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## African Development Bank

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# African Development Bank

## Major Rating Factors

### Strengths:

- Strong capital position and liquidity;
- Prudent financial management and policies; and
- Strong support from its members, which include 13 'AAA' rated countries contributing nearly Special Drawing Rights (SDR)5.5 billion in callable capital.

### Weaknesses:

- Large nonperforming loans; and
- The inability of the governments of most African countries to borrow from the bank.

### Counterparty Credit Rating

Foreign Currency

AAA/Stable/A-1+

## Rationale

The rating on the African Development Bank (AFDB) is based on its strong capital position and liquidity, prudent financial management and policies, and strong support from its members, which include 13 'AAA' rated countries contributing nearly SDR5.5 billion in callable capital. Offsetting these positives are the bank's large nonperforming loans and the inability of the governments of most African countries to borrow from the bank.

AFDB is a regional multilateral development finance institution (MDFI) established in 1964 by 29 African countries. Nonregional member countries (NRMCS) were admitted beginning in 1982, and AFDB's membership now includes all 53 African countries (regional member countries [RMCs]) and 24 NRMCS.

AFDB is the nonconcessional lender within the AFDB Group, which also includes soft-loan windows African Development Fund (AFDF) and Nigeria Trust Fund (NTF). 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.

AFDB provides medium- and long-term loans to African governments and other public sector entities with sovereign guarantees. It also lends to some public-sector entities without sovereign guarantees and to the private sector, makes equity investments, and has provided a few small guarantees. Of AFDB's total outstanding loans, 94% were to governments or were government guaranteed. These loans (including accrued income and charges receivable on loans), development-related debt securities, equity investments, and guarantees (together, AFDB's development-related exposure [DRE]) totaled SDR6.3 billion at year-end 2007; 95% was loans, 2% development-related securities, and 3% equity investments. However, AFDB has begun emphasizing support for the private sector in its RMC's, and in 2007, nearly 60% of approvals for financing was for private sector entities.

AFDB has restricted its sovereign lending to its most creditworthy regional member countries since 1995. Fifteen RMCs are, in principle, eligible to borrow from the bank; however, Zimbabwe (unrated) is ineligible for new disbursements due to ongoing arrears to the bank, and Libya (unrated) has never borrowed. The other 38 African countries can borrow only from AFDF and NTF. However, primarily as a result of loans granted before 1995, more than 23% of AFDB's total outstanding loans at year-end 2007 was to the public sectors in countries no longer eligible to borrow from the bank.

AFDB's outstanding loans (including accrued income and charges receivable on loans) increased by 4.0% during 2007 to SDR5,976 million at year-end, reversing the declines of the previous two years. However, they were still less than half of total assets, and DRE as a percentage of total assets was less than 52%. Reflecting the weak credit standing of some of its borrowers, SDR588 million of AFDB's outstanding loans of SDR5,540 million had principal or interest payments past due by more than six months, SDR338 million of which was loans to Côte d'Ivoire.

The expected losses embedded in AFDB's loan portfolio are much smaller than one might expect. Standard & Poor's expects AFDB to receive preferential treatment on its sovereign and sovereign-guaranteed loans compared with that received by commercial and bilateral lenders, in line with its status as a preferred creditor. Given the economic distress of many of AFDB's borrowing members, however, 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. In addition, other debt relief initiatives are expected to place these countries in a better financial position to service their external debts, including those to AFDB.

AFDB has steadily strengthened its capital position in recent years, to the point where its ratio of provisions for losses on DRE plus adjusted shareholders' equity (its narrow-risk-bearing capacity) was nearly 83% of DRE at year-end 2006. This ratio declined to less than 81% at year-end 2007, but this is still one of the highest such ratios among rated MDFIs. In addition, AFDB's financial strength is bolstered by its callable capital, nearly SDR5.5 billion of which was from countries rated 'AAA' by Standard & Poor's at year-end 2007. 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 169% at year-end 2007. While this was down from 177% one year earlier, it is still the highest such ratio among MDFIs (excluding the newly-established Eurasian Development Bank [BBB+/Stable/A-2; all ratings herein are as of Dec. 2, 2008]. In addition, capital contributions of more than SDR35 million are scheduled to be received by the end of 2017.

AFDB's income before transfers approved by its board of governors was almost SDR324 million during 2007, up from SDR194 million one year earlier; however, the increase was more than accounted for by changes in provisions for impairments. Nonetheless, this resulted in a return on average assets plus guarantees of 2.7% and a return on average adjusted shareholders' equity of 7.2%. In recent years, much of the bank's income has been allocated for purposes other than bolstering the capital of AFDB, slowing the increase in the bank's risk-bearing capacity.

The bank's liquidity position was one of the strongest among rated MDFIs at year-end 2007. This is the counterpart of the bank's very strong capital position.

## Outlook

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

## 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

alternative, 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 consists of 12 regional and six nonregional members, none of whom may be governors or alternates. They serve a maximum of two three-year terms. At year-end 2007, one director represented in principle only the U.S. (that position was vacant); all other directors represented multi-country constituencies.

The president of the bank may serve a maximum of two five-year terms. Mr. Donald Kaberuka, formerly a Minister for Finance and Economic Planning for Rwanda (unrated), assumed the presidency on Sept. 1, 2005, from Mr. Omar Kabbaj, who had served two terms. AFDB's regular staff totaled 1,142 at year-end 2007, up from 1,044 at year-end 2006; management and professionals accounted for 769 of the total, up from 705 one year earlier.

The bank was headquartered in Abidjan, Côte d'Ivoire (unrated), from its inception until February 2003. Political unrest in that country prompted the bank to temporarily relocate to backup facilities in Tunis, Tunisia (BBB/Stable/A-3), where it remains pending more settled conditions in Côte d'Ivoire. The bank is expanding its network of field offices, and 23 of the planned 25 were open at year-end 2007.

## Balance Sheet

Table 1 summarizes AFDB's balance sheet. The bank's financial statements are expressed in "Units of Account" (UA). However, under the Agreement Establishing the Bank ("agreement"), one UA is defined as the equivalent of one Special Drawing Right (SDR), and this more familiar designation is used throughout this report.

AFDB's financial statements are prepared in accordance with International Financial Reporting Standards (IFRS). The 2007 statements were the first audited by the Paris office of KPMG, who succeeded the London office of Deloitte & Touche LLP. AFDB's 2005 and 2006 financial statements were qualified on the grounds that the bank classified members' capital subscriptions as equity—as it had since the inception of the bank—while Deloitte & Touche LLP interpreted IFRS as requiring that they be classified as puttable financial instruments that should be classified as liabilities. In February 2008 the International Accounting Standards Board issued amendments to IAS1 and IAS32 that clarified that AFDB's members' capital subscriptions qualified as equity, which has been Standard & Poor's position throughout. Accordingly, AFDB's 2007 financial statements received a clean opinion from KPMG.

In 2005, the bank adopted all of the new and revised standards and interpretations issued by International Accounting Standards Board and the International Financial Reporting Interpretations Committee that are applicable to its activities. In some cases, numbers for 2004 and 2003 were not restated and are therefore not strictly comparable with those of later years.

**Table 1**

African Development Bank--Summary Balance Sheet					
(Mil. SDR)	--Year ended Dec. 31--				
	2007	2006	2005	2004	2003
<b>Assets</b>					
Cash, due from banks, demand obligations	99	133	74	48	70
Treasury investments	5,304	6,093	5,155	4,435	4,136

Table 1

<b>African Development Bank--Summary Balance Sheet (cont.)</b>					
Accrued income and charges receivable on loans	436	456	431	406	169
Accumulated provision for impairment on accrued income and charges receivable on loans	(169)	(223)	(198)	(188)	0
Loans disbursed and outstanding	5,540	5,291	5,512	5,640	5,612
Accumulated provision for impairment on loans disbursed and outstanding	(196)	(214)	(195)	(214)	(469)
Equity participation, of which:	192	123	172	164	182
Participation in African Development Fund	64	63	97	97	112
Accumulated provision for losses on equity investments	(2)	(4)	(3)	4	(18)
Securities issued by entities in regional member countries	95	0	0	0	0
Non-negotiable instruments on account of capital	15	20	26	31	42
Derivative assets	425	273	286	275	254
Other assets	344	383	340	198	57
<b>Total assets</b>	<b>12,082</b>	<b>12,332</b>	<b>11,601</b>	<b>10,792</b>	<b>10,035</b>
<b>Liabilities</b>					
Borrowings, of which:	6,199	5,870	5,940	5,639	5,799
Portion of gross debt maturing during the next year	1,154	323	252	325	487
Derivative liabilities	591	482	317	514	396
Other liabilities	584	1,527	965	386	309
<b>Total liabilities</b>	<b>7,374</b>	<b>7,879</b>	<b>7,223</b>	<b>6,539</b>	<b>6,504</b>
<b>Capital</b>					
Paid-in capital	2,176	2,147	2,112	2,066	2,023
Other capital	2,532	2,305	2,266	2,187	1,507
Shareholders' equity	4,708	4,453	4,378	4,253	3,531
<b>Off-balance-sheet items</b>					
Guarantees	0	0	0	15	4
Callable capital from 'AAA' rated member countries.	5,466	5,491	5,484	5,492	4,981

AFDB's total assets declined SDR250 million to SDR12,082 million during 2007 (although they increased by US\$542 million due to exchange rate changes) after increases the three previous years. This occurred despite the bank's gross loans (including accrued income and charges receivable) increasing by SDR229 million after declines the previous two years. In addition, during 2007 the bank purchased SDR93 million (SDR95 million at year-end on a fair value basis) of project- and program-related debt securities issued by entities in its RMCs, which are akin to loans from a credit perspective. Finally, the bank invested SDR40 million in equity investments during the year, accounting for most of SDR69 million increase in the fair value of gross equity investments shown on the balance sheet. The bank's reported shareholders' equity increased by SDR255 million during the year.

## Capital, Risk-Bearing Capacity, And Capital Adequacy

Table 2 shows AFDB's capital, risk-bearing capacity, and development-related credit exposure, as well as measures of capital adequacy.

Table 2

African Development Bank--Capital, Risk-Bearing Capacity, And Capital Adequacy					
--Year ended Dec. 31--					
(Mil. SDR, unless otherwise indicated)	2007	2006	2005	2004	2003
<b>Capital</b>					
Authorized capital	21,870	21,870	21,870	21,870	21,870
Subscribed capital	21,693	21,795	21,636	21,598	21,564
Callable capital, of which:	19,342	19,437	19,367	19,375	19,376
From 'AAA' rated member countries	5,466	5,491	5,484	5,492	4,981
Paid-in capital*	2,176	2,147	2,112	2,066	2,023
Reserves	2,532	2,305	2,266	2,187	1,507
Shareholders' equity	4,708	4,453	4,378	4,253	3,531
<b>Risk-bearing capacity</b>					
Non-negotiable instruments on account of capital	(15)	(20)	(26)	(31)	(42)
Participation in African Development Fund	(64)	(63)	(97)	(97)	(112)
Adjusted shareholders' equity	4,629	4,369	4,255	4,125	3,377
Accumulated provision for impairment on accrued income and charges receivable on loans	169	223	198	188	0
Accumulated provision for impairment on loans disbursed and outstanding	196	214	195	214	469
Accumulated provision for losses on equity investments	2	4	3	0	18
Narrow risk-bearing capacity	4,996	4,810	4,651	4,526	3,864
Callable capital from 'AAA' rated member countries	5,466	5,491	5,484	5,492	4,981
Broad risk-bearing capacity	10,462	10,301	10,135	10,018	8,845
<b>Development-related exposure</b>					
Accrued income and charges receivable on loans	436	456	431	406	169
Loans disbursed and outstanding	5,540	5,291	5,512	5,640	5,612
Securities issued by entities in regional member countries	95	0	0	0	0
Equity investments excluding participation in African Development Fund	128	60	75	63	70
Guarantees	0	0	0	15	4
Total development-related exposure	6,198	5,806	6,019	6,125	5,855
<b>S&amp;P capital adequacy calculations</b>					
Narrow risk-bearing capacity/adjusted total assets¶ (%)	41.6	39.3	40.5	42.4	39.1
Broad risk-bearing capacity/adjusted total assets¶ (%)	87.2	84.1	88.3	93.9	89.5
Narrow risk-bearing capacity/development-related exposure (%)	80.6	82.8	77.3	73.9	66.0
Broad risk-bearing capacity/development-related exposure (%)	168.8	177.4	168.4	163.5	151.1
AFDB maximum sustainable portfolio	12,861	11,926	11,549	10,868	10,869
Narrow risk-bearing capacity as a % of AFDB maximum sustainable portfolio	38.8	40.3	40.3	41.6	35.6
Broad risk-bearing capacity as a % of AFDB maximum sustainable portfolio	81.3	86.4	87.8	92.2	81.4

\*After cumulative gains and losses arising from exchange rate movements affecting NRM's capital contributions. ¶ Total assets less non negotiable instruments on account of capital less participation in the African Development Fund.

## Capital

AFDB's authorized capital (that which its board of governors has authorized to be issued) totaled SDR21.87 billion at year-end 2007; of this amount, SDR21.69 billion—more than 99%—was subscribed (claimed by members). However, less than SDR2.18 billion of the latter amount was actually paid in.

AFDB's SDR19.34 billion of callable capital at year-end 2007 could be called by its board of governors, but only to meet obligations created by AFDB's borrowings or guarantees. A capital call would oblige all members to contribute their pro rata shares of the amount called, but one member's failure to meet a call would not release other members from their obligations to do so. If a first-round call did not raise the amount required, subsequent calls could be made, but no member would be obliged to pay more than the amount to which it subscribed. No multilateral lending institution has ever issued a capital call to avoid a default, and the willingness and ability of members to respond to such a call is undemonstrated. Accordingly, Standard & Poor's uses the callable capital from 'AAA' rated member countries as a proxy for the expected amount that would be forthcoming if there were a call on all callable capital.

AFDB's paid-in capital is supplemented by its reserves, which at SDR2.53 billion exceeded its paid-in capital at year-end 2007. While these include gains (and potentially losses) on AFDB's available-for-sale investments, such gains have not exceeded SDR9 million at the end of any of the last four years.

## Risk-Bearing Capacity

Risk-bearing capacity is a measure of the losses that an MDFI can sustain before its liabilities exceed its assets. AFDB's narrow risk-bearing capacity is calculated by adding adjusted shareholders' equity and provisions for losses on its DRE.

Two adjustments are made to AFDB's reported shareholders' equity. First, SDR15 million of non-negotiable instruments on account of capital are carried as assets on AFDB's year-end 2007 balance sheet; however, these instruments may not be immediately available to AFDB in a time of financial stress. Second, AFDB's SDR64 million net equity holding in the AFDF at year-end 2007 is also carried as an asset on the balance sheet; this asset is illiquid and of uncertain value, and this would be especially true in the event of widespread financial stress. Accordingly, these two asset classes are assigned a value of zero, and reported shareholders' equity (and total assets, to get adjusted assets) is reduced by the sum of the two.

AFDB has three types of provisions for losses on its DRE. First, the bank's accrued income and charges receivable on loans—SDR436 million at year-end 2007—are treated in this analysis as loans, and hence the provision for losses on these items—SDR169 million, or 39%—is included in provisions for losses on DRE. Second, the bank had an accumulated provision for impairment on loans of SDR196 million—3.5% of loans disbursed and outstanding. And third, AFDB had an accumulated provision for impairment of equity investments of SDR2 million against its equity investments excluding the AFDF—1.8%.

AFDB's narrow risk-bearing capacity at year-end 2007 was thus SDR4.99 billion. This was an increase of SDR186 million from one year earlier.

Standard & Poor's assumes that MDFI's callable capital from 'AAA' rated member countries is a useful proxy for

the capital contributions that would actually be received in the event of a call on all of AFDB's callable capital. We thus add 'AAA' capital to narrow risk-bearing capacity to calculate broad risk-bearing capacity. Of AFDB's callable capital of SDR19.34 billion at year-end 2007, SDR5.47 billion was from countries rated 'AAA' by Standard & Poor's. Accordingly, AFDB's broad risk-bearing capacity totaled SDR10.46 billion at year-end 2007.

## Capital Adequacy

As of year-end 2007, the bank's DRE totaled SDR6.20 billion, up 6.8% from SDR5.81 billion one year earlier. Accordingly, AFDB's narrow risk-bearing capacity was almost 81% of its DRE. Among 'AAA' rated MDFIs, this percentage was exceeded only by the Islamic Development Bank (102%) and the European Bank for Reconstruction and Development (87%) at their latest fiscal years-ends.

At the same time, broad risk-bearing capacity was nearly 169% of DRE. This was by far the highest such ratio among 'AAA' rated MDFIs as of their latest fiscal years-ends. Moreover, this ratio implies that, assuming no losses on other balance sheet or off-balance sheet items and all of the 'AAA' rated countries contributed the full amount of their callable capital, all of AFDB's income receivable from accrued income and charges receivable on loans, outstanding loans, securities issued by entities in RMCs, and equity investments could be written off without the bank becoming insolvent. AFDB's capital position at year-end 2007 was thus extremely solid.

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 from its equity investments), and guarantees to the sum of its unimpaired subscribed capital, reserves, and surplus. This ratio has been about 33% in recent years and has not been a constraint on AFDB's lending and other DRE-generating activities; however, since AFDB's subscribed capital includes SDR11.5 billion in callable capital from AFDB's RMCs, most of which either have low ratings or are unrated, this measure by itself is not very useful from a credit perspective.

The bank also calculates a capital-driven "maximum sustainable portfolio," which is a more useful measure. The first step calculates the amount of shareholders' equity necessary to support the existing portfolio of loans, treasury assets, and equity investments (all net of specific provisions for losses), based on internal ratings on the loans, risk-weighting of the treasury assets, and 100% capital backing for the bank's equity investments. At year-end 2007, this calculation concluded that the bank's existing portfolio of SDR5,006 million in public-sector loans net of provisions for losses required capital of SDR1,800 million; its net non-public-sector loans of SDR338 million required SDR134 million of capital; its treasury assets required SDR93 million of capital; and its equity investments required SDR125 million of capital. This left SDR2.56 billion of capital available to support new DRE. Assuming that all of the available capital was used to make loans of "moderate" risk, the maximum sustainable portfolio at year-end 2007 would have totaled SDR12.86 billion, more than twice the actual portfolio. The implications of a portfolio of that size for the ratio of narrow and broad risk-bearing capacity to DRE are shown at the bottom of Table 2. Both of these ratios would be at or near the bottom of the range of those of 'AAA' rated MDFIs in recent years.

## Leverage And Liquidity

AFDB's leverage and liquidity are summarized in table 3.

Table 3

(Mil. SDR, unless otherwise indicated)	--Year ended Dec. 31--				
	2007	2006	2005	2004	2003
<b>AFDB leverage measures</b>					
Total borrowings as a % of 80% of total callable capital	40.1	37.8	38.3	36.4	37.8
Total borrowings as a % of total usable capital	54.5	58.3	59.5	57.1	67.9
Senior debt as a % of callable capital from non-borrowings members	65.0	60.7	61.1	57.9	60.3
<b>S&amp;P leverage measures</b>					
Gross debt/adjusted shareholders' equity	133.9	134.4	139.6	136.7	171.7
Gross debt/adjusted shareholders' equity + 'AAA' callable capital	61.4	59.5	61.0	58.6	69.4
Gross debt net of liquid assets/adjusted shareholders' equity	17.2	(8.1)	16.7	28.0	47.2
Gross debt net of liquid assets/adjusted shareholders' equity + 'AAA' callable capital	7.9	(3.6)	7.3	12.0	19.1
<b>AFDB liquidity</b>					
Prudential minimum liquidity	1,600	1,430	1,260	1,150	1,200
Liquidity	2,680	3,060	3,020	2,670	2,550
Liquidity as a % of prudential minimum liquidity	167.5	214.0	239.7	232.2	212.5
<b>S&amp;P liquidity measures</b>					
Liquid assets/total assets	44.7	50.5	45.1	41.5	41.9
Liquid assets/gross debt	87.2	106.1	88.0	79.5	72.5
Liquid assets/undisbursed loans + equity investments + estimated one-year debt service	177.6	239.6	224.7	212.1	167.9

AFDB has three debt-related policies:

- Total debt may not exceed 80% of total callable capital (the percentage was 32% at year-end 2007);
- 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 (55% at year-end 2007); 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 (65% at year-end 2007).

AFDB has been well within all of these constraints in recent years.

Standard & Poor's calculates four leverage ratios for comparative purposes:

- Gross debt to adjusted shareholders' equity (134% at year-end 2007);
- Gross debt to adjusted shareholders' equity plus 'AAA' callable capital (61%);
- Gross debt net of liquid assets to adjusted shareholders' equity (17%); and
- Gross debt net of liquid assets to adjusted shareholders' equity plus 'AAA' callable capital (8%).

All of these ratios have been trending lower in recent years, and AFDB's leverage at year-end 2007 was one of the lowest among rated MDFIs.

AFDB's liquidity policy calls for maintaining liquidity in excess of the "prudential minimum level" of liquidity, which is defined as the sum of debt-service payments over the next year, the projected net loan disbursements for the next year, the loan equivalent of guarantees, and undisbursed equity investments. The bank typically carries liquidity

far above the prudential minimum level—for instance, at year-end 2007, prudential minimum liquidity was SDR1.60 billion, while the bank's liquidity was SDR2.68 billion. Unlike some years back, AFDB now funds itself at rates sufficient to permit it to earn positive spreads on its liquid assets.

Standard & Poor's calculates three liquidity measures for comparative purposes. At year-end 2007, liquid assets (including all cash and deposits and treasury investments, regardless of maturity) were almost 45% of total assets and more than 87% of total borrowings; and liquid assets as a percentage of undisbursed loans and equity investments and projected one-year debt service was 178%. Each of these ratios was the highest among 'AAA' rated MDFIs as of their latest fiscal year-ends.

In sum, AFDB's leverage and liquidity ratios are currently among the strongest of those of 'AAA' rated MDFIs, essentially the counterpart of the bank's very strong capital position.

## 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 receiving some additional paid-in capital—as noted previously, SDR35 million is scheduled to be received by 2017—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 interest-earnings assets), the spread on loans and investments funded by borrowings, provisions for losses, and noninterest expense (primarily administrative). Table 4 summarizes the principal components of AFDB's operating and net income.

**Table 4**

African Development Bank--Summary Income Statement					
	--Year ended Dec. 31--				
(Mil. SDR, unless otherwise indicated)	2007	2006	2005	2004*	2003*
Income from loans and debt securities	347	329	324	323	325
Income from investments and related derivatives	238	214	155	124	100
Interest and amortized issuance costs	(268)	(245)	(219)	(231)	(220)
Other borrowing-related expenses	(7)	(3)	(22)	16	(82)
Provision for impairment on loan charges	53	(29)	(7)	(2)	0
Provision for impairment on loan principal	17	(23)	21	(51)	22
Provision for impairment on equity investments and other receivables	(7)	(35)	1	3	(2)
Other income (net)	(2)	28	17	7	3
Administrative expense	(42)	(37)	(42)	(38)	(45)
Other expense	(6)	(5)	(8)	(7)	(5)
Operating income	324	194	221	144	97
Transfers of income approved by the board of governors	(120)	(139)	(144)	0	0
Net income	204	55	77	144	97
<b>Memo items</b>					
Operating return on average adjusted assets and guarantees (%)	2.7	1.6	2.0	1.4	2.0

Table 4

African Development Bank--Summary Income Statement (cont.)					
Operating return on average adjusted shareholders' equity (%)	7.2	4.5	5.3	3.8	5.4
Transfers of income approved by the board of governors Post Conflict Assistance--DRC	65	67	37	54	13
African Development Fund	14	21	46	10	25
Heavily Indebted Poor Countries Initiative	22	11	11	6	9
Special Relief Fund	0	15	5	0	10
Post Conflict Countries Facility	0	25	30	45	0
Middle Income Country Technical Assistance Fund	10	0	15	0	0
Investment Climate Facility for Africa	9	0	0	0	0
Total	120	139	144	115	57

\*Figures for 2004 and 2003 are not strictly comparable with later years.

As shown in table 4, AFDB has been consistently profitable, and its operating return on adjusted assets plus guarantees is relatively high by comparison with its MDFI peers (excluding the International Finance Corporation [IFC; 'AAA'] and the European Bank for Reconstruction and Development [EBRD; 'AAA'], both of whose net income in recent years was bolstered by outsized gains on their equity investment portfolios). This reflects, inter alia, the relatively large portion of AFDB's interest-bearing assets that is funded by shareholders' equity.

Like almost all other MDFIs, AFDB does not pay a dividend. However, a significant portion of its operating income—averaging almost 55% over the past three years and 37% for 2007—is not retained by the bank, but rather is allocated by its board of governors the following year to a variety of development and humanitarian uses (see "transfers of income approved by the board of governors" in the "memo items" in Table 4). Consistent with IFRS, such allocations are reported as expenses on AFDB's income statement, although they are fundamentally different from other expenses reported there. The allocation of operating income outside the bank reduces the growth of the bank's risk-bearing capacity; at the same time, however, it increases the financial support provided the bank's least-developed members, who cannot borrow from the bank, and thereby increases the bank's franchise value to these members.

## Risk

AFDB's narrow and broad risk-bearing capacity act as cushions for the risk resulting from the bank's activities. These activities may be separated into treasury activities, which result in holdings of cash and investments, borrowings, and hedging instruments; and development-related activities, which result in holdings of loans (including accrued income and charges for loans), development-related securities, equity investments, and the issuance of guarantees (DRE). AFDB makes a fundamental distinction between non-core risks—those that are incidental to bank's development mandate—and core risks—those which are essential to the bank's development mandate. Treasury-related risks are non-core risks, while those related to DRE are core risks.

### Treasury-related risk

The bank seeks to mitigate non-core risks and is willing to forego possible profit opportunities to do so. 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.

***Credit risk.***

AFDB's trading counterparties are generally rated 'A' or higher. Its derivative counterparties are required to have ratings of 'A-' or higher (for those with whom the bank has entered into a collateral exchange agreement) or ratings of 'AA-' or higher from two approved rating agencies (for those without collateral exchange agreements). In addition, AFDB generally executes International Swaps and Derivatives Assoc. (ISDA) master agreements and netting agreements with its derivative counterparties. Its bank and corporate investment counterparties are required to have ratings of 'A' or higher for exposure of six months or less; 'AA-' for exposure for six months to five years; and 'AAA' for longer term exposure. Its government, government agency, and supranational investment counterparties are required to have ratings of 'A' for exposure of one year or less; 'AA-' for exposure up to 15 years; and 'AAA' for longer term exposure. Mortgage-backed and asset-backed securities must be rated 'AAA.' In addition, the bank has exposure limits based on the size and credit rating of its counterparties, and it may have exposure no greater than 8% of risk capital—defined as paid-in capital, reserves, and general provisions for losses—to any single counterparty. At year-end 2007, 43% and 54% of the credit exposure to AFDB's derivative and investment counterparties were rated 'AAA' and 'AA,' respectively. According to BIS standards, AFDB's derivative and investment counterparty exposure required 2.0% of the bank's risk capital at year-end 2007.

At year-end 2007, AFDB had SDR240 million of asset-backed securities and SDR266 million of mortgage-backed securities; of the mortgage-backed securities, SDR13 million were Alt-A and SDR4 million were subprime.

***Exchange-rate risk.***

The agreement establishing the AFDB requires liabilities in any currency to be matched with assets in the same currency. Because the bank borrows disproportionately in U.S. dollars and Japanese yen, it employs currency and cross currency swaps to achieve this matching; to avoid creating new currency mismatches, the bank requires borrowers to service their loans in the currency disbursed. However, since much of the bank's assets are funded by shareholders' equity, the bank is still left with a net asset position that is exposed to translation risk when exchange rates fluctuate. It addresses this problem by matching, to the extent practicable, the composition of its net assets with the composition of the SDR. These policies resulted in translation adjustments of less than 0.2% and 0.1% of net assets for 2007 and 2006, respectively, despite sharp movements in the values of major currencies.

***Interest rate risk.***

Interest rate risk for the bank comes 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 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 immunize itself fully against the impact of interest rate changes on assets funded by equity. However, the bank reduces 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 (that is, by having 10% of assets funded by equity repriced each year). This results in the net interest margin on these assets tracing 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 relatively low interest rates of recent years has made repayment or refinancing an attractive option for some of AFDB's more creditworthy borrowers, and SDR471 million and SDR542 million were prepaid during 2003 and 2004, respectively. The prepayments during 2004 were nearly 10% of year-end 2003 loans. Prepayments slowed to SDR70 million in 2005, due largely to an increase in interest rates. They picked up again, to SDR298 million and SDR199 million during 2006 and 2007; however, the prepayments

during the last two years have overwhelmingly been of market based floating rate loans, reducing the adverse impact on AFDB's profitability.

In sum, the risks related to AFDB's treasury activities appear to be well-contained by its policies and practices and consistent with its desire to minimize non-core risks.

### Development-related exposure risk

The vast bulk of AFDB's risk lies in the product of its core activities, its DRE. This risk is lower than it might appear; however, the prospect of global recession bodes ill for several of AFDB's borrowers and could well have a negative effect on the bank's asset quality.

### 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 World Bank Group for determining which countries may borrow only from the bank, which may borrow from the bank, the AFDF and the NTF, and which may borrow only from AFDF. Under these criteria, only 13 of AFDB's 53 regional member countries were eligible to borrow only from AFDB at year-end 2007; of these 13, Libya (not rated) has never borrowed from the bank. In addition, Nigeria (BB-/Stable/B) and Zimbabwe (not rated) are eligible for a blend of AFDB and AFDF or NTF lending, although Zimbabwe was barred from doing so because it was under sanctions for delays in servicing its obligations); and 38 countries were eligible to borrow only from AFDF.

AFDB historically has focused on lending to the public sector, and as shown in table 5, at year-end 2007, nearly 94% of outstanding loans were to public or publicly guaranteed borrowers. However, the bank has begun focusing more on lending to public sector entities without sovereign guarantees and private sector borrowers. Nearly half of the loan approvals during 2009-2012 are anticipated to be for loans to non-public sector borrowers, and such loans will account for most of the growth in AFDB's loan portfolio over this period.

**Table 5**

African Development Bank--Financing By Purpose					
(SDR Mil., unless otherwise indicated)	--Year ended Dec. 31--				
	2007	2006	2005	2004	2003
<b>Approvals</b>					
Project lending	1,462	515	597	417	566
Public and publicly guaranteed	646	245	459	256	360
Private and non-publicly guaranteed	816	270	138	161	206
Policy-based lending	20	411	148	389	177
Equity investments	185	0	35	3	0
Other	3	119	89	711	4
Total	1,670	1,045	869	1,520	746
<b>Outstanding loans, development-related securities, and equity investments</b>					
Private sector loans*	350	316	362	319	228
Public sector project loans*	2,459	2,587	2,849	3,193	3,476
Policy-based loans*	2,042	1,679	1,559	1,367	1,561
Other public sector loans*	690	709	743	761	347
Total outstanding loans	5,540	5,291	5,512	5,640	5,612

**Table 5**

<b>African Development Bank--Financing By Purpose (cont.)</b>					
Securities issued by entities in regional member countries	95	0	0	0	0
Equity investments	192	123	172	161	182
<b>Memo items</b>					
Public sector as a % of total loans	93.7	94.0	93.4	94.3	95.9
Policy-based loan approvals as a % of total financing approvals	1.2	39.3	17.0	25.6	23.7
Policy-based loans as a % of total outstanding public sector loans	39.3	31.7	28.3	24.2	27.8

\*Does not include accrued income and charges receivable on loans.

Types of DRE. Most of AFDB's loans are for public sector projects, but large amounts of the bank's financing approvals in any one year can be for policy-based loans—more than 39% in 2006. Outstanding policy-based loans have been increasing in recent years, reaching more than 39% of outstanding public sector loans at year-end 2007.

During 2007 the bank began buying debt instruments issued by entities in its RMCs to finance development projects and programs. The SDR95 million in such securities outstanding at year-end 2007, while less than 2% of DRE, is expected to increase in the future.

AFDB's agreement permits the bank to make equity investments, but the bank historically has been cautious about doing so. Its equity investments of SDR189 million at year-end 2007, 3% of DRE, were of four types. The largest single investment, in the AFDF, had a net carrying value of SDR64 million. The bank has three other classes of equity investments. SDR19 million represented small shareholdings in regional development banks; SDR9 million was small shareholdings in other development institutions; and SDR99 million was small investments in a wide variety of investment funds. Most of the bank's equity investments were made many years ago, aside from some recent small investments in investment funds.

The bank has also provided some guarantees in the past. However, it has had none outstanding at year-end since 2004.

#### ***Loan maturities.***

Consistent with its development focus, AFDB typically extends medium- and long-term loans, with final maturities of as much as 20 years, including an appropriate grace period. At year-end 2007, less than 17% of AFDB's loans had remaining maturities of less than one year and more than 51% had remaining maturities of five years or more.

#### ***Loan concentration.***

Bank management has established a limit on total exposure to any single country of 15% of the maximum sustainable portfolio. At year-end 2007, the maximum sustainable portfolio was SDR12,861 million, implying maximum single-country exposure of SDR1.93 billion. However, specific country limits are reviewed annually and are based on the economic potential of the country and the perceived risk level.

AFDB's countries of largest DRE are shown in table 5. The largest country exposure at year-end 2007, to Morocco (BB+/Stable/B), was less than 64% of the maximum single-country exposure. It was also less than 25% of AFDB's narrow risk-bearing capacity.

Table 6

African Development Bank--DRE Country Concentration					
--Year ended Dec. 31--					
Largest country exposures*/ratings†	2007	2006	2005	2004	2003
Largest	Morocco/BB+	Tunisia/BBB	Tunisia/BBB	Tunisia/BBB	Tunisia/BBB
Mil. SDR	1,229	1,180	1,227	1,211	1,157
% DRE	21.7	22.1	22.0	21.2	20.4
% Narrow risk-bearing capacity	24.6	24.5	26.4	26.7	29.9
2nd largest	Tunisia/BBB	Morocco/BB+	Morocco/BB+	Morocco/BB	Algeria/NR
Mil. SDR	1,145	1,095	853	683	764
% DRE	20.2	20.5	15.3	12.0	13.4
% Narrow risk-bearing capacity	22.9	22.8	18.4	15.1	19.8
3rd largest	DR Congo/NR	DR Congo/NR	DR Congo/NR	Nigeria/NR	Morocco/BB
Mil. SDR	690	709	743	426	596
% DRE	12.2	13.2	13.3	7.4	10.5
% Narrow risk-bearing capacity	13.8	14.7	16.0	9.4	15.4
4th largest	Egypt/BB+	Nigeria/BB-	Nigeria/NR	Cote d'Ivoire/NR	Nigeria/NR
Mil. SDR	561	401	463	361	492
% DRE	9.9	7.5	8.3	6.3	8.6
% Narrow risk-bearing capacity	11.2	8.3	10.0	8.0	12.7
5th largest	Nigeria/BB-	Cote d'Ivoire/NR	Cote d'Ivoire/NR	DR Congo/NR	Cote d'Ivoire/NR
Mil. SDR	375	360	362	343	360
% DRE	6.6	6.7	6.5	6.0	6.3
% Narrow risk-bearing capacity	7.5	7.5	7.8	7.6	9.3
Share of DRE of five countries of largest exposure	70.6	70.0	65.3	52.9	59.2
Percentage of narrow risk-bearing capacity of five countries of largest exposure	80.1	77.9	78.4	66.8	87.2

\*Outstanding loans, equity investments, and guarantees. † Ratings as of balance sheet dates.

The relatively highly rated North African countries of Morocco, Tunisia, and Egypt have been among the largest recipients of AFDB financing in recent years, accounting for nearly 52% of total DRE at year-end 2007, which helps bolster the quality of the bank's portfolio. Despite its relatively small number of borrowers and the seemingly high percentage of its loans to its largest borrowers, AFDB's ratio of DRE in its five largest countries of exposure relative to risk-bearing capacity, 80%, is well below those of most 'AAA' rated MDFIs, reflecting the bank's strong capital position.

Development-related exposure quality and provisions for losses. Table 7 provides additional indicators of the quality of AFDB's DRE and the provisions for losses available to cover the losses embedded in that exposure. The index of quality of development-related exposure is an exposure-weighted average of the default rates associated with the long-term foreign currency sovereign credit ratings (or confidential credit assessments for countries that do not have 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 accounting changes implemented in 2005, which resulted in an increase in the loan exposure to the Democratic Republic of the Congo, which had a relatively low confidential credit assessment.

The index has fallen since that time, but it remains the case that by this measure, AFDB's DRE portfolio contained more embedded credit risk in percentage terms at year-end 2007 than any other rated MDFI except for the Islamic Development Bank ('AAA/Stable/A-1+). It is important to note that this measure does not differentiate between public- and private-sector loans, which are ordinarily expected to carry more risk, and hence this measure understates the embedded credit risk relative to other institutions whose loan portfolios consist entirely of public-sector loans. This has been of limited significance in recent years, given the small percentage of private-sector loans in AFDB's portfolio. However, private-sector loans are expected to grow rapidly as a percentage of total loans over the medium term, and unless they are relatively strong credits in relatively highly-rated RMCs, there is clearly some risk of a deterioration in the quality of the loan portfolio.

**Table 7**

<b>African Development Bank--Loan Quality And Accumulated Provisions For Losses</b>					
<b>--Year ended Dec. 31--</b>					
<b>(Mil. SDR, unless otherwise indicated)</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>	<b>2004</b>	<b>2003</b>
Index of quality of development-related country exposure	13.3	14.4	15.1	13.9	14.2
<b>Loans</b>					
Private sector loans as a % of total loans	6.3	6.0	6.6	5.7	6.1
Impaired/nonaccrual loans*	603	670	702	700	1,188
As a % of total loans	10.9	12.7	12.7	12.4	22.8
Principal past due	418	419	378	305	302
As a % of total loans	7.5	7.9	6.9	5.4	5.8
Accumulated provision for loans as a % of impaired loans	32.5	32.0	27.7	30.5	39.5
Accumulated provision for accounts receivable for accrued income/charges receivable on loans	169	223	198	188	N.A.
As a % of accounts receivable for accrued income/charges receivable on loans	38.7	48.9	45.8	46.3	N.A.
Accumulated provision for sovereign loans	184	199	179	203	449
As a % of sovereign loans	3.5	4.0	3.5	4.1	9.2
Accumulated provision for private sector loans	12	15	16	11	20
As a % of private sector loans	3.5	4.9	4.4	3.3	6.2
Accumulated provision for equity losses¶	50.7	52.6	18.1	18.8	17.9
As a % of total equity investments¶	26.8	44.2	10.7	11.7	10.9

\* 2004 and 2003 figures are nonaccrual loans. ¶ Includes shareholding in African Development Fund

AFDB's loan portfolio performance has, by some measures, been well below that of other rated MDFIs. Impaired loans, while falling in absolute terms over the past three years, were SDR603 million at year-end 2007, nearly 11% of total loans, still a very high percentage for an MDFI. Moreover, the principal past due has increased to SDR418 million at year-end 2007—7.5% of total loans—from SDR302 million, 5.8% of outstanding loans—four years earlier. This is also a very high percentage for an MDFI. Finally, the bank has substantial accrued interest and loan charges—SDR436 million at year-end 2007—from its borrowing RMCs.

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. However, it did reschedule the Democratic Republic of the Congo's (DRC) loans in 2002, albeit in such a way that the present value of the scheduled repayments equaled that of the original payments. The DRC remains current on its loans.

AFDB has generally been treated as a preferred creditor by its RMCs. However, such status means only that its loans are likely to be repaid before those of commercial or official bilateral lenders; it does not ensure that they will in fact be repaid in full and on time. Given the economic distress of many of its borrowing members, it is not surprising that they have on occasion fallen behind on their payments.

The credit risk in AFDB is significantly mitigated by the HIPC Initiative. At year-end 2007, of AFDB's 53 RMCs, 19 were "completion point countries" and another seven were "decision point countries;" in addition, seven more were "pre-decision point countries." At year-end 2007, AFDB had SDR156 million in outstanding loans to completion point countries; SDR741 million to decision point countries; and SDR397 million to pre-decision point countries. SDR484 million in payments on behalf of the completion point and decision point countries are expected to be received from the HIPC trust fund. Payments for AFDB's loans from the pre-decision point countries are also likely to be substantial, although it is uncertain when—or even if—these countries will be eligible for the program.

Despite never having written off a sovereign loan, as shown in Table 7, AFDB maintains provisions for losses on both accrued interest and charges on loans and on the principal amount of the loans themselves. The accumulated provision on the former totaled nearly 39% of the outstanding amount, while the accumulated provision on the latter—both for public-sector and private-sector loans—were 3.5%. Because the bank expects the principal, interest, and charges of all of its public-sector loans to be repaid, the provisions for impairment on these items cover delays in receipt. The provision for loss on private-sector loans covers the potential non-collectivity of both principal and interest. Whether these provisions, in particular the latter, are adequate remains to be seen. This is important in the context of the expected substantial increase in private-sector lending over the medium term.

It is no doubt true that AFDB has more risk embedded in its loan portfolio than most other 'AAA' rated MDFIs. However, this is more than offset by its strong capital position. Accordingly, AFDB's financial profile places it solidly within the 'AAA' rating category and gives the bank the capacity to substantially increase its development-related exposure while maintaining the 'AAA' rating.

#### Ratings Detail (As Of January 8, 2009)\*

##### African Development Bank

Counterparty Credit Rating

*Foreign Currency* AAA/Stable/A-1+

Certificate Of Deposit

*Foreign Currency* AAA

Commercial Paper

*Foreign Currency* A-1+

Senior Unsecured (205 Issues)

AAA

Subordinated (6 Issues)

AA+

##### Counterparty Credit Ratings History

24-Jul-2003 *Foreign Currency* AAA/Stable/A-1+

06-Jun-2001 AA+/Stable/A-1+

09-Aug-2000 AA+/Negative/A-1+

\*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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