

RATING ACTION COMMENTARY

Fitch Revises IDB Invest's Outlook to Negative; Affirms at 'AAA'

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Fitch Ratings - London - 02 Feb 2021: Fitch Ratings has revised the Outlook on Inter-American Investment Corporation's (IDB Invest) Long-Term Issuer Default Rating (IDR) to Negative from Stable and affirmed the IDR at 'AAA'.

KEY RATING DRIVERS

IDB Invest's 'AAA' Long-Term IDR reflects the bank's intrinsic credit profile, underpinned by its liquidity and solvency assessments of 'aaa'. The revision of the Outlook to Negative reflects faster-than-expected deterioration in the bank's capitalisation metrics and downside risks to asset quality resulting from the coronavirus pandemic and the bank's rapid loan expansion in recent years. The recent rise in leverage, driven by rapid loan growth, and the challenging macroeconomic environment in Latin America are exerting pressure on our assessment of the bank's solvency and strategy risks. This could lead to a downgrade of the bank's Long-Term IDR.

The 'aaa' solvency assessment reflects the bank's 'excellent' capitalisation and 'low' risk profile. Capitalisation buffers have significantly diminished owing to fast loan growth (56% through end-September 2020) while the bank's equity only marginally increased (4% over the same period). The increase in equity was mostly driven by paid-in capital transfer from

the Inter-American Development Bank (IADB/AAA/Stable), on behalf of shareholders. Part of the increase in lending has been driven by the bank's pandemic response, which led to an increase in loan disbursements through end-September 2020 of USD2.2 billion, compared with USD1.2 billion over the same period last year.

The equity/adjusted assets ratio, Fitch's main metric to assess capitalisation, significantly declined to 33.9% as of end-September 2020 from 57.6% a year before. Fitch's usable capital to risk-weighted assets (FRA) ratio fell to 46.7% from 73.2% over the same period. The deterioration in capitalisation metrics has been significantly more pronounced than Fitch expected at the previous rating review, partly driven by the bank's large pandemic response aimed at supporting private sector borrowers and trade finance operations. IDB Invest's policy response to the Covid-19 crisis has been one of the most significant across all the multilateral development banks (MDBs) rated by Fitch.

Fitch expects capitalisation metrics to further deteriorate and for the bank to operate with a higher level of leverage than previously expected. While the overall assessment of capitalisation should remain 'excellent', supported by capital transfers from IADB and marked deceleration in the growth in the banking portfolio, the bank's capitalisation buffers could be significantly weaker. Internal capital generation is also expected to be affected by higher loan loss provisions and the low interest rate environment in years to come.

As of end-September 2020 loan loss reserves increased to USD167 million (4.4% of loans) from USD98 million (4.0% of loans) at end-2019, reflecting the increased size of the loan book and coronavirus-credit quality deterioration. The increase in loan loss reserves was also driven by the bank's adoption of a model of provisioning based on expected credit loss (as per US GAAP). Despite the increase in provisions, Fitch expects that higher non-performing loans (NPL) and worsening in borrowers' creditworthiness could further affect the bank's profitability in the medium term.

The bank's 3x maximum leverage limit (1.7x as of end-September 2020), as measured by debt-to-equity, is consistent with an equity/adjusted assets ratio above the 'excellent' threshold of 25%, as outlined in Fitch's Supranationals Rating Criteria. The FRA is set to deteriorate further, in line with our expectation of an increase in leverage, but to remain above the 35% 'excellent' threshold. There are downside risks for both metrics, given lending targets and the increased risk to asset quality as a result of downgrades and Negative Outlooks across Latin American issuers.

The bank's 'low' risk profile balances the inherent risk in its non-sovereign lending and investing activities against a track record of operating with 'low' NPLs and 'very low' obligor concentration risk metrics. The assessment also considers the bank's 'very low', equity and market risks, as well as its 'excellent' risk management policies. We expect any negative impact on the bank's own funds from potential losses on its equity investments to remain limited, given the 'very low' share of equity participations in the total banking exposure (2.8% of total banking exposure; TBE).

IDB Invest is the private-sector lending-arm of the IADB Group, and has been gradually taking over all of the group's non-sovereign investing activities. This entails a 'moderate' level of credit risk, as measured by the weighted average rating of loans and guarantees at 'BB-' as of end-September 2020. This is unchanged from a year before, and is based on Fitch's ratings where available, and IDB Invest's internal credit quality assessments.

The NPL ratio, as reported by the bank, was 0.8% as of end-September 2020, which is below historical levels (average of 1.4% over 2015-2019) and lower than private-sector focused MDBs. The decline primarily reflects loan growth dilution and limited NPLs incurred since the onset of the Covid-19 crisis. The bank has also extended temporary payment deferrals to borrowers, which account for approximately 1.7% of total loans. Fitch considers these exposure subject to payment deferral as non-performing, leading to an NPL ratio, as defined by Fitch, of 2.5%. The bank does not consider these exposures as impaired, but the agency's approach reflects the risk that the temporary payment relief may only delay loan impairments.

In Fitch's view, the large increase in lending may mask risks to asset quality and performance. Positive net financing flows to existing exposures support borrowers' repayment performance in the short term but may lead to larger NPLs and losses over the long-term. The share of lending to financial institutions (FI) increased to 49% of the total at end-September 2020 (compared with 44% a year prior). The FI loan book is fully performing and has been a key factor in exerting positive pressure on asset quality. However, while the share of FI lending has slightly increased in relative terms, the absolute increase in the non-FI loan book represents a significant downside risk to NPL projections.

The large deterioration in Latin American creditworthiness is evidenced by the record number of sovereign downgrades in 2020. Fitch estimates that banking exposures in which the sovereign rating has been downgraded by at least one notch accounted for 46% of TBE as of end-September 2020. Exposures in countries in which the Outlook on the sovereign is Negative account for 53% of TBE, while the share of exposures located in countries rated 'B-' or below account for a 20% of TBE. The bank's exposures are exclusively to non-

sovereign entities, but the negative rating actions taken on Latin American sovereigns highlight deterioration in the macroeconomic conditions in those countries, which will affect the credit quality of non-sovereign entities.

Fitch assesses liquidity at 'aaa'. IDB Invest's liquid assets/short-term debt ratio is expected remain well above the 150% threshold that is consistent with an 'excellent' assessment as per our criteria, over the medium term. The liquidity buffer is also supported by the increased size of short-term trade finance loans. The quality of treasury assets is 'excellent', with 75% of the portfolio rated 'AA-' or above as of end-September 2020. The bank's sound liquidity profile is also supported by its increasing access to capital markets, as well as alternative sources of liquidity from committed credit facilities with the IADB.

IDB Invest's overall business environment is assessed as medium risk, which does not translate into an adjustment from Fitch's solvency or liquidity assessments of 'aaa'. IDB Invest's medium-risk business profile is affected by a high-risk strategy, characterised by ambitious lending growth targets. In addition, our assessment captures IDB Invest's limited, albeit increasingly important, policy mandate, and medium-risk operating environment.

Consistent with Fitch's Supranationals criteria, extraordinary support from shareholders is not currently a factor in the overall rating, as the average rating of IDB Invest's key shareholders is 'BBB' and there is no callable capital. IDB Invest's 'AAA' rating therefore reflects only the bank's intrinsic strengths.

IDB Invest's Long-Term IDR is materially above Mexico's sovereign rating (BBB-/Stable), therefore the issue rating on the Mexican national rating scale is 'AAA(mex)'. A downgrade of IDB's Long-Term IDR by one notch would not result in a downgrade of the issue rating on the Mexican national rating scale.

ESG CONSIDERATIONS

IDB Invest has an ESG Relevance Score of 4 for 'Exposure to Social Impact'. IDB's policy response to the coronavirus crisis was one of the largest policy responses of the MDBs in the portfolio (in comparison with initial lending plans for 2020). This has eroded the capital buffers of the bank. The bank has also allowed payment deferral to provide temporary liquidity support to some of its borrowers. This has a negative impact on the credit profile, and is relevant to the ratings in conjunction with other factors.

IDB Invest 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. 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 (Capitalisation): Continued decline in capitalisation metrics with an equity to assets and guarantees ratio sustained at a level close to or below 25% or a FRA ratio close to or below 35%. This could be driven by losses, continued rapid growth in banking operations, and/or a significant increase in risk-weighted assets.
- Solvency (Risk): Higher levels of NPLs and/or a decline in the average rating of loans and guarantees below 'BB-'.
- Business Environment (Business Profile/Operating Environment): Continued rapid growth in the bank's operations relative to its capital resources that affects our assessment of the bank's strategy. Further deterioration in the macroeconomic environment in the bank's countries of operations in Latin America.

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

- Solvency (Capitalisation): Stronger-than-expected capitalisation metrics with an equity to assets and guarantees ratio sustained at a level well above 25% and a FRA ratio above 35%. This would be the case if capitalisation metrics stabilised at the current level.
- Solvency (Risk): Stronger-than-expected performance in the loan book as evidenced by a continued 'low' NPL ratio following greater loan seasoning and moderated loan growth. Resilience and/or improvement in the average rating of the portfolio would also exert positive pressure on our assessment.

- Business Environment (Business Profile/Operating Environment): Improvement in the macroeconomic environment across countries of operations that reduces downside risks to the credit quality and performance of the loan book. A significant new capital increase that supports the bank's public mandate and provides additional equity resources to back lending expansion.

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 that even if experiencing severe difficulties member countries will continue to exempt IDB Invest's private sector borrowers from any measures that may impact the transfer and/or convertibility of their debt service payments to IDB Invest.

Fitch assumes that IDB Invest will maintain its conservative risk management and governance policies.

We also assume that the global economy evolves in line with its 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 IDB Invest's financial statements and other information provided by IDB Invest.

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
Inter-American Investment Corporation (IDB Invest)	LT IDR	AAA Rating Outlook Negative	Affirmed	AAA Rating Outlook Stable
●	ST IDR	F1+	Affirmed	F1+
● senior unsecured	LT	AAA	Affirmed	AAA
● senior unsecured	Natl LT	AAA(mex)	Affirmed	AAA(mex)

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APPLICABLE CRITERIA

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

[Metodología de Calificación de Supranacionales \(pub. 12 Jun 2020\)](#)

[National Scale Rating Criteria \(pub. 22 Dec 2020\)](#)

[Metodología de Calificaciones en Escala Nacional \(pub. 22 Dec 2020\)](#)

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