S&P Global Ratings

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Research Update:

European Bank For Reconstruction And Development 'AAA/A-1+' Ratings Affirmed; Outlook Stable

August 30, 2024

Overview

- We expect the European Bank for Reconstruction and Development (EBRD) to focus its medium-term lending engagements on Ukraine, with lending projected at €1.5 billion-€2.0 billion annually over 2024-2026, accentuating the bank's position as one of Ukraine's largest institutional investors.
- We consider the shareholders' decision to increase the EBRD's paid-in capital an illustration of the bank's policy relevance since it underpins its ability to execute the owners' medium-term policy priorities.
- We also consider EBRD's strong financial management, including advanced underwriting processes, prudent provisioning policies, and comprehensive use of risk-mitigation techniques, will minimize material asset quality deterioration in the expanding Ukraine portfolio.
- We affirmed our 'AAA/A-1+' long- and short-term issuer credit ratings on the EBRD and maintained the stable outlook.

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Rating Action

On Aug. 30, 2024, S&P Global Ratings affirmed its 'AAA' long-term and 'A-1+' short-term issuer credit ratings on the European Bank for Reconstruction and Development (EBRD). The outlook is stable.

Outlook

The stable outlook reflects our expectation that over the next 24 months, the EBRD will continue receiving strong shareholder support that will enable the bank to fulfil its mandate and provide support to the countries it operates in, while mitigating pressure on financial metrics caused by credit quality challenges in its exposures. Our outlook is further supported by the EBRD's ample

'AAA' callable capital, which could mitigate a significant weakening of its financial profile and support the rating at the current level.

Downside scenario

We could consider lowering the rating if we observed that the quality of the bank's exposure deteriorates more than we currently expect, for example due to a sharp rise in nonperforming loans (NPLs) that was not followed by mitigating risk management actions and shareholder support. We could also consider a downgrade if major shareholders left the bank or significantly reduced their support.

Rationale

The EBRD continues to commit to Ukraine with total finance deployed at €4.5 billion in June 2024. During the Ukraine Recovery Conference in June 2024, the EBRD extended its wartime commitment to Ukraine by €600 million, with total deployed finance now at €4.5 billion. The disbursements continue to support Ukraine's energy and food security needs, improve municipal infrastructure for energy, water, and wastewater services, and address the needs of internally displaced persons. We expect the EBRD could further increase its annual Ukraine lending volumes when the country's reconstruction begins, possibly extending to over €3 billion annually, up from the €1.5 billion projected in 2024. Contrary to the pre-conflict exposures in Ukraine, which were primarily focused on the broader private sector, the bank now disburses new loans predominantly to the public sector or affiliated companies that support critical infrastructure.

The EBRD has a long track record of fulfilling its mandate. The EBRD was established in 1991 to support the transition to open market economies in central and eastern Europe and the Commonwealth of Independent States by promoting private and entrepreneurial initiatives. Over the past decade, the EBRD has strategically enlarged its mandate, and now includes a meaningful presence in Türkiye and the southern and eastern Mediterranean region (SEMED).In addition, in 2023, the board of governors agreed to expand the bank's mandate to sub-Saharan Africa and Iraq. In April 2024, Benin became the first sub-Saharan African country to join EBRD, becoming the bank's 75th shareholder. We expect the membership base could further expand as membership processes are currently ongoing with several countries. We expect to see steady but measured progress on this expansion.

We expect EBRD's outstanding Eastern Europe and Caucasus portfolio to grow meaningfully over 2024-2026 driven by the increased lending support directed to Ukraine. Consequently, we expect this region to make up just over 20% of the total development-related portfolio (which includes undisbursed commitments) in 2026, up 5 percentage points from its position in 2023. We think this focus aligns with the bank's original mandate and positively affects our assessment of EBRD's overall policy importance.

We assess the shareholders' support of EBRD's financial capacity through guarantees, grants, and the upcoming capital replenishment as an endorsement of the bank's policy work. Approved in December 2023, the €4 billion capital increase will be effective from December 2024 and is expected to increase the bank's total authorized capital stock to €34 billion, from the current €30 billion. Payments are expected to be made in five annual instalments, from April 2025 until April 2029. This will increase the share of paid-in capital to 30% of total capital stock from the current 20%. We understand that subscriptions are coming in according to expectations.

We regard the capital increase as necessary to support the EBRD's activities and investments in Ukraine during wartime and in the future post-war period for the country's reconstruction. We believe the shareholders' capital increase will allow EBRD to take up riskier lending positions in Ukraine, as expected by shareholders. We further regard the capital increase will increase operational agility by reducing reliance on direct risk sharing resources (grants and guarantees) from shareholders and donors. These resources, totaling €1.75 billion in May 2024, have been deployed since 2022 to ensure the prompt delivery of the bank's support to Ukraine. About 70% of these resources are guarantees and 30% are outright grants.

The capital increase also ensures that EBRD's commitment to Ukraine does not hamper the bank's capacity to meet the needs of other countries where it operates. Looking beyond the bank's commitment to Ukraine, the additional capital resources should allow it to continue making progress in its key thematic lending areas, such as the green transition and expanding its presence in sub-Saharan Africa. This will also help mitigate risks of pressure on the EBRD's capital position, allowing the bank to fulfil its broader mandate.

We assess the EBRD's governance and management as strong, based on its diversified shareholder base, transparent governance, experienced senior staff, and conservative risk management policy. Management maintains a conservative approach to classifying exposure as NPLs and making provision for losses. In addition to specific provisions, the bank holds about €458 million in so-called post-model adjustments to mitigate the increased risk to asset quality, especially in Ukraine. As of the first quarter of 2024, the bank held €1.9 billion in general and specific provisions, €259 million in loan loss reserves, and €306 million in special reserves, which together represent 7.3% of total loan operating assets or 1.1x the gross value of the impaired assets. We consider EBRD's expansion and risk appetite to be in line with the expectations and policy preferences of shareholders and expect they will continue to support the bank's strategy.

Even so, we expect EBRD's NPL stock to remain elevated over the medium term as the bank upscales its presence in Ukraine. The bank's asset quality has deteriorated since the outbreak of Russia-Ukraine war. In March 2024, EBRD's impaired loans amounted to €2.35 billion, of which 48% was related to Ukraine. Additionally, the bank's total NPLs stood at 6.8% of total purpose-related loans, which is relatively high compared with the pre-war numbers of 4.9% in 2021. On a positive note, the NPLs book appears to be stabilizing, with a decrease from 7.9% at year-end 2023, which was also partly due to the sale and write-off of the bank's last remaining debt exposure in Russia. Furthermore, outside the warzone, the non-Ukrainian NPLs are consistently declining and stood at 3.8% in March 2024.

We characterize EBRD as a predominantly private sector lender and do not consider preferred creditor treatment (PCT) awarded on sovereign exposure to substantially improve its enterprise risk profile. Despite its increasing sovereign lending, we continue to regard bank's business portfolio, strategy, and overall enterprise risk profile to be principally focused on the private sector. We could reconsider this approach if the EBRD increased and maintained its outstanding sovereign exposures structurally above 25% of its total investments. That said, we consider the arrears on EBRD's sovereign exposures in our capital assessment. In this regard, we treat EBRD's outstanding exposures to the government of Belarus--about 1.5% of the bank's total sovereign operating assets--to be in default, which effects our risk-adjusted capital computations. We do not expect EBRD's arrears to sovereign counterparts to extend beyond the current outstanding exposure to Belarus.

We expect EBRD to continue to benefit from preferred creditor treatment on its direct sovereign exposures. We view this as important since the bank's lending over the medium term will expand into the stressed Ukrainian public sector, including to the Ukraine central government. In this regard, on Aug. 2, 2024, we placed our Ukraine sovereign foreign currency rating on selective default, following the government's missed coupon payment amid ongoing debt restructuring discussions. We do not exclude that the overall restructuring process of Ukraine's sovereign debt could also progress to also include some government-guaranteed securities of state-owned enterprises (SOEs). EBRD holds a debt security from a Ukrainian SOE that benefits from a central government guarantee. We assess the contractual nature of this bond security based on its pari passu terms and the absence of a direct and individual sovereign commitment to EBRD, alongside other key characteristics of the transaction. If losses were to emerge on this sovereign guaranteed bond, we would not view this as an indication of a deteriorated preferred creditor status of the EBRD vis-à-vis Ukraine's direct loan obligations to the bank.

Importantly, we would also expect any losses to be minimal relative to EBRD's total development-related assets of about €40 billion. We expect these types of investments will remain limited. However, if they were increased in scale or resulted in recurring losses for the bank, we may view this as a sign of weaker investment underwriting vis-à-vis peers, which could weigh on EBRD's overall capitalization. That said, we expect EBRD to maintain its preferred creditor position on all its direct sovereign lending exposures. This is due to the bank's established position in the multilateral architecture, and in particular with regards to Ukraine, the recognition of the EBRD's relevance as a key long-term institutional investor to the country's private and public sectors.

We estimate the EBRD will be able to sustain a RAC ratio after adjustments above 23%. The capital position remains extremely strong and stood at 30.7% as of December 2023, from 32.1% in June 2023. Furthermore, we consider the EBRD's strong internal capital generation to support its capital position. In this respect, the bank recorded strong financial results in 2023, generating net operating profits of €2.1 billion, which offset the atypical losses seen in 2022. Increasing interest rates, more conducive equity markets, and lower impairment charges in 2023 allowed the bank to record an ROE of 14.9%, significantly improving the average return on equity to 6.6% over the last five years.

The EBRD's eligible callable capital provides it with an additional buffer against any higher-than-anticipated deterioration of its capital position. More specifically, the EBRD's 'aaa' stand-alone credit profile (SACP) is strengthened by €6.1 billion (about 30% of adjusted common equity) in callable capital subscribed by members rated 'AAA'. Therefore, even if we were to lower our assessment of the SACP of the bank to 'aa+' or 'aa' due to a weakened cash capital position, it would likely not affect the issuer credit rating on the EBRD. In such a scenario, we could factor in shareholder support from eligible callable capital provided by members rated above the SACP, all other things being equal.

The EBRD's funding profile benefits from strong access to capital markets and a diversified investor base. Our funding and liquidity ratios for the EBRD indicate that the bank would be able to fulfil its mandate for at least one year, even under extremely stressed market conditions, without access to capital markets. As of December 2023, our stressed liquidity ratio for the EBRD remained at a comfortable 1.6x at 12 months, albeit down from 1.9x from one year earlier due to a ramp up in planned disbursements and a managed reduction in treasury assets of about 8%

during 2023. In addition, we estimate that the EBRD would not need to reduce the scheduled disbursements of its loan commitments even if it were to draw down half of the total commitments in one year.

Ratings Score Snapshot

Issuer Credit Rating	AAA/Stable/A-1+
Stand-alone credit profile	aaa
Enterprise risk profile:	Extremely strong
Policy importance	Very strong
Governance and management expertise	Strong
Financial risk profile:	Extremely strong
Capital adequacy	Extremely strong
Funding and liquidity	Very 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, Jan. 31, 2022
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Ukraine FC Rating Lowered To 'SD' On Missed Coupon Payment Amid Debt Restructuring; 'CCC+/C' LC Ratings Affirmed, Aug. 2, 2024
- Abridged Supranationals Interim Edition 2024: Comparative Data For Multilateral Lending Institutions, July 12, 2024

Ratings List

Ratings Affirmed	
European Bank for Reconstruction and Development	
Issuer Credit Rating	
Foreign Currency	AAA/Stable/A-1+
European Bank for Reconstruction and Development	
Senior Unsecured	AAA
Commercial Paper	A-1+