S&P Global Ratings

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Research Update:

French Public-Sector Funding Agency Agence France Locale Assigned 'AA-/A-1+' Ratings; Outlook Stable

May 20, 2019

Overview

- Agence France Locale Group (AFL Group) is composed of a parent company, AFL-Société Territoriale (AFL-ST), and its operating subsidiary, Agence France Locale (AFL).
- AFL Group benefits from a very strong financial profile because of its very robust funding and liquidity profile, as well as capital position, which counterbalances a moderate enterprise profile, mainly due to a still-weak, though improving, business position.
- We also believe that AFL Group benefits from an extremely high likelihood of support from its largest and most creditworthy local and regional government (LRG) members (hereafter refered to as the supporting group or members), due to a very strong and binding joint guarantee scheme, and the strong willingness of those members to diversify their sources of funding through AFL.
- We are therefore assigning our 'AA-/A-1+' issuer credit ratings to AFL.
- The outlook is stable.

PRIMARY CREDIT ANALYST

Mehdi Fadli

Paris

(33) 1-4420-6706

mehdi.fadli
@spglobal.com

SECONDARY CONTACTS

Christophe Dore

Paris

(33) 1-4420-6665

christophe.dore
@spglobal.com

Patrice Cochelin

Paris

(33) 1-4420-7325

patrice.cochelin
@spglobal.com

ADDITIONAL CONTACT

EMEA Sovereign and IPF

SovereignIPF
@spglobal.com

Rating Action

On May 20, 2019, S&P Global Ratings assigned its 'AA-/A-1+' long- and short-term issuer credit ratings to France-based public-sector funding agency (PSFA) Agence France Locale (AFL). The outlook is stable.

Outlook

The stable outlook reflects our expectation that AFL will remain a core subsidiary of AFL Group, that AFL Group's guarantee scheme will remain unchanged, and that the PSFA will continue to benefit from unwavering membership support. We also anticipate that the PSFA's management will maintain its prudent funding and liquidities policies to contain risks associated with the wholesale-funded nature of its activities. We also expect AFL Group will maintain very strong capitalization and continue closely monitoring the credit quality of its loan portfolio.

Because AFL receives support from its group members rather than the French central government, our rating on AFL isn't directly linked to the French sovereign rating. However, there is a degree of linkage between the rating on AFL and the sovereign, given that a substantial part of AFL's creditworthiness depends on the quality of its loans to French local and regional governments (LRGs) whose credit quality, particularly for the most creditworthy ones, often evolves with that of the sovereign.

We could lower our ratings on AFL over the next two years, if we believed that the willingness of the supporting group (which we estimate has an average credit quality at 'aa-') to support AFL Group had weakened, for example if the share of supporting members' borrowings through AFL were to fall, or if the average credit quality of those members were to deteriorate. We could also lower the rating if AFL Group's capitalization decreased rapidly, due to continued losses or lower paid-in capital, or if its funding and liquidity profile deteriorated, for example due to a widening funding gap.

We could raise the ratings if AFL Group's management significantly improved its business position without weakening its risk and financial management practices and, at the same time, if the average credit quality of the group's supporting members improved.

Rationale

AFL Group became operational in 2015, after the French central government passed a law in 2013 allowing the creation of a group owned by French LRGs so that the LRGs could access funding on the market. AFL Group consists of two entities so that operations are separate and independent from the LRG members: AFL–ST, a financial company that is fully owned by LRGs members; and AFL, its operating subsidiary, which carries out lending and funding operations. AFL is a specialized credit institution that is more than 99.9% owned by AFL–ST and supervised by the French banking regulator (ACPR). In our view, AFL is integral and fully integrated into AFL Group's identity, strategy and operations. We equalize our ratings on AFL with our 'aa-' assessment of AFL Group's group credit profile (GCP), because we view AFL as core to AFL Group.

We assess AFL Group's stand-alone credit profile (SACP) at 'a', based on the group's very strong financial profile, with robust risk-adjusted capitalization and very strong funding and liquidity position. This is counterbalanced by its moderate enterprise risk profile, which mainly results from AFL Group's still-weak, but improving business position. Moreover, we see an extremely high likelihood of AFL Group receiving extraordinary financial support from its supporting LRG members, thanks especially to a very strong and binding joint guarantee scheme. As such, we incorporate two notches of uplift in our 'aa-' GCP.

Extremely high likelihood of support, mainly from a very strong and binding guarantee scheme

- Under the joint guarantee scheme, we expect that a group of the largest potential supporting members, which we estimate have an average credit quality at 'aa-', will provide support to AFL Group, in case of need.
- We assess the likelihood of extraordinary support provided by the group's supporting entities to be extremely high, given the agency's integral link to, and very important role for, its LRG members.

AFL Group has two guarantee mechanisms: The first is a guarantee from AFL-ST to AFL. AFL-ST's board ("Conseil d'administration") determines the maximum amount of this guarantee (currently €10 billion). The second is the LRG members' guarantees. On joining AFL Group, all members must sign a joint guarantee scheme granted to AFL that makes them liable up to their amount of long-term debt borrowed through AFL. Those LRG members' guarantees currently cover more than 70% of AFL Group's financial liabilities.

We consider that within the guarantee scheme the strongest and most timely mechanism is the possibility of a "preventive call" by AFL on AFL-ST's guarantee, which in turn would call the LRG members. AFL could preventively activate this guarantee to avoid a default on its debt obligations or a potential breach of regulatory ratios. For this purpose, AFL's executive board ("Directoire") only needs the approval of its supervisory board ("Conseil de surveillance") to call on this guarantee, but does not need the approval of the "Conseil d'admnistration" of AFL-ST, meaning that the final decision is in the hands of AFL, and not in the hands of the LRG members. In case of default, an investor could also call the AFL-ST guarantee, or call directly the guarantee of any LRG member.

In our view, AFL Group plays a very important role for its LRG members. In a very competitive environment with ample liquidity, those LRGs participated to the creation of AFL Group, or joined it, in order to diversify their sources of funding, and are willing to support its development through disbursement of capital and borrowing from it. LRG members currently fund 25% of their needs through AFL (compared with a national market share of about 5% for AFL) testifying to their involvement in the development of the entity.

In our view, the creation of AFL Group under French law does not imply any support from the central government to AFL. AFL Group is not a state public agency and the law explicitly states that the entity will fund itself mainly through debt issuances, excluding any direct revenues from the central government or any guarantee provided by the central government.

Enterprise Risk Profile: Weak business position counterbalanced by an adequate public-sector industry and country risk assessment (PICRA)

- AFL Group's PICRA benefits from France's wealthy and resilient economy, stable financial sector, and LRGs' stable institutional framework and moderate direct debt burden.
- AFL Group's business position is weak, given its limited although slightly increasing market share, with some concentration risks.
- We consider AFL Group's management policies and practices prudent overall and that the management team has a good level of expertise, with some key man risk.

AFL Group operates in a very competitive environment. French LRGs currently enjoy ample liquidity provided by many players--including national and supranational public banks, as well as commercial banks--and direct access to the market. In our view, the presence of large public banks also limits the direct public policy role of AFL Group in the French market.

AFL Group slightly improved its market share in 2018, but the latter remains limited at about 5% of French LRGs' annual credit inflows. We expect this share will continue to increase slightly and reach 6% by 2020 or 2021, supporting AFL Group's generation of enough revenue to break even from 2021. Despite its low national market share, AFL Group benefits from a stable and committed customer base: its members are willing to support the entity and borrow from it, while exit rules are very stringent. Nevertheless, at this stage, we consider that there is still a risk in terms of revenue generation, given that AFL Group's loan book remains concentrated, with the

10-largest borrowers representing about 40% of total exposure. We believe that the concentration is likely to reduce in the next three to five years, because of new customers and the large exposure regulatory limits. However, this means that AFL Group will face some pressure in terms of revenue generation capacity, and we understand that its target is to attract at least one LRG with a large budget per year.

The French LRG sector exhibits some key strengths thanks to France's resilient economy, but with some uneven wealth distribution among LRGs and some wealth concentration in the Ile-de-France region. French LRGs' institutional framework and the financial system in which they evolve are stable. French LRGs' direct debt is overall moderate, but their exposure to contingent liabilities is high, mainly due to large guarantees and the existence of various government-related entities.

We view AFL Group's overall risk and financial management as prudent. Internal risk management policies are enhanced by regulation. Due to its status of financial company, AFL-ST needs to abide by regulatory rules defined by the French Monetary and Financial Code, especially in terms of internal controls. AFL-ST also has to ensure that AFL follows these rules. Moreover, as a specialized credit institution, AFL is a fully regulated financial institution supervised by ACPR and has to abide by many regulatory rules, especially in terms of solvency and liquidity ratios. In our view, AFL Group proactively manages its regulatory requirements.

We view the group's 2017-2021 strategic plan as more realistic than the initial business plan in terms of loan and revenue generation, as well as its targeted breakeven point. The updated plan includes a target of 5% national market share in 2018 (versus more than 15% in the initial plan), which AFL did reach. We consider the updated target of achieving a 6% national market share by 2020 or 2021 and a breakeven point from 2021 as manageable.

AFL Group's management has a substantial expertise and experience in the LRG sector and its funding. AFL consists of about 35 employees and top management is stable. However, we believe that there is some key person risk, given AFL's small size. From AFL Group's starting point, top management is strongly involved in supporting the development of this PSFA, and we believe that the loss of key personnel could affect the entity's business plan.

Since its creation, AFL Group has loosened some of its internal policies regarding loan origination and capital contribution, but those changes have not affected its financial profile, which remains a key strength of its SACP.

Financial Risk Profile: High capitalization and very strong liquidity provide notable financial buffers

- AFL Group's strong capitalization is supported by consistent increase in memberships.
- AFL Group's conservative liquidity management policies, comprehensive treasury portfolio, and solid access to funding are supportive.

We assess AFL Group's capitalization on a consolidated basis. We compute our risk-adjusted capital (RAC) to a very strong 55.4% before adjustments as of end-2018. When factoring in our adjustments, in particular from important single-name concentration, the RAC after adjustments is lower, but stands at a still very strong 19.1%. However, we believe that some risks are not fully reflected by our RAC, given the discrepancies in terms of credit quality across the LRG loan portfolio. We expect our adjusted RAC ratio will decrease moderately, but still continue to comfortably exceed 15% and remain a key support to the group's financial risk profile.

In a regulatory context, the group reported a tier-1 ratio of 18.9% as of end-2018. We note that the

AFL Group's regulatory ratios are lower than some of its peers', which benefit from a zero risk weight for most of their loans versus 20% for AFL Group. AFL Group has no hybrid instruments and all equity is eligible as tier-1 capital, which we also incorporate into our total adjusted capital calculation.

The addition of new members has been positive for the group's capital ratio. Since its inception, AFL has gone through 19 capital increases and capital has increased to €146 million as of end-2018 from €37 million as of end-2014. The latest one took place in February 2019, with the addition of 10 new members and €3.7 million of paid-in capital. The addition of new members have also helped in reducing the concentration in the lending portfolio. The largest exposure, as a percentage of total lending, is down to 5.3% as of end-2018 from 8.8% as of end-2017, and the exposure to 10-largest borrowers has decreased to 43% in 2018 from 55% in 2017. In 2016 and 2017, AFL relaxed its capital payment conditions to facilitate the addition of more members. We believe this has helped AFL increase its shareholders, and we expect the trend will continue.

AFL has established debt programs and is a regular benchmark issuer, with a diversified funding profile in terms of geographies, maturities, and investor types. AFL's asset and liability management policy limits the difference between average maturity of assets and liabilities to one year, with permission to go up to 18 months until the end of 2022. It has no eminent refinancing risk, with most of the funding being long term. The cumulative maturing assets cover more than its cumulative maturing liabilities for the next 12 months and support its strong funding profile.

AFL has a robust liquidity position. Although the agency is exposed to risk through its dependence on wholesale market funding, we consider that this is mitigated by prudent liquidity policies and a comprehensive treasury portfolio. AFL is setting up a mechanism by which most of its loan portfolio can be used as a collateral for access to central bank liquidity. We believe that finalizing of this mechanism will further strengthen liquidity.

At year-end 2018, AFL's total liquidity reserves amounted to €856 million. The liquidity portfolio is invested in liquid fixed-income securities issued by governments, states, regional governments, multilateral development banks, and financial institutions--all with high credit ratings. Our liquidity sources-to-uses ratio indicates that AFL will largely be able to meet its financial obligations over a one-year period, factoring in stressed market conditions.

Key Statistics

Table 1

Agence France Locale Group* -- Selected Indicators

	--Year ended Dec. 31--			
(Mil. €)	**2018**	**2017**	**2016**	**2015**
Business position				
Total adjusted assets	3,226	2,532	1,385	914
Customer loans (gross)	2,230	1,431	892	384
Growth in loans	55.9	60.4	132.6	N.M.
Net interest revenues	7.9	6.6	4.7	0.5
Non interest expenses	10.5	10.5	10.6	11.0
Capital and risk position				
Total liabilities	3,105	2,416	1,292	856
Total adjusted capital	118	111	87	48

Table 1

Agence France Locale Group* -- Selected Indicators (cont.)

	--Year ended Dec. 31--			
(Mil. €)	2018	2017	2016	2015
Assets/capital	25.9	21.0	14.1	14.1
RAC ratio before diversification	55.4	N/A	N/A	N/A
RAC ratio after diversification	19.1	N/A	N/A	N/A
Gross nonperforming assets/gross loans	0.0	0.0	0.0	0.0
Funding and liquidity* (x)				
Liquidity ratio with loan disbursement	2.0	N/A	N/A	N/A
Liquidity ratio without loan disbursement	7.7	N/A	N/A	N/A
Funding ratio with loan disbursement	>1	N/A	N/A	N/A

Agence France Locale-Société Territoriale consolidated accounts. *One-year horizon. N/A--Not applicable. N.M.--Not meaningful.

Ratings Score Snapshot

Agence France Locale Group

SACP	a
Enterprise risk profile	Moderate (4)
PICRA	Adequate (3)
Business position	Weak (5)
Management and governance	Moderate (4)
Financial risk profile	Very strong (1)
Capital adequacy	Strong (2)
Funding	Positive
and liquidity	Very strong (1)
Support	+2
GRE support	+2
Group support	0
Additional factors	0
GCP	aa-

GCP--Group credit profile. SACP--Stand-alone credit profile. PICRA--Public-sector industry and country risk assessment.
GRE--Government-related entity.

Agence France Locale

Issuer Credit Ratings	AA-/Stable/A-1+
Group status	Core

Related Criteria

- Criteria - Governments - International Public Finance: Public-Sector Funding Agencies: Methodology And Assumptions, May 22, 2018
- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Assumptions For Liquidity Gap Analysis Under "Public-Sector Funding Agencies: Methodology And Assumptions", May 22, 2018
- Public-Sector Funding Agencies Risk Indicators: May 2019, May 13, 2019

Ratings List

New Rating	
Agence France Locale	
Issuer Credit Rating	AA-/Stable/A-1+