FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms North American Development Bank at 'AA'; Outlook Stable

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Fitch Ratings - London - 17 Mar 2021: Fitch Ratings has affirmed The North American Development Bank's Long-Term Issuer Default Rating (IDR) at 'AA' and Short-Term IDR at 'F1+'. The issue ratings on NADB's senior unsecured bonds are also affirmed at 'AA'. The Outlook on the Long-Term IDR is Stable.

KEY RATING DRIVERS

The ratings of NADB are driven by both its intrinsic features, with solvency and liquidity assessed at 'aa+' and 'aaa' respectively, as well as shareholder support. The bank's medium-risk business environment translates into a one-notch negative adjustment below our assessment of solvency, resulting in an intrinsic rating of 'aa'. The support rating, also assessed at 'aa', reflects our forecast coverage of net debt by callable capital over the medium term, along with a 'moderate' propensity demonstrated by NADB's shareholders to support the bank.

NADB's 'aa+' solvency assessment is underpinned by the bank's 'excellent' capitalisation metrics, with Fitch's primary measure of capitalisation (equity-to-adjusted-assets and guarantees) improving to 35.4% as of end-2020 (end-2019: 34.1%). Fitch also uses its usable capital / risk-weighted assets (FRA) ratio to assess NADB's capitalisation. The bank's equity is adjusted to include an additional 10% of the bank's 'AAA' rated callable capital subscribed by the U.S. (AAA/Negative) leading to an inflated usable capital, and an overall FRA ratio of 153% at end-2020. Both of these ratios are above the 'excellent' thresholds outlined in our criteria.

Both of these ratios have improved following the receipt of USD225 million of paid-in capital from the U.S. during 2020, of-which USD60 million was reflected as equity at end-2020. This comprised USD10 million one-off payment of paid-in capital (relating to legacy delays of a prior capital increase), USD50m paid-in capital injected into the bank as part of the U.S.-Mexico-Canada Agreement (USMCA) capital increase and the remaining USD165 million (also relating to the USMCA paid-in capital increase) received from the U.S.. The disbursement of the latter into the bank's equity is subject to the receipt of paid-in capital from Mexico (BBB-/Stable). As part of the USMCA capital increase, Mexico will pay in USD215 million to the bank over the medium term.

In Fitch's opinion, NADB maintains a 'low' risk profile, faces significant downside risks from, particularly the medium-term impact of Covid-19 on the bank's borrowers and the impact of potential regulatory changes affecting the Mexico electricity sector. In 2020, the Mexican government proposed regulatory changes to its electricity market, to impose new fees and obligations for wind and solar producers, as well as re-prioritising the order of electricity generation, which will negatively affect a significant portion of NADB's borrowers. As of March 2021, the bank has placed on Negative Watch all 13 potentially affected projects in its lending portfolio and Fitch will continue to monitor the performance of these borrowers over the coming months, as the regulatory changes are litigated within the Mexican judicial system.

The bank's strong underwriting standards were further illustrated during 2020, with the loan portfolio demonstrating resilience against the macroeconomic impact of the Covid-19 crisis, with impairments only representing 1.2% of the portfolio as of end-December 2020. In March 2020, the bank approved a framework allowing borrowers to potentially benefit from potential debt suspension, as has been seen at other private-sector focussed MDBs but, unlike most other peers with similar programmes initiated in 2020, NADB's framework has been unused. Fitch expects the level of impaired loans to increase to 2%-3% over the medium term, given the uncertainties around the medium-term impact of the pandemic as well as the impact of the proposed changes in the renewable electricity sector in Mexico.

Fitch's forecast of the average rating of the loan book continues to be 'BBB', in line with the revision made to our approach in March 2019. Fitch continues to utilise the bank's internal ratings to compute the average rating of NADB's portfolio (when no external rating is available), and the bank's internal risk-grading system continues to improve and be made more robust in line with peers'. In particular, the bank now assigns its internal ratings to borrowers during the approval stage of the loan, rather than upon disbursement.

In terms of concentration, the top five largest exposures accounted for 32% of total banking exposure (TBE) at end-2020, within our 'low' threshold. Geographic and sectoral concentration are high for NADB relative to private-sector focussed MDBs' given its narrow mandate in terms of sector and geography. However, given the continued uncertainty around the renewable energy sector in Mexico, the bank is currently exploring other sectors to lend to, such as mobility, energy storage and green manufacturing.

Fitch continues to assess NADB's risk-management practices as 'strong'. The bank maintains conservative limits for leverage, liquidity and capitalisation. Its prudent investment practices maintain the quality of its treasury assets and market risk is contained using derivatives.

Fitch maintains its liquidity assessment at 'aaa' to reflect the excellent liquidity of NADB and the quality of its treasury assets. As of December 2020, the bank's liquid assets / short-term debt was well in excess of 1,000% (far exceeding the 150% 'excellent' threshold outlined in our criteria) and the quality of the treasury portfolio improved, with over 92% of the book now invested in 'AA'-'AAA' rated assets. Following the agreed capital injection from the U.S. and Mexico, whereas we had previously expected the bank's balance sheet (including treasury operations) to significantly decrease over the medium term to preserve leverage limits, we now expect a more moderate decline in the bank's treasury operations to closer to USD800 million at end-2023 from around USD1 billion at end-2020.

Fitch continues to assess NADB's business environment as medium risk and to discount one notch from its solvency assessment, despite the sovereign downgrade of Mexico by Fitch in April 2020 to 'BBB-' from 'BBB'. Fitch's assessment balances the small size of operation, of USD1 billion, focus on non-sovereign loans, and our 'high-risk' assessment of the importance of the bank's public mandate with sound governance standards. The bank maintains good relations with local governments and municipalities as these are the key beneficiaries of its programmes.

Fitch's evaluation of shareholder's support at 'aa' is unchanged from last year, but we have adjusted our assessment of both the capacity and propensity of the bank's shareholders to provide support to NADB.

In terms of capacity to support, which is anchored to the coverage of NADB's net debt by callable capital provided by the U.S., following the revision of the Outlook of the U.S. to Negative in July 2020, we have revised downwards our medium-term expectation of capacity to support to 'aa+'. This is in line with recent practice at other MDBs whose shareholders experienced negative rating action over the past year.

We have revised our assessment of the propensity of the bank's shareholders to support upwards to 'moderate' from 'weak' following the receipt of USD225 million from the U.S. in 2020, following clarity provided this year to the USMCA capital increase that, at the time of the last rating review in March 2020, was not available. As part of this capital increase, Fitch also expects Mexico to contribute a further USD215 million of paid-in capital to the bank over the medium-term.

ESG CONSIDERATIONS

NADB 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.

NADB has an ESG Relevance Score of '4' for 'Policy Status and Mandate Effectiveness'. The bank only operates in the U.S. and Mexico as per its bylaws. Any sovereign rating action taken on Mexico or the US could affect our assessment of NADB's loan portfolio and/or support rating.

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 positive rating action/upgrade:

- Support (Capacity): Assuming an unchanged intrinsic assessment, a revision of the Outlook on the sovereign rating of the U.S. (AAA/Negative) back to Stable would lead to an improvement in the support assessment.

- Solvency (Risks): A material improvement in the credit quality of the bank's loan portfolio that could lead to an upward revision in Fitch's assessment of the bank's exposure to risks (currently assessed as 'low').

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

- Support (Propensity): A deterioration in our assessment of the propensity of the bank's shareholders to provide support to the bank, for example if Mexico fails to honour their expected share of the on-going paid-in capital increase over the coming years, would put negative pressure on the rating.

- Solvency (Capitalisation): Rapid asset growth that outpaces capital growth and results in a reduction in NADB's capitalisation metrics below levels commensurate with 'excellent' could lead to a negative adjustment to the 'aa+' solvency assessment.

- Solvency (Risks): Higher non-performing loans and/or weakening in the average rating of loans driven by deterioration in the economic performance of the bank's two countries of operations, likely due to the impact of Covid-19 and/or changes affecting the banks borrowers operating in Mexico's renewable energy sector, could lead to negative rating action.

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

- NADB's business model to remain unchanged.

- NADB to continue to manage growth to sustain its capital position.

- Conservative risk-management and governance policies are maintained, including liquidity coverage for short term-debt and debt limits.

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
North American Development Bank	LT IDR	AA Rating Outlook Stable	Affirmed	AA Rating Outlook Stable
•	ST IDR	F1+	Affirmed	F1+
• senior unsecured	LT	AA	Affirmed	AA

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Supranationals Rating Criteria - Effective from 30 April 2020 to 20 May 2021 (pub. 30 Apr 2020) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

North American Development Bank	UK Issued, EU Endorsed

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Sovereigns   Supranationals, Subnationals, and Agencies   North America   United States

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