
RATING PERSPECTIVE

Corporación Andina de Fomento (CAF): Rating rationale and political and economic risks of Andean region

Corporación Andina de Fomento (long-term senior debts: AA-) started its operation in 1970 for the purpose of assisting economic and social development in five Andean countries (Bolivia, Colombia, Ecuador, Peru and Venezuela), which spread from the north to the middle of the South American Continent. As one of few long-term fund providers in the region, CAF provided 54% of the total loans made available to the region by Multilateral Development Banks (MDBs) in the last five years. JCR's rating reflects CAF's strong support from its shareholder countries as exemplified by their repeated capital contributions in the past and its maintenance of a preferential creditor status over a long period. It is also supported by CAF's extremely sound fiscal position backed by its strong capital base, no default records in the public sector in the past and improving loan-portfolio quality and profit stability for long years. CAF's creditworthiness has been endorsed by the fact that it has been operating without any serious problems and successful in raising funds in the international capital markets even during the periods of economic and political difficulties in the Andean region. On the other hand, the rating is constrained mainly by the political and economic risks inherent in the Andean countries. This report reviews the rationale behind the rating and analyzes the political and economic situations in the Andean countries, which are CAF's major shareholders as well as main borrowers.

1. Rationale behind CAF rating

1.1 Strong support from shareholder countries and preferential creditor status

CAF's shareholders consist of regional and non-regional funding countries and some private financial institutions. At the end of June 2006, the five Andean countries together held 89.0% of its stocks on a paid-in capital basis, with the remaining 11.0% held by 11 non-regional member countries, including Brazil, Mexico and Spain (which joined CAF in 2002), and 16 private banks in the region. Its capital has been increased continuously since its inception. During the economic crisis in the Latin American region, no member countries seceded or withdrew their capital. Even when Venezuela and Ecuador defaulted on some of their loans in 1998 and 1999, respectively, they continued repaying their debt to CAF. To date, CAF has reported not a single case of sovereign debt default. These facts tell why CAF has been able to maintain its preferred creditor status since its foundation.

1.2 Sound financial records

As an MDB, CAF pursues a prudent financial management policy in line with its internal guidelines. It holds the outstanding balance of loans, guarantees and equity invest-

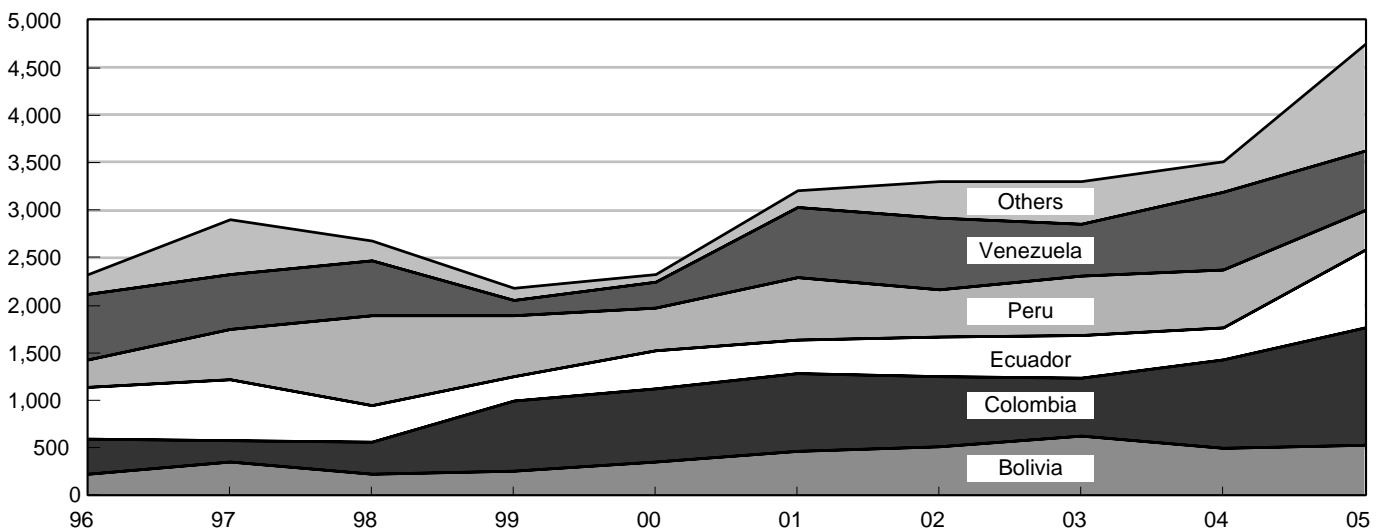
ments below an upper limit four times its shareholders' equity. The ratio stood at 2.2 times at the end of June 2006. The upper limit on loans to any regional shareholder country is either 30% of the total loan portfolio or 100% of the country's equity stake. The balance of financial liabilities is limited to 3.5 times the shareholders' equity. The ratio stood at 1.8 times at the end of June 2006. The amount of liquid assets is required to be kept higher than 45% of the total undisbursed loan commitments or higher than 35% of the total sum of estimated debt service payments and estimated loan disbursements over the next twelve months. These ratios stood at 108.9% and 63.7%, respectively, at the same date. The guidelines require CAF to invest at least 80% of its total liquid assets in investment grade instruments. The ratio was 93.2% at the same date. Its equity participation in any single company in a regional shareholder country is limited to 1% of the total shareholders' equity. It is not allowed to become the biggest single shareholder in a company. Moreover, the total amount of its equity investments cannot exceed 10% of the total shareholders' equity. The ratio was 2.8% at the end of June. The outstanding balance of credit guarantees is limited to 20% of the total shareholders' equity. The ratio was 6.3% at the end of 2005. CAF's asset-liability management is also sound and conservative. Interest rate and currency risks are properly hedged by swapping fixed-rate loans and bonds denominated in currencies other than U.S. dollar for floating-rate instruments denominated in U.S. dollar. Residual maturities of assets and liabilities are also adjusted to minimize their mismatch. The average term of financial assets was 3.86 years and that of financial liabilities was 4.03 years as of the end of 2005. Like other MDBs, CAF is not a profit-oriented institution. However, thanks to the strong support from the member countries and its conservative financial operations, CAF has continued to report a profit every year since 1973. Its profitability has been kept stable, with its internal annual profit targets achieved over a long period in the past. In 2005, CAF posted US\$283.2 million in net income, up 36.3% over the year before, on an increased loan balance, bigger interest income amid higher interest rates and reduced loan-loss allowances. In the first half of 2006, net income increased 25.1% to US\$186.7 million. A comparison of main fiscal indicators tells that CAF has a much sounder fiscal structure than other MDBs. It keeps the balance of financial liabilities lower vis-a-vis its paid-in capital or total assets. Its non-performing loan ratio is extremely low. It holds the administration cost lower and keeps the profitability higher.

Exhibit 1. Comparison of main fiscal indicators with other multilateral financial institutions (2005)

	Corporación Andina de Fomento (CAF)	Central American Bank for Economic Integration (CABEI)	International Bank for Reconstruction and Development (IBRD)	Inter-American Development Bank (IDB)
Rating		AA-	A	AAA
Paid-in capital/Total assets		33.8%	20.0%	17.1%
Loan outstanding/Paid-in capital		2.2	2.1	2.7
Financial debt/Paid-in		1.8	1.3	2.6
Non-performing loan ratio		0.0%	0.9%	3.4%
Provisions for loan loss/Loan asset		2.2%	4.0%	0.5%
Interest coverage ratio		2.1	1.5	2.3
Administration cost/Total assets		0.2%	0.1%	0.4%
ROA		3.0%	0.8%	1.7%
ROE		9.4%	4.0%	10.3%

Sources: Annual reports of CAF, CABEI, IBRD and IDB (2005)

Exhibit 2. Approval of lending (US\$ mn)



Source: CAF Annual Reports

1.3 CAF continued operations even during regional economic crisis

Despite the economic difficulties that hit the regional member countries in the past, CAF has always kept quality of its assets at extremely good levels. In particular, CAF has never suffered arrears longer than 180 days on payment of interest and principal with regard to public-sector loans. As a result, it has not written off any of its public-sector loans, a clear indication of the strength of its preferred creditor status. Non-performing private-sector loans as a percentage of the total loan portfolio decreased from 0.28% at the end of 2004 to 0.02 % at the end of 2005. The loan-loss reserve ratio was adequately high at 2.2% at the end of 2005. The outstanding loan balance stood at US\$7.35 billion as of the same date, up 3.4% year-on-year, which was the largest among MDBs in the region. CAF accounted for 54% of the total loan commitments made by MDBs in the region between 2001 and 2005. As of the end of 2005, CAF made as much as 94.0% of its total loans to the five Andean member countries, a considerably

high concentration. However, its country risks will be diversified in the medium term since demand for funds is expected to increase in non-regional member countries such as Brazil. By sector, 88.8% of CAF loans went to the public sector and the remaining 11.2% to the private sector. Its exposure to the private sector is relatively low as compared with those of other MDBs. By industry, the biggest share of 42.2% was made available to infrastructure development such as transportation and telecommunications, 29.7% to social development, 10.9% to structural reforms and 10.6% in the form of loans arranged by financial institutions. A breakdown of the loan commitments made in 2006 (Exhibit 2) indicates that demand for funds from non-regional countries was increasing in the light of economic integration of the South America and that a growing volume of loans was being made to the private sector, centering on those funneled through financial institutions to finance the development of small- and medium-sized enterprises. Loan portfolio risks have been diminishing amid favorable economic

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growth in the region. According to CAF's internal credit risk rating, 98% of its loans are classified as "satisfactory."

2. Political and Economic risks in the Andean region

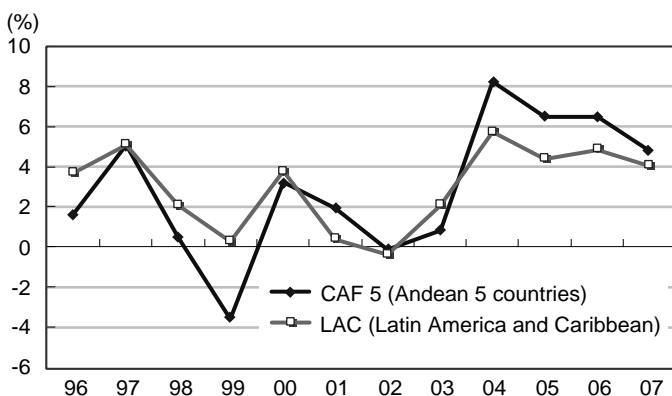
As seen above, CAF as an MDB keeps its fiscal position quite sound. However, its creditworthiness is constrained by political and economic risks inherent in the Andean countries* which together contribute a dominant 89% of CAF's paid-in capital and are its main borrowers as well. The Andean region has a combined population of 122 million (22.2% of the total population of the Latin American and Caribbean countries and almost equal to that of Japan). Its total land area is 4.7 million square kilometers, 12 times as big as Japan. Its nominal GDP is US\$ 38.7 billion (15.6% of LAC's and 10% of Japan's). Per-capita GDP (in PPP terms) is US\$5,714, which is lower than the average of LAC (US\$7,142). Most of the countries in the region abound in natural resources and benefit most among the LAC countries from the ongoing high commodity prices. On the political front, three of the five countries elected a leftist in their presidential election in 2006. In those countries, the new governments have been trying to nationalize the energy sector or restructure the public debt, steps that could have some negative impact on the inflow of foreign direct investment. Some of those left-wing governments heavily rely on volatile oil- and gas-related revenues and tend to boost spending on social welfare when they have bigger revenues. It should be noted that these policies can make their future fiscal position uncertain. This section reviews the macroeconomic and fiscal situations in the Andean countries and analyzes their inherent political and economic risks.

* In this report, the Andean countries (region) mean five countries; Bolivia, Colombia, Ecuador, Peru and Venezuela. Venezuela withdrew from the Andean Community (CAN) in April, 2006. However, it remains a member of CAF.

2.1 Macroeconomic situation

The region registered an annual average economic growth

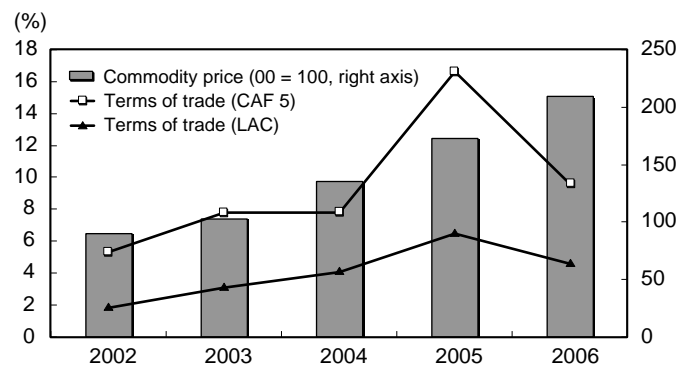
Exhibit 3. Growth rate in CAF 5 has been higher than the average of LAC countries since 2004



Source: EIU

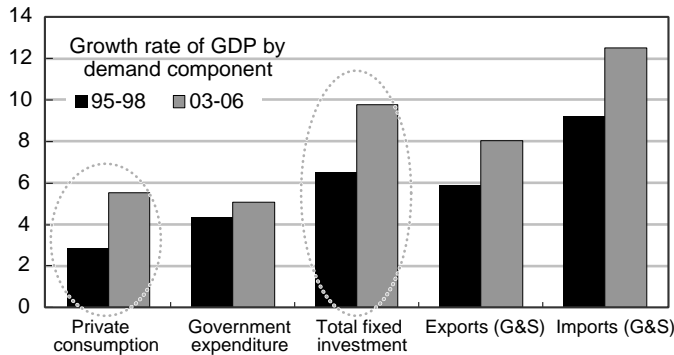
rate of 5.0%, higher than that of the LAC average, for three consecutive years from 2004. The trend remained the same in the last decade. Among GDP components, private consumption has been rapidly expanding since 2004. There have been marked increases in the volume of foreign direct investment inflows into Colombia and Peru. The main factor behind the rapid economic growth is the surge of primary commodity prices (crude oil, natural gas, minerals and agriculture products), which are the main export items from the region. At the same time, the terms of trade have considerably improved, leading to a rapid increase in the trade surplus. As in other LAC countries, an increased transfer account surplus mainly stemming from bigger remittances by migrant workers is greatly contributing to the expansion of the current account surplus and private consumption. The inflation rate, a longstanding problem in the region, has fallen to a historical low (5.5% in 2006) except for Venezuela, which has been posting about 16% amid escalated government expenditures. The average unemployment rate also declined from 11.8% in 2003 to 9.3% in 2006. The stable inflation rate despite the surging commodity prices may mean that the monetary policies taken by the Andean countries have gained in credibility. The external debt as a percentage of both exports and GDP has been on the constant decline. The average non-performing loan ratio of the financial institutions in the entire Latin American region has declined to 4.4%. Foreign currency reserves have also been on the increase thanks to a growing current account surplus. The Andean economy may somewhat slow down in 2007 due to possible deceleration of the U.S. economy. But such impact would not be significant since exports from the region are less dependent on the U.S. market than those from other LAC countries. A favorable expansion of the Andean economy is expected to continue in this situation. The commodity prices, which have the biggest impact on the regional economy, may modestly dip in 2007 onward. But the volume of exports will not be much affected amid continuing global demand growth.

Exhibit 4. Improving terms of trade amid commodity price hike



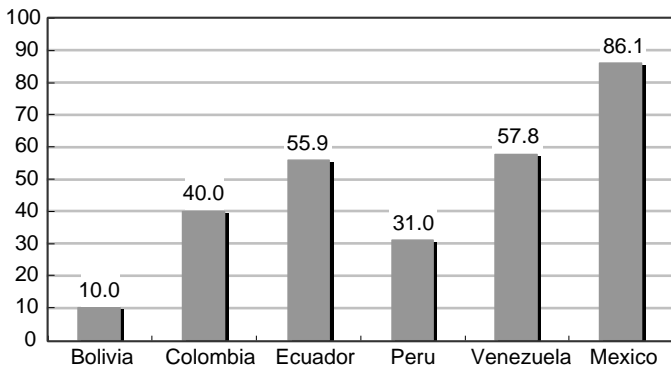
Source: EIU

Exhibit 5. Private consumption and total fixed investment have been rapidly increasing



Source: EIU

Exhibit 7. Exports to US/Total exports (%), 2005

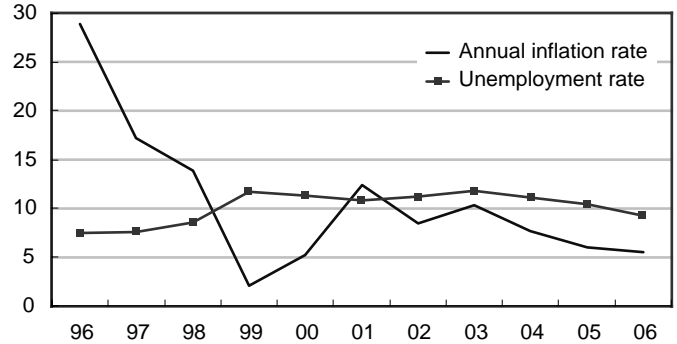


Source: EIU

2.2 Fiscal balance turned favorable, public debt reduced significantly

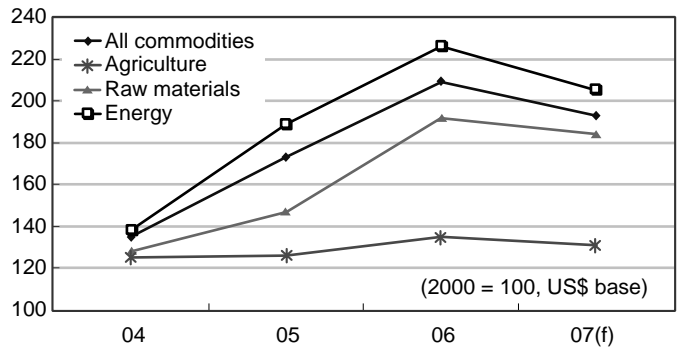
The fiscal balance has been improving in each of the Andean countries thanks to increasing revenues. The five countries as a whole have been registering an annual primary balance surplus since 2003. This has added to the flexibility of their fiscal position. However, the degree of fiscal stability varies among the countries depending on their reliance on oil-related income. Ecuador, Venezuela and Bolivia heavily rely on oil- and gas-related revenues. Rapid oil price fluctuations could deteriorate their fiscal balance. Attention needs to be paid, in particular, to Venezuela. While benefiting from the biggest revenue growth among the three countries, it has been spending more on social welfare. In 2006, Venezuela posted a central government budget deficit equivalent to an estimated 0.6% of GDP. On the other hand, Colombia depends on oil-related income for only 3.6% of its total budget revenues. It has structured a stable revenue base by implementing tax reforms. Seen from the viewpoint of expenditures, Ecuador, Venezuela and Bolivia have one feature in common. In recent years, they have managed to keep a fiscal balance by having bigger spending for the poor counterbalanced by even bigger revenues. In contrast, Peru where the

Exhibit 6. Inflation rate and unemployment rate have been improved (CAF 5 average)



Source: EIU

Exhibit 8. Commodity price seems downward but stay as high as 2005



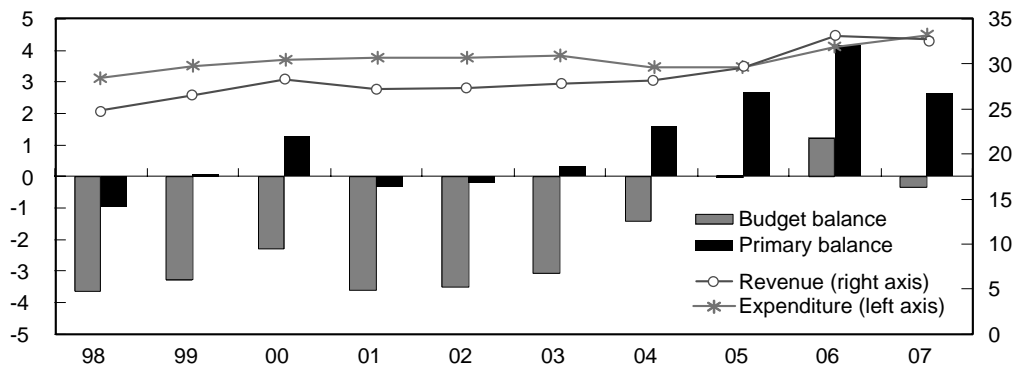
Source: Association of European Conjunction Institutes

left-wing presidential candidate was defeated in a runoff in April 2006 has kept its fiscal structure balanced through years of efforts to cut spending rather than increasing revenues. The Peruvian government is expected to stick to a similar fiscal management style in the future.

The public debt in the Andean countries has been on the steady downtrend. In terms of the debt/GDP ratio, all countries except Bolivia have been outperforming the LAC average. Bolivia could substantially reduce its debt under the World Bank-led Multilateral Debt Reduction Initiative (MDRI). However, whether it will continue to do so remains to be seen as the present government is unclear about its future debt reduction plan. Ecuador used to reduce its debt on the back of increased revenues centering on oil-related income. However, President Rafael Correa who took office in January 2007 may possibly change this policy. The president has pledged to give greater priority on poverty alleviation than on debt reduction and indicated that his administration might restructure part of the country's public debt, if necessary. However, considering its solid relationship with CAF, the country may not include CAF loans in its possible debt restructuring program.

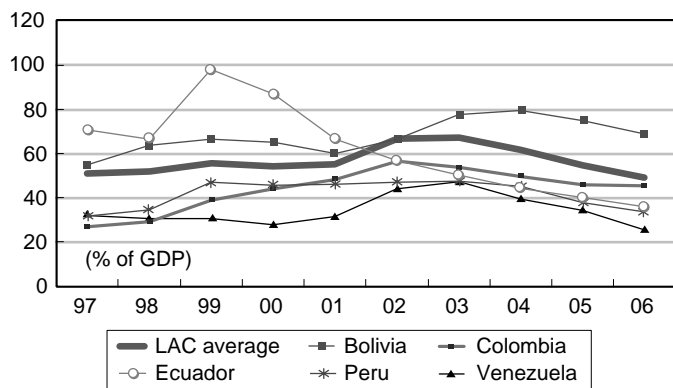
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Exhibit 9. Fiscal position of CAF 5 countries (% of GDP, Average of five countries)



Source: Ministry of finance, CAF 5

Exhibit 10. Public debt outstanding (% of GDP) is lower than the LAC average, except for Bolivia



Sources: Ministry of Finance, CAF 5 and LAC

2.3 Political and economic risks in the region and their outlook

The Andean region is more stable now than in the past thanks to a favorable economic expansion and improving fiscal position. However, there still exist some risks as mentioned below.

- a. Exports mainly consist of primary commodities, which are vulnerable to price drops, deterioration of weather conditions and deceleration of external demand.

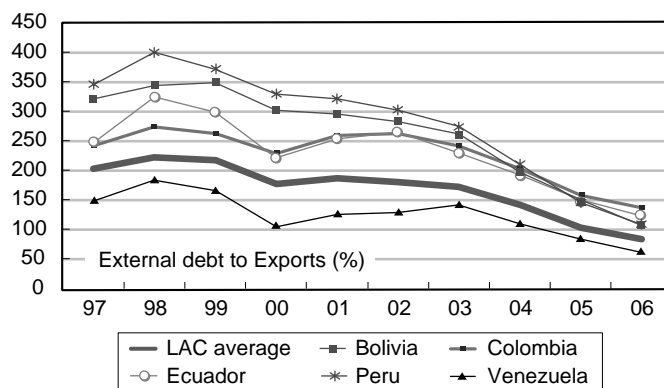
Exhibit 12. Share of main commodities in total exports

Bolivia	Colombia	Ecuador	Peru	Venezuela
80.1%	49.3%	75%	74.4%	86.8%

Sources: JETRO, Ministry of Foreign Affairs for Bolivia

As Exhibit 8 indicates, commodity prices are likely to stay pegged at high levels though they may somewhat slacken in 2007. Such a trend might not have a serious impact on the regional economy for the present. In the longer term, however, the regional countries need to transform their industrial structure.

Exhibit 11. External debts continue to decline



Source: EIU

b. Inflation rate remains high in Venezuela

Venezuela is the only country in the region that annually continues recording a double-digit inflation rate. It primarily relies on price control without setting an inflation target. The system has brought about some problems. Differentials in inflation rates are widening between goods under price control and those not under price control. At the same time, goods whose prices are not controlled are becoming less competitive against imported goods due to the accelerating inflation rate.

- c. Overloaded fiscal expenditures and excessive market intervention under the left-wing administration may have negative impact on the economy.

Exhibit 13. Negative impact of the left-wing administration on the economy.

Bolivia	Colombia	Ecuador	Peru	Venezuela
✓		✓		✓

In the presidential election held in 2006, Venezuelan President Hugo Chavez won another six-year term of office. In

Bolivia, Mr. Evo Morales, the champion of the lower-income indigenous people in the north, was elected president. A left-wing government has been also established in Ecuador. New Ecuadorian President Correa is a left-wing economist, who resigned as economics minister under the former administration of President Alfredo Palacio after launching an economic policy that drew vehement objection from neo-liberalists. Both Venezuela and Bolivia are pushing ahead with nationalization of their key industries. Bolivia and Ecuador are politically unstable over the proposed amendment of the Constitution. President Correa has implied that his administration might seek to restructure the country's public debt. How these moves will evolve needs to be closely watched.


Exhibit 14. Main fiscal indicators: Corporación Andina de Fomento

(US\$ mn)

		2001	2002	2003	2004	2005
Total Assets		6,805	7,584	8,818	9,586	9,541
Total lending		5,455	6,062	6,597	7,104	7,347
Provisions for loan losses		177	196	210	182	162
Net lending		5,278	5,866	6,387	6,922	7,185
Authorized capital		2,500	5,000	5,000	5,000	5,000
Subscribed capital		1,985	2,083	2,431	2,611	2,794
Callable capital		912	912	1,112	1,112	1,112
Paid-in capital		1,073	1,171	1,319	1,499	1,682
General reserves		555	644	753	866	1,033
Net profit		97	127	134	208	283
(Statutory ratio)						
Sharholders' equity/Total assets	%	27.8	27.1	27.0	29.1	33.8
BIS capital ratio	%	30.8	31.3	34.3	36.5	38.8
Gearing ratio*	times	2.8	3.1	2.9	2.7	2.2
Leverage ratio**	times	2.2	2.4	2.5	2.3	1.8
Liquid assets/borrowings	%	33.4	28.8	29.2	28.8	27.0
ROE	%	5.6	6.6	6.1	8.0	9.4

* Total amount of loans, guarantee and securities investment/Shareholders' equity (less than 4)

** Financial debt outstanding/Sharholders' equity (less than 3.5)