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Supranationals - Americas

Exposure risks to Venezuela vary, but strong buffers contain negative credit pressures

On 15 May, the Inter-American Development Bank (IADB, Aaa stable) announced that the government of Venezuela (C stable) had accrued missed payments of over 180 days. As a consequence the Bank placed Venezuela on non-accrual status, the first instance for an IADB-sovereign borrower receiving that designation since 2000-01. Two other multilateral development banks (MDBs) that operate in Latin America – Corporacion Andina de Fomento (CAF, Aa3 stable) and Fondo Latinoamericano de Reservas (FLAR, Aa2 stable) – have outstanding loans to Venezuela, which remain current. These three MDBs have varying degrees of exposure, but overall we consider that their capital and liquidity buffers would allow them to sustain a protracted period of non-payment or even some potential losses on loans to Venezuela with minimal impact on their credit profiles. We also believe that their preferred creditor status will help contain any potential losses.

» **Loan exposures to Venezuela vary.** Relative to their total loan book, FLAR is the most exposed as its loan to Venezuela, now valued at $436 million, was the only one on its balance sheet until earlier this year when it extended a $1 billion loan to Costa Rica. Meanwhile, Venezuela accounts for just 2.3% ($2 billion) and 13.9% ($3.3 billion) of total loans for the IADB and CAF, respectively.

» **Despite Venezuela's challenges, multilateral creditors maintain preferred creditor status with the sovereign.** Notwithstanding Venezuela's arrears with the IADB, all three institutions continue to enjoy preferred creditor status. Since October 2017, Venezuela has defaulted on several debt obligations with private sector creditors, but has made efforts to remain current with its multilateral creditors. While the IADB may now experience some losses on its exposure to Venezuela, we believe that the severity of these losses will be significantly lower than those that will be experienced by private creditors.

» **Non-payment is credit negative for the IADB but has a very limited impact on the bank's overall credit profile.** Venezuela's most recent arrears increase the IADB's nonpeforming loan (NPL) ratio to 0.8% (from 0.5%), which remains low relative to the Aaa-rated multilateral development bank (MDB) average of 1.6% in 2016. Liquidity would remain healthy even if these arrears were to accrue during the rest of 2018. Moreover, the IADB's capital adequacy mandate aims to ensure that the bank has sufficient equity to safeguard its Aaa rating during times of economic distress.

» **FLAR has strong buffers and new policies in place to partially mitigate credit pressures**. Venezuela its loan from FLAR due on 30 May. The Central Bank of Venezuela, the borrower, paid down part of the loan and obtained a new credit to roll over the remaining principal. By extending the maturity and amortizing principal repayment, the structure of the new loan will likely favor its repayment. The fund has strong buffers, including general reserves and loan-loss provisions, that provides shock absorption capacity from potential losses. We should also note that its exposure relative to the funds total assets is much smaller than relative to just its limited loan book, 7% compared to 30%, respectively.

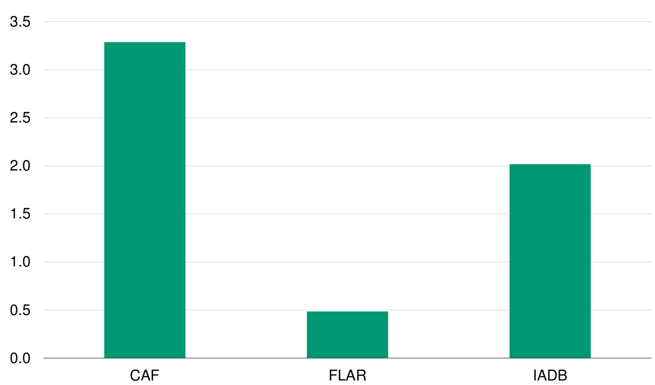
» **CAF's credit risk from Venezuela exposure is manageable and as the sovereign remains current on its loans**. Venezuela's debt service on CAF loans is manageable and has remained well under $500 million every year since 2011. In the event that Venezuela were not current on its repayments, NPLs would likely remain contained below 5% unless the sovereign remained delinquent on repayments for two-to-three years, at which point this would begin to weigh on CAF's large existing capital buffers and potentially on its creditworthiness. However, because Venezuela remains current on all obligations to CAF despite the severe external liquidity crunch the sovereign is experiencing, it is unlikely that CAF's loan book will be materially affected.

Loan exposures to Venezuela vary

As of December 2017, FLAR had the largest exposure to Venezuela in terms of its loan book as the $485 million loan was the only one outstanding at that point – this has changed in 2018 as the loan was paid down in May while a new, smaller loan was extended, as well as another $1 billion loan was disbursed to Costa Rica (Ba2 negative) in March, dropping Venezuela's share down to 30%. For CAF, Venezuela is one of its top borrowers at 13.9% ($3.3 billion) of total loans, close to Argentina (12.7%, B2 stable) and Ecuador (12.0%, B3 stable). For the IADB, Venezuela is a relatively small exposure ($2 billion or 2.3% of total loans) when compared with Mexico (17.7%, A3 stable) and Brazil (16.9%, Ba2 stable). Loans to Venezuela as a share of the total loan book have fallen steadily for both CAF and IADB. Reflecting its role as provider of external funding to countries experiencing severe balance of payment pressures, FLAR lent to Venezuela in 2016, for the first time since 1990.

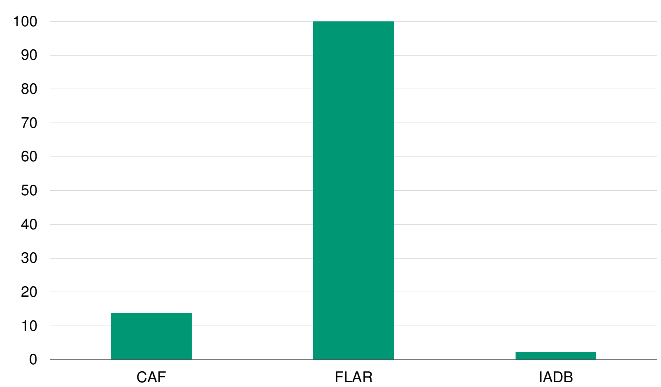
As a proportion of total assets, loans to Venezuela account for just 1.6%, 8% and 7.7% for the IADB, CAF and FLAR, respectively. Given that Venezula was FLAR's only loan, this points to the significant share that FLAR's treasury assets represent and the high degree of liquidity the entity maintains to fulfill its mission as a regional lender of last resort and reserve asset manager. Loss absorption capacity also varies, although the full exposure to Venezuela would not be deemed nonperforming at once and these MDBs do not write-off loans to sovereigns. For the IADB, loans to Venezuela account for about 6% of total equity. A full loss of loans to Venezuela for CAF would have a more significant effect on its equity, as its exposure is close to 30%. For FLAR, Venezuela represented 15% of equity.

Exhibit 1
CAF has the largest nominal exposure...
(Venezuela loans, $ billion, as of end-2017)



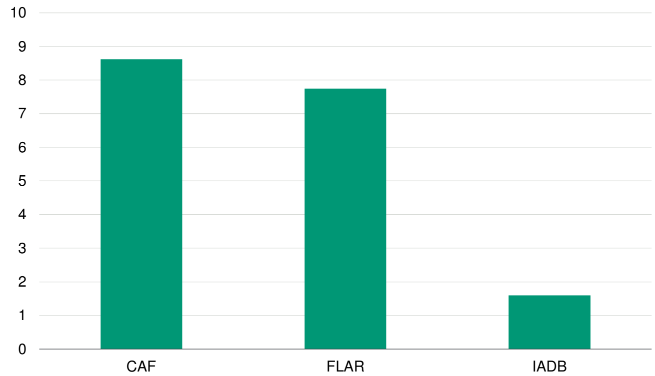
Sources: CAF, IADB, FLAR and Moody's Investors Service

Exhibit 2
but Venezuela represents the largest share of loans for FLAR
(Venezuela loans, % of gross loans, end-2017)



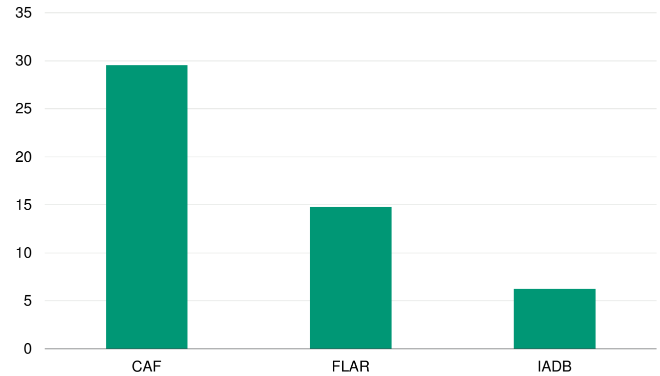
FLAR's exposure has declined to 30% of total loans as of June 2018.
Sources: CAF, IADB, FLAR and Moody's Investors Service

Exhibit 3
CAF and FLAR have similar exposures relative to total assets...
(Venezuela loans, % of total assets, end-2017)



Sources: CAF, IADB, FLAR and Moody's Investors Service

Exhibit 4
but Venezuela would be a higher burden on CAF's capital buffers
(Venezuela loans, % of total equity, end-2017)



Sources: CAF, IADB, FLAR and Moody's Investors Service

Despite Venezuela's challenges, multilateral creditors maintain preferred creditor status with the sovereign

Notwithstanding the fact that the government of Venezuela was unable to avoid running into arrears with the IADB past 180 days, we note that all three institutions continue to enjoy preferred creditor status relative to private sector creditors. Interestingly, even among multilateral creditors Venezuela seems to be prioritizing some over others. The sovereign remains current on its loans to CAF, while making partial repayments to FLAR on its large maturity last month – this was rolled over into a new loan operation – as well as to the IADB, which has not extended any new credits to the government. This also highlights the severity of Venezuela's liquidity crisis.

Since October 2017, Venezuela has defaulted on several debt obligations with private sector creditors, although it has remained current on some specific bonds due to certain conditions such as attachment risk. That said, the government has made efforts to remain current with its multilateral creditors. While we acknowledge that the IADB may now experience some losses on its exposure to Venezuela, we believe that the severity of these losses will be significantly lower than those that will be experienced by private creditors. Venezuela's C rating signals our view that losses to bondholders will be very high, most likely in excess of 65%. In contrast, historical evidence suggests that multilateral creditors tend to have much higher recovery rates than private creditors whenever there is a sovereign default because they do not restructure loans, and loss-given-default assumptions tend to be in the 0%-10% for these MDBs.[1]

Non-payment is credit negative for the IADB but has a very limited impact on the bank's credit profile

On 15 May, the IADB announced that Venezuela had missed payments on its loans for over 180 days. As a consequence, the bank placed Venezuela on non-accrual status, the first instance for an IADB-sovereign borrower to receive that designation since Suriname (B2 negative) in 2000-01. Venezuela's non-payment is a credit-negative development for the IADB but it has a very small impact on the bank's credit profile, as we consider it to have strong policies in place to ensure that this type of event does not materially affect its capital adequacy and liquidity metrics.

The IADB has specific guidelines for when sovereign-guaranteed exposures become nonperforming. As a matter of policy, the bank does not reschedule its sovereign-guaranteed loans. Additionally, the bank would take different actions depending on how long the sovereign has been nonperforming (see Exhibit 5). After a sovereign borrower is late beyond 180 days, the bank cannot undertake any lending activities with this borrower until its arrears are cleared.

Since being established in 1959, only five borrowing countries have been placed in non-accrual status by the IADB (see Exhibit 6). The maximum aggregate balance in non-accrual status had never exceeded 8% of total loans outstanding at the time. Panama (Baa2 positive) was in non-accrual status the longest at almost four years, while Peru (A3 stable) had the largest amount in non-accrual. We note that these episodes of non-accrual did not reflect issues of willingness to repay the IADB but rather these governments had ability to pay problems due to political and/or economic crises. The fact that Venezuela had payments overdue for more than 180 days with the IADB shows that its current liquidity position is very constrained, particularly as declining oil production has increased its cash flow stress.

Exhibit 5

IADB's treatment of non-performing sovereign-guaranteed loans

Days overdue	Action
30 days after loan due date	The Bank suspends disbursements on the loan in arrears and all other loans to the borrower. The Bank informs the guarantor of the arrears by the borrower and requests prompt payment of the amount in arrears. No loan contract with any borrower in the country in question is signed by the Bank and no loan proposal is approved.
120 days after loan due date	The Bank suspends disbursements on all loans to the guarantor and to other borrowers guaranteed by the same guarantor, if the guarantor fails to pay the amounts due.
180 days after loan due date	The Bank places in non-accrual status all loans for the country in question of which the government, the central bank or any government entity is a borrower or guarantor, unless it is determined that all payments of amounts in arrears are in process and will be collected in the immediate future. Placement in non-accrual status implies a reversal of all accrued income to date and no further income accumulation until all pending amounts are received. All Bank missions to the country intended for programming, preparing or processing of loans are suspended.

Source: IADB

Exhibit 6

IADB's prior instances of sovereign-guaranteed loans in non-accrual status
(Loans outstanding shown in US$ million)

Country	In Non-Accrual	Out of Non-Accrual[1]	Days	Maximum Outstanding Loan Balances[2]
Panama	29-Mar-88	18-Mar-92	1,450	$320
Nicaragua	11-May-88	17-Sep-91	1,224	$78
Peru	1-Mar-89	17-Sep-91	930	$674
Honduras	4-Dec-89	6-Jul-90	214	$223
Suriname	10-Nov-92	23-Dec-92	43	$12
Suriname	9-Nov-93	14-Feb-94	97	$13
Suriname	13-Dec-00	6-Jun-01	175	$27
Panama[3]	Mar-88	Mar-92	1,450	$198
Peru[3]	Feb-89	Feb-91	942	$267
Suriname[3]	Oct-93	Feb-94	123	$2
Suriname[3]	Dec-00	Jun-18	175	$2

[1] Repayment dates
[2] Maximum outstanding loan balances as of any given year-end during the period the country was in non-accrual
[3] Due to transfers of net assets from the FSO in 2017, countries that have been in non-accrual while the FSO had operations are included
Source: IADB

As of 14 May, Venezuela had $88.3 million in arrears over 180 days, while total arrears were $212.4 million. Although IADB's total loans to Venezuela amount to $2 billion, only the amount overdue ($212.4 million) would be considered nonperforming. Incorporating this amount to the IADB's stock of NPLs as of end-2017 would increase its NPL ratio to 0.8% from 0.5%, still a very small ratio compared to the Aaa-rated MDB average of 1.6% in 2016.

The IADB's capital adequacy mandate aims to ensure that the bank has sufficient equity to maintain its Aaa rating during times of economic distress. In October 2015, the IADB revised its Capital Adequacy Policy, and approved a revised Income Management Model (IMM). The IMM requires Bank Management to balance equity accumulation and lending growth so as to ensure that (i) accumulation of capital is "consistent with the Bank capital adequacy policy targets" and (ii) net interest income covers at least 90% of Ordinary Capital's administrative expenses (after considering 90% of non-sovereign guaranteed interest income) on a three-year rolling basis.

Although Venezuela's non-accrual status would have led to a reassessment of the probability of default assigned to this sovereign for the purposes of the capital adequacy position calculation, this remains very strong and well above the internal capital coverage ratio buffer zone, as was the case at end-2017.

Moreover, even if Venezuela's missed payments were to continue to accrue during the rest of 2018, the IADB's liquidity position is unlikely to be significantly affected. Over the course of the second to the fourth quarter of 2018, Venezuela will owe another $170.6

million in principal and $54.5 million in interest. This upcoming principal amount and the existing total arrears represent only 4.9% of total loan repayments in 2017. At this level, we would not expect IADB to alter its borrowing and lending programs for 2018.

FLAR has strong buffers and new policies in place to partially mitigate credit pressures

FLAR does not provide long-term financing to its members in its role as a regional financial arrangement rather than a development bank. Its main role is to act as a regional lender of last resort and as a provider of short-term liquidity support, although its relatively small size limits its scope. Additionally, FLAR's borrowers are the national central banks, not the central government as is the case for other MDBs. This is important in the case of Venezuela as the Central Bank's (CBV) operations do not fall under the purview of the national assembly, which in recent years – and after it became controlled by the opposition – deemed some borrowing operations by the sovereign illegal.

FLAR has only had one loan outstanding to Venezuela since 2016 – it had not provided financing to Venezuela since 1990. That operation was converted to a one-year liquidity support loan approved in May 2017, with an interest rate of 3-month LIBOR + 179 bps, and was due on 30 May 2018. Since its disbursement, the CBV had made all timely payments on interest and associated fees. At the time of maturity, Venezuela paid $48.5 million in principal as well as accrued interest and other fees for a total of $64 million.

Given Venezuela's current macroeconomic situation and its constrained external liquidity position, FLAR approved a new loan operation for $436 million that was used to amortize the maturing loan. We consider that this operation goes in line with FLAR's mission to provide liquidity in times of external stress. The amortization schedule is also more conservative than the previous loan as it requires a 10% principal payment at the end of the first and second years, and quarterly payments in the thrid and fourth years. The interest rate on the loan is 3 month LIBOR + 489 bps paid quarterly. We also note that following this new operation, and after FLAR disbursed a $1 billion loan to Costa Rica in March, its exposure to Venezuela fell to 30% of total loans from 100% at end-2017. Additionally, the new loan represents 88% of Venezuela's paid-in capital, compared to 99% before.

Central banks have historically paid back FLAR's loans in a timely manner, in some case even pre-paying their obligations to the fund, resulting in nil NPLs. As such, FLAR has an established track record of preferred creditor status with its member countries.

In October 2017, FLAR incorporated a new risk policy to protect its capital from potential losses stemming from its loan operations. FLAR will provision for potential losses based on: (1) the nominal exposure to the credit risk; (2) the probability of nonperformance; (3) the loss in case of non-accrual; (4) the foreign-currency credit rating of the borrower; and, (5) FLAR's de facto preferred creditor status. Based on these criteria, FLAR will charge an initial and then future credit risk fees on all its loans.

As of end 2017, FLAR's provisions for loan losses totaled $11.2 million, a relatively small amount compared to the full loan to Venezuela (2.3%). FLAR also maintains institutional reserves equal to 10% of total paid-in capital ($298 million) that would also provide additional coverage before a delay in payments affected its capital adequacy ratios. However, even if Venezuela were to delay repayment to FLAR beyond the 180-day grace period, the fund has a very strong capital buffer. Its ratio of equity over loans last year was 677%, among the highest of all MDBs – the Aa-median was 48% and the Aaa-median 32%.

In terms of liquidity, because FLAR does not have any debt a Venezuelan delayed repayment would not compromise debt servicing. As a deposit receiving entity, FLAR must ensure it has enough assets to cover any potential deposit outflows – FLAR's liquid assets were almost double its deposit liabilities by end-2017, providing ample coverage.

CAF's credit risk from Venezuela exposure is manageable and as the sovereign remains current on its loans

CAF has never recorded a sovereign loan nonperformance despite the low credit quality of some of its public sector borrowers. CAF's preferred creditor status ensures that debt owed to the bank is excluded from debt restructurings carried out by official debtors.

When Ecuador defaulted on two global bonds in 2008, it did not default on its debt owed to CAF. Both Ecuador and Peru (in the 1980s) remained current on their obligations to CAF even when they defaulted or were in arrears on their obligations to other MDBs, including the World Bank (IBRD, Aaa stable) and the IADB. As a result, CAF is not only a preferred creditor, but in practice has been a preferred creditor among MDBs.

This is partly a reflection of the strong sense of ownership among borrowing countries that serves as an incentive for them to fulfill their commitments to the institution. In this regard, Venezuela is one of CAF's three main shareholders (along with Peru and Colombia), owning 17% of the institution.

As of the date of this report, Venezuela remained current on all obligations to CAF, including interest and principal on debt service, and more importantly, on capital contributions in the context of the latest general capital increase program through 2031. Although from time to time Venezuela has been delayed with some scheduled interest payments on loans, the sovereign usually clears up the late payments within a matter of weeks if not days. The delays seem to be mainly related to operating issues, including challenges posed by US sanctions.

This highlights Venezuela's commitment to remaining current with the institution and a differential order of priority relative to other official creditors. Moreover, CAF has managed its exposure to Venezuela prudently so that there is little incentive for Venezuela to default on its payments to CAF. Venezuela's debt service on CAF loans is manageable and has remained well under $500 million every year since 2011. This amount is less than the yearly disbursements that the sovereign receives from CAF, resulting in a positive, net yearly flow of hard currency to Venezuela.

Similar to IADB, Venezuela would need to go over 180 days past due to be declared in non-accrual status. The total amount of the specific loan overdue would become non-performing rather than CAF's entire Venezuela portfolio. The accrual for interest on loans is discontinued at the time a loan is delinquent. In the event that Venezuela were not current on its repayments to CAF, NPLs would likely still be contained below 5% unless the sovereign remained delinquent on repayments for two-to-three years, at which point this would begin to weigh on CAF's large existing capital buffers and potentially on its creditworthiness. However, because Venezuela remains current on all obligations to CAF despite the severe external liquidity crunch the sovereign is experiencing, it is unlikely that CAF's loan book will be materially affected.

Moody's related publications

- **Credit Opinion**: CAF (Corporación Andina de Fomento) - Aa3 Stable: Regular update, 27 April 2018
- **Credit Opinion**: Government of Venezuela – C stable: Update following downgrade and change in outlook to stable, 9 March 2018
- **Credit Opinion**: Inter-American Development Bank – Aaa Stable: Regular update, 21 September 2017
- **Credit Opinion**: Fondo Latinoamericano de Reservas (FLAR) – Aa2 Stable: Regular update, 31 August 2017
- **Issuer in-Depth**: Venezuela's Debt Default, 23 February 2018
- **Issuer Comment**: Declining Oil Production Increases Cashflow Stress for the Government, 7 February 2018
- **Issuer Comment**: Venezuela's new exchange rate policy will not address macroeconomic imbalances or improve debt service capacity, 5 February 2018
- **Issuer in-Depth**: Restructuring ranks among the largest sovereign defaults ever and is more complicated, 29 November 2017
- **Outlook**: Sovereigns – Latin America and the Caribbean: 2018 outlook stable as growth momentum offsets rising debt and policy uncertainty, 9 January 2018
- **Rating Methodology**: Multilateral Development Banks and Other Supranational Entities, 29 March 2017

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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Endnotes

1 In contrast debt relief from bilateral creditors and associated institutions involving government-to-government lending, like the Paris Club, tends to be even higher than in sovereign restructurings involving private creditors.

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