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Research Update:

# French Public Sector Lender 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+'; Otlk Stable

## Overview

- Group Agence France Locale's (Group AFL) growing member base and continued loan growth have supported its revenue generation and increased its presence in the competitive market for funding French local and regional governments (LRGs).
- Group AFL maintains a very robust funding and liquidity position, which is now supported by its access to the French central bank's liquidity.
- The group 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, the group's operating entity.
- We therefore affirmed our 'AA-/A-1+' long- and short-term ratings on AFL, which we see as core to the Group AFL.
- The stable outlook reflects our view that Group AFL will maintain robust financial indicators, which will continue to strongly support AFL.

## Rating Action

On May 21, 2021, 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 will continue to benefit from unwavering membership support and its guarantee structure will remain unchanged. We also anticipate that Group AFL will be able to sustain its growth targets without significantly weakening its robust financial indicators. In addition, we expect Group AFL will maintain prudent funding and liquidity management, which will contain risks associated with the wholesale-funded nature of its activities.

### Downside scenario

We could lower our rating if we believed that the willingness and ability of the group of supporting members to provide extraordinary assistance to the 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 higher-than-anticipated lending growth resulted in an erosion of Group AFL's currently strong capital position or of its funding and liquidity position, for example due to a widening funding gap.

### Upside scenario

We could raise the rating if Group AFL strengthened its market share and income generation without materially weakening its capitalization and risk profile, and, at the same, if the average credit quality of its group supporting members improved.

## Rationale

We equalize our ratings on AFL with our group credit profile (GCP) on Group AFL because we view AFL as core to Group AFL. In 2013, the French central government allowed the creation of a group owned by French 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. More recently, in 2021, AFL was recognized as public development bank by the French regulator.

We assess Group AFL's GCP at 'aa-', two notches above its stand-alone credit profile (SACP), based on a very strong financial profile with robust risk-adjusted capitalization and very strong funding and liquidity, which counterbalances a moderate enterprise risk profile. 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.

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

- Group 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.
- Group AFL has enhanced its business position with active lending growth and new LRGs joining the bank. Nevertheless, Group AFL operates in a highly competitive environment and has some concentration risks, though declining.

- Thanks to prudent management policies and practices, coupled with the LRG sector's resilience to the COVID-19 pandemic, Group AFL's asset quality remains sound.

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. While the group is still in a growing phase, we believe its strategy has gained clarity compared with a very ambitious initial business plan that targeted a 15% market share by 2018.

That said, we expect Group AFL to continue increasing its market share at a moderate pace, especially through the addition of the largest French LRGs. In 2020, the bank provided 6% of French LRGs' annual credit inflows and continued to progress toward its long-term target of reaching a 25% market share. Positively, Group AFL has focused on improving its business stability, which is supported by a growing membership base and increased business diversification. The group continues to expand its national footprint, with 63 new joiners in 2020. On March 2021, an additional 19 LRGs joined AFL, including the large Région Grand Est. In December 2019, the scope of LRGs able to join AFL-ST's capital was extended to any type of grouping of EPCI ("Etablissements Publics de Coopération Intercommunale"), including syndicates, of which nine were already members of the AFL as of March-end 2021.

Despite its still moderate national market share, Group AFL benefits from a stable customer base and we expect little volatility in the future since exit rules are very stringent and LRGs are keen to develop this new funding tool.

Revenue generation capacities have improved over recent years. In 2020, Group AFL reached breakeven point, with net income reaching €2.3 million, and we expect the bank will continue increasing its revenue in the years to come. Although concentration risk is significant, it is receding, with the 10 largest borrowers representing 31.5% of total exposure at December-end 2020 against slightly less than 40% at year-end 2019. We see this decline as positive for revenue generation and believe that concentration is likely to continue declining in the next three to five years.

In 2021, AFL was recognized by the French regulator as a public development credit institution. While this has limited direct impact on the targets and management of the bank, it is a recognition by the French authorities of the unique role filled by AFL for French LRGs.

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 despite the ongoing COVID-19 stress. French LRGs' direct debt will remain overall moderate although high capital expenditure and tighter budgets linked to the pandemic will widen French LRGs' deficits after capital accounts. As a result, new borrowings will increase, with total debt reaching almost €155 billion or higher by the end of 2021 versus €150 billion in 2018. In addition, LRGs exposure to contingent liabilities is high, mainly through large guarantees and various government-related entities.

Group AFL's overall risk and financial management is prudent and it proactively manages regulatory requirements. Internal risk management policies are enhanced by compliance with the French Monetary and Financial Code regulatory rules due to its status as a financial company. Moreover, as a specialized credit institution, AFL is a fully regulated financial institution supervised by ACPR and therefore has to abide by solvency and liquidity regulatory ratios, among others.

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. From Group AFL's starting point however, top management has been strongly involved in supporting the development of this public sector funding agency 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 Group AFL consolidates its position on the French market.

We note that AFL reported two nonperforming loans (NPLs) that represented only 0.1% of the total lending portfolio in 2020. We do not expect AFL to report losses on these NPLs and we understand that these have been classified as Stage 3 loans under IFRS9 because the counterparty defaulted on a credit line provided by a third party lender. We expect new NPLs to remain exceptional and losses virtually nil. 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. According to the Cazeneuve report published on Feb. 25, 2021, the financial impact from the pandemic on LRGs' budget could total €3.8 billion. We expect the low interest rate environment, continuous support from the French government, and upcoming budgetary stimulus will be helpful in alleviating the pressure on French LRGs.

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

- Strong capitalization, supported by a consistent increase in Group AFL's membership base.
- Broad and diversified access to capital markets and robust asset liability management underpin Group AFL's very strong funding and liquidity profile.
- AFL recently gained access to the French central bank, further strengthening its liquidity position.

Despite Group AFL's sustained loan growth, its capital position remains structurally strong, in our view. We expect that the RAC ratio after adjustments will remain above a solid 10%. We assess Group AFL's capitalization on a consolidated basis and at AFL-ST's level. Our initial assessment is based on our risk-adjusted capital (RAC) ratio at a very strong 42.8% before adjustments as of end-2020. When factoring in our adjustments, in particular from high single-name concentration, the RAC ratio after adjustments declines to 14.6%, reflecting AFL's still high concentration. Our current view of a strong capital position also captures the credit quality of Group AFL's exposures to French LRGs across its entire loan book.

In a regulatory context, the group reported a Tier 1 ratio of 15.13% as of end-2020 (15.78% as of end-2019). We note that Group AFL's regulatory ratios are lower than some of its peers' and our RAC ratio before adjustment, since AFL applies a 20% risk weight on French LRGs, which is higher than peers. Group 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.

Group AFL's capital has continuously increased since inception, mainly through its growing membership base, which bolstered capital to €177 million as of end-2020, from €37 million at end-2014. The latest capital increase took place in March 2021 when 19 new members provided an additional €2.2 million of paid-in capital. This has partly offset the sustained growth in new lending, and we expect it will continue to do so in the future.

The increasing membership has also contributed toward the diversification of the lending portfolio. The largest exposure, as a percentage of total lending, is down to 3.7% as of end-2020, from 8.8% as of end-2017 and the exposure to the 10 largest borrowers has decreased to 32% in

2020 from 38% in 2019.

We assess Group AFL's funding and liquidity position as strong. 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 the end of 2022. It has no notable refinancing risk, with most of the funding being long term. The cumulative maturing assets cover 4.9x cumulative maturing liabilities for the next 12 months and support its strong funding profile.

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.

Positively, AFL gained access to the French central bank's automated interface for pledging credit claims (TRICP) during the second quarter of 2020. This enables the bank to repo LRGs' claims at the central bank and benefit from central bank funding of up to €2.7 billion as of March-end 2021.

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 2.86x as of Dec. 31, 2020. AFL's total liquidity reserves amounted to €1.6 billion at year-end 2020 (€946 million at end-2019). 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. 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 any risks other than those 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 based on a very strong and binding guarantee scheme, 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 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.

In our view, Group AFL benefits from a dual guarantee mechanism. 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 standing at €10 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. The guarantee of those LRG members currently covers more than 70% of Group AFL'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 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'administration" 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 39% 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.

## Key Statistics

Table 1

### Agence France Locale Group -- Selected Indicators

| | --Year ended Dec. 31-- | | | | |
|---|---|---|---|---|---|
| (Mil. €) | 2020 | 2019 | 2018 | 2017 | 2016 |
| **Business position** | | | | | |
| Total adjusted assets | 5,728 | 4,355 | 3,218 | 2,525 | 1,380 |
| Customer loans (gross) | 3,832 | 3,161 | 2,230 | 1,431 | 892 |
| Growth in loans | 21.2 | 41.7 | 55.9 | 60.4 | 132.6 |
| Net interest revenues | 11.8 | 10.1 | 7.9 | 6.6 | 4.7 |
| Non interest expenses | 11.2 | 11.6 | 10.5 | 10.5 | 10.6 |
| **Capital and risk position** | | | | | |
| Total liabilities | 5,580 | 4,233 | 3,105 | 2,416 | 1,292 |
| Total adjusted capital | 142 | 118 | 110 | 105 | 82 |
| Assets/capital | 39.3 | 35.9 | 28.2 | 23 | 15.8 |
| RAC ratio before diversification | 42.8 | 49.5 | 55.4 | N/A | N/A |
| RAC ratio after diversification | 14.6 | 17.7 | 19.1 | N/A | N/A |
| Gross nonperforming assets/gross loans | 0.1 | 0.1 | 0 | 0 | 0 |
| **Funding and liquidity* (x)** | | | | | |
| Liquidity ratio with loan disbursement | 2.9 | 2.1 | 2 | N/A | N/A |
| Liquidity ratio without loan disbursement | 6.4 | 9 | 7.7 | N/A | N/A |
| Funding ratio with loan disbursement | >1 | >1 | >1 | N/A | N/A |

N/A--Not applicable.

## Ratings Score Snapshot

Table 2

### Group Agence France Locale - Ratings Score Snapshot

| | To | From |
|---|---|---|
| Stand-Alone Credit Profile | a | a |
| Enterprise Risk Profile | Moderate (4) | Moderate (4) |
| PICRA | Adequate (3) | Adequate (3) |
| Business Position | Moderate (4) | Weak (5) |
| Management & Governance | Moderate (4) | Moderate (4) |
| Financial Risk Profile | Very Strong (1) | Very Strong (1) |
| Capital Adequacy | Strong (2) | Strong (2) |
| Funding | Positive | Positive |
| and Liquidity | Very Strong (1) | Very Strong (1) |
| Support | 2 | 2 |
| GRE Support | 2 | 2 |
| Group Support | 0 | 0 |
| Additional Factors | 0 | 0 |
| Group Credit Profile | aa- | aa- |
| Agence France Locale | To | From |
| Issuer Credit Ratings | AA-/Stable/A-1+ | AA-/Stable/A-1+ |
| Group Credit Profile | aa- | aa- |
| Group status | Core | Core |

## 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: Principles Of Credit Ratings, Feb. 16, 2011

## Related Research

- Local Government Debt 2021: French LRG Debt Could Surpass €155 Billion Within A Year, March 25, 2021

## Ratings List

| Ratings Affirmed | |
|---|---|
| **Agence France Locale** | |
| Issuer Credit Rating | AA-/Stable/A-1+ |
| **Agence France Locale** | |
| Senior Unsecured | AA- |
| Commercial Paper | A-1+ |