



RATING ACTION COMMENTARY

Fitch Affirms Islamic Development Bank at 'AAA'; Outlook Stable

Tue 26 May, 2020 - 10:52 ET

Fitch Ratings - London - 26 May 2020: Fitch Ratings has affirmed Islamic Development Bank's (IsDB) Long-Term Issuer Default Rating (IDR) at 'AAA' with a Stable Outlook. The Short-Term IDR has been affirmed at 'F1+'. The trust certificates issued by IDB Trust Services Ltd have also been affirmed at 'AAA'.

KEY RATING DRIVERS

IsDB's 'AAA' Long-Term IDR is driven by the intrinsic credit quality of the bank with solvency and liquidity both assessed at 'aaa'. Despite negative pressures on asset quality and capitalisation as a result of the global pandemic, Fitch expects the overall impact on the bank's credit profile to remain limited with solvency metrics slightly deteriorating but remaining at a level consistent with the bank's Long-Term IDR of 'AAA'.

IsDB's 'aaa' solvency assessment is underpinned by the bank's 'excellent' capitalisation with an equity-to-adjusted-assets ratio of 38.5% at end-2019, down from 40% the previous year. Fitch's usable capital to risk-weighted assets ratio (FRA ratio) is above 40%, which is also consistent with an 'excellent' assessment (above 35%). Fitch expects the two capitalisation ratios to remain at levels consistent with an 'excellent' assessment in the medium term.

IsDB's Board of Executive Directors has approved a group-wide USD2.3 billion financial package to support member countries, which includes USD1.52 billion that will be funded out of IsDB's ordinary capital resources. The approved package primarily represents a re-allocation of committed resources that aims to support member countries' efforts to prevent, contain, mitigate and recover from the impact of the COVID-19 pandemic. This will lead to an acceleration of disbursements in 2020 but not to a significant increase in the bank's financing operations.

The bank continues to receive paid-in capital contributions from shareholders as a result of the fourth general capital increase but these amounts have not been sufficient to offset the growth in the financing portfolio and have led to an increase in leverage to 1.56x at end-2019 compared with 0.9x at end-2014. This remains low compared with 'AAA' rated peers but is close to the bank's prudential limit on leverage.

The bank's shareholders have endorsed a significant increase to the bank's paid-in capital that would enable the bank to meet the growing financing needs of member countries while bolstering capitalisation metrics. Fitch understands that final approval should take place this year in the upcoming Board of Governors meeting.

Fitch assesses IsDB's overall exposure to risks as 'low', balancing 'moderate' credit risk in its financing portfolio with 'low' concentration, market, and equity risks. The bank's average rating of the loan portfolio was 'B+' at end-2019, unchanged from recent years and despite incorporating sovereign downgrades year to date.

Non-performing loans (NPLs, based on Fitch's own calculation) decreased to 5.1% of the total at end-2019 from 5.6% at end-2018, driven by loan growth dilution and the write-off of a non-sovereign NPL that was fully provisioned. NPLs relate to the bank's sovereign exposures to countries facing political troubles and special circumstances, including Sudan, Syria, and Yemen. The bank has not recorded new arrears in 2020. Fitch expects a moderate rise in non-sovereign NPLs but overall for the ratio to remain below 6% through 2022. Nonetheless, non-performing sovereign exposure is a downside risk to the forecast.

The bank's preferred creditor status (PCS) has recently been evidenced with Lebanon (RD) honouring the bank's commitments while defaulting to private creditors. Despite this, the bank's overall PCS is only assessed as 'moderate' given the large number of sovereigns in arrears to the bank (five as of end-2019).

Concentration risk is lower than for regional multilateral development banks, with the five largest exposures accounting for 33% of total banking exposure at end-2019. The bank's largest exposure is to the Turkish sovereign (BB-/Stable) and accounted for 10.5% of total loans at end-2019, followed by Indonesia (BBB/Stable) and Pakistan (B-/Stable). Fitch expects a slight improvement in concentration risk metrics, with the five largest exposures accounting for about 30% by 2022.

The bank's risk management is conservative overall and Fitch deems risk management policies 'strong'. Prudential rules include strict limits on country, sector and single borrower exposures. The bank has adopted FAS 30 from 2020 onwards. This accounting standard is expected to harmonise expected loss measurement guidelines with IFRS9 but the overall impact of this adoption on the bank's equity would remain limited (below 1% of equity).

IsDB's 'aaa' liquidity assessment reflect the bank's excellent liquidity buffers, with liquid assets-to-short-term debt expected to remain well above the 1.5x excellent threshold through 2022 (2.7x at end-2019), against the moderate asset quality in its treasury portfolio. The share of 'AA' to 'AAA' rated assets in the bank's treasury portfolio is expected to remain within the moderate range (10%-40%), which is below 'AAA' rated peers. This is mitigated by an overall high share of investment-grade assets in total treasury assets (98% at end-2019) and the bank's overall sizeable buffer.

Fitch assesses IsDB's access to capital markets as 'excellent', with the institution regularly being able to issue on the international capital markets as a 'benchmark' sukuk issuer. In 2019, IsDB raised nearly ID3.35 billion (ID2.8 billion in 2018) in US dollar/euro sukuk issues. The weight of sukuk in total funding has increased in recent years at 52% in 2019 (from 41% in 2014). Further, IsDB is able to attract additional funding from Islamic financial markets in the form of commodity placements and wakala deposits. The bank issued its first Green euro Sukuk in 2019 (EUR1 billion).

IsDB's business environment is assessed as medium risk. This primarily reflects the bank's focus on lending to non-investment grade countries (only two of the top 10 exposures are investment-grade) and the generally low credit quality and high political risk in countries of operations. The medium risk also accounts for the moderate share of non-sovereign exposures (15% of total banking exposure at end-2019) and the medium size of IsDB's banking portfolio (USD23.2 billion). This is mitigated by the bank's quality of governance, including experienced staff and a prudential risk framework. Fitch's assessment also benefits from the importance of IsDB's public mandate for the bank's member countries and the

operational support that member states can provide to the bank, including Saudi Arabia (where IsDB is located).

Shareholders' support is not a rating driver. The support assessment has decreased to 'a' from 'a+' previously, reflecting increased leverage at the 2022 forecast horizon and the fact that net debt would now only be covered by callable capital from shareholders rated 'A' or higher (from 'aa-' at end-2019) following the downgrade of Saudi Arabia (A/Stable) in 2019. The average rating of key shareholders consisting of Saudi Arabia, the United Arab Emirates, Libya, Iran and Nigeria (B/Negative) fell to 'BB' following the downgrade of Saudi Arabia and Nigeria (from B+) since the last review. Except for countries facing political troubles, shareholders have consistently demonstrated their propensity to support the bank through regular inflows of fresh capital, and despite the moderate size of the bank's balance-sheet, IsDB is an important tool to channel sharia-compliant financing to member states.

RATING SENSITIVITIES

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

The ratings are 'AAA', which is the highest level on Fitch's scale. The ratings cannot be upgraded.

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

- Deterioration in the capitalisation assessment. This could stem from an increase in leverage, an increase in risk-weighted assets, and/or failure from shareholders to agree on a timely and significant capital increase.
- Weakening of asset quality metrics as evidenced by deterioration in the average rating of the loan portfolio and/or an increase in the NPL ratio above 6%.
- Deterioration in the liquidity assessment potentially stemming from a decline in the credit quality and size of the bank's treasury portfolio and/or a significant increase in short-term debt.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Public Finance 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

We assume that the global economy develops in line with our Global Economic Outlook published on 22 April, including a deep but short-lived recession in 2020 due to the pandemic. There is an unusually high level of uncertainty around these forecasts and risks are firmly to the downside.

Fitch assumes that the bank's Board of Governors will approve a significant increase to the bank's paid-in capital as endorsed in the Islamic Summit of May 2019. Further, Fitch assumes that the member countries will continue to participate in the ongoing capital increase.

SOURCES OF INFORMATION

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

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
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ENTITY/DEBT	RATING		
Islamic Development Bank	LT IDR	AAA	Affirmed
●	ST IDR	F1+	Affirmed
IDB Trust Services Limited			
● senior unsecured	LT	AAA	Affirmed

[VIEW ADDITIONAL RATING DETAILS](#)

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APPLICABLE CRITERIA

[Sukuk Rating Criteria \(pub. 22 Jul 2019\)](#)

[Supranationals Rating Criteria \(pub. 01 May 2020\) \(including rating assumption sensitivity\)](#)

ADDITIONAL DISCLOSURES

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Islamic Development Bank

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