French banks: part of the solution but revenue equation more complex

Policy efforts to avoid the emergence of problem loans are bearing fruit and supporting the resilience of French banks. But as banks and clients adapt to a blurred economic reality, new balance-sheet dynamics are putting renewed pressure on revenues.

We expect French banks to be resilient through the cycle. Through a variety of measures, policy makers are striving to boost bank lending and simultaneously delay the emergence of problem loans. This phase will likely last until the end of 2020. The objective is to boost banks' lending capacity to foster a rebound of the economy. But while banks are being projected as part of the solution, policy measures are not neutral on banking as a business. Pre-crisis issues have not disappeared. Solutions implemented to relaunch the economy are even accentuating them.

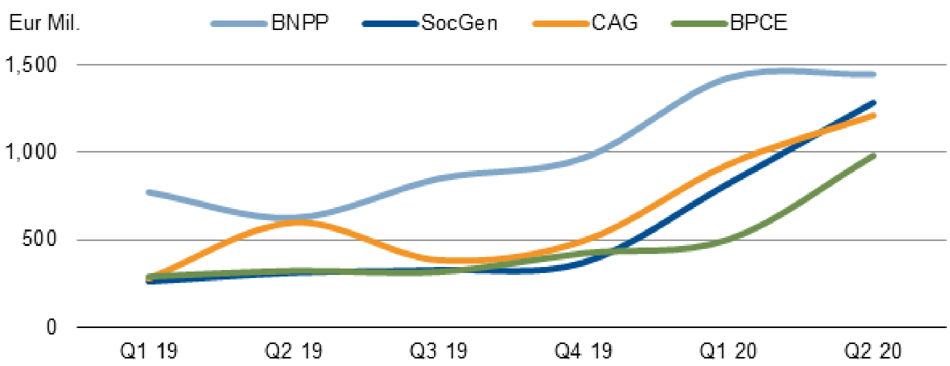
French banks can withstand a V-shaped economic shock

French GDP declined by 13.8% in the second quarter after a 5.9% contraction in the first quarter. French banks withstood the initial lockdown and its immediate aftermath well. They should prove resilient to the uncertain operating conditions because:

- During lockdown, banks stayed open and continued operating. Due to their role in payment processing and financing, banks remained relevant, unlike sectors such as tourism or airlines, which were unable to operate. They also benefited from the relative inertia of business flows originated pre-crisis or derived from their large balance-sheet activities.
- Banks' financial soundness has improved since the last crisis. The build-up of buffers and accommodating countercyclical measures – from dividend bans to conservative provisioning policies – have contributed to preserving their credit standing.
- Stimulus measures to relaunch the French economy are intended to facilitate a vigorous V-shaped economic recovery. Scope Ratings is forecasting an 11% real GDP contraction for full-year 2020 followed by a 7.2% rebound in 2021.

After two quarters of challenging operating conditions, the cost of risk for the large French banks rose significantly, but from a low level. If banks were to provision 30% less in the second half -- given the expected economic rebound -- it would still represent close to 2.5x 2019 levels for the full year, or 50bp-60bp in aggregate, which is manageable. But there are downside risks, as the easing of lockdown remains fragile and risk-adverse behaviour could result in a more gradual return to pre-crisis levels.

Figure 1: quarterly cost of risk is on the rise, but manageable



CAG: Credit Agricole Group. Source: banks, Scope Ratings

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Fundamental risk metrics are sound

Financial risk profiles are preserved

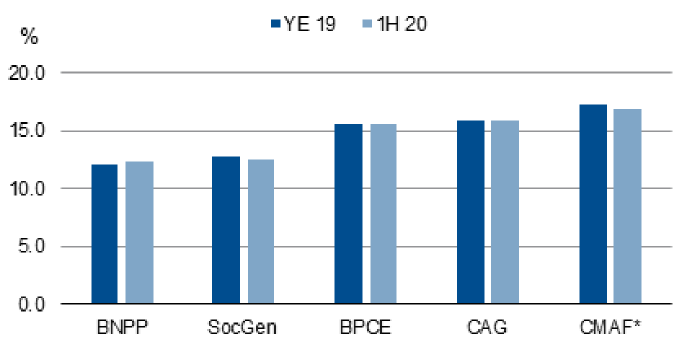
As of end-June 2020, French banks display resilient capital ratios. Non-performing loan (NPL) ratios stand well below their end 2018 levels. Provisioning policies show a 60-40 mix between provisions for problem loans (stage 3 under IFRS 9) and efforts to load up front precautionary collective provisions (stages 1 & 2). The challenge is to achieve a proper balance between ex ante provisioning efforts that anticipate a worsening picture and the central V-shaped economic scenario. Managing bottom-line results can also limit ex ante provisioning policies.

Exposure to volatile CIB activities the main game changer

Net profits for the first half fell significantly compared to the first half of 2019 owing to pressure on operating revenue and rising cost of risk for all banks. But results varied widely mainly because of sector concentration in more volatile corporate and investment banking (CIB) activities. In particular, Societe Generale and Natixis (BPCE group) were exposed to losses in their equity derivatives businesses following dividend payment cancellations. BNP Paribas benefited more widely from the market rebound in the second quarter. Societe Generale's stated loss for the first half also reflects non-cash items in the form of goodwill and deferred tax asset impairment (EUR 684m and EUR 650m respectively).

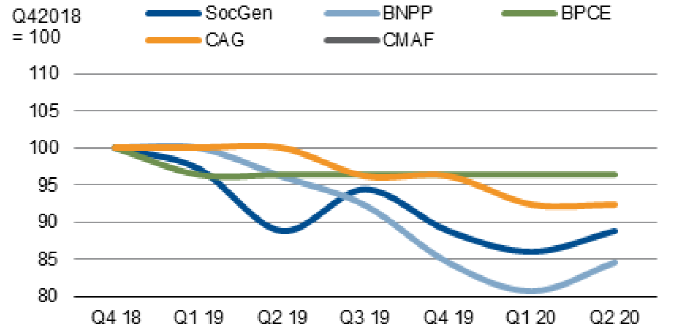
Figure 2: Large French banks are resilient but net income, the first line of defence, took a hit.

CET1 capital ratios, strengthened pre-crisis, are resilient



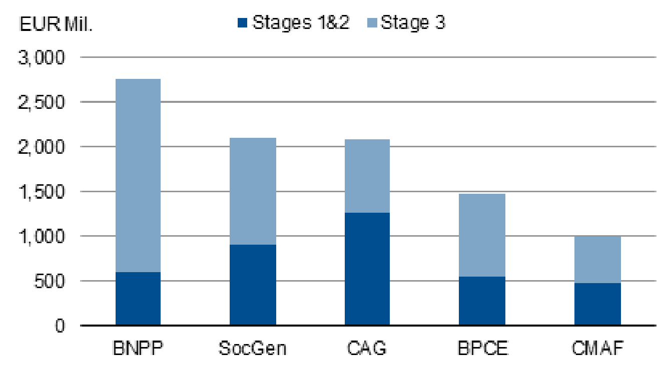
Source: banks, Scope Ratings

Non-performing loan ratios are stable (index)



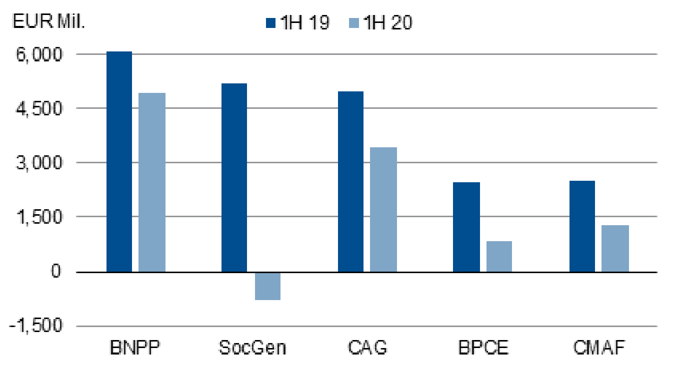
CMAF: Credit Mutuel Alliance Federale. Source: banks, Scope Ratings

Banks started building precautionary provisions



Source: banks, Scope Ratings

Net income for the first half varied widely among banks; cost of risk is not the only reason



Source: banks, Scope Ratings

Boosting bank lending: a macro-policy tool to facilitate the rebound of the economy

Among the various measures put in place, such as solidarity funds, tax relief, furlough and short-term working, banks have been asked to make extra efforts to finance the economy. The boost comes from a massive EUR 300bn State-guaranteed loan programme (PGE, prêts garantis par l'Etat) for corporate working-capital needs. Banks are playing a major role in distributing these loans. As of July 31, a total of EUR 116.6bn of lending facilities had been granted. Growth was marginal in recent weeks.

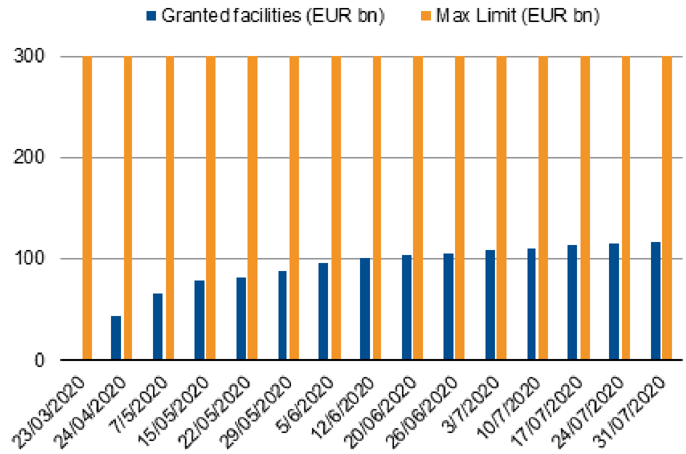
Figure 3: overview of the PGE (Prêts Garantis par l'Etat) programme

Main features of the PGE programme

Total program amount: € 300 bn
Validity: until Dec. 31, 2020
Eligibility: corporate entities of all sizes, current on their financial obligations
Maximum individual amount: up to 25% of 2019 turnover
Maturity profile of the granted facilities: grace period of 1 year, bullet or amortizing over a maximum of 5 years
Interest rate: banks are required to grant loans at cost. On top corporate must pay a fixed guarantee premium of 25bps the first year, 50 bps the 2nd and 3rd years, 100bps from the 4th to 6th years.
State-guaranteed amount: 90% of the facility (reduced to 80% or 70% for larger companies)

Source: Ministry of Economy, Scope Ratings

A rapid initial pick-up, now increasing marginally



Source: Ministry of Economy, Scope Ratings

PGE programme vital for the economy but has a compounding effect on French banks' pre-crisis issues

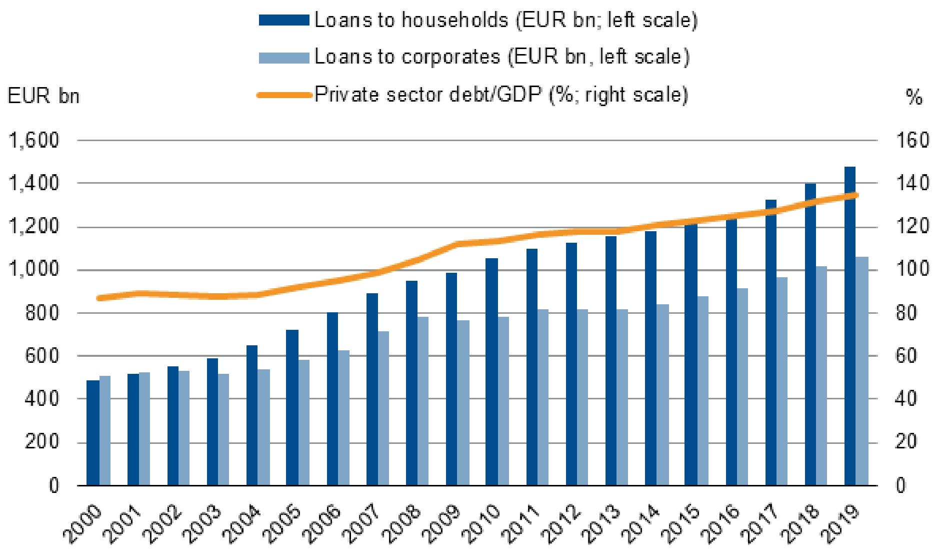
From a credit standpoint, three important characteristics of the PGE programme have meaningful consequences on French banks' pre-crisis challenges, which have not disappeared with the crisis. These measures will have a lasting compounding effect if there is no orderly exit strategy in sight:

- Banks grant credit facilities at cost. For corporates, this provides a new low benchmark rate in the short term, compared to other commercial credit facilities.
- The State guarantee usually covers 90% of the loan facility for corporates (according to their size). The substitution effect provides capital relief to banks and as loan books grow, the corresponding amount of risk-weighted assets remains broadly flat. This increases the linkage between banks and sovereign creditworthiness.
- By design, at the time of granting a facility, the total outstanding exposure of a bank to an individual corporate entity must show an increase. Documenting this balance is a condition of activating the guarantee at a later stage if needed. It provides a boost to lending but the flip side is that corporate indebtedness can only grow.

Piling debt on the private sector a source of concern; mitigated by high net wealth

The sustainability of continuously growing levels of private-sector indebtedness in France had been questioned before the pandemic, since it has outpaced GDP growth for years. For banks, higher volumes have compensated for declining rates; a trend supported by low risk-weights on property loans and growing property prices. Earlier this year, authorities asked banks to tighten their credit standards. GDP contraction and incentives to increase lending will exacerbate the trend in 2020, although this will be mitigated by the comfortable net wealth and liquidity positions of households and corporates.

Figure 4: private sector indebtedness kept growing for years



Source: Banque de France, Scope Ratings

Delaying the emergence of problem loans: an immediate priority

Surge of problem loans could impact capital adequacy

Preventing private-sector borrowers from defaulting on their existing loan obligations is a high policy priority because a surge of problem loans would trigger a surge in provisioning, impacting not just banks' P&Ls but potentially their capital adequacy and it would jeopardise their ability to lend. A quick economic rebound would help, so measures like the PGE programme are contributing to this goal. But other measures have been implemented.

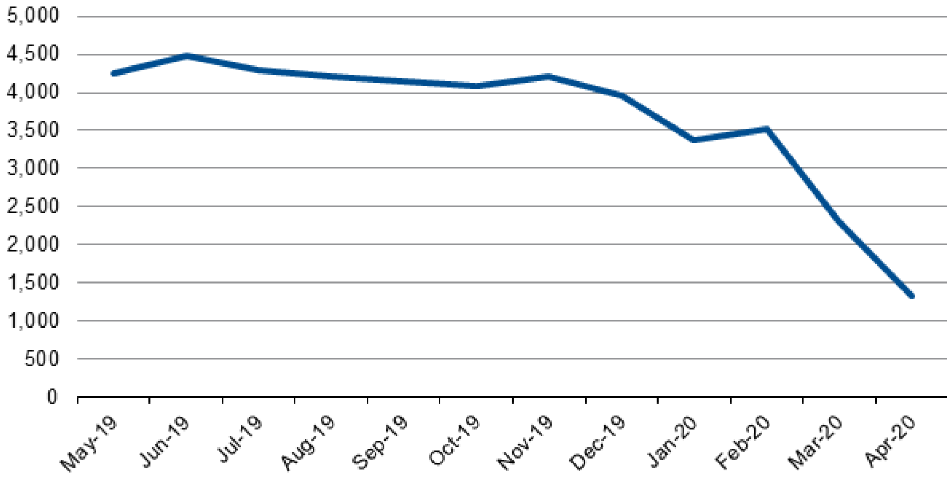
In addition to the PGE, French banks agreed on a collective moratorium covering around EUR 20bn of outstanding professional loans, postponing repayments for up to six months. Other payment holidays can be negotiated with banks on a case-by-case basis.

No material spike of problem loans so far but banks are navigating a blurred economic reality

Support measures appear successful so far. At this early stage, we do not observe a material spike in problem loans in France. NPL ratios are stable but loan volumes, the denominator of these ratios, have also increased. With the uncertain macro prospects, operational issues and exceptional support measures, banks are navigating a blurred economic reality. Intrusive support measures create a disconnect that could lead to a delayed recognition of problem loans.

The expected correlation between GDP contraction and asset-quality deterioration – hence the required level of provisioning – was heavily debated during the Q1 results season. Some risks cannot be properly assessed because of operational limitations. For instance, commercial courts processing bankruptcies were unable to operate at full capacity during lockdown. For bankruptcy filings, delays were also granted to accommodate operational constraints. Hence, the monthly number of bankruptcies went down significantly in April, which is counter-intuitive.

Figure 5: a counter-intuitive decline of monthly corporate bankruptcies



Source: Banque de France, Scope Ratings

Regulatory forbearance rules for loans under moratoriums guide banks to record loans as current if the customer was current on the obligation when entering the moratorium. Banks are continuing to monitor the ability of the borrowers to pay during payment deferrals and will take action if necessary. Discretionary selection of clients is a challenge and risks late identification of problem loans.

New balance-sheet dynamics show how banks and customers are adapting to the crisis

Balance-sheet movements illustrate three domestic trends

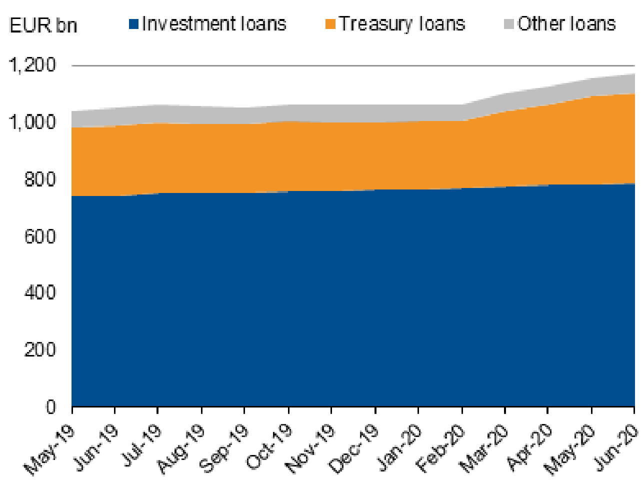
Recent balance-sheet movements have illustrated three important domestic trends since the beginning of the year:

1. Corporates have switched to short-term working capital facilities,
2. Housing loan production is holding up well at low rates, with no sign of repricing,
3. Precautionary savings in the form of sight deposits are on the rise across the board.

Corporate borrowers have turned massively to working capital (treasury) facilities. This reflects the pick-up of the PGE programme, and illustrates efforts to maintain proper liquidity or short-term risk-averse strategies. On a positive note, loans for investment have not stopped and debt-raising through wholesale markets (mainly for larger corporates and not accounted for here) has also been dynamic.

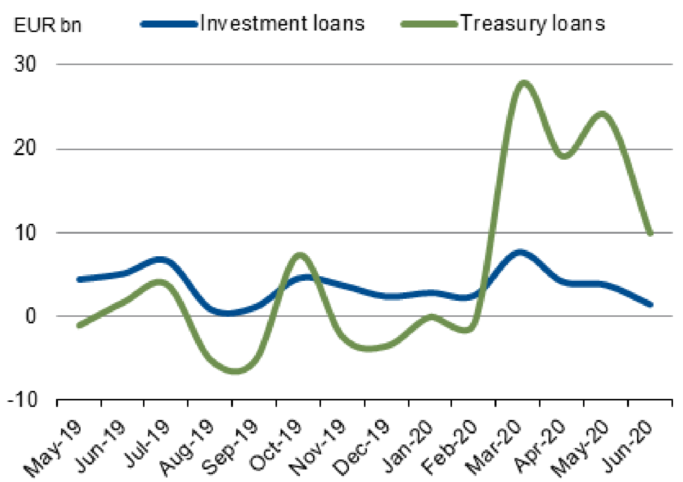
Figure 6: treasury facilities, boosted with the PGE, are the main driver of corporate lending growth

Outstanding amount of bank lending to corporates



Source: Banque de France, Scope Ratings

Monthly production of corporate loans

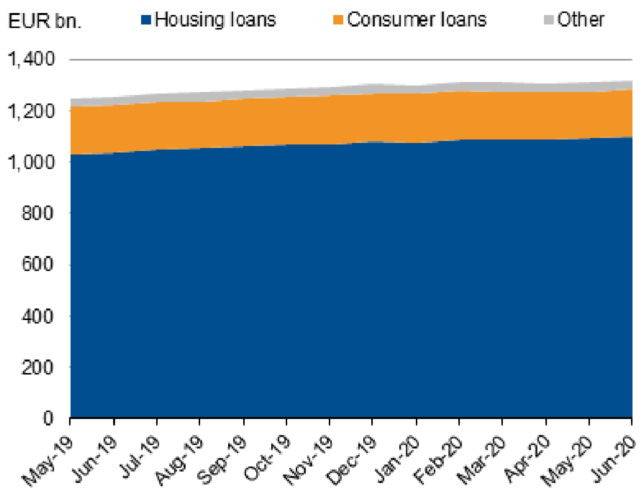


Source: Banque de France, Scope Ratings

For operational reasons, lockdown had a direct temporary impact on mortgage lending as customers were unable to finalise property transactions. But it is picking up again, reflecting good housing market fundamentals. The structural shortage of housing in parts of the country but also favourable lending conditions, with low-for-long interest rates, explain the resilience of property prices. This segment is sensitive to a more severe economic downturn. Employment is holding up well but the return to pre-crisis GDP will take years. Scope Ratings is forecasting a rise in unemployment to 11% at the end of 2021, from 8.5% at end-2019.

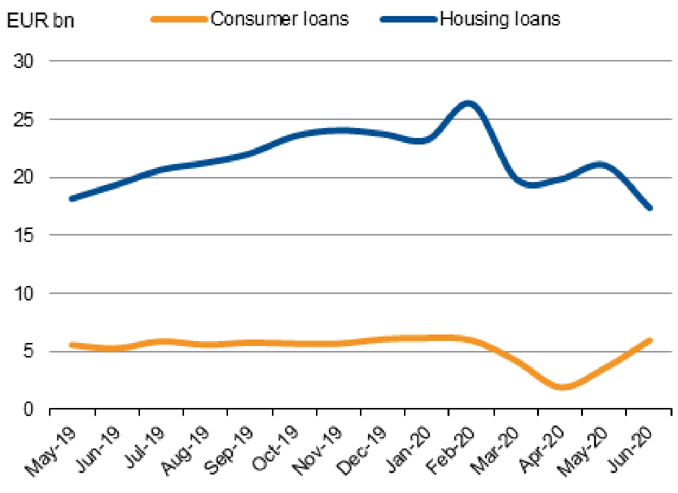
Figure 7: French retail lending is mainly made of secured housing loans

Outstanding amount of retail loans



Source: Banque de France, Scope Ratings

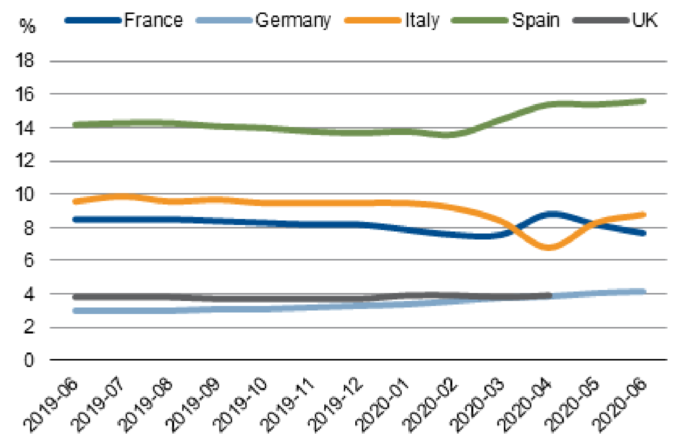
Monthly production of retail loans



Source: Banque de France, Scope Ratings

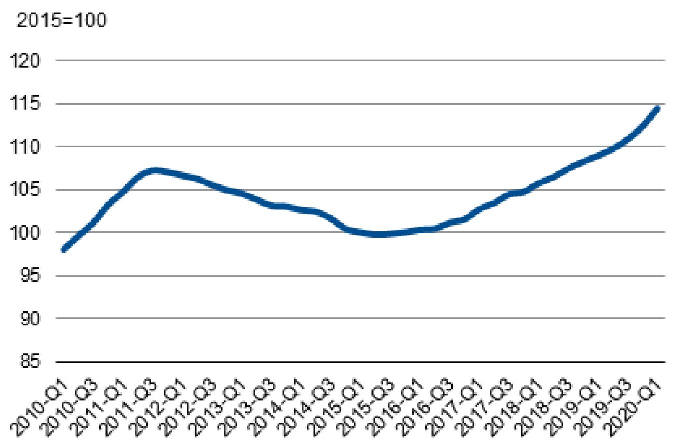
Figure 8: employment and property price movements underpin the resilience of the housing loan segment

In many European countries, government measures have helped control unemployment



Source: OECD, Scope Ratings

Attractive credit conditions and shortage of supply explain recent property price movements

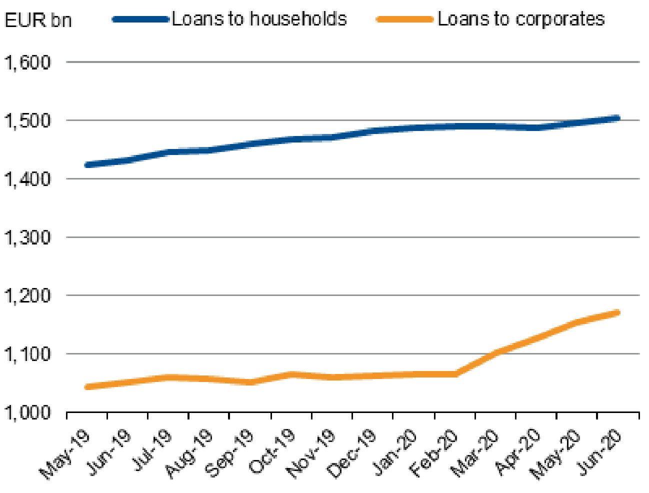


Property price index on second-hand dwellings. Source: INSEE, Scope Ratings

On the liabilities side, banks accumulated large inflows of deposits from retail and corporate clients in the second quarter. In part, this reflects an increase in corporate loans as well as demand for low-risk liquid products.

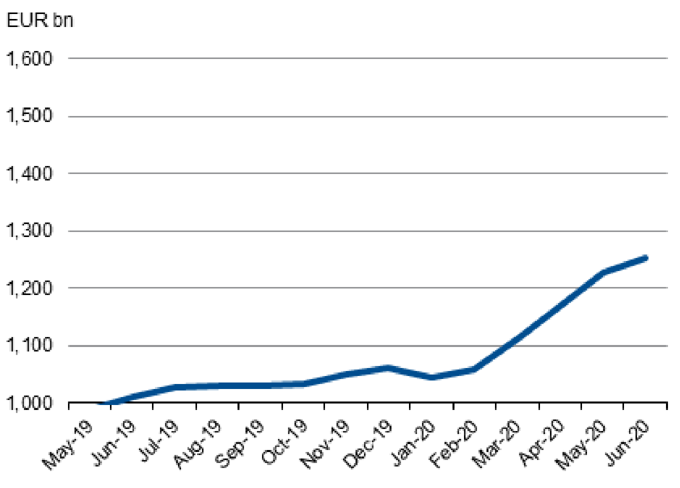
Figure 9: rising liquid placements show retail and corporate customers are becoming cautious

Outstanding amounts of retail and corporate loans



Source: Banque de France, Scope Ratings.

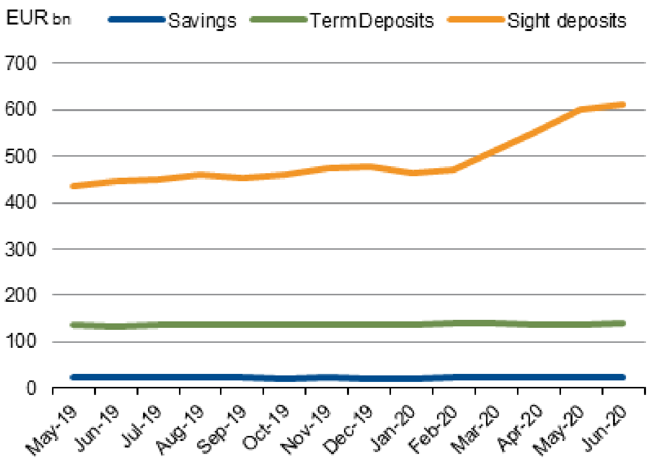
Outstanding amount of sight deposits with banks



Source: Banque de France, Scope Ratings.

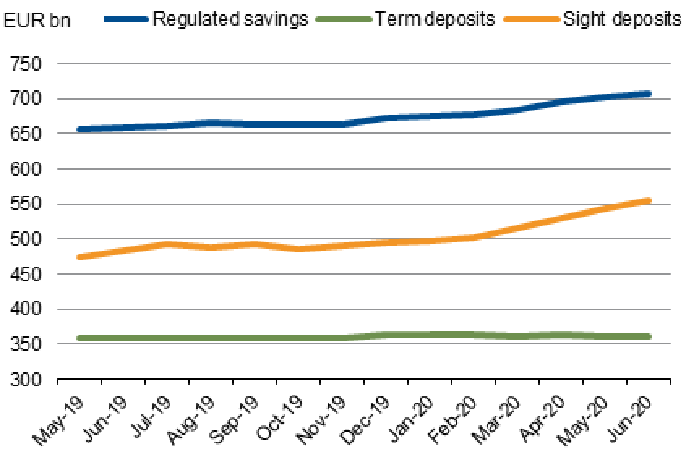
Figure 10: both retail and corporate customers favor short-term liquid placements

Outstanding corporate deposits with banks



Source: Banque de France, Scope Ratings.

Outstanding retail deposits with banks



Source: Banque de France, Scope Ratings.

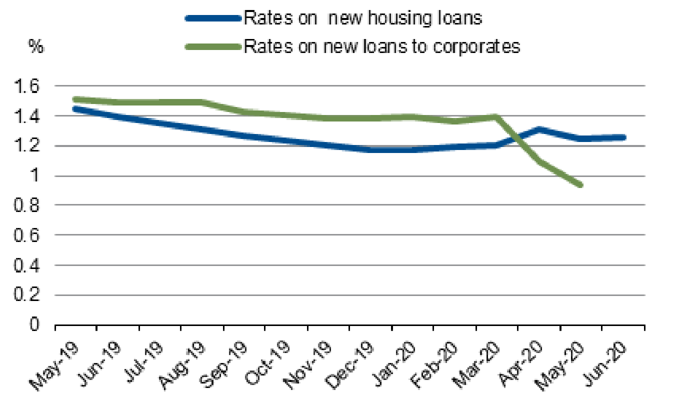
Equation to generate interest revenue much more complex with pinching margins

Interest revenues increasingly being squeezed

Domestic credit conditions are locked in for some time. With these balance-sheet dynamics, interest revenues are increasingly being squeezed: lending rates are decreasing or are standing at low levels while banks are remunerating a larger amount of client deposits.

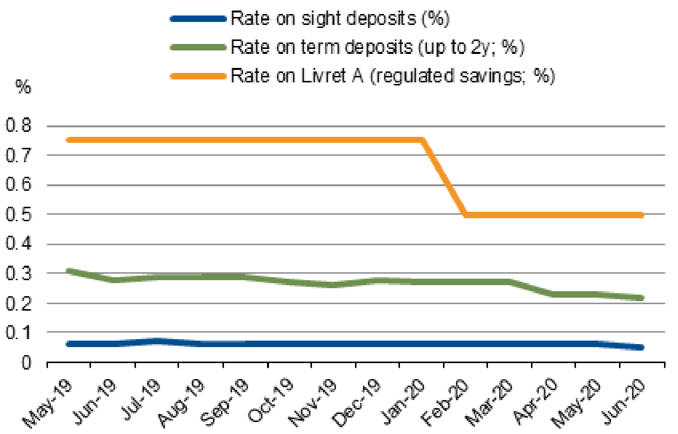
Figure 11: net interest margin is under pressure in the absence of a parallel move between lending and deposit rates

Rates on corporate loans show refocus on State-guaranteed short-term facilities



Source: Banque de France; Scope Ratings

Rates on deposits remain sticky



Source: Banque de France, Scope Ratings

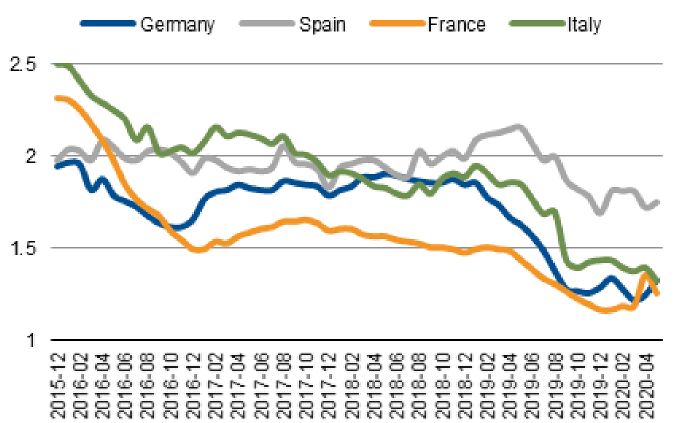
Finding attractive liquid assets to park the flow of precautionary savings is a challenge. Many safe short-term placements for banks carry negative rates. Even if rates on customer deposits have come down, they remain positive for most customers. The possibility of imposing negative rates on a wider range of clients, beyond high net worth individuals and large corporate clients, was under discussion before the crisis and will inevitably return.

But it may be harder now to implement such charges at the expense of financially weakened customers. Exit strategies could include redirecting savings into more efficient products, both for banks and for an economic rebound, as accumulating precautionary savings rather than consuming will not provide a boost to the economy.

Fixed rates on housing loans are not picking up. Crédit Logement, the largest French provider of financial guarantees on housing loans, recently pointed out that rates on housing loans, net of inflation, have only recently gone back to positive levels. And it did not last. Competition, a shortage of housing in the most dynamic cities, and prospects for an economic rebound are keeping rates at low levels.

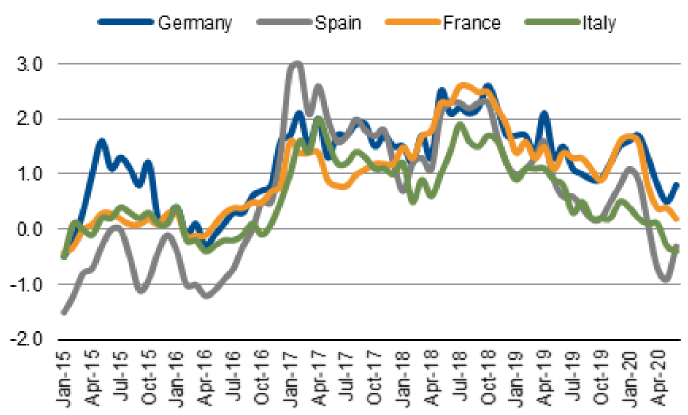
Figure 12: rates on new housing loans came down earlier in France than in other markets, even below inflation

Rates on new loans for housing purchase



Source: ECB, Scope Ratings

Evolution of inflation rates



HICP. 2015 = 100. Source: Eurostat, Scope Ratings

Revising rates upward in this environment could have reputational issues or impact property prices. Banks have limited room for manoeuvre and are focusing on cross-selling retail products to compensate. This already tense situation may explain why State-initiated collective moratoriums on retail property loans were not implemented in France.

There are limited short-term answers to the profitability challenge

Little leeway to address the revenue challenge

There is little leeway for banks to address the revenue challenge. One solution is to reduce the cost base. The reported operating expense base fell 2.5% on average for the five largest French banks during the first half of this year compared to the same period of last year. Lockdown helped on that front but dealing with costs needs to be a permanent feature.

Revenue diversification also will not happen overnight. Non-interest revenues from insurance, flow businesses or capital markets activities have limited growth prospects, if any, in the current context. For most French banks, domestic activities represent the main part of their activities and revenues. With the global spread of the pandemic, geographic diversification no longer provides any benefit, although a differentiated pace of recovery will help at a later stage.

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