Research Update:

African Development Bank 'AAA/A-1+' Ratings Affirmed On Solid Business Profile; Outlook Remains Stable

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Overview

- In our view, African Development Bank (AfDB) has a solid business profile because it is a key source of multilateral financing in the region. As AfDB increases its private-sector lending, we expect this will be managed prudently and in a way that aligns with its institutional strategy and mandate.

- While S&P Global Ratings' risk-adjusted capital (RAC) ratio, after adjustments, declined for the second year in a row, we expect that management at AfDB will be conservative, and the bank will maintain solid levels of liquidity.

- We are affirming our 'AAA' long-term issuer credit and 'A-1+' short-term issuer credit ratings on AfDB.

- The stable outlook reflects our expectation that, over the next two years, AfDB will prudently manage its capital consumption trajectory, the RAC ratio after adjustments will remain over 15%, the bank will maintain shareholder support, and borrowers will continue to treat the bank as a preferred creditor.

Rating Action


Rationale

Our ratings on AfDB, which pertain only to AfDB's ordinary capital resources, reflect our view of its very strong business profile and very strong financial profile.

AfDB, established by treaty in 1964, is the keystone member of the AFDB Group, which also includes soft-loan windows, the African Development Fund (AfDF), and the Nigeria Trust Fund (NTF). There is no recourse to AfDB for obligations with respect to ADF and NTF liabilities.

We expect that AfDB will continue to be a key source of multilateral financing
and maintain its important role in the region, even as the bank increasingly shifts more of its lending to private-sector operations. As part of its 2013-2022 strategy focusing on inclusive and green growth, the bank identified key priorities with an emphasis on infrastructure financing and private-sector development.

As of December 2017, private-sector lending exposure grew by 16% to Special Drawing Rights (UA) 3.9 billion, compared with 8% in 2016, representing 22% of the combined loan portfolio. We expect the relative share of private-sector loans to increase to 25% over the medium term from 22% in 2017. While this may, to some extent, limit AfDB's ability to lend countercyclically to sovereigns, we view this as in line with its mandate and institutional strategy. Furthermore, in 2017, AfDB introduced a limit on policy-based loans, to 15% of total approvals—after record-high approval levels in 2016 at UA7.62 billion—to support borrowers hit by the commodity collapse over the past few years. Its sovereign exposure increased by 15% to $17.8 billion in 2017, albeit growth was comparably slower than 21% the year before.

We believe AfDB will manage risks associated with a larger share of private-sector exposure prudently. AfDB has been retooling its operational structure to support these efforts by creating a Special Operations Unit in 2015 as well as a new Syndications, Co-financing and Clients Solution department in 2017. To ensure the right skill mix, AfDB expects to hire approximately 100 bankers, which it views as the first line of defense in its credit risk management strategy. While we remain cautious about AfDB's private-sector borrowing initiatives given that the geographic region is typically characterized by higher operating and credit risks, we believe that AfDB's comprehensive risk management will counterbalance these.

Furthermore, AfDB implemented a robust development outcome and additionality framework in 2008, which is an ex-ante evaluation required for each project, alongside the project appraisal and credit note, to ensure that transactions provide value and deliver on their development outcomes.

AfDB members continue to demonstrate their support for the bank. The Board of Governors approved the bank's sixth general capital increase (GCI) in May 2010, representing a 200% increase over the bank's capital. Members continue to pay their installments on time, and we expect timely payments going forward. In May 2018, the Board of Governors approved the commencement of discussions with shareholders for a seventh general capital increase. While the details in terms of size and timing are still unresolved, we expect this to materialize in the near term.

The bank's business profile incorporates our expectation that it will continue to receive preferred credit treatment (PCT) on its public-sector exposure. In our view, AfDB's track record of PCT is weaker than that of MLI peers. The number of sovereign borrowers in nonaccrual status as of Dec. 31, 2017, remained unchanged at three (Sudan, Somalia, and Zimbabwe), representing 2% of the outstanding loan portfolio. Zimbabwe is making progress, although slowly, on its arrears clearance program, and AfDB is working closely alongside the
World Bank and the International Monetary Fund. We expect likely clearance of these arrears in the medium term. We also assume no other sovereign borrowers will enter into arrears with the bank.

The bank's members include all 54 African countries and 26 nonregional, nonborrowing countries. We have seen AfDB's shareholder base expand in recent years. Prior to GCI-VI, the Board of Governors authorized two capital increases, which allowed Turkey and the Grand Duchy of Luxembourg to become the 78th and 79th members of the bank in October 2013 and May 2014, respectively. A special capital increase allowed South Sudan to become the 80th member country in 2015.

We view the shareholder structure, with majority of voting shares (60% as of 2017) coming from borrowing-eligible members, as potentially vulnerable to agency risk, where the interests of borrowing members could differ from those of creditors. However, this is counterbalanced by our view of AfDB's strong risk management and risk culture, on par with peers we rate 'AAA'. The board approved its first risk-appetite statement in 2012 and carefully manages risk within prudential limits.

Furthermore, AfDB has been undergoing a comprehensive organization restructuring, including implementing a decentralization plan and a revised business-delivery model in order to take the bank closer to its clients and enable it to carry out its work more quickly and efficiently. AfDB has established five regional offices, and in 2016, the bank established three new sector vice presidency positions. This will further enhance, in our view, AfDB's close links to the region, with its current presence in 41 countries, managing the majority of projects from field offices. The decentralization plan did pose some personnel and cost pressures, but we expect AfDB to manage this prudently.

AfDB has no private-sector shareholding, so, in our view, private interests don't dilute its public policy mandate.

Also, AfDB has attracted various partnerships and co-financing agreements, which speaks to its unique role. This includes a US$6 billion agreement with the government of Japan to launch the Japan-Africa Energy Initiative and a EUR2.2 billion co-financing partnership with the EU to support transformational projects. These agreements, among others, enable AfDB to share its risk and enhance our assessment of the business profile.

The rapid growth of its loan portfolio has translated in a decline in AfDB's risk-adjusted capital (RAC) ratio after adjustments to 19% as of December 2017, from 21% in 2016 and 24% at its peak in 2015. AfDB's lending capacity may be constrained because of its high capital consumption trajectory over the next few years. This has prompted AfDB to moderate its credit and growth assumptions until the seventh capital increase goes into effect, and we expect them to manage risk within approved limits. On the other hand, AfDB benefits from UA12.4 billion in eligible callable capital from its 'AAA' rated shareholders, and so we incorporate an uplift above the 'aa+' stand-alone.
credit rating to derive the 'AAA' long-term issuer credit rating. (The RAC ratio after diversification does not reflect the criteria correction published on July 11, 2017. We believe the impact of the correction on the ratio is not material to the rating.)

AfDB's sovereign exposure is largely concentrated, with the top five borrowers accounting for approximately 47% of the total, resulting in a large penalization for sovereign concentration risk in our capital adequacy assessment. Currently, only 17 out of 54 countries are eligible to borrow from AfDB, while ADF supports the majority of member countries with concessional lending.

The bank has focused its efforts on optimizing its balance sheet and exploring various risk-transfer mechanisms to free up capital through its Room 2 Run initiative. The bank entered into an exposure-exchange agreement with the World Bank and the Inter-American Development Bank in 2015. The exchange involved the concurrent cross-guaranteeing of credit risk on predefined sovereign exposures with similar credit risk profiles, with AfDB buying protection on eight African sovereigns while selling protection on 13 sovereigns worldwide. This provided the bank with extensive capital relief. Despite interest, a second exposure exchange agreement has not been announced.

In 2018, AfDB expects to approve two transactions on its nonsovereign portfolio: a funded synthetic securitization of a portion of its nonsovereign loan portfolio, as well as purchase credit insurance on a portion of its financial-sector portfolio. While we view these risk-transfer mechanisms as positive insofar as they free up capital and support additional lending in line with the mandate, we believe AfDB's ability for significant capital relief is limited unless it significantly scales these types of transactions. Although unlikely, if AfDB's ability to unlock additional financing relied solely on risk-transfer mechanisms at the expense of capital increases, this could weigh on the business profile.

While historically asset quality has been a rating weakness for AfDB, we have seen improvements in nonperforming loans (NPLs). In 2017, NPLs on the nonsovereign portfolio declined to a reported 4.6% of total private-sector loans, down from 7.6% a year earlier, in part because of write-offs on four loans that were fully provisioned as well as the outcome of successful resolution on NPLs. Of AfDB's defaulted private-sector loans, recovery rates tend to be very high, typically over 90%.

AfDB reported stronger earnings in 2017, with net income of UA176.43 million, compared with UA25.07 million in 2016. The increase was the result of the combined effect of higher interest income from increased volumes of loans and investments, reduced impairment on nonsovereign loans, and a favorable valuation of borrowings and derivatives.

AfDB's funding profile remains very diverse in terms of investor base, currency, and maturity, and it regularly issues benchmark bonds in both international and domestic debt capital markets. The bank has been deepening
and widening its investor base. In 2017, it attracted new investors in Europe (72%), Asia (17%), Africa and Middle East (7%), and the Americas (4%). The bank has also developed and enhanced its social, green, and themed bond programs. 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. AfDB's static funding gap at one year, excluding loan disbursements, was 1.2x at year-end 2017.

The bank maintains a strong liquid asset cushion, accounting for 39% of adjusted total assets and 69% of gross debt as of Dec. 31, 2017. Liquid assets comprise high-quality bonds, largely in the 'AAA' (53%) and 'AA' (39%) rating categories, cash, and a small portfolio of asset-backed securities. Our calculations of AfDB's liquidity incorporate stressed market conditions and assume no market access. Under these conditions, we calculate that AfDB's liquid assets are sufficient to service its borrowing and maintain operations through the next year without slowing the pace of planned disbursements. According to our calculations, AfDB's liquidity at the one-year horizon under stressed market conditions and assuming scheduled disbursements was 1.2x as of Dec. 31, 2017. However, we estimate that the bank would need to slow down planned disbursements under a stress scenario.

Outlook

The stable outlook reflects our expectation that, over the next two years, AfDB will prudently manage its capital consumption trajectory and the RAC ratio after adjustments will remain over 15%, while maintaining solid levels of high-quality liquidity assets and a robust funding program. We expect that shareholders will remain supportive by providing capital increases when needed; the bank will continue benefiting from PCT; and the bank will prudently manage growth in private-sector lending in a way that's aligned with the institution's mandate. We also assume extraordinary shareholder support to the bank will remain unchanged.

We could lower our ratings if we observe signs of weakening PCT from borrowing members, or if shareholders are slow in granting the bank a further capital increase, which limits AfDB's ability to carry out its public-policy mandate. We could also lower the ratings if capital adequacy and liquidity ratios deteriorate as the bank pursues private-sector or less-creditworthy sovereign exposures or if we perceive internal controls to be ineffective.

Related Criteria

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria - Governments - General: Multilateral Lending Institutions And Other Supranational Institutions Ratings Methodology, Nov. 26, 2012
Related Research

- Sovereign Ratings History, July 5, 2018
- How Brexit Could Impact Ratings On Supranational Institutions, April 10, 2017
- 2016 Annual Sovereign Default Study And Rating Transitions, April 3, 2017
- Supranationals Special Edition 2017: Comparative Data For Multilateral Lending Institutions, Oct. 20, 2017

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+

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.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.