



CAFFIL

Activity Report

for the period from January 1st to March 31, 2018

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

1. Reminder of shareholding structure, economic model and ratings 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 – 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 impeccable 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 23 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 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. 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, 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 non-privileged funding and some of the derivatives 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 inter-mediated derivatives) are obtained by SFIL:

- either by its shareholders under credit agreements:
 - Caisse des dépôts et consignations (CDC) for the needs linked to operations booked prior to the date of acquisition of SFIL

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

(January 31, 2013) and to the new export refinancing activity;

- La Banque Postale (LBP) for 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, since 2016 SFIL gradually set up its signature by launching EMTN benchmark issues in EUR and USD. SFIL issued a new EMTN benchmark of EUR 1 billion over the first quarter of 2018 and EMTN bonds outstanding now represent an amount of EUR 4.1 billion. Refinancing issued by SFIL on financial markets will gradually replace refinancing provided by shareholders. Nevertheless, the latter will continue to be available if necessary in particular in the event of a need for liquidity during a stress context.

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 2017 – 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 partly or totally the management of these agreements 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 – 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 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 the first quarter of 2018

2.1 – THE COVERED BOND MARKET

The primary market for public euro-denominated covered bond issues (benchmark public issues) was active over the first quarter of 2018, with EUR 48 billion of new issues through 63 transactions (stable in comparison with the first quarter of 2017). During this quarter two following points can be highlighted, first of all the progressive decrease of purchases by the European Central Bank in anticipation of the expected end of the quantitative easing in the next September and the net offer which has been positive with EUR +22 billion. In this context, spreads remained stable even if the entrance cost in the primary market materialized by new issue premiums has slightly increased. In terms of distribution, German and French issuers represented 35% of the offer and

Canadian issuers, with almost 11%, benefited of costs of funding more favorable in euro than in dollar. Issuers from peripheral countries (Spanish, Italian and Greek) remained at a low level with 10% of the offer.

In this context, Caisse Française de Financement Local decided to enter the market early in the year by launching in January a successful issue of EUR 1.5 billion composed by two *tranches* with a maturity of 8 (for EUR 1 billion) and 15 years (for EUR 0.5 billion). It also took advantage of investor demand for long maturities to conduct private placements of EUR 222 million and to provide additional liquidity for its existing 2033 *souche* via a tap in the amount of EUR 150 million. With this tap the amount of this issue has stood at EUR 650 million. The average maturity of the financing raised over the first quarter of 2018 by Caisse Française de Financement Local was 12 years.

2.2 – RATING OF OBLIGATIONS FONCIÈRES

The ratings of the *obligations foncières* issued by Caisse Française de Financement Local were not altered over the first quarter of 2018.

As of March 31, 2018, 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, over the first quarter of 2018, Caisse Française de Financement Local acquired a total of EUR 1.5 billion in loans (EUR 1.8 billion over the first quarter 2017). Since the beginning of the partnership, loans acquired through LBP have accounted for almost EUR 13.7 billion.

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.

Over the first quarter of 2018, Caisse Française de Financement Local granted SFIL a new refinancing loan for a total amount of EUR 1.7 billion.

It is reminded to the reader that the drawing of refinancing large export credits loans is staggered over a number of years.

3. Changes in main balance sheet items

EUR billions	12/31/2016	12/31/2017	3/31/2018	Change 2018 / 2017
value after currency swaps				
Cover pool	58.2	55.8	55.8	0.0%
Loans	47.0	46.9	47.5	1.3%
Securities	7.5	7.2	7.3	1.6%
Cash deposit in central bank	3.7	1.7	1.0	(40.1)%
Assets temporary removed from the cover pool	-	-	0.0	ns
Privileged debt	51.7	49.7	49.7	0.0%
Obligations foncières ⁽¹⁾	50.4	49.0	49.2	0.4%
Cash collateral received	1.3	0.7	0.5	(21.1)%
Non-privileged debt	5.2	4.8	4.9	1.4%
SFIL	5.2	4.8	4.9	1.4%
Equity IFRS (excluding unrealized gains and losses)	1.4	1.5	1.5	0.4%

(1) Including registered covered bonds

As of March 31, 2018, Caisse Française de Financement Local's cover pool excluding accrued interest not yet due amounted to EUR 55.8 billion (stable compared with December 31, 2017). 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, invested in bank or European public sector securities or lent to SFIL, the parent Company of Caisse Française de Financement Local. The cash surplus, placed with the Banque de France, represents EUR 1.0 billion at the end of March 2018, versus EUR 1.7 billion at the end of December 2017. The cash surplus invested in securities or lent to SFIL represents a total of EUR 1.9 billion as of March 31, 2018 versus EUR 1.6 billion at the end of December 2017.

As of March 31, 2018, 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, stable in comparison with December 2017.

As of March 31, 2018, the debt contracted with the parent company totaled EUR 4.9 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 2018

The cover pool over the first three months of 2018 remained stable compared with December 31, 2017. This change is explained by the following items.

EUR billions	2018 Q1
1- Acquisition of loans from La Banque Postale	1.5
Loans to the French public sector (vanilla loans in euros)	1.5
2- Export credits drawings	0.1
Loans to SFIL to refinance export credit guaranteed by the French State	0.1
3- Reduction of loan sensitivity	0.0
Sensitive structured loans eliminated	(0.1)
Refinancing loans (vanilla loans in euros)	0.0
New loans (vanilla loans in euros)	0.1
4- Amortization of portfolio of loans and securities	(1.1)
5- Early reimbursements	(0.1)
6- Changes in treasury	(0.4)
Net change in securities investments	0.3
Net change in Banque de France cash deposit	(0.7)
7- Other changes	(0.0)
Net change in the cover pool	0.0

Over the first quarter of 2018, Caisse Française de Financement Local acquired a total of EUR 1.5 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 2018 Q1 in the amount of EUR 0.1 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 over the first quarter of 2018 made it possible to decrease outstanding loans considered as sensitive by EUR 0.1 billion through their replacement with fixed rate loans. They were accompanied by new fixed rate loans in the amount of EUR 0.1 billion.

The natural amortization of the portfolio of loans and securities represented EUR 1.1 billion in 2018 Q1, and early reimbursements represented EUR 0.1 billion.

Available cash decreased by EUR 0.4 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 over the first three months of 2018.

4.2 – OUTSTANDING ASSETS AS OF MARCH 31, 2018

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	12/31/2017	3/31/2018
Loans and bonds to the public sector	53.2	53.3
<i>of which local public sector business line</i>	52.2	52.6
<i>of which large export credits refinancing business line ⁽¹⁾</i>	0.2	0.3
<i>of which treasury investment in public sector bonds ⁽³⁾</i>	0.7	0.5
Banque de France cash deposit ⁽³⁾	1.7	1.0
Replacement assets ⁽³⁾	0.9	1.4
COVER POOL	55.8	55.8
Financing commitments granted to refinance large export credits ⁽¹⁾⁽²⁾	3.0	4.7
Financing commitments granted to other public sector loans	0.1	0.0
FINANCING COMMITMENTS GRANTED	3.1	4.7

(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 2017 and 2018, commitments granted represented concluded contracts in drawing phase.

(3) The total amount of excess treasury (cash or cash investments) decreased from EUR 3.3 billion to EUR 2.9 billion over the quarter.

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 securities or in replacements assets (securities issued by banks or loans to SFIL, its parent company). These cash or cash equivalent are detailed in the above table (footnote 3).

The amount of financing commitments given came to EUR 4.7 billion as of March 31, 2018. They represented 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.

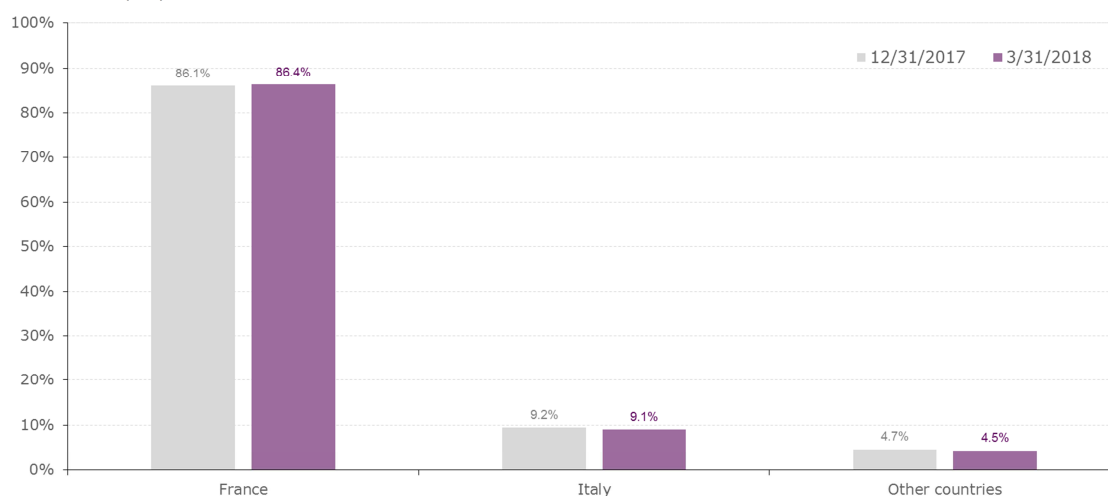
4.2.1. Public sector loans and securities (excluding replacement assets and treasury placed with the Banque de France)

4.2.1.1. Geographic breakdown

At the end of March 2018, French public sector loans made up the majority (86.4%) of the cover pool, a share due to increase in the future. They include loans acquired from La Banque Postale since 2013 for 22% (EUR 11.9 billion) and State-guaranteed loans granted to SFIL to refinance large export credits for less than 1% (EUR 0.3 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.



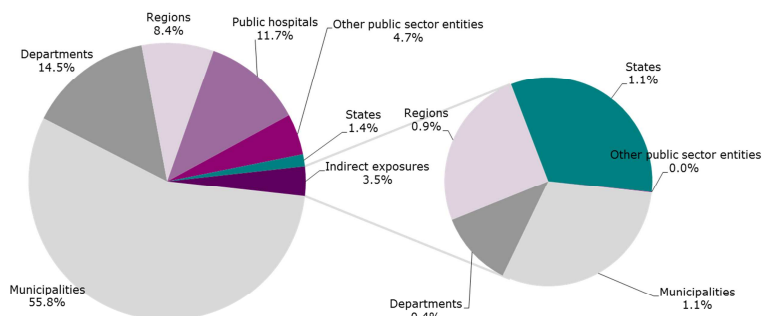
Exposures to Other countries as of March 31, 2018, are broken down by country in the section Bonds and public sector loans, which is presented at the end of this activity report.

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 March 31, 2018, replacement assets represented 2.9% 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 loans to SFIL to invest its surplus cash. These loans are also included in the replacement assets.

Replacement assets	Country	12/31/2017	3/31/2018
EUR millions			
Step 1 credit rating			
Covered bonds			
	France	176	135
	Other countries ⁽¹⁾	127	252
Other bank bonds			
	France	148	168
	Other countries ⁽¹⁾	100	200
Loans to parent company, SFIL	France	360	500
Step 2 credit rating			
Bank bonds (maturity < 100 days)			
	France	-	85
	Other countries ⁽¹⁾	-	95
Bank accounts balances	France and Other countries ⁽¹⁾	10	3
TOTAL		921	1,438

⁽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. Structured loans, according to the charter of good practices, which can be consulted on the Internet site of the French Ministry of the Interior and signed by several organizations that represent local governments in France, 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⁾		
	12/31/2017	3/31/2018	Change	% cover pool	12/31/2017	3/31/2018	Change
French public sector loans	45.0	45.6	0.6	81.7%	15,366	14,988	(378)
Vanilla loans	39.6	40.4	0.8	72.5%	13,720	13,432	(288)
Structured loans	5.4	5.2	(0.2)	9.3%	1,646	1,556	(90)
Sensitive loans not in the charter	0.6	0.6	(0.0)	1.0%	64	61	(3)
Sensitive loans (3E/4E/5E)	0.8	0.7	(0.1)	1.3%	162	155	(7)
Subtotal sensitive loans:	1.4	1.3	(0.1)	2.3%	226	216	(10)
Structured loans benefiting from the derogatory mechanism of the support fund	0.5	0.4	(0.0)	0.8%	71	67	(4)
Other structured loans	3.5	3.5	(0.0)	6.3%	1,349	1,273	(76)

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

In 2018, outstanding loans to the French public sector have increased by EUR 0.6 billion, with a EUR 0.8 billion increase in non-structured loans (vanilla) and a decrease of EUR 0.2 billion in structured loans (see the definition above).

At the end of March 2018, structured loans on the balance sheet of Caisse Française de Financement Local represented EUR 5.2 billion.

4.2.4.3. Sensitive loans

Sensitive loans, which are the most structured, totaled EUR 1.3 billion as of March 31, 2018, compared with EUR 1.4 billion as of December 31, 2017. Among these loans, those considered to be the most sensitive (outside the charter) represented EUR 0.6 billion, or 1.0% of the cover pool and 61 customers as of March 31, 2018 (64 customers as of December 31, 2017). These 61 customers are mostly municipalities with a population of more than 10,000 inhabitants and groups of municipalities, and to a lesser extent, public 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 663 between SFIL's launch and March 31, 2018 (216 customers as of March 31, 2018, against 879 clients at SFIL's launch). At the same time, the outstanding sensitive loans dropped from EUR 8.5 billion to EUR 1.3 billion (2.3% of the cover pool), i.e. a decrease of more than 84%. In addition, at the end of March 2018, 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. These decrease include EUR 0.4 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.

5. Debt benefiting from the legal privilege

As of March 31, 2018, 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	12/31/2017	3/31/2018
Cash collateral received	0.7	0.5
<i>Obligations foncières</i> and registered covered bonds	49.0	49.2
Total	49.7	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 2017. Its level stood at EUR 0.5 billion at the end of March 2018.

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 2018

Over the first quarter of 2018, Caisse Française de Financement Local achieved a volume of issues of EUR 1.9 billion by issuing a new public benchmark, by increasing the amount of one existing *souche* (tap) and by continuing to work in the private placement segment.

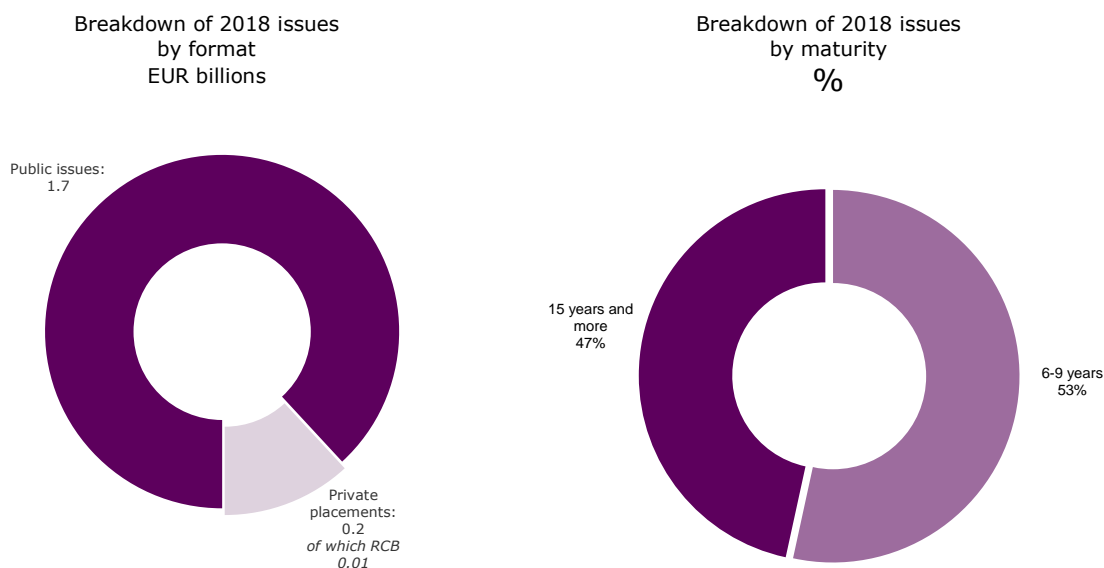
At the beginning of January, Caisse Française de Financement Local raised money in the primary market through a EUR 1.5 billion dual tranche bond transaction:

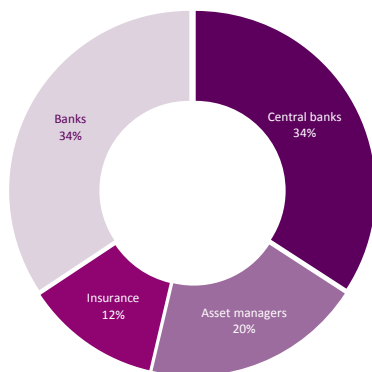
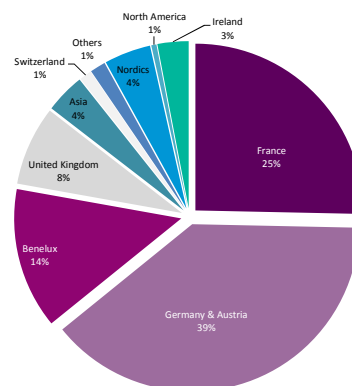
- a 8-year issue for EUR 1.0 billion;
- a 15-year issue for EUR 0.5 billion.

Moreover, Caisse Française de Financement Local provided additional liquidity for its issue of January 2033 *via* a tap for an amount of EUR 0.15 billion.

In addition to these public transactions, Caisse Française de Financement Local remained active in the private placement segment, thus making it possible to respond to investors' search for long and very long maturities. A total of EUR 0.2 billion was raised in this market segment, of which more than 97% on maturities of 20 years or more.

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.



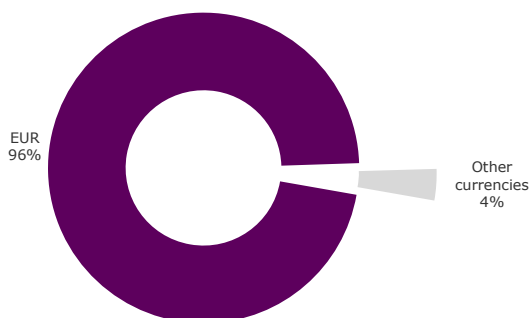
Breakdown of 2018 public issues
by investor category
%Breakdown of 2018 public issues
by geographic zone
%

5.2.2. Outstanding debt at the end of March 2018

Outstanding *obligations foncières* and registered covered bonds totaled EUR 49.2 billion in swapped value at the end of March 2018. This includes new issues of *obligations foncières* for EUR 1.9 billion and amortization of issues maturing in the first quarter for EUR 1.7 billion.

EUR billions, value after currency swaps	2017	2018
BEGINNING OF THE PERIOD	50.4	49.0
Issues	6.0	1.9
Amortizations	(7.2)	(1.7)
Buyback	(0.2)	-
END OF THE PERIOD	49.0	49.2

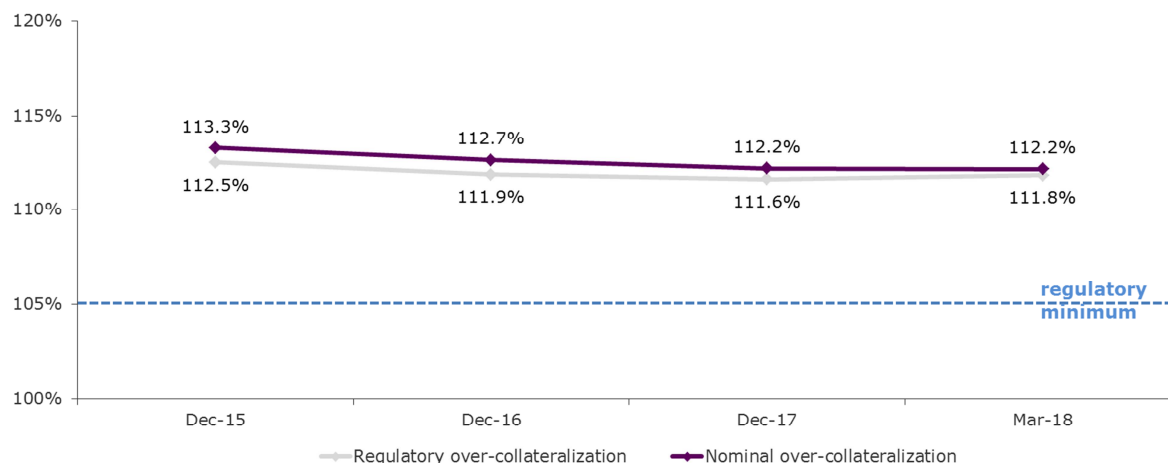
As of March 31, 2018, issues can be broken down by currency as follows:



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.

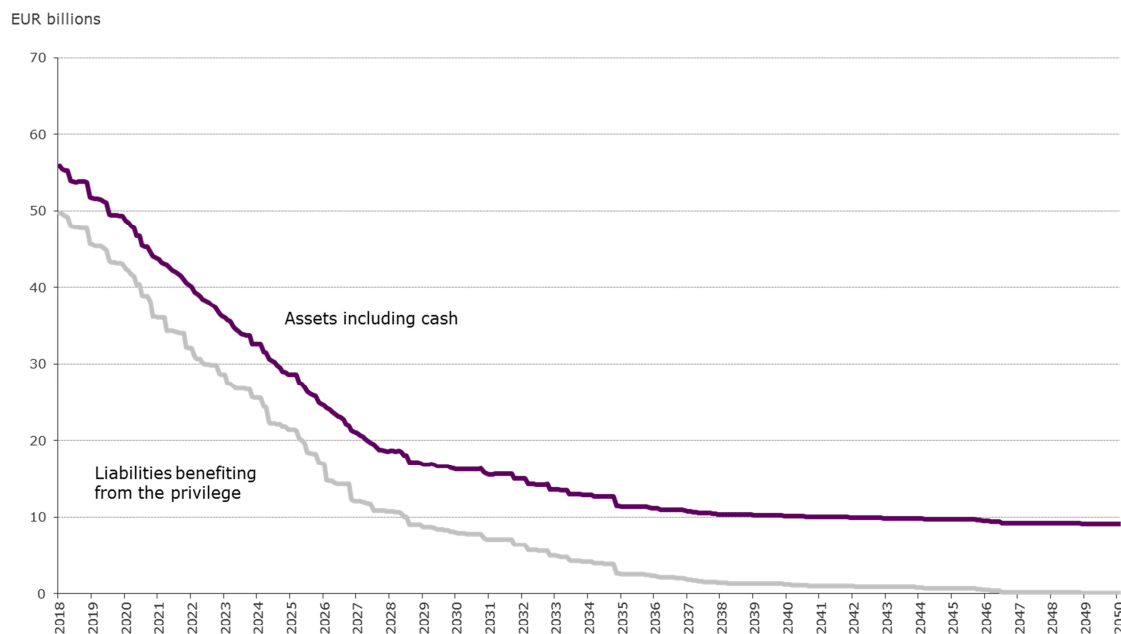


Regulatory over-collateralization may differ from nominal over-collateralization. In fact, it is calculated on the basis of the rules determined by the Autorité de contrôle prudentiel et de résolution (ACPR). In particular, these rules require different weighting levels according to the assets. The assets in Caisse Française de Financement Local's cover pool are all 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 March 31, 2018.

Amortization of assets and liabilities as of March 31, 2018



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 March 2018, 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. This fund does not benefit from the privilege stipulated in the law on *sociétés de crédit foncier*, but it is 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	12/31/2017	3/31/2018
SFIL	4.8	4.9
Banque de France	-	-
TOTAL	4.8	4.9

8. Caisse Française de Financement Local's main risks

8.1 – CREDIT RISK

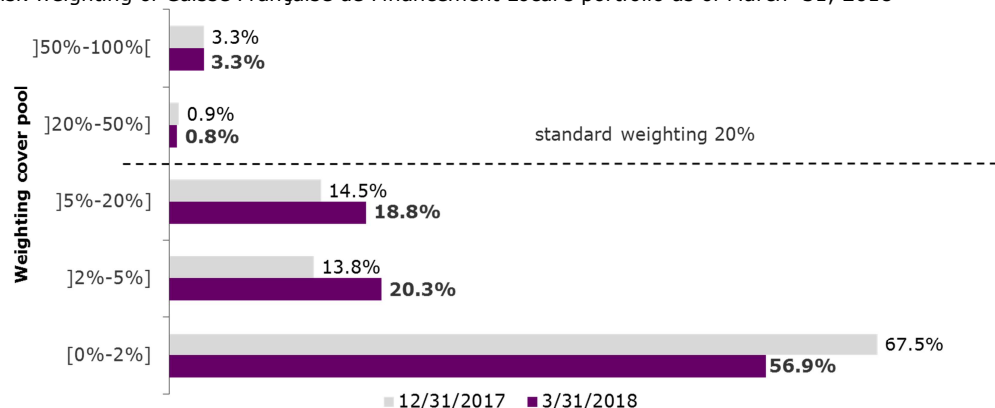
8.1.1. Definition

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.

8.1.2. 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 March 31, 2018, 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 March 31, 2018



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

- more than 76% of the portfolio has a weighting of less or equal to 5%;
- the average risk weighting of the cover pool assets is 6.7%, 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%.

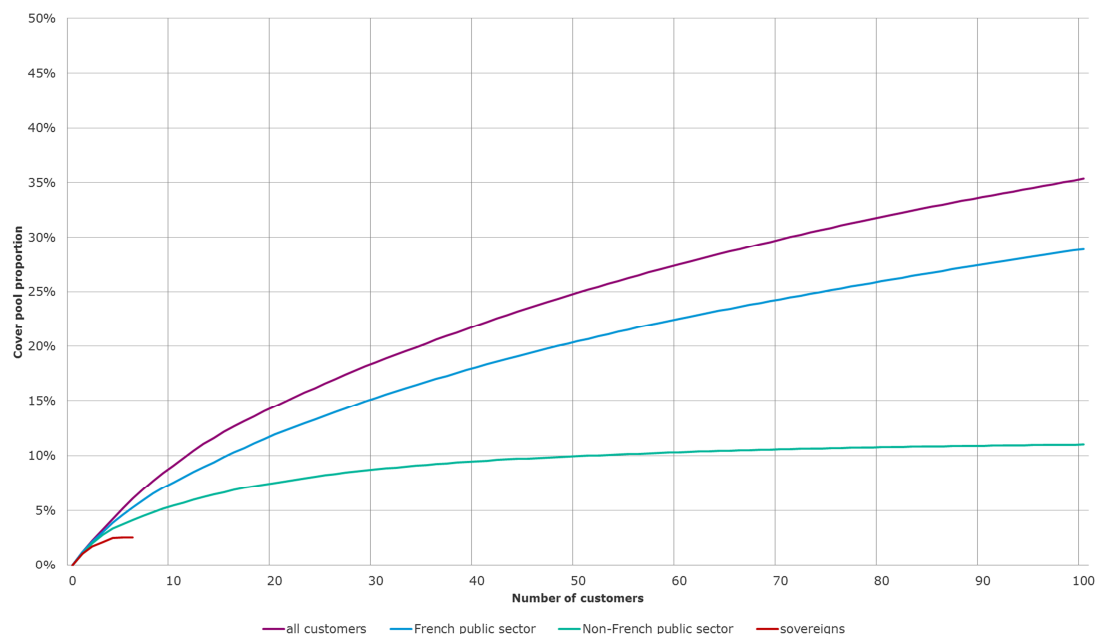
Since December 31, 2017, Change in weighting is mainly due to methodological changes within internal rating models of Caisse Française de Financement Local.

Weighted exposure with respect to credit risk amounted to EUR 5,177 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 5,826 million.

8.1.3. 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.



As of March 31, 2018, 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, 2017). The largest exposure accounted for only 1.2% of the cover pool and the twentieth exposure 0.4%.

8.1.4. Non-performing loans, litigious loans, provisions

Caisse Française de Financement Local does not publish quarterly accounts, but only half-year and annual accounts. Therefore, information concerning Non-performing loans, litigious loans and provisions is not available in this activity report. Last updated information about these issues was disclosed in the management report of the annual financial report 2017 which is on the website of the Company.

8.1.5. 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 1.4 billion (see 4.2.2.);
- bank account balances in euros and other currencies, representing EUR 3 million, excluding cash deposited on the Banque de France account;
- 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 never 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 March 2018, Caisse Française de Financement Local was exposed (positive fair value of the swaps) on nine banking counterparties which all paid cash collateral of EUR 0.5 billion, offsetting total exposure.

All derivative exposures as of March 31, 2018, 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	18.8%	(1.5)	-	-	1
Other counterparties	35.3	66.8	81.2%	(2.4)	0.5	0.5	25
Total	35.3	82.3	100.0%	(3.9)	0.5	0.5	26

The swaps negotiated with external counterparties represented 81.2% of outstanding long-term swaps and those signed with SFIL 18.8%. The long-term swaps signed with the five largest counterparties represented a total of 44% of the long-term notional amounts.

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

8.1 – MARKET RISK

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 valuation of assets recognized through at fair value profit or loss and those recognized at fair value through other comprehensive income, 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.

8.3 – ALM RISK

8.3.1. Liquidity risk

8.3.1.1. Definition and liquidity risk management

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.

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-collateralization¹.

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

- financing of the assets (EUR 47.5 billion in loans, EUR 7.3 billion in securities, and EUR 1.0 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:

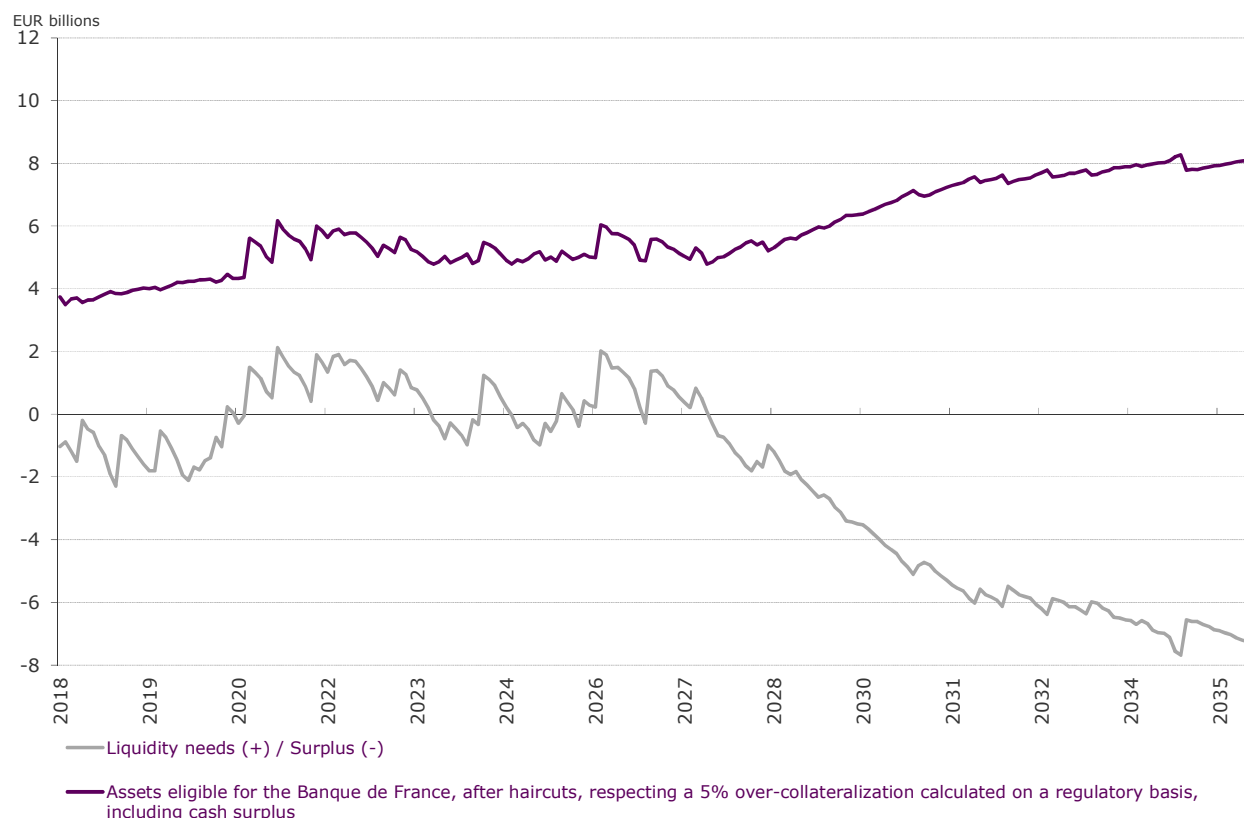
- debt benefiting from the legal privilege, i.e. *obligations foncières* and registered covered bonds (EUR 49.2 billion) and the cash collateral received by Caisse Française de Financement Local (EUR 0.5 billion);
- refinancing arising from the loan agreement entered into with SFIL to cover the financing requirements related to Caisse Française de Financement Local's over-collateralization (EUR 4.9 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 2018, 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.

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

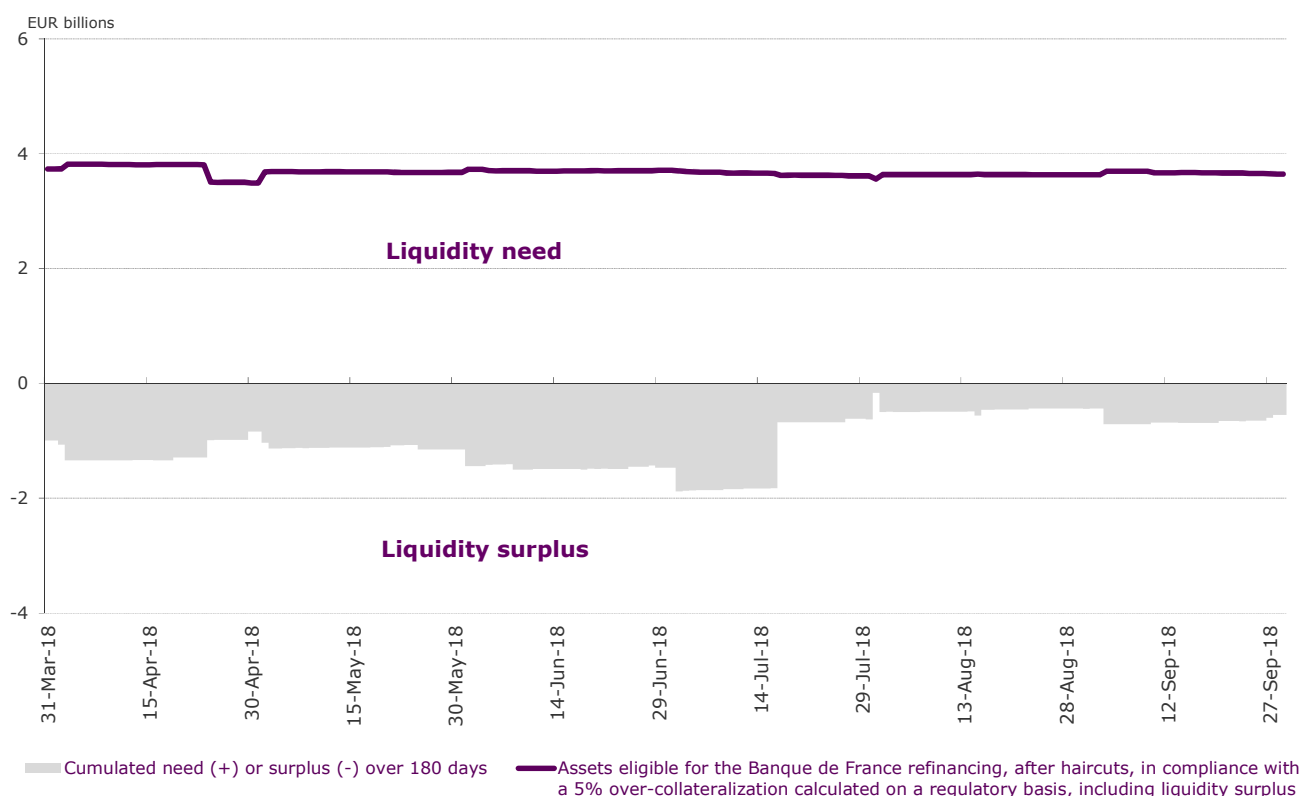
The chart below shows the forecast aggregate liquidity requirement and the assets needed to cover this requirement.



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 March 2018, 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 March, 2018, Caisse Française de Financement Local's LCR was 480%.

- 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 0.97 years as of March 31, 2018 (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.

8.3.1.2. 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 8.3.2.2.), 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 8.3.2.2.), 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)":

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

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	3/31/2017	6/30/2017	9/30/2017	12/31/2017	3/31/2018
<i>Cover pool</i>	7.35	7.02	7.23	7.44	7.64
Privileged liabilities	6.32	6.36	6.45	6.49	6.67
Gap in asset-liability duration	1.03	0.67	0.77	0.95	0.97
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)	3/31/2017	6/30/2017	9/30/2017	12/31/2017	3/31/2018
<i>Cover pool</i>	7.88	7.63	7.82	7.99	8.17
Privileged liabilities	6.75	6.86	6.93	6.93	7.12
Gap in asset-liability weighted average life	1.13	0.77	0.88	1.06	1.05

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.

8.3.2. Interest rate risk

8.3.2.1. 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.

8.3.2.2. 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 cancellation 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.

8.3.2.3. 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	3/31/2017	6/30/2017	9/30/2017	12/31/2017	12/31/2017
Sensitivity	(25)/25	(0.1)	(1.6)	1.0	1.5	(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	3/31/2017	6/30/2017	9/30/2017	12/31/2017	12/31/2017
Short term	(10)/10	0.1	0.4	(1.7)	0.2	(7.1)
Medium term	(10)/10	2.0	(4.5)	(2.4)	(4.6)	(2.1)
Long term	(10)/10	(2.6)	1.5	3.8	3.1	5.6
Very long term	(10)/10	0.4	1.1	1.3	2.7	2.0

Risk of slope between two close points on the rate curve

Sum of sensitivities in absolute value

EUR millions	Limit	3/31/2017	6/30/2017	9/30/2017	12/31/2017	12/31/2017
Short term	20	3.3	7.8	10.2	11.6	11.5
Medium term	20	5.1	12.4	10.9	14.8	4.6
Long term	20	4.9	3.5	7.1	3.6	7.9
Very long term	20	5.3	5.6	6.5	6.9	10.5

8.3.2.4. 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 March 31, 2018.

Breakdown of outstanding swaps	Notional
EUR billions	Absolute value
Euribor against Eonia	
Macro-hedges	35.3
TOTAL SHORT-TERM SWAPS	35.3
Fixed rate swaps against Euribor	
Micro-hedges on <i>obligations foncières</i>	40.5
Micro-hedges on loans and debt securities	21.9
Macro-hedges on loans	14.9
Subtotal	77.3
Currency swaps	
Micro-hedges on <i>obligations foncières</i>	1.6
Micro-hedges on loans	2.8
Micro-hedges on debt securities	0.6
Subtotal	5.0
TOTAL LONG-TERM SWAPS	82.3

8.3.3. Foreign exchange risk

8.3.3.1. 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.

8.3.3.2. 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, in the event of a delay of drawing dates initially planned and hedged. 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.

8.4 – OTHER RISKS

8.4.1. Operational risk

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.

Caisse Française de Financement Local delegates to SFIL the functions of internal control, within the framework of a management agreement. The management processes applied to operational risks and permanent control are described in the section 9.2.4. of the Management Report of the Annual Financial Report 2017.

8.4.2. Legal and tax risks

8.4.1.1. 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.

8.4.1.2. Legal risk

As of March 31, 2018, the number of borrowers in litigation for structured loans was 23, compared with 25 as of December 31, 2017. Since SFIL's creation, 200 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, the Versailles Court of Appeal and the Court of Cassation have handed down 32 court decisions ruling in favor of Dexia Crédit Local, SFIL and Caisse Française de Financement Local. The Court of Cassation has confirmed, by a judgment on March 28, 2018, the analysis of the Court of Appeal and the validity of structured loans. 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 March 31, 2018, there were no other significant lawsuits or disputes between Caisse Française de Financement Local and its borrowers.

8.4.1.3. 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 income tax. However, Caisse Française de Financement Local does not agree with the position of the tax authorities and started an appeal since 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.

8.4.3. Risks of non-compliance

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 ».

Caisse Française de Financement Local delegates to SFIL the functions of internal control, within the framework of a management agreement. The management processes applied to non-compliance risks are described in the section 9.2.6. of the Management Report of the Annual Financial Report 2017.

9. 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 March 31, 2018

EUR millions	3/31/2018				12/31/2017	
	Direct exposure		Indirect exposure			
COUNTRY	Loans	Bonds	Loans	Bonds	Total	Total
France						
State:						
- export refinancing	-	-	282	-	282	218
- others	5	-	113	-	118	118
Banque de France	1,022	-	-	-	1,022	1,707
Regions	1,823	90	259	-	2,172	2,399
Departments	6,976	-	189	-	7,165	7,018
Municipalities	15,594	19	419	-	16,032	16,165
Groups of municipalities	11,463	83	146	-	11,692	11,172
Public sector entities:					-	
- health	6,215	8	-	-	6,223	6,219
- social housing	1,252	-	-	-	1,252	1,291
- others	885	243	1	-	1,129	1,119
Credits institutions	503	388	-	-	891	694
Subtotal	45,738	831	1,409	-	47,978	48,120
Germany						
Länder	-	275	-	-	275	275
Subtotal	-	275	-	-	275	275
Austria						
Länder	-	-	186	-	186	187
Subtotal	-	-	186	-	186	187
Belgium						
Regions	8	-	22	-	30	30
Public sector entities	51	-	-	-	51	54
Credits institutions	-	57	-	-	57	57
Subtotal	59	57	22	-	138	141
Canada						
Communities	161	-	-	-	161	161
Public sector entities	35	-	-	-	35	35
Subtotal	196	-	-	-	196	196
Spain						
State	-	200	-	-	200	200
Regions	-	65	-	-	65	65
Municipalities	80	-	-	-	80	80
Subtotal	80	265	-	-	345	345
United States						
Federated States	-	252	-	-	252	253
Subtotal	-	252	-	-	252	253

EUR millions	3/31/2018				12/31/2017	
	Direct exposure		Indirect exposure		Total	Total
PAYS	Loans	Bonds	Loans	Bonds		
Italy						
State	-	550	-	-	550	543
Regions	-	1,973	-	-	1,973	1,975
Provinces	-	516	-	-	516	522
Municipalities	8	1,822	-	-	1,830	1,851
Subtotal	8	4,861	-	-	4,869	4,891
Japan						
Municipalities	-	25	-	-	25	25
Subtotal	-	25	-	-	25	25
Norway						
Credits institutions	-	177	-	-	177	70
Subtotal	-	177	-	-	177	70
Netherlands						
Credits institutions	-	95	-	-	95	-
Subtotal	-	95	-	-	95	-
Portugal						
Municipalities	17	-	-	-	17	17
Public sector entities	4	-	-	-	4	5
Subtotal	21	-	-	-	21	22
United Kingdom						
State	-	-	-	209	209	232
Subtotal	-	-	-	209	209	232
Sweden						
Municipalities	18	-	-	-	18	18
Credits institutions	-	217	-	-	217	100
Subtotal	18	217	-	-	235	118
Switzerland						
Cantons	263	-	28	-	291	303
Municipalities	423	-	-	-	423	493
Public sector entities	60	-	-	-	60	90
Subtotal	746	-	28	-	774	886
Supranational						
International organizations	26	-	-	-	26	28
Subtotal	26	-	-	-	26	28
TOTAL COVER POOL	46,892	7,055	1,645	209	55,801	55,789

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.