European Supranational Outlook 2021

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Towards a green safe asset? January 2021

European Supranational Outlook 2021

Key takeaways

1. Credit profiles remain resilient despite higher debt and weakening asset quality

- Covid-19 crisis weakens credit quality, but significant buffers remain
- Counter-cyclical response set to increase issuance and debt level especially of the EU in line with mandate

2. Mandates and operating guidelines adapt as government policy priorities shift

- Immediate action to tackle Covid-19 crisis
- Evolving mandates to address sustainability challenges; operating guidelines of supranationals to change

3. EU's NGEU key instrument to increase euro-denominated (ESG) safe assets

- EU set to become the largest green bond issuer in coming years
- Supply of EUR-denominated, long-term bonds to increase significantly; safe ESG assets to facilitate investors' and central banks' targets of "greening" portfolios, resulting in shift towards EUR
- Limits remain: temporary nature of NGEU; how green will the greenback become under President Biden?

4. Increasing ESG-relevance pioneered by supranationals in Europe

- Catalytic effect for private and public sector

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Scope's supranational coverage

- Current coverage of seven supranationals; expansion to 10 issuers by end-2021
- Similar rating levels but different emphasis of rating drivers

Supranational	Scope	Moody's	S&P	Fitch
EIB	AAA/Stable	Aaa/Stable	AAA/Stable	AAA/Stable
EBRD	AAA/Stable	Aaa/Stable	AAA/Stable	AAA/Negative
CEB	AAA/Stable	Aa1/Stable	AAA/Stable	AA+/Stable
BSTDB	A/Stable	A2/Stable	A-/Positive	--
EU	AAA/Stable	Aaa/Stable	AA/Positive	AAA/Stable
ESM	AAA/Stable	Aa1/Stable	AAA/Stable	AAA/Stable
EFSF	AA+/Stable	Aa1/Stable	AA/Stable	AA/Stable

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Overview & coverage

Supranational Rating		Adjustments	EIB	EBRD	CEB	BSTDB	ESM	EFSF	EU
FUNDAMENTAL RATING DRIVERS	Key Shareholder Rating	--	AA-	AA-	A+	BB	AA-	AA-	AA-
	Shock Absorption Capacity	-1; +2	+1	+1	+0	+1	+2	N/A	N/A
	Indicative rating		**AA**	**AA**	**A+**	**BB+**	**AA+**	**AA-**	**AA-**
	Limits to Shareholder Support / Preferred Creditor Status / Risks of Mandated Activities	+/- 2	+0	+0	+1	+0	-1	-2	+1
	Additional considerations		+0	+0	+0	+0	+0	+1	+2
	Indicative fundamental rating		**AA**	**AA**	**AA-**	**BB+**	**AA**	**A+**	**AAA**
OPERATIONAL RATING DRIVERS	Liquidity & Funding	-2; +7	+5	+4	+4	+2	+5	+2	+2
	Leverage & Asset Quality	-2; +4	+1	+2	+0	+3	+2	+1	+1
	Profitability	+/-1	+1	+1	+1	+0	+0	N/A	N/A
	Additional considerations		+0	+0	+0	+0	+0	+0	+0
FINAL RATING			**AAA**	**AAA**	**AAA**	**A**	**AAA**	**AA+**	**AAA**
		"AAA-buffers"	**5**	**5**	**2**	**-5**	**5**	**-1**	**3**

Credit quality of shareholders are starting point of the analysis

- Key shareholders own and control the institution (*de facto* back stop if ever needed)
  - Reputational channel: Strong shareholders can, in case of need, provide emergency loans or capital increases
  - Preventing possible default of supranational is high priority among key shareholders (no supranational default to date)
  - Scope acknowledges the credibility of callable capital of highly-rated shareholders
- Mandates determine the operational framework and activities
  - Counter-cyclical or through-the-cycle activities often result in weak asset quality per mandate of institution, but PCS
  - Operating environment (often that of shareholders) correlates with average borrower quality and volatility of returns
  - Preferential regulatory treatment and eligibility for central bank operations critical for liquidity buffers and funding
- Strong key shareholders are a sufficient condition for a high rating assessment

But intrinsic strength of a supranational can provide up to 16-notch uplift

- Scope's rating scale has 20-points from AAA to D
- If a supranational's shareholders are extremely weak, for example, with a key shareholder rating of B-, the supranational could still be rated AAA given the potential 16-notch uplift for endogenous rating drivers

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➢ Evolving mandates determine operational frameworks and activities

Government policy priorities
Policy priorities in Europe have shifted towards the green transition

Supranational mandates
Mandates expand and adapt to the evolving policy priorities

Operational frameworks and guidelines
Criteria/guidelines for project selection, counterparty selection, treasury investments change; disclosures adjust

Funding and financing targets
Funding instruments and financing activities gradually shift

Catalytic effect
Market stabilization and development basis for private sector engagement; Co-financing with private sector generates wider societal impact

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Evolving mandates and rising ESG-issuance

➢ Mandates and policies adapt as government policy priorities shift

	EU (AAA/STA)	EIB (AAA/STA)	ESM (AAA/STA)
Covid-19	SURE - EUR 100bn - Dec 2022 - Social Bond Framework	Pan-European guarantee fund - EUR 25bn	Pandemic Crisis Support - EUR 240bn - Dec 2022 - Social Bond Framework
Recovery & sustainability	European Green Deal - Climate neutrality by 2050 - EU Taxonomy NGEU - ~ EUR 750bn - ~ EUR 225bn in green bonds Source: European Green Deal; Council Conclusions	Climate action and env. sustainability > 50% of lending by 2025 (~ EUR 30bn/year) to mobilise EUR 1tn by 2030 100% of financing activities aligned with Paris Agreement - Shadow price of carbon for project selection - Physical risk assessment for direct lending Source: EIB Group Climate Bank Roadmap 2021-2025	Backstop to Single Resolution Fund as of 2022 - EUR 68bn - Permanent Responsible investment framework to assess alignment of issuers with ESG criteria Source: Investor Relations Presentation, Jan 2021

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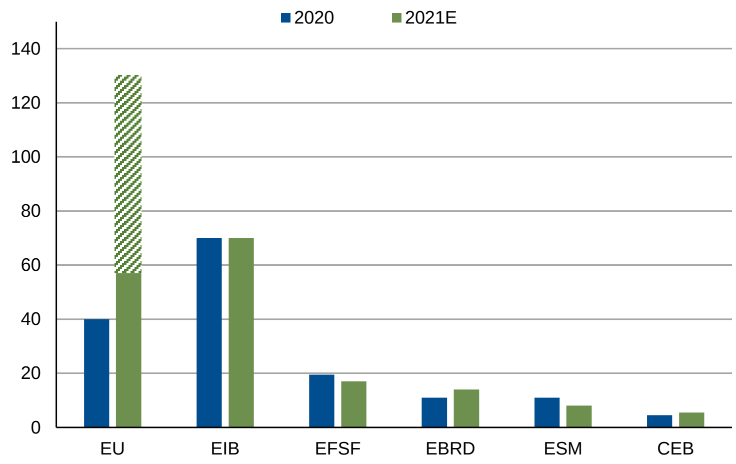
Evolving mandates and rising ESG-issuance

➢ Mandates and policies adapt as government policy priorities shift

	EBRD (AAA/STA)	CEB (AAA/STA)	BSTDB (A/STA)
Covid-19	EBRD's coronavirus Solidarity Package: - Ensure short-term liquidity and working capital needs of existing clients - Enhanced financing to SMEs - Vital Infrastructure Support	Adapted and streamlined its Public Finance Facility (PFF) - EUR 3.1bn in loans approved to finance COVID-19 response to sovereigns and sub-sovereigns - EUR 1.5bn financed by social bond issuance	- Refocusing of project pipeline of around EUR 900m to support member countries - Support to the SME sector
Recovery & sustainability	Green Economy Transition & Strategic and Capital Framework - Green finance to comprise more than 50% of business - Reinforce private sector focus - Extend annual lending by up to 30% Source: Green Economy Transition, Strategic and Capital Framework	Development Plan 2020-2022: - Focus on social impact, sustainability and the SDGs - Alignment of its project portfolio with the Paris Agreement on Climate Change and improving the tracking of green and climate action finance Source: CEB Development Plan 2020-2022	Updated Medium-Term Strategy and Business Plan 2019-2022: - Increase relevance for shareholders via an increase of the balance sheet and in the share of sovereign lending to 25%, also via key infrastructure projects Source: Medium-Term Strategy and Business Plan 2019-2022

➢ Expected total issuance

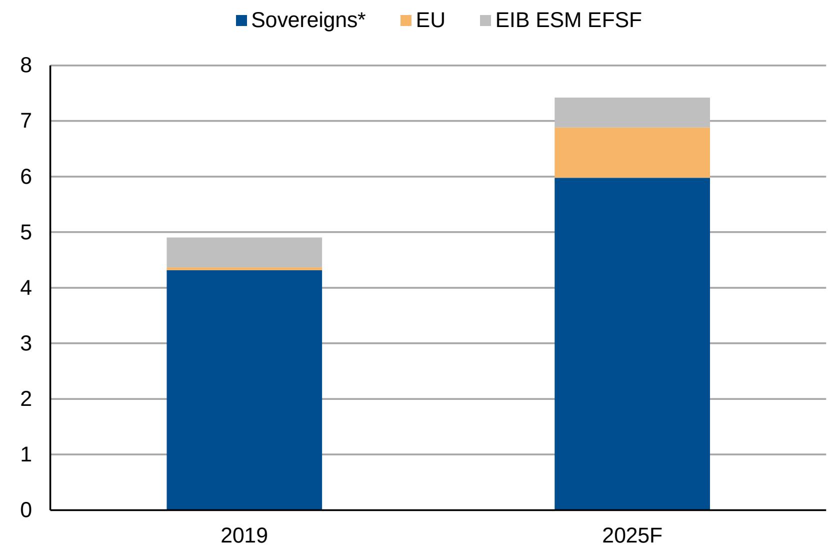
Gross issuance, 2020 vs 2021E
EUR bn



N.B. For the EU, the dashed area represents estimated NGEU funding.

Source: Issuers, Scope Ratings GmbH

Euro-denominated debt, 2019 – 2025F
EUR tr



*General government debt securities rated AA- or above (excluding Estonia). Estimates assume 1% inflation and that new issuance will be in euro.

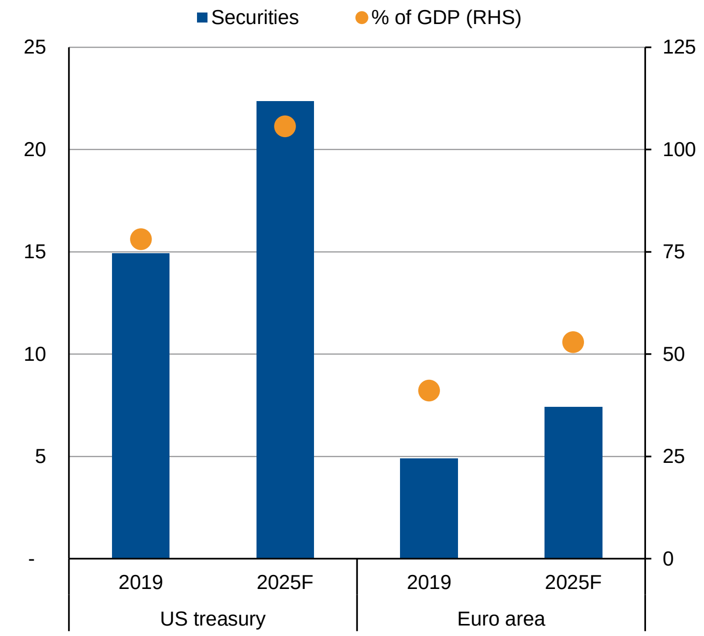
Source: IMF, Issuers, Scope Ratings GmbH

Increasing role but some limitations of EUR as safe asset

- EC set to become the largest green bond issuer in coming years
  - Bond issues will be in EUR only, with long maturity, increasing supply of green, long-dated bonds significantly
  - Safe ESG assets to facilitate investors'/central banks' "greening" of portfolios, resulting in shift towards EUR
- But: Temporary nature
  - NGEU is not a permanent, centralized fiscal capacity
- Actual NGEU issuance might be lower than assumed
  - Implementation hurdles may result in delays; Member states may not be willing to take-up loans (EUR 390bn)
- USD issuance set to increase in coming years and still to dominate markets
  - How green will the greenback become under Biden?

US treasury securities and EA safe assets outstanding

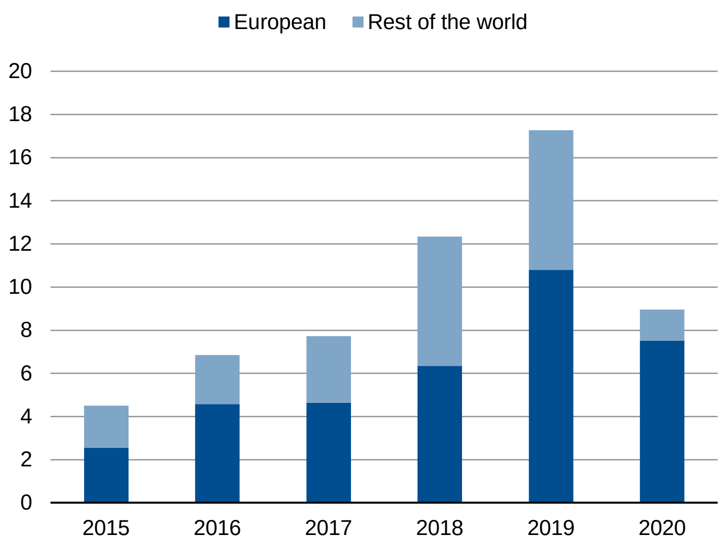
EUR tr (l.h.s.) and % of GDP (r.h.s)



US: Marketable US treasury securities. Euro area safe assets as defined on p. 11 r.h.s. chart.
Source: IMF WEO, US Treasury, Macrobond, Scope Ratings GmbH

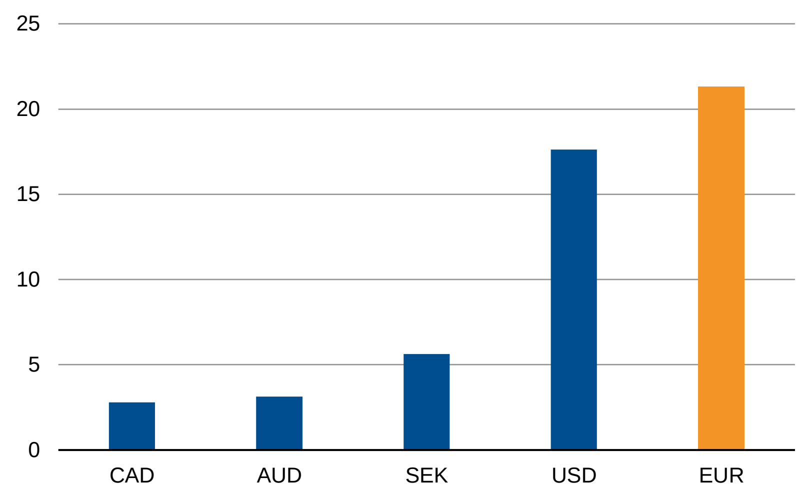
➢ Growing importance of Euro(pean) green finance

Supranational annual green bond issuance
EUR bn, cumulative 2015-20



Source: Bloomberg, Scope Ratings GmbH
N.R.: European issuers are EUROFIMA, EBRD, EIB, NIB

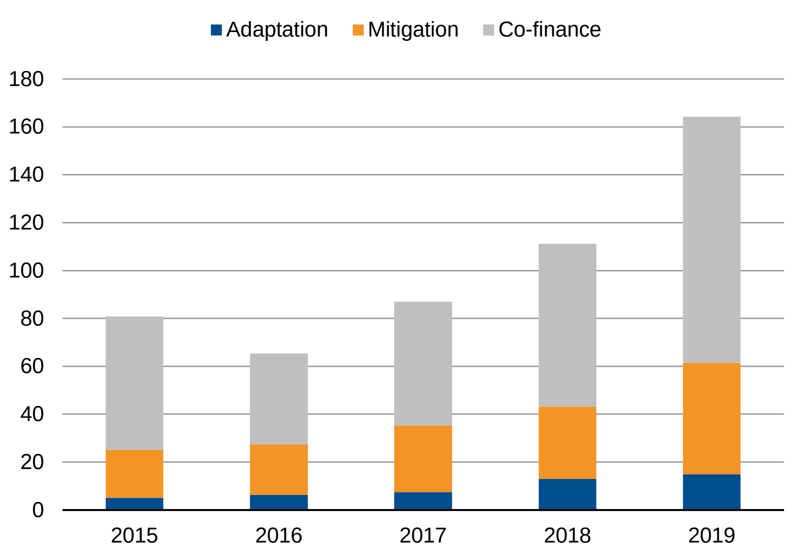
Currency composition of green bonds
EUR bn, cumulative 2015-20



Source: Bloomberg, Scope Ratings GmbH

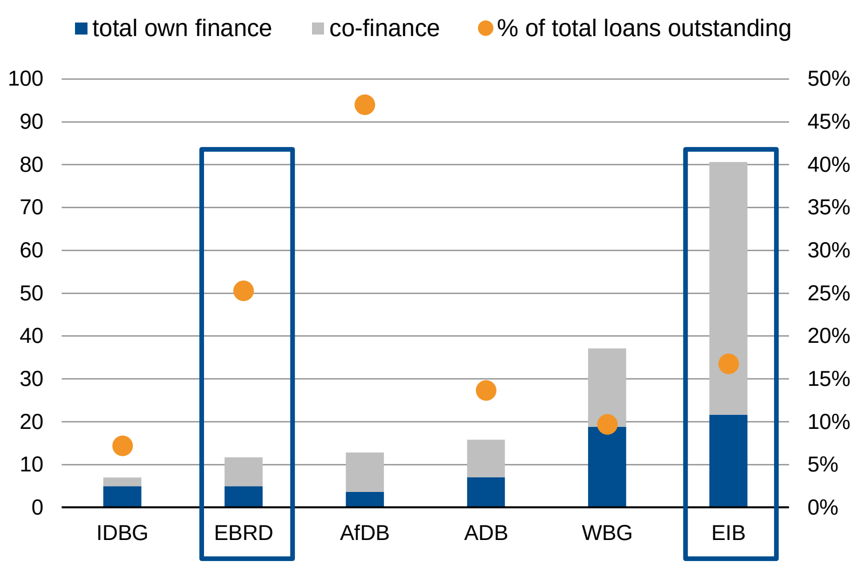
➢ Beyond green issuance - Climate finance activities

Climate Finance commitments of major MDBs
bn USD, 2019



Source: MDB Climate Finance Report 2019, Scope Ratings GmbH

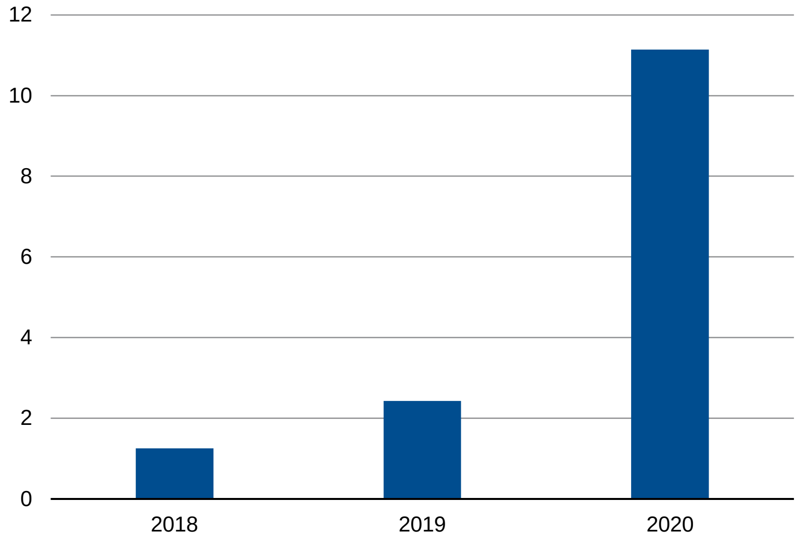
Climate finance of major global MDBs
bn USD (l.h.s.)



Source: MDB Climate Finance Report 2019, Scope Ratings GmbH

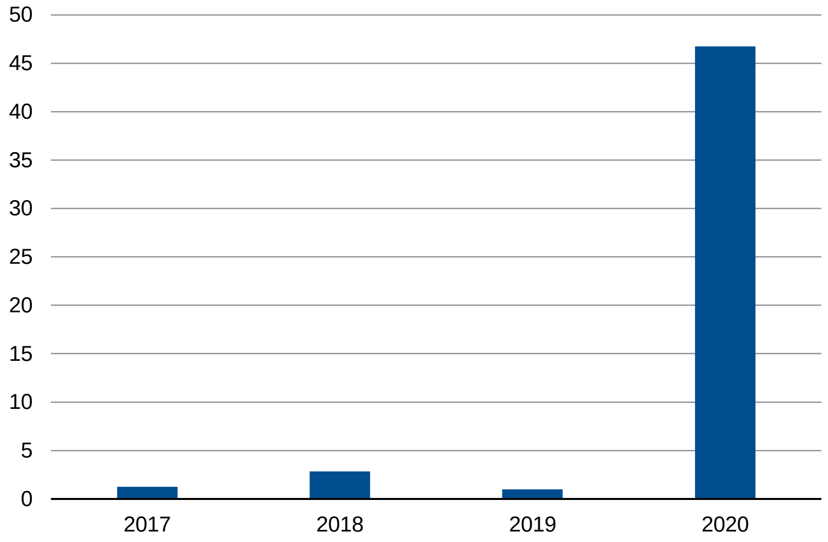
➢ Beyond green issuance – Social and Sustainability Bonds gain importance

Supranational Sustainability Bond Issuance
bn EUR



Source: Bloomberg, Scope Ratings GmbH
Issuers: European Investment Bank, Asian Infrastructure Investment Bank, IDB Trust Services

Supranational Social Bond Issuance
bn EUR



Source: Bloomberg, Scope Ratings GmbH
N.B.: The EU accounts for 85% (EUR 39.5bn) of 2020 bond issuance; Rest consists of CEB, EBRD, AfDB, IDBG, IFC and CAF

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4. Increasing ESG-relevance pioneered by supranationals in Europe

- Catalytic effect for private and public sector

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Issuer profiles – European Union (AAA/STA)

Credit strengths

- ✓ Highly rated shareholders
- ✓ Strong institutional setup providing de facto joint and several support, debt service priority and budget flexibility
- ✓ High liquidity buffers

Credit weaknesses

- ✓ Significant increase in debt
- ✓ Crisis-country exposure
- ✓ High shareholder concentration
- ✓ High guarantees to EIB operations ability of shareholder support

Positive rating-change drivers

- ↑ N/A

Negative rating-change drivers

- ↓ Downgrades of key shareholders
- ↓ Rebates to strong shareholders
- ↓ Change in institutional setup
- ↓ Reduction in liquidity buffers

➢ Rating action release, 30 October 2020

European Supranational Outlook 2021

Issuer profiles – European Investment Bank (AAA/STA)

Credit strengths

- ✓ Highly rated shareholders
- ✓ High liquidity buffers; excellent access to capital markets and to the ECB's refinancing operations
- ✓ Excellent asset quality performance
- ✓ High retained earnings

Credit weaknesses

- ✓ High leverage
- ✓ Concentrated shareholder base
- ✓ Rising equity and higher-risk activities

Positive rating-change drivers

- ↑ N/A

Negative rating-change drivers

- ↓ Downgrades of key shareholders
- ↓ Significant reduction in liquidity buffers
- ↓ Marked deterioration of capital base

➢ Rating action release, 16 October 2020

European Supranational Outlook 2021

Issuer profiles – European Bank for Reconstruction & Development (AAA/STA)

Credit strengths

- ✓ Highly rated shareholders
- ✓ Substantial capital position
- ✓ Very high liquidity buffers
- ✓ Excellent access to capital markets

Credit weaknesses

- ✓ Weak asset quality
- ✓ High earnings volatility through equity investments

Positive rating-change drivers

- ↑ N/A

Negative rating-change drivers

- ↓ Downgrades of key shareholders
- ↓ Reduction in liquidity buffers
- ↓ Losses reducing the capital base

➢ Rating action release, 10 July 2020

Credit strengths

- ✓ Highly rated shareholders
- ✓ Substantial capital position
- ✓ Very high liquidity buffers
- ✓ Excellent access to capital markets

Credit weaknesses

- ✓ Crisis-country exposure and concentrated loan portfolio
- ✓ Concentrated shareholder base

Positive rating-change drivers

- ↑ N/A

Negative rating-change drivers

- ↓ Downgrades of key shareholders
- ↓ Reduction in liquidity buffers
- ↓ Losses reducing the capital base

➢ Rating action release, 8 May 2020

European Supranational Outlook 2021

Issuer profiles – European Financial Stability Facility (AA+/STA)

Credit strengths

- ✓ Highly rated shareholders
- ✓ Strong over-guarantee mechanism
- ✓ Excellent access to capital markets

Credit weaknesses

- ✓ Crisis-country exposure and concentrated loan portfolio
- ✓ Concentrated shareholder base

Positive rating-change drivers

- ↑ Upgrades of key shareholders
- ↑ Higher and sustained liquidity buffers

Negative rating-change drivers

- ↓ Downgrades of key shareholders
- ↓ Permanently lower liquidity buffers
- ↓ Weaker market access

➢ Rating action release, 8 May 2020

European Supranational Outlook 2021

Issuer profiles – Council of Europe Development Bank (AAA/STA)

Credit strengths

✓ Highly rated shareholders

✓ Very high liquidity buffers

✓ Strong asset quality

✓ Increasing strategic importance

Credit weaknesses

✓ High leverage

✓ High shareholder concentration

Positive rating-change drivers

↑ N/A

Negative rating-change drivers

↓ Downgrades of key shareholders

↓ Significant reduction in liquidity buffers

↓ Marked deterioration of capital base relative to lending activities

➢ Rating action release, 2 October 2020

European Supranational Outlook 2021

Issuer profiles – Black Sea Trade & Development Bank (A/STA)

Credit strengths

- ✓ High capitalisation
- ✓ Sound liquidity profile
- ✓ Strong asset quality and well diversified loan portfolio
- ✓ Stable profitability

Credit weaknesses

- ✓ Limited ability of shareholder support
- ✓ High risk of mandated activities in challenging operating environment
- ✓ Rising leverage

Positive rating-change drivers

- ↑ Increase in liquidity buffers
- ↑ Significant increase in profitability, raising capitalisation
- ↑ Upgrade of key shareholders

Negative rating-change drivers

- ↓ Reduction in liquidity buffers
- ↓ Significant weakening of asset quality resulting in sustained losses
- ↓ Marked increase in leverage
- ↓ Downgrade of key shareholders

➢ Rating action release, 6 November 2020

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Key Shareholder Rating: Rationale

- Key shareholders own and control the institution
  - Signaling channel: Strong shareholders enable an institutional framework ensuring access to and acceptance by liquid capital markets via preferential regulatory treatment, eligibility for central bank operations and listing on exchanges
  - Reputational channel: Strong shareholders can, in case of need, provide emergency loans or capital increases

- Reputational risk of a possible default is a high priority among the supranational's key shareholders
- Decision-making not always unanimous but with qualified majorities
- Strong key shareholders are a sufficient condition for a high rating assessment

Key Shareholder Rating: Assessment

- Average capital-key-weighted rating of the key shareholders whose cumulative capital share, starting with the largest shareholder, comprises at least 75% of the supranational's capital
- Rating range: From AAA to D

Shock Absorption Capacity: Rationale

- Capitalisation level of the institution with two key aspects to address statutory principles and long-term characteristics of supranationals:

$$\frac{\text{Equity + [callable capital of potentially borrowing member states rated} \geq \text{AA-]}}{\text{Total potential liabilities}}$$

1. Includes **callable capital** of shareholders who are <u>able</u> and <u>willing</u> to honour a capital call defined as

   i) having a rating ≥ AA- (ability)

   ii) being able to benefit directly from the activities of the institution (willingness)

   - To account for the capital structure of supranationals
   - To balance the credibility of callable capital with the fact that to date no capital call has been made

2. Uses **potential/ maximum leverage** as per the institution's Statutes

   - To account for the counter-cyclical nature of the mandate

➢ Shock Absorption Capacity: Assessment

- Capitalisation level of the institution with two key aspects to address specificities of supranationals:

$$\frac{\text{Equity + [callable capital of potentially borrowing member states rated} \geq \text{AA-]}}{\text{Total potential liabilities}}$$

- Numerator:
  - Equity: paid-in capital, accumulated reserves and retained earnings
  - Callable capital of shareholders i) rated AA- or above and ii) who can directly benefit from the institution's activities

- Denominator:
  - Total potential liabilities as per the Statutes/ Borrowing policies

- Ratio and assessment:
  - Rounded to full percentage
  - The higher (lower) the ratio, the higher (lower) Scope's adjustment to the key shareholder rating (-1 to +2 notches)

Limits to Shareholder Support: Rationale

- Shock-Absorption Capacity may be inflated by callable capital of shareholders rated AA- or above
- Shareholder concentration
  - Risk of supranational relying on a few highly rated shareholders only
- Paid-in/ Callable capital
  - Low share of paid-in capital could signal a limited willingness to actually provide financial resources in case of need

Limits to Shareholder Support: Assessment

- Shareholder concentration
  - Herfindahl-Hirschman Index (HHI): sum of squares of capital shares of shareholders rated ≥ AA- multiplied by 10,000
  - Rounded to nearest 100
- Paid-in/ Callable capital
  - Rounded to whole number
- Scope will deduct the notch in case at least one criteria is assessed as 'Medium/ High'

Criteria	**Unit**	**Limits to shareholder support**	
		Low	Medium/ High
Shareholder concentration	HHI	≤ 2,000	> 2,000
Paid-in/ Callable capital	%	≥ 10%	< 10%
Rating notches		0	-1

Preferred Creditor Status (PCS): Rationale

- Sovereigns have generally granted supranationals PCS
- Practice without a legal or regulatory basis (no contractual seniority)

Preferred Creditor Status (PCS): Assessment

- History and track record: over-ruling sufficient condition to receive 1-notch uplift
- In the absence of clear evidence of having benefited from PCS, the following criteria need to be met
  1. Mandate: Lender of last resort
  2. Exposure to own shareholders: Own shareholders more likely to provide PCS
  3. Private sector exposure: PCS usually only granted by sovereigns

Criteria	**Unit**	**Risks to PCS**		
		Low		Medium/ High
History and track record		Yes	No	
Mandate			Lender of Last Resort	Profit oriented
Exposure to own shareholders	% total loans		≥ 75%	< 75%
Private sector exposure	% total loans		≤ 25%	> 25%
Rating notches		+1	+1	0

Risks of Mandated Activities: Rationale

- Mandates lead to inherently risky and weak asset quality, but risks differ across several dimensions:
  - Activities (loans, equity), geographies (high vs low risk) and sectors (public vs private)
- Risk of country exposure
  - Provides insight into the likely asset quality of the supranational - unlikely to change over medium-term
- Maximum equity investments
  - To account for risk that investing directly in equity is riskier than providing loans

Risks of Mandated Activities: Assessment

- Risk of country exposure: Weighted average rating of Top 10 country exposures
- Maximum equity investments: Equity investments as per Statute as % of equity (paid-in capital + reserves)

Criteria	**Unit**	**Risks from mandated activities (1)**		
		Low	Medium	High
Risk of country exposure	Rating	≥ A-	≥ BBB-	< BBB-
Max equity investments	% equity*	≤ 50%	--	--

Risks from mandated activities (2)		Max equity investments	
		Low	High
Risk of country exposure	Low	+1	0
	Medium	0	-1
	High	-1	-1

Liquidity: Rationale

- Liquidity buffers ensure the supranational's ability to finance its operations and honour debt obligations
- Large pools of liquidity needed to maintain high lending volumes during periods of stress

Liquidity: Assessment

- Liquid assets ratio: $\frac{\text{Liquid assets}}{\text{Liabilities maturing within 1 year}}$
- Liquid assets
  - Cash and cash equivalents, assets with a horizon ≤ 12 months, assets rated ≥ AA-
  - Expected cash inflows from lending operations are excluded
- Liabilities maturing within 1 year
  - Includes maturing long-term debt within the next 12 months
  - Includes expected full-year disbursements in the following year

Criteria	Unit	Risks to liquidity position					
		Extremely Low	Very Low	Low	Moderate	Medium	High
Liquid assets ratio	%	> 120	< 120; ≥ 80	< 80; ≥ 50	< 50; ≥ 30	< 30; ≥ 20	< 20
Rating notches		+4	+3	+2	+1	0	-1

Funding: Rationale

- Funding sources ensure the supranational's ability to finance its operations and honour debt obligations
- Supranational benefits from 'Flight to quality' during times of stress if it is perceived as benchmark issuer
- Ability to issue across maturities, currencies and jurisdictions resulting in highly diversified investor base

Funding: Assessment

- Weighted-average maturity of issuance during latest year: the longer, the better
- Funding volume and currency diversification
  - Annual funding volume: the higher, the better
  - Concentration of funding currencies: the lower, the better
- Share of ESG-related issuance: Growing ESG-investor community may provide additional funding flexibility

Criteria		Unit	Risks to funding		
			Low	Medium	High
WAM issuance		Years	≥ 5	< 5; ≥ 2	< 2
	Rating notches		+1	0	-1
Funding volume		EUR or USD bn	≥ 10	--	--
Funding currency		Top 1 share (%)	≤ 70	--	--
	Rating notches		+1	0	0
ESG issuance		% total issuance	≥ 15	--	--
	Rating notches		+1	0	0

Leverage: Rationale

- Actual leverage may be much lower than potential leverage as assessed under Shock Absorption Capacity
- Leverage ratio more likely to change from one period to the next, compared to 'mandated activities'
- Leverage ratio risk-insensitive but simple and comparable across all supranationals
- Leverage ratio is a more robust indicator for capitalisation problems than risk-based capital ratios
  - IMF and Basel literature on financial crises

Leverage: Assessment

- Leverage ratio: $\frac{\text{Outstanding debt securities}}{\text{Equity (paid-in capital, accumulated reserves)}}$

Criteria	Unit	Risk		
		Low	Medium	High
Leverage ratio	% equity	≤ 300*	> 300; ≤ 600	> 600
Rating notches		+1	0	-1

*In case the leverage ratio is below 100, Scope assigns an exceptional uplift of 2-notches.

Asset Quality: Rationale

- Actual risk on balance sheet could be much lower compared to risk assessed under 'mandated activities'
- Institution may conduct most of its operations in creditworthy countries but could still hold poor asset quality

Asset Quality: Assessment (1)

- Non-performing loans ratio: $\frac{\text{Loans with payments overdue by 90+ days}}{\text{Total loans}}$

- Actual direct equity participations: $\frac{\text{Actual equity exposure}}{\text{Equity (paid-in capital, accumulated reserves)}}$

Criteria	**Unit**	**Actual asset quality risk**		
		Low	Medium	High
NPLs	% total loans	≤ 2	> 2; ≤ 4	> 4
Actual equity participation	% equity*	≤ 50	--	--

*Equity includes accumulated reserves.

Portfolio Concentration: Rationale

- A highly concentrated portfolio is inherently riskier than one distributed among many borrowers

Portfolio Concentration: Assessment

- Herfindahl-Hirschman Index (HHI): sum of squares of shares of exposures
  - By geography (Top 10 country exposures)
  - By sector (Based on UN's International Standard Industrial Classification) to map sectors across supranationals

- A 'Low' portfolio concentration in either dimension results in a positive 1-notch adjustment

Criteria	**Unit**	**Portfolio concentration**		
		Low	Medium	High
Geographical concentration	HHI	≤ 2,000	--	--
Sectoral concentration	HHI	≤ 2,000	--	--
Rating notches		+1	0	0

Profitability: Rationale

- Above-average profitability generates internal capital buffers and enhances the institution's Shock Absorption Capacity
- Sustained periods of losses will lead to lower capital levels

Profitability: Assessment

- Return on equity ratio: $\frac{\text{Retained profit}}{\text{Equity}}$
- Net income after distribution of dividends to shareholders and transfers to concessional arms

Criteria	**Unit**	**Risks to profitability**		
		Low	Medium	High
Return on equity	%	≥ 3	< 3; ≥ 0	< 0
Rating notches		+1	0	-1

Additional research

- ✓ Scope's 2021 Sovereign Outlook
- ✓ Sovereign methodology
- ✓ Sub-sovereign methodology
- ✓ Government related entities methodology
- ✓ Supranational methodology
- ✓ Supranational methodology: Feedback report
- ✓ Supranational risk-taking: Assessing EU budget guarantees, EIB credit enhancements and member states' contingent liabilities

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