



ANNUAL FINANCIAL REPORT

2017

CAFFIL

Public sector assets – *Obligations foncières*
to support the French economy.

ANNUAL FINANCIAL REPORT 2017

Caisse Française de Financement Local CAFFIL

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This free translation of the annual financial report published in French is provided solely
for the convenience of English-speaking readers.

Profile

Caisse Française de Financement Local (also known by its acronym CAFFIL) is an issuer of covered bonds with a portfolio of assets solely comprised of loans to public sector entities. It is fully owned by the French State-owned development bank SFIL.

Caisse Française de Financement Local is a French specialized credit institution (*société de crédit foncier*). Its sole business is the refinancing of loans to public sector entities through the issue of covered bonds, called *obligations foncières*.

Caisse Française de Financement Local and its parent company have been tasked by the French State:

- to finance loans to French local governments and public hospitals granted by La Banque Postale;
- to refinance large export credits with the unconditional and irrevocable guarantee of the French State.

Caisse Française de Financement Local is a wholly-owned subsidiary of SFIL, which also manages the Company in accordance with article L.513-15 of the Monetary and Financial Code. SFIL is a credit institution approved by the Autorité de contrôle prudentiel et de résolution (ACPR), 75% of which is held by the French State, its reference shareholder, 20% by Caisse des Dépôts et Consignations (CDC) and 5% by La Banque Postale (LBP). The shareholding structure of Caisse Française de Financement Local is thus firmly anchored in the public sphere, reflecting the missions entrusted to it by the French State.

CAFFIL is the leading European issuer of covered bonds, which are secured by a portfolio of public sector loans. The Company issues *obligations foncières* (covered bonds) regularly. Their primary characteristics are that:

- they are regulated by specific legal provisions;
- they are rated AA+/Aaa/AA by Standard and Poor's, Moody's, and Fitch;
- they comply with the EU's UCITS and CRD directives, and with article 129 of the CRR standard;
- they benefit from the Covered Bond Label created by the European Covered Bond Council (ECBC).

The *obligations foncières* issued by CAFFIL are thus eligible for refinancing by the European Central Bank (ECB) and thus enable investors to benefit from the best prudential treatment.

In 2016, CAFFIL was named the best issuer of the year for its covered bonds in euros by three separate specialized publications (*The Covered Bond Report* in June, *The Cover* in September, and *CMD Portal* in December). In 2017, for the second consecutive year, CAFFIL was named the best issuer of the year by *CMD Portal*.

Key figures

as of December 31, 2017

Portfolio of assets (cover pool)	<i>Obligations foncières</i> (covered bonds)
EUR 55.8 billion	EUR 49.0 billion
Assets eligible for the central bank (% cover pool)	<i>Obligations foncières</i> issued in 2017
75.3%	EUR 6.0 billion
Non-performing and litigious loans (% cover pool)	Regulatory over-collateralization
1.0%	111.6%
Common Equity Tier 1 Ratio (Basel III - fully loaded)	Liquidity Coverage Ratio (LCR)
23.2%	371%

Management Report

Caisse Française de Financement Local

2017

1. General presentation of Caisse Française de Financement Local

1.1 - NATURE AND ACTIVITIES OF THE COMPANY

Caisse Française de Financement Local (also known by its acronym CAFFIL) is a credit institution active in the refinancing of loans to public sector entities through the issue of covered bonds, which are called *obligations foncières*.

It is a specialized credit institution authorized to operate as a *société de crédit foncier*. As a credit institution, the Company is subject to all legal and regulatory provisions that apply to credit institutions. It conducts banking transactions in its ordinary course of business. As a *société de crédit foncier*, it engages in transactions that are specialized and have an exclusive purpose, as defined in articles L.513-2 and following of the Monetary and Financial Code.

In the case of Caisse Française de Financement Local, this specialization is exclusively limited to transactions with public sector entities or entities they guarantee as specified in its October 1, 1999, authorization and its own by-laws:

- The authorization mentions that the Company “is approved as a *société de crédit foncier*, the activities of which exclusively concern the granting or acquisition of loans to public sector entities or those they guarantee, as well as the holding of securitization units or shares of similar entities when the assets in these securitizations are for at least 90% composed of assets of the same nature as the above-mentioned loans, in accordance with article 94-II and III of law 99-532”.
- The purpose of the Company (article 2 of the by-laws) specifies that the exclusive purpose of the Company is:
 - to grant or to acquire exposures on public sector entities as defined in article L.513-4 of the Monetary and Financial Code as well as securitization units or shares of similar entities considered as exposures on public sector entities as defined in article L.513-5 of the Monetary and Financial Code;
 - to hold securities and other assets under the conditions set by decree to be considered as replacement assets.

Sociétés de crédit foncier, which were created by the law of June 1999, are now well-known in the world of bond issuers and investors. They issue covered bonds called *obligations foncières* and contract other covered debt negotiable or not in regulated markets. All these instruments are characterized by the legal privilege that primarily affects cash flows from the Company's assets to pay the interest and reimbursement of the *obligations foncières*. *Sociétés de crédit foncier* may also issue or contract non-covered debt. *Obligations foncières* constitute a significant element in the international covered bond market.

1.2 - LEGAL AND SHAREHOLDING STRUCTURE OF THE COMPANY

1.2.1. Legal structure and name of the Company

The Company was created on December 29, 1998, for a period of 99 years. It was authorized to operate as a *société de crédit foncier* by the Comité des établissements de crédit et des entreprises d'investissement (now a part of ACPR) at its meeting on July 23, 1999. The authorization became definitive as of October 1, 1999.

On January 31, 2013, the Company took the name Caisse Française de Financement Local to replace that of Dexia Municipal Agency, upon the sale of its sole shareholder, Société de Financement Local (renamed SFIL in June 2015), to the French State, Caisse des dépôts et consignations and La Banque Postale.

The Company's registered office is located at 1-3, rue du Passeur de Boulogne in Issy-les-Moulineaux (92130), France.

Caisse Française de Financement Local is a *société anonyme à directoire et conseil de surveillance*, a joint-stock corporation with an Executive Board and a Supervisory Board, under the provisions of articles L.210-1 and following of the Code of Commerce. Its operation is regulated by articles L.511-1 and following (credit institutions) and L.513-2 and following (*sociétés de crédit foncier*) of the Monetary and Financial Code.

1.2.2. Shareholding structure of the Company

Caisse Française de Financement Local and its parent company SFIL are key elements in the financing of local governments and public hospitals in France. The organization, introduced by the French State in 2013, is based on a commercial activity developed by La Banque Postale with refinancing provided by Caisse Française de Financement Local. Since 2015, the French State has entrusted SFIL and Caisse Française de Financement Local with a second mission that is the responsibility to refinance large export credits with the guarantee of the State (see 1.3.2.). The objective is to enable

large export credits, as well as French local governments and public hospitals to benefit from optimal financing conditions through a high rating and irreproachable risk management.

The capital of Caisse Française de Financement Local is 100% held by SFIL, which also manages the Company in accordance with article L.513-15 of the Monetary and Financial Code. SFIL is a credit institution approved by the Autorité de contrôle prudentiel et de résolution (ACPR). Its shareholders are the French State (75%), Caisse des dépôts et consignations (20%) and La Banque Postale (5%). SFIL's shareholders are thus firmly anchored in the public sphere, reflecting the missions the French State assigned it.

The French State is the "reference shareholder" of SFIL and Caisse Française de Financement Local for ACPR, underlining its commitment to ensure oversight and to influence strategic decisions, as well as its determination to ensure Caisse Française de Financement Local's and SFIL's ongoing financial transactions and to comply with regulatory requirements, if so required.

1.3 – ECONOMIC MODEL OF CAISSE FRANÇAISE DE FINANCEMENT LOCAL

1.3.1. Refinancing of loans to the French local public sector and public hospitals in partnership with La Banque Postale

In early 2013, Caisse Française de Financement Local and La Banque Postale signed an exclusive sale agreement to fund the needs of the French local public sector and public hospitals. The arrangement, set up under the aegis of the French State, works as follows: La Banque Postale markets loans to the French local public sector and public hospitals, then sells them to Caisse Française de Financement Local, which refinances them by issuing *obligations foncières* (covered bonds). The loans originated are exclusively in euros with a vanilla interest rate. La Banque Postale committed to propose to Caisse Française de Financement Local all the loans that would be eligible for its cover pool.

This partnership enables Caisse Française de Financement Local to maintain its control of the credit risk through a two-stage analysis.

- When the loan is originated, the initial analysis of the counterparty is carried out simultaneously at the two entities. The loans that do not meet the credit and eligibility criteria of Caisse Française de Financement Local cannot be transferred to its balance sheet. Caisse Française de Financement Local's eligibility criteria are strictly monitored by internal management policies and limit eligible counterparties to French local public sector entities and public hospitals.
- Before loans originated by La Banque Postale are sold to Caisse Française de Financement Local, a new analysis of the assets is conducted, and Caisse Française de Financement Local may refuse a loan prior to the sale if the asset no longer meets the criteria.

As required by law, the sale of loans to Caisse Française de Financement Local is carried out by using a transfer form (*bordereau de cession*) that is specific to *sociétés de crédit foncier*.

1.3.2. Refinancing of large export credits

In addition to their mission of refinancing French local governments and public hospitals, SFIL and Caisse Française de Financement Local have been entrusted with a second mission by the French State: to refinance large French export contracts, with the objective to support French exports in terms of financial competitiveness, in accordance with a public refinancing plan comparable to that of other OECD countries. In this context, SFIL signed a protocol agreement governing relations with 20 commercial banks, thereby confirming relations with almost all the banks active in the French export credit market. SFIL may acquire all or a part of the participation of each of these banks in an export credit.

In this context, Caisse Française de Financement Local grants loans to SFIL in order to refinance its export credits. Such loans benefit from an irrevocable and unconditional 100% guarantee by the French State (enhanced guarantee⁽¹⁾). This business brings Caisse Française de Financement Local closer to the French State, without modifying the risk profile of its cover pool.

These new loans, like the new French public sector loans marketed by La Banque Postale, are added to the portfolio of Caisse Française de Financement Local, which is financed by the issue of *obligations foncières*. Given the current size of the cover pool and the growth of its traditional line of business, the percentage share of this new activity will increase gradually and will only become significant in several years. This share may rise to 13% until 2021, based on an annual production of large export credits of more than EUR 2.0 billion.

1.3.2.1. Organization

The system functions as follows:

- SFIL contributes to the financial proposal made by one or more banks in the banking syndicate granting the buyer credit covered by the export credit insurance guaranteed by the French State.
- After the export contract finalization, these banks sell a part of the loans (and the attached rights) to SFIL and keep at least the share of the export credit not covered by the insurance (usually 5%).
- Caisse Française de Financement Local grants a loan to SFIL to enable it to refinance the acquired export credit. This refinancing loan benefits from an irrevocable and unconditional 100% guarantee by the French State, referred to as an enhanced guarantee.

(1) The enhanced guarantee was introduced by law 2012-1510 of December 29, 2012, and the decree 2013-693 of July 30, 2013.

Loans granted by Caisse Française de Financement Local to SFIL to refinance the purchased export credits thus constitute exposures that are totally guaranteed by the French State and eligible for the cover pool of a *société de crédit foncier*. These loans also comply with the European CRR regulation (article 129, which specifies the assets authorized for inclusion in a cover pool to ensure that the covered bonds will benefit from the best prudential treatment).

1.3.2.2. French State export guarantees

Previously granted by Coface, since late 2016, these guarantees have been managed by Bpifrance Assurance Export, in the name of, on behalf of, and under the control of the French State, pursuant to article L.432.2 of the Insurance Code.

- Guarantee-granting decisions are made by the Minister in charge of the Economy and Finances after instruction by Bpifrance Assurance Export and the opinion of the French Export Credit and Guarantee Commission (*Commission des garanties et du crédit au commerce extérieur*).
- Bpifrance Assurance Export issues insurance policies, as well as enhanced guarantees, in accordance with the decision made. In this context, Bpifrance Assurance Export is also tasked with collecting insurance and guarantee premiums, managing risks, payments, and collections on behalf of the French State.
- The risks related to these guarantees are borne by the French State and all financial flows (premiums, payments, repayments) are recorded in separate accounting entries by Bpifrance Assurance Export. Premiums and collections are received directly on the account of the French State, and payments are made directly from the same account, without passing through the accounts of Bpifrance Assurance Export.

1.3.3. Servicing and financing provided by SFIL

The role of SFIL primarily involves the following:

- to ensure the complete operational management of the Company (day-to-day management as well as the operational management of the reduction in the sensitivity of the structured loans on the balance sheet of Caisse Française de Financement Local), as defined by the regulations applicable to *sociétés de crédit foncier*, in particular article L.513-15 of the Monetary and Financial Code;
- to provide Caisse Française de Financement Local with some of the derivatives and non-privileged funding it needs to carry out its activities.

The funds required to finance the activity of Caisse Française de Financement Local (financing of over-collateralization and intermediated derivatives) are obtained by SFIL:

- either by its shareholders under credit agreements:
 - Caisse des dépôts et consignations (CDC) for all the needs linked to operations booked prior to the date of acquisition of SFIL (January 31, 2013) and to the new export refinancing activity;
 - La Banque Postale (LBP) for all the needs related to loans to French local public sector and public hospitals that it originates.
- or on financial markets by issuing short-term debt (certificates of deposit) or long-term debt (bonds), in order to diversify its financing sources. In the French State Agencies segment, SFIL gradually set up its signature by launching a first benchmark issue in the last quarter of 2016, followed by two new benchmark issues, including one in USD, in 2017.

In addition to commitments of the French State as the reference shareholder, on January 31, 2013, SFIL signed a declaration of support of Caisse Française de Financement Local, which is reproduced in this annual financial report - General information.

It should be noted that SFIL also supplies services for the business of lending to French public sector entities engaged by La Banque Postale (LBP) and its joint venture LBP/CDC, La Banque Postale Collectivités Locales. These services concern activities involving commercial support, financial oversight, the supply of data for risk analysis and back office operations.

1.3.4. Other management agreements

Specific individual agreements have been established with entities that, in the past, have transferred assets to the *société de crédit foncier*, and continue to ensure management for their national clientele. These assets are now managed in a run-off mode. At the end of 2017, there were agreements with the following entities: Kommunalkredit Austria (Austria), Belfius Banque et Assurances (Belgium), and Dexia Crediop (Italy). These agreements already existed in previous years.

Starting in 2015, management of new registered covered bonds (RCB) is entrusted to Landesbank Baden-Württemberg (LBBW). Dexia Kommunalbank Deutschland continues to manage registered covered bonds issued prior to 2015.

1.4 - LEGAL FRAMEWORK

1.4.1. European framework

The *obligations foncières* issued by Caisse Française de Financement Local are covered bonds. Many countries have passed specific legal provisions for covered bonds in recent years, and the number of issuers has risen significantly.

Two directives govern and define covered bonds:

- The first directive is Undertakings for Collective Investment in Transferable Securities (UCITS) on the legislative, regulatory, and administrative aspects of certain vehicles for collective investment in securities, article 52-4.

- The second is the Capital Requirements Directive (CRD), on the minimum regulatory capital requirement, which is complemented by the related Capital Requirements Regulation (CRR), article 129.

These two directives in particular specify the assets that may be incorporated into the portfolio financed by the covered bonds, the privilege that protects investors, as well as the required level of public oversight and transparency in terms of communication. Investors in bonds that satisfy the requirements of these two directives and the associated regulation benefit from financial and regulatory advantages.

The *obligations foncières* issued by Caisse Française de Financement Local satisfy the requirements of these two European directives and the associated regulation. In this regard, they benefit from a 10% preferential risk weighting in the calculation of the solvency ratio with the standard method (given their current rating). Current and future *obligations foncières* issued by Caisse Française de Financement Local respect the conditions of eligibility for refinancing by the European Central Bank.

In addition, all the *obligations foncières* backed by the cover pool of Caisse Française de Financement Local benefit from the Covered Bond Label, which was created in 2012 by the European Covered Bond Council (ECBC) to improve the quality of financial information and the transparency of the European covered bond market.

To meet Label requirements, Caisse Française de Financement Local committed to respect the above-mentioned directives and to ensure a high level of transparency in its communication to investors. All detailed information on the issues and cover pool of Caisse Française de Financement Local is now posted on the Covered Bond Label site (<https://www.coveredbondlabel.com/issuer/47/>). It includes the harmonized transparency template (HTT) reporting used by all beneficiaries of the label. Since the end of 2015, the European Banking Authority and the European Commission have been leading a project to harmonize the legal framework of European covered bonds, which in 2017 was the subject of numerous discussions among the various stakeholders. The European Commission published a draft package (directive and regulation) on March 12, 2018, with an implementation target of mid-2019.

1.4.2. French legislative framework and regulations

Sociétés de crédit foncier are governed by the contents of articles L.513-2 to L.513-27 and R.513-1 to R.513-18 of the Monetary and Financial Code.

These articles of the law are complemented by the following regulatory texts:

- regulation 99-10 of the Comité de la réglementation bancaire et financière of July 9, 1999, as amended, relating to *sociétés de crédit foncier* and *sociétés de financement de l'habitat*;
- ACPR instructions 2011-I-06, 2011-I-07, 2014-I-16 and 2014-I-17.

In addition to these regulations and the law on *sociétés de crédit foncier*, which is described below, Caisse Française de Financement Local is subject to the same obligations as credit institutions in terms of reporting vis-à-vis the regulator and respect for liquidity ratios. The solvency ratio, large exposures and the leverage ratio are reported to the regulator on a consolidated basis, at the level of the parent company SFIL.

1.4.2.1. General framework

Article L.513-2 describes the general framework of the activities of *sociétés de crédit foncier*, in particular:

- their exclusive purpose which is to finance guaranteed home loans or loans to the public sector, or replacement assets, and the issue of *obligations foncières* and other resources benefiting or not from the legal privilege;
- the possibility to obtain financing by assigning in guarantee certain assets (which no longer contribute to the calculation of over-collateralization);
- the impossibility of owning subsidiaries or affiliates.

Application to Caisse Française de Financement Local

The assets are comprised of commitments on public sector entities. These assets are financed through the issue of debt that is covered by a legal privilege that guarantees them a priority right on the cash flows generated by the assets. The portion of assets that is not financed by covered debt – over-collateralization – is funded by the Company's equity and debt that does not benefit from the privilege, which is subordinated to the covered debt. Non-privileged debt is provided by SFIL, the sole shareholder of Caisse Française de Financement Local.

Since Caisse Française de Financement Local is not allowed to have any subsidiaries or affiliates, it does not publish consolidated financial statements and has no obligation to produce IFRS financial statements. Nonetheless, for reasons of comparability and transparency, Caisse Française de Financement Local publishes annual and half year financial statements according to IFRS.

1.4.2.2. Assets

Articles L.513-3 (home loans), L.513-4 (commitments on public sector entities), L.513-5 (securitization units) and L.513-6 (replacement assets) define the exposures that may be included in the assets of *sociétés de crédit foncier*.

Application to Caisse Française de Financement Local

The assets held by Caisse Française de Financement Local are solely comprised of commitments on public sector entities that are eligible by the terms of article L.513-4 of the Monetary and Financial Code, i.e. States, local governments or groups of such, public sector entities in the European Economic Area, Switzerland, the United States of America, Canada and Japan. These commitments are comprised of loans and bond issues representing a commitment on, or totally guaranteed by, these public bodies. Exposures to foreign public sector entities were marketed by the company's former shareholder

and are now managed in a run-off mode. Since 2013, all of Caisse Française de Financement Local's new assets relate to French borrowers.

Other assets, which current legislation calls replacement assets, may be acquired if they correspond to exposures on credit institutions benefiting from at least a Step 1 rating (level triple A or double A) or, when their maturity does not exceed 100 days, from a Step 2 rating (level simple A), their total amount is limited to 15% of the total of outstanding *obligations foncières* and other debt benefiting from the legal privilege (registered covered bonds in the case of Caisse Française de Financement Local). This asset category is used for cash investments by the Caisse Française de Financement Local.

1.4.2.3. Liabilities and the privilege

Article L.513-2 specifies that to finance their assets, *sociétés de crédit foncier* may issue debt that benefits (*obligations foncières* or other covered resources) or does not benefit from the privilege. Article L.513-10 makes it possible to hedge the assets and the privileged liabilities by derivative instruments that thus benefit from the privilege.

Article L.513-15 requires that a *société de crédit foncier* entrust the management of its operations to another credit institution with which it has signed an agreement. To maintain the privilege that benefits investors in *obligations foncières* and other covered resources, a *société de crédit foncier* should not have any employee (who would benefit in French law from a first-rank privilege). This management agreement itself benefits from the privilege of article L.513-11, *pari passu* with holders of privileged debt.

Article L.513-11 describes this privilege, in particular:

- that when a *société de crédit foncier* is subject to bankruptcy or liquidation procedures, cash flows generated by the assets, after any financial instrument hedges if such be the case, are allocated in priority to serve the *obligations foncières* and other resources benefiting from the privilege, also after any financial instrument hedges if such be the case;
- that the liquidation of a *société de crédit foncier* does not accelerate the reimbursement of *obligations foncières* and other debt benefiting from the privilege, which continue to be paid at their contractual due dates with priority over all other commitments. These other commitments can only be settled after all debt benefiting from the privilege has been discharged.

Article L.513-20 stipulates that the bankruptcy or liquidation of the shareholder of a *société de crédit foncier* cannot be extended to the *société de crédit foncier*.

Lastly, article L.613-55-1.I of the Monetary and Financial Code, transposing the BRRD, stipulates that *obligations foncières* cannot be used to absorb losses in the event of the resolution of a *société de crédit foncier* (bail-in).

Application to Caisse Française de Financement Local

The contracts of Caisse Française de Financement Local that benefit from the legal privilege are the *obligations foncières* and registered covered bonds that it issues, the hedging derivative contracts and the servicing agreement signed with SFIL. In addition to its equity, Caisse Française de Financement Local uses two categories of debt to finance its assets:

- debt that benefits from the legal privilege, defined by law as *obligations foncières* or other resources benefiting from the legal privilege by reason of their contract. Caisse Française de Financement Local thus issues registered covered bonds benefiting from the legal privilege by reason of their contract in the same way as *obligations foncières*; intended for German institutional investors, these private placements governed by German law also benefit from the French legal privilege attached to issues of *sociétés de crédit foncier*;
- debt that does not benefit from the legal privilege includes debt that is not covered by the assets and which, for this reason, is subordinated vis-à-vis debt benefiting from the privilege (see 5. Debt benefiting from the legal privilege). With equity, it finances over-collateralization. It may be of three types:
 - debt negotiated according to the terms of a financing agreement signed with the parent company;
 - refinancing in its own name from the Banque de France. Caisse Française de Financement Local implemented the organizational and IT procedures required to participate in the refinancing operations of the Banque de France, and tests them regularly. The financing obtained does not benefit from the privilege specified by the legislation on *sociétés de crédit foncier*, but is guaranteed by assets assigned to the central bank. These pledged assets are temporarily excluded from the cover pool and the calculation of the over-collateralization ratio;
 - financing obtained from credit institutions within the framework of repurchase agreements (repo).

In addition, on January 31, 2013, SFIL, the parent company of Caisse Française de Financement Local, signed a declaration of support ensuring that "Société de Financement Local and the French State, its reference shareholder, will ensure that Caisse Française de Financement Local will always be able to pursue its activity in an ongoing manner and to honor its financial commitments in compliance with the obligations imposed by banking regulations in effect". This declaration of support is reproduced in issuance documents and the annual financial report of Caisse Française de Financement Local.

1.4.2.4. Other provisions

The other articles of the Monetary and Financial Code define management and control procedures for *sociétés de crédit foncier*. They can be consulted on the Company's Website (<http://www.caffil.fr/en/portrait/la-loi/>) or on the official Legifrance Website (<http://www.legifrance.gouv.fr/>).

It can be noted that article L.513-12 and article R.513-8 of the Monetary and Financial Code require that the over-collateralization ratio, i.e. the ratio between the assets covering the privileged debt and the debt benefiting from the privilege at all times be greater than 105%.

The items concerning this ratio, as well as the management of the interest rate, foreign exchange and liquidity risks are discussed below in the chapters dedicated to these subjects.

1.5 - RATINGS OF THE *OBLIGATIONS FONCIÈRES* ISSUED BY CAISSE FRANÇAISE DE FINANCEMENT LOCAL

The issuance program of Caisse Française de Financement Local is rated by three of the main rating agencies - Standard & Poor's (S&P), Moody's and Fitch.

The ratings of the bonds issued by Caisse Française de Financement Local are at the highest level of credit quality (Step 1). This requires that the quality of the cover pool and strict management rules be consistent with the criteria and approaches of the three agencies.

The principle by which each agency rates *obligations foncières* (and covered bonds in general) involves taking as a starting point the issuer's rating or that of the parent company if the issuer is not rated, and enhancing this rating by one or more notches in function of the current safeguards (legal framework, quality of assets, asset/liability management, over-collateralization, etc.).

The rating of SFIL is now set at the same level as that of France for S&P and one notch below France for Moody's and Fitch. These very good ratings have been attributed because the agencies consider SFIL as an entity that is linked to the French government. They take into account a strong probability that the French State will provide extraordinary support to SFIL if necessary because of the strategic importance of the public service responsibilities SFIL was entrusted with, State commitments and the State's influence on SFIL's governance.

The close relationship between Caisse Française de Financement Local and the French State, due to its shareholding structure and support, but also to its mostly French cover pool, creates a link between the rating of *obligations foncières* and the rating of France for Fitch. Fitch's rating may thus not be higher than the sovereign rating; otherwise Fitch would apply an ultra-stressed rating scenario (an 80% default rate, with recoveries limited to 20%), making it necessary to have a level of over-collateralization that would be incompatible with the profitability of the business model.

Besides, the rating of *obligations foncières* is limited by S&P to one notch above the rating of SFIL and consequently to one notch above the rating of the French State, by reason of the non-conformity of certain derivative contracts with the agency's most recent methodological criteria (counterparties not rated by S&P or absence of a replacement clause).

Lastly, since the end of 2017, the *obligations foncières* issued by Caisse Française de Financement Local benefit from a Prime rating from the extra-financial rating agency Oekom by reason of the Company's performance in societal and environmental issues.

2. Highlights of 2017

2.1 - THE COVERED BOND MARKET

The primary market for public euro-denominated covered bond issues (benchmark public issues) was active in 2017, but its volume fell compared with previous years: EUR 115 billion, compared with EUR 127 billion in 2016 and EUR 146 billion in 2015. This decrease stemmed mainly from Canadian issuers, who focused on more favorable non-euro issues, as well as Spanish issuers, who instead used the long-term financing operations (TLTRO) available from the ECB on favorable terms.

Business nevertheless remained buoyant in 2017. The high issuance volumes are mainly attributable to the significant refinancing of bonds that matured in 2017 (EUR 123 billion), but also to the significant growth in Dutch issuance (8% of supply) and the active presence of non-eurozone issuers for whom this market's long-term financing conditions were favorable. German and French issuers remained the most active, accounting for more than 39% of supply, while Norwegian, Australian and UK issuers combined accounted for 15% of the market (no change from 2016).

During the first half of 2017, elections in Europe (Netherlands, France and Germany) affected the value of these countries' covered bonds. Nevertheless, despite a period of consolidation in the first half of the year, these events did not affect the solidity of the euro covered bond market, which performed robustly over the year as a whole.

In 2017, the market continued to benefit from the strong support provided by the ECB's covered bond purchase program, which totaled nearly EUR 241 billion as of December 31, up by around EUR 37 billion from a year earlier.

In this context, Caisse Française de Financement Local implemented its annual covered bonds financing program with good conditions of volumes, spreads and average maturities (EUR 6.0 billion issued, with an average maturity of more than 11 years). This allowed it to provide the long-term liquidity needed to refinance La Banque Postale's commercial offer for the French public sector, to develop a large export credit refinancing activity and to support the sensitivity reduction policy.

In 2018, in a changing regulatory environment (Basel III and Solvency 2), we expect the very favorable treatment enjoyed by covered bonds to encourage investors to prioritize them in their asset allocation. Demand should also be naturally supported by the maturing of significant volumes (around EUR 90 billion) of covered bonds; it is estimated that net supply in 2018 will be zero or slightly positive (versus negative net supply of EUR 8 billion in 2017).

2.2 - RATING OF OBLIGATIONS FONCIÈRES

The ratings of the *obligations foncières* issued by Caisse Française de Financement Local were not altered in 2017.

As of December 31, 2017, the ratings were as follows: AA+ by Standard and Poor's, Aaa by Moody's and AA by Fitch. The outlook associated with each of these ratings is stable.

2.3 - REFINANCING OF PUBLIC SECTOR LOANS GRANTED BY LA BANQUE POSTALE

In its first line of business, Caisse Française de Financement Local refinances loans granted by LBP to French local governments and public hospitals.

In this context, in 2017, Caisse Française de Financement Local acquired a total of EUR 3.3 billion in loans, which is roughly 14% more than the volume acquired from La Banque Postale in 2016 (EUR 2.9 billion). Since the beginning of the partnership, loans acquired through LBP have accounted for almost EUR 12.2 billion.

Since 2015, the CAFFIL/SFIL/LBP network has been recognized as the largest provider of funding for the French local public sector.

2.4 - LARGE EXPORT CREDITS REFINANCING

In its second line of business, Caisse Française de Financement Local grants loans to SFIL to refinance large export credits it has granted. Such loans benefit from an unconditional and irrevocable 100% guarantee by the French State. This new business brings Caisse Française de Financement Local closer to the French State without modifying the risk profile of its cover pool.

After a first year launching the business in 2016, in 2017 Caisse Française de Financement Local granted SFIL refinancing loans for a total amount of EUR 2.6 billion, compared to EUR 0.6 billion the previous year. The drawing of these loans is staggered over a number of years.

2.5 - SENSITIVITY REDUCTION AND DECREASE IN LITIGATION RELATED TO STRUCTURED LOANS

Caisse Française de Financement Local has, in its portfolio, some structured loans considered as sensitive (see 4.2.4.) which had been granted to French clients by Dexia Credit Local before the acquisition of Caisse Française de Financement Local by SFIL. Certain of these customers initiated legal proceedings against Dexia Credit Local, Caisse Française de Financement Local and/or SFIL.

The structured loan sensitivity reduction policy implemented by SFIL since its creation in early 2013 has made it possible to effect a significant reduction in both the size of Caisse Française de Financement Local's sensitive structured loan portfolio (see 4.2.4.) and the number of lawsuits (see 9.2.5.). This trend continued in 2017.

3. Changes in main balance sheet items

EUR billions value after currency swaps	12/31/2015	12/31/2016	12/31/2017	Change Dec. 2017 / Dec. 2016
Cover pool	60.0	58.2	55.8	(4.2)%
Loans	50.5	47.0	46.9	(0.2)%
Securities	7.0	7.5	7.2	(4.4)%
Cash deposit in central bank	2.5	3.7	1.7	(53.7)%
Privileged debt	53.0	51.7	49.7	(3.7)%
Obligations foncières ⁽¹⁾	51.6	50.4	49.0	(2.6)%
Cash collateral received	1.4	1.3	0.7	(45.6)%
Non-privileged debt	5.5	5.2	4.8	(7.6)%
SFIL	5.5	5.2	4.8	(7.6)%
Equity IFRS (excluding gains and losses through equity)	1.5	1.4	1.5	2.9%

(1) Including registered covered bonds

As of December 31, 2017, Caisse Française de Financement Local's cover pool excluding accrued interest not yet due amounted to EUR 55.8 billion, reflecting a 4.1%, or EUR 2.4 billion decrease from its end-2016 level of EUR 58.2 billion. Caisse Française de Financement Local's cover pool is composed of loans and debt securities and also includes the temporary cash surplus put aside to anticipate the forthcoming repayment of *obligations foncières* or the refinancing of new export loans. This cash is deposited at the Banque de France, or invested in bank or European public sector securities. The cash surplus, placed with the Banque de France, represents EUR 1.7 billion at the end of December 2017, versus EUR 3.7 billion at the end of December 2016. The cash surplus invested in securities or lent to SFIL represents a total of EUR 1.6 billion as of December 31, 2017 versus EUR 0.9 billion at the end of December 2016.

As of December 31, 2017, no assets were excluded from the cover pool in order to be sold to a bank in a repurchase agreement or assigned in guarantee to the Banque de France.

As of this date, outstanding debt benefiting from the legal privilege, including cash collateral received, was EUR 49.7 billion, which decreased 3.7% in comparison with December 2016.

As of December 31, 2017, the debt contracted with the parent company totaled EUR 4.8 billion and does not benefit from the legal privilege. It mainly corresponds to the financing of the over-collateralization of the cover pool which is at a significantly higher level than the amount required by regulators and the rating agencies.

4. Cover pool

4.1 - CHANGE IN ASSETS IN 2017

The net change in the cover pool in 2017 corresponded to a decrease in assets in the amount of EUR 2.4 billion. This change is explained by the following items.

EUR billions	2017
1- Acquisition of loans from La Banque Postale	3.3
Loans to the French public sector (vanilla loans in euros)	3.3
2- Export credits drawings	0.2
Loans to SFIL to refinance export credit guaranteed by the French State	0.2
3- Reduction of loan sensitivity	0.3
Sensitive structured loans eliminated	(0.4)
Refinancing loans (vanilla loans in euros)	0.4
New loans (vanilla loans in euros)	0.3
4- Amortization of portfolio of loans and securities	(4.7)
5- Early reimbursements	(0.2)
6- Changes in treasury	(1.3)
Net change in securities investments	0.7
Net change in Banque de France cash deposit	(2.0)
7- Other changes	0.0
Net change in the cover pool	(2.4)

In 2017, Caisse Française de Financement Local acquired a total of EUR 3.3 billion in loans to the French local public sector and public hospitals originated by La Banque Postale.

Drawings on refinancing loans of large export credits granted to SFIL became effective during 2017 in the amount of EUR 0.2 billion. These loans benefit from an irrevocable and unconditional 100% guarantee by the French State.

In application of the policy of reduction of loan sensitivity in effect since the beginning of 2013, the operations conducted by SFIL in 2017 made it possible to decrease outstanding loans considered as sensitive by EUR 0.4 billion through their replacement with fixed rate loans. They were accompanied by new fixed rate loans in the amount of EUR 0.3 billion.

The natural amortization of the portfolio of loans and securities represented EUR 4.7 billion in 2017, and early reimbursements represented EUR 0.2 billion.

Available cash decreased by EUR 1.3 billion. It is deposited at the Banque de France, invested in bank bonds classified as replacement assets, invested in European public sector bonds or lent to SFIL.

There were no divestments, except for treasury investments, in 2017.

4.2 - OUTSTANDING ASSETS AS OF DECEMBER 31, 2017

Caisse Française de Financement Local's pool of assets is exclusively composed of exposures on public sector entities, or guaranteed by the same, and replacement assets (within the limits specified by current legislation).

EUR billions	12/31/2016	12/31/2017
Loans and bonds to the public sector	53.8	53.2
<i>of which large export credits refinancing⁽¹⁾</i>	-	0.2
<i>of which treasury invested in public sector bonds</i>	0.2	0.7
<i>of which other loans and bonds to the public sector</i>	53.6	52.2
Banque de France cash deposit	3.7	1.7
Replacement assets	0.7	0.9
COVER POOL	58.2	55.8
Financing commitments granted to refinance large export credits ⁽¹⁾⁽²⁾	3.7	3.0
Financing commitments granted to other public sector loans	0.1	0.1
FINANCING COMMITMENTS GRANTED	3.8	3.1

(1) For the record, loans refinancing large export credits concluded with SFIL benefit from an irrevocable and unconditional 100% guarantee granted by the French State (enhanced guarantee).

(2) In 2016, commitments granted represented EUR 3.1 billion of signed firm offers and EUR 0.6 billion of concluded contracts in drawing phase. In 2017, commitments granted represented concluded contracts in drawing phase.

Surplus cash is deposited in an account opened by Caisse Française de Financement Local at the Banque de France or invested in European public sector or bank (replacement assets) securities, respectively amounting to EUR 1.7 billion, EUR 0.7 billion and EUR 0.5 billion as of December 31, 2017. In 2017, Caisse Française de Financement Local also invested some of its surplus cash in loans granted to its parent company SFIL (replacement assets), for a total of EUR 0.4 billion as of December 31, 2017.

The amount of financing commitments given came to EUR 3.1 billion as of December 31, 2017, including EUR 3.0 billion for loans to SFIL signed but not yet drawn, in connection with the refinancing of large export credits. As a reminder, these loans benefit from an irrevocable and unconditional 100% guarantee by the French State.

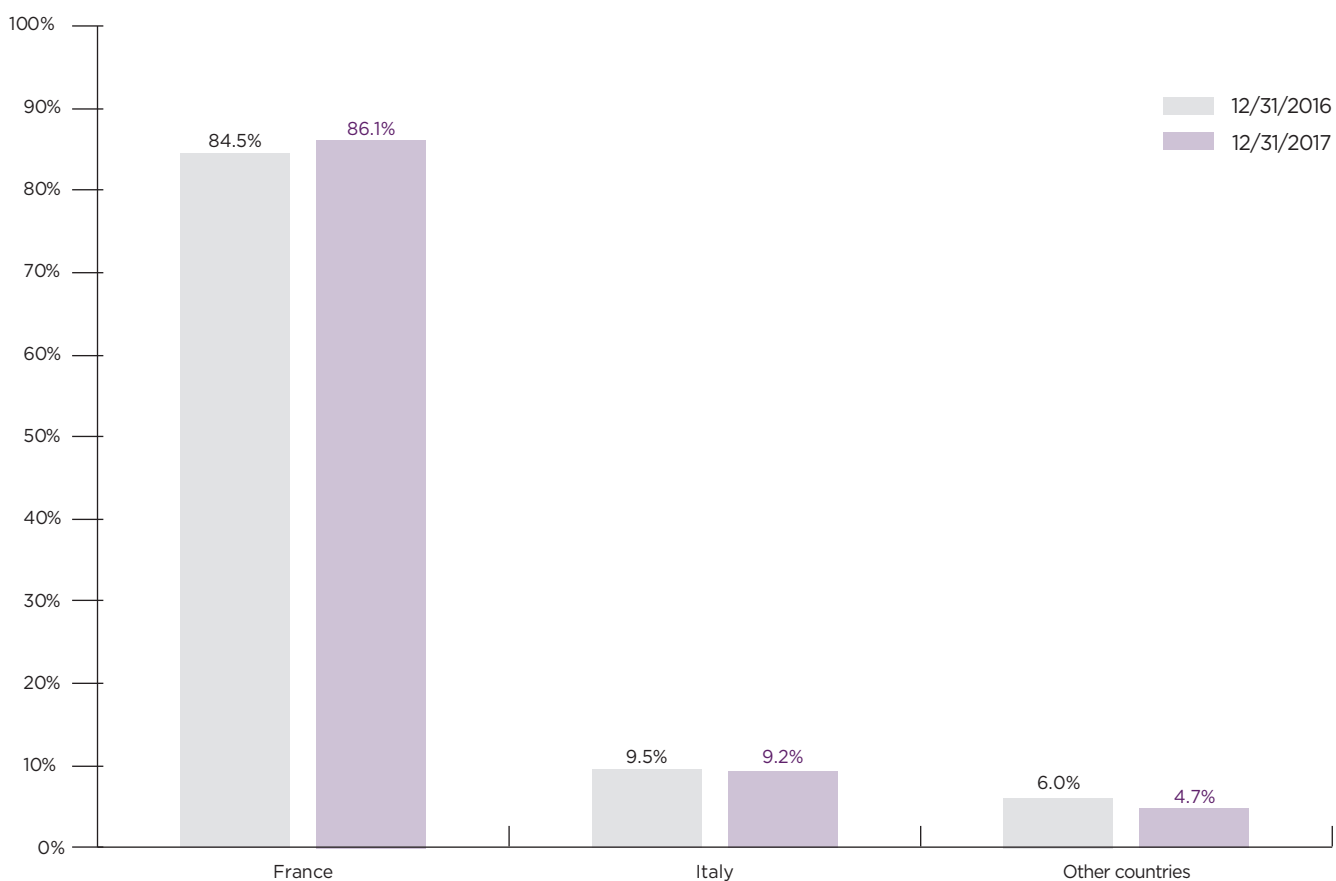
4.2.1. Public sector loans and securities (excluding replacement assets and treasury placed with the Banque de France)

4.2.1.1. Geographic breakdown

At the end of December 2017, French public sector loans made up the majority (86.1%) of the cover pool, a share due to increase in the future. They include loans acquired from La Banque Postale since 2013 for 20% (EUR 10.7 billion) and State-guaranteed loans granted to SFIL to refinance large export credits for less than 1% (EUR 0.2 billion).

The other assets are managed in a run-off mode; they correspond to granular and geographically diversified exposures on foreign public sector entities.

The relative proportion of the total assets can be broken down as follows.

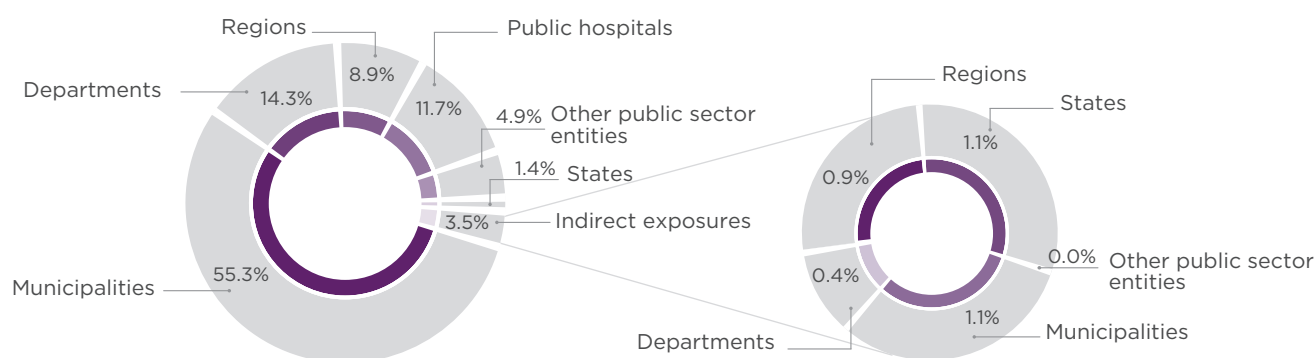


Exposures to Other countries as of December 31, 2017, are broken down by country in the section Bonds and public sector loans, which is presented at the end of this management report.

4.2.1.2. Breakdown by type of counterparty

The portfolio of Caisse Française de Financement Local is made up of the following items:

- for 81%, direct or indirect exposures on municipalities, departments or regions;
- for 12%, exposures on public hospitals;
- for 7%, sovereign exposures or commitments on other public sector entities (including public social housing).



Indirect exposures are composed of exposures guaranteed by public sector entities, most of which are local. Large export credits refinancing exposures are listed in the category of indirect exposures guaranteed by States.

4.2.1.3. Securitizations

There are no securitization units in the cover pool of Caisse Française de Financement Local (since July 2013). Its *obligations foncières* respect the conditions of eligibility for refinancing by the European Central Bank and the new CRR/CRD IV requirements.

4.2.2. Replacement assets

Assets considered by law as replacement assets correspond to exposures on credit institutions benefiting from at least a Step 1 rating, or a Step 2 rating when their remaining maturity does not exceed 100 days, and their total amount is limited to 15% of *obligations foncières* and registered covered bonds.

As of December 31, 2017, replacement assets represented 1.8% of *obligations foncières* and registered covered bonds. The Caisse Française de Financement Local's cash surplus can be invested in banking sector securities (in addition to deposits at the Banque de France and investments in European public sector securities) or lent to SFIL. In this case, bank exposures are classified as replacement assets, broken down below based on the rating of the issuers. In addition, Caisse Française de Financement Local granted two loans to SFIL to invest its surplus cash. These loans are also included in the replacement assets.

Replacement assets EUR millions	Country	12/31/2016	12/31/2017
Step 1 credit rating			
Covered bonds			
	France	26	176
	Other countries ⁽¹⁾	-	127
Other bank bonds			
	France	120	148
	Other countries ⁽¹⁾	-	100
Loans to parent company, SFIL	France	-	360
Step 2 credit rating			
Bank bonds (maturity < 100 days)			
	France	500	-
	Other countries ⁽¹⁾	-	-
Bank accounts balances	France and Other countries ⁽¹⁾	4	10
TOTAL		650	921

(1) Corresponds to other countries of the European Union and the European Economic Area, except for bank accounts, which can be held in non-European countries

4.2.3. Assets removed from the cover pool

Because of its status as a credit institution, Caisse Française de Financement Local has access to refinancing operations offered to banks by the Banque de France within the Eurosystem. In steering its cover pool and its over-collateralization or in order to meet the need for temporary liquidity, Caisse Française de Financement Local may thus convert a portion of its assets into cash. The loans or securities assigned in guarantee with the central bank in order to obtain financing on the occasion of tenders organized by the Banque de France are then taken out of the cover pool and replaced by the cash thus obtained.

The same treatment would be applied to the assets in the cover pool if they were mobilized in interbank repurchase agreements in the event of a need for liquidity.

During the last three fiscal years, in the context of the regular tests of its operational procedures for accessing refinancing from the Banque de France or bank counterparties, Caisse Française de Financement Local has mobilized assets of very small unit amounts.

4.2.4. Structured loans

4.2.4.1. Definition

Certain loans to French public sector entities in the cover pool of Caisse Française de Financement Local may be qualified as structured loans. To define this notion, Caisse Française de Financement Local refers to the charter of good practices signed by banks and local governments (the Gissler charter), which can be consulted on the Internet site of the French Ministry of the Interior⁽¹⁾. This document was signed on December 7, 2009, by several organizations that represent local governments in France (Association des maires de France, Fédération des maires des villes moyennes, Association des petites villes de France, Association des maires de grandes villes de France and Assemblée des communautés de France) as well as certain banks.

Therefore, structured loans are defined as:

- all the loans with structures belonging to Gissler charter categories B to E;
- all the loans “outside the charter”, the commercialization of which is excluded by the charter, either because of their structure (leverage > 5, etc.), their underlying index(es) (foreign exchange, etc.), or their currency (loans denominated in CHF, JPY, etc.);

The most structured loans according to the Gissler classification (categories 3E, 4E and 5E as well as loans which the charter does not allow to be marketed) may be qualified as “sensitive”. They are closely monitored and specific measures are taken to reduce their sensitivity. They benefit from support from funds set up by the French government in order to allow customers to convert sensitive loans into fixed rate vanilla loans.

4.2.4.2. Part of structured loans in the cover pool

EUR billions	Outstanding				Number of customers ⁽¹⁾		
	12/31/2016	12/31/2017	Change	% cover pool	12/31/2016	12/31/2017	Change
French public sector loans	44.8	45.0	0.2	80.7%	16,335	15,366	(969)
Vanilla loans	38.4	39.6	1.2	71.0%	14,578	13,720	(858)
Structured loans	6.4	5.4	(1.0)	9.7%	1,757	1,646	(111)
Sensitive loans not in the charter	0.7	0.6	(0.1)	1.1%	85	64	(21)
Sensitive loans (3E/4E/5E)	1.0	0.8	(0.2)	1.4%	189	162	(27)
Subtotal sensitive loans:	1.7	1.4	(0.3)	2.5%	274	226	(48)
Structured loans benefiting from the derogatory mechanism of the support fund	0.7	0.5	(0.2)	0.8%	83	71	(12)
Other structured loans	4.0	3.5	(0.5)	6.3%	1,400	1,349	(51)

(1) considering the customer in the category with its most highly structured loan

In 2017, outstanding loans to the French public sector have increased by EUR 0.2 billion, with a EUR 1.2 billion increase in non-structured loans (vanilla) and a decrease of EUR 1.0 billion in structured loans (see the definition above).

At the end of 2017, structured loans on the balance sheet of Caisse Française de Financement Local represented EUR 5.4 billion.

4.2.4.3. Sensitive loans

Sensitive loans, which are the most structured, totaled EUR 1.4 billion as of December 31, 2017, compared with EUR 1.7 billion as of December 31, 2016.

Of these loans, those considered to be the most sensitive (outside the charter) represented EUR 0.6 billion, or 1.1% of the cover pool and 64 customers on December 31, 2017. In particular, this portfolio included loans indexed on the EUR/CHF exchange rate. This portfolio concerns the following customer categories.

Sensitive loans not in the charter EUR billions	12/31/2016		12/31/2017	
	Amounts	Number of customers	Amounts	Number of customers
Municipalities with fewer than 10,000 inhabitants	0.0	6	0.0	5
Municipalities with more than 10,000 inhabitants and groups of municipalities	0.3	50	0.2	34
Regions and departments	0.1	9	0.2	9
Public hospitals	0.3	17	0.2	14
Other customers	0.0	3	0.0	2
TOTAL	0.7	85	0.6	64

(1) http://www.interieur.gouv.fr/content/download/3021/30417/file/Charte_de_bonne_conduite_entre_les_etablissements_bancaires_et_les_collectivites_territoriales.pdf

The 64 customers are mostly municipalities with a population of more than 10,000 inhabitants and groups of municipalities, and to a lesser extent, public hospitals. There are five municipalities with a population less than 10,000 inhabitants with a sensitive loan “not in the charter” and the outstanding loans concerned by these municipalities total almost zero. At the end of 2017, more than 93% of the borrowers with loans indexed on EUR/CHF saw loan sensitivity disappear completely, and of this number, 96% were small local governments and hospitals.

4.2.4.4. Reduction in loan sensitivity

Proactive sensitivity reduction measures, the use of support funds and, to a lesser extent, the maturing of certain loans made it possible to reduce the number of sensitive customers by 653 between SFIL’s launch and December 31, 2017. The number of customers holding sensitive loans decreased from 879 to 226, and the outstanding sensitive loans dropped from EUR 8.5 billion to EUR 1.4 billion (2.5% of the cover pool), i.e. a decrease of more than 83%.

This decrease includes EUR 0.5 billion that represents outstanding loans for which the customers chose to maintain their sensitive loan temporarily, while having the option of receiving aid from the local government support fund if the structured component of their loan becomes activated (system for helping pay interest at a degraded rate provided for by the support fund doctrine). The loans concerned by this option mainly correspond to loans with an interest rate based on leverage and which are, at this time, most often at fixed rates because the structured component is not or has never been activated.

Based on transactions already entered into, total sensitive structured loans will be reduced to EUR 1.2 billion by the end of 2018, of which a maximum of EUR 0.6 billion relating solely to local government entities. On the same basis, by end-2018, sensitive loans with an activated structured component and a rate exceeding 5% will amount to less than EUR 0.2 billion and will concern 34 customers, i.e. 0.4% of the cover pool and 0.2% of customers in the French local public sector.

5. Debt benefiting from the legal privilege

As of December 31, 2017, debt benefiting from the legal privilege is composed of *obligations foncières* and registered covered bonds issued by Caisse Française de Financement Local as well as of cash collateral received from counterparties in derivative transactions.

EUR billions	12/31/2016	12/31/2017
Cash collateral received	1.3	0.7
<i>Obligations foncières</i> and registered covered bonds	50.4	49.0
TOTAL	51.7	49.7

5.1 - CHANGE IN CASH COLLATERAL

Cash collateral received by Caisse Française de Financement Local decreased compared with the situation at the end of December 2016. Its level stood at EUR 0.7 billion at the end of December 2017.

5.2 - CHANGE IN ISSUES

Within the recurrent annual program of EUR 5 billion to EUR 7 billion, the issuance policy of Caisse Française de Financement Local primarily aimed to construct a coherent yield curve in the euro market while keeping an eye on the good performance of its benchmarks in the secondary market. The diversification of its sources of financing is necessary to achieve long maturities coherent with its needs. This implies an active presence in the market of private placements within the framework of the EMTN program or the issue of registered covered bonds.

5.2.1. New issues in 2017

In 2017, Caisse Française de Financement Local achieved a volume of issues of EUR 6.0 billion by enhancing its reference curve with four new points, by increasing the amount of existing *souches* (taps) and by continuing to work in the private placement segment.

Caisse Française de Financement Local raised money in the primary market on three occasions for a total amount of EUR 4.0 billion:

- a 10-year issue in January for EUR 1.5 billion;
- a dual tranche issue (7 and 15 years) in May for a total amount of EUR 1.75 billion;
- a 10-year issue in September for EUR 0.75 billion.

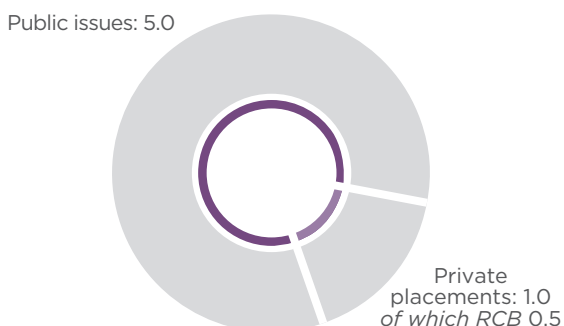
At the same time, Caisse Française de Financement Local provided additional liquidity for several of its reference issues via six taps in 2017 for a cumulated amount of EUR 1.0 billion.

In addition to these public transactions, Caisse Française de Financement Local remained active in the private placement segment and especially with the registered covered bond (RCB) format, thus making it possible to respond to investors’ search for long and very long maturities. A total of EUR 1.0 billion was raised in this market segment, of which more than 60% on maturities of 20 years or more.

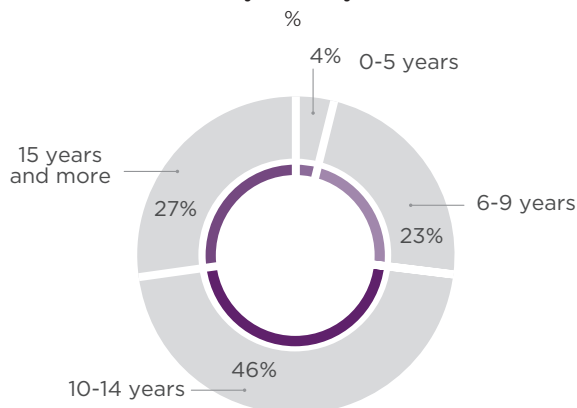
The weighted average life of 11.3 years for 2017 issues made for an excellent match between assets and liabilities.

The breakdown of new issues by public/private format and maturity is presented below, as well as the breakdown of public issues by investor category and geographic zone.

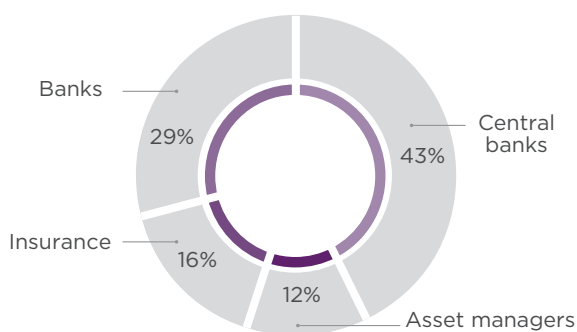
Breakdown of 2017 issues by format
EUR billions



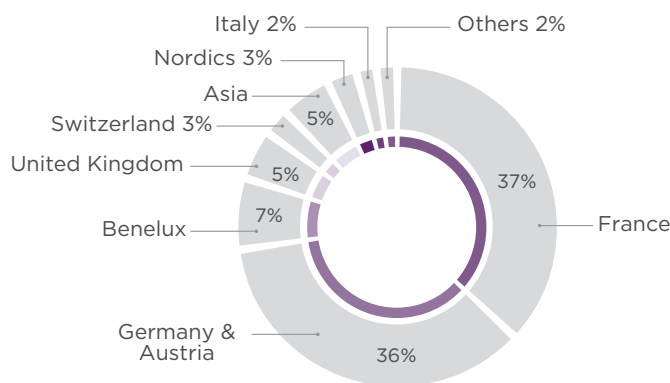
Breakdown of 2017 issues by maturity
%



Breakdown of 2017 public issues by investor category
%



Breakdown of 2017 public issues by geographic zone
%



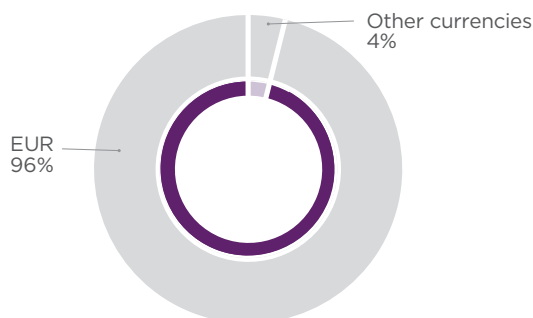
5.2.2. Outstanding debt as of December 2017

Outstanding *obligations foncières* and registered covered bonds totaled EUR 49.0 billion in swapped value at the end of December 2017. This includes new issues of *obligations foncières* for EUR 6.0 billion and amortization of issues maturing in 2017 for EUR 7.2 billion.

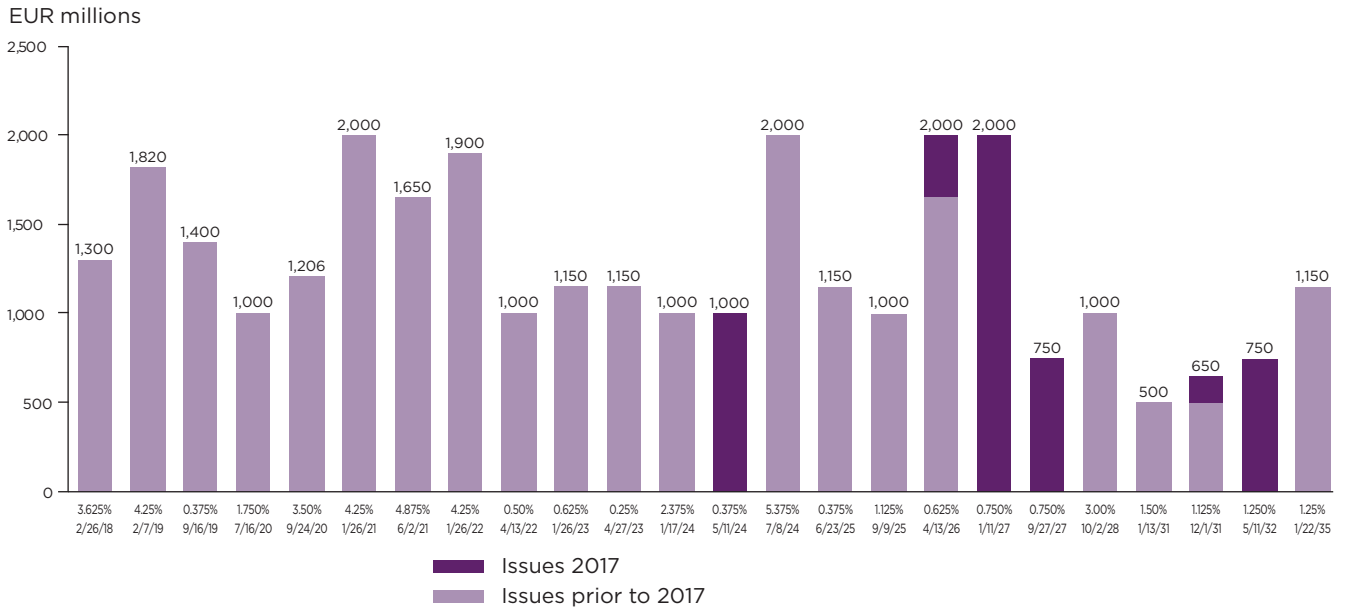
Limited buybacks of *obligations foncières* were performed over the year in order to smooth out the amortization profile of Caisse Française de Financement Local's privileged debts.

EUR billions value after currency swap	2016	2017
BEGINNING OF THE YEAR	51.6	50.4
Issues	5.9	6.0
Amortizations	(7.0)	(7.2)
Buyback	(0.1)	(0.2)
END OF THE YEAR	50.4	49.0

As of December 31, 2017, issues can be broken down by currency as follows:

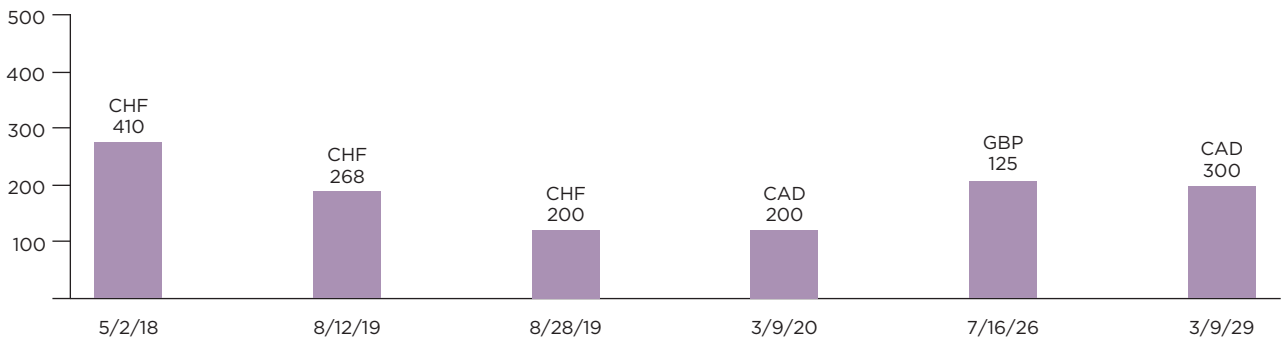


Breakdown of benchmark tranches in EUR



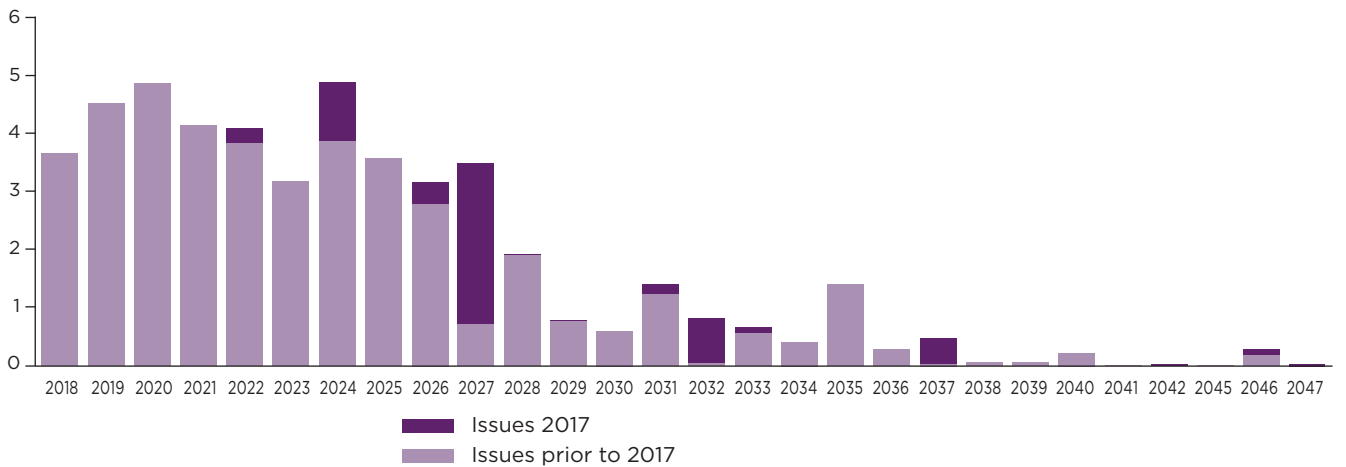
Main tranches in other currencies

value in EUR millions (swapped value)



Amortization of obligations foncières and registered covered bonds

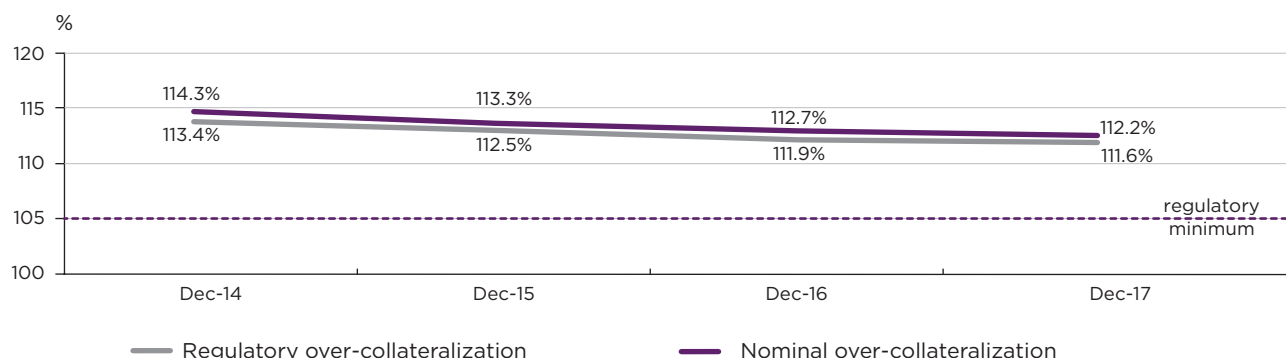
En EUR billions



6. Changes in the over-collateralization ratio

The over-collateralization ratio, which is calculated on the basis of regulatory standards governing *sociétés de crédit foncier*, is the ratio between the assets and the resources benefiting from the legal privilege. The legal minimum threshold is set at 105% and corresponds to the minimum level that Caisse Française de Financement Local had committed to maintain since its creation.

In practice, the over-collateralization ratio is regularly higher than 105%. To maintain an adequate level of credit rating, a level of over-collateralization of more than 5% may be required. This requirement depends on the method applied by each of the rating agencies and on the new assets and liabilities on Caisse Française de Financement Local's balance sheet and it may vary over time. Caisse Française de Financement Local takes these particular requirements into account in the management of its activity in order to make sure they are constantly met and strives to maintain its over-collateralization at a relatively stable level, as can be seen in the following graph.

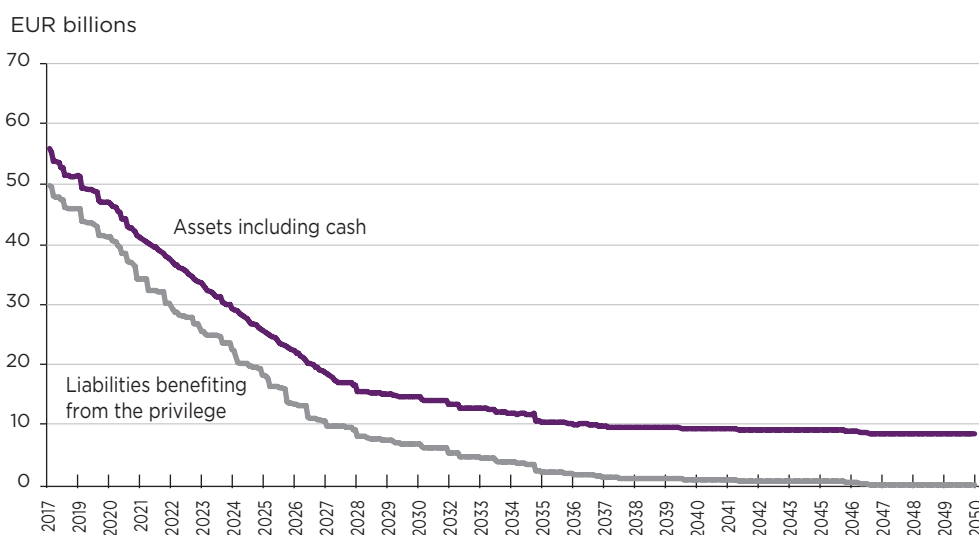


Regulatory over-collateralization may differ from nominal over-collateralization. In fact, it is calculated on the basis of the rules determined by the Autorité de contrôle prudentiel et de résolution (ACPR). In particular, these rules require different weighting levels according to the assets. The assets in Caisse Française de Financement Local's cover pool are weighted at 100%. The small difference between the two ratios can be explained by the accrued interest not yet due taken into account in the regulatory over-collateralization ratio.

Any assets that Caisse Française de Financement Local may have assigned in guarantee to borrow funds from the Banque de France or any other banking institution would be excluded from the calculation of over-collateralization.

Over - collateralization may also be illustrated by the gap between the amortization curves of the assets and liabilities benefiting from the privilege. The following graph presents the curves as of December 31, 2017.

Amortization of assets and liabilities as of December 31, 2017



In this graph, the assumption is made that excess cash generated over time is included in the cover pool.

7. Change in debt that does not benefit from the legal privilege

The asset surplus (assets exceeding *obligations foncières* and registered covered bonds) and miscellaneous needs are financed by equity and debt that does not benefit from the privilege of the law on *sociétés de crédit foncier*.

Such financing is obtained through the parent company. At the end of December 2017, the funds borrowed from SFIL within the framework of the financing agreement were made up of different loans with maturities that could initially run from one day to ten years with an Euribor or Eonia index.

Temporary financing may also be obtained from the Banque de France. These funds do not benefit from the privilege stipulated in the law on *sociétés de crédit foncier*, but they are guaranteed by loans and securities assigned for this purpose in the account of Caisse Française de Financement Local at Banque de France. Since the creation of SFIL, except when it used

small sums to test the access procedure for such funding, Caisse Française de Financement Local has not contracted any loans from the Banque de France or from credit institutions other than its parent company.

The change in financing that does not benefit from the legal privilege, excluding accrued interest not yet due, can be presented as follows.

EUR billions	12/31/2016	12/31/2017
SFIL	5.2	4.8
Banque de France	-	-
TOTAL	5.2	4.8

8. Internal Control and Preparation of accounting and financial information

8.1 - GENERAL DESCRIPTION OF THE INTERNAL CONTROL PROCEDURES

8.1.1. Responsibilities of internal control and the general architecture of internal control

SFIL, with its subsidiary Caisse Française de Financement Local, is one of the large banks that has been under the direct supervision of the European Central Bank (ECB) since November 2014 in the framework of the Single Supervisory Mechanism (SSM). In addition, as a *société de crédit foncier*, Caisse Française de Financement Local is subject to special and additional oversight by the Autorité de contrôle prudentiel et de résolution (ACPR).

Since it manages Caisse Française de Financement Local, SFIL has been delegated to exercise the functions of internal control for Caisse Française de Financement Local pursuant to its management agreement. Consequently, internal control at SFIL also meets the regulatory obligations of Caisse Française de Financement Local in this regard.

The objectives and organization of SFIL's internal control are defined within the framework set by the Monetary and Financial Code, and by the *arrêté* of November 3, 2014. According to these articles, the internal control system requires that different control procedures are applied to provide:

- a control system for operations and internal procedures;
- an organization of financial and accounting data;
- systems to measure risks and results;
- systems to monitor and control risks;
- a system for documentation and information;
- surveillance of flows of cash and securities.

This internal control system is a process put into practice by Executive Management and all the employees of SFIL, at the initiative of its Board of Directors. The organization is designed to provide reasonable but not absolute assurance with regard to the achievement of the objectives that SFIL set in terms of performance, profitability and protection of its financial assets.

Specifically, the objectives assigned to internal control in effect at SFIL on behalf of Caisse Française de Financement Local aim to:

- verify the efficiency of risk control procedures. It aims to guarantee that the risks taken by the Company are in line with the policy defined by the Supervisory Board and the Executive Board and do not exceed an agreed-upon level of risk;
- ensure that the financial and accounting data produced is reliable and relevant. The main objective of the financial information is to give a true and fair view of the position of Caisse Française de Financement Local in a regular, complete and transparent manner;
- monitor compliance with internal and external rules and practices of business ethics. The diligent operation of Caisse Française de Financement Local implies strict respect of legislative and regulatory obligations, in particular with regard to corporate governance and compliance;
- monitor the effectiveness and operational efficiency of processes, in order to ensure that operations are carried out properly while guaranteeing efficient management of available resources.

In order to allow the accomplishment of the objectives set, and in compliance with the *arrêté* of November 3, 2014, the general architecture of the internal control system of SFIL is based on three levels of control:

- the first control level takes place in the operating teams;
- the second level corresponds to the permanent control activities carried out under the responsibility of the Operational Risks and Permanent Control division or, for non-compliance risks, the Compliance division (in the four compliance areas: organization of compliance, ethics and markets integrity, protection of customer interests and financial security);
- the third control level concerns periodic control conducted by an independent team, the Internal Audit and Inspection division, which reports to the Chief Executive Officer of SFIL and which exercises periodic oversight of the efficient and effective application of the two above-mentioned levels of control.

The different functions in charge of internal control (Operational Risks and Permanent Control division, Compliance division and Internal Audit and Inspection division) meet every quarter in an Internal Control Committee in order to share information about the risks each division has identified in its field of competence, to coordinate internal control initiatives so as to remedy risk situations and analyze the conclusions in their respective control plans.

If they deem it necessary, the heads of internal control functions report to SFIL's Chief Executive Officer and its Board of Directors. They report regularly to the appropriate board committee, the Risks and Internal Control Committee. They may be heard by this committee at their request and can report directly to the Board of Directors if they believe that a potentially significant event should be brought to its attention. These managers may not be terminated without the approval of the Board of Directors. If these missions or events concern Caisse Française de Financement Local, these managers report to the Executive Board and, if necessary, to the Supervisory Board.

These different levels of control are deployed under the aegis of the supervisory and management bodies of SFIL and Caisse Française de Financement Local.

8.1.2. Executive Board of Caisse Française de Financement Local

The Executive Board of Caisse Française de Financement Local is the front-ranking guarantor of the efficient operation of the Company's internal control procedures. In light of the structure of Caisse Française de Financement Local and of the management agreement which binds it to its parent company, the Executive Board relies on the governance and organization of internal control in effect at SFIL.

- The Risks and Internal Control Committee, which is composed of the members of the Board of Directors of SFIL, is responsible, in keeping with the Code of Commerce and the *arrêté* of November 3, 2014, for ensuring the efficiency of internal control and risk management systems, giving an appreciation of the quality of internal control, in particular the coherence of measurement, surveillance and risk control systems, and suggesting, if need be, any additional action. This committee is also responsible for monitoring permanent control, compliance and periodic control at SFIL. It likewise examines, with the Company's auditors, any risks weighting on their independence.
- SFIL's Chief Executive Officer and its Deputy Chief Executive Officer are considered as accountable officers by banking regulators. They guarantee the efficient operation of the bank's internal control system. They allocate the resources required to carry out the missions of the different divisions in charge of control, verify that the objectives are attained and that the internal control system is adapted to the needs of SFIL and Caisse Française de Financement Local. To this end, they regularly receive activity reports and the results of the controls carried out in terms of permanent control, compliance and periodic control. These reports are also presented and discussed at meetings of SFIL's Executive Committee, and the issues raised engender action and decisions in order to ensure continuous improvement in internal control.

8.1.3. First level of control: operating divisions

As the first level of the internal control system, employees and managers of SFIL's operating divisions are in charge of analyzing the risks involved in all the transactions they have initiated, organizing and conducting first-level controls for such operations, verifying that internal control procedures in their division are adapted to such risks and contributing to their development. To this end, they rely on the policies, procedures, systems, limits and indicators with a clear separation between the launch of operations and their validation, control or settlement. These policies, procedures, systems, limits and indicators are defined by several specialized committees. They are composed of operating, support, and control staff, and chaired by a member of the Executive Committee of SFIL.

8.1.4. Second level of control: first pillar - permanent control excluding compliance

Permanent control excluding compliance ensures the reliability of the system of risk control, the efficiency of the control of operations and internal procedures, the quality of accounting and financial information and of IT systems.

8.1.4.1. Organization and governance

The permanent control system (excluding compliance) applies to all divisions and activities. It is operated by the Operational Risks and Permanent Control division, part of the Risks division, in such a way as to maintain synergies with the operational risk management, IT security and business continuity systems. The system relies on both the Operational Risks and Permanent Control division, which performs certain second-level controls, and a network of operating division correspondents tasked with performing and monitoring certain controls and reporting thereon to the Operational Risks and Permanent Control division.

8.1.4.2. Activities

The management principles governing permanent control, excluding compliance, are described in the management policy for operational risks and permanent control. Permanent control is based on a control plan which is prepared in collaboration with the operating divisions and covers the range of SFIL's activities. It is reviewed every year. The objective of this review is to adapt the controls to the situation at SFIL by taking into account:

- the results of controls carried out during the year (their match with the risks to be covered, their efficiency, their formalization and the pertinence of related measurement indicators);
- the review of incidents noted;
- the recommendations of the internal audit division, the statutory auditors and the regulator;
- new products and processes at SFIL.

Thus, efforts to ensure continuous improvement make it possible to develop the control plan by adapting existing controls, while adding new ones and removing controls which are redundant or no longer relevant.

The Operational Risks and Permanent Control division and its correspondents conduct or evaluate controls within their scope at a pre-determined frequency based on the criticality of the underlying risks (usually quarterly but in some cases semi-annu-

ally or annually). This evaluation is documented by a commentary and supporting documentation. The results of the controls, conducted or evaluated by correspondants, are reviewed by the Operational Risks and Permanent Control division, which may validate or refuse them, particularly in the latter case if the documentation is deemed insufficient. In the event the control results are unsatisfactory, action plans are systematically put in place to obtain a satisfactory result for subsequent periods. These action plans are regularly monitored and a quarterly report is submitted to the Operational Risks and Permanent Control Committee.

At the end of 2017, 133 permanent controls were in place.

8.1.4.3. Reporting

The accountable officers, the members of the Executive Committee and of the Board of Directors are kept regularly informed of permanent control activities through the Risk and Internal Control Committee. The same is true for the Executive and Supervisory Boards of Caisse Française de Financement Local.

The Operational Risks and Permanent Control division publishes a quarterly report presented to the Operational Risks and Permanent Control Committee. This Committee is chaired by the Deputy Chief Executive Officer of SFIL and is made up of all the members of SFIL's Executive Committee. The Chairman of the Executive Board of Caisse Française de Financement Local also takes part. The Committee meets quarterly to review the permanent control system: results of control evaluations, monitoring of action plans, review of control frequencies, additions, deletions or changes of controls. It also looks at the main issues linked to permanent control and at areas of anticipated improvements. The main points which are recognized are presented to the Risk and Internal Control Committee by the head of the Risks division as part of the Quarterly Risk Review.

The Risks and Internal Control Committee meeting of January 25, 2018 and the Executive Board meeting of February 13, 2018 were informed of the control results, focus points, corrective actions to be implemented and permanent control improvements achieved in 2017.

8.1.5. Second level of control: second pillar - compliance control

8.1.5.1. Organization and governance

The Compliance division is responsible for managing compliance risk, as defined in article 10 of the *arrêté* of November 3, 2014, for all of SFIL's and Caisse Française de Financement Local's activities. The aim of compliance risk management is to ensure compliance with:

- laws, regulations, professional conduct rules and directives;
- measures to protect the reputation of the Group, its investors and its customers;
- ethical rules relating to business practices, and measures to prevent conflicts of interest, protect customers' interests and maintain markets integrity;
- anti-money laundering, corruption and financing of terrorism measures, and financial embargoes.

Pursuant to article 29 of the *arrêté*, SFIL's Compliance division is autonomous, independent of all operational units and particularly of any commercial activity. It reports to SFIL's General Secretary, Chief Compliance Officer, Executive Committee member and SFIL's and Caisse Française de Financement Local's designated compliance control manager for relations with the ACPR. Reporting directly to SFIL's Chief Executive Officer, the General Secretary has direct and independent access to the company's Risks and Internal Control Committee and Board of Directors. The General Secretary also acts as the TRAC-FIN correspondent in connection with the bank's anti-money laundering and financing of terrorism obligations.

8.1.5.2. Compliance control activities

To ensure that the system for managing SFIL's and Caisse Française de Financement Local's non-compliance risks is effective, the Compliance division implements a control plan aimed at containing and, if possible, eliminating non-compliance risks.

This control plan is based on the non-compliance risk mapping and is updated at least annually to take into account changes in SFIL's and Caisse Française de Financement Local's internal and external environments.

The Compliance division implements and documents compliance controls in accordance with the control plan. Specific action plans sent to the divisions responsible for implementing remediation actions are systematically implemented in the event of malfunctions identified by the controls. The Compliance division monitors these action plans and their overall progress.

The Compliance division updates the non-compliance risk mapping and the resulting control plan as necessary to take into account changes in SFIL's activity and those arising from the entry into force of new regulations. The methodology for rating «gross» and «net» non-compliance risks is identical to the internal audit methodology. The updated non-compliance risk mapping and control plan are submitted every January for approval by the Risks and Internal Control Committee. The 2018 non-compliance risk mapping and control plan were presented to and approved by the Risks and Internal Control Committee on January 25, 2018. Caisse Française de Financement Local's Executive Board was also informed of the non-compliance risk mapping and control plan update on February 13, 2018.

Lastly, the Compliance division uses various internal tools to report shortcomings, breaches and malfunctions: a network of compliance correspondents, a professional and ethical alert procedure and an incident reporting system.

8.1.5.3. Reporting

SFIL's and Caisse Française de Financement Local's accountable officers, the members of SFIL's Executive Committee and Board of Directors and of Caisse Française de Financement Local's Supervisory Board are regularly kept up to date with the

compliance system. The Compliance division submits a semi-annual report to the Executive Committee, Caisse Française de Financement Local's Executive Board and the Risks and Internal Control Committee presenting the results of its activities and controls, including compliance control results, action plan monitoring, and the compliance risk mapping and annual control plan. The Executive Committee issues an opinion on the compliance system's main issues and broad areas for improvement.

Lastly, every year the Compliance division makes a presentation and submits an annual activity report to a special Risks and Internal Control Committee meeting excluding general management, to which the risk, compliance and periodic control officers contribute. In respect of the 2017 fiscal year, this presentation was made at the Risks and Internal Control Committee meeting of January 25, 2018, and the Executive Board was informed of the compliance control results and improvements achieved in 2017 at its meeting of February 13, 2018.

8.1.6. Third level of control: periodic control

The periodic control of Caisse Française de Financement Local, which is ensured by SFIL, involves internal audit and inspection.

8.1.6.1. Organization and governance

Periodic control, in the sense of the *arrêté* of November 3, 2014, is exercised by the Internal Audit⁽¹⁾ and Inspection⁽²⁾ division which is under the responsibility of the General Auditor. The scope of this function covers all the activities, operating processes and systems of the SFIL Group with no reserve or exception, including externalized essential activities and anti-fraud techniques. The independence and efficiency of the internal audit and inspection function are guaranteed by several factors:

- the General Auditor's direct reporting to SFIL's Chief Executive Officer;
- the absence of involvement in the operating management of SFIL's activities;
- unconditional, immediate access to all information, documents, premises, systems or persons its activities require;
- the resources made available by Executive Management to carry out these missions;
- the respect of the principles of integrity, objectivity, confidentiality and competence (through a permanent training plan to inculcate audit techniques and regulatory developments) on the part of the staff of the internal audit division.

These principles are reflected in the internal audit charter and the inspection charter, approved by the SFIL Risks and Internal Control Committee meeting of January 26, 2017, and distributed to all SFIL employees to remind them of the rights and duties of the auditors and the auditees.

More specifically, the General Auditor of SFIL exercises a particular function concerning Caisse Française de Financement Local, as spelled out in article 5.8 of the management agreement between Caisse Française de Financement Local and SFIL. SFIL's Internal Audit division audits all of the transactions and procedures of Caisse Française de Financement Local. It also provides periodic control in Caisse Française de Financement Local's internal control.

It ensures that all the risks incurred by Caisse Française de Financement Local are covered by:

- the identification of these risks and the periodic evaluation of the internal control environment;
- the planning and accomplishment of internal audit missions;
- the coordination of regulatory authorities' audits;
- the follow-up on recommendations;
- investigations (preventive measures, awareness and detection of fraud).

The General Auditor has direct access to the Chairman of the Supervisory Board of Caisse Française de Financement Local.

As of January 1, 2018, the Internal Audit and Inspection division counted nine positions (plus two alternates), including six auditors and audit managers. The General Auditor supervises all audit activities and reports issued by the department. The General Auditor is assisted by a Supervisor, who is in charge of the team of auditors and oversees the audit missions carried out by the auditors under the responsibility of the audit managers. In addition, every auditor and audit manager is responsible for a specific field through permanent documentation, risk oversight, and the monitoring of recommendations for implementation by SFIL's operating divisions.

8.1.6.2. Activities

Activities in this area are described in an internal audit brochure that is regularly updated and based on the reference framework of the professional internal audit practices of IFACI (Institut Français de l'Audit et du Contrôle Interne). The last update of this manual dates from June 2017. In order to monitor the efficiency and performance of these activities and to identify opportunities for improvement, quantitative and qualitative indicators were introduced and are regularly measured.

Internal Audit and Inspection has adopted a top-down approach for the annual evaluation of risks, in line with the recommendations of the Institute of Internal Auditors. It is based on the identification of SFIL's objectives, then on a study of risks that are critical to the success of such goals.

In 2017, an annual assessment of risks was carried out in the second half and it gave rise to an update of the mapping of the major risks of SFIL and Caisse Française de Financement Local. This map was compared to the similar information culled in 2016. Based on this mapping, Internal Audit and Inspection prepared its 2018 map and multi-year audit and inspection plan.

(1) Internal audit is an independent and objective activity which assures SFIL of the degree of control of its operations, contributes advice on how to improve, and creates value added. It helps the organization to reach its objectives by applying a systematic and methodical approach to evaluate its risk management, control and governance processes and by making proposals to reinforce their efficiency.

(2) In the SFIL Group, inspection activities work in an independent and objective manner to enhance control of the risk of fraud.

This plan was approved by the Risks and Internal Control Committee on January 25, 2018, and by the Executive Board on February 13, 2018. The Supervisory Board is also informed on a yearly basis.

SFIL's multi-year audit plan, which is reviewed every year, is broken down into audit missions that are conducted throughout the year on the basis of a pre-established schedule and budget, depending on audit resources. These different missions include four main stages (preparation, accomplishment, conclusion and finalization). The audit methodology, which is based on IFACI methodology, was reviewed in terms of operating efficiency and in particular to focus on the significant risks identified within the audited scope. Audit missions are carried out using the methods described in a Company brochure on internal audits that is regularly updated and based on the reference framework of the professional internal audit practices of IFACI. The latest update of this manual was in June 2017.

In 2017, internal audit assignments focused on themes related to the SFIL Group's core business (management of French local public sector debt), key operational processes (corporate governance, cash management, financing provided by SFIL's shareholders) or support processes (training management, logistics and security processes), risk monitoring and internal models (recovery plan, managing derivatives-related operational risk), the information system (management of local applications) and outsourced services. The 2017 audit plan was 83% completed, exceeding the initial objective of 80%. The findings of each of these assignments and the associated recommendations were presented to the Risks and Internal Control Committee on September 5, 2017, and January 25, 2018, as well as to the Executive Board of Caisse Française de Financement Local on August 31, 2017, and on February 13, 2018.

The follow-up on recommendations made after the missions organized by Internal Audit and Inspection, oversight bodies or the Company auditors, as is the case, is carried out in a continuous and automated process to monitor the deployment of action plans resulting from these recommendations. Responsibility for the appropriate implementation of the recommendations is incumbent on identified managers. The follow-up of this implementation is under the responsibility of the auditors and audit managers in function of their field of competence. The validation of the stage of progress or accomplishment of these action plans is the responsibility of the Supervisor and the General Auditor. All of these recommendations prompted continuous monitoring in 2017 and official reports based on the situations as of May 31 and October 31, 2017, as well as presentation to the Executive Committee (in July 2017 and January 2018), the Risks and Internal Control Committee on September 5, 2017, and January 25, 2018, and the Executive Board of Caisse Française de Financement Local on February 13, 2018.

Internal Audit and Inspection is also in charge of the preparation, organization, and follow-up of the missions regulatory authorities carried out at SFIL. It also coordinates the preparation of responses to reports and the monitoring of action plans subsequent to the recommendations made.

In addition, under the aegis of the Chairman of the Financial Statements Committee and the Risks and Internal Control Committee, Internal Audit and Inspection ensured the organization of all the meetings of these committees. It oversees the respect of deadlines in the transmission and communication of information and files required for decision-making. It monitors the annual program of works set out by the Chairman of these committees. It also provides the minutes that are drawn up at each of the meetings in close cooperation with the Chairman of the committee. Lastly, it has responsibility for the safe storage of the minutes. In 2017, Internal Audit and Inspection organized six meetings for the Risks and Internal Control Committee and four for the Financial Statements Committee.

Finally, Internal Audit and Inspection is also in charge of inspection at SFIL. The purpose of this function is to play a role in the prevention, detection and investigation of fraud and to propose corrective measures in the event of dysfunctions. This unit may also respond to particular requests from the Company's legal division to provide information that may serve corporate interests. SFIL's Executive Management may also solicit the function of inspection to carry out missions and address certain specific issues. In 2017, inspection services focused on the rules governing the staff's use of SFIL's resources, access to sensitive computer applications and sensitive directories.

8.1.6.3. Reporting

SFIL's Executive Committee is kept regularly informed of internal audit and inspection activities. In particular, the audit plan is presented every year for information after discussion with SFIL's Executive Management. Every audit mission is discussed (scope, objectives, planning, etc.) for information and commentary before it effectively takes place, and its conclusions are presented for discussion and decision *via* a report which comprises:

- a general assessment regarding the subject of audit;
- an evaluation of residual risks to enable the Executive Committee to validate their match with SFIL's risks profile;
- recommendations to improve the efficiency of processes and internal controls.

A report on the follow-up of the recommendations of internal audit, inspection, oversight bodies and statutory auditors as well as the implementation of related action plans is likewise presented every six months.

The internal audit charter and the charter of inspection activities are submitted for validation to the Risks and Internal Control Committee. The audit and inspection plan is also submitted annually to this committee for validation. This committee is informed every six months of the results of the follow-up recommendations of internal audit, inspection, oversight bodies and statutory auditors and of the progress made in related action plans. Regular reports of activity are also presented for study. In addition, the annual report on internal control at SFIL and Caisse Française de Financement Local (articles 258 and following of the *arrêté* of November 3, 2014) is presented every year for review. A synthesis of these different reports is presented to SFIL's Board of Directors by the Chairman of the Risks and Internal Control Committee and to the Executive Board and the Supervisory Board of Caisse Française de Financement Local.

8.1.7. Specific Controller

The Specific Controller of Caisse Française de Financement Local is a French professionally certified auditor named by the Company's Supervisory Board. The Specific Controller carries out controls pursuant to articles L.513-23 and L.513-24 and articles R.513-15 and R.513-16 of the Monetary and Financial Code as well as CRBF standard 99-10. He is responsible for ensuring that the Company respects its exclusive corporate purpose and prudential standards. He conducts appropriate audits in cooperation with the statutory auditors and is completely independent vis-à-vis the Company's officers. He is also liable for the negative consequences of any error or negligence committed in the exercise of his functions. The Specific Controller has access to all information from management, internal control units and internal audit. In addition, operating services and internal control units have been instructed to provide specified information in order to allow the Specific Controller to monitor the over-collateralization ratio, the nature of assets, interest rate risk management, the gap in the average life of assets and privileged liabilities, coverage of cash needs over 180 days, and the coverage plan of privileged liabilities by the assets. For every Caisse Française de Financement Local issue contract or on the basis of a quarterly issuance program, he affirms compliance with legal and regulatory standards concerning the over-collateralization ratio of the privileged liabilities by the assets, once the issue has been settled. The Specific Controller certifies that the documents the Company sends to the ACPR meet legal and regulatory requirements for *sociétés de crédit foncier*. At the request of the Banque de France, the Specific Controller annually issues a certificate in support of the statement submitted by Caisse Française de Financement Local concerning the composition of the cover pool. He submits an annual report on his activity to the Supervisory Board of Caisse Française de Financement Local, and a copy is addressed to the Autorité de contrôle prudentiel et de résolution (ACPR).

8.2. PREPARATION OF ACCOUNTING AND FINANCIAL INFORMATION

8.2.1. Financial statements

A company's annual financial statements, in addition to all the financial data produced by the Accounting department should give a true and fair view of its assets, financial position and results. For credit institutions, the *arrêté* of November 3, 2014, on internal control highlights in its accounting chapter that the organization adopted should guarantee the existence of procedures called audit tracks. They make it possible to establish a link between accounting data and the original justification, and vice-versa. All these items should make it possible to reconstitute, justify and explain any and all financial items produced for accounting or regulatory purposes. This principle grounds the organization of accounting practices in the SFIL Group and also applies to both SFIL and Caisse Française de Financement Local.

In 2017, attention focused on preparing for changes resulting from the introduction of new accounting standards applicable from 2018, in particular preparing for the implementation of IFRS 9, the expected impacts of which are set out in detail in the notes to the financial statements and in the management report. The accounting teams also contributed significantly to the work carried out on the Group's information system, of which a number of components are being overhauled in 2017 and 2018.

8.2.1.1. Role and organization of Accounting

Accounting data is produced at Caisse Française de Financement Local by the Accounting division of SFIL, within the framework of the management agreement between the two companies. Accounting at SFIL reports to the Chief Financial Officer (CFO), who also oversees the Back-Office and Financial Performance Management divisions, including the oversight of balance sheets, management control and purchasing. Accounting plays a central role in the piloting of SFIL and in financial management, thereby making it possible to benefit from this central viewpoint.

Accounting produces basic accounting data for the financial statements of Caisse Française de Financement Local. It also provides accounting data for La Banque Postale within the framework of the business at hand. It is also responsible for producing the consolidated financial statements of the SFIL Group and, with the Risks division, ensuring all regulatory and prudential standards are respected.

Accounting has a role of analysis and verification of accounting data. It relies on the reconciliation of a set of figures with that of other teams in Finance. This approach is used to analyze the income, but also to confirm the information on the Company's balance sheet, and in particular entries to risk bases used to calculate prudential indicators.

To carry out its mission, Accounting gets all the information required in participating in committees either directly or through the Chief Financial Officer. It participates in the development of IT systems, and relies on a cross-division team within the Strategic IT Project division to improve, secure and ensure long life to its IT system. In particular, this division is in charge of accounting and regulatory tools as well as ALM and management control tools. It has the mission to participate actively in the development and the improvement of the tools used by SFIL's operating divisions. This system makes it possible to ensure continuous improvement in terms of quality, process efficiency and the reliability of financial information.

8.2.1.2. Preparation of the financial statements

In the preparation of the financial statements, the accounting system of Caisse Française de Financement Local is in large measure automatically supplied by upstream management systems that manage transactions with customers and market counterparties as well as operating expenses. When data is entered into one of the management systems, it is automatically recorded in accounting according to a pre-defined plan, and complemented by manual entries for certain types of operations. Caisse Française de Financement Local can record operations in a single accounting system based on a double

set of accounting standards (French GAAP and EU IFRS). The synthesis of this data is thus obtained automatically using parameterized publication tools.

The internal control system in the operating divisions guarantees the completeness and accuracy of accounting entries. The team in charge of accounting standards ensures compliance with standards, validates automated accounting procedures and examines complex or unusual operations. When certain operations can not be completely incorporated into the management tools available, they are processed using specific internal control procedures.

A first level of control is conducted by Accounting teams that are specialized by products, in particular by analyzing accounting/management data reconciliation, bank reconciliation and technical suspense accounts. Monthly comparisons with management data and reconciliations of micro-hedges make it possible to ensure the correct transcription of financial operations. In order to verify the coherence of interest expense and income from one period to another, this data is compared with average outstandings in order to produce average rates that are easier to compare from one period to the next. Finally, these teams also prepare a synthetic memorandum on the work done which points out areas that need attention and improvement for the processes to be used in future financial statements.

Complementary controls are carried out by other teams from Accounting at the monthly, quarterly and annual closings. Through specific reviews, the teams in charge of preparing the financial statements check the quality of the work done by the teams responsible for first-level control. These teams also reconcile the accounting data from Net banking income with management data produced by separate teams. This cross referencing is done at least once a quarter and consistency from one period to the next is verified using analytical controls. The main changes deserve an explanation. These analyses are synthesized in a quarterly report that is submitted to the Chairman of the Executive Board of Caisse Française de Financement Local.

To ensure thorough implementation of its control plan, Accounting has a monitoring tool at its disposal with which it can verify the deployment of key controls and their validation. This information and any comments on discrepancies are subject to review by the head of Accounting with the main team members.

The preparation of the financial statements is carried out by the aggregation of the accounts thus produced according to an automated and standardized process. This function requires parameters administered by a dedicated and independent team. Stability in reporting, which represents a key point in terms of communication, is thereby verified. Notes to the consolidated and financial statements are generally produced based on accounting data that may be enhanced by management information. Qualitative analyses are then carried out through cross-referenced controls of synthetic data in accounting as well as with the contribution of the teams in charge of monitoring the Group's balance sheet. Cross-referenced controls are also conducted between the financial statements and the notes to the financial statements. Throughout this process, reviews and controls are carried out according to the hierarchical delegations that exist.

8.2.1.3. Approval of the financial statements

The financial statements, balance sheet, income statement and notes are subject to particular scrutiny during the preparatory phase and in their final form by a delegated member of Caisse Française de Financement Local's Executive Board. The Executive Board of Caisse Française de Financement Local approves the yearly and half-yearly financial statements at a meeting attended by the two statutory auditors and the accounting department. The principal issues in the period's management report are also examined on this occasion. These annual and half-year financial statements are subject to an audit and a review (respectively) by the statutory auditors.

The annual financial report is prepared by Caisse Française de Financement Local's Executive Board in liaison with units of SFIL, in particular the CAFFIL Coordination division, Accounting, Risks and the General Secretary. The Company's statutory auditors verify the information it contains. This document is presented to Caisse Française de Financement Local's Supervisory Board, and then to the annual shareholders' meeting.

The calling of shareholders' meetings and the right to attend such meetings are described in articles 27 and 28 of the Company's by-laws.

8.2.1.4. Publication of the financial statements of Caisse Française de Financement Local

This accounting and financial information is made public in several ways. In addition to the regulatory publication in the BALO, the half-year and annual financial statements, together with the corresponding management reports, are posted on the Internet site www.caffil.fr and www.caissefrancaisedefinancementlocal.fr. Half-year and annual financial reports are posted on the Autorité des Marchés Financiers (AMF) through the NASDAQ regulatory information wire. Moreover, unaudited activity reports are drawn up to describe the situation as of March 31 and September 30. They are available to the public on the Company's Website.

Some of this information is also available, with differences in presentation, in the report on the quality of the assets that is submitted to regulatory authorities and posted on the Internet site of Caisse Française de Financement Local, in compliance with CRBF instruction 2011-I-07. Other information is also posted on the Website of the Company, as required by the Covered Bond Label.

8.2.1.5. Role of statutory auditors

Both SFIL and Caisse Française de Financement Local are audited by two auditing firms working together.

The statutory auditors review the financial statements only on a yearly and half-yearly basis. They are consulted throughout the process of preparation of the financial statements in order to ensure efficiency and transparency. In due diligence, they analyze accounting procedures and evaluate current internal control systems to determine the nature, period and extent of

their controls of the principal areas of risk. They may make recommendations on internal control procedures and systems that could improve the quality of financial and accounting information produced. They have access to all memoranda and notes produced by staff that is in charge of accounting principles and standards, and they also review the accounting manuals, as well as the analyses conducted by the Accounting teams. They consult internal audit and inspection reports. They verify the consistency of the data in the management report with the accounting information, as well as the conformity of the management report and the financial statements with all the items they have reviewed and audited. Their contribution includes a review of all the agreements that are regulated. They provide an exhaustive and accurate summary of regulated agreements in the special report they submit at the end of their annual mission. They employ due diligence to obtain reasonable assurance that the financial statements are free of any material misstatement.

8.2.2. Management reporting

The financial statements (balance sheet, off-balance sheet, income statement, cash flow statement and notes) that Caisse Française de Financement Local communicates to its shareholder and to the general public are completed by quarterly activity reports.

This management information also includes items related to loans originated by La Banque Postale and acquired by Caisse Française de Financement Local, as well as to the refinancing of large export credits and updates on the reduction of the sensitivity of structured loans. This data is accompanied by forecasts and evaluations of risks, which is directly supplied by the operating divisions or the Risks division before it is incorporated into the annual financial report. Their accuracy is therefore guaranteed by the internal control system of the divisions concerned.

New loans are granted solely in France as concerns LBP's marketing activity, as well as the business of refinancing large export credits and the efforts to reduce the sensitivity of structured loans. A geographic breakdown of borrowers who are French residents and those who are domiciled in another country is presented in the Management Report. This data is prepared by the Financial Performance Management division based on management and accounting data.

Since, at the same time, SFIL manages Caisse Française de Financement Local and acts as servicer for La Banque Postale, analytical accounting of costs has been adopted to ensure proper billing of financial services rendered.

9. Risks management

9.1 - OVERVIEW OF THE RISK MANAGEMENT SYSTEM

Because the Company is an issuer of covered bonds, the risks authorized for Caisse Française de Financement Local are strictly selected and limited. When the Company was created, a distinction was made between risks that are compatible and risks that are not compatible with the legal and regulatory framework of *sociétés de crédit foncier* and with the specific nature of Caisse Française de Financement Local's by-laws and its license granted by the Comité des établissements de crédit et des entreprises d'investissement (CECEI), now merged into the Autorité de contrôle prudentiel et de résolution (ACPR).

The criteria of the rating agencies define restrictions or limits for risks compatible with the Company's activity.

The general approach decided by the Executive Board of Caisse Française de Financement Local and applied in every unit of SFIL in charge of the operations concerned involves monitoring that:

- risks not compatible with the activity of Caisse Française de Financement Local are not taken by the Company or are eliminated from the start;
- risks compatible with the activity are maintained exactly within authorized limits;
- controls are defined by the Risks division and carried out by the front and middle offices of SFIL. The results of the controls are reported to the Executive Board of Caisse Française de Financement Local and any anomalies discovered during such controls are reported to the Supervisory Board. Finally, these results are transmitted to the Specific Controller and the data is made available for his review.

SFIL and Caisse Française de Financement Local have implemented a complete risk management system:

- to identify, monitor, manage and measure risks using specific methods;
- to decide on limits to be implemented;
- to decide on delegations to assign to the front office teams;
- to decide on the amount of provisions that are required;
- to inform the competent committees regarding changes in these risks, proactively warning them that a limit or threshold has been exceeded.

The level of risk that is acceptable for SFIL and Caisse Française de Financement Local is defined by Executive Management and the Risks Committee at SFIL, in line with the risk appetite of the two companies. It is then approved by the SFIL Risks and Internal Control Committee and finally by the SFIL Board of Directors. It is also approved by the Executive and Supervisory Boards of Caisse Française de Financement Local. Within this framework, policies have been defined for the entire scope as well as limits and rules for delegating decisions. The Risk Management division monitors these limits and, where appropriate, proposes measures to Executive Management to ensure compliance therewith.

A Quarterly Risks Review is presented to the Risks and Internal Control Committee every quarter by the head of risks of SFIL. This review provides a synthetic view of the main risks at SFIL and Caisse Française de Financement Local and their development during the quarter (credit risks, market and balance sheet risks, operational risks) as well as changes in regu-

lations over the period. Items concerning Caisse Française de Financement Local are also presented by the Executive Board to the Supervisory Board of Caisse Française de Financement Local.

All operations conducted by Caisse Française de Financement Local are subject to the control by different committees set up by SFIL. This oversight takes into account the particular rules and limits applicable to Caisse Française de Financement Local.

The Risks division relies on several committees, the missions and composition of which have been approved by the Risks and Internal Control Committee of SFIL. These committees may be cross-divisional – Risks Committee, Committee on the Validation of Methods and Models, New Products Committee – or specialized on credit risks, market risks and operational risks.

The Risks Committee defines the risk profile of SFIL and Caisse Française de Financement Local, validates risk control dispositions and ensures their respect. In particular, it is in charge of defining delegations in the granting of credit and approving the risk policies of SFIL concerning all types of risks and the limits defined by the Risks division.

The Market Validation Committee is responsible for validating and implementing the Group's market risk and derivatives valuation models. The Credit Validation and Quality Control Committee is responsible for validating the internal rating systems used to calculate regulatory capital and the IFRS 9 impairment and economic capital models as well as their implementation.

The New Products Committee, chaired by the SFIL's Chief Risks Officer, examines all new products, management processes and transformation of a pre-existing product or process. It makes decisions in this respect. This committee also studies new products intended for financing, refinancing or hedging risks, as well as the development of any existing product or service to the extent that it substantially modifies the risk profile or the internal processes of the Company. It also determines and evaluates the risks of non-compliance connected to the creation or modifications of products or services based on the compliance opinion submitted to it.

9.2 - CAISSE FRANCAISE DE FINANCEMENT LOCAL'S MAIN RISKS

9.2.1. Credit Risk

9.2.1.1. Definition

Credit risk represents the potential loss that Caisse Française de Financement Local may incur as the result of the decline in a counterparty's solvency.

9.2.1.2. Organization and governance

The Risks division defines the policies, guidelines and procedures relating to credit risk. It is responsible for developing the decision-making process (principally the granting of loans) and the framework of delegations and for supervising the analysis and rating process. SFIL's Risks Committee and Caisse Française de Financement Local's Executive Board are responsible for final approval of the credit risk policies.

Within the framework of its surveillance of credit risk, the Risks division provides for:

- the definition of credit risk policies in conformity with the risk appetite of SFIL and Caisse Française de Financement Local;
- the definition of limits by type of counterparty setting the maximum exposure considered to be acceptable;
- the proactive monitoring of limits, which the Risks division may change at any time in function of trends in related risks;
- the definition of delegations by type of counterparty and the monitoring of respect for the rules governing the lending process;
- the management of the lending process both for new commitments and rescheduled loans through credit analyses and internal ratings (by using either the internal rating systems or expert advice);
- the monitoring of credit risk in all the portfolios of SFIL and Caisse Française de Financement Local (local public sector in France, international, bank counterparty, export credit, etc.) by generating credit analyses and reviewing ratings annually;
- the identification of assets with downgraded risks susceptible to be put on the watchlist;
- the proposal of specific or segment-based impairment for the portfolio.

The Risks division is also in charge of maintaining and developing:

- internal rating systems for the French and Italian local public sector, for banks and sovereign;
- Pillar 2 models (economic capital).

The Risks division finally deals with statistical models linked to the different stress scenarios.

The Risks division relies on several specialized committees, as described below.

- The Credit Committee approves new commitments⁽¹⁾ by SFIL and Caisse Française de Financement Local (loans and market transactions) and the rescheduled loan agreements on the balance sheet of Caisse Française de Financement Local. It sets credit limits when certain predefined thresholds are exceeded. Each file presented to the Credit Committee contains

(1) Except for commitments delegated to the Risks division, to the Debt Portfolio Management division, and the sales teams of La Banque Postale.

an independent analysis conducted by the Risks division. At each meeting, the Credit Committee is also informed of commitments made within the framework of delegations granted to the Risks division, to the Debt Portfolio Management division, the Treasury and Financial Markets division or the commercial teams of La Banque Postale. This committee meets on a weekly basis.

- The Watchlist Committee is in charge of monitoring assets kept under particular scrutiny because of the downgrade of risk and it may propose specific impairment. This committee meets quarterly.
- The Default Committee decides whether a file should be given default status or be upgraded, and it qualifies debt due as real default, operational debt due or technical debt due. This committee meets quarterly.
- Every quarter, the Impairment Committee sets the amount of collective impairment and finalizes the calculation of specific impairment on the basis of the provision rate decided by the Watchlist Committee.
- The Non-Performing Exposures and Forbearance Committee quarterly approves the list of counterparties with non-performing exposures and a second list for counterparties that benefited from financial concessions due to their financial difficulties.
- The Rating Committee ensures the proper application of the internal rating systems and the appropriateness of the rating processes. This committee meets quarterly. Although it is an integral part of the credit risk management process, the committee is organized by the head of the Validation Credit and Quality Control team, which reports directly to the head of Risks in order to guarantee the independence of the control process.

Moreover, within the framework of the purchase of assets by Caisse Française de Financement Local, the control of eligibility is organized at two successive levels.

- The CAFFIL Coordination division within SFIL pilots the process of asset acquisition and associated controls of eligibility prepared by the different divisions of SFIL; the definitive portfolio is validated by the Executive Board after soliciting the opinion of the SFIL's Credit Committee.
- The customer back-office division carries out permanent controls daily on outstanding assets.

These controls are standardized by procedures.

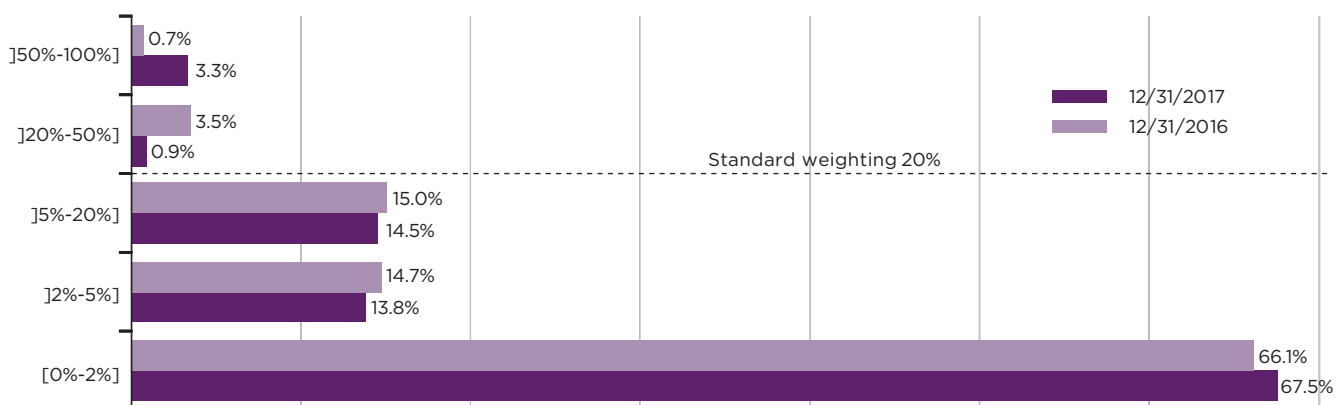
The Specific Controller also carries out regular, detailed ex-post checks on asset eligibility.

9.2.1.3. Breakdown of exposures according to risk weighting

The quality of Caisse Française de Financement Local's portfolio is illustrated by the risk weighting assigned to its assets (Risk Weighted Assets) for the calculation of the bank's solvency ratio. This reflects the fact that for most of its assets SFIL has opted for the advanced method of calculating regulatory capital requirements. Banking regulators authorized the Company to use the advanced internal models developed for the consolidated calculation and reporting of capital requirements for credit risk. The calculation of such weighting in particular combines the probability of default (PD) and loss given default (LGD) of the counterparty.

This enables Caisse Française de Financement Local to present an analysis of its exposure as of December 31, 2017, broken down by risk weighting, such as used for the calculation of capital requirements for credit risk.

Risk weighting of Caisse Française de Financement Local's portfolio as of December 31, 2017



This analysis confirms the excellent quality of the assets in Caisse Française de Financement Local's portfolio:

- more than 81% of the portfolio has a weighting of less than 5%;
- the average risk weighting of the cover pool assets is 6.6%, versus 20% for European local governments according to the Basel II/III standard method;
- only 4% of the portfolio has a weighting of more than 20%.

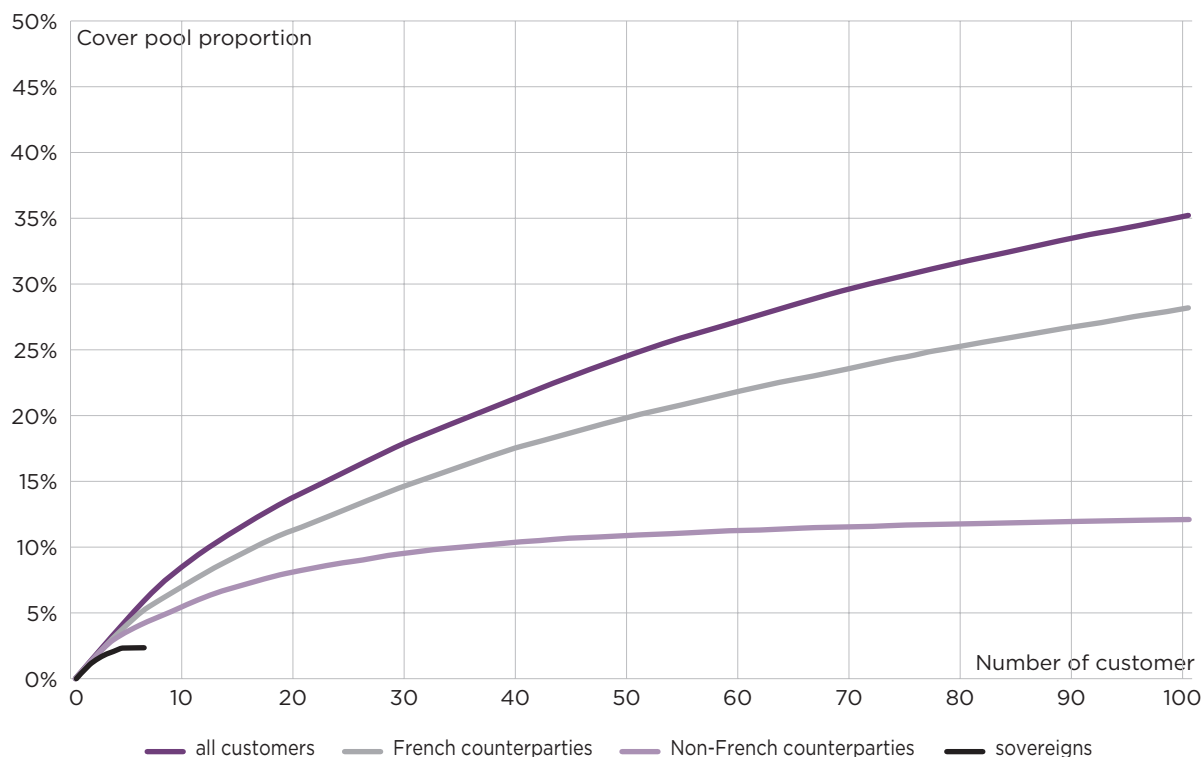
Weighted exposure with respect to credit risk amounted to EUR 4,864 million. Including weighted assets associated with the credit valuation adjustment (CVA) volatility risk and with operational risk (there being no risk weighted assets associated with market risk), total risk weighted assets came to EUR 5,508 million. Combined with its high level of regulatory equity, the credit quality of Caisse Française de Financement Local's assets enabled the Company to post a phased-in Basel III solvency ratio of 24.0% as of December 31, 2017. The fully loaded Common Equity Tier 1 Ratio in Basel III was 23.2% as of December 31, 2017.

9.2.1.4. Concentration by customer

The risk of concentration refers to exposure to a limited number of counterparties. Diversification can make it possible to avoid this problem, and it is a risk management tool to protect from any loss in capital.

The chart below presents the concentration of cover pool by type of counterparty. It confirms the great diversity of Caisse Française de Financement Local's portfolio of assets.

Cover pool concentration by type of customer



As of December 31, 2017, all categories combined, the 20 largest exposures (excluding replacement assets and cash investments) represented 14% of the global cover pool (stable compared with December 31, 2016). The largest exposure accounted for only 1.1% of the cover pool and the twentieth exposure 0.5%.

9.2.1.5. Non-performing loans, litigious loans, provisions

Caisse Française de Financement Local's loans and most of its securities are classified in the Loans and receivables portfolio under IFRS, reflecting its intention to hold them until maturity. They are measured at amortized cost, plus, for fair value hedges, any changes in the fair value of hedged risk; they are subject, if appropriate, to impairment provisions if they show a non-recovery risk.

In addition, collective provisions are calculated on the various loans and receivables portfolios. In the absence of specific impairment, they cover the impairment risk relating to objective indications of probable losses on certain portfolio segments or other lending commitments in force at the closing date. These losses are estimated on the basis of experience and each segment's past performance, as well as the borrowers' ratings and current economic environment. For this purpose, Caisse Française de Financement Local uses a credit risk model based on historical losses, which uses an approach combining probability of default and loss given default. This model is regularly tested, on an ex-post basis.

As of December 31, 2017, arrears amounted to EUR 65 million, representing a decrease of 20% from December 31, 2016 (EUR 81 million) and 51% from December 31, 2015. Arrears are concentrated on a very limited number of counterparties.

As of December 31, 2017, non-performing and litigious loans represented 1% (EUR 558 million) of Caisse Française de Financement Local's cover pool, illustrating the portfolio's excellent quality. They were stable compared with December 31, 2016 (EUR 557 million) and down 17% compared with December 31, 2015 (EUR 673 million).

EUR millions	12/31/2015	12/31/2016	12/31/2017
Non-performing loans and litigious loans	673	557	558
% of cover pool	1.1%	1.0%	1.0%
Arrears	133	81	65

Non-performing and litigious loans comprise:

- EUR 526 million of receivables classified as non-performing, corresponding to loans granted to customers whose total unpaid outstanding came to EUR 33 million (including EUR 28 million on structured loans). When a customer is classified in default in terms of credit risk, the outstanding amount of all its loans is automatically classified as non-performing, by contagion, in addition to its existing past dues;

- EUR 32 million in receivables classified as litigious, corresponding to unpaid interest on structured loans subject to ongoing legal proceedings.

The table below shows the breakdown of non-performing and litigious loans by type of borrowers.

Non-performing and litigious loans EUR millions	12/31/2016		12/31/2017	
	Non-performing loans	Litigious loans	Non-performing loans	Litigious loans
FRANCE				
State	-	-	-	-
Regions	54	-	52	-
Departments	70	-	-	23
Groups of municipalities	117	14	118	-
Municipalities	268	12	238	8
Public sector entities	21	1	118	1
TOTAL NON-PERFORMING AND LITIGIOUS	530	27	526	32
<i>of which arrears on structured loans</i>	46	27	28	32
<i>of which arrears on other loans</i>	8	-	5	-

The table below shows the change in the number of non-performing customers and customers with a portion of their outstanding loans classified as litigious (past dues on sensitive loans).

Non-performing loans and litigious loans (number of customers)	2016		2017	
	Non-performing loans	Litigious loans	Non-performing loans	Litigious loans
BEGINNING OF THE YEAR	74	35	49	14
New	17	4	29	1
Outgoing	42	25	17	8
END OF THE YEAR	49	14	61	7

The number of customers classified as litigious decreased significantly in 2017. At the same time, the number of customers classified as non-performing increased owing to:

- the transfer of customers initially considered to be litigious on account of their structured loans;
- the inclusion in this category of customers with a very low level of past dues on non-structured loans.

The table below shows the total amount of provisions as of December 31, 2017 pursuant to IFRS.

EUR millions	12/31/2016	12/31/2017
Specific impairment	60	23
Collective impairment	46	30
TOTAL	106	53

As of December 31, 2017, specific impairments under IFRS amounted to EUR 23 million. The change in this amount compared with December 31, 2016 takes into account a reversal in 2017 following the use of more accurate method for estimating recoverable flows on non-performing loans⁽¹⁾.

In addition, collective impairments are calculated on the various loans and receivables portfolios. These provisions amounted to EUR 30 million at end-2017 compared with EUR 46 million at end-2016. The review of the loan portfolios and associated risks led to an adjustment reversing collective impairments in a total amount of EUR 16 million, reflecting notably progress in reducing sensitive loans, which made it possible to reassess the legal risk associated with customers who have taken out legal action against Caisse Française de Financement Local.

As a result, at the end of 2017, the Cost of risk calculated in accordance with IFRS showed an improvement of EUR 53 million.

9.2.1.6. Bank counterparty risk

Counterparty risk refers to the risk of loss on an exposure linked to the default of a counterparty. It is naturally in function of the amount of the exposure, the probability of default on the part of the counterparty, and the portion of the loan that cannot be recovered in the event of default.

Caisse Française de Financement Local holds three types of exposure to banks:

- replacement assets in the amount of EUR 0.9 billion (see 4.2.2.);
- bank account balances in euros and other currencies, representing EUR 10 million, excluding cash deposited on the Banque de France account;

⁽¹⁾ Within the framework of the successful policy to reduce the interest rate sensitivity in 2016 and the confirmation of legal decisions favorable to the bank, Caisse Française de Financement Local was able to hone, in a reasonable and prudent manner, the methods it uses to estimate the recoverability of flows of non-performing loans on its balance sheet. In particular, in order to account for the impact of the spread of payments, the implementation of this approach, which is in compliance with IFRS, makes it no longer systematically necessary to estimate the total amount of interest to account for hypotheses of future recovery. Thus, the net interest rate expense is improved through a recovery of provisions in the amount of EUR 31 million, recorded as of December 31, 2017.

- its derivative contracts, entered into within the framework of its management of interest rate and foreign exchange risks.

All of Caisse Française de Financement Local's derivative operations are conducted within the framework of standard ISDA or FBF (Fédération bancaire française) contracts with major international banks. These contracts have particular characteristics, since they must meet the standards set by rating agencies for *sociétés de crédit foncier* (and other issuers of covered bonds). In 2017, Caisse Française de Financement Local amended these contracts to take into account recent regulatory changes (variation margin amendments). These interest rate and currency swaps all benefit from the same legal privilege as *obligations foncières*. For this reason, Caisse Française de Financement Local does not pay its derivative counterparties any collateral (or variation margin), whereas they have to pay Caisse Française de Financement Local except for some which benefit from the agencies' highest short-term rating.

At the end of December 2017, Caisse Française de Financement Local was exposed (positive fair value of the swaps) on nine banking counterparties, eight of these paid cash collateral of EUR 0.7 billion, offsetting total exposure, and one paid no collateral because of its very good short-term rating. This counterparty represented a limited exposure (EUR 8 million).

All derivative exposures as of December 31, 2017, are listed below.

EUR billions	Short-term notional amounts	Long-term notional amounts	% of long-term notional amounts	Mark to market		Collateral received	Number of counterparties
				-	+		
SFIL	-	15.4	18.7%	(1.6)	-	-	1
Other counterparties	46.8	66.7	81.3%	(2.4)	0.7	0.7	25
TOTAL	46.8	82.1	100.0%	(4.0)	0.7	0.7	26

The swaps negotiated with external counterparties represented 81.3% of outstanding long-term swaps and those signed with SFIL 18.7%. The long-term swaps signed with the five largest counterparties represented a total of 44% of notional amounts.

Short-term swaps (Eonia) were all contracted with external counterparties.

9.2.2. Market risk

9.2.2.1. Definition

Market risk is defined as the potential risk of loss (through income statement or directly through other comprehensive income) resulting from fluctuations in the prices of financial instruments that make up a particular portfolio. If the transactions of a portfolio are entered into for trading purposes, regulatory market risk requires daily monitoring of risks and results indicators of that portfolio. Changes in the value of trading portfolios directly impact the income statement.

Caisse Française de Financement Local, as a *société de crédit foncier*, is not authorized to hold a trading or stocks investment portfolio and is therefore not exposed to regulatory market risk.

Caisse Française de Financement Local's banking portfolio positions and activities that pose a risk to its accounting income and equity as a result of exposure to market volatility are monitored as non-regulatory market risks. These are mainly market risks resulting from fluctuation of the available for sale (AFS) reserve or the provision for placement securities under French GAAP, as well as risks resulting from the export credit activity (monitoring of the value changes of the indicator specific to export credit and, for USD-denominated loans, the change in the valuation of currency swaps hedging this activity). Changes in accounting valuation adjustments on derivatives, such as credit valuation adjustments (CVA), debit valuation adjustments (DVA) and funding valuation adjustments (FVA) are also considered as non-regulatory market risks.

9.2.2.2. Governance

The governance of market risks is built around the Market Risks Committee, which conducts a quarterly review of defined risk indicators (sensitivity, mark to market changes in structured swaps hedging the assets of customers in default, and monitoring of AFS reserves, provisions for placement securities under French GAAP, limits, cash collateral received and export credit activity indicators). This committee is also in charge of approving the policies, guidelines and procedures relating to market risks for submission to the Risks Committee.

The continuous monitoring of non-regulatory market risks is carried out by SFIL's Market and Balance Sheet Risks division, which is mainly responsible for:

- defining policies, guidelines and procedures related to the monitoring of market risks;
- defining limits;
- defining calculation and assessment methods for these risks;
- validating the valuation of derivatives for accounting purposes;
- carrying out daily controls of margin calls on derivatives (cash collateral);
- valuing balance sheet items (assets and liabilities);
- monitoring the valuation of currency swaps entered into to hedge refinancing loans for large export credits in USD not yet recognized under hedge accounting;
- monitoring the valuation of swaps that can no longer be classified under hedge accounting following the default of certain customers.

Control of non-regulatory market risks is carried out by monitoring sensitivity to market variables (the «Greeks»), which reflects instruments' fair value change in response to a standardized movement (or shock) in market variables.

The interest rate risk on securities not offering a variable rate at outset that are classified as AFS or placement securities under French GAAP is generally hedged by swaps. The securities portfolio's residual risk is therefore limited to its credit spread risk. The Market and Balance Sheet Risks division calculates the AFS reserve's sensitivity to issuers' credit spreads.

It also monitors accounting valuation adjustments on derivatives (CVA, DVA and FVA) every quarter.

9.2.3. ALM risk

9.2.3.1. Governance

Balance sheet risk management is structured around three committees:

- the Asset-Liability Management (ALM) Committee, on which sit representatives of the Finance division's ALM unit, the Market and Balance Sheet Risks division and the other bank business lines concerned by this management, determines the strategy for managing balance sheet risks and ensures that it is correctly applied by monitoring management indicators;
- the Interest Rate ALM and Liquidity ALM committees prepare information for the ALM Committee and are responsible for implementing its decisions operationally.

The Finance division's ALM unit is responsible for implementing the ALM policies defined for SFIL and Caisse Française de Financement Local in compliance with the relevant management limits and regulatory framework.

The Market and Balance Sheet Risks division is in charge of defining the balance sheet risk management policy, calibrating and monitoring the limits on ALM indicators and performing second-level controls on most of these indicators.

9.2.3.2. Liquidity risk

Definition

Liquidity risk is defined as the risk that the institution may not be able to find the necessary liquidity, on a timely basis and at a reasonable cost, to cover the financing needs related to its activity.

Liquidity risk management

Caisse Française de Financement Local's liquidity risk mainly reflects how able it is to reimburse certain debts benefiting from the legal privilege on a timely basis in the event of an excessive lag between the repayment of its assets and that of its debt benefiting from the legal privilege. It relates to the fact that SFIL is responsible for most of the funding requirement associated with the Caisse Française de Financement Local's over-collateralization⁽¹⁾.

Caisse Française de Financement Local has two main types of liquidity need:

- financing of the assets (EUR 46.9 billion in loans, EUR 7.2 billion in securities, and EUR 1.7 billion in cash deposited with the Banque de France) that cover the *obligations foncières* it issues;
- financing of the liquidity requirements related to compliance with regulatory ratios, specific *sociétés de crédit foncier* ratios and the rating agency methodologies used to meet a rating target.

The sources of financing used to meet these requirements, other than the entity's equity (EUR 1.5 billion), are:

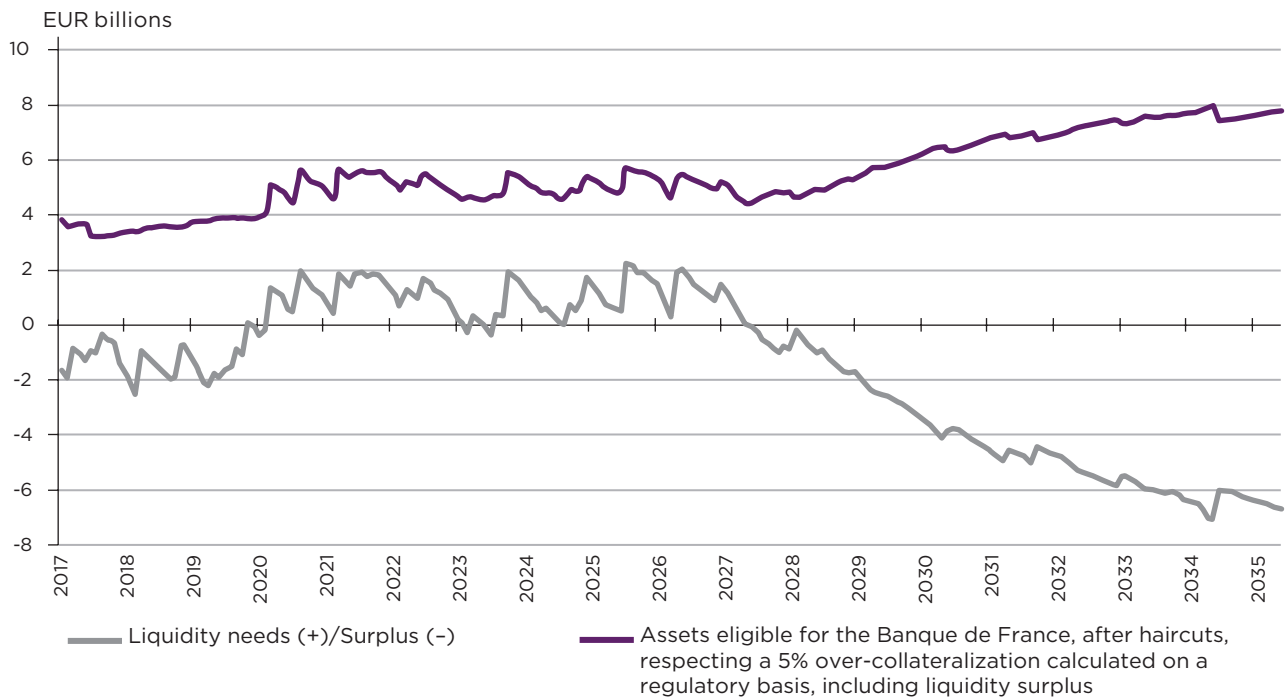
- debt benefiting from the legal privilege, i.e. *obligations foncières* and registered covered bonds (EUR 49.0 billion) and the cash collateral received by Caisse Française de Financement Local (EUR 0.7 billion);
- refinancing arising from the loan agreement entered into with SFIL to cover the financing requirements related to Caisse Française de Financement Local's over-collateralization (EUR 4.8 billion).

Furthermore, Caisse Française de Financement Local has a large stock of assets eligible for European Central Bank refinancing via the Banque de France. In addition to access to the central bank in its own name, Caisse Française de Financement Local can also mobilize certain of its assets by using interbank financing in the form of repurchase agreements. If necessary, these transactions would easily cover its cash flow requirements. There were no transactions of this type in 2017, except for operational tests.

The aggregate maximum liquidity requirement that Caisse Française de Financement Local could face in the future in a run-off situation in which it was unable to issue new *obligations foncières* is lower than the maximum funding already occasionally obtained on a one-off basis from the central bank in the past. It is also lower than the Caisse Française de Financement Local's refinancing potential with the Banque de France, measured by the amount of eligible assets after haircut that would be available while complying with the minimum over-collateralization required by the regulations.

The chart below shows the forecast aggregate liquidity requirement and the assets needed to cover this requirement.

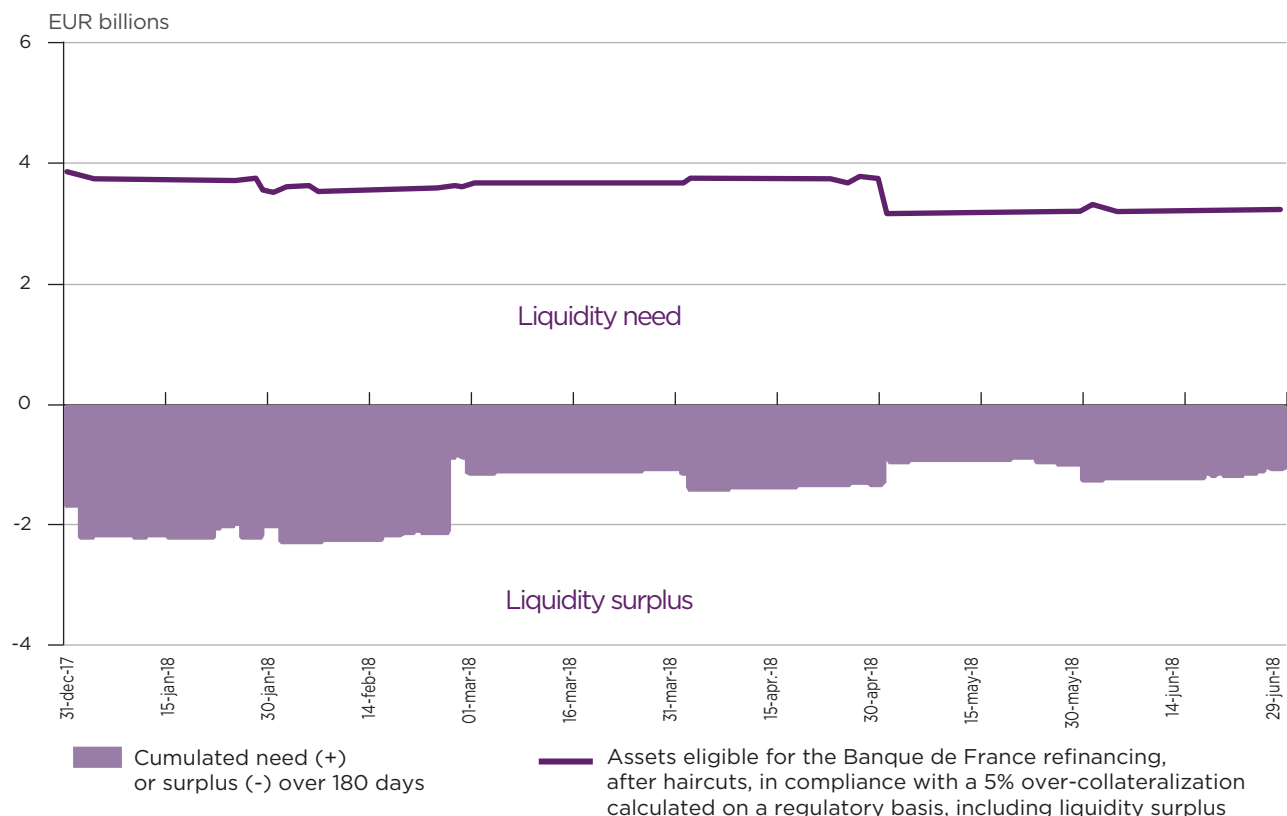
(1) A part of Caisse Française de Financement Local's over-collateralization is refinanced by its equity.



Caisse Française de Financement Local has its own autonomous resources that enable it to cover its temporary liquidity needs, even in the event of the default of its parent company, since any legal proceedings engaged for the bankruptcy or liquidation of its parent company cannot be extended to Caisse Française de Financement Local (article L.513-20 of the Monetary and Financial Code).

Meanwhile, Caisse Française de Financement Local manages its liquidity risk using the following indicators:

- Regulatory indicators specific to *sociétés de crédit foncier*:
 - the regulatory coverage ratio (or over-collateralization ratio): this represents the ratio between assets and debts benefiting from the legal privilege, and must be at least 105% (see section 6.);
 - the maximum gap of 1.5 years between the average maturity of debt benefiting from the legal privilege and that of assets eligible to make up the minimum amount necessary to meet the regulatory coverage ratio (see the specific section on transformation risk below).
 - forecast cash needs at 180 days: Caisse Française de Financement Local ensures that, at any times, its cash needs over a period of 180 days are covered by replacement assets and assets eligible for Banque de France’s credit operations. Cash needs include repayments of *obligations foncières* and registered covered bonds, debt not benefiting from the legal privilege and forecast repayments of cash collateral received, after deduction of cash flows from amortization of assets. This forecast is published quarterly in the Asset Quality Report, and is shown below. At the end of December 2017, there was a liquidity surplus for the whole period.



- The regulatory liquidity indicators applicable to credit institutions, in particular the liquidity coverage ratio (LCR). As of 31 December, 2017, Caisse Française de Financement Local's LCR was 371%.
- Internal liquidity indicators:
 - the liquidity projections for the short term (three months) and long term (two years);
 - the management coverage ratio (or over-collateralization ratio), which targets an over-collateralization level consistent with the Caisse Française de Financement Local's target rating (see section 6.);
 - the difference in duration between assets and debts benefiting from the legal privilege (limited to three years): this is published every quarter and came to 0.95 years as of December 31, 2017 (see the specific section on transformation risk below);
 - the maximum difference between assets and liabilities maturing within the same year, this limit being reviewed annually;
 - the one-year survival horizon in stressed conditions;
 - the sensitivity of the net present value of the static liquidity gap adjusted for regulatory constraints (compliance with the LCR and the over-collateralization ratio);
 - the indicators related to refinancing of large export credits activity: consumption of the spread and EUR/USD basis risk appetite by the various maturities of refinancing loans for large export credits, monitoring of geographical and sector limits and relating to firm offers over one year.

Lastly, dynamic liquidity forecasts (taking into account new assets and refinancing assumptions) are carried out regularly in normal and stressed conditions, aimed at:

- defining the amounts and maturities of the various sources of financing that could be raised;
- assessing the capacity of Caisse Française de Financement Local and the SFIL Group to withstand a liquidity shock.

Definition of the transformation risk contained in the specific components monitored in connection with liquidity risk

Transformation risk is part of liquidity risk. It corresponds to the differences in maturity between assets and the resources used to refinance them.

Caisse Française de Financement Local manages this risk using the following two indicators:

- Duration gap
- Weighted average life gap

Duration gap

The difference in maturity between assets and liabilities can lead to liquidity risk. As interest rate risk is controlled (see section 9.2.3.3.), Caisse Française de Financement Local ensures that asset and liability maturities match by keeping the difference in duration between assets and debts benefiting from the legal privilege to three years or less.

Given the method used to hedge interest rate risk (see section 9.2.3.3.), assets and debts benefiting from the legal privilege are all recognized at floating rates after swaps. Caisse Française de Financement Local's balance sheet thus appears to have a single loan opposite a single borrowing. Durations are calculated as follows: "sum of the periods, weighted by the cash flows and discounted at the zero coupon curve rate for the period (t), over the sum of cash flows discounted at the interest rate of the zero coupon curve for the period (t)":

$$D = \frac{\sum_{t=1}^T [(t \times CF_t) / (1 + st)^t]}{\sum_{t=1}^T [CF_t / (1 + st)^t]}$$

The duration gap between the assets and the liabilities is closely monitored since it is sensitive to fluctuations in interest rates used to calculate the net present value and to significant changes in assets and liabilities.

The duration gap observed in practice remains under the three-year limit, as shown in the table below.

Duration in years	12/31/2016	3/31/2017	6/30/2017	9/30/2017	12/31/2017
Cover pool	7.22	7.35	7.02	7.23	7.44
Privileged liabilities	6.10	6.32	6.36	6.45	6.49
Gap in asset-liability duration	1.13	1.03	0.67	0.77	0.95
Duration gap limit	3	3	3	3	3

Weighted average life gap

Changes in the gap in weighted average life can differ from the changes in the gap in duration over the same period, for the evolution in the duration gap is partly attributable to movements in the interest rate curve. The gap in the weighted average life of the cover pool and the liabilities benefiting from the legal privilege is presented below.

Weighted average life in years	12/31/2016	3/31/2017	6/30/2017	9/30/2017	12/31/2017
Cover pool	7.71	7.88	7.63	7.82	7.99
Privileged liabilities	6.47	6.75	6.86	6.93	6.93
Gap in asset-liability weighted average life	1.24	1.13	0.77	0.88	1.06

Regulatory limit

Current regulations impose a limit of one and a half years on the weighted average life gap between the cover pool, considered on the basis of the minimum amount required to satisfy the legal over-collateralization ratio of 105% and the resources benefiting from the privilege. Caisse Française de Financement Local respects this limit.

9.2.3.3. Interest rate risk

Definition

Interest rate structural risk is defined as the risk of loss incurred in the event of a change in interest rates that would lead to a loss in value of balance sheet and off-balance sheet transactions, excluding any trading portfolio transactions. Since Caisse Française de Financement Local does not have a trading portfolio, it is not concerned by this exception.

There are three different types of interest rate risk:

- the fixed interest rate risk that results from the difference in volume and maturity between fixed rate assets and liabilities, or adjustable rate assets and liabilities for which the interest rate has subsequently been fixed. This risk can result in yield curve parallel shifts, steepening, flattening or rotation;
- the basis risk that results from the gap that may exist in the matching of assets and liabilities indexed on variable rates of different types or index tenors;
- the fixing risk that results, for each index, from the gap between the adjustment dates applied to all the variable rate balance sheet and off-balance sheet items linked to the same tenor.

These risks are generally hedged using derivatives.

Hedging strategy

To limit its impact, interest rate risk is hedged in two stages by Caisse Française de Financement Local:

- In the first stage, all the assets and the liabilities benefiting from the privilege which do not naturally have a floating rate are hedged against Euribor until maturity as soon as they are recorded on the balance sheet. In practice, acquisitions of loan portfolios (in which the unit amount is generally small) are usually macro-hedged. Loans granted individually or bond issues can be micro- or macro-hedged. Hedging of assets and liabilities is more often obtained in using new interest rate swaps, but the same effect can also be obtained whenever possible by the cancelation of swaps of opposite direction.
- In the second stage, Euribor lending and borrowing flows (naturally or after hedges) are swapped against Eonia over a sliding period of maximum two years in order to eliminate the basis risk generated by differences in the tenor (Euribor 1, 3, 6 or 12 months) and the fixing risk due to refixing dates of reference indices that differ for the assets and the liabilities. The residual risk is managed using macro-hedges with a management horizon of one week.

These hedges can be entered into either directly on the market by Caisse Française de Financement Local, or through SFIL, which in turn hedges its resulting position in the market.

Non-privileged debt is not concerned by these hedging operations. In fact, debt contracted by Caisse Française de Financement Local with its shareholder to finance over-collateralization is borrowed either directly with a Eonia index and does not need to be swapped, or with a Euribor index and thus finances assets also indexed on Euribor. Short-term debt owed the Banque de France with a fixed rate (if any) is not hedged, but finances fixed rate assets.

These different types of interest rate risk are monitored, analyzed and managed through the production of gaps (fixed rate, basis and fixing), and/or net present value (NPV) sensitivity indicators.

More specifically, the following indicators are produced in a static view:

- the fixed rate gap, which corresponds to the difference between balance sheet and off-balance sheet assets and liabilities for fixed rate transactions or transactions for which the rate has been fixed. This gap is calculated every month until balance sheet extinction;
- index gaps, which correspond to the difference between balance sheet and off-balance sheet assets and liabilities for a given index tenor that has not yet been fixed. This gap is calculated every month until balance sheet extinction;
- basis gaps, which result from the matching of two index gaps. There are therefore as many basis gaps as there are index pairs;
- the fixing gap, which corresponds, for a given tenor index, to the difference between adjustable rate balance sheet and off-balance sheet assets and liabilities, by fixing date.

Limits governing interest rate risk

The sensitivity of residual positions in fixed rates and variable rates fixed for a determined period of time that remain after the two levels of hedging is monitored on a monthly basis. Limits provide a framework for this sensitivity and are designed to reduce the impact on the value of balance sheet items in the event of a shift in the yield curve or a move in sloping/rotation. They are calibrated so as not to lose more than 6% of equity (i.e. EUR 80 million) with a quantile of 99% calculated based on 2007-2017 historical data.

The net present value (NPV) sensitivity indicators are calculated for a rate shock of 100 x +1 basis point (bp), aiming to limit losses in value in the event of:

- a parallel yield curve shift (limit of EUR 25 million for a shock of 100 x 1bp) to limit the fixed rate or directional rate risk;
- sloping/rotation of the interest rate curve:
 - net present value sensitivity calculation and limiting by time bucket, using four buckets of distinct risks on the yield curve in order to limit risk between distant points on the curve (limit per bucket of EUR 10 million for a shock of 100 x 1bp);
 - net present value sensitivity in terms of absolute value calculation and limiting by time bucket, using four buckets of distinct risks on the yield curve in order to limit risk between near points on the curve, within each bucket (limit per bucket of EUR 20 million for a shock of 100 x 1bp).

Limiting directional risk

The measurement of sensitivity at the end of each quarter is presented below.

Directional risk

Total sensitivity

EUR millions	Limit	12/31/2016	3/31/2017	6/30/2017	9/30/2017	12/31/2017
SENSITIVITY	25.0	(0.5)	(0.1)	(1.6)	1.0	1.5

Measurement of the slope/rotation risk

The quarter-end sensitivity measurements are presented below.

Risk of slope between two distant points on the rate curve

Sum of sensitivities

EUR millions	Limit	12/31/2016	3/31/2017	6/30/2017	9/30/2017	12/31/2017
Short term	10.0	(0.9)	0.1	0.4	(1.7)	0.2
Medium term	10.0	0.3	2.0	(4.5)	(2.4)	(4.6)
Long term	10.0	0.1	(2.6)	1.5	3.8	3.1
Very long term	10.0	0.1	0.4	1.1	1.3	2.7

Risk of slope between two close points on the rate curve

Sum of sensitivities in absolute value

EUR millions	Limit	12/31/2016	3/31/2017	6/30/2017	9/30/2017	12/31/2017
Short term	20.0	4.4	3.3	7.8	10.2	11.6
Medium term	20.0	4.3	5.1	12.4	10.9	14.8
Long term	20.0	8.1	4.9	3.5	7.1	3.6
Very long term	20.0	5.9	5.3	5.6	6.5	6.9

The main risks identified and associated with a low interest rate environment are:

- exposure to a rapid normalization of rates;
- an increase in early repayments not offset by early repayment penalties;
- margin reduction.

Caisse Française de Financement Local has little exposure to interest rate changes and therefore to a rapid normalization of rates: it uses interest rate risk management indicators to manage and monitor exposure to the risks of both parallel and non-parallel shifts in the yield curve, including exposure to the risk associated with the sudden normalization of interest rates.

Caisse Française de Financement Local has little exposure to early repayment risk as almost all of its loan agreements contain early repayment penalty clauses.

Lastly, Caisse Française de Financement Local's business model, based on the refinancing of the local public sector and large export credits, is relatively insensitive to the low interest rate environment. In particular, because Caisse Française de Financement Local does not take sight deposits, it is unaffected by the issue of transformation margin reduction in a low interest rate environment.

Outstanding derivatives

The strategies employed to hedge interest rate risk and foreign exchange risk are illustrated by notional outstanding swaps analyzed in the following table, broken down between external counterparties and an internal counterparty (SFIL), as of December 31, 2017.

Breakdown of outstanding swaps	Notional Absolute value
EUR billions	
Euribor against Eonia	
Macro-hedges	46.8
TOTAL SHORT-TERM SWAPS	46.8
Fixed rate swaps against Euribor	
Micro-hedges on obligations foncières	40.0
Micro-hedges on loans and debt securities	22.3
Macro-hedges on loans	14.5
Subtotal	76.9
Currency swaps	
Micro-hedges on obligations foncières	1.8
Micro-hedges on loans	2.8
Micro-hedges on debt securities	0.6
Subtotal	5.2
TOTAL LONG-TERM SWAPS	82.1

9.2.3.4. Foreign exchange risk

Definition

The foreign exchange risk is defined as the risk of a loss, linked to a change in the exchange rate of currencies vis-à-vis a reference currency. The reference currency of Caisse Française de Financement Local is the euro. The foreign exchange risk reflects a change in the value of assets and liabilities denominated in a currency other than the euro by reason of fluctuations of this same currency vis-à-vis the euro.

Hedging Strategy

Caisse Française de Financement Local 's foreign exchange risk management policy is to incur no foreign exchange risk: it enters into cross-currency swaps against the euro for its issues and assets denominated in foreign currency, on initial recognition at the latest and until their final maturity, thereby ensuring that these balance sheet items' principal and interest rates are fully hedged. Floating rate exposures generated by this management policy are incorporated into interest rate risk management. Nonetheless, certain loans to refinance large credit exports denominated in USD may cause a very limited risk of foreign exchange during their drawing phase. This residual risk is handled through the calculation of a very low sensitivity limit.

Foreign exchange risk is monitored using the net foreign exchange position in each currency, calculated on all foreign currency balance sheet receivables, commitments and accrued interest not yet due. Caisse Française de Financement Local's ALM unit and Market and Balance Sheet Risks division ensure that it has no net foreign exchange positions.

9.2.4. Operational risk

9.2.4.1. Definition

Operational risk represents the risk of loss resulting (i) from the lack of adaptation or failure on the part of internal processes, staff, systems or (ii) external events. It includes the risks linked to the security of IT systems, as well as legal and fiscal and compliance risks, but it excludes strategic risk. This definition is in line with the formulation of the Basel Committee. Management procedures for operational risks apply to all of the operating divisions of SFIL in charge of the management of Caisse Française de Financement Local.

9.2.4.2. Organization and governance

SFIL has implemented an organization, procedures and a management system for monitoring and controlling its risks. The Operational Risks and Permanent Control division, within the Risks division, defines the management policy to be used for operational risks, as well as the methods employed to identify and limit them. It pilots operational risk management and relies on a network of correspondents designated in each operating division. Their role is to collect operating incidents and losses, to assess risks and measure key risk indicators with the help of the staff of the Operational Risk and Permanent Control division. The involvement of business line managers strengthens the system's effectiveness.

The operational risk profile in the different operating divisions is presented to the Operational Risks and Permanent Control Committee. It is chaired by SFIL's Deputy CEO, and its members are the entire Executive Committee, including the Chairman of the Executive Board of Caisse Française de Financement Local. It meets quarterly. This committee studies the major operational risks so identified and key risk indicators that have exceeded their alert threshold. It decides as to whether they are acceptable or not and what corrective measures should be taken. It also validates management policies and methods with regard to the management of operational risks. It examines operating incidents that have occurred in the quarter and monitors risk prevention and improvement proposals (permanent control, operational risk management, information security, business continuity).

A synthesis of highlights is presented every quarter to the Risks and Internal Control Committee and the Supervisory Board of Caisse Française de Financement Local in the form of the Quarterly Risks Review. A detailed presentation of action plans, areas for improvement and corrective measures proposed or already implemented to limit operational risk was also organized for Risks and Internal Control Committee on January 25, 2018 and the Executive Board meeting of February 13, 2018.

9.2.4.3. SFIL's policy of operational risk

SFIL has opted for the standard method for calculating equity in respect of operational risk, as provided for by the Basel Committee directives.

SFIL's policy for measuring and managing operational risks consists of regularly identifying and assessing its risk exposure and the existing mitigation and control systems to establish whether or not the level of residual risk is acceptable. The policy applied involves three main processes: the collection and reporting of operational incidents, the mapping of operational risks and the monitoring of key operational risk indicators. This system is complemented by an IT security management policy, a Recovery and Business Continuity Plan (RBCP) and, where necessary, insurance policies to cover specific risks.

9.2.4.4. Operational risk measurement and management

Collection of operational incidents

SFIL has defined an operational incident and loss collection process governed by guidelines and procedures. The systematic collection and analysis of operational incidents provides the information needed to assess SFIL's exposure to operational risk. This operational incident and loss collection process allows SFIL not only to comply with regulatory requirements but also to gather key data to improve the quality of its internal control system.

Various collection thresholds have been defined and communicated to SFIL's operating divisions. The threshold of the mandatory declaration for financial impacts is EUR 2,500. The identification and the analysis of the incidents are the responsi-

bility of the operational risks correspondents with the support of the Operational Risks and Permanent Control division. To this end, SFIL uses an operational risk management tool and in particular a module for incident collection. In function of the results of this analysis, corrective or preventive measures are taken in order to reduce SFIL's exposure to operational risk.

Operational risk identification and assessment

Based on the incidents and losses collected, operational risks are mapped and the resulting mapping is regularly updated. This mapping consists of assessing the operational risks that each SFIL division incurs. It makes it possible to regularly identify and assess these risks, identify existing mitigating factors (systems or controls in place) and determine the residual impacts in order to decide whether or not to accept them. In the event of non-acceptance of the risks, corrective or improvement actions must be implemented (strengthening of systems and procedures, strengthening of the permanent control plan, implementation of systems for monitoring and controlling risks).

The Group is also currently mapping its operational risks by process under a three-year plan to formalize SFIL's processes and activities launched in the second half of 2016. It has defined four main types of activity (steering, asset acquisition, assets and liabilities management until their maturity, and resource provision) and 37 major bank processes within these broad categories. These processes are currently being documented. As part of this plan, the Operational Risks and Permanent Control division has introduced a new methodology for identifying and assessing operational risks by process. This is being deployed as and when SFIL's processes are formalized, in collaboration with the process manager and the operational risk correspondents of the divisions involved, and is gradually replacing the mapping currently in force.

Monitoring of key operational risk indicators

The Operational Risks and Permanent Control division also set up, with SFIL's operating divisions, key risk indicators associated with warning levels. These indicators act as signals of growth in the level of operational risk, a decline in process performance, or of dysfunctions of the internal control system itself. They make it possible to survey in a continuous and dynamic manner the development of operational risks, together with operational risk mapping, which periodically gives a snapshot of SFIL's risk profile.

IT security management

The Operational Risks and Permanent Control division set up a system with a policy and guidelines based on ISO standard 27000, which is applicable to all of SFIL's operating divisions. It is designed to protect information data from any attack on confidentiality, integrity or availability. This policy and these guidelines define the principles applicable by category of security as well as the roles and responsibilities of the different security players. It comprises operational rules, procedures and processes determined with the Information System division, especially those involving the management of authorizations to access SFIL's IT applications and systems.

In addition, a three-year IT security plan has been defined in order to improve the existing systems.

The IT security procedures and changes therein are monitored quarterly by the IT Security and Business Continuity Plan Committee and validated by the Operational Risks and Permanent Control Committee.

Business continuity and crisis management

SFIL has developed a Recovery and Business Continuity Plan (RBCP). It comprises a set of measures and procedures designed to ensure, in various operational crisis scenarios including extreme shocks, that the services or other essential operational tasks that SFIL performs continue, if necessary temporarily or in degraded mode. It also provides for the programmed recovery of these activities so as to limit the losses caused by operation in degraded mode. This plan is based on a business impact assessment that formalizes the needs of SFIL's operating divisions to enable them to restart and resume business based on their criticality.

The RBCP is based on the following three features.

- The operational business continuity plan, which is managed by the Operational Risks and Permanent Control division and documented in guidelines and operational procedures. These guidelines and procedures are regularly updated and the business continuity plan is regularly tested. Disaster recovery sites have been selected for the Issy-les-Moulineaux and Lyon offices to enable the resumption and operational continuation of SFIL's activities. Tests on the functioning of these sites were carried out in March, in May and in June 2017.
- The IT disaster recovery plan, which is managed by the Information Systems division and documented in guidelines and operational procedures. This plan is also regularly tested, with the most recent full live test for SFIL carried out in September 2017.
- The crisis management system, which is managed by the Operational Risks and Permanent Control division. A crisis unit has been identified and regularly tested crisis scenarios have been defined. In particular, a transportation unavailability scenario associated with potential terrorist risk is tested three times a year. A crisis unit exercise, based on a specific scenario, was carried out in November 2017.

New developments in security and business continuity are monitored quarterly by the Information Systems Security and Business Continuity Plan Committee and validated by the Operating Risks and Permanent Control Committee.

Operational risks insurance

To reduce the potential financial impact of operational risks, SFIL has subscribed to several insurance policies. Targeted policies cover the liability of members of the Company's management bodies, professional liability and fraud, as well as multi-risks premises, IT equipment. It also has a policy to protect it from cybercrime. These policies cover SFIL and Caisse Française de Financement Local.

Security of means of payment

Caisse Française de Financement Local does not provide its customers with any means of payment and is not exposed to operational risks in this area.

9.2.5. Legal and tax risks

9.2.5.1. Definition

Legal risk is the risk of any litigation with a counterparty resulting from any misunderstanding, lack or insufficiency that may be attributed to the Company in the exercise of its activities.

9.2.5.2. Organization and monitoring

Caisse Française de Financement Local's monitoring of legal risks focuses on the prevention of litigation, the anticipation of legal developments and the respect of governance principles. The legal risk control is in particular under the responsibility of the SFIL's Legal division, which is part of the General Secretariat. In its capacity, the Legal division has a dual role:

- to advise other SFIL divisions so as to allow them to measure the legal risks inherent in their activities;
- to defend the interests of SFIL and Caisse Française de Financement Local.

Furthermore, the Legal division contributes to the work of various committees:

- Within the framework of its Regulatory Watch Committee, it provides information on the principles underlying legal and regulatory provisions that affect the operations of SFIL and Caisse Française de Financement Local;
- Within the New Products Committee, it advises, as necessary, on the cases presented to it;
- It analyses legal risks associated with the cases presented for the Credit Committee;
- It reviews the cases under litigation and the progress of the procedures at the Loan Sensitivity Reduction Committee meeting. It also expresses its opinion when a loan sensitivity reduction operation involves a legal risk.

The Legal division may also participate in formulating the comments made as part of the audit and internal control operations.

The Board of Directors, Executive Management and Executive Committee of SFIL, as well as the Executive Board and Supervisory Board of Caisse Française de Financement Local receive regular updates on the progress of litigation. A management report regarding the lawsuits is presented at each supervisory board.

SFIL's Finance division is responsible for tax declarations and may consult the SFIL's General Secretariat for tax advice. SFIL relies notably on tax advisory firms of excellent repute for managing its tax risk.

Legal risk

As of December 31, 2017, the number of borrowers in litigation for structured loans was 25⁽¹⁾, compared with 39 as of December 31, 2016 and 131 as of December 31, 2015. Since SFIL's creation, 198 borrowers have dropped their claims against the Group.

Since the entry into force on July 30, 2014 of the law on the securing of structured loan contracts taken out by common law legal entities, the Nanterre Court of First Instance, the Nanterre Commercial Court and the Versailles Court of Appeal have handed down 31 court decisions ruling in favor of Dexia Crédit Local, SFIL and Caisse Française de Financement Local. Only one unfavorable decision, concerning a single non-structured loan, has been handed down, being noted this is a first-instance judgment which is not yet final. Caisse Française de Financement Local, SFIL and Dexia Crédit Local have appealed this decision.

As of December 31, 2017, there were no other significant lawsuits or disputes between Caisse Française de Financement Local and its borrowers.

Fiscal risk

For the record, in 2015, French tax authorities investigated the income declared and the tax paid for 2012 and 2013. Following the tax assessment, the tax authorities expressed their disagreement with the tax treatment of the following two points: the taxation in Ireland of the income from the Dublin branch of Dexia Municipal Agency, which was closed in 2013, and the deductibility of provisions for non-performing loans. In order to safeguard its rights to the disputed adjustment, in 2017 the tax authority initiated a verification procedure relating to the consequences of its previous assessment of taxable income for the 2014 to 2016 fiscal years. The two points of disagreement resulting from the 2015 assessment still held following this tax audit. There were no other new developments.

In order to take into account the risk of an unfavorable outcome in these proceedings, Caisse Française de Financement Local recorded a provision for additional income tax in the amount of EUR 38 million in its 2015 IFRS financial statements. However, Caisse Française de Financement Local does not agree with the position of the tax authorities and started an appeal in 2016 within the framework of legal recourse allowed by current tax regulations. Neither the discussions that took place with the tax authorities nor the new tax audit called into question the assumptions used to calculate the amount provisioned in the accounts.

9.2.6. Risks of non-compliance

9.2.6.1. Definition

Article 10-p of the *arrêté* of November 3, 2014 on the internal control of banks defines non-compliance risk as «the risk of judicial, administrative or disciplinary sanction, of significant financial loss or loss of reputation resulting from failure to comply with the prevailing laws and regulations and professional and ethical standards relating to banking and financial activities or with instructions from the executive body issued in particular pursuant to directives from the decision-making body».

(1) After accounting for a suit which the court had previously declared subject to the statute of limitation.

9.2.6.2. Organization and governance

Pursuant to the provisions of the *arrêté* of November 3, 2014, SFIL uses non-compliance risk mapping and a control plan, which are updated whenever necessary and at least annually, to monitor and control both its own non-compliance risk and that of Caisse Française de Financement Local. This mapping reviews the legislative, regulatory, professional and Group-specific provisions applicable to each line of business or function, and the procedures and controls implemented to ensure compliance with these provisions. The mapping provides a visual indication of the company's exposure to non-compliance risks and defines the boundaries of the bank's non-compliance risk profile. To this end, non-compliance risks are:

- identified and classified;
- assessed (frequency of occurrence and level of severity);
- compared and ranked.

Once the risk areas have been identified through the non-compliance risk mapping, the Compliance division ensures that the risk management system can be used to reduce gross risk.

9.2.6.3. Monitoring of non-compliance and reputation risks

Non-compliance risks associated with the activities of SFIL and Caisse Française de Financement Local concern the following areas:

- employee ethics, prevention of conflicts of interest and the compensation policy;
- protection of the integrity and transparency of financial markets;
- customer protection;
- financial security, in particular compliance with international financial sanctions and the fight against money laundering, financing of terrorism and corruption;
- maintenance of the confidentiality of information and protection of personal data.

At the same time, the Compliance division carries out a regulatory watch to monitor legislative and regulatory changes as well as case law developments liable to impact the Group's compliance activities. It accordingly sits on SFIL's Regulatory Watch Committee. In the event that the institution is impacted by one of these developments, the Compliance division liaises with the divisions concerned to enable them to define and implement the new mechanisms required or, where applicable, propose changes or updates to the associated tools.

The identification and monitoring of regulatory compliance issues in certain specific areas (accounting standards, prudential ratios, control of major counterparty risks, recommendations on IT security, etc.) are the responsibility of SFIL's relevant operating divisions, which duly have appropriate expertise and tools at their disposal.

Moreover, as well as completing the compliance control plan (see section 8.1.5.), the Compliance division controls non-compliance risks:

- by ensuring that its procedural framework is updated. In this regard, in 2017 the Compliance division:
 - completed the anti-money laundering and counter-terrorist financing (AML-CFT) system and the financial security policy relating to the refinancing of large export credits, to take into account regulatory changes;
 - updated the market abuse prevention measures;
 - updated the procedures for protecting customers' interests;
 - set up a steering committee on the protection of personal data ahead of regulatory changes planned for May 2018.
- by continuing its compliance system awareness raising and training initiatives for all of the bank's employees. This involved providing mandatory compliance system training to give employees a full and practical understanding of the importance for the bank of compliance and the systematic use of best practices. This training aims to enable employees to carry out their duties with complete integrity. The Compliance division also dispenses employee training under its AML-CFT obligations. Lastly, it raised the awareness of «insider» employees on market abuse prevention measures. The training system is a key platform for disseminating a compliance culture within the SFIL Group.

The SFIL Group has also set up a formal anti-money laundering and financing of terrorism system. This system, which is adapted to SFIL's local public sector financing activities, has been strengthened to meet the requirements of its export credit refinancing activity, notably in terms of monitoring compliance with embargoes.

EU directive 2015/849 of June 5, 2015 on the prevention of the use of the financial system for the purposes of money laundering or financing terrorism was transposed into French law by ordinance 2016-1635 of December 1, 2016. The directive aims *inter alia* to bring EU law into line with the recommendations of the Financial Action Task Force (FATF) adopted in February 2012. In 2017, the company's AML-CFT system was adapted to incorporate the new provisions and obligations arising from the fourth European anti-money laundering directive.

Lastly, the Compliance division ensures the prevention of reputation risk, which is defined as the risk resulting from customers', counterparties', investors' or regulators' negative perception of the SFIL Group that could undermine its ability to initiate or maintain business relationships and/or its continued access to financing sources.

At the request of the Compliance division, the Communication division has introduced an e-reputation risk monitoring system, and submits a specific quarterly report on this subject to the Compliance division.

10. Commitments granted – commitments received

Commitments granted as of December 31, 2017, are mainly comprised of financing offers granted to SFIL for the refinancing of the export credit business in the amount of EUR 3.0 billion and to a lesser extent the portion not yet paid out of loans granted to French local governments in the amount of EUR 0.1 billion.

Commitments received were principally:

- the authorized overdraft in the current account as stipulated in the financing agreement signed with SFIL for EUR 50 million;
- guarantees received on loans to customers for EUR 2.5 billion.

11. Payment deadlines

In application of articles L.441-6-1 and D.441-4 of the Code of Commerce, Caisse Française de Financement Local must publish every year a breakdown of the balance of the monies it owes to suppliers by due date.

Caisse Française de Financement Local has a very limited number of direct suppliers, since its management is contractually entrusted to its parent company, in conformity with article L.513-15 of the Monetary and Financial Code. Caisse Française de Financement Local usually settles its bills as soon as they are recorded, and the balance of monies owed to suppliers is theoretically always zero. As of December 31, 2017, all supplier accounts were settled. The only supplier debt recorded corresponded to invoices not yet received.

(A) Classes of late payments	Arrears on invoices received by the closing date					TOTAL
	0 day (for information)	1 to 30 days	31 to 60 days	61 to 90 days	91 days and more	
Number of invoices concerned	-	-	-	-	-	-
Total amount of invoices concerned excluding VAT (EUR thousands)	-	-	-	-	-	-
Proportion of total amount of invoices received in the year	-	-	-	-	-	-
(B) Invoices excluded from (A) concerning litigious debt or debt not yet accounted for:						
Number of invoices concerned						-
Total amount of invoices concerned						-

Reference payment period: legal or contractual, generally 45 days.

12. Research and development

Since the Company exercises no activity in research and development, no data related to this activity is mentioned in the financial statements.

13. Non-tax-deductible charges and expenses

In accordance with article 223 (4) of the French General Tax Code, no non-deductible expense or charge referred to in article 39-4 of the General Tax Code was made by the Company during the year.

General operating expenses considered as non-deductible following a definitive tax assessment (article 223 (5), article 39-5 and 54 (4) of the General Tax Code) are therefore zero.

14. Social, environmental and societal information

In application of article L.225-102-1 of the Code of Commerce modified by article 225 of law 2010-788 of July 12, 2010 (Grenelle 2 law) and decree 2012-557 of April 24, 2012, Caisse Française de Financement Local must communicate information on social, environmental and societal issues in the Management Report. Since Caisse Française de Financement Local has no salaried employees nor actual premises, social, environmental and societal issues do not apply to this entity.

Social, environmental and societal information concerning SFIL, which manages the activities of Caisse Française de Financement Local, is presented in its annual financial report and on its website.

15. Income for the year

15.1 - INCOME ACCORDING TO IFRS

Caisse Française de Financement Local publishes its financial statements according to IFRS, as adopted by the European Union in order to allow for a better understanding and a better comparability of its financial statements by international investors.

The income statement for 2017 is presented in a synthetic form as follows.

IFRS EUR millions	2015	2016	2017	Change 2017/2016
Interest margin	115	150	185	
Net commissions	(26)	(7)	(12)	
Net result of assets at fair value	(32)	(38)	(33)	
Net result of financial assets	(2)	14	16	
Other income and expense	(0)	(0)	-	
NET BANKING INCOME	55	119	156	31%
General operating expenses	(90)	(91)	(98)	
Taxes	(6)	(7)	(7)	
GROSS OPERATING INCOME	(41)	21	51	143%
Cost of risk	(14)	18	22	
INCOME BEFORE TAX	(55)	39	73	87%
Income tax	(21)	(29)	(32)	
NET INCOME	(76)	10	41	310%

As of December 31, 2017, net income was positive at EUR +41 million, compared with EUR +10 million as of December 31, 2016.

15.1.1. Income restated excluding non-recurring items

Income was strongly influenced by the following factors that should be mentioned in the analysis:

- adjustments in fair value concerning hedges. The application of certain accounting standards or methods (see below) is a source of volatility in Net banking income. The impact of these adjustments was significantly negative in 2015, 2016 and 2017 as shown in the table below.

EUR millions	2015	2016	2017
Fair value adjustments on hedging	(36)	(37)	(37)

For the record, since 2013, fair value adjustments have an effect on existing hedging transactions the Company uses to cover its interest rate and foreign exchange risks. These adjustments impacted asymmetrically the hedged item and its hedging derivative, although the Company applies strict financial hedging rules, and this factor was therefore the cause of major changes in Net banking income:

- fair value adjustments introduced by the standard IFRS 13: Credit Valuation Adjustment / Debit Valuation Adjustment (CVA / DVA), Funding Valuation Adjustment (FVA);
- fair value adjustment of collateralized derivatives: to account for French banks' best practices, the Company chose a valuation against Eonia for derivatives for which it receives cash collateral while the other derivatives remain valued against Euribor. This change in the valuation of hedging derivatives, whereas the valuation of hedged items is not modified, creates inefficiency in hedging relations;
- evaluation of the hedged risk of certain assets and liabilities that are swapped against an Euribor index different from that in the reference curve that serves to value instruments on the balance sheet. The value of the derivative and that of the hedged item follow independent trends, thereby creating hedging inefficiency in accounting;
- adjustment of fair value of derivatives that hedge the foreign exchange risk related to export credit refinancing loans denominated in USD, which in 2017, could not be formally documented as hedging derivatives before the foreign currency loans are recorded on the Company's balance sheet.

These adjustments in the accounting value are recorded in the income statement mainly in the item Net result of assets at fair value.

- the contribution to the support funds created by the French State to solve the problem of sensitive structured loans. The commitment was totally covered by provisions once Caisse Française de Financement Local decided to contribute to the public hospitals support fund in 2015; the impact on the Cost of risk is presented below.

EUR millions	2015	2016	2017
Contributions to support fund for sensitive structured loans	(20)	-	-

- the effect of changes in the income tax rate: in 2017, Caisse Française de Financement Local has taken note of the reduction in corporate income tax to 25% as of 2022. To this end, it reduced its deferred tax assets and recorded a non-

recurring expense of EUR -2 million in its accounts. For the record, in 2016, Caisse Française de Financement Local also took into account legislative measures reducing the tax rate to 28% from 2020, and recorded a non-recurring expense of EUR -14 million.

EUR millions	2015	2016	2017
Adjustments of deferred tax assets	-	(14)	(2)

The recurring income statement for 2016 and 2017 is as follows.

EUR millions	2016			2017		
	Accounting income statement	Non-recurring items	Recurring income statement	Accounting income statement	Non-recurring items	Recurring income statement
NET BANKING INCOME	119	(37)	156	156	(37)	193
Operating Expenses	(98)	-	(98)	(105)	-	(105)
GROSS OPERATING INCOME	21	(37)	58	51	(37)	88
Cost of risk	18	-	18	22	-	22
INCOME BEFORE TAX	39	(37)	76	73	(37)	110
Income tax	(29)	(1)	(28)	(32)	11	(43)
NET INCOME	10	(38)	48	41	(26)	67

Excluding non-recurring items indicated above, Net banking income increased from EUR +156 million in 2016 to EUR +193 million in 2017, and Net income increased from EUR +48 in 2016 million to EUR +67 million in 2017.

15.1.2. Analysis of recurring net income

The improvement in Caisse Française de Financement Local's recurring income in 2017 is due in particular to its sensitivity reduction operations⁽¹⁾, which resulted in:

- an increase in Net banking income, resulting in particular from reversals of provisions against interest on non-performing loans for EUR +31 million in 2017 compared with EUR +5 million in 2016;
- reversals of provisions under Cost of risk for EUR +22 million in 2017 compared with EUR +18 million in 2016.

Meanwhile, the improvement in financing conditions also contributed to the increase in the Interest margin from EUR +150 million in 2016 to EUR +185 million in 2017.

Operating expenses consist mainly of the invoicing of the parent company for Caisse Française de Financement Local's operational management. The increase in Operating expenses between 2016 and 2017 was mainly driven by an increase in IT expenditure.

The income tax charge for the fiscal year amounted to EUR - 43 million; in particular it reflects the non-deductibility of the contribution to the Single Resolution Fund.

15.1.3. First-time application of IFRS 9

The new IFRS 9, which relates to financial instruments and replaces IAS 39, is applicable from January 1, 2018. It has three main strands: classification and measurement, impairment, and hedge accounting. Its application to Caisse Française de Financement Local's activity is presented below.

15.1.3.1. Classification and measurement

The new standard now only provides for three categories of financial instruments: those recognized at amortized cost, those recognized at fair value through profit or loss and those recognized at fair value through other comprehensive income. This classification depends both on the business model in which the financial asset is used and the instrument's contractual features. A financial asset is at amortized cost if:

- the sole purpose for holding it is to collect the associated contractual cash flows;
- these contractual cash flows represent solely payments of principal and interest (SPPI⁽²⁾).

Most of the loans and securities listed as assets of Caisse Française de Financement Local meet these simplicity criteria (hold to collect models and SPPI characteristics) and continue to be recognized at amortized cost. However, certain portfolios will have to be recognized at fair value: these are mainly cash investments under a hold to collect and sell model (fair value recognized directly through other comprehensive income) and structured loans whose financial flows are not SPPI (fair value recognized through profit or loss). Furthermore, sensitivity reduction operations and certain restructurings of non-SPPI loans as SPPI loans are now systematically considered as capable of derecognition, leading to immediate recognition of the early repayment penalty:

(1) Within the framework of the successful policy to reduce the interest rate sensitivity in 2016 and the confirmation of legal decisions favorable to the bank, Caisse Française de Financement Local was able to hone, in a reasonable and prudent manner, the methods it uses to estimate the recoverability of flows of non-performing loans on its balance sheet. In particular, in order to account for the impact of the spread of payments, the implementation of this approach, which is in compliance with IFRS, makes it no longer systematically necessary to estimate the total amount of interest to account for hypotheses of future recovery. Thus, the net interest rate expense is improved through a recovery of provisions in the amount of EUR 31 million, recorded as of December 31, 2017.

(2) SPPI: Solely Payments of Principal and Interest

- in equity for the first time application of IFRS 9 for restructurings that occurred prior to January 1, 2018;
- in the income statement for restructurings that will occur from January 1, 2018.

15.1.3.2. Impairment

In accordance with the new IFRS 9, loans and securities measured at amortized cost or at fair value through other comprehensive income will be classified in one of three levels:

- level 1: performing loans;
- level 2: loans whose risk has deteriorated significantly;
- level 3: non-performing loans.

Provisions will be recorded in respect of all these assets, including performing loans. The related impairment will be based on forward-looking scenarios (defined by probability of occurrence), and will take into account expected losses over the next 12 months (level 1) or the asset's life (levels 2 and 3).

In addition, changes in the credit risk of loans and securities recognized at fair value through profit or loss will be included in their valuation.

15.1.3.3. Hedge accounting

Pending the entry into force of the future macro-hedging standard, Caisse Française de Financement Local has chosen to continue applying IAS 39 in this area.

15.1.3.4. Expected impacts on future equity and results

The first-time application of IFRS 9 to transactions on Caisse Française de Financement Local's balance sheet as of January 1, 2018 will have a limited impact on equity as regards the new provisioning methods, but a more significant impact from the classification and measurement standpoint.

Overall, the first-time application of the standard will have a positive impact of less than 1% on the CET1 solvency ratio.

IFRS 9 will also have an impact on future results due mainly to changes in the fair value of non-SPPI loans, which will lead to increased income volatility. This standard will therefore increase the volatility of NBI in a way unrelated to Caisse Française de Financement Local's activity, as its business model involves holding all loans until maturity. It will therefore be necessary to be able to isolate these impacts and remove them from the Company's performance analyses.

15.2. INCOME ACCORDING TO FRENCH GAAP

Net income for the year 2017 is presented below in a synthetic manner.

French GAAP EUR millions	2015	2016	2017	Change 2017/2016
Interest margin	186	179	127	
Net commissions	(26)	(7)	(12)	
Provisions and income on trading portfolio	0	(0)	0	
Provisions and income on securities	21	(9)	3	
Other income and expense	(0)	-	-	
NET BANKING INCOME	181	163	118	(28)%
General operating expenses	(90)	(91)	(98)	
Taxes	(6)	(7)	(7)	
GROSS OPERATING INCOME	85	65	13	(80)%
Cost of risk	(14)	18	22	
OPERATING INCOME	71	83	35	(58)%
Income (loss) on fixed assets	(5)	-	-	
Income tax	(96)	(16)	(5)	
NET INCOME	(30)	67	30	(56)%

The Company's business is piloted according to IFRS (as adopted by the European Union). The French GAAP financial statements are published in accordance with legal requirements and serve as a base to calculate income subject to corporate income tax.

Readers are reminded that the accounting treatment for recognition of the penalties due to the early repayment of loans and swap unwinding payments for termination of hedging swaps in the French GAAP accounts differs from the treatment applied in the accounts prepared pursuant to IFRS. Pursuant to IFRS, cash payments and penalties are usually amortized, while they are usually recognized immediately in Net banking income, according to French GAAP. This accounting treatment may lead to recognition of the results earlier than would a systematic amortization approach. These penalties and cash payments are generated by early reimbursements, but also by renegotiations, which generally accompany active debt management by borrowers, as well as swaps which are cancelled in order to back assets to liabilities directly. The methods employed, which have not changed in the last three years, are described in the rules of presentation and evaluation of the financial statements in the notes to the financial statements in the sections entitled Customer loans, Micro-hedge transactions and Macro-hedge transactions.

Net banking income dropped by 28%, i.e. EUR -45 million, as compared with the same period in 2016, from EUR +163 million to EUR +118 million.

This decrease was due in particular to Interest margin, which decreased by EUR -52 million from EUR +179 million to EUR +127 million. The Interest margin corresponds to the difference between assets income and the cost of liabilities (fully hedged against interest rate and foreign exchange risks). It varies depending on whether it is presented under IFRS (economic view) or French GAAP (see above), which can make changes difficult to interpret, especially in years of very active local government entity debt management (including sensitivity reduction operations). This was particularly the case in 2016, which explains the high level of interest margin for that year.

At the same time, Net commissions increased compared with 2016, representing a net charge of EUR -12 million.

Lastly, Provisions and income on securities increased by EUR +12 million, reflecting a provision reversal in 2017 related to the increase in market value of placement securities.

Operating expenses consisted mainly of the invoicing of the parent company for Caisse Française de Financement Local's operational management. The increase in operating expenses between 2016 and 2017 was mainly driven by an increase in IT expenditure.

The Cost of risk was positive at EUR +22 million in 2017, up EUR +4 million compared with 2016. This improvement results from the positive effects generated by the structured loan sensitivity reduction policy.

There was a EUR -5 million income tax charge for the fiscal year.

Net income fell from EUR +67 million in 2016 to EUR +30 million in 2017.

15.3. YIELD OF THE ASSETS

Article R.511-16-1 of the Monetary and Financial Code, introduced by the decree 2014-1315 of November 3, 2014, requires that in their annual financial report, credit institutions publish the yield of their assets, defined as the ratio between the net result and the total of the balance sheet. In 2017, this ratio equals +0.06% in IFRS and +0.05% in French GAAP.

16. Proposed allocation of net income

In previous years, Caisse Française de Financement Local has made the following distributions:

Year of distribution	Distributed from the year's income	Amount distributed EUR	Amount per share EUR	Number of shares
2000	1999	3,600,000	1.20	3,000,000
2001	2000	-	-	4,000,000
2002	2001	-	-	4,500,000
2003	2002	-	-	4,500,000
2004	2003	120,000,000	24.00	5,000,000
2005	2004	62,000,000	10.00	6,200,000
2006	2005	84,320,000	12.40	6,800,000
2007	2006	116,280,000	15.30	7,600,000
2008	2007	70,080,000	8.00	8,760,000
2009	2008	113,520,000	12.00	9,460,000
2010	2009	133,560,000	12.60	10,600,000
2011	2010	110,075,000	9.25	11,900,000
2012	2011	15,080,000	1.16	13,000,000
2013	2012	-	-	13,150,000
2014	2013	-	-	13,150,000
2015	2014	-	-	13,150,000
2016	2015	-	-	13,150,000
2017	2016	35,110,500	2.67	13,150,000

The Ordinary Shareholders' Meeting will be asked to distribute a dividend in the amount of EUR 50 millions and to vote a resolution to allocate net income as follows (in euros).

ALLOCATION OF NET INCOME	EUROS
Net income for the year	29,705,091.31
Legal reserve (5%)	(1,485,257.57)
Income available	28,219,836.74
Retained earnings	23,640,014.37
Income available for distribution	51,859,851.11
Proposed dividends	(49,950,000)
Retained earnings after allocation	1,909,851.11

17. Outlook for 2018

In 2018, Caisse Française de Financement Local and its parent company SFIL will aim to:

- maintain their role as a major player in the market for loans to French local governments and public hospitals, within the framework of the system established with La Banque Postale;
- continue their key role as refinancer of partner banks of French exporters, for large export credits.

The bulk of the sensitivity reduction work has been completed and by end-2018 the most at-risk outstandings, i.e. those indexed on EUR/CHF, will be reduced to a marginal level. This activity, which generally involves granting new loans to the local government entities concerned, will now be scaled down. In addition, the already very significant reduction in the number of lawsuits issued in the year ended December 31, 2017, is expected to continue in 2018.

In addition, as announced on March 8, 2018, SFIL's refinancing export credit system may be expanded to loans designed to finance projects considered strategic for France without necessarily having to be linked to an underlying export. These projects will benefit from a new guarantee of the French State, and may be refinanced by Caisse Française de Financement Local through an enhanced guarantee arrangement.

In 2018, new loans will be included in Caisse Française de Financement Local's cover pool representing exposures to the French local public sector and the French State.

To cover its financing requirements, in 2018 Caisse Française de Financement Local plans to issue between EUR 4 billion and EUR 6 billion of *obligations foncières* with a long average maturity, adapted to the profile of the assets financed. Its program will mainly be carried out through a number of benchmark issues in euros and private placements adapted to the needs of its broad investor base.

Lastly, from a macro-economic point of view, as in 2017, two significant background issues will be closely monitored in 2018:

- developments in the regulatory environment;
- market volatility in a context influenced by the perspectives for a quantitative easing exit strategy announced by the European Central Bank, the provisions linked to Brexit and the geopolitical environment.

Breakdown of cover pool as of December 31, 2017

EUR millions	12/31/2017				12/31/2016	
	Direct exposure		Indirect exposure		Total	Total
COUNTRY	Loans	Bonds	Loans	Bonds		
France						
State:						
- export refinancing	-	-	218	-	218	-
- other	5	-	113	-	118	98
Banque de France	1,707	-	-	-	1,707	3,685
Regions	1,813	325	261	-	2,399	2,051
Departments	6,834	-	184	-	7,018	6,986
Municipalities	15,706	19	440	-	16,165	16,648
Groups of municipalities	10,935	83	154	-	11,172	11,004
Public sector entities:						
- health	6,219	-	-	-	6,219	6,310
- social housing	1,291	-	-	-	1,291	1,421
- other	875	243	1	-	1,119	945
Credit institutions	370	324	-	-	694	650
Subtotal	45,755	994	1,371	-	48,120	49,798
Germany						
Länder	-	275	-	-	275	515
Subtotal	-	275	-	-	275	515
Austria						
Länder	-	-	187	-	187	191
Subtotal	-	-	187	-	187	191
Belgium						
Regions	8	-	22	-	30	44
Communities	-	-	-	-	-	50
Public sector entities	54	-	-	-	54	60
Credit institutions	-	57	-	-	57	-
Subtotal	62	57	22	-	141	154
Canada						
Provinces	-	-	-	-	-	22
Communities	161	-	-	-	161	172
Public sector entities	35	-	-	-	35	129
Subtotal	196	-	-	-	196	323
Spain						
State	-	200	-	-	200	200
Regions	-	65	-	-	65	104
Municipalities	80	-	-	-	80	88
Subtotal	80	265	-	-	345	392
United States						
Federated States	-	253	-	-	253	252
Subtotal	-	253	-	-	253	252

EUR millions	12/31/2017					12/31/2016
	Direct exposure		Indirect exposure		Total	Total
	Loans	Bonds	Loans	Bonds		
COUNTRY						
Italy						
State	-	543	-	-	543	541
Regions	-	1,975	-	-	1,975	2,043
Provinces	-	522	-	-	522	566
Municipalities	8	1,843	-	-	1,851	1,973
Subtotal	8	4,883	-	-	4,891	5,123
Japan						
Municipalities	-	25	-	-	25	25
Subtotal	-	25	-	-	25	25
Norway						
Credit institutions	-	70	-	-	70	-
Subtotal	-	70	-	-	70	-
Portugal						
Municipalities	17	-	-	-	17	20
Public sector entities	5	-	-	-	5	6
Subtotal	22	-	-	-	22	26
United Kingdom						
State	-	-	-	232	232	320
Subtotal	-	-	-	232	232	320
Sweden						
Municipalities	18	-	-	-	18	18
Credit institutions	-	100	-	-	100	-
Subtotal	18	100	-	-	118	18
Switzerland						
Cantons	263	-	40	-	303	386
Municipalities	493	-	-	-	493	556
Public sector entities	90	-	-	-	90	91
Subtotal	846	-	40	-	886	1,033
Supranational						
International organizations	28	-	-	-	28	32
Subtotal	28	-	-	-	28	32
TOTAL COVER POOL	47,015	6,922	1,620	232	55,789	58,202

Loans and securities are off premium / discount. Loans and securities denominated in foreign currencies are recorded at their euro swapped value. Loans and bonds are presented after specific impairments. In addition to these impairments, Caisse Française de Financement Local makes collective and sectorial impairments.

Income for the last five years

	2013	2014	2015	2016	2017
FINANCIAL POSITION					
Share capital (EUR millions)	1,315	1,315	1,315	1,315	1,350
Number of shares	13,150,000	13,150,000	13,150,000	13,150,000	13,500,000
RESULTS OF OPERATIONS (EUR MILLIONS)					
Revenues ⁽¹⁾	2,287	1,177	2,172	2,476	575
Income before income tax, amortization, depreciation and contingencies net of reversals	94	63	71	86	14
Income tax	(5)	(9)	(96)	(16)	(5)
Income after income tax, amortization, depreciation and contingencies net of reversals	(21)	8	(30)	67	30
Exceptional distribution	-	-	-	-	-
Dividend ⁽²⁾	-	-	-	35	50
PER SHARE DATA (EUR)					
Revenues	173.89	89.54	165.16	188.28	43.72
Income after income tax, before amortization, depreciation and contingencies net of reversals	6.74	4.12	(1.92)	5.37	0.64
Income tax	(0.42)	(0.69)	(7.34)	(1.19)	(0.40)
Income after income tax, amortization, depreciation and contingencies net of reversals	(1.56)	0.59	(2.30)	5.08	2.26
Exceptional distribution	-	-	-	-	-
Dividend per share ⁽²⁾	-	-	-	2.67	3.70

(1) Revenues are comprised of the macro-hedging items:
- interest and related income, netted of macro-hedging expense;
- commission income;
- net income on foreign exchange transactions;
- other operating income.

(2) For 2017: proposed distribution for the fiscal year.

Report of one of the statutory auditors, appointed as independent third-party, on the social, environmental and societal information published in the management report

Year ended December 31, 2017

This is a free English translation of the statutory auditors' report issued in French and is provided solely for the convenience of English-speaking readers. This report should be read in conjunction with, and construed in accordance with, French law and professional standards applicable in France.

To the Shareholders' Meeting,

In our capacity as statutory auditor of Caisse Française de Financement Local, and appointed as independent third-party, for whom the certification request has been approved by the French National Accreditation Body (COFRAC) under the number 3-1048⁽¹⁾, we hereby present you with our report on the social, environmental and societal information prepared for the year ended December 31, 2017 (hereinafter the "CSR Information"), presented in the management report pursuant to Article L.225-102-1 of the French Code of Commerce (Code de commerce).

RESPONSIBILITY OF THE COMPANY

The Executive Board is responsible for preparing a management report including CSR Information in accordance with the provisions of Article R.225-105-1 of the Code of Commerce.

INDEPENDENCE AND QUALITY CONTROL

Our independence is defined by regulatory texts, the profession's Code of Ethics as well as by the provisions set forth in Article L.822-11 of the Code of Commerce. Furthermore, we have set up a quality control system that includes the documented policies and procedures designed to ensure compliance with rules of ethics, professional auditing standards and the applicable legal texts and regulations.

RESPONSIBILITY OF THE STATUTORY AUDITOR

Based on our work, our responsibility is:

- to attest that the CSR Information required under article R.225-105-1 of the Code of Commerce is presented in the management report or, in the event of omission, is explained pursuant to the third paragraph of article R.225-105 of the Code of Commerce;
- to express a reasoned opinion on the accuracy of information included in the management report and, if need be, the explanations relating to the omission of some of the CSR Information required under the third paragraph of article R.225-105 of the Code of Commerce;
- the procedures performed to conduct our mission.

Our work was carried out by a team of two people in March 2018. To assist us in conducting our work, we referred to our corporate responsibility experts.

We conducted the following procedures in accordance with professional guidance issued by the French national institute of statutory auditors (Compagnie nationale des commissaires aux comptes) and with the *arrêté* of May 13, 2013 determining the methodology according to which the independent third party entity conducts its assignment.

As indicated in the management report, the company does not disclose any CSR information because of the absence of employees and physical footprints. Our work consisted in the appreciation of the pertinence of the explications related to total absence of CSR information.

CONCLUSION

Based on these procedures:

- we attest the relevance of the explanations relating to the total omission of CSR Information in the management report;
- we do not have any observation to mention about the provided explanations.

Neuilly-sur-Seine, March 29, 2018.

French original signed by one of the statutory auditors:

DELOITTE & ASSOCIÉS
Sylvie Bourguignon

(1) the scope of which is available at www.cofrac.fr

