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## Research Update:

# Corporacion Financiera de Desarrollo S.A. 'BBB+/A-2' Ratings Affirmed, Outlook Remains Stable

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## Research Update:

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## Overview

- Peru-based development bank Corporacion Financiera de Desarrollo S.A. (COFIDE) has maintained its significant role in funding domestic infrastructure projects, very strong link with the government, and stand-alone credit profile (SACP) of 'bbb'.
- We're affirming our 'BBB+/A-2' issuer credit ratings on COFIDE.
- The stable outlook reflects our view that the ratings on COFIDE will likely move in tandem with those on the sovereign if the bank's SACP remains above 'bb+'.

## Rating Action

On May 10, 2016, S&P Global Ratings affirmed its 'BBB+/A-2' rating on Corporacion Financiera de Desarrollo S.A. (COFIDE). The outlook is stable. COFIDE is the second-largest government-owned bank in Peru; it's a development bank mainly focused on infrastructure projects.

## Rationale

The ratings on COFIDE reflect its SACP of 'bbb' and our view of a high likelihood that the Republic of Peru (foreign currency: BBB+/Stable/A-2; local currency: A-/Stable/A-2) would provide extraordinary and timely support to the bank in the event of financial distress, in accordance with our criteria for government-related entities (GREs). We don't expect significant changes to the bank's GRE status regardless of who wins Peru's presidential election in June.

Our view of a high likelihood of support is based on COFIDE's:

- Important role for the government given that the bank promotes and finances investments and public and private infrastructure projects in Peru, which has a significant infrastructure gap.
- Very strong link with the government, which owns 99% of the bank through "El Fondo Nacional de Financiamiento de la Actividad Empresarial del Estado" (FONAFE), a fund created in 1999 to oversee the government's corporate activities and equity stakes. The Corporacion Andina de Fomento (CAF; AA-/Negative/A-1+) owns the remaining share of COFIDE through preferred shares. Several capital injections in recent years and COFIDE's close reputation with the government demonstrate the bank's close link with the latter.

Our bank criteria use our Banking Industry Country Risk Assessment (BICRA) economic risk and industry risk scores to determine a bank's anchor, the starting point in assigning an issuer credit rating. Our anchor for a commercial bank operating only in Peru is 'bbb-'.

We believe that economic risk for banks operating in Peru has increased. Economic growth has slowed down significantly since 2014, and we have revised our assessment of Peru's growth prospects. We expect growth to average 3.7% between 2015 and 2018, 2.8% in per capita terms, which will hinder Peru's ability to catch up to its more developed peers in the medium term. Nevertheless, we believe that a strong fiscal position, prudent monetary policies, and a credible and effective central bank provide the country with enough flexibility to withstand present and future external shocks. Credit growth rates have fallen since 2014, but this growth continues to add more than 2 percentage points to leverage (credit to GDP) per year, which increases the risk of economic imbalances. Although credit and real estate prices have been growing steadily, Peru doesn't have a real estate bubble, in our view. Real estate prices have risen thanks to solid economic growth, an increase in household income, and an expanding middle class. We have observed a rapid alignment of real estate prices growth with slower economic growth since 2014.

We consider industry risk for banks operating in Peru to be, in general, lower than its peers'. We believe that the country has a sound regulatory framework, with ample supervisory coverage and periodic risk based supervision under a highly professional regulator. Both Peru's central bank and Superintendencia de Banca y Seguros, a banking and insurer regulator, are very active. In the past two years, authorities have introduced several prudent measures to ensure financial stability at the macro level amid a weakened economy and rising external risk. The domestic financial system has generated strong profitability and adequate levels of capitalization in the past five years, and there are no significant market distortions that could alter the system's competitive dynamics in the near term. We also believe the country's financial system has a healthy and diversified funding mix through deposits, domestic market debt, and external debt (banks and markets), as well as strong government support to provide liquidity if needed.

We view COFIDE's business position as adequate, reflecting its role in supporting Peru's crucial infrastructure needs. Its key role as the only development bank in Peru bolsters our view of its high stability. With total assets of about PEN13.5 billion as of March 31, 2016, COFIDE is the second-largest government-owned bank in Peru in terms of assets with a 25.9% market share and in terms of loans and with a 27.7% market share among public banks. In the financial system, it holds a market share of 3.3% in terms of assets and 2.7% in terms of loans.

COFIDE, as a development bank, provides financing through banks, municipal and rural financial institutions, credit unions, and entities specializing in financing small and midsize enterprises (SMEs). We believe COFIDE has adequate business stability because of its unique role in providing long-term financing

to infrastructure projects crucial to country's economic development. COFIDE also offers competitive and long-term financing to the SMEs in economic sectors that the government wants to promote. We expect COFIDE to offer its credit lines across new sectors such as forestry, health, sanitation, and education in the next few years. As of March 31, 2016, the bank's financing of infrastructure projects constituted about 82% of its lending exposures, while the remaining exposures are directed to SMEs. We expect this lending mix to remain stable for the next five years. Because of its narrow range of products, COFIDE's business diversity is lower than that of commercial banks that offer a wide range of products across different business segments. Nevertheless, COFIDE's management has a satisfactory track record of implementing operational policies. Although following the presidential election, COFIDE's board composition and senior management could change, we don't expect its strategy to change substantially, while Peru's infrastructure gap will continue to be an important issue for the new administration.

We view COFIDE's capital and earnings as adequate, with a projected risk-adjusted capital (RAC) ratio before diversification of 7.0%-7.5% for the next 12-18 months and good quality of capital and earnings, in our view. Its RAC ratio is weaker than its regulatory capital ratios (currently at 30.5% as of December 2015) mainly because of the bank's large equity exposure through its investments in CAF. We view this exposure as having higher risk weights under our capital methodology, in comparison with the regulator's methodology. Our base-case scenario forecasts Peru's GDP growth of 3.5% in 2016 and 3.8% in 2017 and loan growth of about 5% and 10%, respectively, slower than in previous years because we expect the new government to take some time to promote new infrastructure projects. We expect COFIDE's net interest margins to drop because of higher funding costs and unexpected pre-payments for some projects, slightly decreasing profitability in the next two years.

COFIDE's risk position is strong, reflecting our view that our RAC overestimates the bank's risks relative to its peers'. Although we believe that the bank's investments in CAF are an insufficient buffer against unexpected losses, we believe the government will provide capital to COFIDE that will offset any such losses. As a result, we offset part of the negative effect these investments have on the bank's capital position through the risk position.

In December 2014, the bank's nonperforming loans (NPLs) sharply increased because of a single exposure, Maple Etanol, which defaulted in December 2014. The exposure was later sold to a large group, and COFIDE was able to recover part of the loan. As of March 31, 2016, its NPL levels decreased to 0.88% from 2.51% in December 2014. They're currently lower than the industry average. COFIDE is exposed to single-name concentration, given the size of the infrastructure projects it funds. The bank's top 10 clients represented 73.3% of its total gross loan portfolio as of March 31, 2016, because of its status as a development bank. However, the ultimate loans are less concentrated. Loans for infrastructure projects are not guaranteed by the bank that transfers the funds, so the risk is associated with the project. However, the structure of these loans incorporates conservative overcollateralization,

which COFIDE and the funding bank closely analyze to make sure all risks are covered. The bank has a higher share of loans denominated in foreign currency (61%) than the industry average (31.6%). Nevertheless, infrastructure loans in foreign currency are only allocated to projects that generate revenues in foreign currency. In addition, the SME loans are typically very granular and short term, and the financial institution that distributes them guarantees repayment, mitigating the risk of default.

COFIDE's funding and liquidity are adequate. Although COFIDE, as a development bank, doesn't receive deposits, its financial flexibility benefits from the government's ongoing support. COFIDE's GRE status gives it ample flexibility to refinance, as seen in strong demand for its debt issuances. Although it receives higher-than-average external funding, we believe it has an adequate funding profile, given the long-term nature of the funding required for its loans. We expect the bank to continue matching tenors and currencies on its balance sheet to mitigate risks. As of Dec. 31, 2015, its funding consisted mainly of debt issuances in international capital markets (63%), loans from Peruvian commercial banks (14%), loans from international commercial banks (12%), debt from local capital markets (7%), and credit lines from multilateral organizations (4%). In addition, the bank has been issuing repos with the central bank in order to extend upcoming debt maturities. According to our methodology, the bank's stable funding ratio was 113.3% as of March 2016 and averaged 97.1% for the past three years.

We view COFIDE's liquidity as adequate. As of March 31, 2016, its broad liquid assets covered 1.86x its short-term wholesale funding. The fixed maturity terms of its funding support our assessment of its liquidity, coupled with the insusceptibility to acceleration. This provides the bank sufficient time to manage its liquidity risk. Moreover, COFIDE has an investment of PEN2.3 billion in CAF, which we consider illiquid because this type of share is only government-owned. However, we expect the government of Peru to purchase these shares in case COFIDE requires support.

The rating on COFIDE's subordinated notes is one notch lower than the bank's SACP, reflecting subordination risk. The bank's current capital position is under pressure, close to the 7% threshold, which we could change to moderate from adequate if we were to revise our BICRA assessment downwards or if our forecast assumptions don't materialize. In such a scenario, we could revise downward COFIDE's SACP to 'bbb-' and consequently lower COFIDE's subordinated notes to 'BB+'.

## **Outlook**

The stable outlook on COFIDE for the next 18-24 months reflects that on the sovereign, given our view of a high likelihood that the latter would provide extraordinary and timely support to the bank in the event of financial distress, in accordance with our criteria for GREs.

## Upside scenario

If COFIDE disposes its investments in CAF shares that would benefit its capital position, we would raise the bank's SACP because we apply high risk weights to this exposure under our capital analysis. Still, a higher credit rating would rely on a similar action on the sovereign.

## Downside scenario

We could lower the ratings in the next 18-24 months if the bank's SACP drops to 'bb+', but we don't expect such deterioration in its capital or risk position. Our current capital assessment is under pressure, close to the 7% threshold, which we could change to moderate from adequate if we revise our BICRA assessment downwards or if the bank posts weaker figures than in our projections. As such, we would lower SACP to 'bbb-' but the credit rating would remain unchanged. A downgrade is therefore unlikely without a prior downgrade on the sovereign.

## Ratings Score Snapshot

Issuer Credit Rating	BBB+/Stable/A-2
SACP	bbb
Anchor	bbb-
Business Position	Adequate (0)
Capital and Earnings	Adequate (0)
Risk Position	Strong (1)
Funding and Liquidity	Average and Adequate (0)
Support	0
GRE Support	+1
Additional Factors	0

## Related Criteria And Research

### Related Criteria

- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria - Financial Institutions - Banks: Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework, June 22, 2012
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Bank Capital Methodology and Assumptions, Dec. 6, 2010

- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Financial Institutions - Banks: Commercial Paper I: Banks, March 23, 2004

## **Ratings List**

Ratings Affirmed

Corporacion Financiera de Desarrollo S.A.

Counterparty Credit Rating	BBB+/Stable/A-2
Senior Unsecured	BBB+
Subordinated	BBB-

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at [www.standardandpoors.com](http://www.standardandpoors.com) for further information. Complete ratings information is available to subscribers of RatingsDirect at [www.globalcreditportal.com](http://www.globalcreditportal.com) and at [www.spcapitaliq.com](http://www.spcapitaliq.com). All ratings affected by this rating action can be found on the S&P Global Ratings public website at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column.

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