BofA SECURITIES

Euro Area Macro Viewpoint

Surprise S&P downgrade for France

S&P's non-scheduled rating update surprises

After market close on 17 October, S&P announced a downgrade of France before their next scheduled rating review on the 28 November. According to Article 8a of the EU Regulation on CRA, not following the pre-announced rating calendar is only allowed in limited circumstances and the reasoning behind the decision must be provided in detail. In the case of France, S&P underscores the "the recent series of no confidence votes in the French parliament, impeding progress on consolidating France's public finances."

Economics: some breathing space, bumpy ride ahead

Temporary respite from failure of no-confidence votes, supporting base case of a negotiated budget with a slight fiscal adjustment and higher taxes. The debate in parliament starts this week. An open process in parliament (without the use of article 49.3), with this level of political fragmentation, is going to be challenging.

OAT-Bund: raising the range to 80-85bp

As PM Lecornu's government survived the motion of censure and a draft budget was presented, the 10y OAT-Bund spread traded back into the 75-80bp range as we expected. We saw risks skewed to a wider spread for the remainder of 2025, but the three catalysts for such a widening did not appear imminent: a fall of the government, the unlikely resignation of Macron, or negative credit rating actions. As the latter has now come true, and in an unexpected fashion, we see spreads widening again to 80-85bp. Our primary concern regarding the investor base is the large foreign holders.

Front-end: limited, but still existent, cheapening pressures

The initial impact of S&P's decision on short-dated euro assets has been limited. We still believe cheapening pressures on French GC to be limited to 2-3bp as OAT-Bund spreads rise to our expected range. The impact may be larger if the market starts to price in a more extreme scenario of France's credit rating at risk of falling strictly below A-.

Agencies: limited immediate regulatory impact

We see no changes to risk-weights for any of the agencies following the downgrade by S&P. As not all rating providers cover all agencies, the rating downgrade by S&P will impact the average credit ratings of the French agencies differently, with the biggest impact seen for SAGESS, AFLBNK, AFD, and CDCEPS. In terms of risk-weights and LCR status, the consequences are more limited, but for SFIL the downgrade means that a downgrade by Moody's next week can result in an increased risk-weight.

FX: risks around France remain asymmetric

Using the recent episodes as reference, a widening of the 10y OAT-Bund spread to 85bp would imply c. 0.5% weakness for EUR-USD. However, we would expect a more muted reaction this time because EUR positioning is slightly lighter. While France still poses downside EUR risks, we also see a lower bar for upside surprises elsewhere in Europe.

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Abbreviations

Buba: Bundesbank
CRA: credit rating agencies
EGB: European government bond
€str: euro short-term rate
EU: European Union
GC: general collateral
IMF: International Monetary Fund
LCR: liquidity coverage ratio
PM: Prime Minister

Surprise S&P downgrade for France

After market close on 17 October, S&P announced a downgrade of France before their next scheduled rating review on the 28 November. According to Article 8a of the EU CRA Regulation, not following the pre-announced rating calendar is only allowed in limited circumstances and the reasoning behind the decision must be provided in detail. In the case of France, S&P underscores the "the recent series of no confidence votes in the French parliament, impeding progress on consolidating France's public finances."

Within the rationale, S&P's key primary concerns include:

- Uncertainty regarding public finances likely remaining elevated until the next presidential elections. The suspension of the pension reform seems to have worked to confirm this. The passage of a budget for 2026 would help in providing clarity, but does not solve the uncertainty problem.

- Policy uncertainty weighing on economic growth, by hindering investment activity and private consumption. S&P currently estimates a growth rate of 0.7% for this year and a muted recovery for next. Additionally, the risk of higher government borrowing costs being passed on to the cost of financing for the rest of the economy is mentioned as a key additional risk to their current forecasts.

- S&P believes France will meet its 2025 general government deficit target of 5.4% this year, but that due to probable modifications to the 2026 budget, the deficits will remain elevated over the next three years.

Moody's up next

Moody's is scheduled to review its rating of France on 24 October, currently at Aa3 with a stable outlook. Moody's most recent rating update stated that a suspension of the pension reform would be seen as a credit negative if it is seen to have negative medium-term implications for France's growth and fiscal trajectory. A deterioration in public debt significantly above current projections, driven potentially by weakening institutions and worse growth prospects would similarly put pressure on the current rating. Moody's current GDP growth forecasts stand at 0.6% for 2025 and 1.2% for 2026, while for deficits, their current estimates are 5.4% for 2025 and 4.9% for 2026.

A rating downgrade by Moody's is possible. But, in our view, a downgrade with the current stable outlook would be seen as a significant step. S&P and Fitch already had negative outlooks prior to downgrading France. A downgrade to single A status by Moody's would assumably mean a return to a AA rating will not be seen in the near future. Keeping the rating at Aa3 but adjusting the outlook to negative is a possibility that would not be surprising.

Economics: some breathing space, bumpy ride ahead

The new French government managed to survive last week's no-confidence votes, with a tight margin. This provides some temporary respite to PM Lecornu and would support our base case of a negotiated budget with a slight fiscal adjustment and higher taxes. But, as we wrote in our Euro Area Watch, 9 Oct 2025, we think the path ahead will continue to be very bumpy.

PM Lecornu officially presented a budget draft on October 14, with a deficit target of 4.7%, EUR 14bn in higher revenues and EUR 17bn of expenditure cuts. We wouldn't read too much into these numbers: this is just a first draft that will likely change meaningfully during complicated parliamentary discussions. We would be positively surprised if, in the end, the deficit really drops below 5% in 2026. Considering the competing demands of political parties and the sluggish growth dynamics, an outcome in the range of 5-5.4% would seem more realistic to us. The debate in parliament starts this week – we will follow the headlines closely.

An open process in parliament (without the use of article 49.3), with this level of political fragmentation, is going to be challenging. We think the risk of roadblocks remains high. Delays in the budgetary process could then require the introduction of 'specials laws' in December, to roll the current budget provisions into 1Q26.

OATs: foreign holdings at risk

Earlier this month we took a look at current foreign holdings of French government bonds (see Global Rates Weekly, 10 Oct 25). As S&P has now downgraded France, we re-visit the topic. Outlined in the previous piece, we make use of IMF's estimated ownership breakdown of French debt, and apply it to more recent outstanding volumes of bonds.

Reserve managers–small share under strict rating constraint

Based on a reserve manager survey done by the World Bank in 2023, credit ratings remain the most common methodology when assessing credit risk (used by 94% of respondents)[1], with alternative models so far being mostly complementary. It details the breakdown of minimum credit ratings the reserve managers were constrained by (Exhibit 2). For government bonds, 14% reported to have a AA+/AA/AA- min rating constraint.

Exhibit 1: IMF government debt holding breakdown estimates (Q4 2024)

Government debt is equal to Maastricht debt. As the large majority is outstanding bonds, we apply the same holding % to the current stock of OATs when discussing nominal values. Foreign investors = non domestic.

	Foreign banks	Foreign non-banks	Foreign official	Domestic banks	Domestic non-banks	ECB
GER	3.4%	17.2%	27.4%	17.9%	10.5%	23.6%
FRA	7.0%	26.2%	18.8%	16.0%	13.7%	18.3%
SPA	10.2%	21.7%	9.9%	19.5%	15.1%	23.7%
ITA	6.0%	19.5%	5.6%	20.3%	26.9%	21.6%

Source: IMF, Bloomberg, BofA Global Research

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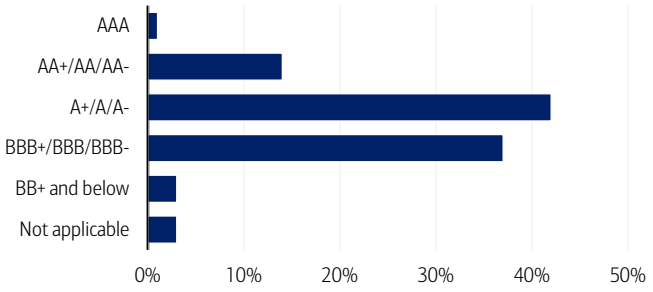
Exhibit 2: Reserve managers' minimum rating standard for gov. bonds

AA is 14%, and the largest minimum rating standard is A at 42%



Source: World Bank, BofA Global Research

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Using the IMF estimates for the breakdown of French general govt debt holders in Q4 and applying to the current OAT stock, we get to an estimate for foreign official holdings of OATs of c.€500bn. Assuming these are spread equally among reserve managers, downgrades to A could result in a €70bn reduction in foreign official holdings.

Important to note though, is that not all reserve managers may treat credit ratings similarly, i.e. some may use the most conservative rating, while others may use less strict approaches, such as averages or a 2/3 majority rating. But the different rating approaches also makes S&P's downgrade significant, as it is only the investors using the most optimistic credit rating that still will consider France a AA sovereign (out of the investors using the big three rating agencies). In addition, some reserve managers with min rating standards below AA could still have to reduce their exposure if they are operating with restrictive internal credit limits.

However, there are also several considerations that may limit the size and timing of outflows: (1) a breach in credit rating thresholds does not automatically result in instant selling for the majority of reserve managers. It can instead be a gradual process (no reinvestment of maturing bonds for e.g.). (2) In the case of sovereign debt, several reserve managers have noted that they are able to deviate from their credit rating limitations. (3) Lastly, structural tailwinds such as de-dollarisation, and improved attractiveness on an outright yield basis versus short-dated USTs if the Fed cuts policy rates, can support demand.

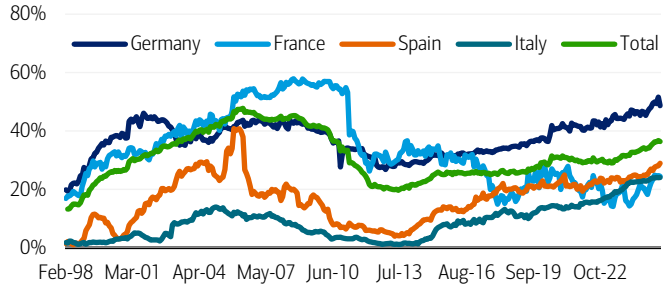
Foreign banks – Euro Area banks can remain large buyers

IMF estimates indicate only 7% of holdings are represented by foreign banks. Within those, non-French Euro Area (EA) banks are included and may account for a large share. Unlike non-EA banks, those would still assign a 0% risk-weight to French govt debt

[1] https://openknowledge.worldbank.org/entities/publication/3e23f0dd-7849-4a55-8ce7-2a104bef2c68

independently from ratings. Due to attractive price levels vs swaps, and falling HQLA holdings from ECB's QT, Euro Area banks have been increasingly buying EGBs, and diversifying their holdings across countries (Exhibit 3). Thus, OATs can continue to benefit from not only domestic but also broader Euro Area bank demand, with the potential systematic selling pressures from downgrades being limited to non-EA banks.

Exhibit 3: EA bank holdings of non-domestic EGBs/total assets,
EA banks are diversifying EGB holdings, but the trend is less apparent in FRA



Source: Haver, ECB, BofA Global Research

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Exhibit 4: Over/under allocation by active Europe (ex UK) mandated FI funds tracked by EPFR, relative to share of outstanding bonds in the EA
Values should be cautiously approached as active EPFR funds only cover $38bn AUM, and should only be seen as an indication. Allocations to non-EA issuers were removed.

Issuer	Over/under allocation	Issuer	Over/under allocation
Spain	3.00%	Italy	-3.26%
Netherlands	1.69%	France	-3.03%
Finland	1.35%	Germany	-0.64%
Austria	0.93%	Portugal	-0.22%
Ireland	0.19%	Greece	-0.11%
Belgium	0.11%		

Source: EPFR, BofA Global Research

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Foreign non-banks

In contrast to foreign banks, we see greater concern regarding foreign non-banks, including asset managers, hedge funds, insurance, and pension funds, etc., as this is arguably the investor base most quick to react and, by IMF estimates, hold about 26% of French general govt debt, estimated to ~€700bn in bonds. Due to the broad range of investors, and limited data on holdings, conclusions are challenging to draw. However, compared to other foreign investors, credit ratings on aggregate seem less important, instead risk-reward ratios assumably play a larger role in investment decisions.

Amongst non-French pension & insurance funds, Dutch pension funds (PFs) are arguably among the most relevant. Their long end demand for government bonds may decrease as they transition from defined benefit to defined contribution. However, we caution that selling of government bonds by Dutch PFs may not be as imminent as their unwind of (ultra) long-end received swaps position. Their portfolio of bonds (albeit including corp bonds) has a much lower duration than that of their swaps positions, and those contemplating a significant shift in their asset allocations may do so over a longer time. Still, it is worth noting that total Dutch pension fund holdings of French govt bonds amounted to €58bn at the end of 1Q25, according to EIOPA data, versus German and Dutch govt bond holdings of €87bn and €53bn respectively.

For European fixed income investment funds, credit ratings are used by a majority. However, it does not necessarily mean it's a key determinant of investment allocations. For passive allocations, we see the primary allocation determinant being outstanding volumes. For active allocators, the primary concern is instead effective risk-reward allocations, where ratings constraints are modest. Data provided by EPFR show active funds with a mandate to invest in Europe (ex-UK), indicate that investment funds are already underweight France (Exhibit 4), although this may not be fully representative.

Lastly, there are however funds with AAA-AA investment mandates. Our understanding is that a common approach for determining the credit rating of an issuer is the average approach (e.g. the method used for iShares Global AAA-AA Govt Bond UCITS ETF and ICE BofA Indices). This means, following S&P downgrade, the divestment may pick-up. However, it is hard to estimate the total AUMs that follow these indices at the moment.

Front-end: limited, but still existent, cheapening pressures

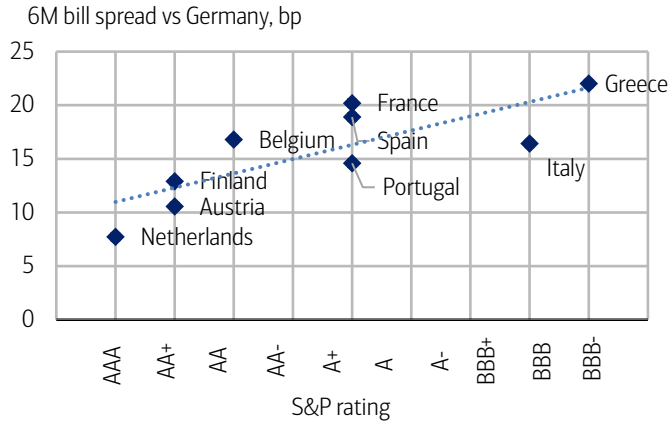
The initial impact of S&P's downgrade on short-dated euro assets has been limited. In the bill market, French 6M bill spreads vs Germany were consistent with a credit rating below AA- prior to both S&P and Fitch's latest downgrade. The current 6M BTF-Bubill spread implies an even lower credit rating (Exhibit 5).

In repo, the limited reaction is consistent with our view that demand for French GC is still firm. We continue to expect cheapening pressures on French GC when the OAT-Bund spread is 80-90bp to be limited to 2-3bp by: 1) banks with excess reserves buying French GC if it cheapens too much above the depo (France one-day GC is at the depo), 2) public institutions placing excess cash in French GC as they get €str-20bp at the Eurosystem ex Buba and 0% at the Buba, and 3) investors that have adjusted their rating requirements to allow for continued purchases of French assets.

We believe the impact on short-dated assets may be larger if the market starts to price in a more extreme scenario of France's credit rating at risk of falling strictly below A-, which may also put France's eligibility in some triparty systems at risk.

The downgrades by Fitch and S&P may lead to forced selling of French assets by some investors, which may also rebalance into assets with a higher sovereign rating. But we believe short-dated euro investors will find it difficult to systemically exclude French assets given their absolute and relative size. The French government account for 38% of euro area short-term government debt outstanding, while French banks account for 48% of euro area short-term bank debt outstanding (Exhibit 6). In both markets, France accounts for more short-term debt than all other higher-rated euro area issuers combined. Given this supply structure, the market may ultimately need to adapt to France's rating in the foreseeable future.

Exhibit 5: 6M bill spread vs Germany and S&P credit rating
France's bill spread is consistent with even lower rating



Source: BofA Global Research, Bloomberg. Data as of 20 Oct 25.

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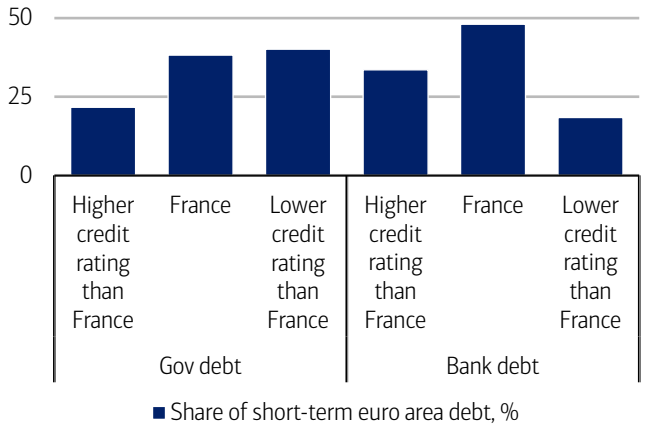
Exhibit 6: Share of short-term euro bank and gov debt, %
France accounts for more short-term debt than other higher-rated euro area issuers combined



Source: BofA Global Research, Bloomberg

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Agencies: limited immediate impact

Last week we published a note on French agencies, detailing the regulatory framework investors must adhere to when determining risk-weights and the LCR status of French agency bonds, as well as the impact that Fitch's downgrade had (see: French agencies: under the regulatory hood). As most of the larger French agencies have a credit rating directly linked to the French state, rating downgrades of the French sovereign will impact the agencies too. However, due to the varying degrees of guarantees the French agencies has from the state, combined with different amounts of rating corporations that cover them, and the different types of institution they operate as, the impact of changes in credit ratings differ among the French agencies.

Immediate impact of S&P less pronounced than Fitch

Within the regulatory framework, there is room for interpretation for several of the agencies, e.g. in terms of what type of institution they operate as, or how their guarantees should be viewed. Based on our interpretations (as non-legal practitioners), we detailed the impact Fitch's rating downgrade had on the major French agencies, as well as the impact a downgrade by S&P would result in (see: Exhibit 7).

The downgrade by Fitch meant changes to risk-weights for several of the agencies, including AFLBNK, AFD, IDFMOB, and RATPFP, but S&P revision may have less immediate impact. In fact, we see no changes to risk-weights for any of the agencies following the downgrade by S&P, but we still remain aware of two important consequences:

- The agency Sfil, which is the only non 0% risk-weighted agency not covered by Fitch, now experienced its first credit rating downgrade into single A status. Fortunately for Sfil, the other two rating agencies covering it are Moody's and DBRS, and thus its risk-weight is in our opinion unchanged. However, due to this downgrade, another downgrade from Moody's next week would result in the composite rating moving to A+, and a change in risk-weight from 20% to 30%.

- As not all rating corporations cover all the French agencies, a downgrade by the S&P will have different effects on the average credit rating of the agencies. Most direct is the impact on SAGESS, who is only covered by the S&P and was not a single A issuer. AFLBNK and AFD who is covered by Fitch and S&P are now also single A rated issuers. CDCEPS's average rating will also move to single A, but with Moody's still having a Aa3 rating for the agency.

Exhibit 7: French agencies, type of institution, credit ratings, and current as well as potential risk-weights – BofA interpretation
The potential risk-weight implications from downgrades are adjusted based on number of ratings providers covering each French agency

Agency	Listed by EBA, ODAC, or ensures 0% risk-weight	Type of agency (*)	Moody's	Fitch	S&P	DBRS Morningstar	DBRS Scope	Risk-weight pre Fitch downgrade	Current risk weight post Fitch & DBRS downgrades	Risk weight if Moody's downgrades (24 Oct)	Risk weight if S&P downgrades (28 Nov)	Risk weight if both S&P and Moody's downgrades
AFLBNK	No	CI	-	A+	AA-	-	-	20%	30%	Not relevant	30%	30%
AGFRNC	No	CI	-	A+	AA-	-	-	20%	30%	Not relevant	30%	30%
BPIFRA	Yes	-	Aa3	A+	-	-	-	0%	0%	0%	Not relevant	0%
CADES	Yes	-	Aa3	A+	AA-	AA	AA-	0%	0%	0%	0%	0%
CDCEPS	Yes	-	Aa3	A+	AA-	-	-	0%	0%	0%	0%	0%
IDFMOB	No	PSE	Aa3	A+	-	-	-	20%	50%	50%	Not relevant	50%
RATPFP	No	Corp	Aa3	A+	-	-	-	20%	50%	50%	Not relevant	50%
SAGESS	Yes	-	-	-	AA-	-	-	0%	Not relevant	Not relevant	0%	0%
SFILFR	No	CI	Aa3	-	AA-	AA	-	20%	20%	20%	20%	30%
SNCF	No	Corp	A1	A+	A+	-	-	50%	50%	50%	50%	50%
SOGRPR	No	PSE	Aa3	A+	-	AA	-	20%	20%	50%	Not relevant	50%
UNEDIC	Yes	-	Aa3	A+	AA-	-	AA-	0%	0%	0%	0%	0%

Source: Rating agencies, French agencies, BofA Global Research. (*) BofA Interpretation for agencies without 0% risk weight (based on EBA & ODAC lists, CRR regulation, and/or explicit statement by the agency itself)
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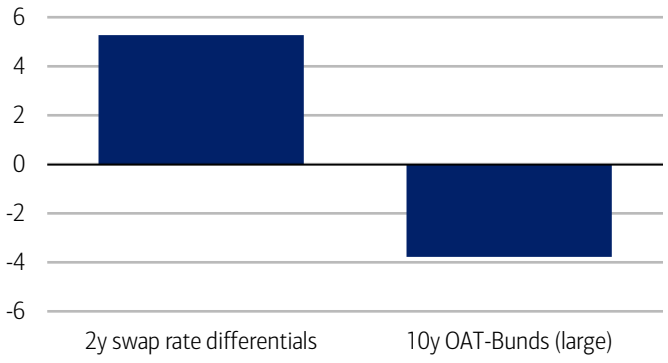
FX: risks around France remain asymmetric

We still view EUR risks around France as skewed to the downside. Using the latest two episodes (end-Aug and Oct 6) as reference points, a widening of the 10y OAT-Bund spread to 85bp would imply c. 0.5% weakness for EUR-USD: 10bp wider 10y OAT-Bund spread typically comes along 0.4% weaker EUR-USD (Exhibit 8), yet EUR response in the recent episodes was almost double as strong. We think this reflected the long EUR positioning, with the move particularly evident in near-dated risk reversals.

However, we would expect a more muted reaction this time because EUR positioning is a little lighter (see Liquid Cross Border Flows 13 Oct '25 and FX and Rates Sentiment Survey 10 Oct '25), and we do not think there was meaningful EUR demand on the back of last week's political relief in France. Relatedly, 3-month EUR-USD risk reversals have not recovered to their 3 Oct levels and remain far from the year highs (Exhibit 9). As a result, we prefer to express our caution in some of the EUR crosses (e.g., EUR-CHF, EUR-AUD, or even EUR-SEK).

These said, we think France developments have resulted in even less constructive sentiment around Europe, which means an even lower bar for upside EUR surprises around European developments down the road.

Exhibit 8: Wider OAT-Bund spread by 1pp comes alongside 4% weaker EUR-USD
EUR-USD beta to 2y swap rate differentials and large 10y OAT-Bunds shocks



Source: BofA Global Research, Bloomberg. Weekly data until from Jan-2015 until September-2025. We define as large spreads those with 2-year z-scores greater than 1 (in absolute value). Betas show the % change in EUR-USD attached to a 1 percentage point (100bp) wider 2-year EUR-USD OIS differentials and to a 1 percentage wider 10-year OAT-Bunds spreads.

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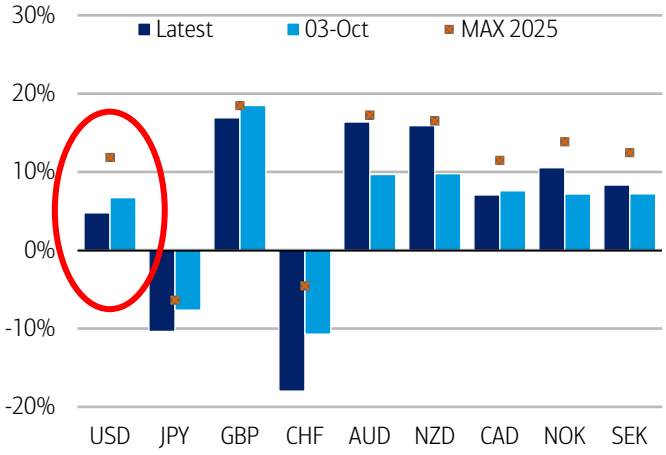
Exhibit 9: EUR-USD risk reversals still below Oct 3 levels
EUR-G10 3-month 25 Delta risk reversals (% of implied vol)



Source: BofA Global Research, Bloomberg

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