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Research Update:

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

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Overview

- We expect the African Development Bank (AfDB) will further increase its lending over the next two years, while maintaining its current stand-alone credit quality, with a very strong business profile and very strong financial profile.
- In addition, we incorporate into our ratings on AfDB potential extraordinary shareholder support, owing to callable capital from 'AAA' rated sovereigns.
- We are affirming our 'AAA/A-1+' ratings on AfDB.
- The outlook remains stable, reflecting our expectation that, over the next two years, the bank will continue fulfilling its development mandate, benefiting from preferred creditor treatment, and that the amount and willingness of extraordinary shareholder support to the bank will remain unchanged.

Rating Action

On July 31, 2017, S&P Global Ratings affirmed its 'AAA/A-1+' long- and short-term issuer credit ratings on African Development Bank (AfDB). The outlook is stable.

Rationale

The ratings on AfDB reflect our assessment of the bank's business profile as very strong and its financial profile as very strong. Our assessment of its stand-alone credit profile (SACP) remains at 'aa+'. We incorporate a one-notch uplift for extraordinary shareholder support from AfDB's SACP, leading to our 'AAA' long-term rating on the bank (see "Multilateral Lending Institutions And Other Supranational Institutions Ratings Methodology," published Nov. 26, 2012, on RatingsDirect).

Established by a treaty in 1964, AfDB is the keystone of the African Development Bank Group, which includes soft-loan windows, the African Development Fund (AfDF), and the Nigeria Trust Fund (NTF). The bank's membership includes 54 African countries and 26 non-regional countries. AfDB lends predominantly to sovereigns, comprising about 76% of total credit exposures, while private-sector lending represents 21% of total credit exposures as of Dec. 31, 2016.

Our assessment of AfDB's very strong business profile is based on our view of the bank's role, public policy mandate, membership support, expectation for preferred creditor treatment (PCT), and governance. Most of the bank's sovereign lending has been concentrated in more economically developed regional members with strong creditworthiness. In 2014, the bank revised its credit policy to increase the number of member countries eligible to borrow, namely to include those member countries that while still economically developing, show improved creditworthiness.

The bank has a history of fulfilling its mandate by providing financing, particularly for infrastructure development, through economic cycles. The robust demand for the bank's lending--which led to a nearly 30% increase in its loan portfolio during the 2009 global financial crisis--has reinforced its role. AfDB currently uses the AfDF and the NTF windows to provide assistance to member countries whose governments are currently not eligible to borrow from the bank. Among African governments, 17 are eligible to borrow only from AfDB, while 34 members may borrow only from the AfDF and the NTF, and three countries are eligible to borrow under all three windows. We believe that expanding the number of eligible borrowing sovereigns in 2014 reinforces the bank's public policy role and mandate on the continent, although we expect only a gradual build-up of investments in these new eligible countries. At the end of 2016, the bank's outstanding exposures increased significantly by 22.5% totaling UA (official reporting currency of the AfDB) 32.7 billion (US\$43.9 billion), largely led by a 27% increase in sovereign exposure.

AfDB views private-sector financing as a key contributor to economic growth and development in regional member countries and is actively increasing its private-sector, non-concessional, non-sovereign guaranteed exposure. AfDB aims to direct 40% of its total approvals to this asset class over the medium term. We consider that this strategy could weigh on the bank's business profile, if it implies the bank is unable to fulfill its development mandate or maintain its financial performance targets, namely strong capital adequacy and asset quality, as a result of this growth. If we were to assess an increasing share of private-sector lending as less essential to the bank's public policy mandate than its traditional exposures, we could change our view of the bank's role, and our assessment of AfDB's business profile could weaken. Rising exposure to the private sector could also worsen our risk-adjusted capital (RAC) ratio for AfDB and ultimately its financial profile, as private-sector lending would be ineligible for PCT.

The bank's business profile incorporates our expectation that it will continue to receive PCT on its public sector exposure, an internationally recognized practice of excluding multilateral lending institutions (MLIs) from restructuring or rescheduling of sovereign debt. In our view, AfDB's track record of PCT is weaker than that of other 'AAA' MLI peers. The bank has experienced both arrears and defaults by public- and private-sector borrowers, respectively. Zimbabwe, Sudan, and Somalia are in arrears on their sovereign-guaranteed loans, reflecting large legacy outstanding balances. We understand that Zimbabwe is also working with the World Bank and other multilateral development banks on a plan to clear these arrears.

The AfDB is in the process of further strengthening aspects of its governance and risk management in light of its weaker track record in managing asset quality, particularly for its non-sovereign guaranteed portfolio. This is a priority for the bank's president, Akinwumi Adesina, of Nigeria, who assumed office on Sept. 1, 2015. That said, we expect the level of nonperforming loans (NPLs) will rise, owing to the difficult operating environment facing its commodity dependent borrowing members and the increasing share of the non-sovereign loans. This highlights the importance for prudently approving new loans and carefully monitoring the composition and credit quality of the overall portfolio. We could change our view on the bank's business or

financial profile if the controls and/or financial performance of the nonsovereign exposures do not meet our expectations.

AfDB's very strong financial profile reflects its capital adequacy and its funding and liquidity. S&P Global Ratings' primary metric to assess capital adequacy, the RAC ratio, was 20.9% before adjustments specific to MLIs as of year-end 2016. However, after taking into account S&P Global Ratings' MLI-specific adjustments, the RAC ratio was 21.3%. For AfDB, the predominant adjustment is a concentration penalization for sovereign exposures, which our expectation for continuing PCT somewhat offsets. The decline in the RAC ratio to 21.3% in 2016 from 24.4% in 2015 incorporates the significant increase in the bank's total exposure by 22.5% to UA32.7 billion in 2016, from UA26.7 billion in 2015. It also reflects relatively rapid loan growth to the broader list of potentially less-creditworthy African countries following the amendment to the bank's credit policy in 2014.

Asset quality is a rating weakness for AfDB relative to similarly rated MLIs, reflecting its focus on private- and public-sector borrowing in geographic areas that carry intrinsically higher operating and credit risks. NPLs in the private-sector portfolio deteriorated in 2016 to a reported 7.6% of total private sector loans, up from 6.2% one year earlier. However, we note that NPLs for AfDB's total loan book, including both private and public sector loans, stood at a moderate ratio of 1.9% of total portfolio.

Given currently low commodity prices and weak global growth, we believe private-sector asset quality will continue to weaken further in 2017. We consider AfDB's loan loss reserve coverage to be modest, at 55% of impaired balances on Dec. 31, 2016, up from 49% one year earlier, with the prospect for increased provisioning in 2017. While its average coverage is low for a financial institution operating in Africa, the bank benefits from our expectation of PCT.

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, green bonds, Uridashi bonds, private placements, and loans. The bank has a positive funding gap up to the two-year static gap. Our positive funding ratio indicates that AfDB is structurally able to cover its scheduled debt repayments without recourse to new issuance for up to two years, but this does not take into account new disbursements. However, a marginal negative funding gap has emerged over the five-year tenor.

In our opinion, AfDB's management of liquidity is sound, aided by the high level of liquid assets the bank holds on its balance sheet. The bank maintains a strong liquid asset cushion, accounting for 40.2% of adjusted total assets, 57.9% of gross debt, as of Dec. 31, 2016. Liquid assets comprise high quality bonds, largely in the 'AAA' (45%) and 'AA' (38%) rating range, cash, and a small portfolio of asset backed securities. Our liquidity ratios for AfDB indicate that the bank would be able to fulfil its mandate for at least one year, even under extremely stressed market conditions, without access to the capital markets. Moreover, we estimate that the bank would not need to reduce the scheduled disbursements of its loan commitments, even if half of the total commitments were to be drawn in one year. On this measure,

we estimate year-end 2016 liquidity ratios were 1.9x at the one-year horizon without any loan disbursements and 1.2x with half-scheduled loan disbursements .

Outlook

The stable outlook reflects our expectation that, over the next two years, AfDB will continue fulfilling its developmental mandate, benefiting from PCT, and that the amount and willingness of extraordinary shareholder support to the bank will remain unchanged. We also factor in our projected RAC ratio after adjustments remaining well above 15% over our outlook horizon, even with increased exposure to the private sector and the broadening in eligibility of African sovereign borrowers since 2014. We anticipate no structural, long-term changes in funding or liquidity ratios.

We could lower our ratings if we observe a weakening in AfDB's public-policy role. In this regard, we view the growth of the bank's private-sector lending as a particular risk, which, without continuing evidence of a developmental mandate, may threaten policy importance. The financial profile could also come under pressure if the bank's asset quality continues to weaken further as it pursues private-sector or less-creditworthy sovereign exposure, internal controls are perceived to be ineffective, or if the RAC ratio after adjustments approaches the 15% threshold.

Related Criteria And Research

Related Criteria

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings - April 07, 2017
- Criteria - Governments - General: Multilateral Lending Institutions And Other Supranational Institutions Ratings Methodology - November 26, 2012
- Criteria - Financial Institutions - Banks: Bank Capital Methodology And Assumptions - December 06, 2010
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009

Related Research

- Supranationals Special Edition 2016 - September 29, 2016

Ratings List

	Rating	
	To	From
African Development Bank		
Issuer Credit Rating		
Foreign Currency	AAA/Stable/A-1+	AAA/Stable/A-1+
Senior Unsecured		
Foreign Currency	AAA	AAA
Subordinated		

Ratings List Continued...

Foreign Currency	AA+	AA+
Short-Term Debt		
Foreign Currency	A-1+	A-1+
Commercial Paper		
Foreign Currency	A-1+	A-1+

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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