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Research Update:

African Development Bank 'AAA/A-1+' Ratings Affirmed On Capital Improvement; Outlook Stable

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African Development Bank 'AAA/A-1+' Ratings Affirmed On Capital Improvement; Outlook Stable

Overview

- Shareholder contributions to the African Development Bank's sixth capital increase continued to be on schedule in 2013, contributing to an improvement in our risk-adjusted capital ratio after adjustments for the bank to 17% from 15% in 2012.
- Although some African regions are experiencing financial stress, the bank's asset quality continues to be robust.
- We are affirming our 'AAA/A-1+' ratings on the African Development Bank.
- The stable outlook reflects our view that the bank will maintain its credit strengths over the next two years.

Rating Action

On Sept. 17, 2014, Standard & Poor's Ratings Services affirmed its 'AAA/A-1+' long- and short-term issuer credit ratings on the African Development Bank (AfDB). The outlook is stable.

Rationale

We base the ratings on AfDB on our assessment of its business risk profile as very strong and its financial risk profile as strong, as our criteria define these terms. The ratings also reflect our expectation that the bank would receive extraordinary shareholder support through callable capital if necessary. We continue to assess the bank's stand-alone credit profile (SACP) at 'aa'.

Established by a treaty incorporating 29 African countries in 1964, AfDB admitted non-regional members from 1982, and its membership now includes 53 African countries and 25 non-regional countries. The most recent member, Luxembourg, joined in 2014. The bank is the keystone of the African Development Bank Group (our rating is on the bank, not the group), which includes soft-loan windows, the African Development Fund (AFDF), and the Nigeria Trust Fund (NTF). AfDB's primary purpose is to contribute to sustainable economic development and social progress in Africa.

Since 1995, AfDB has restricted its sovereign lending to its more economically developed regional members. Among African governments, 17 are currently eligible to borrow from the bank only, while 35 members may only borrow from AFDF and NTF, and two countries are eligible to borrow under both windows. Lending to the private sector, however, is not restricted to entities domiciled in eligible countries. AFDF and NTF offer grants and loans at concessional rates. These instruments help AfDB to maintain support in countries where governments are currently not eligible to borrow from the bank.

The very strong business risk profile reflects our view of AfDB's policy importance and its governance and management expertise. We assess the bank's policy importance based on its role, public policy mandate, the strength and stability of the relationship with shareholders, and preferred creditor treatment.

AfDB has provided financing for infrastructure development in Africa over the past five decades. The strong demand for the bank's lending during the global financial crisis in 2009 has reinforced its role. This led to a nearly 30% increase in its loan portfolio. The lending is directed to African governments, and public and private sectors. In recent years, sovereign and public-sector lending has started to grow slowly, due to financial stress experienced by some African sovereigns and the reaching of risk limits in North Africa which had been a traditional lending base. As a result, the bank is expanding the number of countries eligible to receive funding to 25 countries from 16 because economic conditions for African sovereigns are generally improving--and with the aim of diversifying assets. Conversely, AfDB has sought to increase private-sector lending--currently about 28% of the total in 2013--because it sees private-sector financing as a key contributor to economic growth. We think that at this stage, increased private-sector lending will not reduce AfDB's public-policy mandate because the lending is still below the bank's 45% limit.

The strength and stability of AfDB's relationship with its shareholders was demonstrated by the sixth general capital increase ("GCI-VI"), which became effective in 2010 and was subscribed by 73 of the bank's 77 member shareholders. Subsequently, Turkey in 2013 and Luxemburg in 2014 joined the bank as new shareholders. While AfDB has benefited from preferred creditor treatment from many of its borrowing members, it has also experienced arrears and defaults by both public- and private-sector borrowers. Furthermore, the Multilateral Debt Relief Initiative has helped many of its borrowing members in honoring their loans to the bank.

In our opinion, AfDB's governance and risk management rest on sound principles, and a balanced shareholder composition. All powers of the bank are vested with the Board of Governors. The bank prepares all financial statements in accordance with International Financial Reporting Standards and has an experienced management team. However, its move back to Abidjan, Ivory Coast, its main headquarters, may potentially result in some personnel leaving and consequently temporarily slow its strategy.

Our assessment of AfDB's financial risk profile as strong predominantly reflects improvement in the bank's capital adequacy after adjustments.

Standard & Poor's risk-adjusted capital (RAC) ratio, its primary measure for assessing a bank's capital adequacy, was 24% before adjustments for AfDB on Dec. 31, 2013. This ratio is stable versus one year ago, balancing a $500 million capital increase and slight shrinkage of the balance sheet in 2013, with a 20% rise in equity and fund participations throughout the year (in part reflecting capital calls) and our slight increase in risk weightings based on our opinion of heightening risks in Africa.

By contrast, our RAC ratio after adjustments for AfDB improved to 17% as of Dec. 31, 2013, from 15% one year earlier. The strengthening reflected a decrease in the bank's largest sovereign concentrations (on- and off-balance sheet) relative to its capital.

AfDB's five largest exposures (outstanding balances, excluding undisbursed loans)--Morocco, South Africa, Tunisia, Egypt, and Botswana--accounted for a reported 151% of adjusted common equity on Dec. 31, 2013, down from 155% on Dec. 31, 2012. We expect AfDB's concentrations to come down as the number of eligible borrowing countries increases, private-sector lending increases as a percentage of total loans, and the bank embarks on some innovative capital management techniques. But we think as a result that the bank may expose itself to higher risk exposures in both loans and limited private equity investment growth, which could lead to a weakening in asset quality indicators. We also think that our RAC framework doesn't fully cover the bank's risk linked to its relatively high number of equity stakes in development financial institutions and potential recapitalization needs, and high gains and losses on exchange rate translation.

Positively, the bank has been developing its private-sector lending and private equity risk management. On Dec. 31, 2013, impaired loans accounted for 2.85% of total loans, and the cost of risk (loan loss provisions to net loans) over the past few years has been stable at about 1.38% despite tighter economic conditions--in our view, attesting to the quality of the bank's risk management and lending decisions.

Our funding ratios indicate that AfDB is structurally able to cover its scheduled debt repayments without recourse to new issuance over up to a five-year period. This ratio would weaken significantly, however, if we include expected loan disbursements. AfDB's funding profile remains very diverse in terms of investor base, currency, and maturity. Global benchmark bonds remain the primary source of funding, with alternative sources from domestic markets, Uridashi, green bonds, private placements, and loans. We also factor in its sizable liquid asset cushion, and cost-pass-through policy under which it passes funding costs on to borrowers.

Our liquidity ratio shows that AfDB would be able to pay all obligations due over the coming year, without access to capital markets. The bank maintains a strong liquid asset cushion that will likely include 34% of total assets, 55% of gross debt, and represent 2.9x short-term debt (maturing in one year) on Dec. 31, 2013. Liquid assets comprise high quality bonds, cash, and a small portfolio of asset-backed securities.

AfDB benefits from the equivalent of Special Drawing Rights (SDR) 9 billion (approximately USD14 billion) in callable capital from 'AAA' rated shareholders. This amount equals 1.5x shareholders' equity on Dec. 31, 2013. If AfDB made a capital call, its cash capital levels could be raised to a point consistent with an extremely strong financial risk profile. Therefore, we incorporate two notches of uplift for extraordinary shareholder support from AfDB's SACP, leading to our 'AAA' long-term rating on the bank.

Outlook

The stable outlook reflects our expectation that we will continue to assess AfDB's SACP at 'aa'. Moreover, we consider that the amount and willingness of extraordinary shareholder support to the bank will remain unchanged. Underlying this expectation is our view that AfDB's business risk profile will remain very strong over the next two years.

Over the longer term, there could be some negative pressure on the ratings if we come to believe that AfDB's increased private-sector lending is weakening its public-policy mandate or potential preferred creditor treatment. Although currently not what we expect, rating pressure could arise in the nearer term if one of the larger public-sector borrowers defaulted to the bank and failed to demonstrate preferred creditor treatment. Deterioration in asset quality (loans, equity, or treasury portfolio) over our 24-month outlook horizon could also weigh negatively on the ratings. Although unexpected, a more aggressive funding or lending strategy could have a negative impact on the ratings.

The financial risk profile could improve in the long term, alongside significant improvements in the RAC, as long as private-sector lending contributions and equity investments don't add more volatility to the bank's cost of risk or bring down our assessment of preferential creditor treatment.

Related Criteria And Research

Related Criteria

- Multilateral Lending Institutions And Other Supranationals Rating Methodology, Nov. 26, 2012
- Bank Capital Methodology And Assumptions, Dec. 6, 2010

Related Research

- South Africa Long-Term FC Rating Lowered To 'BBB-'; LC Rating Lowered To 'BBB+' On Ongoing Weak Growth; Outlook Stable, June 13, 2014
- Supranationals: Special Edition 2013: Comparative Data For Multilateral Lending Institutions, March 11, 2014
- How An Erosion Of Preferred Creditor Treatment Could Lead To Lower Ratings On Multilateral Lending Institutions, Aug. 26, 2013

Ratings List

Ratings Affirmed

African Development Bank	
Issuer Credit Rating	
Foreign Currency	AAA/Stable/A-1+
Senior Unsecured	AAA
Subordinated	AA+
Commercial Paper	A-1+

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