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African Development Bank

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Credit Ratings

AAA/Stable/A-1+

■ Note

The African Development Bank (AFDB) regularly issues notes under its Global Debt Issuance Facility and commercial paper under its €1 Billion Commercial Paper Program. Standard & Poor's practice is not to issue separate rating letters for small issues under these facilities. However, as of the date of this report, Standard & Poor's rated all senior debt issued under the Global Debt Issuance Facility 'AAA' and all subordinated debt 'AA+'; Standard & Poor's rated all commercial paper issued under the Commercial Paper Program 'A-1+'. Standard & Poor's maintains annual surveillance on facility issuances.

■ Major Rating Factors

Strengths:

- Strong capital position and liquidity;
- Prudent financial management and policies; and
- Strong support from its members, particularly its nonregional members, which include numerous 'AAA' rated countries.

Weaknesses:

- Inability of most regional member countries (RMCs) to borrow from the bank.

■ Rationale

AFDB, a regional multilateral development finance institution (MDFI), was established in 1964 by 29 African countries. Non-African countries were admitted beginning in 1982, and its membership now includes all 53 African and 24 nonregional countries. The bank is the keystone of the AFDB Group, which also includes soft-loan windows African Development Fund (AFDF; not rated) and Nigeria Trust Fund (NTF; not rated), which make grants and loans at concessional rates and together accounted for about 43% of AFDB Group's disbursements over the past five years. However, while AFDB has an equity investment in AFDF, it is not responsible for the financial obligations of either of these funds.

Since 1995, AFDB has restricted its lending to its most creditworthy RMCs. Fifteen countries are, in principle, currently eligible to borrow from the bank; however, two (the Republics of Zimbabwe [not rated] and Seychelles [not rated]) have arrears on payments that bar new disbursements, and one (the Great Socialist People's Libyan Arab Jamahiriya [not rated]) has never borrowed from the bank. As a consequence of AFDB's credit policy, the other 38 RMCs are allowed to borrow only from AFDF and NTF on highly concessional terms. However, as a result of loans granted prior to 1995, at year-end 2003 more than 31% of AFDB's government and government-guaranteed (sovereign) loans were to countries no longer eligible to borrow from the bank, although these amounts are dropping as loans amortize.

The bank's primary activity is providing medium- and long-term loans with sovereign guarantees to African governments and other public sector entities. These accounted for almost 93% of AFDB's total loans, equity investments, and guarantees (together, its development-related exposure) at year-end

2003. AFDB also lends to the private sector, makes equity investments, and has provided guarantees in small amounts.

AFDB's outstanding loans totaled Special Drawing Rights (SDR) 5,612 million at year-end 2003, representing 56% of its total assets (AFDB's financial accounts are expressed in Units of Account [UA], one of which is defined as equivalent to one SDR). Reflecting the weak credit standing of many of its regional members, SDR1.2 billion—nearly 22%—of AFDB's SDR5.4 billion in sovereign loans had principal or interest payments past due by more than six months at year-end 2003. Most of these arrears are owed by countries either in conflict or recently emerged from conflict. The initiatives sponsored by the international donor community and developed to assist these countries are expected to reduce the arrears.

The expected losses embedded in AFDB's loan portfolio are much smaller than they might appear, largely because of the payments AFDB expects to receive on behalf of its borrowers through the Highly Indebted Poor Countries (HIPC) Initiative. At year-end 2003, 23 countries with loans outstanding to AFDB were participating in the HIPC Initiative, and nine more may eventually satisfy the requirements for participation. The 23 HIPC participants accounted for nearly 15% of AFDB's loans, while potential participants accounted for more than 11%.

AFDB has steadily strengthened its financial profile in recent years. As an example, the ratio of provisions for losses plus adjusted shareholders' equity (together, narrow risk-bearing capacity) to development-related exposure was 67% at year-end 2003, up from 44% at year-end 1999. In addition, AFDB's financial strength is bolstered by callable capital, nearly SDR5 billion of which was from countries rated 'AAA' by Standard & Poor's at year-end 2003. As a consequence, the ratio of narrow risk-bearing capacity plus 'AAA' callable capital (broad risk-bearing capacity) to development-related exposure was 153% at year-end 2003, up from 98% at year-end 1999—the highest such ratio among rated MDFIs. In addition, ongoing capital contributions are slated to increase paid-in capital by SDR179 million by year-end 2008.

AFDB's operating income fell to SDR178 million during 2003 from SDR189 million one year earlier, as a net charge-back of nearly SDR22 million for provisions recorded in previous years more than offset lower net interest income. This left the decrease to be explained principally by the extraordinary costs of the temporary relocation of AFDB Group's offices to Tunis, Tunisian Republic ('BBB'; all country ratings herein are long-term foreign currency sovereign credit ratings as of Feb. 28, 2005), from Abidjan, Cote d'Ivoire (not rated). AFDB's cumulative nonaccrued income on loans at year-end 2003 was more than SDR700 million, and a portion of this is expected to be realized in the future as members become current on their loans.

AFDB's treasury assets have increased substantially in recent years, and its ratio of treasury assets to gross borrowings at year-end 2003, 73%, up from 24% at year-end 1999, is above that of most 'AAA' rated MDFIs. Over the same period, liquid assets increased to 168% of undisbursed loans and projected one-year debt-service payments from 42%, also above that of most 'AAA' rated MDFIs.

■ Outlook

The outlook for the ratings on AFDB is stable. The bank's capital position and liquidity should remain strong and its franchise value high. It is essential that AFDB maintain the support of its regional and nonregional shareholders over the medium term, which it will do, in part, by management's constructive administration of AFDB and AFDF and its championing of regional initiatives, such as the New Partnership for Africa's Development (NEPAD).

■ Membership And Voting Power

The Agreement Establishing the African Development Bank (the Agreement) was signed in 1963 and came into force in 1964. The bank began operations in 1966 with 29 members, all of whom were African countries. In 1982, the Agreement was amended to permit nonregional members, all of whom are required to be members of, or contributors to, AFDF. At end-2003, AFDB's membership consisted of all 53 African and 24 nonregional countries.

Each member has 625 votes plus one vote for each share of stock held. Countries with the largest

voting power at year-end 2003 were: the Federal Republic of Nigeria (not rated), 9.0%; U.S. ('AAA'), 6.6%; Japan ('AA-'), 5.4%; the Arab Republic of Egypt ('BB+'), 5.1%; the Federal Republic of Germany ('AAA'), 4.1%; the Republic of South Africa ('BBB'), 3.9%; Algeria (not rated), 3.8%; and Canada ('AAA') and the Republic of France ('AAA'), 3.7% each.

In May 1998, when AFDB's shareholders approved the fifth general capital increase, the allocation of shares was such that the ownership share of nonregional members would rise to 40% from the previous 33% when fully subscribed. At the same time, AFDB changed its general voting rules for both the board of governors and the board of directors to a two-thirds majority from a simple majority, with a provision for a 70% majority upon request from any member state. The qualified majority votes promote consensus in decisionmaking and protect the interests of nonregional member countries.

A number of AFDB's regional members have run arrears on payments on their capital subscriptions, including eleven at year-end 2003. Subscribed shares not paid for are reallocated to other members, subject to the 60%/40% overall split between RMCs and nonregional members, with priority in reallocation given to countries whose shareholdings are small relative to their economic strength.

■ Organization And Management

All powers of the bank are vested in its board of governors, which inter alia sets policy, admits new members, determines the bank's capital structure, and elects the president. It delegates most of its operational responsibilities to the board of directors, although it retains the power to override their decisions. Each member country appoints a governor and an alternate, who serve nominal five-year terms; however, these may be abbreviated or extended by the appointing member country.

The board of directors is composed of 12 regional and six nonregional members, none of whom may be governors or alternates. They serve a maximum of two three-year terms. While one director represents only the U.S., all other directors (both regional and nonregional) represent multicountry constituencies.

The president of the bank may serve a maximum of two five-year terms. Mr. Omar Kabbaj was reelected to a second term as president in 2000; accordingly, a successor will be elected by the board of governors during 2005. The president heads up a staff that totaled 987 at year-end 2003, down from 1,028 one year earlier, 583 of which were management and professionals.

The bank had been headquartered in Abidjan since its inception. However, due to the unrest in Cote d'Ivoire, AFDB temporarily relocated to its backup facilities in Tunis, Tunisia, in February 2003. AFDB has been increasing its field and other offices in RMCs and plans to have 25 by the end of 2006.

■ Balance Sheet

Table 1 summarizes AFDB's balance sheet. The most notable features from a credit perspective are the continuous decline in loans outstanding during the past four years; a similar increase in shareholders' equity; and the very sharp increase in investments.

| | --Year ended Dec. 31-- | | | | |
|---|------------------------|-------|-------|-------|-------|
| (Mil. SDR, unless otherwise indicated) | 2003 | 2002 | 2001 | 2000 | 1999 |
| Assets | | | | | |
| Cash, due from banks | 70 | 96 | 121 | 66 | 138 |
| Receivables from swaps | 254 | 149 | 136 | 256 | 1,020 |
| Investments | 4,136 | 1,973 | 2,071 | 1,808 | 1,130 |
| Nonnegotiable instruments on account of capital | 42 | 57 | 63 | 61 | 75 |
| Gross loans outstanding | 5,612 | 5,968 | 6,466 | 6,566 | 6,790 |
| Accumulated provision for loan losses | (469) | (492) | (494) | (421) | (387) |
| Equity participations | 182 | 182 | 179 | 178 | 172 |
| Accumulated provision for equity losses | (18) | (18) | (19) | (13) | (12) |

| | | | | | |
|--|--------|--------|--------|--------|--------|
| Other assets | 225 | 282 | 352 | 229 | 256 |
| Total assets | 10,035 | 8,197 | 8,874 | 8,729 | 9,181 |
| Liabilities | | | | | |
| Accounts payable | 195 | 232 | 383 | 297 | 253 |
| Securities sold under agreements to repurchase | 114 | 0 | 0 | 0 | 0 |
| Payables for swaps | 396 | 62 | 65 | 63 | 861 |
| Borrowings | 5,778 | 4,455 | 5,211 | 5,384 | 5,228 |
| Total liabilities | 6,483 | 4,749 | 5,659 | 5,744 | 6,342 |
| Capital | | | | | |
| Paid-in capital after exchange adjustments | 2,023 | 1,983 | 1,948 | 1,871 | 1,823 |
| Reserves | 1,528 | 1,465 | 1,266 | 1,114 | 1,016 |
| Shareholders' equity | 3,551 | 3,448 | 3,214 | 2,984 | 2,839 |
| Memo items: | | | | | |
| Guarantees of securities | 4 | 3 | 0 | 0 | 0 |
| Development-related exposure | 5,798 | 6,153 | 6,645 | 6,744 | 6,962 |
| \$US/SDR (period end) | 1.4860 | 1.3595 | 1.2567 | 1.3029 | 1.3710 |
| Total assets (Mil. US\$) | 14,911 | 11,144 | 11,152 | 11,373 | 12,587 |
| Shareholders' equity (Mil. US\$) | 5,277 | 4,687 | 4,040 | 3,888 | 3,892 |

Risk

AFDB's activities may be separated into treasury activities, which result in holdings of cash and investments, borrowings, and risk-management products; and development-related activities, which result in holdings of loans and equity investments and the issuance of guarantees.

Treasury-related risk

Like most other MDFIs, AFDB does not view its treasury operations as a source of significant income for the bank; rather, they are intended to fund the bank in a conservative yet cost-effective manner. Consequently, the risk arising from AFDB's treasury activities is limited.

Credit risk. AFDB's operating policies call for cash and deposits to be held in institutions with ratings of 'A' or higher; derivative counterparties to have ratings of 'AA-' or higher; and medium- and long-term financial instruments to have ratings of 'AA' or higher. The credit quality of AFDB's investment and derivatives portfolios has increased substantially during the past few years; 67% of its exposure was 'AAA' at year-end 2003, up from 30% in 1999; 27% was in the 'AA' category; and 6% in the 'A' category. In addition, the bank generally executes International Swaps and Derivatives Association (ISDA) master agreements and netting agreements with its derivatives counterparties. AFDB's ratings-based policies are supplemented by a risk-concentration policy that limits the bank's exposure to any entity to 10% of its risk capital, defined as paid-in capital, reserves, and general provisions for losses.

Exchange-rate risk. AFDB funds itself in a wide variety of currencies in an effort to minimize funding costs and ensure market access. At year-end 2003, its borrowings were concentrated in U.S. dollars (44% of total borrowings); Japanese yen (34%); and euros (6%). At the same time, AFDB's loans were concentrated in U.S. dollars (43%); euros (37%); and Japanese yen (16%). AFDB's Agreement requires liabilities in any one currency to be matched with assets in the same currency. To achieve this, the bank actively uses the swap market. In addition, since much of its balance sheet is funded by equity, which is denominated in SDRs, the bank also seeks to match, within a narrow range, the currency composition of its net assets with the currency composition of the SDR. These policies have historically resulted in only modest translation adjustments to comprehensive income.

Interest-rate risk. Interest-rate risk for the bank arises from two principal sources: the net interest margin for those assets funded by debt; and the interest-rate sensitivity of assets funded by the bank's equity. Management seeks to generate a stable net interest margin for the more than half of the bank's assets funded by debt by matching the interest rate characteristics of each class of assets and liabilities through the use of swaps. There is no way for the bank to fully immunize itself against the impact of interest-rate changes on those assets funded by equity. However, it does seek to reduce the volatility in its net interest margin by adjusting the repricing profile of the fixed-rate loans and investments funded by equity to match a 10-year repricing profile benchmark, i.e., by having 10% of assets funded by equity repriced each year. This results in the net interest margin on assets funded by equity tracking a 10-year moving average of SDR interest rates.

A third source of interest-rate risk arises from prepayments for loans issued before 1997, which did not carry a prepayment penalty. The decline of interest rates in recent years has made refinancing an attractive option for some of AFDB's more creditworthy borrowers: SDR292 million in loans were prepaid during 2002 and another SDR471 million during 2003.

In sum, the risk of loss from AFDB's treasury activities appears to be well contained by its policies, and any losses are expected to be small.

Development-related exposure risk

The vast bulk of AFDB's risk lies in its development-related exposure. However, this risk is lower than might be expected, and it has sharply decreased in recent years.

Borrower eligibility. AFDB lends only to African countries and to public and private sector entities domiciled in African countries. Since 1995, the AFDB has used the same eligibility criteria as the International Bank for Reconstruction and Development (IBRD; 'AAA' [all MDFI ratings herein are foreign currency issuer credit ratings]) for determining which countries may borrow only from the bank, which may borrow from both the bank and AFDF, and which may borrow only from AFDF. Under these criteria, 13 of AFDB's RMCs at year-end 2003 were eligible to borrow only from the bank, one of which (Seychelles) was barred from doing so because it was under sanctions for delays in servicing its loan obligations and another of which (Libya) has never borrowed from the bank; two members (Nigeria [not rated] and Zimbabwe [not rated]) were eligible in principle to borrow from both the bank and AFDF (although Zimbabwe was barred because it was under sanctions for delays in servicing its loan obligations); and 38 members were eligible to borrow only from AFDF.

AFDB has historically focused on lending to the public sector in its RMCs. As shown in Table 2, public sector loans accounted for nearly 96% of total outstanding loans at year-end 2003. There has been an increasing demand for lending to public sector borrowers without sovereign guarantees. Since IBRD is unable to make such loans under its Articles, AFDB expects this to become an attractive market niche in the future.

AFDB also lends to private sector borrowers, and, while still very small in volume, this lending has grown rapidly: outstanding loans increased to SDR228 million at year-end 2003 from SDR169 million at year-end 2002 and SDR28 million at year-end 1999. Management expects to further increase the share of its lending to private sector borrowers over the medium term.

| (Mil. SDR, unless otherwise indicated) | --Year ended Dec. 31-- | | | | |
|---|------------------------|-------|------|------|------|
| | 2003 | 2002 | 2001 | 2000 | 1999 |
| Approvals | 746 | 1,068 | 987 | 843 | 794 |
| Project lending, of which: | 566 | 690 | 568 | 402 | 570 |
| Public and publicly guaranteed, of which: | 360 | 491 | 376 | 375 | 473 |
| Project loans | 175 | 275 | 261 | 215 | 213 |
| Lines of credit | 185 | 216 | 115 | 159 | 260 |

| | | | | | |
|---|-------|-------|-------|-------|-------|
| Private and nonpublicly guaranteed loans, of which: | 206 | 199 | 192 | 27 | 97 |
| Project loans | 91 | 98 | 43 | 4 | 1 |
| Lines of credit | 114 | 100 | 149 | 23 | 97 |
| Policy-based lending, of which: | 177 | 186 | 232 | 0 | 198 |
| Sector adjustment | 177 | 82 | 79 | 0 | 103 |
| Structural adjustment | 0 | 103 | 153 | 0 | 95 |
| Special relief fund | 4 | 5 | 1 | 6 | 1 |
| HIPC debt relief | 0 | 188 | 175 | 174 | 21 |
| Project loan approvals as a % of total loan approvals | 75.8 | 64.6 | 57.6 | 47.7 | 71.8 |
| Public sector approvals as a % of total approvals | 72.4 | 81.4 | 79.5 | 65.7 | 87.2 |
| Loans outstanding | 5,612 | 5,968 | 6,466 | 6,566 | 6,790 |
| Project lending | 3,705 | 3,702 | 4,181 | 4,352 | 4,551 |
| Public and publicly guaranteed; of which: | 3,476 | 3,533 | 4,103 | 4,303 | 4,523 |
| Project loans | 2,300 | 2,544 | 3,037 | 3,154 | 3,295 |
| Sector investment and rehabilitation loans | 194 | 200 | 292 | 318 | 352 |
| Lines of credit | 982 | 789 | 774 | 830 | 876 |
| Private and nonpublicly guaranteed loans, of which: | 228 | 169 | 78 | 50 | 28 |
| Project loans | 78 | 33 | 42 | 31 | 28 |
| Lines of credit | 150 | 136 | 36 | 19 | 0 |
| Policy-based lending, of which: | 1,561 | 1,918 | 2,285 | 2,213 | 2,239 |
| Sector adjustment | 699 | 854 | 1,135 | 1,150 | 1,134 |
| Structural adjustment | 862 | 1,064 | 1,150 | 1,063 | 1,105 |
| Debt and debt service reduction loans | 347 | 348 | 0 | 0 | 0 |
| Project loans outstanding as a % of total loans outstanding | 66.0 | 62.0 | 64.7 | 66.3 | 67.0 |
| Public sector loans outstanding as a % of total loans outstanding | 95.9 | 97.2 | 98.8 | 99.2 | 99.6 |

Types of development-related exposure. Table 2 also shows AFDB's financing approvals and outstanding loans by the purpose of the financing for the past five years. Most of AFDB's lending is for projects; project lending has accounted for 48%-76% of approvals and 62%-67% of outstanding loans over the past five years. Policy-based lending approvals have been volatile, but outstanding policy-based loans have been dropping both in absolute terms and as a percentage of total loans (to 28% at year-end 2003). A third major category of lending is lines of credit to financial institutions, both public and private sector (whereby AFDB enables them to fund medium- and long-term projects that satisfy AFDB criteria). This is a growing activity, and enables the bank to finance private sector borrowers indirectly, including small and midsize enterprises.

Loan maturities. Consistent with its development focus, AFDB typically extends medium- and long-term loans with final maturities of up to 20 years. At year-end 2003, about 30% of loans were to mature during 2004 and 2005; 26% during 2006-2008; 24% during 2009-2012; and 19% between 2013-2023.

Equity investments. The Agreement permits AFDB to make equity investments. The bank has been cautious about doing so, and the gross value of its equity investments at year-end 2003 was SDR182 million, of which SDR112 million represented AFDB's long-standing equity in AFDF; SDR21

million in a variety of regional development banks; and the remaining SDR49 million in a variety of equity funds, banks, and other entities. The bank does not anticipate substantial additions to its equity holdings.

Exposure limits and concentration. AFDB's Agreement limits the total amount of both undisbursed and outstanding loans, equity investments (including the bank's contingent liability for amounts subject to call), and guarantees to the sum of its unimpaired subscribed capital, reserves, and surplus. As calculated by AFDB, the total of loans, equity investments, and guarantees was less than 25% of its subscribed capital, reserves, and surplus at year-end 2003; accordingly, this limit is not a binding constraint.

Given the small number of RMCs eligible to borrow from AFDB, concentration in its development-related portfolio is a concern. Management has established a limit that reflects the bank's internal risk rating for and the economic potential of each borrowing RMC; in addition, the maximum loan equivalent exposure for any single country is limited to 15% of the bank's maximum outstanding loans.

In practice, as shown in Table 3, AFDB's loan concentration is surprisingly low. Its exposure to its five countries of largest exposure relative to its narrow risk-bearing capacity has typically been lower than that of the IBRD, the Inter-American Development Bank ('AAA'), and the Asian Development Bank ('AAA') and only slightly higher than that of the European Bank for Reconstruction and Development ('AAA'), and has declined substantially over the past five years. (See the Comparative Data section at the end of this report for information on accessing Standard & Poor's "Supranationals Special Edition 2004," which provides comparative data for AFDB and 14 other supranational institutions.)

| Table 3 African Development Bank Geographic Concentration Of Lending | | | | | |
|--|------------------------|-------------|-------------|-------------|------------------|
| | --Year ended Dec. 31-- | | | | |
| Largest country exposures/ratings* | 2003 | 2002 | 2001 | 2000 | 1999 |
| Largest | Tunisia/BBB | Tunisia/BBB | Morocco/BB | Morocco/BB | Morocco/BB |
| Mil. SDR | 1,157 | 1,107 | 1,107 | 1,103 | 1,085 |
| % total loans | 21.5 | 18.6 | 17.1 | 16.8 | 16.0 |
| % accumulated provisions for losses + adjusted shareholders' equity | 29.8 | 29.2 | 31.1 | 34.0 | 35.6 |
| 2nd largest | Algeria/NR | Morocco/BB | Tunisia/BBB | Tunisia/BBB | Tunisia/BBB- |
| Mil. SDR | 764 | 912 | 1,098 | 978 | 1,029 |
| % total loans | 14.2 | 15.3 | 17.0 | 14.9 | 15.1 |
| % accumulated provisions for losses + adjusted shareholders' equity | 19.7 | 24.1 | 30.9 | 30.1 | 33.7 |
| 3rd largest | Morocco/BB | Algeria/NR | Algeria/NR | Algeria/NR | Nigeria/NR |
| Mil. SDR | 596 | 753 | 783 | 739 | 761 |
| % total loans | 11.1 | 12.6 | 12.1 | 11.3 | 11.2 |
| % accumulated provisions for losses + adjusted shareholders' equity | 15.3 | 19.9 | 22.0 | 22.8 | 24.9 |
| 4th largest | Nigeria/NR | Nigeria/NR | Nigeria/NR | Nigeria/NR | Cote D'Ivoire/NR |
| Mil. SDR | 492 | 569 | 635 | 703 | 484 |
| % total loans | 9.1 | 9.5 | 9.8 | 10.7 | 7.1 |
| % accumulated provisions for losses + adjusted shareholders' equity | 12.7 | 15.0 | 17.9 | 21.7 | 15.9 |
| 5th largest | Cote | Cote | Cote | Cote | Algeria/NR |

| | D'Ivoire/NR | D'Ivoire/NR | D'Ivoire/NR | D'Ivoire/NR | |
|--|-------------|-------------|-------------|-------------|-------|
| Mil. SDR | 360 | 352 | 429 | 455 | 694 |
| % total loans | 6.7 | 5.9 | 6.6 | 6.9 | 10.2 |
| % accumulated provisions for losses + adjusted shareholders' equity | 9.3 | 9.3 | 12.1 | 14.0 | 22.7 |
| Largest two country exposures | 1,921 | 2,019 | 2,205 | 2,081 | 2,114 |
| % total loans | 35.7 | 33.8 | 34.1 | 31.7 | 31.1 |
| % accumulated provisions for losses + adjusted shareholders' equity | 49.5 | 53.3 | 62.1 | 64.1 | 69.3 |
| Largest three country exposures | 2,517 | 2,772 | 2,988 | 2,820 | 2,874 |
| % total loans | 46.7 | 46.5 | 46.2 | 43.0 | 42.3 |
| % accumulated provisions for losses + adjusted shareholders' equity | 64.8 | 73.2 | 84.1 | 86.9 | 94.2 |
| Largest four country exposures | 3,009 | 3,341 | 3,623 | 3,524 | 3,358 |
| % total loans | 55.9 | 56.0 | 56.0 | 53.7 | 49.5 |
| % accumulated provisions for losses + adjusted shareholders' equity | 77.4 | 88.2 | 102.0 | 108.5 | 110.1 |
| Largest five country exposures | 3,368 | 3,693 | 4,052 | 3,978 | 4,052 |
| % total loans | 62.6 | 61.9 | 62.7 | 60.6 | 59.7 |
| % accumulated provisions for losses + adjusted shareholders' equity | 86.7 | 97.5 | 114.1 | 122.5 | 132.8 |
| Memo items: | | | | | |
| Total outstanding loans | 5,384 | 5,968 | 6,466 | 6,566 | 6,790 |
| Accumulated provisions for losses + adjusted shareholders' equity | 3,885 | 3,788 | 3,553 | 3,246 | 3,051 |
| *Long-term foreign currency sovereign credit rating at year-end. NR-Not rated. | | | | | |

Development-related exposure quality and provisions for losses. Table 4 provides indicators of the quality of AFDB's development-related exposure and the accumulated provisions for the losses embedded in that exposure. The index of the quality of development-related country exposure is an exposure-weighted average of the default rates associated with the long-term foreign currency sovereign credit ratings (or confidential credit assessments for countries that do not have published ratings) of AFDB's RMCs, adjusted for the preferred creditor treatment that obligations to AFDB are expected to receive; the higher the index, the greater the risk embedded in the portfolio. By this measure, while there has been some reduction in the embedded risk in AFDB's portfolio, it nonetheless remains the highest among rated MDFIs. However, this index does not differentiate between sovereign loans and private sector exposure, which ordinarily is expected to carry more risk than sovereign lending. It thus typically understates the total risk embedded in the portfolios of institutions dealing, in whole or in part, with private sector entities.

| Table 4 African Development Bank Loan Quality And Accumulated Provisions For Losses | | | | | |
|--|-------------------------------|-------------|-------------|-------------|-------------|
| | --Year ended Dec. 31-- | | | | |
| (Mil. SDR, unless otherwise indicated) | 2003 | 2002 | 2001 | 2000 | 1999 |
| Index of quality of development-related country exposure | 16.3 | 16.2 | 16.6 | 16.9 | 16.9 |
| Private sector loans as a % of total loans | 4.1 | 2.8 | 1.2 | 0.8 | 0.4 |
| Loan writeoffs, of which: | 0 | 5 | 0 | 0 | 0 |
| Sovereign loans | 0 | 0 | 0 | 0 | 0 |
| Nonsovereign loans | 0 | 5 | 0 | 0 | 0 |
| Impaired/nonaccrual loans | 1,188 | 851 | 1,286 | 1,620 | 981 |

| | | | | | |
|--|-------|-------|-------|-------|-------|
| As a % of total loans | 21.2 | 14.3 | 19.9 | 24.7 | 14.5 |
| Principal past due | 302 | 222 | 484 | 430 | 361 |
| Accumulated provisions for losses on loans, of which: | 469 | 492 | 494 | 421 | 387 |
| Sovereign loans | 449 | 479 | 479 | 407 | 372 |
| % sovereign loans | 8.3 | 8.3 | 7.5 | 6.2 | 5.5 |
| Nonsovereign loans | 20 | 13 | 15 | 14 | 16 |
| % nonsovereign loans | 8.6 | 7.5 | 19.4 | 28.6 | 54.3 |
| Accumulated provisions as a % of impaired/nonaccrual loans | 39.5 | 57.7 | 38.4 | 26.0 | 39.5 |
| Accumulated provisions as a % of total loans | 8.4 | 8.2 | 7.6 | 6.4 | 5.7 |
| Accumulated provisions for losses on equity investments | 18 | 18 | 19 | 13 | 12 |
| Accumulated provisions as a % of total equity investments | 9.8% | 9.9% | 10.6% | 7.5% | 6.7% |
| Memo items: | | | | | |
| Private sector loans | 228 | 169 | 78 | 50 | 29 |
| Public sector loans | 5,384 | 5,799 | 6,388 | 6,516 | 6,762 |
| Total loans | 5,612 | 5,968 | 6,466 | 6,566 | 6,790 |
| Equity investments | 182 | 182 | 178 | 178 | 171 |

As noted above, AFDB has been increasing its exposure to the private sector, albeit from a very low level, and private sector loans increased to 4% at year-end 2003 from less than one-half of one percent at year-end 1999. AFDB's own internal calculations indicate that, having improved substantially over the past five years, the quality of AFDB's private sector portfolio is only modestly lower than that of its sovereign loan portfolio. Nonetheless, the performance of AFDB's private sector portfolio will bear watching as loans mature and the portfolio increases in size.

The historical performance of AFDB's loan portfolio has been well below that of other rated MDFIs. As shown in Table 4, impaired loans as of the past five year-ends have ranged from a low of SDR851 million to a high of SDR1,620 million, and the principal actually past due from SDR222 million to SDR484 million. However, AFDB's actual losses are likely to be substantially lower than these figures suggest; in over 40 years of operation, the bank has never written off a sovereign or sovereign-guaranteed loan. More generally, loans to MDFIs are typically brought current by one of three means:

- A country using its own funds to become current. AFDB's weakest RMCs are no longer eligible to borrow from the bank, and loans to those not in nonaccrual status are slowly amortizing. RMCs participating in the HIPC Initiative must eliminate their arrears to AFDB, an important incentive for these countries to remain or become current on their obligations.
- Rescheduling loans (although MDFIs do this only rarely, in extreme circumstances). This was done on a highly exceptional basis during 2002 for the Democratic Republic of the Congo (DRC; not rated). However, whether or not this proves only a cosmetic improvement depends upon whether the rescheduled loans are serviced. Since the rescheduling, DRC has serviced its loans.
- Donor aid, which permits the country to at least become current on its obligations, if not have them extinguished.

The HIPC Initiative has become the principal instrument for providing donor aid to the poorest countries. As of late 2004, 32 of the 38 countries eligible or being considered for the HIPC Initiative were AFDB RMCs. These include 11 (out of the total of 14) that reached their completion points; 12 (of 13) that reached their decision points; and 9 (of 11) that were still to be considered for relief under the HIPC Initiative. Of these 32 RMCs, AFDB had credit exposure to 22 at year-end 2003. Loans outstanding to RMCs that reached their completion points as of October 2004 totaled SDR193 million, or 3.6% of total sovereign loans outstanding; loans to countries that reached their decision points, SDR609 million, or 11.3% of loans outstanding; and loans to countries still to be

considered, SDR605 million, or 11.2% of loans outstanding. In effect, nearly 15% of AFDB's loans to its highest-risk borrowers are either benefiting or are highly likely to benefit from the HIPC Initiative, as may another 11%, although this will occur over a longer time period.

The significance of countries becoming eligible for HIPC relief is that donors other than AFDB will, in effect, repay a major portion of AFDB's outstanding loans to these countries.

Additional relief may be forthcoming for the African HIPC countries. The original program was "enhanced" once to increase the amount of relief provided, and there is sentiment that still more should be done for the poorest of the poor. Additional debt relief or other aid to AFDB's HIPC countries would further improve the quality of AFDB's loan portfolio, either directly, if provided under the existing HIPC program, or indirectly, by making it more possible for countries to service their loans from their own resources. The tenth replenishment of the resources of AFDB, concluded in December 2004, was 43% higher than the ninth replenishment and augurs well for additional aid.

Despite never having written off a sovereign loan, AFDB maintains provisions against losses on its sovereign loans; indeed, it has gradually increased these to 8.3% of total outstanding sovereign loans at year-end 2003 from 5.5% at year-end 1999. These provisions are high compared to those of other MDFIs; however, the embedded risk in AFDB's sovereign portfolio is also higher, and this higher level is appropriate.

AFDB keeps similar provisions for losses against its nonsovereign loans—8.6% at year-end 2003, a substantial decrease from the 54% at year-end 1999. However, the portfolio was much smaller at that point, and AFDB believes that the quality of its nonsovereign loan portfolio has since increased substantially. Nonetheless, AFDB's provisions for nonsovereign loans are lower than those of some other MDFIs.

The equity investment lines in Table 4 are more difficult to interpret, since equity investments are qualitatively different from loans: they can, in principle, produce capital gains, whereas loans cannot. AFDB's equity investments are carried on its balance sheet at cost less provisions for losses for those investments for which there is a significant and lasting decline in value. Provisions of less than 10% of gross equity investments are low by comparison with those of some other rated MDFIs making equity investments. In addition, the value of AFDB's equity in AFDF seems highly uncertain.

■ Capital, Risk-Bearing Capacity, And Capital Adequacy

Table 5 summarizes AFDB's capital, risk-bearing capacity, and capital adequacy.

| Table 5 African Development Bank Capital, Risk-Bearing Capacity, and Capital Adequacy | | | | | |
|---|------------------------|--------|--------|--------|--------|
| | --Year ended Dec. 31-- | | | | |
| (Mil. SDR, unless otherwise indicated) | 2003 | 2002 | 2001 | 2000 | 1999 |
| Capital | | | | | |
| Authorized capital | 21,870 | 21,870 | 21,870 | 21,870 | 21,870 |
| Subscribed capital | 21,564 | 21,510 | 21,491 | 20,548 | 16,760 |
| Paid-in capital after exchange adjustments | 2,023 | 1,983 | 1,948 | 1,871 | 1,823 |
| Reserves | 1,528 | 1,465 | 1,226 | 1,114 | 1,016 |
| Total shareholders' equity | 3,551 | 3,448 | 3,214 | 2,984 | 2,839 |
| Risk-bearing capacity | | | | | |
| Callable capital, of which: | 19,376 | 19,395 | 18,531 | 14,781 | 13,927 |
| AAA' rated member countries | 4,981 | 4,981 | 4,151 | 4,999 | 3,767 |
| Nonnegotiable instruments on account of capital | 42 | 57 | 63 | 61 | 75 |
| Equity participation in AFDF | 112 | 112 | 112 | 112 | 112 |
| Adjusted shareholders' equity* | 3,398 | 3,278 | 3,040 | 2,812 | 2,652 |

| | | | | | |
|---|-------|-------|-------|-------|-------|
| Accumulated provisions for losses | 487 | 510 | 513 | 434 | 399 |
| Narrow risk-bearing capacity¶ | 3,885 | 3,788 | 3,553 | 3,246 | 3,051 |
| Broad risk-bearing capacity§ | 8,866 | 8,769 | 7,704 | 8,245 | 6,817 |
| Capital adequacy | | | | | |
| Narrow risk-bearing capacity/total assets (%) | 38.7 | 46.2 | 40.0 | 37.2 | 33.2 |
| Broad risk-bearing capacity/total assets (%) | 88.4 | 107.0 | 86.8 | 94.5 | 74.3 |
| Narrow risk-bearing capacity/development-related exposure (%) | 67.0 | 61.6 | 53.5 | 48.1 | 43.8 |
| Broad risk-bearing capacity/development-related exposure (%) | 152.9 | 142.5 | 115.9 | 122.2 | 97.9 |
| *Shareholders' equity less nonnegotiable instruments on account of capital less equity participation in AFDF. ¶Accumulated provisions for losses plus adjusted shareholders' equity. §Narrow risk-bearing capacity plus callable capital from 'AAA' rated member countries. | | | | | |

Paid-in capital

Almost all of AFDB's nearly SDR21.9 billion in authorized capital (i.e., capital that its board of governors has authorized to be issued) was subscribed (i.e., claimed by members) at year-end 2003. However, of the SDR21.6 billion in subscribed capital, only SDR2,023 million (after the effects of exchange rate changes on the SDR value of capital contributions in members' national currencies or U.S. dollars) was paid in at year-end 2003; the remainder was callable. Carried as assets on AFDB's balance sheet are nonnegotiable instruments on account of capital (SDR42 million at year-end 2003) and AFDB's equity holding in the AFDF (SDR112 million). Since the former may not be immediately available to AFDB in a time of financial stress, and since the value of the latter is highly uncertain, Standard & Poor's deducts the amount of these assets from AFDB's paid-in capital to calculate adjusted paid-in capital, which totaled SDR1,869 million at year-end 2003.

Reserves and shareholders' equity

AFDB's paid-in capital is buttressed by its reserves, which consist of the general reserve and the current year's net income less sums allocated or transferred outside the bank by its board of governors and the adjustment for translation gains and losses other than those relating to capital subscriptions. Reserves totaled SDR1,528 million at year-end 2003. AFDB's adjusted shareholders' equity (the sum of adjusted paid-in capital plus reserves) thus totaled SDR3,398 million at year-end 2003, up SDR120 million from one year earlier.

Callable capital

AFDB's adjusted shareholders' equity is, in turn, buttressed by its subscribed callable capital. Governors can issue a call on this capital, but only to meet obligations created by AFDB's borrowing or the issuance of a guarantee. Calls are made on a pro rata basis, but one member's failure to meet a call does not excuse other members from meeting that call. In the event that a first-round call does not raise the amount required, subsequent calls can be made up to the limit of each country's subscription. The ability and willingness of members to meet a capital call, and to do so in a timely fashion, are uncertain and cannot easily be quantified; accordingly, Standard & Poor's focuses exclusively on the callable capital from member countries rated 'AAA'. AFDB's 'AAA' callable capital totaled SDR4,981 million at year-end 2003, bringing the bank's broad risk-bearing capacity to SDR8,866 million.

Risk-bearing capacity

Standard & Poor's has two different measures of risk-bearing capacity:

- Narrow risk-bearing capacity, which includes accumulated provisions for losses and adjusted shareholders' equity; and
- Broad risk-bearing capacity, which includes narrow risk-bearing capacity and callable capital from 'AAA' rated member countries.

Table 5 includes four measures of capital adequacy. The two comparing narrow and broad risk-bearing capacity to total assets are of limited relevance, since most of AFDB's nondevelopment-related assets have little risk (credit or market) associated with them. However, these ratios were

39% and 88%, respectively, at year-end 2003, both having increased substantially from four years earlier. The reduction in these ratios during 2003 reflects the 22% increase in AFDB's total assets, which was more than accounted for by increased investments.

The more relevant comparison is between risk-bearing capacity and development-related exposure. The more conservative ratio of narrow risk-bearing capacity to development-related exposure was 67% at year-end 2003, having steadily increased from 44% four years earlier as the result of an absolute reduction in development-related exposure and an increase in adjusted shareholders' equity. The less-conservative ratio of broad risk-bearing capacity to development-related exposure increased to a very robust 153% from 98% four years earlier. This even greater percentage increase reflects the absolute increase in the amount of 'AAA' callable capital, as Canada, the Republic of Finland, and the Kingdom of Denmark gained 'AAA' ratings while Japan lost its 'AAA' rating. The 67% ratio of narrow risk-bearing capacity to development-related exposure means that, assuming no losses from AFDB's other assets, 67% of the bank's development-related portfolio could be deemed worthless before the bank would become insolvent; the 153% ratio of broad risk-bearing capacity to development-related exposure means that, assuming all 'AAA' rated member countries met a capital call in full, all of the bank's development-related exposure and more than 70% of its other assets could be deemed worthless before the bank would become insolvent. This is a cushion unsurpassed by other rated MDFIs, although the greater risk embedded in AFDB's development-related portfolio must be kept in mind.

■ Net Income

As a development institution, AFDB does not seek to maximize income, but rather to earn a return adequate to ensure its financial strength and to permit it to meet its development and other financing goals. But while AFDB is currently benefiting from increases in paid-in capital, increases in reserves from retained earnings are likely to be the primary source of growth in its risk-bearing capacity over the medium term.

The principal drivers of AFDB's operating income are the level of interest rates (since equity funds a large portion of its earning assets); the spread on loans and investment assets funded by borrowings; provisions for losses; and noninterest expense, primarily administrative. Table 6 summarizes the principal components of AFDB's net income.

| (Mil. SDR) | --Year ended Dec. 31-- | | | | |
|---|------------------------|-------|-------|-------|-------|
| | 2003 | 2002 | 2001 | 2000 | 1999 |
| Income from loans | 325 | 415 | 448 | 438 | 471 |
| Income from investments | 100 | 74 | 121 | 90 | 60 |
| Borrowing expenses | (220) | (259) | (350) | (340) | (345) |
| Net income from loans and investments before provision for losses | 206 | 230 | 220 | 188 | 185 |
| Provision for losses on loans | 22 | (4) | (60) | (39) | (29) |
| Net interest income after provision for losses | 227 | 227 | 160 | 149 | 157 |
| Administrative expense net of management fees | (45) | (32) | (30) | (30) | (30) |
| Other income, net (loss) | (4) | (6) | (4) | (2) | (3) |
| Operating income | 178 | 189 | 125 | 117 | 124 |
| Unrealized net (loss)/gain on nontrading derivatives | (61) | 37 | 82 | 0 | 0 |
| Net income | 117 | 226 | 208 | 117 | 124 |
| Memo items: | | | | | |
| Allocation of net income to: | | | | | |
| Democratic Republic of Congo (post-conflict assistance) | 13 | 0 | 0 | 0 | 0 |
| AFDF | 25 | 10 | 10 | 10 | 10 |

| | | | | | |
|---|----|----|----|----|----|
| HIPC Initiative | 9 | 6 | 6 | 6 | 6 |
| Special Relief Fund | 10 | 5 | 0 | 3 | 0 |
| Technical Assistance Fund for AFDF-only countries | 0 | 1 | 0 | 0 | 0 |
| Total | 57 | 22 | 16 | 19 | 16 |

AFDB's operating income fell to SDR178 million during 2003 from SDR189 million during 2002. Net income from loans and investments before provisions for losses fell to SDR206 million from SDR230 million the previous year due to lower average interest rates and a decrease in average loans outstanding—reflecting, in part, large prepayments of loans. However, the reduction in the sovereign portfolio resulted in a release of general provisions, and net income after provisions was virtually unchanged from one year earlier. Administrative expenses increased by nearly SDR13 million, or 40%, during 2003, due primarily to the cost of the temporary relocation of the bank's headquarters to Tunis from Abidjan.

Net income fell more sharply, to SDR117 million from SDR226 million, during 2003. The difference was attributable to unrealized losses on nontrading derivatives, primarily those used to hedge AFDB's borrowings portfolio. The bank has elected not to define any qualifying hedges, but rather to mark all derivatives to fair value. This decision increases the volatility of net income.

AFDB had SDR703 million in nonaccrued income at year-end 2003. As and when AFDB's nonaccrual loans are repaid, this income will be recognized, boosting operating and net income.

While AFDB does not pay dividends to its shareholders, not all of its net income is retained to bolster its risk-bearing capacity. Depending upon the performance of the bank, a portion of reserves may be allocated to support development-related initiatives for Africa. As shown in Table 6, these amounts have varied from SDR16 million (in 1999) to SDR57 million (in 2003) over the past five years. The principal beneficiaries of the SDR136 million of allocations have been the AFDF (SDR65 million) and the HIPC Initiative (SDR39 million).

■ Borrowing And Liquidity

Under the Agreement, development-related exposure plus undisbursed loans cannot exceed subscribed capital plus reserves; expressed differently, debt cannot exceed callable capital plus investments. In addition, there are currently three other debt-related policies:

- Total debt may not exceed 80% of total callable capital;
- Total debt may not exceed 100% of usable capital, which is paid-in capital in convertible currencies, reserves, and callable capital of countries rated 'AA' or higher;
- Total senior debt (AFDB is unique among rated MDFIs in having some subordinated debt outstanding) may not exceed 80% of the callable capital of nonborrowing member countries.

AFDB has been well within these limits in recent years. For instance, total debt was less than 25% of callable capital plus investments; less than 30% of callable capital; and less than 61% of usable capital at year-end 2003. Senior debt was less than 60% of nonborrowing members' callable capital.

Standard & Poor's calculates four measures of leverage:

- Gross debt to adjusted shareholders' equity;
- Gross debt to shareholders' equity plus 'AAA' callable capital;
- Gross debt net of liquid assets to adjusted shareholders' equity; and
- Gross debt net of liquid assets to shareholders' equity plus 'AAA' callable capital.

AFDB's leverage has declined substantially in recent years, and at year-end 2003 its leverage by all of these measures was the second or third lowest among 'AAA' rated MDFIs.

The bank's liquidity policy calls for maintaining liquidity in a zone between:

- The prudential minimum level of liquidity (PML), equal to the sum of debt service payments for the next year, the projected net loan disbursements for the next year, the loan equivalent value of signed guarantees, and undisbursed equity investments; and
- The operational level of liquidity (OLL), equal to PML plus 50% of the stock of undisbursed loans.

Standard & Poor's calculates two measures of liquidity: liquid assets to gross debt; and liquid assets to undisbursed loans and equity investments plus estimated one-year debt service. By both of these measures, there has been a huge improvement in AFDB's liquidity, and AFDB had the second strongest liquidity position among 'AAA' rated MDFIs at year-end 2003.

In sum, while Africa remains a challenging environment in which to operate, the bank's management in recent years has greatly strengthened the bank's financial profile. AFDB's capital and liquidity, as well as its qualitative features, place it solidly in the 'AAA' rating category.

■ Comparative Data

Comparative data for AFDB and 14 other MDFIs may be found on pages 57 through 60 of Standard & Poor's annual Supranationals Special Edition 2004 (available on www.sandp.com; enter Supranationals Special Edition in the search box and click on the title under "Credit Ratings" in the center of the screen.)