leading to sovereign arrears and/or higher NPLs in the non-sovereign loan book leading to a rise in the NPL ratio above the upper bound 'very low' risk threshold of 1%.
- Solvency (Risk): Increased concentration risk driven by a rise in the share of existing exposures and/or increased exposure to sovereigns in financial distress.
- Solvency (Capitalisation): Greater than expected decline in capitalisation metrics. This could be driven by losses, rapid growth in banking operations, and/or a significant increase in risk-weighted assets.

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

- Solvency (Risk): Stronger-than-expected performance in the loan book as evidenced by a continued 'very low' NPL ratio and resumption of debt servicing from BMCs that have benefitted from the debt service support initiative. Resilience and/or improvement in the average rating of the portfolio would also exert positive pressure on our assessment.

- Solvency (Risk): A material improvement in concentration risk or asset quality metrics, potentially driven by greater exposure to higher rated borrowers.

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

Fitch assumes the bank will continue to abide by its conservative risk management policies and limits.

We also assume that the global economy evolves in line with the most recent update of the Global Economic Outlook published on 7 December 2020.

SOURCES OF INFORMATION

The sources of information used to assess these ratings were CDB's financial statements and other information provided by CDB

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.

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Caribbean Development Bank	LT IDR	AA+ Rating Outlook Negative	Affirmed	AA+ Rating Outlook Stable
●	ST IDR	F1+	Affirmed	F1+

[VIEW ADDITIONAL RATING DETAILS](#)

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APPLICABLE CRITERIA

[Supranationals Rating Criteria \(pub. 30 Apr 2020\) \(including rating assumption sensitivity\)](#)

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Caribbean Development Bank

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