Agence Francaise de Developpement

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Major Rating Factors

Strengths:
- Almost certain extraordinary financial support from the French government.
- Virtual prompt access to emergency funding from the French treasury through the government's public debt fund ("Caisse de la Dette Publique").
- Sovereign mandate for official development assistance.
- Sound governance and management practices.

Weaknesses:
- Large exposure to speculative-grade counterparties.
- Significantly deteriorating capital ratios.
- Wholesale funded.

Rationale

Standard & Poor's Ratings Services equalizes its ratings on French state public agency Agence Francaise de Développement (AFD) with those on the Republic of France (AA/Stable/A-1+, unsolicited ratings), reflecting its opinion that there is an "almost certain" likelihood that the French government would provide timely and sufficient extraordinary support to AFD in the event of financial distress.

Under our criteria, we consider AFD to be a government-related entity (GRE), and we base our rating approach on our view of AFD's:
- "Critical" role as the legally mandated agency for the French government's bilateral aid and concessionary lending to developing countries and French overseas territories; and
- "Integral" link, due to its place in the machinery of the state, including being controlled and, as a bank, fully owned by the state.

AFD's status as an "Etablissement Public à Caractère Industriel et Commercial" (EPIC), prevents it from being subject to bankruptcy proceedings as the French government has ultimate legal responsibility for all of AFD's financial obligations. This government support gives AFD access to cheap wholesale funding.

Also reflected in our approach is the French government's strong financial and operational involvement with and monitoring of AFD as well as our belief that the agency's business model as a mainly wholesale funded bank, and public service focused activities, could not be carried out on a commercial basis.

Furthermore, we understand that AFD has potential prompt access to emergency funding from the French treasury through the state's public debt fund, "Caisse de la Dette Publique," which can implement any financial operation defending France's credit standing.

In a context of budgetary constraint, AFD has become even more important to the French government in meeting
international official development assistance (ODA) obligations at limited cost to the budget. France is committed to achieving 0.7% ratio of ODA to gross national income by 2015, although it probably won't meet this target. AFD's efficiency in leveraging state budgetary resources mitigates the cost of ODA to the government. In contrast, government transfers to multilateral development entities, which still channel 70% of French ODA, weigh directly on the government budget.

AFD showcases France's international development ambitions by delivering aid and helping to define the French approach to ODA. Along with the fight against extreme poverty, which is the primary goal of ODA, the stated objectives under the framework agreement between AFD and the French government comprise a focus on sustainable development, environmental protection, political freedom, and stability. AFD has also increasingly become a soft tool for French economic diplomacy, and remains one of the main sources of funds for French overseas territories.

On a stand-alone basis, we view AFD's exposure as risky, underpinned by a large number of loans to speculative-grade entities. Non-government-guaranteed loans increased to 92% of the total portfolio at year-end 2012, compared with 70% four years earlier. Nonetheless, AFD's banking regulatory framework underpins sound governance and risk management practices, in our view.

AFD has no retail deposit base, is structurally dependent on government funding, and even more so on wholesale funding. We believe, however, that funding overall is well matched to assets and that AFD has only limited exposure to currency and interest rate risks.

On Dec. 31, 2012, the regulatory capital ratio remained well above minimum requirements at 19%. But we note that this was a significant deterioration in comparison with 2008 levels close to 50%. AFD is aiming to bottom at 14% in 2016. If the agency is to reach this target we would expect it to curb its loan growth commitments after 13% average growth over the last five years, and to stabilize its loan book from 2016. To be able to improve its capital ratio from 2016, we think that AFD will need the government to accept a change in dividend policy to increase retained earnings.

The 'A+' rating on AFD's €500 million undated deferrable subordinated debt is two notches below the rating on AFD, the minimum deduction we apply to all bank hybrid capital instruments. Under our criteria for instruments containing non-viability contingency clauses leading to principal write-downs, we rate AFD's €300 million deeply subordinated debt three notches below the issuer credit rating at 'A'.

**Outlook**

The stable outlook reflects that on France.

**Government Support And GRE Methodology Impact**

"Almost certain" likelihood of timely government support

AFD belongs to the category of GREs which, in our view, would receive the strongest form of government support if needed and therefore whose ratings we equalize with those on the owner-governments. AFD is of critical importance for the French government because the agency plays the key public-policy role of fulfilling France's ODA.
commitments: activities that could not be undertaken on a commercial basis, and that could not be channeled exclusively by international multilateral agencies. The agency also promotes French economic diplomacy.

AFD's links with the French government are integral and durable, as reflected by the government's financial and operational involvement with, and monitoring derived from, the agency's status as an EPIC. This status also confers the sovereign's ultimate legal responsibility on all of AFD's financial obligations, as, if AFD were to be dissolved, all its assets and liabilities would be taken over by the state. Furthermore, we understand that AFD has potential prompt access to emergency funding from the French treasury through the state's public debt fund ("Caisse de la Dette Publique"). We believe that there is an "almost certain" likelihood that the French government would provide timely and sufficient extraordinary support to AFD in the event of financial distress (see "Rating Government-Related Entities: Methodology and Assumptions," published on Dec. 9, 2010, on RatingsDirect).

**AFD plays a critical role in the fulfillment of France's ODA international commitments in a context of budgetary constraint, and has become a soft power tool in French economic diplomacy**

AFD was created in 1941. Over the years, it has become the key operator of French ODA, gradually taking on almost full responsibilities in technical assistance, donation, and subsidies management, which were previously assumed by the Ministry of Cooperation, the Ministry of Foreign Affairs and MINEFI (Ministry of Economy, Finance, and Industry).

Beside implementing French ODA, AFD has played a larger role in defining the priorities of French ODA, which used to be defined by the Ministry of Foreign Affairs. AFD has had a crucial role in setting up sustainable and environmental development as key objectives. The OECD Development Assistance Committee published a report in July 2013 that mentioned that there was a risk French ODA would privilege environmental development at the cost of poverty reduction. However, we note that shortly after, conclusions reached by the Inter-ministerial Committee on International Cooperation and Development (CICID) confirmed that the AFD would stick to its original objectives. So, even if 70% of French ODA is channeled through multilateral institutions, AFD has increasingly become the platform for showcasing the French government's experience and goals regarding official development policy. Furthermore, the share of ODA channelled by AFD has increased to 30% from 15% over the last five years.

The French administration sees its official development policy as a contributing factor to its international reputation and, therefore, linked to its diplomacy and economic policies. In that respect, AFD has become a new soft power tool in promoting French exports and investments, in a context where the reduction in current account deficit has become a key priority of the French administration. AFD presents itself as a member of the French Team of Exports, alongside UBIFRANCE (the French Agency for International Business Development) and COFACE (the French Export Credit Agency), among others. AFD can work with French companies interested in export or investment opportunities in developing countries. AFD provides these companies with general information and contacts, capitalizing on AFD's network with local companies in key sectors, such as the energy or the transport sector.

Due to the 2007 financial crisis and the ensuing budgetary constraints, the AFD financing scheme has become increasingly important in helping France to reach its international commitments regarding ODA levels, 0.7% of gross national income (GNI). While government restrictive budget policy has required AFD to operate with constrained amounts of government transfers, AFD, as a leverage tool, has increased its lending to developing countries. Nevertheless, in order to at least maintain its exposure to emerging countries—which would be necessary for not
overshooting the 0.7% of GNI target by too much--AFD would need to increase its capital by renegotiating the dividend policy with the government.

**The agency's double status provides strong government support and control and strong supervision by the financial authority**

Linked to its sovereign mandate, AFD derives its strong government support from its EPIC status, which confers an ultimate government responsibility on AFD's financial obligations. Should an EPIC be dissolved, its assets and liabilities would be transferred to the authority responsible for its creation. Consequently, the French government would service AFD's financial debt directly if the agency were dissolved.

Furthermore, if needed, AFD would have prompt access to emergency funding from the French treasury through funding from the state's public debt fund, "Caisse de la Dette Publique." We think that such a mechanism would be implemented in less than three days.

As a bank, AFD is fully owned by the government. The government also supports AFD's capital in the form of subordinated loans under 30-year contracts. Government funding of this nature stood at €2.3 billion, or 10% of AFD's total balance sheet, at year-end 2012. Moreover, we believe that the government may support an increase in AFD's capital through a policy of increased retained earnings in the coming years, as it has done in the past.

Since 2007, AFD has operated under strategic plans agreed with the French government, as well as a framework under an Aims and Means Contract concluded at the end of 2010 with its two main line ministries (Foreign Affairs, and Economics).

In addition, the government closely monitors AFD. The agency's CEO is appointed by public decree, but the government appoints the president of the board of directors. The board comprises 17 members, six of whom are designated by the government and four by Parliament (two by the National Assembly and two by the Senate). The five experts in economics, development, and environment are appointed by public decree.

Still, in a 2010 report, which has not been officially addressed yet, the French Court of Auditors raised that the existence of various tutelary ministries--including those for the economy and finance, foreign affairs, the interior and, more recently the environment, given the focus on green development--poses risks to the efficiency and coherence of AFD's supervision.

The 1998 creation of the CICID, which was supposed to coordinate the different line ministries, has had a limited impact in reinforcing the coordination, given the fact that it has convened unevenly over the last decade (less than once every two years).

Lastly, AFD's status as an "Institution financière spécialisée" under the provisions of the Financial and Monetary Code in France supports AFD's banking-like governance and efficiency culture, in our view. AFD is subject to French banking commission controls and must comply with the same regulatory obligations as any other French bank. We consider that this financial supervision, along with the control of the state auditing agency (which applies to all EPICS) reinforces the management and governance practices.
Business Position

The stable franchise is offset by exclusive business focus
AFD's core mission is to finance development projects and programs in developing and emerging countries as well as in overseas French territories. Although the agency's contributions to projects in Africa have drastically decreased relative to total loan exposures (at about 40%), it continues to be AFD's traditional focus. More specifically, we view its operations as twofold, which ensure strong state integration:

• Own account activities (92% of total loans). AFD provides grants and concessionary loans to developing countries, as well as lending to French overseas departments and territories. In recent years, AFD has materially increased its origination in foreign countries while gross outstanding loans in overseas France remained broadly stable (see chart 1). Proparco, its 57%-owned, fully-consolidated subsidiary, is in charge of financing private sector development in developing countries by way of equity investments or market loans. We note that Proparco has also increased its origination steadily. So, we expect the proportion of own account activities to keep expanding; and

• Activities on behalf of the French government (8% of total loans). AFD receives commissions or subsidies for the various funds it manages on behalf of third parties, chiefly its primary supervising ministry MINEFI and also including France's contribution to the International Monetary Fund's Enhanced Structural Adjustment, the French bilateral component of the Poverty Reduction and Growth Facility (PRGF) initiative, and the French funding obligations--guaranteed by the government--toward the International Finance Facility for Immunisation (IFFIIm), among others.

As a result, AFD's risks were split between foreign countries (73%) and overseas France (19%) at year-end 2012. Lending to overseas France is principally aimed at the public and banking sectors. Loans that directly represent French government risks are divided between loans guaranteed (6%) and loans serviced by the government after their cancellation (2%) (see chart 1).
We expect that AFD will continue to increase its exposure to foreign countries during the coming years before stabilization in 2016, in line with its 2012-2016 strategic plan.

Since 2007, AFD has been expanding its product and geographic mix (chart 2), increasing the weight of nonconcessionary lending in its portfolio. In 2012, a joint letter from the Ministry of Foreign Affairs and the Ministry of the Economy and Finance authorized AFD to operate in a few new countries, such as Armenia, Azerbaijan, Bangladesh, Colombia, the Philippines, or Sri Lanka.
We believe Africa and the overseas French communities will remain priority areas. At year-end 2012, about 60% of loans outstanding were dedicated to Africa or French overseas territories (see chart 3). It is also AFD's stated goal to support the transition in Northern African countries following the Arab Spring.
At the end of 2012, AFD's total balance sheet stood at €23.6 billion, 17% higher than the previous year. We forecast that AFD's balance sheet could increase to about €30 billion by 2015. Total financing activities—including loans, subsidies, guaranties, and participations—reached €6.9 billion at year-end 2012, roughly stable compared with the previous year. AFD expects the annual financing volume to stabilize at €8 billion in 2016.

Table 1

| Agence Francaise de Developpement Production Eligible to Official Development Assistance --Year ended Dec. 31-- |
|---|---|---|---|---|---|---|
| Concessionary lending | 1,992 | 1,984 | 2,365 | 1,882 | 1,687 | 1,314 |
| of which is sovereign | 1,733 | 1,533 | 1,610 | 1,247 | 1,092 | 678 |
| of which is nonsovereign | 259 | 451 | 755 | 635 | 595 | 636 |
| Project subsidies | 209 | 201 | 173 | 217 | 212 | 314 |
| Aid subsidies | 58 | 30 | 47 | 142 | 303 | 111 |
| TOTAL: Agence Francaise de Developpement's own account commitment accounting for Official Development Assistance | 2,259 | 2,215 | 2,585 | 2,241 | 2,202 | 1,739 |
Capital And Earnings

Weakening but still adequate capital position

AFD must abide by general banking regulation, including minimum regulatory capital and concentration limits. To meet these requirements, AFD issued various tier 1 and tier 2 instruments until 2006, which increased its regulatory capital base to €4.7 billion (year-end 2012), of which €2.8 billion is common equity or core tier 1. As of Dec. 31, 2012, the tier 1 capital ratio was 11.7%, above regulatory minimum requirement. But it has deteriorated significantly compared with 2007 levels, which were close to 35%.

We believe AFD capitalization will continue to weaken. We expect our risk-adjusted capital (RAC) ratio for AFD will continue to contract. The ratio should be approximately 7.0%-7.5% over the next 24 months, on the back of modest retained earnings, strong growth in risk-weighted assets and a 20% payout ratio from 2014. All of AFD’s 2012 net income was distributed as dividends in 2013, and we believe that the same is likely for 2013 net income. Our RAC ratio declined to 9.4% as of Dec. 31, 2012, from 11.4% at year-end 2011 due to loan portfolio growth without retained earnings.

The difference between our RAC ratio and the tier 1 ratio is also a result of our more severe stance on equity exposures. We consider the agency’s €840 million private equity investments, which are mostly in developing countries, to be very high risk. As a result, we apply risk weights in the RAC framework that are four to five times higher than those in the regulatory framework.

Table 2

<table>
<thead>
<tr>
<th>Agence Francaise de Developpement Risk-Adjusted Capital Framework Data</th>
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<tbody>
<tr>
<td><strong>(Mil. €)</strong></td>
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<tr>
<td>----------------</td>
</tr>
<tr>
<td><strong>Credit risk</strong></td>
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<tr>
<td>Government and central banks</td>
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<tr>
<td>Institutions</td>
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<tr>
<td>Corporate</td>
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<tr>
<td>Retail</td>
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<tr>
<td>Of which mortgage</td>
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<tr>
<td>Securitization§</td>
</tr>
<tr>
<td>Other assets</td>
</tr>
<tr>
<td><strong>Total credit risk</strong></td>
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<tr>
<td><strong>Market risk</strong></td>
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<tr>
<td>Equity in the banking book†</td>
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<tr>
<td>Trading book market risk</td>
</tr>
<tr>
<td><strong>Total market risk</strong></td>
</tr>
<tr>
<td><strong>Insurance risk</strong></td>
</tr>
<tr>
<td><strong>Total insurance risk</strong></td>
</tr>
<tr>
<td><strong>Operational risk</strong></td>
</tr>
<tr>
<td><strong>Total operational risk</strong></td>
</tr>
</tbody>
</table>
We view AFD’s profitability as modest. Like other development banks, AFD does not aim to maximize profits per se. Nevertheless, the agency has generated positive core annual earnings for the past 10 years in the €50 million-€250 million range. Still, in recent years, the net earnings’ inflows have dried up, reflecting an increasing cost-to-income ratio at about 70% on Dec. 31, 2012, versus less than 50% three years prior. In 2012, AFD posted a €95 million net consolidated profit, up from €65 million in 2011.

In this context, we forecast that 2013 and 2014 net consolidated profits will stand near €110 million-€140 million, notwithstanding any major credit events. However, we recognize that AFD remains exposed to volatile and high-risk economies due to its business focus, which could trigger potentially large credit losses and directly hurt the bottom line. In particular, our forecast is based on the following items:

- We expect operating revenues to marginally increase on the interest side as a result of rising volumes, and on the fees side given AFD’s dynamic underwriting activity.
- We anticipate the 2014 cost-to-income ratio will be about 75%. However, AFD’s governing bodies might request the agency to further reduce its cost base as part of the general effort to lower France’s public deficit.
- In our opinion, the cost of risk will remain relatively elevated, close to 2012 levels. This reflects our view that AFD is likely to maintain a prudent provisioning policy to soften the potential volatility of loan loss provisions.

We forecast that AFD’s balance sheet could increase to about €30 billion by 2015. Nevertheless, we understand from management that AFD will progressively curb the growth in loan commitments, as a result of its strategic plan, to stabilize total outstanding loans by 2016.

**Risk Position**

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### Table 2

**Agence Francaise de Developpement Risk-Adjusted Capital Framework Data (cont.)**

<table>
<thead>
<tr>
<th>(Mil. €)</th>
<th>Basel II RWA</th>
<th>Standard &amp; Poor's RWA</th>
<th>% of Standard &amp; Poor's RWA</th>
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<tbody>
<tr>
<td><strong>Diversification adjustments</strong></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>RWA before diversification</td>
<td>--</td>
<td>24,525</td>
<td>--</td>
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<tr>
<td>Total Diversification/Concentration Adjustments</td>
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<td>--</td>
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<tr>
<td>RWA after diversification</td>
<td>--</td>
<td>24,525</td>
<td>--</td>
</tr>
<tr>
<td>(Mil. €)</td>
<td>Tier 1 capital</td>
<td>Tier 1 ratio (%)</td>
<td>Total adjusted capital</td>
</tr>
<tr>
<td>Capital ratio</td>
<td>--</td>
<td></td>
<td></td>
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<tr>
<td>Capital ratio before adjustments</td>
<td>--</td>
<td>2,873</td>
<td>11.7</td>
</tr>
<tr>
<td>Capital ratio after adjustments‡</td>
<td>--</td>
<td>2,873</td>
<td>11.7</td>
</tr>
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</table>

*Exposure at default. §Securitisation Exposure includes the securitisation tranches deducted from capital in the regulatory framework. †Exposure and Standard & Poor’s risk-weighted assets for equity in the banking book include minority equity holdings in financial institutions. ‡Adjustments to Tier 1 ratio are additional regulatory requirements (e.g. transitional floor or Pillar 2 add-ons). RWA—Risk-weighted assets. RW—Risk weight. RAC—Risk-adjusted capital. Sources: Company data as of Dec. 31, 2012, Standard & Poor’s.

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**Significant exposure to speculative-grade counterparties**

We view AFD's exposure as risky, owing to large amounts of loans to speculative-grade entities. Non-government-guaranteed loans increased to 92% of the total portfolio at year-end 2012, compared with 70% four years earlier. Moreover, we expect outstanding loans at AFD's risk to continue to increase in both absolute and relative terms. This, we believe, is a result of the agency's significant commitments, the long-tail nature of the disbursement schedule, and the long average term of loans.

However, that 92% of loans are non-government-guaranteed belies the fact that the vast majority of AFD's sovereign loans (approximately 40% of the total loan book) are eligible for Paris Club debt restructuring, i.e. the French government takes the place of the defaulting country when the Paris Club reschedules a loan.

In the nongovernmental field, we expect the nonperforming loan rate to stay near 5% in the coming years. Our expectation is based on AFD committing an increasingly large amount to corporate entities, and therefore taking on additional risk, in our opinion. We recognize that AFD's longstanding expertise in operating in high risk economies is a mitigating factor, however. In our view, AFD's capacity to select creditworthy local counterparts--to monitor each transaction closely and regularly--and design robust guarantee schemes has enabled AFD to demonstrate a favorable track record and reduce the likelihood of steep rises in credit losses.

Additionally, our estimate of 90% impairment coverage of nonperforming loans as of Dec. 31, 2012, offers a degree of financial flexibility to withstand and manage volatile local economic conditions, in our view. As with other multilateral development banks and most bilateral ODA providers, AFD's status legally prevents it from disbursing funds to any country in arrears. After three months, a country in arrears can no longer present projects to AFD and, after six months AFD stops all disbursements.

AFD systematically hedges interest- and exchange-rate risks related to fixed-rate or non-euro-denominated loans with derivative instruments. In addition, the agency tracks the sensitivity of its net income with a parallel 100 bps shock on interest rates. At June 2013, AFD reported limited potential impact from such a shock, amounting to €5 million.

**Funding and Liquidity**

*Wholesale funded with well-managed liquidity*

AFD is purely wholesale funded, which we view as a weakness. Its funding profile is structurally dependent on the following market and government funding:

- **Borrowing on market terms.** Although the French government no longer explicitly guarantees AFD's debt issues, its strongly government-affiliated status ensures easy access to market resources (well diversified by investors, maturities, and currencies) and low-cost funding, even amid turbulent times in the wholesale markets;
- **Borrowing from the treasury in the form of subordinated loans under 30-year contracts (with 10-year capital deferral);** and
- **Allocated public funds,** which are used to finance loans managed on behalf of third parties.

AFD makes comprehensive use of a €25 billion Euro Medium-Term Note (EMTN) program. As an alternative option, the agency has recourse to nondomestic markets--including CFA franc, Japanese yen, and U.S. dollar--for its funding,
mainly through bonds issued on the euromarket. As such, AFD has launched syndicated issues and arranged private placements that can be structured exclusively around interest-bearing instruments. To fund its growing balance sheet, AFD had to issue increasing amounts of wholesale debt totaling €5.13 billion in 2012. The agency's issuer spread moves in tandem with the French government's issuer spread, which is consistent with the way we rate this institution.

In our view, AFD's liquidity is well managed. Liquid assets (defined as cash and securities excluding equity and derivatives) amounted to €1.4 billion at year-end 2012, of which €1.2 billion was bonds issued by governments or related public entities. We understand that the investment policy of AFD requires a minimum rating of 'AA' for held-to-maturity securities and 'A-2' for shorter term investments. Furthermore, the vast majority of these liquid assets are eligible for repurchase agreements at the European Central Bank.

The agency's cash position mainly hinges on mismatches between loan disbursements and reimbursement, which we view as fairly predictable. It typically deposits such working cash overnight with counterparties rated 'A-1' or higher. Peaks can be adequately managed through a €2 billion certificate of deposit program, repurchase transactions of some of AFD's investments, and the management of long-term issuance.

Given AFD's highly liquid profile, we think it very unlikely that the agency would need to use the last resort cash advance from the special account held by the French treasury. These advances do not require any specific parliamentary approval and are accorded at the discretion of the MINEFI and the head of the French treasury.

Comment On Junior Subordinated Debt

In application of paragraph 60 of our bank hybrid criteria (see "Bank Hybrid Capital Methodology And Assumptions"), we notch down the issue ratings of AFD's hybrid capital instruments from the issuer credit rating (ICR). That's because we consider that France would likely provide sufficient financial support to prevent activation of a non-payment trigger. This reflects our view that AFD has very close legal, operational, strategic, and reputational links with the French government.

The 'A+' rating on AFD's €500 million undated deferrable subordinated debt stands two notches below the ICR, the minimum deduction applying to all bank hybrid capital instruments. Under our criteria for instruments containing non-viability contingency clauses leading to principal write-downs, we rate AFD's €300 million deeply subordinated debt three notches below the ICR at 'A'.

Related Criteria And Research

- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Bank Hybrid Capital Methodology And Assumptions, Nov. 1, 2011
- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010
- Bank Capital Methodology And Assumptions, Dec. 6, 2010

Ratings Detail (As Of February 28, 2014)

| Agence Francaise de Developpement | Issuer Credit Rating | AA/ Stable/ A-1+ |
Ratings Detail (As Of February 28, 2014) (cont.)

Certificate Of Deposit
  Local Currency  AA/A-1+
  Junior Subordinated  A
  Junior Subordinated  A+
  Senior Unsecured  AA

Issuer Credit Ratings History

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<th>Date</th>
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<td>12-Nov-2013</td>
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<tr>
<td>17-Jan-2012</td>
<td>AA+/Negative/A-1+</td>
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<tr>
<td>07-Dec-2011</td>
<td>AAA/Watch Neg/A-1+</td>
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</table>

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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