CMFB Workshop on the classification of development banks: session IV case studies The Agence Française de Développement

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Presentation structure

- AFD at a glance

  => Legal form, main activities and key figures
- Issue 1: is AFD an institutional unit?

  => Control / Autonomy of decision
- Issue 2: Does AFD carry out financial intermediation?

  => Market / non market activity for a financial entity
- Issue 3: Is a special treatment needed in National Account?

  => Further developments about sovereign loans notably whether further clarification in current texts is needed
- Conclusion

AFD at a glance: legal form and key figures (1/5)

- An industrial and commercial State public undertaking (EPIC) with the status of a financially-independent legal entity
- A financing company with an ongoing role that serves the public interest. Financing company => placed under the direct supervision of the French Prudential Supervisory Authority (ACPR)
- AFD's role is to carry out financial operations that contribute to the implementation of the French State's official development aid policy to developing countries abroad and the development of the French Overseas Departments

  => Provides loans and finances them mostly through market borrowing
- Key figures in 2017: 2000 employees, total assets 40 €billions, net banking income 570 €millions, net income 215 €millions

=> AFD can be assimilated to a **development bank** insofar as its cooperation activities are mainly based on public policy and that this is a public owned bank

AFD at a glance: activities, functioning and main figures (2/5)

- AFD provides loans that are mostly funded on the market
- AFD activities are either made on its own behalf or under a mandate given by the State
- 3 categories of assets:
  - ✓ non-concessional loans = not subsidized, granted at market rates = 50 % of AFD's approvals in 2017
  - ✓ concessional loans = at subsidized rates = 40 % of approvals in 2017
  - ✓ + subsidies, to the poorest countries, mainly in sub-Saharan Africa = 10 % of approvals in 2017

AFD at a glance: activities, functioning and main figures (3/5)

Balance sheet: assets. €Billions

	2017	2016
Loans	32	30
- net loans on AFD’s own behalf	30	29
- loans on behalf of the State	2	1
Short-term cash assets	5	3
Other	3	3
Total	39	36

Source: AFD’s financial report

	2017	2016
Loans at AFD Group’s risk	30	29
- Foreign countries	25	24
Sovereign	15	13
Non-sovereign	10	11
- French Overseas Collectivities	5	5
- Other loan outstandings	0,1	0,1

Source: AFD’s financial report

AFD at a glance: activities, functioning and main figures (4/5)

AFD's financing own activities

- Mainly from market borrowing
- Loans from the Treasury on favorable terms (30-year term including a 10-year grace period, interest rate of 0.25%). AFD contracts loans with the State for a period of 30 years, including 10 years deferred at 0.25%. Eligibility for Tier 2 of the regulatory capital
- Budgetary resources funds for foreign country and French Overseas Departments and Collectivities loan; subsidies received from the State for project subsidy and Non Governmental Organizations activities
- Financial transaction tax

AFD at a glance: activities, functioning and main figures (5/5)

Balance sheet: liabilities, €Billions (source AFD's financial report)

	2017	2016
Market borrowings	29	26
Borrowings from French Treasury	1	1
Current accounts	0,5	0,4
Other liabilities	4	4
Capital	5	5
Total	39	36

Financial results: €Billions (source AFD's financial report)

	2017	2016	2015	2014	2013
Capital	4,79	4,61	2,10	1,94	1,86
Net banking income	0,57	0,54	0,53	0,45	0,44
Net income	0,22	0,14	0,18	0,12	0,09
Net income/capital	4.48%	3.00%	8.58%	6.25%	5.00%
Net income	0.52%	0.37%	0.51%	0.40%	0.35%
Staff					
Number of employees (thousands, average)	2,0	1,8	1,7	1,7	1,7
Total payroll costs	0,24	0,21	0,19	0,19	0,18

Is AFD an institutional unit: autonomy of decision / control ? (1/4)

AFD has the characteristics of an institutional unit within the meaning of para 2.12 of the ESA :

- ✓ autonomous agency (EPIC status)
- ✓ responsible for the management of its own activities and the use of its budget
- ✓ may enter into commitments in its own name
- ✓ publishes accounts in accordance with IFRS standards, subject to the supervision of the ACPR (banking license)

Company with a single public shareholder and an explicit mandate, operating in a broad framework defined by the State => Is this public interaction such that it could call into question AFD's decision-making autonomy?

Is AFD an institutional unit: autonomy of decision / control ? (2/4)

General policy => clear State involvement

✓AFD operates within the strategic framework defined by the committee for International Cooperation and Development (the CICID), a State body. The CICID meets every 2 years

✓The strategic steering committee (SSC), a State body comprising representatives on the ADF's Board of Directors and chaired by the Minister for Cooperation, prepares the practical implementation of the decisions adopted by CICID by the AFD through the elaboration of the AFD's two years Objectives and Resources Contract (COM) and supervises its execution

✓AFD is managed by a CEO (qualify personality) who is appointed by decree for a three-year term

✓The BoD deliberates on strategic orientations implementing the objectives entrusted by the State. It is composed of seventeen members (in addition to its Chairman): five State representatives, six qualified personalities, four parliamentarians, and two staff representatives. **The board endorse all the decision related to loans. <u>The State has no majority in this board => "governance" in the hands of AFD</u>**

Is AFD an institutional unit: autonomy of decision / control ? (3/4)

The day to day policy => no State involvement (1/2)

- ✓ The high degree of decision-making autonomy in the identification, appraisal and selection of projects, <u>including the use of budgetary appropriations</u> (grants, subsidies) is fully equivalent to the autonomy of a CEO and his board of executive directors, vis-à-vis his managing board (board of administrators) in an incorporated company of the private sector
- ✓ AFD develops its own "country strategies" and sectoral policies, selects projects with regard to their viability and relevance to its strategic orientations. In all cases, the agency seeks counterparties with the best signatures in its countries of intervention according to the development objectives
- ✓ A majority of loans are co-financed with other bilateral bank (KFW, DEG, FMO, DFID) or multilateral banks (BEI, world bank) or private banks
- ✓ The activity of AFD develops in a competitive environment
- ✓ Not all subsidies provided by the State are used by AFD : the degree of use is <u>conditional to the credit-risk management decisions of AFD</u>

Is AFD an institutional unit: autonomy of decision / control ? (4/4)

The day to day policy => no state involvement (2/2)

In accordance with its approval as a financing company, AFD has its own risk control and monitoring system organized through committees. In particular

- ✓ the Risk Committee is responsible for proprietary risks, in particular in the areas of country and credit risk assessment
- ✓ The role of the credit committee is to examine financing files before they are submitted to AFD's decision-making bodies. The presidency is based on the amounts of the files submitted, with several levels of delegation defined. In line the best practices also implemented by the private sector, the most significant projects are the responsibility of the Executive Board

=> overall, because of its status and activity, AFD is an institutional unit controlled by the State. The various links between the State and AFD **do not contribute to depriving the latter of its decision-making autonomy, which is real and effective. The ability of AFD to manage its activity in a sustainable manner is scrutinized by the ACPR which is an autonomous administrative agency**

Does AFD carry out financial intermediation (1/3)

Financial intermediation

- ✓ The activity by which an institutional unit acquires financial assets and enters into commitments for its own account through financial transactions in the market (ESA 2.56)
- ✓ The activity consists in channeling funds between third parties, one of whom has surplus funds and the other is seeking funds. The financial intermediary is not only an agent acting on behalf of these institutional units, but also bears a risk itself by acquiring financial assets and entering into commitments on its own behalf (ESA 2.57)

⇒What is the nature of AFD's assets and liabilities? What are its resources? Own risks / own accounts?

⇒Channeling funds ?

⇒Profitability? Subsidies?

Does AFD carry out financial intermediation (2/3)

- ✓ Clear distinction between loans at Group risks and those carried out under specific mandates. No guarantees on assets. Cofinancing and budgetary lines not fully used
- ✓ From the balance sheets clear role in channeling funds : borrows on the market and lends to customers
- ✓ How to account for the compensation received by AFD for subsidized loans in the national accounts? In national accounts, this subsidy is similar to grant for interest relief (ESA 4.37). AFD finances an infrastructure project through a subsidized loan whose interest rate is not economically significant in this case. To cover this difference, it receives compensation from the State. In reality, it is the counterpart of the Rest of the World that directly benefits from this subsidy: AFD is transparent and its profitability is not affected (interest is calculated after reallocation of interest subsidies to their beneficiaries). In addition, the subsidy has no impact on the carrying of the risk that remains for AFD

Does AFD carry out financial intermediation (3/3)

Profitability?

✓Net banking income positive (remember also slide 7)

✓Payments from the State in exchange of carrying out mandated activities small

✓Net income product around zero after taking into account subsidies on interest rate

Banking income, €Millions

	2017
Interests and related income	1819
- of which grant for interest relief	492
Interests and related expenses	1251
Net banking income	568
Loans activities	442
Subsidies (activities on behalf of the State)	34
Guarantees activities	5
Other activities	87

Is a special treatment needed in National Account? (1/9)

Classification of AFD (unit) or part of it discussed many times during the last few years with Eurostat

- ✓ Standard Dialogue Visit 2014: rearrangement of a part of sovereign loans (0.9 billion in 2017) => case 1
- ✓ Standard Dialogue Visit 2017: governance and discussion on other sovereign loans (14.6 billions in 2017) => case 2

Is a special treatment needed in National Account? (2/9)

Sovereign loans need to be analyzed carefully

Case 1 (already on GG's balance sheet): clear cut situation of reclassification of assets/liabilities

- The French State asks explicitly AFD to grant a loan
- and gives an explicit guarantee on the asset
- the asset are shown separately on AFD's balance sheet

=> GG takes all the risks, AFD is acting on behalf of government

Is a special treatment needed in National Account? (3/9)

Case 2: sovereign loans granted by AFD on its own account. They have the following features

- ✓ granted to a State
- ✓ most of the time low-interest loan (part of it eligible ODA)
- ✓ can be subject to Paris Club's negotiations

=> Is being sovereign enough to reclassify a loan? No: the main question should be on the risk and rewards.

How does AFD manage to price low interest rate ?

- ✓ simply by having a good credit rating (a)
- ✓ by « subsidizing » the client (b)
- ✓ benefiting from concessional loans granted by the French State (c)

Is a special treatment needed in National Account? (4/9)

(a) Market perception and the low credit risk premium : what does it mean ?

Rating agencies (Standard and Poor's and Fitch) have chosen a mixed approach :

i. They assimilate the rating of AFD with the rating of the French Government (under their assumption of the "almost certain" likelihood that timely, "extraordinary" support would be granted in case of default).

ii. Rating agencies recognize that [Fitch] "*the French state has no legal obligation to prevent a default by an EPIC*"

iii. Their credit risk analysis regards AFD as an autonomous analytical object (specific analytical report). Analytical report by S&P includes a section specifically assessing AFD on a stand-alone basis.

=> *AFD pays a low risk premium when they issue paper, reflecting the low risk profile and medium term sustainability of its business model*

Is a special treatment needed in National Account? (5/9)

(b) Lower interest rate because of direct subsidy

AFD can lower the offered interest-rate because the State compensates the difference between the « normal » and the subsidized one.

The AFD does not really beneficiate from the subsidy (the client does)

AFD has no monopoly on the supply of these type of loans. Competition with finance offered via various channels by entities acting on behalf of other countries or multilateral institutions. No automatic relation between the subsidy and the volume of loans granted (ultimate decision by the customer, filter of AFD credit risk management)

In case (b) the subsidy given by the State impacts GG's deficit

Is a special treatment needed in National Account? (6/9)

(c) Lower interest rate because the French State grants concessional loans to AFD (called RCS) so AFD can grant concessional loans...

AFD still has to repay the loan => AFD is at risk on its liability side. however we observe that

- A concessional loan can be divided into a loan at market conditions plus a grant element
- The outstanding of RCS is increasing over time: when AFD repays the RCS the State grants more

The issue raised by case (c) being that

- the grant element is not easy to assess
- The B.9 impact of this scheme of financing should (idealy) be similar to case (b)

Is a special treatment needed in National Account? (7/9)

To account for this grant element of the RCS Insee chose to record **the change in RCS** as capital transfer (D.9)

=> the B.9 impact of this treatment is limited : between 10 and 200 M€ a year.

=> this is homogeneous with MGDD provisions concerning Multilateral Development Banks replenishments (although AFD is no multilateral bank and not providing mainly concessional loans)

Is a special treatment needed in National Account? (8/9)

Finally, is the potential renegociation within the Paris Club a condition for reclassifying sovereign loans ?

The issue was already discussed at the EDPSWG and methodological task force → the reply is "no" since there is no automaticity of the write-offs : the possibility for a loan to be renegociated within the Paris Club can't be seen as an ex ante guarantee

Is a special treatment needed in National Account? (9/9)

Overall

- ✓ The treatment of the French RCS (as capital transfer) is the best available option given that the current MGDD doesn't allow for the recognition of a grant element
- ✓ The same goes when it comes to International Development Association (IDA) replenishments: States contributions are to be treated as capital transfer, even if they are loans
- ✓ However, the IDA 2018 replenishment could call for a methodological change:

=> Countries participating can choose between two options:

A- to give money (G)

B- to grant a concessional loan (L) to IDA but with grant element equal to G

The current MGDD implies B.9 impact in case option A is chosen is G, but L if option B is chosen

Conclusion

To conclude, various general issues at stake in the AFD case:

✓**Control / autonomy of decision**: If control too strong => autonomy of decision rejected => then consolidation with the controlling unit

Too strong => day to day management “intrusion”. Interpretation of ESA 2.12 “decision-making autonomy in the exercise of its principal function”

✓**Financial intermediation**: balance sheet management / own risks Profitability is part of the assessment but not a necessary condition

✓Sovereign loan: no further guidance needed

Risk and reward assessment sufficient

Paris’s club: not an ex ante guarantee

✓Further developments about grant element

=> Overall: AFD belong to the S12 sector. This is an institutional unit, carries out financial intermediation. Sovereign loans are on its own risks and rewards and the commissions received for its mandated activities are negligible in its bank income product

Thank you for your attention!
Questions?

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