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Research Update:

France-Based Agence France Locale 'AA-/A-1+' Ratings Affirmed; Outlook Stable

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Creditwire headline:

S&PGR Affirms Agence France Locale At 'AA-/A-1+'; Outlook Stbl

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Overview

- Agence France Locale (AFL) has a very robust funding and liquidity profile as well as a strong capital position. Its market position is slightly improving but remains weaker than peers'.
- Group AFL continues to benefit from an extremely high likelihood of support from its group of supporting members, thanks 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 affirming our 'AA-/A-1+' long- and short-term ratings on AFL.
- The stable outlook reflects our view that Group AFL will maintain its prudent funding and liquidity policies and that its group of supporting members will maintain at least the same average credit quality and will continue to strongly support AFL's development.

Rating Action

On May, 27 2020, S&P Global Ratings affirmed its 'AA-/A-1+' long- and short-term issuer credit ratings on France-based public-sector funding agency Agence France Locale. The outlook is stable.

Outlook

The stable outlook reflects our expectation that Group AFL's guarantee structure will remain unchanged over the next two years and that the public-sector funding agency (PSFA) will continue to benefit from unwavering membership support. We also anticipate that the PSFA's management will maintain its prudent funding and liquidity policies to contain risks associated with the wholesale-funded nature of its activities. The outlook also reflects our view that Group AFL will maintain its capital at very high levels despite its sustained growth.

Downside scenario

We could lower our rating if we believed that the willingness of the PSFA's group of supporting members to support Group AFL 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 Group AFL's capitalization were to decrease rapidly. This could result from higher lending book expansion, continued losses, higher-than-expected provision needs, and/or lower paid-in capital, coupled with sustained concentration on the top clients. We could also lower the rating if its funding and liquidity profile deteriorated, for example due to a widening funding gap.

Upside scenario

We could raise the rating if Group AFL managed to expand its loan book, supporting stronger market share and income generation without weakening its risk and financial management practices and, at the same, if the average credit quality of its group supporting members improved.

Rationale

We equalize our ratings on AFL with our 'aa-' group credit profile (GCP) on Group AFL because we view AFL as core to Group AFL. The French central government allowed in 2013 the creation of a group owned by French local and regional governments (LRGs) to access funding on the market. Group AFL, which has been operational since 2015, consists of two entities (in order to allow the operations to be separate and independent from the LRG members). The parent company is AFL–ST, a financial company fully owned by LRG members. Its operating subsidiary is AFL, which carries lending and funding operations. AFL is a specialized credit institution 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 with Group AFL's identity, strategy and operations.

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

Enterprise Risk Profile: Competitive market for LRG funding in France constrains AFL's growth strategy

- AFL targets LRGs whose creditworthiness is supported by the wealthy and resilient French economy and stable institutional framework, which will continue to offset risks posed by the sector's moderate direct debt burden and high contingent liabilities.
- AFL has limited market shares and some concentration risks, but we expect it will continue expanding its loan book and customer base despite a competitive environment.
- Despite a slight increase in nonperforming loans in 2019, management policies and practices

are overall prudent and we view the 2017-2021 strategic plan as more realistic than the initial business plan.

- The management team has a good level of expertise but with some key man risk.

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

In this environment, Group AFL's market share improved in 2019 but remains limited at about 6% of French LRGs' annual credit inflows. We expect this share will continue to increase modestly while Group AFL is likely to reach break-even in 2020. Positively, the perimeter of LRGs able to join AFL-ST's capital has been extended to any type of grouping of EPCI ("Etablissements Publics de Coopération Intercommunale"), including syndicates. This will enable Group AFL to penetrate the French LRG market further. Despite its still weak national market share, Group AFL benefits from a stable customer base: Its members are willing to support the entity and borrow from it, while exit rules are very stringent, making it almost impossible to leave the group. Nevertheless, at this stage, we consider that there is still a risk in terms of revenue generation as Group AFL's loan book remains concentrated, with the 10 largest borrowers representing slightly less than 40% of total exposure. We believe that the concentration is likely to decline in the next three to five years because of the large exposure regulatory limits. However, this means that Group AFL 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 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 through large guarantees and various government-related entities.

We view Group AFL's overall risk and financial management as overall prudent. Internal risk management policies are enhanced by regulation. Due to its status as a 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 must also ensure that AFL is following 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, Group AFL is proactive in managing its regulatory requirements.

Negatively, we note that two loans on counterparties representing 0.1% of total assets defaulted in 2019. While no losses are expected, this is unusual for PSFAs. We expect such defaults to remain exceptional. Looking forward, we expect the COVID-19 impact on French LRGs' debt sustainability to be manageable and its impact on AFL's asset quality to be muted. This is because we expect the French government will step in to alleviate the pressure on French LRGs in accordance with French representatives' latest statements.

We view the 2017-2021 strategic plan as more realistic than the initial business plan in terms of loan and revenue generation as well as targeted break-even point. The updated plan includes a target of 5% national market share in 2018, which AFL reached, versus more than 15% in the initial plan. We consider the group's updated forecasts to reach a 6% national market share by 2020/2021 and a break-even point from 2021 as manageable.

Group AFL's management has long-standing expertise and experience in the LRG sector and its funding. It has about 35 employees, and top management is stable. However, we believe that there is some key person risk. From Group AFL's starting point, top management has been strongly involved in supporting the development of this PSFA and we believe that the loss of some key personnel could affect the entity's business plan. We note that this risk is receding and will continue to as AFL consolidates its position in the French market.

Since its creation, Group AFL has eased some of its internal policies regarding loan origination and capital contribution, but these changes have not affected its financial profile, which remains very favorable and the key strength of its SACP.

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

- Strong capitalization supported by a consistent increase in members.
- Broad and diversified access to capital markets and robust asset liability management underpin AFL's very strong funding and liquidity profile.

Despite AFL's sustained growth, we expect the capitalization profile to remain strong. We assess AFL's capitalization on a consolidated basis and at AFL-ST's level. We calculate our risk-adjusted capital (RAC) ratio at a very strong 49.5% before adjustments as of end-2019. When factoring in our adjustments, in particular from high single-name concentration, the RAC declines but stands at a still very strong 17.7%. However, we adjust the assessment derived from our capital model to strong as we believe that some risks are not fully reflected by our RAC ratio. In particular, the model doesn't allow to fully capture the discrepancies in terms of credit quality across the entire spectrum of French LRGs.

In a regulatory context, the group reported a Tier 1 ratio of 15.78% as of end-2019 (18.89% as of end-2018). We note that AFL's regulatory ratios are lower than some of its peers' and our RAC ratio, since AFL applies a higher-than-peers 20% risk weight on French LRGs. AFL has no hybrid instruments and all equity is eligible as Tier 1 capital, which we also incorporate in our total adjusted capital (TAC) calculation.

The addition of new members has been positive for the group's capital ratio. Since its inception, AFL's capital has increased to €154 million as of end-2019, from €37 million as of end-2014. The latest capital increase took place in March 2020 with the addition of eight new members and €3.3 million of paid-in capital. The addition of new members has also helped reduce the concentration in the lending portfolio. The largest exposure, as a percentage of total lending, is down to 4.1% as of end-2019, from 5.3% as of end-2018 and the exposure to top-10 largest borrowers has decreased to 38% in 2019 from 43% in 2018. In 2016 and 2017, AFL relaxed its capital payment conditions to facilitate the addition of more members. We believe this has helped AFL in increasing its shareholders and we expect the trend to 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, temporarily extended to 18 months until end of 2022. It has no notable refinancing risk, with most of the funding being long term. The cumulative maturing assets cover 476% of cumulative maturing liabilities for the next 12 months and support its strong funding profile. Positively, we expect AFL to gain access to the European Central Bank's Targeted Longer-Term Refinancing Operations (TLTRO) in 2020.

AFL has robust liquidity. 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 collateral for access to central bank liquidity. We believe that finalization of this mechanism will further strengthen liquidity.

At year-end 2019, AFL's total liquidity reserves amounted to €946 million (€856 million at end-2018). 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. We calculate AFL's liquidity ratio was 2.06x as of June 30, 2019. We factor into our calculations stressed market conditions, under which we assume the agency would not have access to the capital markets.

We do not foresee other risks not captured in our RAC calculations and funding and liquidity metrics, since AFL hedges risk through derivatives. However, this hedging creates material counterparty exposures to financial institutions, especially to the clearinghouse, LCH Clearnet, although entirely and mutually collateralized.

Extremely high likelihood of support mainly backed by a very strong and binding guarantee, resulting in a two-notch uplift to the SACP

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

The guarantee mechanism within Group AFL is dual. The first one is a guarantee from AFL-ST to investors. AFL-ST's board ("Conseil d'administration") determines the amount of this guarantee (currently about €6 billion). The second one is the LRGs members' guarantees. On joining Group AFL, all members must sign a joint guarantee scheme granted to AFL-ST that makes them liable up to their amount of long-term debt borrowed through AFL. Those LRGs members' guarantees currently cover more than 70% of Group AFL's financial liabilities.

We consider that within the guarantee scheme the strongest and timely mechanism is the possibility of a "preventive call" by AFL on the AFL-ST guarantee, which in turn would call the LRG members. AFL could activate preventively this guarantee to avoid a default on its debt obligations or a potential breach of regulatory ratios. The Executive Board ("Directoire") of AFL needs the approval of the Supervisory Board of AFL ("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 LRGs 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, Group AFL plays a very important role for its LRG supporting members group. In a very competitive environment with ample liquidity, these LRGs participated in the creation or joined Group AFL 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 30% of their needs through AFL (compared with a national market share of about 6% for AFL) testifying to their involvement in the development of the entity.

In our view, the legislation put in place to allow the creation of Group AFL does not imply any support from the central government to AFL's credit standing. Group AFL is not a state public agency and the law explicitly states that the entity will fund itself mainly through debt issuance, excluding any direct revenue from the central government or any guarantee provided by the central government.

Table 1

Agence France Locale Group -- Selected Indicators

	--Year ended Dec. 31--				
(Mil. €)	2019	2018	2017	2016	2015
Business position					
Total adjusted assets	4,355	3,218	2,525	1,380	910
Customer loans (gross)	3,161	2,230	1,431	892	384
Growth in loans	41.7	55.9	60.4	132.6	N.M.
Net interest revenues	10.1	7.9	6.6	4.7	0.5
Non interest expenses	11.6	10.5	10.5	10.6	11
Capital and risk position					
Total liabilities	4,233	3,105	2,416	1,292	856
Total adjusted capital	118	110	105	82	45
Assets/capital	35.9	28.2	23.0	15.8	19.0
RAC ratio before diversification	49.5	55.4	N/A	N/A	N/A
RAC ratio after diversification	17.7	19.1	N/A	N/A	N/A
Gross nonperforming assets/gross loans	0.1	0.0	0.0	0.0	0.0
Funding and liquidity* (x)					
Liquidity ratio with loan disbursement	2.1	2.0	N/A	N/A	N/A
Liquidity ratio without loan disbursement	9.0	7.7	N/A	N/A	N/A
Funding ratio with loan disbursement	>1	>1	N/A	N/A	N/A

N/A--Not applicable.

Ratings Score Snapshot

Table 2

Group Agence France Locale Ratings Score Snapshot

Group Agence France Locale	
Stand Alone Credit Profile	a
Enterprise Risk Profile	Moderate (4)
PICRA	Adequate (3)
Business Position	Weak (5)
Management & Governance	Moderate (4)
Financial Risk Profile	Very Strong (1)
Capital Adequacy	Strong (2)

Table 2

Group Agence France Locale Ratings Score Snapshot (cont.)

Funding	Positive
and Liquidity	Very Strong (1)
Support	2
GRE Support	2
Group Support	0
Additional Factors	0
Group Credit Profile	aa-
Agence France Locale	
Issuer Credit Ratings	AA-/Stable/A-1+
Group Credit Profile	aa-
Group Status	Core

PICRA--Public-sector industry and country risk assessment.

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- 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: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed	
Agence France Locale	
Issuer Credit Rating	AA-/Stable/A-1+
Senior Unsecured	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. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at