Research Update:

Black Sea Trade and Development Bank Placed On CreditWatch Negative On Challenges To Funding Profile

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Overview

- We believe the funding access of Black Sea Trade and Development Bank (BSTDB) is constrained ahead of its $420 million Eurobond redemption in less than 12 months.
- If necessary, we would expect the bank to use its ample liquidity to repay the bond, but limited funding sources could constrain the bank's lending capacity and pressure its liquidity position.
- At the same time, most shareholders subscribed to the capital replenishment program in January 2023, which added about €205 million in paid in capital until 2030 and illustrates ongoing support for the bank.
- We therefore placed our 'A-' long-term issuer credit and issue ratings on BSTDB and its debt on CreditWatch with negative implications and affirmed our 'A-2' short-term rating.

Rating Action

On July 26, 2023, S&P Global Ratings placed its 'A-' long-term issuer credit rating on Greece-headquartered Black Sea Trade and Development Bank (BSTDB) on CreditWatch with negative implications and affirmed the 'A-2' short-term issuer credit rating. We also placed the 'A-' issue rating on its debt facilities on CreditWatch with negative implications.

CreditWatch

The CreditWatch placement reflects our view that we could lower our ratings on BSTDB in the coming months if its access to funding markets does not normalize well ahead of its June 2024 Eurobond maturity, resulting in a depletion of liquidity reserves, or raising concerns over its public policy role.

In addition, pressure on the rating could also arise over the medium term if:

- Further pressure on the bank's asset quality occurred, so that its capital positioned weakened, and our risk-adjusted capital (RAC) ratio fell below 15%.
- BSTDB's shareholders lessened their supportive stance toward the bank, for example by not following through on the ongoing capital replenishment program, prompting concerns about the bank's strategic role and shareholder backing.

Rationale

BSTDB is currently experiencing restricted access to funding markets, with any potential issuance likely carrying a high premium. The negative CreditWatch reflects our concerns that the bank's challenges to its funding profile could worsen liquidity pressures ahead of its large Eurobond maturity, or lead to an extended period of subdued lending, raising questions about its longer-term policy importance. At present, liquidity sources are ample and new disbursements are limited. This avoids near-term liquidity pressures and we expect the bank's liquidity buffers to cope with near-term loan payment deferrals and strained access to global financing markets. However, the market access constraints may no longer be compatible with an 'A-' rating.

We estimate that BSTDB has €630 million of its own liquidity, about 75% of which comprises free cash or short-dated securities. In addition, the bank has secured €30 million in a credit facility with Development Bank of Austria earmarked for Ukraine and green investments. BSTDB has €110 million of debt (bonds and bilateral loans) due in the remainder of 2023, and €427 million in 2024. As of June 30, 2023, our estimated 12-month liquidity ratio was 1.2x (including scheduled loan disbursements), while the six-month ratio was 3.15x. We are monitoring BSTDB's liquidity coverage and market access closely ahead of its $420 million Eurobond maturity in June 2024. The initial amount outstanding of the Eurobond was $550 million, but the bank repurchased $130 million in June 2023, and that somewhat reduced the refinancing risk.

In addition to potential liquidity stress, we believe a prolonged period away from capital markets could alter BSTDB's policy role. As part of the medium-term strategy for 2023-2026, the bank plans to reign in lending activity for the first two years to safeguard capital and liquidity during a period of stress. We consider this as prudent in the current environment, but also see a risk of diminishing policy importance if it limits lending longer than initially planned. More specifically, the bank expects its portfolio to contract until June 2024 to focus on financial stability. Any new lending will likely be smaller in size, and focus on the less wealthy shareholder countries, such as Ukraine. In Phase 2 (2025-2026) of the medium-term strategy, the bank will again target growth, albeit likely at a slower pace than before the war.

External risks halted the expansion agenda and strong lending growth that BSTDB enjoyed over the four years prior to the conflict. Over that period, its continued profitability and stronger mandate fulfilment led to its shareholders' unanimous agreement to start a capital replenishment program in October 2021. However, we expect near-term consolidation of its loan book, in line with the strategy, because new disbursements are very limited, and new lending to Russia is suspended, which we anticipate will remain the case until the conflict ends and international sanctions on Russia are relaxed.

BSTDB's shareholders have demonstrated their support to the bank by approving the capital replenishment program. Following a four-month delay, the subscription period for the capital subscription program closed on Jan. 31, 2023. We understand that almost all shareholders subscribed at least according to their pro rata ownership, with two shareholders oversubscribing, and one of the smaller shareholders refraining from participating. We understand that shares have so far been allocated to the shareholders that qualify without regulatory concerns. The final transfer of voting rights will take place upon the shareholders' submission of promissory notes for all future instalments. However, any member that misses an annual cash instalment will be penalized through a pro rata reduction of the voting rights already granted.

Although we understand that Russia has expressed its willingness to participate in the capital increase, our expectation remains that the sanctions imposed on it will prohibit it from taking part. This would dilute Russia's ownership stake to less than 13%, versus the current 16.5%. The final decision of the allocation of shares will likely be decided in the third quarter of 2023, a slight delay from the initial time slated for the annual general meeting in July 2023.

That the shareholders subscribed to the capital subscription program represents, in our view, an important step in confirming BSTDB's policy relevance. In particular, we believe this demonstrates the shareholders' long-term commitment in the current geopolitical environment and limited new disbursements expected for the coming two years. In the near term, it will be crucial that the shareholders confirm their commitment for the bank to restore capital market confidence and regain functional access to funding markets. Capital has yet to be paid and hence some uncertainty remains about BSTDB's completion of its capital-raising exercise. We understand that the letters of subscription represent a commitment by the shareholders, but that final submission of promissory notes needs to go through decision processes at each shareholder's level.

We believe that BTSDB's capital position has proven more resilient than feared at the start of the military incursion. We estimate BSTDB's RAC ratio at 20.6% using balance-sheet exposures as of Dec. 31, 2022, but also more recent parameters such as sovereign ratings and Banking Industry Country Risk Assessments as of July 10, 2023. This ratio is up from 19.1% on Dec. 31, 2021, primarily reflecting consolidation of the lending book.

We believe the bank will lean on its liquidity and capital buffers to navigate the near-term fallout from any loan payment disruption and temporarily strained capital market access. BSTDB furthermore benefits from the solid monitoring processes of its lending counterparts, as illustrated during the pandemic, which only led to a mild impact on asset quality. We believe this is continuing also in the current stressed environment, with regular reporting from its borrowers. BSTDB makes use of several risk-sharing mechanisms, such as public-sector guarantees and lending via intermediating financial institutions, through which the bank conducts all its lending to small and midsize enterprises. These, along with the increasing share of public-sector loans before the conflict, provide some cushion to prevent abrupt declines in capital.

Still, a prolonged conflict could pressure the bank's asset quality and liquidity flows beyond what we currently expect, given that about 30% of its loans are to borrowers in Russia and Ukraine. We estimate that in a stress scenario with a significant write-down of BSTDB's exposures in Russia and Ukraine, the RAC ratio could fall below 15%, signalling erosion of the bank's capital to a level not commensurate with the current rating.

BSTDB's lending exposures in Ukraine face the most acute risk of credit deterioration, in our view. As of Dec. 31, 2022, loans to Ukraine represented about 13% of total lending. Nevertheless, we understand that so far the majority of its clients are current on their obligations and are operating without material disruptions. About one-third of the clients have received approval for payment deferrals, but the remainder are current on their obligations. In 2022, the bank received about 60% of scheduled payments due from Ukraine exposures, and as of May 31, 2023, about

40% of payments due. One operation, a wind power plant near Crimea (corresponding to about 9% of the Ukraine portfolio and less than 1% of the total portfolio) has been forced to cease operations fully because of severe damage to its operations. That said, we still see a risk of further deterioration and nonperforming loans (NPLs) in the Ukraine portfolio if the conflict is prolonged, and we see a risk of further uptick in provisions by year-end 2023.

We consider Russian borrowers' technical ability to service loans to be the key short-term liquidity risk for BSTDB, rather than an imminent drop in their credit standing. We note that significant portions of BSTDB's overall lending exposures in Russia are to, or are closely linked to, the public-sector and related companies, which we believe indicates the resilience of their financial standing. Also, we understand that they have the financial ability to pay BSTDB but are hindered by the lengthy processes to gain specific approval from Russian authorities required for all borrowers paying from Russia to make transfers to the EU.

We understand that the Russian government has explicitly reiterated its intention to respect BSTDB's MLI status. The commitments that shareholders subscribe to in the articles of agreement mean that the bank would be less likely to be subject to imposed restrictions, for example capital controls. We consider this important, also considering that parts of BSTDB's lending in Russia are conducted in hard currency.

Even so, payment flows from Russian counterparties experience delays. This is because Russian borrowers need to be granted a specific license from Russian authorities to make cross-border payments, but also because the intermediating commercial banks, domiciled in the EU, U.S., and the U.K., are required to seek regulatory approval to execute the transactions. About 75% of BSTDB's Russian borrowers are currently under the sanction regimes introduced by the U.S., EU, and the U.K., which further complicates the transaction process. We understand that progress has been made and that most borrowers have received licenses so that payment flows can feed into BSTDB's accounts. However, the licences are typically issued on a limited time frame and therefore we see risks of delays continuing.

Provisions and credit-impaired exposures are rising as a consequence of the war, but from low levels. In line with International Financial Reporting Standard 9, BSTDB recorded a sizable uptick in provisions, as it did in 2022. About 56% of its loans to borrowers in Ukraine were recognized as Stage 3 loans, while the Russian exposures were primarily classified as Stage 2. The provisions for impaired loans amounted to €68 million, more than doubling the amount already on the balance sheet. This was partly absorbed by continued positive income before impairments of €40.4 million (up from €29.6 million in 2021), leading to a total drain on capital of €27.6 million.

Even though impairments have markedly increased, in line with our expectations, we note that very few loan exposures have turned nonperforming. As of June 30, 2023, three operations were classified as NPLs by the bank, corresponding to about 5.6% of total exposures, up from no exposure overdue more than 90 days as of June 30, 2022. Two exposures in Russia are classified as NPLs, primarily because of issues receiving licences to pay from Russian authorities. In particular, the lending exposures in Ukraine continue to exhibit performing credit characteristics, with the exception of the above-mentioned wind power plant near Crimea. Still, we understand that about one-third of the clients in Ukraine have received approval for payment deferrals, and if these are included in the overall NPL ratio it increases to about 13%. We note that this is somewhat higher than other private-sector-focused peers but believe this is primarily a reflection of the current situation and BSTDB's area of operation, rather than a structural feature reflective of BSTDB's risk management and general loan performance. Importantly, the bank is coming from a strong position with no NPLs before the war.

The conflict is having a macroeconomic impact on the Black Sea region, which could lead to asset quality concerns in its wider portfolio beyond Russia and Ukraine. This exacerbates the risk for BSTDB from operating in this region, which already had pockets of economic distress. One example is Turkey, which is home to 22% of the bank's outstanding loans and where we assess economic policy developments will push inflation to about 44% in 2023, with a highly uncertain growth trajectory. That said, we understand that there is no major pressure so far in the other regions of operations, and no NPLs outside Russia and Ukraine as of June 30, 2023.

BSTDB's private-sector-focused mandate precludes it from being treated as a preferred creditor. We therefore do not incorporate preferred creditor treatment in our assessment of the bank's enterprise risk profile.

The ratings on BSTDB do not reflect potential extraordinary support from shareholder. This is because we rate all of BSTDB's sovereign shareholders lower than the bank. In addition, our view of the bank's moderate policy importance precludes the notion of callable capital support.

Ratings Score Snapshot

Issuer credit rating	A-/Watch Neg/A-2
Stand-alone credit profile	a-
Enterprise risk profile:	Moderate
Policy importance	Moderate
Governance and management expertise	Adequate
Financial risk profile:	Very Strong
Capital adequacy	Very Strong
Funding and liquidity	Strong
Extraordinary support	0
Callable capital:	0
Group support:	0
Holistic approach	0

Related Criteria

- Criteria | Governments | General: Multilateral Lending Institutions And Other Supranational Institutions Ratings Methodology , Jan. 31, 2022
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings , Oct. 10, 2021
- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology , July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- General Criteria: Principles Of Credit Ratings , Feb. 16, 2011

Ratings List

Ratings Affirmed; CreditWatch Action

	To	From
Black Sea Trade and Development Bank		
Sovereign Credit Rating		
Foreign Currency	A-/Watch Neg/A-2	A-/Negative/A-2
Black Sea Trade and Development Bank		
Senior Unsecured	A-/Watch Neg	A-