Communauté Française De Belgique

Update to Key Credit Factors

Summary Rating Rationale

The Aa3 long-term and Prime-1 short-term issuer and debt ratings of the Communauté Française de Belgique (CFB) reflect its (i) sound financial performance; (ii) active, sophisticated cash management; (iii) moderate, albeit growing, debt burden.

Amongst Moody’s rated regional and communities in Belgium, the CFB is rated in the middle of the range which spans from A1 to Aa2. The rating of CFB, on par with the sovereign, reflects the tight linkages with the Kingdom of Belgium as almost all of its revenues take the form of transfers effectively guaranteed by the federal government.

Exhibit 1

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Revenues (€bn)</th>
<th>Total Expenditures (€bn)</th>
<th>Net Direct and Indirect Debt / Total Revenues (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>10.2</td>
<td>9.4</td>
<td>9.2</td>
</tr>
<tr>
<td>2012</td>
<td>10.1</td>
<td>9.3</td>
<td>9.1</td>
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<tr>
<td>2013</td>
<td>10.0</td>
<td>9.2</td>
<td>9.0</td>
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<tr>
<td>2014</td>
<td>9.9</td>
<td>9.1</td>
<td>8.9</td>
</tr>
<tr>
<td>2015</td>
<td>9.8</td>
<td>9.0</td>
<td>8.8</td>
</tr>
<tr>
<td>2016P</td>
<td>9.7</td>
<td>8.9</td>
<td>8.7</td>
</tr>
</tbody>
</table>

2016P denotes preliminary data.
Source: Communauté Française de Belgique and Moody’s

Credit Strengths

» Access to revenue effectively guaranteed by the federal government and based on socio-economic trends
» Predictable and adequate liquidity position
» Moderate, albeit rising, debt burden

Credit Challenges

» Limited budget flexibility and larger deficits in recent years add to the debt burden
» A significant multi-year educational reform presents implementation challenges
» Subdued economic growth prospects
Rating Outlook
The stable outlook on the CFB reflects the Belgian sovereign ratings' stable outlook and CFB’s sound financial performance.

Factors that Could Lead to an Upgrade

» Given the strong fiscal linkages between the federal government and the community, an upgrade of CFB’s rating would require an upgrade of the sovereign ratings.

Factors that Could Lead to a Downgrade

» Should the sovereign be downgraded, this would have negative implications for CFB.

» Failure to meet fiscal consolidation targets, leading the community to record wider financing deficits and rapidly increasing debt levels, would weigh on its rating.

Key Indicators

Exhibit 2

<table>
<thead>
<tr>
<th>Key Indicators</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016P</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross operating balance / operating revenues (%)</td>
<td>-1.5</td>
<td>-0.7</td>
<td>-1.3</td>
<td>-1.9</td>
<td>-2.0</td>
<td>-1.3</td>
</tr>
<tr>
<td>Interest expenses / operating revenues (%)</td>
<td>1.8</td>
<td>1.8</td>
<td>1.9</td>
<td>1.9</td>
<td>1.8</td>
<td>1.8</td>
</tr>
<tr>
<td>Intergovernmental revenues / operating revenues (%)</td>
<td>97.4</td>
<td>97.5</td>
<td>97.6</td>
<td>97.7</td>
<td>97.0</td>
<td>97.3</td>
</tr>
<tr>
<td>Capital spending / total expenditure (%)</td>
<td>1.8</td>
<td>1.9</td>
<td>1.7</td>
<td>2.2</td>
<td>1.8</td>
<td>2.5</td>
</tr>
<tr>
<td>Financing surplus (requirement) / of total revenues (%)</td>
<td>-3.4</td>
<td>-2.6</td>
<td>-3.1</td>
<td>-4.2</td>
<td>-3.9</td>
<td>-3.9</td>
</tr>
<tr>
<td>Net operating balance / operating revenues (%)</td>
<td>-7.0</td>
<td>-3.5</td>
<td>-3.8</td>
<td>-5.1</td>
<td>-4.3</td>
<td>-8.1</td>
</tr>
<tr>
<td>Net Direct and Indirect debt / operating revenues (%)</td>
<td>55.9</td>
<td>56.4</td>
<td>59.6</td>
<td>60.8</td>
<td>65.7</td>
<td>70.7</td>
</tr>
</tbody>
</table>

2016P denotes preliminary data.
Source: Communauté Française de Belgique and Moody’s

Detailed Rating Considerations
The rating assigned to CFB combines the baseline credit assessment (BCA) of aa3 for the community and the high likelihood of extraordinary support coming from the national government in the event that the entity faced acute liquidity stress.

Baseline Credit Assessment
ACCESS TO REVENUE EFFECTIVELY GUARANTEED BY THE FEDERAL GOVERNMENT AND BASED ON SOCIO-ECONOMIC TRENDS

The institutional framework for Belgian communities is well established and has benefited from various enhancements since 2002. Although communities do not benefit from flexibility in setting tax rates, their revenues are almost exclusively made up of national taxes, with the responsibility of collection and timely remittance falling to the federal government. According to Article 54 of the 1989 financial law, communities are entitled to offset insufficient or untimely receipts from the central government with a guaranteed loan. Under these circumstances the CFB could take on a loan without the federal government's prior authorization, the costs of which the government would cover. Hence, given that the quasi-totality of the CFB’s revenues stem from the federal government (Aa3 stable), the CFB’s revenue stream is effectively guaranteed, and the CFB’s and the federal government’s ratings are intrinsically linked as a result. In addition, the risk of having the institutional framework altered in a detrimental way for CFB’s financials is limited by the necessity to gather a majority in both linguistic groups (French and Dutch/German) in the national parliament.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moodys.com for the most updated credit rating action information and rating history.
Transfers received by CFB are overall very predictable as the indexation formula ruling their evolution is based on growth and inflation prospects, as well as demographic trends (i.e. population under 18 and over 80). On the spending side, the revision of salaries, which account for the lion’s share of primary expenditure, is based since 1994 on a sub-component of HIPC which makes its budget planning highly predictable but in turn provides limited flexibility.

PREDICTABLE AND ADEQUATE LIQUIDITY POSITION

At the end of 2016, the CFB’s ratio of short-term debt to total direct debt stood at 15.3% (€1,050 million), reflecting the community’s use of commercial paper and short term EMTN (€375 million) and its long-term debt repayments for 2017 (€675 million). We note that the available facilities (i.e. an overdraft cash facility of €2.5 billion and €150 million of committed back-up lines both valid until end-2018 are sufficient to cover CFB’s liquidity needs.

We consider that the structure of the community’s debt does not raise any particular concerns. After accounting for various coverage instruments, CFB’s holds to a rule that variable-rate debt should always account for less than 15.0% of the total amount; it equated to 8.2% at end of December 2016. The amortisation schedule appears reasonably well distributed, and the CFB’s debt management principles state that debt maturing within the next five years should be limited to 50% of the CFB’s total direct debt. At year-end 2016, debt maturing over 2016-2020 accounted for 43% of the CFB’s direct debt stock.

MODERATE DEBT BURDEN, ALBEIT RISING

CFB’s debt has risen substantially over the past nine years from a period of low and stable debt levels, driven by financing deficits which have accumulated since the economic crisis of 2009. Preliminary figures show CFB’s direct-and-indirect debt, including guarantees, standing at 70.7% of revenue in 2016, up from 65.7% in 2015. While higher than the pre-crisis days of under 50% of revenue, CFB’s debt remains moderate compared to peers in the same rating category. Furthermore, CFB’s debt is relatively affordable, with interest comprising 2.5% of revenues in 2015.

As of end-2016, CFB’s direct debt (about 62% of revenue in 2016) is comprised of (i) a €5 billion EMTN programme (of which €791 million was available); (ii) Schuldschein issuances of about €1.3 billion, and (iii) €375 million short-term EMTN and commercial paper, (iv) diverse private loans and other debt instruments comprising the remaining (4%) of debt. In December 2016, CFB secured a €600 million loan on favourable terms from the European Investment Bank (EIB) to fund a €1.3 billion multi-year programme of capital investments. The projects for which the investment is intended (principally school infrastructure) have already been identified, hence the loan represents debt which is already included in CFB’s financial plans. The EIB loan allows CFB to further diversify its source of funding, which is supportive to CFB’s credit profile.

In addition to the €6.1 billion of direct debt, CFB also holds about €790 million in guarantees, 93% of which are guarantees to fund investments in schools which are outside of its direct remit (écoles du réseau libre, for example). To date, there has never been a call on CFB’s guarantees, and while individual schools have at times needed assistance to repay their debts, this assistance has come from other schools who are members of the guarantee fund. Hence, we consider the risk of a guarantee being called to be relatively low.

Going forward, we expect that the CFB’s debt stock will continue to increase at a modest pace, in order to finance the community’s forecasted deficits of 2-4% of revenue. According to this plan, direct debt as a percent of revenue should rise until 2018 to just over 56% of revenue, and stabilize at that point.

LIMITED BUDGET FLEXIBILITY AND SLIPPERY DEFICIT TARGETS

As a result of its mandate, CFB’s expenses relatively rigid. Its capital expenditure represent a marginal share of its total expenditure, leaving little room to implement savings. In addition, civil servants’ salaries, mainly in education, account for more than 50% of current expenditure, and grow in line with a sub-component of the inflation index.

On the revenue side, while we consider the community’s revenues, in their immense majority in the form of transfers from the federal government, as effectively guaranteed by the latter, thereby providing strong revenue predictability, in turn this means that CFB has very limited capacity to generate additional resources.
This rigidity can be seen in financial results, as the CFB authorities have had to revise deficit projections over the last few years, each time pushing out the target year at which they intend to reach fiscal balance. While the cause is understandable, as GDP growth has been muted, and revenues (which are partially indexed to these) have not kept pace with expenditure. This has resulted in a the growing debt burden to finance these deficits. While, as mentioned, the debt burden remains moderate compared to peers, continual slippage in fiscal consolidation is a key credit challenge for CFB.

A SIGNIFICANT MULTI-YEAR EDUCATIONAL REFORM PRESENTS IMPLEMENTATION CHALLENGES

The CFB has been engaged over the past year in consultations with educational staff, policymakers and other stakeholders in the French-speaking educational system in Belgium. The goal of these consultations was to arrive at a consensus concerning a significant educational reform, dubbed the Pacte d’Excellence, which the authorities expect to take the next several years, finishing in 2030. At that date, the total net cost of the reform, according to the authorities' projections will be around €50 - €70 million, as expenditure will be balanced out by savings. However, the implementation timeline may contain spending peaks and troughs depending on the roll-out of the reform. We consider the implementation of the reform to be a credit challenge for CFB as it represents a potential risk to fiscal consolidation targets. Furthermore, economic benefits of the reform, for example more dynamic GDP growth or lower employment which could translate into stronger fiscal results for CFB, will only be felt in the long term. The CFB authorities are currently working on an implementation timeline and plan to have new fiscal projections in Q3 2017.

SUBDUED GROWTH AND INFLATION PROSPECTS

2016 estimated real GDP growth for Belgium slowed further to 1.2%, from 1.5% in 2015. Inflation at the end of the 2016 picked up to 2% over the same period last year, up from 1.5% in 2015, however, driven in part by higher excise taxes and electricity prices. The continued relatively subdued performance of the real economy has weighed down CFB’s fiscal consolidation efforts, given the indexation formula setting the level of annual transfers from the federal government. As a result of the above mentioned limited spending flexibility and the quasi-absence of taxation autonomy, we expect the projected low growth environment (Moody’s forecasts real GDP growth of 1.2% in 2017) to continue challenging fiscal consolidation efforts.

Extraordinary Support Considerations

Moody’s assigns a high likelihood of extraordinary support from the national government, reflecting Moody’s assessment of the reputation risk for the federal government if CFB were to default, as well as indications of support stemming from the federal government’s commitment to enable federated entities to reach sound financials.

Rating Methodology and Scorecard Factors

In the case of CFB, the BCA matrix generates an estimated BCA of a2, compared with the BCA of aa3 assigned by the rating committee.

The matrix-generated BCA of a2 reflects (1) an idiosyncratic risk score of 3 (presented below) on a 1 to 9 scale, where 1 represents the strongest relative credit quality and 9 the weakest; and (2) a systemic risk score of Aa3, as reflected in the sovereign bond rating (Aa3 stable). The two-notch differential between the BCA assigned and the matrix-generated BCA reflects the predictability of CFB’s revenues given that they are almost entirely composed of transfers from the federal government, which somewhat offsets the absence of taxation autonomy and ultimately revenue flexibility as captured by the scorecard.

The idiosyncratic risk scorecard and BCA matrix, which generate estimated baseline credit assessments from a set of qualitative and quantitative credit metrics, are tools used by the rating committee in assessing regional and local government credit quality. The credit metrics captured by these tools provide a good statistical gauge of stand-alone credit strength and, in general, higher ratings can be expected among issuers with the highest scorecard-estimated BCAs. Nevertheless, the scorecard-estimated BCAs do not substitute for rating committee judgments regarding individual baseline credit assessments, nor is the scorecard a matrix for automatically assigning or changing these assessments. Scorecard results have limitations in that they are backward-looking, using historical data, while the assessments are forward-looking opinions of credit strength. Concomitantly, the limited number of variables included in these tools cannot fully capture the breadth and depth of our credit analysis.
Rating factors

Communauté Française De Belgique

<table>
<thead>
<tr>
<th>Baseline Credit Assessment</th>
<th>Score</th>
<th>Value</th>
<th>Sub-factor Weighting</th>
<th>Sub-factor Total</th>
<th>Factor Weighting</th>
<th>Total</th>
</tr>
</thead>
</table>

**Factor 1: Economic Fundamentals**
- Economic strength: 5, Score: 98.00, Weight: 70%, Total: 38, Weight: 20%, Total: 0.76
- Economic volatility: 1, Weight: 30%

**Factor 2: Institutional Framework**
- Legislative background: 1, Weight: 50%, Total: 0.5
- Financial flexibility: 7, Weight: 50%

**Factor 3: Financial Performance and Debt Profile**
- Gross operating balance / operating revenues (%): 7, Score: -3.33, Weight: 12.5%, Total: 3.5, Weight: 30%, Total: 1.05
- Interest payments / operating revenues (%): 3, Score: 2.04, Weight: 12.5%
- Liquidity: 1, Weight: 25%
- Net direct and indirect debt / operating revenues (%): 5, Score: 65.78, Weight: 25%
- Short-term direct debt / total direct debt (%): 3, Score: 18.30, Weight: 25%

**Factor 4: Governance and Management - MAX**
- Risk controls and financial management: 1, Score: 1, Weight: 30%, Total: 0.3
- Investment and debt management: 1
- Transparency and disclosure: 1

**Idiosyncratic Risk Assessment**
- Score: 2.91(3)

**Systemic Risk Assessment**
- Rating: Aa3

**Suggested BCA**
- Rating: a2

Source: Moody’s Investors Service

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**Exhibit 5**

<table>
<thead>
<tr>
<th>Category</th>
<th>Moody’s Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>COMMUNAUTE FRANCAISE DE BELGIQUE</strong></td>
<td></td>
</tr>
<tr>
<td>Outlook</td>
<td>Stable</td>
</tr>
<tr>
<td>Issuer Rating</td>
<td>Aa3</td>
</tr>
<tr>
<td>Senior Unsecured - Dom Curr</td>
<td>Aa3</td>
</tr>
<tr>
<td>ST Issuer Rating</td>
<td>P-1</td>
</tr>
<tr>
<td>Other Short Term - Dom Curr</td>
<td>(P)P-1</td>
</tr>
</tbody>
</table>

Source: Moody’s Investors Service
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