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Ratings

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Dexia Credit Local

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Dexia Credit Local

SACP	bb	+	Support	+3	+	Additional Factors	0

Anchor	bbb+	
Business Position	Adequate	0
Capital and Earnings	Adequate	0
Risk Position	Weak	-2
Funding	Below Average	-1
Liquidity	Moderate	

ALAC Support	0
GRE Support	+3
Group Support	0
Sovereign Support	0

Issuer Credit Rating
BBB/Stable/A-2

Major Rating Factors

Strengths:	Weaknesses:
• High likelihood of extraordinary government support from Belgium and France, mainly due to the bank's state ownership and substantial funding guarantees. • Strong commitment of the Belgian and French governments, enabling steady liquidity improvement.	• Loss-making entity in the long run, although the first-time application of a new accounting rule (International Financial Reporting Standards [IFRS] 9) significantly bolstered its solvency ratios. • Tail risks resulting from concentration on single names and geographies, like Italy. • High sensitivity of liquidity needs to interest rates due to almost completely swapped balance sheet. • Wholesale funding structure influenced by capital markets' appetite for government-guaranteed or secured funding.

Outlook: Stable

S&P Global Ratings' outlook on France-domiciled Dexia Credit Local (DCL) is stable. This reflects our expectation that the bank will implement an orderly wind-down of its operations and continue to benefit from the strong commitment of the Belgian and French governments in this process over the next 18-24 months. The ratings already factor in our expectation that, although DCL will be loss making for several years, its capitalization will remain adequate, as deleveraging continues. A downgrade of Belgium or France would not in itself prompt a negative rating action on DCL.

We might lower the ratings on DCL if, contrary to our expectations, the bank was unable to maintain sufficient access to market funding, including through market repurchase agreement transactions complementing a €85 billion maximum amount of government-guaranteed debt to implement its wind-down plan. We might also lower the ratings if the likelihood of government support was to diminish.

Ratings upside is remote, given the level of ongoing and extraordinary government support factored into the ratings.

Rationale

Our ratings on DCL incorporate our view of DCL's core status within the Dexia group, of which it is the main operating entity, and the continuous strong commitment of the Belgian and French governments to assist the group in its orderly wind-down.

We acknowledge that DCL has focused on reducing its footprint, operating complexity, and risks, and has improved its solvency ratios. Accelerated asset sales, as recently exemplified by the sale of Dexia Kommmunalbank Deutschland GmbH (renamed Kofiba) to Helaba, combined with favorable market conditions, have helped strengthen its capital well beyond our expectations. Such improvement has diminished the risk of immediate recapitalization by shareholders, and may broaden the options for the next steps in the orderly wind-down.

These options will likely be explored nearer to 2021, the initial date set for the renewal of the guaranteed debt program. That said, there is no credible scenario that would not require a form of funding support from the sovereigns to DCL. Therefore, we expect the guarantees will be extended, as announced by the group in early 2019. The Belgian and French states notified the European Commission of the extension of the refinancing guarantee in favor of Dexia for the period after Dec. 31, 2021. This proposed scheme is still subject to discussion. It contemplates a guarantee commission payable by Dexia to the states should a liquidation occur. This commission would likely absorb any net liquidation proceeds leading to losses on tier-1 instruments that we rate 'D' (default).

DCL's stand-alone group creditworthiness remains constrained by its dependence on its shareholders' funding support through its sovereign-guaranteed debt programs, and its potentially significant liquidity needs.

Finally, the long-term rating on DCL, which incorporates three notches of uplift, reflects our opinion that there is a high likelihood of timely and sufficient extraordinary support from the Belgian and French states in the event of financial distress.

Anchor: 'bbb+', reflecting exposures mainly in France, Italy, the U.S., the U.K., and Spain

Under our bank criteria, we use our Banking Industry Country Risk Assessment (BICRA) economic risk and industry scores to determine a bank's anchor, the starting point in assigning an issuer credit rating. The anchor for DCL is 'bbb+', based on an industry risk score of '3' for France, where the Dexia group main operating entity, DCL, is domiciled, and, as DCL's asset exposure is mainly in France, Italy, the U.S., the U.K., and Spain, a blended economic risk score of '4'.

Table 1

Dexia Credit Local Key Figures

	--Year-ended Dec. 31--				
(Mil. €)	**2018**	**2017**	**2016**	**2015**	**2014**
Adjusted assets	158,767.0	180,903.0	212,739.0	230,254.0	247,097.0
Customer loans (gross)	35,444.0	99,833.0	119,906.0	128,732.0	136,110.0
Adjusted common equity	4,946.0	5,114.0	4,221.0	5,132.5	6,171.0
Operating revenues	(226.0)	(72.0)	651.0	907.0	(315.0)
Noninterest expenses	365.0	421.0	407.0	470.0	382.0
Core earnings	(503.0)	(473.0)	426.0	236.8	(767.0)

Source: Dexia S.A.'s consolidated balance sheet.

Business position: Focus on the management of residual assets in run-off

Our assessment of DCL's business position as adequate primarily reflects the stability provided by the French and Belgian governments' commitment to support an orderly wind-down of the DCL group. In our view, implicit state support compensates for weaknesses and uncertainties regarding the wind-down period. Over the duration of the orderly resolution, DCL will be sensitive to fluctuations in the macroeconomic environment and market parameters, including exchange rates, interest rates, and credit spreads. Over the past couple of years, the bank has demonstrated its ability to meet banking regulation requirements.

The fact that DCL is enhancing its regulatory capital ratios following implementation of the new IFRS 9 accounting rule, may create further options for the group, including quicker footprint reduction in the next couple of years. The group has reached its target perimeter, with a balance sheet of €158 billion as of Dec. 31, 2018, compared with €413 billion at year-end 2011.

Under today's orderly resolution plan, its balance sheet should reach about €100 billion at year-end 2021 through natural amortization of approximately €12 billion of assets per year, and targeted asset sales. Last year and early 2019 were marked by the sale of Dexia Kommunalbank Deutchland GmbH (renamed KOFIBA) and Dexia Israel, and the closure of the group's branches in Madrid and Lisbon. We understand that the group's deleveraging will continue to take place through natural amortization of the portfolio, and an asset sale plan focused on asset-value optimization within an annual budget. The group could accelerate the plan should market opportunities arise.

Following assessment of the group's simplification and financial priorities, DCL's management has agreed to outsource operational processing of market activities to Cognizant, and further centralize activities. We believe this will improve

DCL's operational efficiency and cost savings, while allowing more flexibility regarding progressive reduction of income, and mitigate the impact of heavy investment, ensuring longer-term sustainable operations.

Table 2

Dexia Credit Local Business Position					
	--Year-ended Dec. 31--				
(%)	**2018**	**2017**	**2016**	**2015**	**2014**
Return on average common equity	(7.6)	(10.1)	8.5	4.8	(25.3)

Capital and earnings: Positive impact of first-time application of new accounting rules

Our assessment of DCL's capital and earnings as adequate takes into consideration that the bank's risk-adjusted capital (RAC) ratio before diversification stood at 8.9% at year-end 2018, up from 5.6% at year-end 2016. This increase is well beyond our expectations, and is a result of progression in the group's orderly wind-down, achieving an accelerated reduction of its balance sheet of 12% in 2018, combined with lower latent losses on its government securities portfolio.

With the introduction of a new IFRS 9 accounting standard as of Jan. 1, 2018, DCL has reclassified most assets available for sale at amortized cost, cancelling a large amount of latent losses previously reported in equity (about €2.5 billion). If such a reclassification decreases the group's sensitivity to credit spread variations on these assets, this accounting change combined with the material assets reduction have, in our view, raised regulatory ratios above some level as it may appear as a strength for the group.

We continue to consider that this accounting change does not fully capture the underlying risk of large unrealized losses embedded into DCL's securities portfolio. Our capital measures usually do not reflect a benefit or loss if fair value changes. However, in some instances, we may reflect unrealized losses on debt securities into our measure of capital based on the nature of the underlying risk, if we believe such losses reflect a sustainable deterioration in credit risk, as opposed to interest rate fluctuations (see §55 of "Criteria - Financial Institutions - General: Risk-Adjusted Capital Framework Methodology," published July 20, 2017, on RatingsDirect).

The accelerated deleveraging strategy included the disposal of heavily capital-demanding assets, such as asset-backed securities and subordinated bank exposures, and took advantage of favorable market conditions to dispose of sovereign exposures, covered bonds, and municipal loans and ABS on student loan. The banks also sold riskier exposures, such as those to Puerto Rico.

We expect the bank's RAC ratio for diversification will remain stable in the next two years, at just below 10%, after compensating for the deficiency in its credit-loss-absorbing capacity highlighted by the negative earnings buffer. Our calculations account for uncertainties regarding potential impairment charges in light of some risk concentrations. We also expect that operational cost-base reduction and reduction of risk-weighted assets are unlikely to offset loss accumulation. DCL will remain, in our view, loss-making for several years, contributing to capital depletion.

Table 3

Dexia Credit Local Capital And Earnings					
	--Year-ended Dec. 31--				
(%)	**2018**	**2017**	**2016**	**2015**	**2014**
Tier 1 capital ratio	26.7	19.5	16.2	15.9	16.4

Table 3

Dexia Credit Local Capital And Earnings (cont.)

	--Year-ended Dec. 31--				
(%)	2018	2017	2016	2015	2014
Adjusted common equity/total adjusted capital	100.0	100.0	100.0	100.0	100.0
Net interest income/operating revenues	(21.7)	(236.1)	30.4	28.6	(57.1)
Fee income/operating revenues	1.8	4.2	0.0	0.6	3.2
Market-sensitive income/operating revenues	110.6	352.8	76.2	75.1	116.8
Noninterest expenses/operating revenues	(161.5)	(584.7)	62.5	51.8	(121.3)
Preprovision operating income/average assets	(0.3)	(0.3)	0.1	0.2	(0.3)
Core earnings/average managed assets	(0.3)	(0.2)	0.2	0.1	(0.3)

Table 4

Dexia S.A. Risk-Adjusted Capital Framework Data

	Exposure*	Basel III RWA	Average Basel III RW(%)	S&P Global Ratings' RWA	Average S&P Global Ratings' RW (%)
Credit risk					
Government & central banks	85,938,606,614	14,388,971,230	17	13,987,588,278	16
Of which regional governments and local authorities	59,182,042,866	5,660,981,913	10	7,126,402,760	12
Institutions and CCPs	32,431,575,635	2,211,522,209	7	2,774,236,334	9
Corporate	24,489,035,240	8,027,026,569	33	24,371,765,603	100
Retail	910,882,207	157,907	0	600,781,792	66
Of which mortgage	0	0	0	0	0
Securitization§	2,830,621,836	744,381,833	26	1,943,681,354	69
Other assets†	1,437,639,507	525,830,652	37	1,678,352,185	117
Total credit risk	148,038,361,040	25,897,890,398	17	45,356,405,546	31
Credit valuation adjustment					
Total credit valuation adjustment	--	2,367,041,603	--	7,042,286,919	--
Market Risk					
Equity in the banking book	154,247,935	404,756,688	262	1,435,091,732	930
Trading book market risk	--	694,841,691	--	1,126,048,097	--
Total market risk	--	1,099,598,379	--	2,561,139,829	--
Operational risk					
Total operational risk	--	347,001,080	--	767,256,958	--
	Exposure	**Basel III RWA**	**Average Basel II RW (%)**	**S&P Global Ratings' RWA**	**% of S&P Global Ratings' RWA**
Diversification adjustments					
RWA before diversification	--	30,364,530,381	--	55,727,089,252	100
Total diversification/ concentration adjustments	--	--	--	7,983,069,330	14
RWA after diversification	--	30,364,530,381	--	63,710,158,582	114

Table 4

Dexia S.A. Risk-Adjusted Capital Framework Data (cont.)

	Tier 1 capital	Tier 1 ratio (%)	Total adjusted capital	S&P Global Ratings' RAC ratio (%)
Capital ratio				
Capital ratio before adjustments	8,278,000,000	27.3	4,946,000,000	8.9
Capital ratio after adjustments‡	8,278,000,000	27.3	4,946,000,000	7.8

*Exposure at default. §Securitization exposure includes the securitization tranches deducted from capital in the regulatory framework. †Exposure and S&P Global Ratings' risk-weighted assets for equity in the banking book include minority equity holdings in financial institutions. ‡Adjustments to Tier 1 ratio are additional regulatory requirements (e.g. transitional floor or Pillar 2 add-ons). RWA--Risk-weighted assets. RW--Risk weight. RAC--Risk-adjusted capital. Sources: Company data as of Dec. 31 2018, S&P Global Ratings.

Risk position: A risk profile sensitive to any deterioration of the economic situation

We assess DCL's risk position as weak. This mainly reflects our view that the bank's mostly unsecured exposures with very long maturities are highly sensitive to any deterioration in economic conditions. In addition, it reflects significant single-name and geographic concentration in weaker economies, such as Italy (18%) and Spain (6%), and litigation risks, although receding. Single–name risk concentration remains relatively high, in the light of the bank's loss position and capitalization.

At year-end 2018, DCL's credit risk exposure amounted to €123 billion, with exposures split between local public sector debt (53%), central governments (22%), financial institutions (8%), project finance (8%), asset and mortgage backed securities (2%), corporates (5%) and monolines (1%). According to DCL's internal system, 91% of credit risk exposures as of year-end 2018, was investment grade ('AAA', 19%; 'AA', 17%; 'A', 25%; and 'BBB', 29%). DCL's assets were primarily booked between 2006 and 2008, with relatively low credit margins, resulting in significant unrealized losses under current market conditions.

Increased risk in any of the countries where DCL is exposed to concentration risk, and any resulting downgrades or defaults, would have a material adverse impact on the group's cost of credit risk and risk-weighted assets. DCL disposed of assets considered to be risky, such as those linked to Puerto Rico. The other main remaining risk areas include Spanish local authorities, and some project, corporate finance and utilities exposures, notably in the UK. We note that the provisioning on DCL's exposure to Chicago Board of Education was reinforced. We no longer consider the stock of sensitive loans to French local authorities and hospitals originated before the financial crisis as risky, thanks to implementation of the French support funds for structured loans. As of year-end 2018, 30 clients were involved in litigation, down from 51 at year-end 2016.

With the implementation of IFRS 9 from Jan. 1, 2018, we believe that sensitivity to credit spreads will reduce. Furthermore, DCL minimizes sensitivity to interest rate fluctuations through hedging interest rate risk, although the group is exposed to liquidity risk associated with the related derivatives, and to market risk from hedging strategies, such as basis risk on cross-currency swaps or between bank-offered rate tenors.

Table 5

Dexia Credit Local Risk Position

	--Year-ended Dec. 31--				
(%)	**2018**	**2017**	**2016**	**2015**	**2014**
Growth in customer loans	(64.5)	(16.7)	(6.9)	(5.4)	5.1
Total managed assets/adjusted common equity (x)	32.1	35.4	50.4	44.9	40.0
New loan loss provisions/average customer loans	(0.2)	(0.0)	(0.1)	0.1	0.0
Net charge-offs/average customer loans	(0.1)	0.1	0.1	0.1	0.2
Gross nonperforming assets/customer loans + other real estate owned	2.3	0.9	0.9	1.0	0.9
Loan loss reserves/gross nonperforming assets	35.2	64.9	65.8	64.8	68.8

Funding and liquidity: Reliance and government funding

We consider DCL's funding as below average, and its liquidity moderate. This is because the bank has lost access to the wholesale-nonguaranteed and unsecured funding markets on which it previously relied, remaining vulnerable to confidence-sensitive market funding. Under our criteria, such an assessment is commensurate with an unsupported group credit profile capped at 'bb'.

Over the last few years, DCL's funding plans have been focused on further reducing its dependence on the European Central Bank (ECB) via short- and medium-term government-guaranteed market issuance and market repurchase agreement funding. As of year-end 2018, guaranteed and secured funding represented 95% of DCL group's funding, compared with 69% in December 2014. Since September 2017, DCL has had no recourse to ECB funding (down from €50 billion at year-end 2012).

DCL's funding remains concentrated on short-term funding, via various guaranteed programs in euros and in U.S. dollars, translating into a low stable funding ratio of 52% and broad liquid asset to short-term wholesale funding of 0.84x when compared with commercial banks at year-end 2018. We consider the risk of relying on market-sensitive funding sources as a key factor in our funding assessment. DCL's funding remains influenced by the capital market's appetite for the government-guaranteed or secured funding planned by the group. The outstanding amount on secured market funding was €35.5 billion at year-end 2018 and €65 billion for guaranteed funding.

As a result of an almost completely swapped balance sheet, DCL's liquidity needs vary depending on interest rates. Their level determines the bank's cash collateral requirements, which are revised upwards in case of a decline in interest rates. As of year-end 2018, these requirements represented €22.7 billion (net), down €3.8 billion from December 2017. In the event of a 10-basis-point fall in 10-year rates, the cash collateral requirement would increase by about €600 million, according to the current business plan.

At year-end 2018, the liquidity reserve was €16.3 billion, stable when compared to one year earlier. Following a decision by the ECB board in 2017, DCL's access to the ECB is now capped at €5.2 billion. As a result, the cash part (deposited both at the ECB and the Federal Reserve Bank) of the liquidity reserve has been increasing and stood at €9 billion as of year-end 2018.

Table 6

Dexia Credit Local Funding And Liquidity					
	--Year-ended Dec. 31--				
(%)	2018	2017	2016	2015	2014
Core deposits/funding base	0.6	2.0	5.3	5.3	4.5
Customer loans (net)/customer deposits	6,392.4	3,784.4	1,460.1	1,426.7	1,700.5
Long-term funding ratio	57.3	60.2	56.7	46.7	54.8
Stable funding ratio	51.9	56.8	52.3	44.2	51.8
Short-term wholesale funding/funding base	46.1	41.4	44.5	54.7	45.9
Broad liquid assets/short-term wholesale funding (x)	0.8	0.4	0.3	0.3	0.3
Net broad liquid assets/short-term customer deposits	(150.8)	(526.0)	(520.7)	(851.2)	(905.0)
Short-term wholesale funding/total wholesale funding	46.4	42.3	47.0	57.8	48.1
Narrow liquid assets/3-month wholesale funding (x)	1.9	0.9	0.6	0.7	0.9

External Support: Three notches of government support

The issuer credit rating on DCL is three notches higher than the bank's stand-alone credit profile. We apply three notches of uplift because we believe there is a high likelihood of support from the French and Belgium governments, in the event of financial difficulties.

With a resolution regime in place, governments' ability to provide support may be less predictable than before, since a resolution could conceivably prevent governments from injecting capital to correct an acute solvency problem without first bailing in senior liabilities (i.e., a bail in). However, we believe there remains a high probability that France and Belgium would provide additional extraordinary support if required, in light of the following:

- France and Belgium hold large equity stakes in the Dexia group;
- The bank is already in orderly resolution; and
- The entity is issuing government-guaranteed debt to fund itself.

Our view that there is a high likelihood of extraordinary government support is based on our assessment of DCL's:

- Important role for the two governments because ensuring a controlled run-off of its balance sheet preserves financial stability and minimizes the cost for the states as bank owners and guarantors of part of its liabilities.
- Very strong link with the two governments. There is no credible scenario that would result in a change in ownership and the commitment of the two governments is reinforced by their introduction of a guarantee scheme to cover funding raised until year-end 2021, with instruments having maturities of up to 10 years. The guarantee is split between Belgium (51.41%), France (45.59%), and Luxembourg (3.00%)

Additional rating factors: None

There are no additional rating factors.

Related entities

We consider Crediop a core subsidiary of DCL, as part of the orderly wind-down. The outlook on the long-term rating on Crediop is negative, mirroring the outlook on Italy. We expect Crediop will continue to be loss making in 2019. It is the major source of the enlarged group's exposure to Italy.

Rating on hybrid instruments

We rate legacy tier-1 instruments at 'D' (default), since we do not expect coupon payments to resume in our central scenario.

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- General Criteria: Hybrid Capital: Methodology And Assumptions, July 1, 2019
- 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: Guarantee Criteria, Oct. 21, 2016
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- General Criteria: Principles For Rating Debt Issues Based On Imputed Promises, Dec. 19, 2014
- Criteria - Financial Institutions - Banks: Assessing Bank Branch Creditworthiness, Oct. 14, 2013
- Criteria - Financial Institutions - Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Financial Institutions - Banks: Commercial Paper I: Banks, March 23, 2004

Anchor Matrix

Industry Risk	Economic Risk									
	1	2	3	**4**	5	6	7	8	9	10
1	a	a	a-	bbb+	bbb+	bbb	-	-	-	-
2	a	a-	a-	bbb+	bbb	bbb	bbb-	-	-	-
3	a-	a-	bbb+	**bbb+**	bbb	bbb-	bbb-	bb+	-	-
4	bbb+	bbb+	bbb+	bbb	bbb	bbb-	bb+	bb	bb	-
5	bbb+	bbb	bbb	bbb	bbb-	bbb-	bb+	bb	bb-	b+
6	bbb	bbb	bbb-	bbb-	bbb-	bb+	bb	bb	bb-	b+
7	-	bbb-	bbb-	bb+	bb+	bb	bb	bb-	b+	b+
8	-	-	bb+	bb	bb	bb	bb-	bb-	b+	b
9	-	-	-	bb	bb-	bb-	b+	b+	b+	b
10	-	-	-	-	b+	b+	b+	b	b	b-

Ratings Detail (As Of July 9, 2019)*		
Dexia Credit Local		
Issuer Credit Rating		BBB/Stable/A-2
Commercial Paper		
Local Currency		A-2
Junior Subordinated		D
Senior Unsecured		AA
Senior Unsecured		BBB
Issuer Credit Ratings History		
25-Jan-2013	*Foreign Currency*	BBB/Stable/A-2
28-Mar-2012		BBB/Watch Neg/A-2
29-Nov-2011		BBB+/Watch Neg/A-2
25-Jan-2013	*Local Currency*	BBB/Stable/A-2
28-Mar-2012		BBB/Watch Neg/A-2
29-Nov-2011		BBB+/Watch Neg/A-2
Sovereign Rating		
France		AA/Stable/A-1+
Related Entities		
Dexia Crediop SpA		
Issuer Credit Rating		BBB/Negative/A-2

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.