International
Credit Analysis

African Development Bank

Ratings

African Development Bank
Foreign Currency

Long-Term IDR*	AAA
Short-Term IDR*	F1+
Outlook	Stable

* IDR – Issuer Default Rating

Financial Data

African Development Bank

	31 Dec 05	31 Dec 04
Total Assets (USDm)	16,543.7	16,712.0
Total Assets (UAm)*	11,575.0	10,761.0
Equity (UAm)	4,352.2	4,221.7
Operating Profit (UAm)	244.9	161.5
Net RoA (%)	1.98	n.a.
Net RoE (%)	5.16	n.a.
Equity/Assets (%)	37.60	39.23
Usable Capital/ Required Capital (x)	14.13	15.43

* UA = Unit of Account;
1 UA = 1 special drawing right (XDR)

Analysts

Jean Paul Debrinski, Paris
+33 1 44 29 92 82
jeanpaul.debrinski@fitchratings.com

Eric Paget-Blanc, Paris
+33 1 44 29 91 33
eric.pagetblanc@fitchratings.com

Rating Rationale

- The ratings of African Development Bank ("AfDB") are primarily based on the support from its member countries, its high level of capitalisation and its conservative risk management policies.
- In conformity with its mandate, the bank provides financial assistance to eligible African countries and hence is highly exposed to speculative-grade borrowers: at end-2005, its sovereign lending was directed to countries with an average credit rating of 'B+'. AfDB's operating environment is challenging, as illustrated by impaired loans standing at 12.7% of the bank's loan book at end-2005 and arrears at 12.1%.
- Despite the challenging operating environment, Fitch Ratings expects AfDB to improve its asset quality, thanks to the debt relief initiatives funded by the donor community (the Heavily Indebted Poor Countries ("HIPC") Initiative and the Multilateral Debt Relief Initiative ("MDRI")) and to arrears reduction schemes. AfDB's loan portfolio is concentrated but somewhat less than those of other multilateral development banks ("MDBs") that lend to developing countries: the ratio of the five largest borrowers to the bank's equity was 80.5% at end-2005. In addition, the preferred creditor status the bank enjoys also provides it with priority over other creditors in the event of a country default and constitutes another layer of protection against default from a sovereign counterparty.
- Yet, as with other regional MDBs, the bank's public-sector lending has contracted consistently since 2001. Significant sovereign loan prepayments support this adverse development. Consequently, the bank aims to increase its lending to the private sector, which accounted for only 6.6% of its portfolio at end-2005 (2001: 1.21%).
- This operational shift will test AfDB's risk management policies, which govern the bank's capital adequacy, funding and liquidity rules, and have performed remarkably well in recent years. AfDB's capitalisation, for instance, is very strong, with a ratio of usable capital to required capital (Fitch's definition) of 14.1x at end-2005.

Support

- AfDB's capital is held by 77 member countries, 53 of which are African. Some 10.5% of the capital has been paid in; the remaining shares could be called in the event of the bank being unable to honour its debt obligations. Some 40% of the bank's capital is owned by non-African countries, most of which are highly rated OECD countries. Fitch believes these countries would provide additional support to the AfDB if necessary.

Rating Outlook and Key Rating Drivers

- The rating Outlook is Stable. AfDB's ratings are primarily based on support from its shareholders and strong capitalisation. Downward pressure on the rating could arise from a significant deterioration in asset quality relating to AfDB's growing exposure to private entities that do not benefit from preferred creditor status. The bank's track record suggests it will make the necessary adjustments if needed.

Profile

- AfDB is an MDB created to assist the economic and social development of its regional member countries ("RMCs"). It is headquartered in Abidjan (Côte d'Ivoire) and employed 1,072 staff at end-2005.
- Out of 53 RMCs, 15 countries are eligible for AfDB loans. Non-eligible states can have access to concessional resources through the African Development Fund ("ADF") and the Nigerian Trust Fund ("NTF"), both of which are managed by AfDB but are financially independent.

12 October 2006

Profile

- **Finances development projects in African countries**
- **Public lending limited to 15 countries**

Background: AfDB is an MDB established in 1964 and a member of the African Development Bank Group. It is mandated with financing economic and social development in Africa. It is headquartered in Abidjan (Côte d'Ivoire), though in 2003 growing political instability in the country forced AfDB's board of governors to relocate operations temporarily to back-up facilities in Tunis (Tunisia). The temporary relocation status is reviewed by the board of governors during the annual meetings held in May.

Organisation: The bank's president is elected by the board of governors for up to two five-year terms. Donald Kaberuka, then minister of finance and economic planning in Rwanda, was elected president of the bank in July 2005. The board of governors is the bank's ultimate decision-making body. Among other things, it approves capital increases and the admission of new members, and defines the bank's strategy. It includes one delegate for each member country, i.e. any country that holds shares in AfDB's capital. The president of the bank also chairs the 18-member resident board of directors, which represents the 77 member countries and oversees operations and policy-making. Six directors represent non-African countries, while 12 represent African nations. While decisions are taken by a two-thirds majority, members have the right to request a 70%-weighted majority. The bank employed 1,072 staff at end-2005 (2004: 1,043).

Purposes: AfDB's main role is to provide financing and technical assistance to RMCs (i.e. African countries). Non-RMCs are not allowed to borrow funds from the bank. They participate in AfDB's capital and support the bank, enabling it to raise resources at the lowest possible cost. The 2003-2007 medium-term strategic plan, which was approved by the bank's board of governors in 2002, reasserts AfDB's focus on poverty reduction and productivity growth in RMCs. The plan identifies the decentralisation of the institution's activities as a key organisational objective: 25 field offices are to be operating by the end of 2006 to ensure the bank's operational efficiency throughout the region. As at 30 September 2006, there were 14 offices in operations.

The African Development Bank Group comprises three entities: AfDB, which provides loans, guarantees and equity stakes to 15 eligible countries (income per capita being the main eligibility criterion); ADF, which grants concessional loans – i.e. loans priced well below market rates – to countries that currently cannot borrow from AfDB, and NTF, a fund set up by Nigeria to support the development efforts of African countries, particularly the low-income nations. ADF and NTF have access to concessional resources subscribed by donor countries and Nigeria respectively – and provide loans under extremely favourable conditions. The NTF's 30-year term ended in April 2006, following which Nigeria has requested the bank to initiate steps for the orderly winding-up of NTF. Discussions between the bank and Nigeria at the highest levels are exploring options for continued collaboration in this context. While managed by AfDB, both ADF and NTF are financially independent. AfDB accounted for about half (44.4%) of the financing approved by the group (excluding HIPC debt relief) in 2005.

AfDB also seeks to mobilise external resources through co-financing arrangements. In 2005, 19 projects totalling UA3.19bn were co-financed compared with UA2.85bn in 2004; the group's contribution amounted to 18.1% of these projects (2004: 29.9%). Such a scheme enables the bank to share the risk among different partners, generally other supranational institutions or bilateral development agencies. The bank's participation in a project also facilitates fundraising from local financial institutions.

Financial Operations

AfDB's commitments take various forms. Fitch distinguishes direct financing (loans and equity) from other forms of development assistance that are not reported on its balance sheet, such as debt relief, which takes the form of a reduction in debt servicing spread over the life of the loan.

Public-Sector Lending

A predominant majority of AfDB's financing is still extended to or guaranteed by governments. At end-2005, public-sector lending represented 92.2% of the bank's total outstanding portfolio on a cumulative basis (2004: 92.7%).

- Project loans, AfDB's principal product, are aimed at supporting specific productive assets in sectorally identifiable activities. Project lending accounted for 76.0% of direct financing approvals in 2005. Just over three-quarters of project loans take the form of financing government-guaranteed projects, advances to other public-sector entities and credit lines to public financial institutions.

- **Sector adjustment loans** aim to support policy reforms or institutional advances in a given sector.

AfDB Approvals by Instrument

(UAm)	2005	2004	2003	2002	2001
Project Loans	597.3	417.0	565.6	689.9	568.4
Of Which Publicly Guaranteed	459.2	255.8	359.8	491.0	376.4
Of Which Private Non-Publicly Guaranteed	138.1	161.2	205.8	198.9	192.0
Equity Investments	35.1	3.21	-	-	-
Policy-Based Loans	147.7	388.7	176.7	185.6	232.1
Emergency Aid	5.7	2.8	3.6	4.6	1.2
Total Direct Financing	785.8	808.6	745.8	880.1	801.7
HIPC Debt Relief**	76.0	707.8	-	188.0	174.9
Guarantees and Other	6.9	-	-	-	10.1
Total	**868.9**	**1,519.5**	**745.8**	**1,068.1**	**986.7**

* 1 UA (Unit of Account) = 1 XDR (Special Drawing Right).
** Net present value of the reduction in debt service granted to the beneficiary countries.
Source: AfDB

- **Structural adjustments loans** aim to encourage specific macroeconomic policy reform.

Sectoral and structural adjustment loans may be offered in the context of aid packages to African countries in difficulty. These loans are usually co-financed by other multilateral institutions – the World Bank, the European Union and the European Investment Bank – and disbursement is generally conditional on implementation of adjustment policies recommended by the International Monetary Fund.

Private-Sector Activities

The bank restricts its assistance to any private enterprise, including loans and guarantees, to one-third of the total cost of the project. Besides project loans, which are not exclusively directed at public-sector operations, the bank also offers other financial instruments to accompany private entities. These non-sovereign-guaranteed products include agency lines, as well as equity stakes and guarantees.

- **Agency lines,** quite recently introduced, consist of loans to private-sector enterprises whose supervision is entrusted to a local financial institution. The latter must supervise the project's implementation as the credit risk of the borrower is solely borne by AfDB. There were no amounts outstanding under agency lines at end-2005.

- **Equity participations** include common shares and preferred stocks with or without participating features. The bank does not intend to assume management responsibility of an enterprise in which it invests and usually develops an exit strategy once the goals of the project are achieved. AfDB's by-laws authorise it to hold up to 25% of an enterprise's capital. As at end-2005, equity stakes – excluding investment in ADF – accounted for 1.3% of the bank's total exposure.

- **Guarantees** pursue a double objective. First, they ensure that eligible borrowers obtain financing in their own local currency to which the bank has no direct access. Second, they act as a credit enhancement product whereby borrowers raise funds with third-party credit institutions using AfDB's preferred creditor status signature. In 2005, the bank approved one credit guarantee operation amounting to UA6.9m.

Though private-sector operations account for a limited amount of AfDB's total financing, they have become a development priority for AfDB. Private-sector financing (lending and equity) increased gradually to 7.8% of AfDB's total outstanding portfolio at end-2005 from 2.2% at end-2001.

Non-Lending Debt Initiatives

The bank mainly grants debt relief under the HIPC Initiative. A new debt alleviation programme – the Post-Conflict Countries Facility ("PCCF") – was introduced in 2004, and the bank, through ADF, is also involved in the MDRI.

- The HIPC Initiative was launched in 1996 by governments of the developed world and multilateral creditors to relieve the external debt burden of the poorest countries. As at end-March 2006, 32 of the bank's RMCs were eligible for assistance; at this stage 25 countries had fulfilled the conditions to qualify for debt relief (known as the "decision point")[1]. Once approval is given, countries must demonstrate their ability to pursue sound economic policies for between two and four years before the debt relief process becomes irrevocable (the "completion point"): to date 15 RMCs have reached the completion point compared with 12

[1] In March 2006, Congo became the 25th RMC to reach the decision point.

at end-December 2004[2]. At end-March 2006, the African Development Bank Group's share for all 32 potential HIPCs, in net present value terms, was estimated at USD3.6bn, which included debt relief granted to the Democratic Republic of the Congo ("DRC") under the arrears clearance mechanism approved in 2002 (see *Credit Risk*). Debt relief committed for the 25 countries amounted to USD2.8bn in net present value terms, of which USD987.6m had actually been delivered at end-March 2006.

- A framework, the PCCF, was established in 2004 to enable countries facing civil war or post-conflict situations to clear their arrears and benefit from reconstruction efforts and debt reduction under HIPC. Out of seven eligible countries, the first two to benefit from the PCCF were Congo and Burundi[3]. The PCCF is funded by donors and allocations from ADF's and AfDB's net income.

- The MDRI is linked to the HIPC Initiative, at least from an operational standpoint. The MDRI is limited to three multilateral institutions – the International Development Association, the International Monetary Fund and ADF – which have agreed to cancel 100% of their debt claims on HIPC post-completion-point countries. The implementation of the MDRI is also conditional on financing assurances taking the form of donor commitments. These were secured as at end-June 2006 for the International Development Association and early September 2006 for ADF. The relief, amounting to USD8.5bn for the latter, is to be provided retroactively to 1 January 2006. Unlike the HIPC Initiative, the impact of the MDRI on the bank will be limited, as it is not liable for ADF's financial obligations.

■ Capital, Funding and Liquidity

- **Strong shareholder support, including ownership by highly rated non-African countries**
- **Strong capitalisation and liquidity**

Capital

The ownership of the bank is controlled by 53 African countries, which held some 60% of subscribed capital at end-2005. Nigeria, Egypt, South Africa and Algeria were AfDB's largest African shareholders. The remaining shares were held by 24 non-regional member countries, most of which are highly rated OECD countries. Following the 1999 increase in authorised capital, the share of non-African member countries has increased to 40%. This gives a blocking minority on the board of governors' general assembly, where a two-thirds majority is required. At end-2005, the main non-regional members were the United States, Japan, Germany, Canada and France, which together owned close to 24% of AfDB's subscribed capital. As a result, member countries with credit ratings of 'AAA' and 'AA' controlled 37.6% of AfDB's capital at end-December 2005. Considering AfDB's predominant role in the economic development of Africa, Fitch believes support from member countries would be forthcoming if necessary.

Breakdown of Callable Capital by Credit Rating

(%)	2005	2004
'AAA'	28.3	28.3
'AA'	9.3	9.3
'A'	3.9	3.9
'BBB'	6.3	6.3
Total Investment Grade	**47.8**	**47.8**
'BB' and Below or Not Rated	52.2	52.2
Total	**100.0**	**100.0**

Source: AfDB and Fitch Calculations

Subscribed capital totalled UA21.6bn as at end-2005. As with other MDBs, paid-in capital only accounts for a fraction (10.5% at end-2005) of subscribed capital. At end-2005, subscribed capital consisted of UA2.3bn in paid-in capital and UA19.4bn of subscribed but uncalled capital, or callable capital.

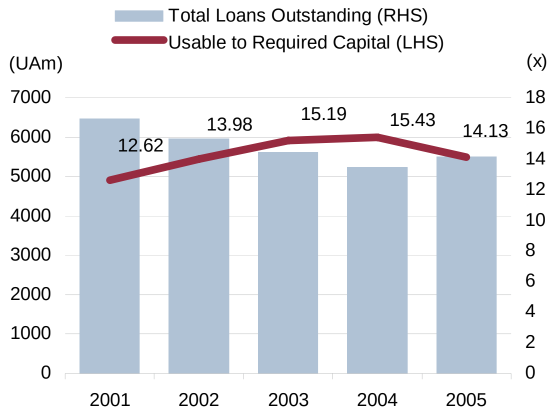
To compare the capital adequacy of MDBs, Fitch has developed its own capital adequacy measures (see "*Multilateral Development Banks: Rating Criteria and Industry Review*", published on 15 June 2005), based on the analysis of the credit quality of both borrowers and shareholders. The agency computes the expected loss to the bank on both its credit and equity operations – required capital – and compares it with the capital that the bank can use to cover this loss, usable capital. This includes shareholders' equity, but also callable capital from non-borrowing investment-grade-rated countries and callable capital from borrowing countries rated 'AAA' to 'AA'. Fitch implicitly assumes that a credit loss large enough to sweep the bank's equity could occur only if the borrowing countries were insolvent, and, hence, not in a position to respond to a capital call. AfDB's ratio of usable capital to required capital is among the highest of the MDBs: at end-2005 it stood at 14.1

[2] In April 2005, Rwanda and Zambia reached completion point, qualifying for irrevocable debt relief of debt committed under the HIPC Initiative.

[3] The other countries facing civil war or post-conflict situations are the Central African Republic, Congo, Cote d'Ivoire, Somalia, Liberia and Sudan .

times versus 15.4 times at end-2004. This slight decrease follows a 5.6% rise in the bank's financed operations (lending and equity).

AfDB's Capital Adequacy Development: Upper-End Position



Source: AfDB, Fitch's Methodology and Calculations

Funding

AfDB's operations are funded by equity or by borrowing on the capital markets. Thanks to its 'AAA' rating, it can raise resources at a very low cost. In 2005, the bank raised a total of UA544m (2004: UA418m) in the capital markets at an average cost of USD LIBOR minus 25.2 basis points. The bank's funding is predominantly long term. In addition to a EUR1bn commercial paper programme, the bank has an unlimited global debt issuance facility that enables it to issue debt in various forms, currencies and markets.

AfDB's average amount of debt has been declining in recent years thanks to strict internal funding policies (see *Risk Management*). Debt reached 147.2% of shareholders' equity at end-2005 compared with 133.8% at end-2004. Such performances are well below the average leverage ratio for all seven MDBs rated 'AAA' by Fitch, which stood at 338.8% at end-2004.

Liquidity

To maintain a high level of liquidity, AfDB holds a large portfolio of liquid assets. It represents readily available resources to meet daily cash requirements, but also funds loan and guarantee commitments when access to financial markets is restricted. As with funding policies, liquidity management follows a conservative set of rules (see *Risk Management*). At end-2005, the liquid assets portfolio consisted of tradeable securities (57.3% of the portfolio) and securities held to maturity (42.7%) in addition to interbank deposits. They are invested in hard currencies, primarily US dollars, euro and pounds sterling. The bank's cash and treasury investments peaked in 2005: it increased to UA4.8bn from UA4.5bn in 2004. Continuous improvements in the bank's liquidity position have been fuelled by loan prepayments, which have reached significant levels in recent years.

■ Risks

- **Significant exposure to credit risk**
- **Loan portfolio benefits from debt reduction initiatives**

Credit Risk

AfDB's loan portfolio carries significant credit risk, reflecting the generally low credit quality of African countries. Thirty-two countries out of 53 are eligible for debt relief under the HIPC Initiative, which suggests that their debt burdens were considered unsustainable. Two out of the 15 eligible for AfDB loans (Seychelles and Zimbabwe) are currently in default. At end-2005, only two of the 10 largest borrowers were rated investment grade: Tunisia ('BBB'/'F2') and South Africa ('BBB+'/'F2'). Financing extended to speculative-grade counterparties accounted for 74.7% of the bank's loan portfolio at end-2005 (2004: 73.2%).

Breakdown of Outstanding Loans by Final Guarantor's Ratings

(%)	2005	2004
'AAA'	0.0	0.0
'AA'	0.0	0.0
'A'	0.4	0.6
'BBB'	24.9	26.2
Total Investment Grade	**25.3**	**26.8**
'BB' and Below or Not Rated	74.7	73.2
Total	**100.0**	**100.0**

Source: AfDB and Fitch Calculations

Most risks lie in the loans granted prior to 1995 to countries in conflict situations and in chronic arrears, such as the DRC, Congo, Liberia and Sudan. As principal and interest payments became due, arrears continued to build up, and impaired loans (i.e. loans recorded with non-performing status) peaked at 24.6% of total loans in 2000, considerably higher than for other MDBs. This trend has been slowly reversing since 2002, with the combined effect of the HIPC Initiative and a specific arrears clearance mechanism sponsored by the donor community and implemented for the DRC.

Indeed, the DRC, the largest borrower in arrears, benefited from an exceptional debt restructuring package arranged in 2002. The scheme was financed through contributions from donors and AfDB net

AfDB's Credit Risk Exposure, Coverage and Internal Ratings

(UAm)	2005*	2004	2003	2002	2001
Sovereign Loans	5,150.3	4,903.5	5,383.9	5,798.7	6,387.8
Accumulated Provisions	376.4	436.4	452.8	475.5	479.1
Provisioning Rate (%)	7.3	8.9	8.4	8.2	7.5
Internal-Scale Rating**	3.2	3.0	2.9	3.0	3.1
Non-Sovereign Loans	362.1	319.0	228.4	168.9	77.9
Accumulated Provisions	16.1	26.5	19.9	12.7	14.8
Provisioning Rate (%)	4.4	8.3	8.7	7.5	19.0
Internal-Scale Rating**	3.2	3.3	3.7	3.5	4.7

* In 2005, provisions on impaired loans are calculated on an incurred basis. Prior to this, the conceptual framework used was that of "expected" and "unexpected" losses.
** AfDB's internal rating calculation is based on a 10-point rating scale with higher values reflecting higher risks.
Source: AfDB

income allocations, which were placed in an account separate from those of AfDB, the "special account for the DRC". In 2003, the DRC qualified for debt relief under the HIPC Initiative. In 2004, the creation of the PCCF enabled the bank to clear part of the arrears of Burundi and Congo. The bank's non-performing have declined significantly in recent years on absolute terms. However, in relative terms, they still accounted for 12.7% of outstanding loans at end-2005, down from 21.5% in 2004 but close to the 14.3% achieved in 2002. Since 2000, defaults from two large borrowers, Zimbabwe and Côte d'Ivoire, have gone against the general trend to clean-up AfDB's loan portfolio. Moreover, in view of the political situation of both countries, no significant repayment is expected in the short term. This has diluted the benefits drawn from the schemes and efforts put in place to clear chronic arrears. In 2005, loan arrears to AfDB rose 14.4% yoy to UA665.6m from UA581.9m.

Meanwhile, in spite of continuing adverse political and economic developments in the region, AfDB has never had to write off a sovereign loan. Such achievement reflects a privileged treatment AfDB shares with other MDBs: preferred creditor status. As this status confers priority over other creditors in the event of a sovereign default, it provides strong protection against credit losses. Preferred creditor status does not apply, however, to private-sector loans. Risk arising from private-sector diversification is nevertheless partly mitigated by the bank's stringent provisioning rules and its general treatment of overdue payments. Indeed, when principal or interest is more than 30 days overdue, the African Development Bank Group ceases disbursement as well as approvals of any new loans from all of its three operating entities (AfDB, ADF and NTF). Loans in arrears for more than six months are classified as non-performing. Until 2005, AfDB made general provisions for statistically probable losses and specific provisions where a permanent impairment could be reasonably assessed. In 2005, loan loss coverage ratios were slightly diluted, as provisions are now calculated on an incurred loss (as opposed to expected loss) basis and exclude general provisions. However, the released general provisions are included in reserves, thereby preserving the equity strength of the bank.

AfDB's growing private-sector involvement will pose inevitable challenges to the bank's management. However, the adoption of the "incurred loss" methodology had an artificial impact on the bank's overall level of provisions: provisions against private-sector financing fell to 4.4% of total non-sovereign operations in 2005 from 19.0% in 2001.

Another component of AfDB's credit risk analysis is the concentrated nature of its loan portfolio. On a standalone basis, the loan portfolio is in effect marked by a high level of concentration. At end-2005, the 10 largest exposures accounted for 90.0% of total sovereign loans and 84.1% of AfDB's entire loan portfolio. North African countries alone (Tunisia, Morocco, Egypt and Algeria) made up 43.6% of AfDB's loan book. The lack of granularity affecting AfDB's loan portfolio results principally from strict lending eligibility criteria, which the bank applies to potential borrowing countries[4]: since 1995 AfDB's loans have been limited to 15 "eligible" countries[5]. This includes two countries – Nigeria and Zimbabwe – that qualify for loans from both AfDB and ADF. Other RMCs only have access to concessional financing from ADF. However, on a comparative basis, AfDB's lending is relatively well positioned across the MDB industry: the five largest borrowers equated to 80.5% of the bank's equity at end-2005, a ratio that is among the lowest for MDB lending to developing countries. Moreover, concentration ratios are declining: AfDB's combined exposure to its five largest borrowers was equivalent

[4] AfDB's 2004 annual report states that "allocation of resources is fundamentally based on several criteria, which include country creditworthiness, per capita GNP and country performance".

[5] Algeria, Botswana, Egypt, Equatorial Guinea, Gabon, Libya, Mauritius, Morocco, Namibia, Nigeria, Seychelles, South Africa, Swaziland, Tunisia and Zimbabwe.

to 126.6% of shareholders' equity at end-2001. Such performance is in part explained by stringent internal exposure guidelines, which limit any borrowing country's loan exposure to 15% of the bank's maximum sustainable portfolio. Loans to Tunisia, AfDB's largest exposure at end-2005, represented 69% of this limit.

There is also residual credit risk relating to the bank's liquid assets portfolio. However, the bank adheres to conservative investment guidelines and cannot invest in financial instruments rated below 'AA–'; the limit is 'A' for money market instruments. Asset-backed securities are restricted to 'AAA'-rated bonds. As at end-2005, 55.8% of the bank liquid asset exposure was with 'AAA'-rated counterparties, 39.3% with 'AA'-rated entities and the remainder with 'A' counterparties.

Concentration Risk

(%)	2005	2004
Five Largest Individual Exposures/Total Equity	80.5	85.9
10 Largest Individual Exposures/Total Loan Portfolio	84.1	82.1

Source: AfDB and Fitch Calculations

Market Risk

AfDB's exposure to market risk is minimal, as market activities are not viewed as a profit-maximising activity. The bank employs a strategy of currency and interest rate matching across the balance sheet. A large share of AfDB's assets consist of floating- and variable-rate loans and investment securities; they are mainly funded by borrowings that, after swapping, bear either a floating rate or a variable rate. Fixed-rate loans and equity stakes are funded by shareholders' equity. Currency mismatching is also kept to a minimum: loans are denominated in convertible currencies (USD, EUR, GBP, CHF and JPY) and are matched in the relevant currency, using currency swaps extensively. The main source of market risk for the bank lies in prepayments from borrowers. In recent years, a number of borrowers prepaid their loans, in particular the fixed-rate loans issued before 1997, which carry a high interest rate and do not charge any prepayment penalty. However, prepayments are on a downward trend, amounting to UA262m in 2005 (4.8% of outstanding loans), down from peak figures in 2004 (UA542m) and 2003 (UA 471m) or 10.4% and 8.4% of total loans outstanding, respectively.

■ Risk Management

Like other MDBs, AfDB is not subject to international banking regulations and, as a consequence, does not have to publish standard capital ratios. The bank uses its own prudential measures, which are defined by its management and approved by the board of directors. In that respect, it abides by conservative policies regarding capital adequacy, liquidity and gearing.

These ratios set the maximum level of operations that the bank can bear, in view of its level of capital. Equity investments, for instance, are limited to 10% of the aggregate amount of the bank's paid-up capital and reserves and surplus included in its ordinary capital resources. Besides stringent investment guidelines, liquidity management also follows conservative rules. They require that liquid assets be at least equal to the loan equivalent value of guarantees and undisbursed equity investments and private-sector loans, plus the following four quarters' net loan disbursements and debt servicing requirements. The prudential minimum level calculation is updated on a quarterly basis.

The board of directors has set the ceiling on borrowing at 80% of callable capital: at end-2005, total debt accounted for 30.7% of the bank's callable capital (2004: 29.16%). Limits have also been set for senior debt, which is capped at 80% of callable capital held by non-borrowing countries (this ratio reached 61.1% as at end-2005). The bank has also set working guidelines for subordinated debt at 40% of total debt, though this does not constitute a board-approved limit. Overall, the bank is well within its internal leverage thresholds.

Internal Leverage Ratios

Ratio (%)	Max.	2005	2004	2003
Total Debt/Callable Capital	80.0	30.67	29.16	29.8
Senior Debt/Callable Capital from Non-Borrowing Countries	80.0	61.13	58.0	59.2

Source: AfDB

AfDB pays close attention the operational risks originating from its financial activities. In that regard, it has a business continuity services contract with a provider in Paris to ensure that data security and critical servicing, including debt servicing and payments to creditors, are up to date. These facilities helped the bank to assure the continuity of its operations during socio-political unrest in Côte d'Ivoire and prior to the temporary relocation to Tunis.

Performance and Prospects

- **No impact on the bank's fundamentals from IFRS adoption**
- **Declining trend in lending continues**
- **Growth in lending will be fuelled by private-sector loans, involving more risk taking**

Accounting Issues

AfDB presents its financial statements in accordance with IFRS (formerly IAS). The application in 2005 of new or revised IAS accounting rules affected the balance sheet and income statement of the bank, resulting in the restatement of previously published 2004 figures (which have been restated accordingly in Fitch's spreadsheets). Overall, these changes have had a positive material impact on AfDB's financial statements: they led to an increase in equity (+UA700m), an increase in assets (+UA748m), and a reduction of earning's volatility. However, in Fitch's view, they had no impact on the intrinsic financial strength of the bank.

Only one rule – IAS 32 – had an adverse effect on the bank's financial statements. It led to the qualification of AfDB's accounts by auditors, on the ground that, according to IFRS, capital subscriptions from member countries cannot be accounted for as equity but as a liability, as member countries are allowed to withdraw from the bank at any time. In Fitch's view, given the provisions contained in the by-laws of the bank regarding withdrawal of a member country, there is no valid reason to treat capital subscription as a liability. The shares of AfDB, held by sovereign nations, are very deeply subordinated and represent the residual interests in the assets of the bank. Part of the evidence is the ability of the bank to defer payment, in the unlikely event of withdrawal of a member country, if such payment would have an adverse impact on its financial situation. In addition, it has to be mentioned that the statutes of AfDB and its treatment of member countries' capital subscription are consistent with the MDBs' industry practice.

The application of IAS39 had a positive impact on the bank's equity.

- Interests on loans in arrears for more than six months are now accrued. This has resulted in higher interest revenues and, in 2005, led to a one-time recognition of UA720m of previously non-accrued interest, including a component of the DRC loan, which were re-incorporated both in the bank's equity and assets.

- The use of incurred losses instead of expected loss as a basis for loan loss provisioning led to a significant reduction (UA236m) in loan loss reserves.

- An amendment to IAS39 has allowed the bank to account at fair value – instead of book value – assets and liabilities containing an embedded derivative that is also fair valued. This reduces substantially the fair-value adjustments that had to be recognised in the income statement (see Fitch's 2004 report on AfDB), and significantly reduces the bank's earnings volatility.

Other accounting changes concerned currency translation adjustments (IAS21), recognition of profits and losses on employee benefits scheme (IAS19), and the accounting treatment of AfDB's participation in ADF, which is now recognised as an "investment in associate" (IAS 28). Their impact is not significant on the bank's equity.

Performance

As for other MDBs, profit generation is not one of AfDB's primary objectives, but rather a means of consolidating its equity base. Though AfDB does not distribute dividends, a significant portion of net income is allocated to debt reduction and arrears clearance schemes in which AfDB participates (in particular the PCCF, the DRC Fund, the HIPC Initiative) as well as to the ADF. These allocations amounted to UA139m, or 62.9% of the 2005 net income. MDRI will not necessitate contributions from AfDB, as only concessional loans – i.e. ADF loans – have been cancelled under this scheme, and debt cancellations will be financed on a dollar-for-dollar basis by contributions from donors.

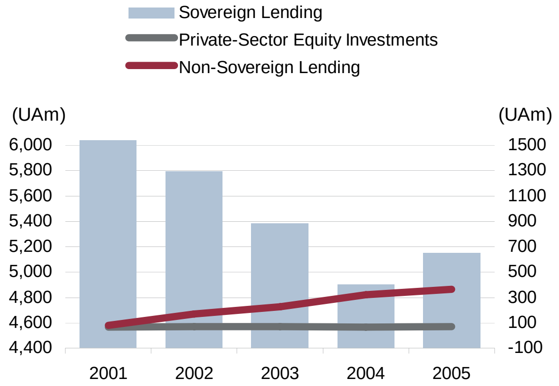
The profitability of AfDB is in line with that of other MDBs and has been stable in recent years. The main drivers of AfDB's earning generation are changes in loan loss provisions and, to a much smaller extent, interest rates: the increase in profits in 2005 was mainly explained by the decline in provisions (write-back of UA13.9m compared with a charge of UA53.9m, on a restated basis, in 2004); it is also attributable to the rise in interest rates on USD, which led to a 25.7% increase in revenues from treasury investments but was largely offset by a corresponding increase in financial charges. Revenues from loans stagnated in 2005 (+0.3% on 2004 restated numbers), reflecting the decline in the bank's loan portfolio.

Prospects

On a comparable basis – i.e. by neutralising the UA720m which was added to the portfolio as a result of accounting changes – the bank's loan portfolio has been on a declining trend since the late 1990s. A number of AfDB's member countries – mainly from North Africa – have improved their access to capital markets in recent years, and have decided to prepay some of their AfDB loans, in particular the "old" fixed-rate loans bearing a high interest rate. However, after peaking in 2004 at UA1012.5m, total loan repayments (scheduled plus prepaid) declined to UA714.0m in 2005. Fitch expects them to stabilise in 2006 and then decline as most of the loans carrying high interest rates have been prepaid. The bank has also to face a lower demand for loans from these countries, while most Sub-Saharan sovereigns are not allowed to borrow from the non-concessional window, leaving the number of eligible public borrowers at 15. Lower lending activity also reflects a shortage of viable public projects to finance and increasing competition from other development institutions. Hence, the declining trend in loan disbursements continued in 2005, with a drop to UA595.3m from UA630.2m in 2004.

The bank expects to reverse this trend mainly through the development of non-sovereign lending. Although still accounting for a limited portion of AfDB's lending in 2005 (6.6% at end-2005), the private sector will represent, according to the bank's projections, more than one-third of total disbursements in 2006 and onward. As part of AfDB's medium-term development plan, a formal limit was approved for the capital allocated to non-sovereign operations at 20% of the bank's net paid-in capital, net reserves and loan loss provisions (referred to as "risk capital"). As at end-2005, the outstanding non-sovereign portfolio used 4.1% of such risk capital, leaving the bank's management with sufficient headroom for future operational developments. To achieve this objective, the bank has opened new local offices in African countries (14 offices are currently operating) and will have to hire more staff. In addition, this strategy will necessitate more risk taking, as the bank will not benefit from preferred creditor status on non-sovereign loans and has relatively limited experience in private-sector lending.

AfDB's Mid-Term Strategy: Operational Growth Led by Non-Sovereign Activities



Source: AfDB

Balance Sheet Analysis
AFRICAN DEVELOPMENT BANK

	31 Dec 2005				31 Dec 2004	
	Year End USDm Original	Year End XDRm Original	As % of Assets Original	Average XDRm Original	Year End XDRm Original	As % of Assets Original
A. LOANS						
1. Loans made through Banks	n.a.	n.a.	-	n.a.	n.a.	-
2. To/Guaranteed by Public Institutions	7,361.1	5,150.3	44.50	5,235.9	5,321.5	49.45
3. To Private Sector	517.5	362.1	3.13	340.6	319.0	2.96
4. Trade Financing Loans	n.a.	n.a.	-	n.a.	n.a.	-
5. Other Loans	n.a.	n.a.	-	n.a.	n.a.	-
6. Loan Loss Reserves (deducted)	560.8	392.4	3.39	397.0	401.7	3.73
TOTAL A	**7,317.8**	**5,120.0**	**44.23**	**5,179.4**	**5,238.8**	**48.68**
B. OTHER EARNING ASSETS						
1. Deposits with Banks	n.a.	n.a.	-	n.a.	n.a.	-
2. Securities held for Sale & Trading	4,227.6	2,957.9	25.55	2,630.4	2,302.9	21.40
3. Investment Debt Securities - (incl. other invest.)	3,145.8	2,201.0	19.02	2,168.7	2,136.4	19.85
4. Equity Investments	241.1	168.7	1.46	164.6	160.6	1.49
TOTAL B	**7,614.6**	**5,327.6**	**46.03**	**4,963.8**	**4,599.9**	**42.75**
C. TOTAL EARNING ASSETS (A+B)	**14,932.4**	**10,447.6**	**90.26**	**10,143.2**	**9,838.7**	**91.43**
D. FIXED ASSETS	**23.4**	**16.4**	**0.14**	**17.0**	**17.6**	**0.16**
E. NON-EARNING ASSETS						
1. Cash and Due from Banks	100.5	70.3	0.61	57.1	43.8	0.41
2. Other	1,487.4	1,040.7	8.99	950.8	860.9	8.00
F. TOTAL ASSETS	**16,543.7**	**11,575.0**	**100.00**	**11,168.0**	**10,761.0**	**100.00**
G. SHORT-TERM FUNDING						
1. Bank Borrowings (< 1 Year)	667.5	467.0	4.03	238.2	9.3	0.09
2. Securities Issues (< 1 Year)	1,001.1	700.4	6.05	653.3	606.1	5.63
3. Other (incl. Deposits)	n.a.	n.a.	-	n.a.	n.a.	-
TOTAL G	**1,668.5**	**1,167.4**	**10.09**	**891.4**	**615.4**	**5.72**
H. OTHER FUNDING						
1. Bank Borrowings (> 1 Year)	n.a.	n.a.	-	n.a.	n.a.	-
2. Other Borrowings (incl. Securities Issues)	6,446.4	4,510.3	38.97	4,771.6	5,032.8	46.77
3. Subordinated Debt	1,042.9	729.7	6.30	n.a.	n.a.	-
4. Hybrid Capital	n.a.	n.a.	-	n.a.	n.a.	-
TOTAL H	**7,489.4**	**5,240.0**	**45.27**	**5,136.4**	**5,032.8**	**46.77**
I. OTHER (Non-Int Bearing)	**1,165.4**	**815.4**	**7.04**	**853.3**	**891.1**	**8.28**
J. GENERAL PROVISIONS & RESERVES	**n.a.**	**n.a.**	**-**	**n.a.**	**n.a.**	**-**
L. EQUITY						
1. Preference Shares	n.a.	n.a.	-	n.a.	n.a.	-
2. Subscribed Capital	30,923.6	21,636.0	186.92	21,617.0	21,597.9	200.71
3. Callable Capital	-27,680.6	-19,367.0	-167.32	-19,370.8	-19,374.6	-180.04
4. Arrears/Advances on Capital	-261.8	-183.2	-1.58	-185.7	-188.2	-1.75
5. Paid in Capital (memo)	3,243.1	2,269.1	19.60	2,246.2	2,223.3	20.66
6. Reserves (incl. Net Income for the year)	3,239.3	2,266.4	19.58	2,226.5	2,186.6	20.32
TOTAL L	**6,220.4**	**4,352.2**	**37.60**	**4,287.0**	**4,221.7**	**39.23**
M. TOTAL LIABILITIES & EQUITY	**16,543.7**	**11,575.0**	**100.00**	**11,168.0**	**10,761.0**	**100.00**
Exchange Rate		USD1 = XDR 0.6997			USD1 = XDR 0.6439	

Income Statement Analysis
AFRICAN DEVELOPMENT BANK

	31 Dec 2005		31 Dec 2004	
	Income Expenses XDRm Original	As % of Total AV Earning Assts Original	Income Expenses XDRm Original	As % of Total AV Earning Assts Original
1. Interest Received	472.3	4.66	436.8	-
2. Interest Paid	219.8	2.17	195.5	-
3. NET INTEREST REVENUE	**252.5**	**2.49**	**241.3**	**-**
4. Other Operating Income	10.0	0.10	8.3	-
5. Other Income	130.6	1.29	111.1	-
6. Personnel Expenses	124.5	1.23	116.1	-
7. Other Non-Interest Expenses	38.3	0.38	32.5	-
8. Loan Loss Provisions	-13.8	-0.14	53.9	-
9. Other Provisions	-0.8	-0.01	-3.3	-
10. OPERATING PROFIT	**244.9**	**2.41**	**161.5**	**-**
11. Exceptional Items	-23.6	-0.23	-18.0	-
12. NET INCOME	**221.3**	**2.18**	**143.5**	**-**

Ratio Analysis
AFRICAN DEVELOPMENT BANK

		31 Dec 2005 Original	31 Dec 2004 Original
I. PROFITABILITY LEVEL			
1. Net Income/Equity (av.)	%	5.16	n.a.
2. Net Income/Total Assets (av.)	%	1.98	473.60
3. Net Interest Revenue + Commitment Fees/Gross Loans (av.) + Liquid Assets (av.) + Average Guarantees (av.)	%	2.47	n.a.
4. Non-int. Exp./Net Interest Rev. + Other Operating Income	%	62.02	59.54
5. Income from Equity Investment/ Equity Investment (av.)	%	n.a.	n.a.
6. Provision on Loans & Equity Part. & Guarantees/ Gross Loans (av.) + Equity Investment (av.) & Guarantees (av.)	%	-0.25	n.a.
II. CAPITAL ADEQUACY			
1. Internal Capital Generation	%	5.16	n.a.
2. Outstanding Loans + Net Equity Invest. + Net Guarantees /Subscribed Capital + Reserves	%	22.13	22.83
3. Equity/Total Assets	%	37.60	39.23
4. AAA-AA- Callable Capital/Callable Capital	%	37.64	37.66
5. Broad Capital/Required Capital	%	2,727.20	2,653.23
6. Usable Capital/Required Capital	%	1,412.99	1,542.62
III. LIQUIDITY			
1. Liquid Assets & Marketable Debt Securities/Debt < 1 Year	%	447.94	728.49
2. Liquid Assets & Marketable Debt Securities/Total Assets	%	45.18	41.66
3. Liquid Assets + Marketable Debt Securities/Undisbursed Loans and Equity	%	281.59	294.09
IV. ASSET QUALITY			
1. Non Accrual Loans /Gross Loans	%	12.74	19.88
2. Loan Loss Reserves / Gross Loans	%	7.12	7.12
3. Equity Loss Reserves /Equity Investment	%	0.41	2.01
4. Total reserves / Gross Loans, Equity Investment & Guarantees	%	6.90	6.90
5. Loan Loss Reserves/Non Accrual Loans	%	55.86	35.82
6. Loans to Investment Grade Borrowers/Gross Loans Loans	%	25.31	24.80
V. LEVERAGE			
1. Debt/Equity	%	147.22	133.79
2. Debt/Subscribed Capital + Reserves	%	26.81	23.75
3. Debt/Callable Capital	%	33.08	29.15
4. Net Income + Interest Paid/Interest Paid	%	200.68	173.40