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African Development Bank

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 Ratings Services' 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 and improving 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:

- Large nonperforming loans; and
- The inability of the governments of most regional member countries (RMCs) to borrow from the bank, which could make continuing shareholder support from some RMCs dependent upon the continued availability of financing from other African Development Bank Group entities.

Rationale

AFDB, a regional multilateral development finance institution (MDFI), was established in 1964 by 29 African countries. Nonregional members were admitted beginning in 1982, and AFDB's membership now includes all 53 African and 24 nonregional countries. AFDB is the

keystone of the African Development Bank Group (AFDB Group), which also includes soft-loan windows African Development Fund (AFDF) and Nigeria Trust Fund (NTF). AFDF and NTF make grants and loans at concessional rates, and together accounted for more than half of AFDB Group disbursements in each of the past two years; their loans and grants help to maintain support for AFDB in countries whose governments are not eligible to borrow from the bank. However, while AFDB has an equity investment in AFDF, it is not responsible for the financial obligations of either of these funds, both of which are unrated.

The bank's primary activity is providing medium- and long-term loans to African governments and other public sector entities with sovereign guarantees. It also lends to the private sector, makes equity investments, and has provided a few small guarantees. However, its sovereign lending (including accrued income and charges receivable on loans) accounted for 91% of its total loans, accrued income and charges receivable on loans, equity investments, and guarantees (together its development-related exposure, or DRE) at year-end 2005, while private sector loans and equity investments equaled 6% and 3%, respectively.

AFDB has restricted its sovereign lending to its most creditworthy RMCs since 1995. Fifteen African countries are (in principle) eligible to borrow from the bank; however, two (Zimbabwe, not rated; and Seychelles, 'B'; all country ratings herein are foreign currency sovereign credit ratings as of Sept. 20, 2006) have arrears on payments that bar new disbursements, and one (Libya, not rated) has never borrowed from the bank. The 38 other African countries can borrow only from AFDF and NTF. However, primarily as a result of loans granted prior to 1995, nearly 29% of AFDB's total loans at year-end 2005 were to countries and public sector entities in countries no longer eligible to borrow from the bank.

AFDB's outstanding loans totaled Special Drawing Rights (SDR) 5,512 million at year-end 2005, less than 48% of its total assets. Reflecting the weak credit standing of many of its regional members, SDR683 million of these loans (more than 12%) had principal or interest payments past due by more than six months, SDR356 million of which was to Cote d'Ivoire.

The expected losses embedded in AFDB's loan portfolio are much smaller than they might appear. Standard & Poor's expects AFDB to receive preferential treatment on its sovereign and sovereign-guaranteed loans compared to that received by commercial and bilateral lenders, in line with its status as a preferred creditor; however, given the economic distress of many of its borrowing members, this special status may be of limited value. More important are the payments AFDB expects to receive on behalf of its borrowers through the Highly Indebted Poor Countries (HIPC) Initiative. Twenty-five member countries reached either their completion points (15) or decision points (10) by mid-May 2006, and another eight are predecision point countries. These countries accounted for 4.8%, 15.1%, and 8.4%, respectively, of AFDB's total loans at year-end 2005. The HIPC Trust Fund will repay a substantial portion of these loans. In addition, the Multilateral Debt Relief Initiative (MDRI) is expected to place these countries in a better position financially to service their external debts, including those to AFDB.

AFDB has steadily strengthened its capital position in recent years. Its provisions for losses plus adjusted shareholders' equity (its narrow risk-bearing capacity) was more than 76% of DRE at year-end 2005. In addition, AFDB's financial strength is bolstered by callable capital, nearly SDR5.5 billion of which was from countries rated 'AAA' by Standard & Poor's at year-end 2005. As a consequence, AFDB's ratio of reserves for losses, adjusted shareholders' equity, and 'AAA' callable capital (its broad risk-bearing capacity) to DRE was nearly 166% at year-end 2005, the highest such ratio among rated MDFIs. In addition, ongoing capital contributions are slated to further increase shareholders' equity through year-end 2008.

AFDB's net income increased to SDR221 million during 2005 from a restated SDR144 million one year earlier, resulting in a return on average assets plus guarantees of 2.0% and a return on average adjusted shareholders' equity of 5.3%. However, these numbers were heavily affected by changes in provisions for losses and derivatives valuations resulting from a change in accounting methodologies.

AFDB's liquidity position continued to strengthen during 2005, and it is now one of the strongest among rated MDFIs.

Outlook

The outlook for the ratings on AFDB is stable. The bank's capital position and liquidity are now extremely strong and its franchise value high and increasing, given the attention Africa and its problems are now receiving from the international community. It has substantial scope for increasing its lending and other risk-generating activities while maintaining its current ratings.

Membership And Voting Power

The agreement establishing AFDB was signed in 1963 and came into force in 1964. The bank began operations in 1966 with 29 members, all of which 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, AFDB. At year-end 2005, AFDB's membership consisted of all 53 African countries 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 2005 were the Federal Republic of Nigeria (not rated), 9.0%; U.S. ('AAA'), 6.5%; 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+'), 4.0%; Algeria (not rated), 3.8%; Canada ('AAA'), 3.7%; and the Republic of France ('AAA'), 3.7%.

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, but total arrears on subscribed capital fell to less than SDR6 million at year-end 2005. 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 with small shareholdings 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. Each member country appoints a governor and an alternate, who serve nominal five-year terms. However, these terms may be abbreviated or extended by the appointing member country. The board of governors delegates most of its operational responsibilities to the board of directors, although it retains the power to override their decisions.

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. Although one director represents only the U.S., all other directors represented multi-country constituencies at year-end 2005.

The president of the bank may serve a maximum of two five-year terms. The second term of Omar Kabbaj, the former president, ended on Aug. 31, 2005. He was succeeded by Donald Kaberuka, formerly Minister for Finance and Economic Planning of the Republic of Rwanda (not rated), on Sept. 1, 2005. AFDB's regular staff totaled 1,020 at year-end 2005, up from 1,012 at year-end 2004. Management and professionals accounted for 675 of the total. The bank is actively recruiting additional professional staff.

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

Balance Sheet

Table 1 summarizes AFDB's balance sheet. During 2005, the bank adopted all of the new and revised standards and interpretations issued by the International Accounting Standards Board and the International Financial Reporting Interpretations Committee. The most important consequences for AFDB's financial statements resulted from:

- The change to incurred loss from expected loss provisioning methodology (IAS 39). Under this methodology, the bank no longer places loans in nonaccrual status; rather, interest and charges are accrued on all loans, including those in arrears, with an assessment for impairment using the incurred loss model appearing on the balance sheet as a contra account against accrued income and charges receivable on loans.
- The utilization of the fair value option (IAS 39). This permits AFDB to fair value all borrowings with embedded derivatives that meet certain conditions and report changes in the fair value in the income statement.

Accordingly, AFDB's year-end 2004 balance sheet is shown both on the prior basis and as restated, employing all of the new standards and interpretations. The principal differences are:

- Disbursed and outstanding loans as restated increased to SDR5,640 million from SDR5,223 million. As a consequence, using the same accounting treatment, outstanding loans decreased during 2005;
- The accumulated provision for impairment of loans decreased to SDR214 million from SDR450 million;
- The value of AFDB's participation in the AFDF was written down by SDR14 million to reflect its share of accumulated losses and the impairment of its value;
- Accrued income and charges receivable on loans increased to SDR406 million from the formerly reported SDR158 million accrued income and receivables on loans and investments, with a contra account for impairment established;
- Total assets increased to SDR10,792 million from 10,044 million;
- Reserves increased to SDR2,187 million from SDR1,486 million;
- Shareholders' equity increased to SDR4,253 million from SDR3,553 million; and
- DRE increased to SDR6,227 million from SDR5,417 million.

There were related changes in AFDB's income statement (see below). In addition, for the first time in its more than 40-year existence, AFDB's auditors qualified their opinion on the bank's financial

statements. The sole basis for this qualification was a determination by the auditors that, under IAS 32, member countries' capital stock should be reclassified in the bank's financial statements as a financial liability instead of equity. Standard & Poor's believes that such a classification is unjustified in substantive terms and has no adverse credit implications. (This issue is discussed in more detail in "Accounting for Capital in Multilateral Institutions," RatingsDirect, May 16, 2006.)

Table 1

African Development Bank Summary Balance Sheet						
—Year ended Dec. 31—						
(Mil. SDR)	2005	2004 restated	2004	2003	2002	2001
<i>Assets</i>						
Cash, due from banks	74	48	48	70	96	121
Investments	5,155	4,435	4,435	4,136	1,973	2,071
Disbursed and outstanding loans	5,512	5,640	5,223	5,612	5,968	6,466
Accumulated provision for impairment of loans	-195	-214	-450	-469	-492	-494
Equity participations, of which:	172	165	179	182	182	178
Equity participation in African Development Fund	97	97	112	112	112	112
Accumulated provision for equity losses	-3	-4	-4	-18	-18	-19
Accrued income and charges receivable on loans	431	406	N.A.	N.A.	N.A.	N.A.
Accumulated provision for impairment on income and charges receivable on loans	-198	-188	N.A.	N.A.	N.A.	N.A.
Accrued income and charges receivables on loans and investments	N.A.	N.A.	158	169	214	301
Nonnegotiable instruments on account of capital	26	31	31	42	57	63
Derivative assets	286	275	275	254	149	136
Other assets	340	198	149	225	282	352
Total assets	11,601	10,792	10,044	10,035	8,197	8,874
<i>Liabilities</i>						
Borrowings	5,940	5,639	5,657	5,799	4,455	5,211
Accounts payable	498	377	311	195	232	383
Securities sold under agreements to repurchase	467	9	9	114	0	0
Derivative liabilities	317	514	513	396	62	65
Total liabilities	7,223	6,539	6,491	6,504	4,749	5,659
<i>Capital</i>						
Paid-in capital after cumulative exchange adjustments on subscriptions	2,112	2,066	2,066	2,023	1,983	1,948
Reserves	2,266	2,187	1,486	1,507	1,465	1,266
Shareholders' equity	4,378	4,253	3,553	3,531	3,448	3,214
<i>Memo items:</i>						
Guarantees of securities	0	15	15	4	3	0
Loans, accrued income and charges on loans, equity investments, and guarantees (DRE)	6,116	6,227	5,417	5,798	6,153	6,644

N.A.-Not available.

While the accounting changes implemented during 2005 blur comparisons, three trends are nonetheless evident from table 1:

- The bank's shareholders' equity has monotonically risen over the past four years;
- DRE has monotonically declined; and

- Cash and investments have risen very substantially.

Taken together, these trends suggest a marked improvement in both the bank's underlying capital strength and its liquidity.

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 accrued income and charges for loans, as of year-end 2005] 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, these operations 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 rated 'A' or higher, derivative counterparties to be rated 'AA-' or higher, and medium- and long-term financial instruments to be rated 'AA-' or higher. The credit quality of AFDB's investment and derivatives portfolios decreased somewhat during 2005, with 92% of its exposure to 'AAA' and 'AA' entities as opposed to 98% at year-end 2004; in both cases, however, the remaining exposure was rated 'A'. The bank generally executes International Swaps and Derivatives Association 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 and, more recently, to help develop the capital markets in its RMCs. At year-end 2005, its borrowings were concentrated in U.S. dollars (45% of total direct borrowings), Japanese yen (32%), and euros (5%). At the same time, AFDB's loans were concentrated in euros (40% of loans), U.S. dollars (38%), and Japanese yen (14%). 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 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 and, consequently, shareholders' equity.

Interest-rate risk.

Interest-rate risk for the bank arises from two principal sources: the net interest margin for assets funded by debt and the interest-rate sensitivity of assets funded by equity. Management seeks to generate a stable net interest margin for the more than half of the bank's interest-rate-sensitive 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 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, particularly those for loans issued before 1997, which did not carry a prepayment penalty. The decline of interest rates in 2002 through 2004 made repayment or refinancing an attractive option for some of AFDB's more creditworthy borrowers, and SDR471 million in loans were prepaid in 2003 and SDR542 million in 2004. The amount in 2004 was nearly 10% of year-end 2003 loans. However, firming interest rates during 2005, as well as the decline in outstanding pre-1997 loans, prompted a reduction in prepayments during 2005 to SDR264 million.

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

Development-related exposure risk

The vast bulk of AFDB's risk lies in its DRE. However, this risk is lower than it might appear, and has 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, AFDB has used the same eligibility criteria as the International Bank for Reconstruction and Development (IBRD; 'AAA') 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 were eligible to borrow only from the bank at year-end 2005. Of these 13, Seychelles was barred from doing so because it was under sanctions for delays in servicing its loan obligations, and Libya (not rated) has never borrowed from the bank. Nigeria and Zimbabwe were eligible (in principle) to borrow from both the bank and AFDF (though Zimbabwe was barred from doing so because it was under sanctions for delays in servicing its loan obligations). In addition, 38 members were eligible to borrow only from AFDF.

AFDB has historically focused on lending to the public sector, and, as shown in Table 2, public sector loans accounted for 93% of total outstanding loans at year-end 2005. There has been an increasing demand for lending to highly creditworthy public sector borrowers without sovereign guarantees. Because 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. Although still very small in volume, this lending has grown rapidly in percentage terms, albeit from a low base: outstanding private sector loans increased to SDR362 million at year-end 2005 from SDR319 million at year-end 2004 and SDR228 million at year-end 2003. Management expects lending to the private sector and to public sector entities without sovereign guarantees to account for most of the growth in the bank's outstanding loans over the medium term.

Table 2

African Development Bank Financing, By Purpose					
	—Year ended Dec. 31—				
(Mil. SDR, unless otherwise indicated)	2005	2004	2003	2002	2001
Approvals	869	1,520	746	1,068	987
Project lending, of which:	597	417	566	690	568
Public and publicly guaranteed	459	256	360	491	376
Project loans	321	243	175	275	261

Table 2

African Development Bank Financing, By Purpose (cont.'d)					
	—Year ended Dec. 31—				
(Mil. SDR, unless otherwise indicated)	2005	2004	2003	2002	2001
Approvals	869	1,520	746	1,068	987
Lines of credit	138	13	185	216	115
Private and nonpublicly guaranteed loans	138	161	206	199	192
Project loans	64	0	91	98	43
Lines of credit	74	161	114	100	149
Policy-based lending, of which:	148	389	177	186	232
Sector adjustment	50	208	177	82	79
Structural adjustment	98	181	0	103	153
Equity participation	35	3	0	0	0
Special relief fund	6	3	4	5	1
HIPC debt relief	76	708	0	188	175
Project loan approvals as a % of total loan approvals	69	27	76	65	58
Public sector approvals as a % of total approvals	79	89	72	81	80
Lines of credit approvals as a % of total approvals	24	11	40	30	27
Loans outstanding	5,512	5,640	5,612	5,968	6,466
Project lending, of which:	3,211	3,512	3,705	3,702	4,181
Public and publicly guaranteed	2,849	3,193	3,476	3,533	4,103
Project loans	1,903	2,043	2,300	2,544	3,037
Sector investment and rehabilitation loans	181	185	194	200	292
Lines of credit	765	965	982	789	774
Private and nonpublicly guaranteed loans	362	319	228	169	78
Project loans	178	173	78	33	42
Lines of credit	184	146	150	136	36
Policy-based lending, of which:	1,559	1,367	1,561	1,918	2,285
Sector adjustment	735	636	699	854	1,135
Structural adjustment	824	732	862	1,064	1,150
Debt and debt service reduction loans	743	761	347	348	0
Project loans outstanding as a % of total loans outstanding	58	62	66	62	65
Public sector loans outstanding as a % of total loans outstanding	93	94	96	97	99
Policy-based loans as a % of outstanding loans	28	24	28	32	35

Types of development-related exposure.

Table 2 also shows AFDB's financing approvals and outstanding loans by the purpose of the financing. Most of AFDB's lending is for projects; project lending has accounted for 27%-76% of approvals (69% in 2005) and 58%-66% of outstanding loans (58% at year-end 2005) over the past five years. Policy-based lending approvals have been volatile, but outstanding policy-based loans, which had been dropping both in absolute terms and as a percentage of total loans, increased in both respects during 2005. 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 has been a growing activity, and such approvals were 24% of total approvals during 2005. Lines of credit enable the bank to finance private-sector borrowers, including small and midsize enterprises, more efficiently than it otherwise could.

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 2005, about 26% of loans were scheduled to mature in 2006 and 2007, with another 19% in 2008 and 2009, and almost 48% of loans had remaining maturities of five years or longer.

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 2005 was SDR172 million (of which SDR97 million represented AFDB's long-standing equity investment in AFDF, SDR31 million was in a variety of regional development banks and other development institutions, and SDR43 million was in a variety of equity funds). The bank is not contemplating substantial additions to its equity investments.

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 33% of its subscribed capital, reserves, and surplus at year-end 2005. Accordingly, this limit is not currently 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 lending 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 sustainable portfolio. Loans to no country exceeded 69% of the 15% limit at year-end 2005.

In practice, as shown in Table 3, AFDB's DRE concentration is surprisingly low. Its total DRE in its five countries of largest exposure relative to its narrow risk-bearing capacity has declined substantially in recent years (the change between 2005 and 2004 is distorted by accounting changes) and was less than 79% at year-end 2005, well below that of the Inter-American Development Bank ('AAA', 189%), the Asian Development Bank ('AAA', 180%), and even the IBRD (122%).

Table 3

African Development Bank Geographic Concentration Of Development-Related Exposure					
—Year ended Dec. 31—					
Largest country exposures/ratings*	2005	2004	2003	2002	2001
Largest	Tunisia/BBB	Tunisia/BBB	Tunisia/BBB	Tunisia/BBB	Morocco/BB
Mil. SDR	1,227	1,243	1,157	1,107	1,107
% DRE¶	20.1	22.9	20.0	18.0	16.7
% narrow risk-bearing capacity§	26.4	27.4	29.8	29.1	31.3
2nd largest	Morocco/BB+	Morocco/BB	Algeria/NR	Morocco/BB	Tunisia/BBB
Mil. SDR	853	683	764	912	1,098
% DRE¶	14.0	12.6	13.2	14.8	16.5
% narrow risk-bearing capacity§	18.4	15.1	19.7	24.0	31.1
3rd largest	DR Congo/NR	Nigeria/NR	Morocco/BB	Algeria/NR	Algeria/NR
Mil. SDR	743	515	596	753	783
% DRE¶	12.1	9.5	10.3	12.2	11.8

Table 3

African Development Bank Geographic Concentration Of Development-Related Exposure (cont.'d)					
—Year ended Dec. 31—					
Largest country exposures/ratings*	2005	2004	2003	2002	2001
% narrow risk-bearing capacity [§]	16.0	11.4	15.3	19.8	22.2
4th largest	Nigeria/NR	Cote d'Ivoire/NR	Nigeria/NR	Nigeria/NR	Nigeria/NR
Mil. SDR	463	367	492	569	635
% DRE [¶]	7.6	6.8	8.5	9.2	9.6
% narrow risk-bearing capacity [§]	10.0	8.1	12.7	14.9	18.0
5th largest	Cote d'Ivoire/NR	DR Congo/NR	Cote D'Ivoire/NR	Cote D'Ivoire/NR	Cote D'Ivoire/NR
Mil. SDR	362	343	360	352	429
% DRE [¶]	5.9	6.3	6.2	5.7	6.5
% narrow risk-bearing capacity [§]	7.8	7.6	9.3	9.3	12.1
Largest two country exposures	2,080	1,926	1,921	2,019	2,205
% DRE [¶]	34.0	35.6	33.1	32.8	33.2
% narrow risk-bearing capacity [§]	44.7	42.5	49.5	53.0	62.4
Largest three country exposures	2,823	2,441	2,517	2,772	2,988
% DRE [¶]	46.2	45.1	43.4	45.1	45.0
% narrow risk-bearing capacity [§]	60.7	53.9	64.8	72.8	84.6
Largest four country exposures	3,286	2,808	3,009	3,341	3,623
% DRE [¶]	53.7	51.8	51.9	54.3	54.5
% narrow risk-bearing capacity [§]	70.6	62.0	77.5	87.8	102.6
Largest five country exposures	3,647	3,151	3,368	3,693	4,052
% DRE [¶]	59.6	58.2	58.1	60.0	61.0
% narrow risk-bearing capacity [§]	78.4	69.6	86.8	97.0	114.7

*Ratings at balance sheet dates. [¶]Loans, accrued income and charges on loans, equity investments, and guarantees. [§]Provisions for losses plus adjusted shareholders' equity. N.R.—Not rated.

Development-related exposure quality and provisions for losses.

Table 4 provides indicators of the quality of AFDB's DRE and the accumulated provisions for losses embedded in that exposure. The index of the quality of country-specific DRE 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 public ratings) of AFDB's RMCs. This figure is 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. This time series has been distorted by the accounting changes implemented during 2005, which resulted in an increase in the reported loan exposure to the Democratic Republic of the Congo (DRC; not rated) and raised the index number for 2005. Nonetheless, it remains true that by this measure AFDB's loan portfolio carries more embedded risk than that of any other rated MDFIs. However, this index does not differentiate between sovereign and nonsovereign loans, which are expected to carry more risk. It thus typically understates the total risk embedded in the portfolios of institutions with relatively more exposure to nonsovereign credits. On the other hand, as noted above, AFDB has been increasing its exposure to nonsovereign entities, albeit from a very low level, and nonsovereign loans increased to more than 6% of total loans plus accrued income and charges at year-end 2005 from less than 1% at year-end 2000.

Table 4

(Mil. SDR, unless otherwise indicated)	—Year ended Dec. 31—				
	2005	2004	2003	2002	2001
Index of quality of country-specific DRE	15.9	14.5	14.6	16.3	14.1
Private sector loans as a % of total loans	6.6	6.1	4.1	2.8	1.2
Loan writeoffs, of which:	0	0	0	5	0
Sovereign loans	0	0	0	0	0
Nonsovereign loans	0	0	0	5	0
Impaired/nonaccrual loans	702	700	1,188	851	1,286
As a % of total loans	12.7	12.4	21.2	14.3	19.9
Principal past due	378	305	302	222	484
Accumulated provision for impairment on loans, of which:	195	214	469	492	494
Sovereign loans	179	203	449	479	479
% Sovereign loans	3.5	N.A.	8.3	8.3	7.5
Nonsovereign loans	16	10	20	13	15
% Nonsovereign loans	4.4	N.A.	8.6	7.5	19.4
Accumulated provision for impairment as a % of impaired/nonaccrual loans	27.7	30.5	39.5	57.7	38.4
Accumulated provision for impairment as a % of total loans	3.5	3.8	8.4	8.2	7.6
Accumulated provision for losses on equity investments	3	4	18	18	19
Accumulated provision as a % of total equity investments	2.0	2.6	9.8	9.9	10.6
Accumulated provision for impairment on accounts receivable	198	188	N.A.	N.A.	N.A.

N.A.-Not available.

AFDB's internal calculations indicate that, having improved substantially over the past five years, the quality of AFDB's nonsovereign loan portfolio is only modestly lower than that of its sovereign loan portfolio, and the quality of its nonsovereign loans is expected to be maintained as the portfolio grows over the medium term. Nonetheless, the performance of AFDB's nonsovereign loan portfolio will bear watching as loans age and the portfolio increases in size.

The historical performance of AFDB's loan portfolio has been well below that of other rated MDFIs. As a result of accounting changes, AFDB now reports impaired loans and not nonaccrual loans (since all loans now accrue). As shown in Table 4, impaired loans were SDR702 million at year-end 2005, 12.7% of total loans and nearly unchanged from the restated SDR700 million of one year earlier. Nonaccrual loans at the four preceding year-ends ranged from a low of SDR851 million at year-end 2002 (14.3% of total loans) to a high of SDR1,286 million at year-end 2001 (19.9%), and were SDR1,121 million at year-end 2004 (21.5%) before the restatement of the balance sheet. Principal past due at year-end 2005 was SDR378 million, up from SDR305 million one year earlier.

However, AFDB's actual losses are likely to be substantially lower than these figures suggest; in more than 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 uses its own funds to become current. AFDB's weakest RMCs are no longer eligible to borrow from the bank, and AFDB's outstanding loans to these countries have been monotonically declining, reaching SDR1,583 million at year-end 2005 (although accounting changes that increased reported loans at year-end 2005 mask this change). RMCs participating in the HIPC Initiative must eliminate their arrears to AFDB before reaching their completion

points, an important incentive for precompletion-point countries to remain current or become current on their obligations.

- The MDFI reschedules a country's loans. MDFIs do this only rarely and in extreme circumstances. AFDB rescheduled DRC's loans in 2002. However, whether or not this proves only a cosmetic improvement depends upon whether the rescheduled loans are serviced. DRC was current on its loans at year-end 2005.
- Donors provide aid to permit 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. At year-end 2005, 32 of the 38 countries eligible or being considered for the HIPC Initiative were AFDB RMCs. These include 14 that reached their completion points, 10 that reached their decision points, and eight that were still to be considered for relief under the HIPC Initiative (predecision-point countries). Of these 32 RMCs, AFDB had credit exposure to 20 at year-end 2005. Loans outstanding to RMCs that had reached their completion points at year-end 2005 totaled SDR264 million (5% of total sovereign loans outstanding); loans to countries that had reached their decision points, SDR832 million (15%); and loans to countries still to be considered for the HIPC program, SDR462 million (8%). In effect, more than 20% of AFDB's loans to its highest-risk borrowers are either benefiting from or are highly likely to benefit from the HIPC Initiative. Another 8% could also benefit, although over a longer time period.

The HIPC debt-relief initiative is having a major impact on the risk profile of AFDB's sovereign portfolio in two principal ways. First, the HIPC program will provide significant debt relief for eligible countries. Once these countries reach their completion points, AFDB will receive funds covering a large portion of the present value of the debt service owed by these countries to the bank. In effect, the portion of the debts owed by these countries to AFDB that is eligible for debt relief will be guaranteed by low-risk investment of these funds. Second, the HIPC program is promoting country reform that is likely to improve the creditworthiness of most HIPC countries. Thus, even the portion of the debt to eligible countries that is not covered by HIPC relief should be lower risk as a result of the HIPC program.

Additional debt relief or other aid to countries to which AFDB has outstanding loans would help improve the quality of AFDB's loan portfolio. The 10th replenishment of the resources of AFDF, concluded in December 2004, was 43% higher than the ninth replenishment and should bolster repayment prospects from AFDF-eligible countries with loans from AFDB. The same is true of the commitment made at the June 2005 G8 meetings to cancel 100% of the debts to AFDF of completion-point countries that are on track with their programs.

Despite never having written off a sovereign loan, AFDB maintains provisions against losses on its sovereign loans. Indeed, it gradually increased these to 8.6% of total outstanding sovereign loans at year-end 2004 (before the restatement of its balance sheet) from 6.2% at year-end 2000. These provisions were high compared with those of other MDFIs. However, the embedded risk in AFDB's sovereign portfolio is also relatively high.

Accounting changes that took place during 2005 dictated that formerly suspended interest on nonaccruing loans, as well as overdue interest on AFDB's restructured loan to the DRC, be recognized on the balance sheet of the bank as an increase in loans. They also dictated the change to an incurred loss methodology from an expected loss methodology. As a consequence of these accounting changes, AFDB's accumulated provision for impairment on loans (formerly its accumulated provision for loan losses) was reduced to SDR195 million from SDR450 million one year earlier (before the balance sheet restatement); however, an accumulated provision for

impairment on accrued income and charges receivable on loans of SDR198 million was established, so the reduction in the total accumulated provision was smaller than it might appear.

AFDB maintained provisions for losses on its nonsovereign loans of 8.8% at year-end 2004, a substantial decrease from 54% at year-end 1999. At year-end 2005, the accumulated provision for impairment was 4.4%. AFDB's provisions for nonsovereign loans are lower than those of some other MDFIs and will bear watching as the private sector portfolio increases.

The equity investment lines in Table 4 are more difficult to interpret because equity investments are qualitatively different from loans: They can, in principle, produce substantial capital gains, whereas loans cannot. AFDB's SDR172 million in gross equity investments are accounted for in three different ways:

- Its SDR97 million investment in AFDF employs equity accounting, whereby the investment is initially recognized at cost and the carrying amount is increased or decreased to recognize the investor's share of the profit or loss of the investee after the date of acquisition;
- Its SDR21 million investments in regional development banks and its SDR10 million in other development institutions are carried at cost less provision for losses for estimated declines in value; and
- Its SDR43 million in various investment funds are carried at fair value.

An accumulated provision for impairment of SDR3 million was applied to AFDB's equity portfolio at year-end 2005.

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)	2005	2004 restated	2003	2002	2001
<i>Capital</i>					
Authorized capital	21,870	21,870	21,870	21,870	21,870
Subscribed capital	21,636	21,598	21,564	21,510	21,491
Callable capital, of which:	19,367	19,375	19,382	19,395	18,531
AAA' rated member countries	5,484	5,492	4,981	4,981	4,151
Paid-in capital*	2,112	2,066	2,023	1,983	1,948
Reserves	2,266	2,187	1,507	1,465	1,226
Total shareholders' equity	4,378	4,253	3,531	3,448	3,214
<i>Risk-bearing capacity</i>					
Nonnegotiable instruments on account of capital	26	31	42	57	63
Equity participation in African Development Fund	97	97	112	112	112
Adjusted paid-in capital¶	1,988	1,938	1,870	1,814	1,774
Adjusted shareholders' equity§	4,255	4,125	3,377	3,278	3,000
Accumulated provision for impairment on income/charges receivable on loans	198	188	N.A.	N.A.	N.A.
Accumulated provisions for impairment on loans	195	214	487	510	513
Accumulated provision for impairment on equity investments	3	4	18	18	19
Narrow risk-bearing capacity**	4,651	4,530	3,882	3,806	3,532
Broad risk-bearing capacity¶¶	10,135	10,022	8,863	8,787	7,682

Table 5

African Development Bank Capital, Risk-Bearing Capacity, And Capital Adequacy (cont.'d)					
—Year ended Dec. 31—					
(Mil. SDR, unless otherwise indicated)	2005	2004 restated	2003	2002	2001
<i>Capital adequacy</i>					
Narrow risk-bearing capacity/total assets (%)	40.1	42.0	38.7	46.4	39.8
Broad risk-bearing capacity/total assets (%)	87.4	92.9	88.3	107.2	86.6
Narrow risk-bearing capacity/development-related exposure (%)	76.1	72.8	67.0	61.9	53.2
Broad risk-bearing capacity/development-related exposure (%)	165.8	161.1	152.9	142.8	115.6

*Balance sheet number. When added to callable capital, does not exactly equal subscribed capital due to valuation adjustments. †Reported paid-in capital less nonnegotiable instruments on account of capital less equity participation in the African Development Fund. ‡Adjusted paid-in capital plus reserves. **Accumulated provisions for losses plus adjusted shareholders' equity. ††Narrow risk-bearing capacity plus 'AAA' callable capital.

Paid-in capital

At year-end 2005, SDR21,636 million (98.9%) of AFDB's nearly SDR21,870 million in authorized capital (capital that its board of governors has authorized to be issued) was subscribed (claimed by members). However, only SDR2,112 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; the remainder was callable. Carried as assets on AFDB's balance sheet are nonnegotiable instruments on account of capital (SDR26 million at year-end 2005) and AFDB's equity holding in the AFDF (SDR97 million). As the former might not be immediately available to AFDB in a time of financial stress and because the value of the latter is uncertain and could well be overstated, Standard & Poor's deducts the amount of these assets from AFDB's paid-in capital to calculate adjusted paid-in capital, which totaled SDR1,988 million at year-end 2005.

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 were affected by accounting changes, with the restated reserves at year-end 2004 increasing to SDR2,266 million from the originally reported SDR1,486 million. AFDB's adjusted shareholders' equity (the sum of adjusted paid-in capital plus reserves) totaled SDR4,255 million at year-end 2005, up SDR130 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. If 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 SDR5,484 million at year-end 2005.

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 because most of AFDB's nondevelopment-related assets have little risk (credit or market) associated with them. However, these ratios were 40% and 87%, respectively, at year-end 2005.

The more relevant comparison is between risk-bearing capacity and DRE. The more conservative ratio of narrow risk-bearing capacity to DRE was 76% at year-end 2005, having increased from 73% one year earlier. While the time series is distorted by accounting changes, this continues the trend of at least the last five years. The less-conservative ratio of broad risk-bearing capacity to DRE increased to a very robust 166% from 161% one year earlier. The improving trend for this measure is even higher, since five member countries—the Kingdom of Denmark, the Republic of Finland, Canada, and the Kingdoms of Sweden and Spain—whose collective callable capital totaled SDR1,568 million at year-end 2005—were upgraded to 'AAA' over this period, while only Japan was downgraded from 'AAA'. The 76% ratio of narrow risk-bearing capacity to DRE means that assuming no losses from AFDB's other assets, 76% of the bank's DRE portfolio could be deemed worthless before the bank would become insolvent. The 166% ratio of broad risk-bearing capacity to DRE means that assuming all 'AAA' rated member countries met a capital call in full, all of the bank's DRE and 73% of its other assets could be deemed worthless before the bank would become insolvent. This is a cushion for loss far higher than that of any other rated MDFI as of their latest fiscal year ends.

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. Although 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 (because equity funds a large portion of its interest-earning assets), the spread on loans and investment assets funded by borrowings, provisions for losses, and noninterest expenses (primarily administrative). Table 6 summarizes the principal components of AFDB's net income.

Table 6

African Development Bank Summary Income Statement						
—Year ended Dec. 31—						
(Mil. SDR, unless otherwise indicated)	2005	2004 restated	2004	2003	2002	2001
Income from loans	324	323	311	325	415	448
Income from investments and related derivatives*	155	124	124	100	74	121
Borrowing expenses	-241	-215	-199	-220	-259	-349
Net income from loans and investments before provision for losses	239	232	235	206	230	220
Provision for impairment on loans and charges	14	-54	18	22	-3	-54
Net interest income after provision for losses	253	178	253	227	227	166

Table 6

African Development Bank Summary Income Statement (cont.'d)						
—Year ended Dec. 31—						
(Mil. SDR, unless otherwise indicated)	2005	2004 restated	2004	2003	2002	2001
Provision for impairment on equity investments	1	3	3	-2	-0	-6
Administrative expense net of management fees	-42	-38	-37	-45	-32	-30
Other income (net)	9	0	0	-2	-5	-4
Operating income	221	144	220	178	189	125
Unrealized net (loss)/gain on nontrading derivatives	N.A.	N.A.	-113	-82	37	82
Net income	221	144	107	97	226	208
<i>Memo items:</i>						
Return on average assets (%)	2.0	N.A.	1.1	1.1	2.7	2.4
Return on average adjusted shareholders' equity (%)	5.3	N.A.	3.2	3.1	7.8	7.4
<i>Allocation of net income to:</i>						
Post conflict assistance—Democratic Republic of Congo	37	54	54	13	0	0
Post Conflict Countries Fund	30	45	45	0	0	0
African Development Fund	46	10	10	25	10	10
HIPC Initiative	11	6	6	9	6	6
Special Relief Fund	5	0	0	10	5	0
Technical Assistance Fund for AFDF-only countries	15	0	0	0	1	0
Total	144	115	115	57	22	16

*Income from investments only for 2004 before restatement and earlier years. N.A.—Not available.

As was its balance sheet, AFDB's 2004 income statement was restated as a consequence of accounting changes, the principal effect being provisions for losses on loans and charges on loans of SDR54 million on the restated income statement, as opposed to a release of provisions for losses on loans of SDR18 million on the original income statement. On a restated basis, AFDB's operating income increased to SDR221 million in 2005 from SDR144 million one year earlier. A release of loan-loss provisions of more than SDR21 million during 2005, in contrast to the more than SDR51 million of provisions made during 2004 (on a restated basis), accounted for SDR72 million of the SDR78 million increase—as higher borrowing costs largely offset higher income from investments and related derivatives. Using the restated 2004 balance sheet numbers, AFDB's return on average assets (adjusted for the bank's investment in AFDF and nonnegotiable instruments on account of capital) was 2.0% during 2005 and its return on average adjusted shareholders' equity was 5.3%, both substantially above the 2004 returns (calculated using the original balance sheet).

Although 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 2001) to SDR144 million (in 2005) over the past five years. The principal beneficiaries of these allocations in 2005 were AFDF, post-conflict assistance to DRC, and the Post Conflict Countries Fund. The allocation to post-conflict assistance to DRC goes to a special account that is separate from the assets of the bank, disbursements from which are used to repay a portion of DRC's borrowings from the bank. The Post Conflict Countries Fund, which is also separate from the assets of the bank, receives allocations from the

net incomes of AFDB and AFDF (and, potentially, other interested parties), to be used to help post-conflict countries reach their HIPC decision points.

Borrowing And Liquidity

Under the agreement, DRE 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; and
- 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. Standard & Poor's calculates four leverage ratios for comparative purposes:

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

AFDB's leverage has declined substantially in recent years, and at year-end 2005 its leverage by all of these measures was among the lowest of 'AAA' rated MDFIs.

The bank's liquidity policy calls for maintaining liquidity in excess of the prudential minimum level of liquidity, which is 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.

Standard & Poor's calculates two liquidity ratios for comparative purposes: 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 in recent years: AFDB had one of the strongest liquidity positions among 'AAA' rated MDFIs at year-end 2005.

In sum, although Africa remains a challenging environment in which to operate, AFDB's management has greatly strengthened the bank's financial profile in recent years. AFDB's capital and liquidity, as well as its qualitative features, place it solidly in the 'AAA' rating category and give it the capacity to substantially increase its development activities consistent with maintaining its 'AAA' rating.

Comparative Data

Comparative data for AFDB and 14 other MDFIs may be found on pages 58-62 of Standard & Poor's annual Supranationals Special Edition 2006. This report is available at www.standardandpoors.com. (Enter Supranationals Special Edition in the search box and click on the title under "Credit Ratings" in the center of the screen.)

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