S&P Global Ratings

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Research Update:

French Public Sector Lender Agence France Locale 'AA-/A-1+' Ratings Affirmed; Outlook Stable

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Overview

- Although Agence France Locale (AFL) has a niche position in the market, we believe its strategic positioning has improved as management has built a consistent track record in its lending activities while preserving its robust funding and liquidity position.
- We therefore believe AFL's the stand-alone credit profile for AFL has improved.
- AFL Group continues to benefit from an extremely high likelihood of support from its supporting members, thanks to a joint guarantee scheme and members' strong commitment to borrowing from 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.
- The stable outlook reflects our view that The AFL group and its supporting members will maintain robust financial indicators.

Rating Action

On May 7, 2024, 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 takes into account our expectation that the underlying municipal sector will maintain high creditworthiness and AFL will continue to benefit from unwavering support from its members. On the other hand, we also consider the risks associated with increased lending to its members.

Downside scenario

We could lower our rating if we believed that the supporting members' willingness and ability to provide extraordinary assistance to AFL had weakened. This could be indicated by a fall in the share of supporting members' borrowings through AFL, or a deterioration of our view on the average credit quality of those members.

In addition, the ratings could also come under pressure if we observed a combination of several factors that weakened AFL's stand-alone credit profile by more than two notches. This could include for example, a material loss of market share and an erosion of AFL's capital or funding and liquidity position.

Upside scenario

Although a remote scenario, we could raise the rating if the average credit quality of AFL's supporting members improved.

Rationale

Founded in 2013 and operational since 2015, AFL remains a moderate-size player in the competitive French local and regional government (LRG) sector, but we expect it will continue to attract new members and gradually gain market shares. In our view, AFL's performance has become more predictable and its objective to become a well-established player with a dominant share in the French LRG funding market more realistic. AFL's continued financial strength relies on its prudent risk management, somewhat replicating the standards of its Nordic peers, and low-risk lending activities. Management successfully operated through the COVID-19 pandemic period and the environment of rapidly changing interest rates with limited volatility in its performance. Finally, AFL's parent company (AFL–ST) is fully owned by LRG members that provide a strong and binding joint guarantee scheme, supporting our ratings.

Enterprise profile: The LRG funding market in France is competitive but AFL's strategic positioning is now clearer

- AFL's member base is growing steadily but from a low base.
- AFL's strategy to become a key player in the French competitive market for LRG funding has gained clarity and its operating performance is now more predictable.
- Risk in France's LRG sector is low, reflecting France's favorable institutional framework for LRGs, as well as its economic resilience and adequate health of its financial system.

AFL operates solely in the stable and low-risk public sector in France. In 2021, AFL was recognized by the French regulator as a public development credit institution. Its public-sector mandate is to provide funding solely to its members, French LRGs. Consequently, AFL is only exposed to the French LRG sector, whose key strengths reflect France's resilient economy and favorable institutional framework. We expect LRGs' creditworthiness to remain resilient to the economic slowdown and budgetary pressures, and anticipate that any changes to the institutional framework would include mitigating measures where required. We believe French LRGs will continue prioritizing deleveraging, thereby conserving their strong creditworthiness.

AFL continues to expand its footprint in the French LRG funding market but faces competition from the traditional banking sector. French LRGs continue to fund themselves through a range of players. Among AFL's competitors are well established commercial banks like BPCE, Credit Mutuel, and Credit Agricole, but also publicly owned Caisse des Dépôts et Consignations through its subsidiaries SFIL and La Banque Postale. This has put pressure on AFL's ability to fully replicate in France the model of Nordic public sector funding agencies. While it will take time for AFL to consolidate its position and become essential for LRGs' funding, we believe recent trends are encouraging. 2023 marked a record year for AFL as 177 LRGs joined (against 103 in 2022), bringing the total membership to 776 as of end-December 2023. As of end-March 2024, the group's national footprint further extended as 61 LRGs joined. France has a very fragmented landscape with more than 35,000 LRGs. More importantly, AFL captured 10.2% of French LRGs' annual credit inflows (excluding market issuances) at the national level against only 7.4% in 2022, becoming the third-largest national lender on the LRG financing segment. This represents €1.9 billion of financing disbursed against €1.4 in 2022, a 37% increase. We expect AFL to keep increasing its market shares to close to 12%-13% in the next two years. The bank aims to reach €2.5 billion annual disbursement by year-end 2028.

In line with increased lending volumes, revenue generation capacity will continue to improve. In 2023, AFL's net income reached €5.7 million, up from €2.8 million in 2022. We expect low margin volatility stemming from changes in interest rates at AFL, unlike commercial banks. This is because AFL is fully wholesale funded and hedges its positions against interest rate risk. Earnings will benefit from larger lending volumes while AFL's operating costs should increase only moderately relative to earnings. The cost-to-income ratio improved to 67% at year-end 2023 against 76% and 87% at end-2022 and 2021, respectively. We expect this trend to continue. Positively, granularity of earnings' sources has also improved as AFL grows and concentration risk recedes. In addition, AFL benefits from a stable customer base and we expect little volatility in the future given that exit rules are very stringent.

In our view, AFL's strategic positioning has become clearer and more predictable. In 2023, AFL's offers remained attractive, with the success rate in tenders reaching 85%. At the same time, AFL met 55% of its members' needs, considering that its members represented a market share of about 25.2% of French LRGs' total outstanding debt at year-end 2023. We believe the plan to continue steadily expanding the member base (about 250 new members annually) and continuously bridging about 55% of their needs makes AFL's performance more predictable and its objective to become a well-established player with dominant market shares in the French LRG funding market more realistic, although long term in our view. Despite AFL's small and dedicated staff, we no longer believe the loss of some key personnel could affect the entity's business plan.

Additionally, AFL's overall risk and financial management is prudent, and it proactively manages regulatory requirements. AFL did not report any nonperforming exposures (NPEs) as of year-end 2023. Management has longstanding expertise and experience in the LRG sector and its funding. AFL's internal risk management policies are enhanced by compliance with the French Monetary and Financial Code's regulatory rules, given its status as a financial company. Moreover, as a specialized credit institution, AFL is a fully regulated financial institution supervised by the French banking regulator, Autorité de contrôle prudentiel et de resolution (ACPR), and therefore has to abide by solvency and liquidity regulatory ratios, among others, and mitigates key risks. Risk management policies and practices reflect the organization's low-risk appetite.

The AFL group consists of two entities, allowing operations to be separated 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 is 99.9% owned by AFL–ST, and carries lending and funding operations. The board of AFL is composed of experienced individuals and it tracks progress on outcomes in regular meetings with senior staff. We believe the structure and governance is key to ensure proper risk management and adequate monitoring of the bank's activities.

Financial profile: High capitalization and very strong liquidity provide financial buffers.

- Strong capitalization despite rapid lending growth, 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.
- Robust risk management and access to the French central bank support strong liquidity buffers.

Despite AFL's sustained loan growth, its capital position remains structurally strong, in our view. We expect the risk-adjusted capital (RAC) ratio after adjustments will remain above a solid 10%. The RAC reduction in recent years primarily reflects the rapid increase in lending. In the future we expect increased diversification, capital injections from new joiners, and enhanced earnings generation to offset the negative impact of the growing lending book on our RAC ratio. The 10 largest borrowers represented 26% of total exposure on Dec. 31, 2023, down from about 29% at year-end 2022 and 38% at year-end 2019.

AFL's funding position is strong, with a broad range of investors and limited maturity mismatches. It has established debt programs and is a regular benchmark issuer with a diversified funding profile in terms of geographies, maturities, currencies, and investor types. In 2023, AFL issued €2.1 billion of debt. Despite rising rates the pricing on AFL's issuances remained attractive--just above that of French government-owned agencies such as the Agence Française de Développement. AFL's asset and liability management policy limits the difference between average maturity of assets and liabilities to one year, temporarily extended to 24 months for a maximum of six months. It has no notable refinancing risk, with most of the funding being long term. The cumulative maturing assets cover 1.5x cumulative maturing liabilities for the next 12 months and support its strong funding profile.

AFL has robust liquidity. Its dependence on wholesale market funding is mitigated by its prudent liquidity policies and a comprehensive treasury portfolio. AFL manages its liquidity with the aim of maintaining 100% of net cash outflows over the next 12 months, within a range of 80% minimum and 125% maximum. AFL's S&P Global Ratings-calculated liquidity ratio was 1.26x as of Dec. 31, 2023, while its regulatory liquidity coverage ratio was 1,046%. AFL's total liquidity reserve stood at €2.0 billion as of Dec. 31, 2023, of which 47% was cash. The noncash liquidity portfolio is invested in liquid fixed-income securities (99% being high quality liquid assets [HQLA] 1 or 2A) issued by governments, states, regional governments, multilateral development banks, and financial institutions. Positively, AFL has access to the French central bank's automated interface for pledging credit claims (TRICP). This enables AFL to repurchase LRGs' claims at the central bank and benefit from central bank funding of up to €2.7 billion as of Dec. 31, 2023.

We do not foresee significant additional risks other than those captured in our RAC calculations and funding and liquidity metrics because AFL hedges risk through derivatives. However, this hedging creates significant counterparty exposures to financial institutions, especially to the clearinghouse, LCH Clearnet, although entirely and mutually collateralized. In addition, there are a few exceptions regarding interest-rate risk with a limited pocket of fixed-rate assets managed within the limits of the economic value of equity.

Extraordinary shareholder support: Extremely high likelihood of support, mainly based on a very strong and binding guarantee scheme, resulting in a one-notch uplift from the SACP

AFL benefits from a dual-guarantee mechanism. The first is a guarantee from AFL-ST to investors. AFL-ST's board (Conseil d'administration) determines the amount of this guarantee. The second is the LRG members' guarantees. On joining 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 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 preemptively activate 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 AFL-ST's Conseil d'administration, 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 directly call the guarantee of any LRG member.

In our view, the legislation that allowed the creation of AFL does not imply any support from the French central government to AFL's credit standing. 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.

Selected Indicators

Table 1

Agence France Locale Group -- Selected indicators

	--Year ended Dec. 31--				
(Mil. €)	2023	2022	2021	2020	2019
Business position					
Total adjusted assets	9,373	8,009	6,996	5,728	4,355
Customer loans (gross)	6,577	4,691	4,431	3,832	3,161
Growth in loans	40.2	5.9	15.6	21.2	41.7
Net interest revenues	24.1	15.6	12.7	11.8	10.1

Table 1

Agence France Locale Group -- Selected indicators (cont.)

	--Year ended Dec. 31--				
(Mil. €)	2023	2022	2021	2020	2019
Operating Revenues	23.2	17.6	14.0	13.8	11.1
Net Income after extraordinaries	5.7	2.8	1.7	2.3	(1.2)
Capital and risk position					
Total liabilities	9,167	7,824	6,819	5,580	4,233
Total adjusted capital	207	185	171	142	118
RAC ratio before diversification	43.9	39.4	44.6	42.8	49.5
RAC ratio after diversification	13.0	13.4	14.9	14.6	17.7
Gross nonperforming assets/gross loans	0.0	0.1	0.1	0.1	0.1
Funding and liquidity* (x)					
Liquidity ratio with loan disbursement	1.3	1.3	1.4	2.9	2.1
Liquidity ratio without loan disbursement	1.7	2.0	2.1	6.4	9.0
Funding ratio with loan disbursement	>1	>1	>1	>1	>1

N/A--Not applicable.

Rating Score Snapshot

Table 2

Group Agence France Locale--Ratings score snapshot

	To	From
Stand-Alone Credit Profile	a+	a
Enterprise Risk Profile	Adequate (3)	Moderate (4)
PICRA	Adequate (3)	Adequate (3)
Business Position	Moderate (4)	Moderate (4)
Management & Governance	Adequate (3)	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	1	2
GRE Support	1	2
Group Support	0	0
Additional Factors	0	0
Group Credit Profile	aa-	aa-
Issuer Credit Ratings	AA-/Stable/A-1+	AA-/Stable/A-1+
Group Credit Profile	aa-	aa-

Table 2

Group Agence France Locale--Ratings score snapshot (cont.)

	To	From
Group Status	Core	Core

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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

Ratings List

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