FitchRatings

RATING ACTION COMMENTARY

Correction: Fitch Affirms African Development Bank at 'AAA'; Outlook Stable

Tue 21 Jul, 2020 - 5:39 AM ET

Fitch Ratings - London - 21 Jul 2020: This rating action commentary replaces the version published on 20 July. It clarifies the final paragraph of the Key Rating Drivers.

Fitch Ratings has affirmed African Development Bank's (AfDB) Long-Term Issuer Default Rating (IDR) at 'AAA' with a Stable Outlook.

KEY RATING DRIVERS

AfDB's 'AAA' rating is driven by the extraordinary support it receives from its shareholders, which Fitch assesses at 'aaa'. The rating is also supported by the bank's intrinsic rating, which has been revised down to 'aa-' from 'aa' previously. The revision reflects the expected deterioration in the bank's asset quality as the result of the COVID-19 crisis. The intrinsic assessment of 'aa-' reflects the lower of the bank's 'aa-' solvency and 'aaa' liquidity assessments.

We assess AfDB's support rating at 'aaa', based on our forecast that the bank's net debt will fully cover by callable capital from 'AAA' rated member states (MS) by 2022. This results in a 'aaa' capacity to support. The 'strong' propensity of shareholders to support translates into no notching down.

Fitch's projection assumes a 125% increase in subscribed capital from 2021 as per AfDB's 7th General Capital Increase (GCI) plan approved in October 2019. Fitch expects all non-regional shareholders will make their first payments before October 2021, as otherwise they would face the risk of their shares being forfeited. Six MS have started to make payments for a total of XDR135 million, including Germany (AAA/Stable) and Norway (AAA/Stable). In Fitch's view, the independent review initiated by the Bureau of the Board of Governors of the process and report of the Ethics Committee, which exonerated the President of the bank of allegations of misconduct, will be resolved soon and will not affect the path of capital subscription by shareholders.

Fitch's projections also assume growth in lending operations by 8% yoy on average. This factors in a significant increase in loan disbursement, especially in 2020, as the bank provides emergency support to its borrowers facing the COVID 19 crisis. As AfDB's own prudential capital ratio is very close to its 100% limit (the risk capital utilisation ratio was 94% in 1Q20), Fitch notes that the bank's ability to continue with fast disbursement is closely linked to the receipt of paid-in capital payments by shareholders.

In April 2020, AfDB's board of governors approved a group-wide COVID-19 Response Facility, a USD10 billion package made to be available to current borrowers (USD5.50 billion for the bank's sovereign borrowers, USD1.35 billion for private sector borrowers, and the remaining USD3.10 billion for operations in countries under African Development Fund) to ease the economic impact of the COVID-19 crisis. The package will be funded out of a reallocation of existing resources and total approval in 2020 will not increase relative to the pre-crisis (XDR5.5 billion). However, as the bulk of support to sovereigns is in the form of emergency budget support, disbursements will be faster than in the pre-crisis scenario.

Fitch has revised the bank's solvency assessment to 'aa-' from 'aa' previously, on the back of deteriorating credit quality of loan and guarantee portfolio as the result of the economic impact of the COVID-19 crisis in the countries where the bank operates. Since March 2020, Fitch has downgraded eight countries accounting for

29% of the loan portfolio, and assigned Negative Outlooks to seven sovereign ratings, which account for a further 27% of loans.

Fitch assesses AfDB's overall risks as 'low', balancing the 'moderate' credit risk profile against 'low' concentration risk, 'very low' equity and market risks and an 'excellent' risk management framework.

In 2019, the average rating of loans and guarantees deteriorated to 'BB-' from 'BB' at the previous review, mainly due to the downgrade of two sovereign borrowers, Namibia (BB/Negative) and Zambia (CC) and of some of the bank's non-sovereign borrowers. The agency expects the bank's average rating of loan and guarantees to fall further to 'B+' over the medium term, reflecting the risk of further downgrades of sovereigns, as evidenced by the seven sovereigns with a Negative Outlook, and non-sovereign borrowers. The high risk profile of the borrowers is somewhat offset by the bank's preferred creditor status, leading to a one-notch uplift of the average rating of loans and guarantees, to 'BB-'.

Non-performing loans (NPL) increased to 3% of gross loans in 2019 and 3.2% as of May 2020 from 2.6% in 2018, with the increase driven by non-sovereign NPLs. Fitch forecasts a continued increase in NPLs driven by higher impairment of non-sovereign loans, although the NPL ratio is expected to remain within a 'moderate' range (3%-6%). The agency expects no new sovereign borrowers in default with the bank. In Fitch's view, the net positive inflows to sovereign borrowers provide strong incentives to remain current with the bank as a default would lead to suspension of new payments. Nonetheless, a default by a sovereign borrower constitutes a downside risk to our forecast.

The bank's risk management policies are conservative and Fitch assesses them as 'excellent', in line with 'AAA' rated regional peers. Concentration risk is 'low' and has benefited from the Exchange Exposure Agreement with Inter-American Development Bank (AAA/Stable) and International Bank for Reconstruction and Development (AAA/Stable) since 2015. The five largest exposures accounted for 31% of the total banking portfolio in 2019, down from 34% in 2018. Fitch expects equity participation to remain below 5% of the banking portfolio by 2022, in line with the internal limit of 15% of risk capital. FX and interest rate risks are very limited and conservatively managed.

AfDB's strong capitalisation assessment primarily reflects the strong equity-to-assets ratio, which slightly declined in 2019 to 21% from 22% in 2018, in part due to

weak internal capital generation, which was affected by an increase in administrative expenses, impairment charges and re-measurement of defined benefit liabilities. Fitch's usable capital to risk-weighted assets (FRA) ratio was slightly below 35% at end-2019. Fitch expects the capital increase to boost both metrics, with equity-to-assets ratio picking up closer to 25% and the FRA ratio exceeding 35%, the threshold for an 'excellent' assessment by 2022.

Fitch assesses AfDB's liquidity profile at 'aaa', reflecting an 'excellent' liquidity buffer and quality of liquid assets. At end-2019, liquid assets were 2.9x short-term debt, while treasury assets accounted for 35% of total assets. The bank plans to use a part of its treasury portfolio to fund loan growth in the next few years, which will result in a decline in the share of treasury assets to below 30% of total assets. The bank's liquidity buffers will remain well above the 1.5x threshold for an 'excellent' assessment by 2022.

The share of 'AA' to 'AAA' rated assets in the bank's treasury portfolio stood at 89% at end-2019 (88% in 2018). Fitch expects this metric to remain well above 70%, the threshold for 'excellent' assessment. Other assets are Chinese (A+; 6% of treasury assets) and Japanese (A; 2.6%) government debt securities and cash in Bank of Japan, which are considered eligible to net debt calculation in our support assessment.

AfDB's business environment is 'moderate risk', which translates into no negative adjustment to the bank's intrinsic rating. The assessment takes into account the large size of the bank and the quality of its governance. The findings of the independent review initiated by the Bureau of the Board of Governors of the process and report of the Ethics Committee, which exonerated the President of the Bank of allegation of misconduct will likely be announced in the near-term. Although these might point to some weaknesses in the bank's internal governance process and controls, Fitch considers that the ongoing independent review is also evidence of the bank's accountability towards its shareholders. Lending growth is set to markedly accelerate. This will be backed by a significant increase in capital and is consistent with a 'moderate' risk strategy. The bank's 'high' risk operating environment is consistent with the low ratings, low income per capita and high political risk in the countries of operations.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

The ratings are the highest level on Fitch's scale and cannot be upgraded.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

Support: Coverage of net debt by callable capital from MS rated 'AAA' falling below 100% due to a lower-than-expected increase in callable capital or delays in capital subscription from 'AAA' rated MS, faster-than-expected growth in lending and debt, a downgrade of one of the large 'AAA'-rated shareholders.

Solvency (risk): Worst-than-expected deterioration in asset quality and loan performance, for example in case sovereign borrowers were falling in default with the bank and/or the NPL ratio was above 6%. A weakening in the bank's solvency assessment leading to a downward revision of the intrinsic assessment below 'aa- ' would result in negative rating action as the uplift above the intrinsic from extraordinary support is currently at the maximum of three notches permitted under our criteria.

Solvency (capitalisation): Weaker-than-expected capitalisation ratio due to marked delays in capital subscriptions and/or significant losses on assets that affect the bank's own funds.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [https://www.fitchratings.com/site/re/10111579].

KEY ASSUMPTIONS

- The global economy will develop in line with Fitch's Global Economic Outlook published on 29 June 2020, including a deep but short-lived recession in 2020 due to the pandemic. There is an unusually high level of uncertainty around these forecasts and risks are firmly to the downside.

- The bank's shareholders will subscribe to the 125% capital increase by end 2021. The payment of the paid-in capital spread over 2020-2032 years.

- No 'AAA' rated member state will be downgraded in the medium term.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

RATING ACTIONS

ENTITY/DEBT	RATING		
African Development Bank	LT IDR	AAA Rating Outlook Stable	Affirmed
•	ST IDR	F1+	Affirmed
• senior unsecured	LT	AAA	Affirmed
• subordinated	LT	AA+	Affirmed
• senior unsecured	ST	F1+	Affirmed

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Supranationals Rating Criteria (pub. 30 Apr 2020) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

African Development Bank	EU Issued

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