MOODY'S
INVESTORS SERVICE

Rating Action: Moody's changes the outlook on North American Development Bank (NADB) to negative from stable; affirms the Aa1 ratings

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New York, September 24, 2020 -- Moody's Investors Service, ("Moody's") has today changed the outlook on the North American Development Bank (NADB) to negative from stable and has affirmed NADB's long-term foreign currency issuer and senior unsecured Aa1 ratings. Moody's also affirmed the short-term foreign currency issuer rating at Prime-1.

The negative outlook reflects firstly the deterioration in the bank's operating environment driven by proposed regulatory changes in Mexico that would be detrimental to the renewable energy sector. Moody's regards this policy and regulatory uncertainty as an environmental risk under its ESG framework. For NADB, the regulatory risk translates into uncertainty in the asset quality and the performance of a large portion of the bank's clean energy projects in Mexico. Secondly, the negative outlook also reflects Moody's view of some weakening of Mexico's support to the institution, on account of these regulatory changes as well as its own deteriorating credit quality.

Moody's affirmation of NADB's ratings at Aa1 takes into account its strong capital position and low leverage, which will be supported by a capital increase and modest loan book growth. The affirmation also considers NADB's robust liquidity position, which reflects a substantial amount of high-quality liquid assets against debt obligations and a prudent liquidity policy. Moreover and notwithstanding the rating agency's assessment of some weakening of shareholder support, member support remains high, which reflects the shareholders' ongoing commitment to provide additional capital to the bank.

RATINGS RATIONALE

RATIONALE FOR THE NEGATIVE OUTLOOK

DETERIORATING OPERATING ENVIRONMENT DRIVEN BY REGULATORY CHANGES IN THE MEXICAN ENERGY SECTOR

In April 2020, Mexican authorities proposed regulatory changes to Mexico's electricity market that if enacted would negatively impact the renewable energy sector in the country, by allowing the government to give preference to hydrocarbon instead of renewable energy. These proposals are a key credit risk for NADB since clean energy projects in Mexico accounted for 49% of NADB's total portfolio as of July 2020. While Moody's expects existing projects will not be severely impacted, the proposed changes will materially discourage future investment in the renewable energy sector, which is NADB's main area of operations.

Moody's expectation of a limited impact on existing projects is based on the existence of several contractual protections in the majority of these projects. Also, current legal disputes between the private-sector operators and the Mexican government will likely be resolved via negotiations.

However, the legal challenges and potential negotiations create uncertainty for these projects, with underperformance risk in about 35% of the Bank's clean energy exposure in Mexico, leading to a deterioration in NADB's asset quality. More specifically, some projects may be subject to an increase in transmission rates, while others may be required to pay to provide ancillary services.

SECOND DRIVER: WEAKENING OF MEXICO'S SUPPORT TO THE INSTITUTION

In terms of members' support, commitment to the institution remains high and has endured the political environment that at times reflected significant tensions between the US and Mexico. However, Moody's considers Mexico's ability to provide extraordinary support to NADB if this was ever needed, to have weakened, as reflected in Moody's downgrade of Mexico to Baa1 from A3 in April 2020 and the agency's decision to maintain the negative outlook. In addition, Moody's considers the proposed regulatory changes to Mexico's energy sector as an indication of Mexico's potentially weaker non-contractual support to NADB.

RATIONALE FOR AFFIRMING THE Aa1 RATING

Moody's affirmation of NADB's rating at Aa1 takes into account its strong capital position and low leverage, which will be supported by a capital increase and modest loan book growth. The affirmation also considers a robust liquidity position, which reflects a substantial amount of high-quality liquid assets against debt obligations and a prudent liquidity policy. Moreover, the rating affirmation also reflects high strength of member support, given the shareholders' ongoing commitment to capitalize the bank, despite some deterioration in member credit quality.

Subscribed capital doubled to $6 billion from $3 billion following a capital increase in 2016 and over the coming eight years paid-in capital will increase to $855 million from $415 million as of December 2019. The signing of the United States Mexico and Canada Agreement (USMCA) which replaced the North American Free Trade Agreement (NAFTA) led to both shareholders agreeing on finalizing the payment schedule of the paid-in capital, with Mexico making a first payment and the US making two contributions to date. All of the US paid in capital contribution has been paid in advance but will be recognized as paid in capital in the balance sheet following an agreed schedule ending in 2028. The expected capital contributions will bolster the bank's capital position and provide a buffer to the asset quality credit pressures.

Most NADB clients will be resilient to the economic shock derived from the pandemic. The area where the bank operates will have a better economic performance than Mexico's national average. Moreover, for the 2021-23 period, NADB expects aggregate loan growth to increase at a moderate pace, which will limit credit risks.

Another credit strength is NADB's solid liquidity position. The bank maintains very solid liquidity buffers, and its liquidity position has recently improved substantially, driven by moderate lending growth and a gradual reduction in outstanding debt. The strong liquidity position and prudent liquidity policies are balanced by the bank's relatively limited presence in capital markets, given its small size. Its bond issuance program has been small and recent, although the bank has proven to have market access during periods of financial market turmoil. NADB has recently embarked on a new funding strategy to increase its presence in markets, with the aim of smoothing out its debt maturity profile and slowly but steadily expand its funding alternatives.

ENVIRONMENTAL, SOCIAL AND GOVERNANCE CONSIDERATIONS

Environmental considerations are material to NADB's rating. This is due to the mandate the bank has to invest in projects with a strong environmental component. In particular, the proposed regulatory changes by the Mexican authorities could negatively impact NADB's asset quality and performance. As such, developments, be they in regulation or in business climate, that boost (hinder) environmentally-friendly projects will have a positive (negative) impact on NADB's creditworthiness.

Moody's regards the coronavirus outbreak as a social risk under its ESG framework, given the substantial implications for public health and safety. For NADB, the coronavirus outbreak poses risks to the bank's operating environment through the negative impact the pandemic has on the Mexican and US economies, but Moody's expects the impact on overall asset quality to be limited.

Governance considerations are material to NADB's credit profile. Moody's considers the bank's governance principles and risk management framework to be sound. The latter has been progressively strengthened in recent years by the adoption of tools to measure risks more accurately, including internal credit rating models.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

The outlook could be returned to stable if Moody's were confident that the regulatory changes in Mexico had a very limited impact in the Bank's asset quality, combined with the continued strengthening of the bank's capital position, via the scheduled additional paid-in capital or an improvement in other capital adequacy indicators.

NADB's credit profile could come under negative pressure if there was a significant deterioration in asset quality and performance, which would lead to an increase in non-performing assets, or if there was evidence of a further deterioration in the ability of members to provide support.

The principal methodology used in these ratings was Multilateral Development Banks and Other Supranational Entities published in June 2019 and available at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1147813 . Alternatively, please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found at: https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004.

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The ratings have been disclosed to the rated entity or its designated agent(s) and issued with no amendment resulting from that disclosure.

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Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1133569 .

At least one ESG consideration was material to the credit rating action(s) announced and described above.

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