# From cost of risk and asset quality to strategic issues: five FAQs about French banks

**Comforting communication around asset quality and accelerating business transformation were the two main takeaways of French banks' 2020 results.**

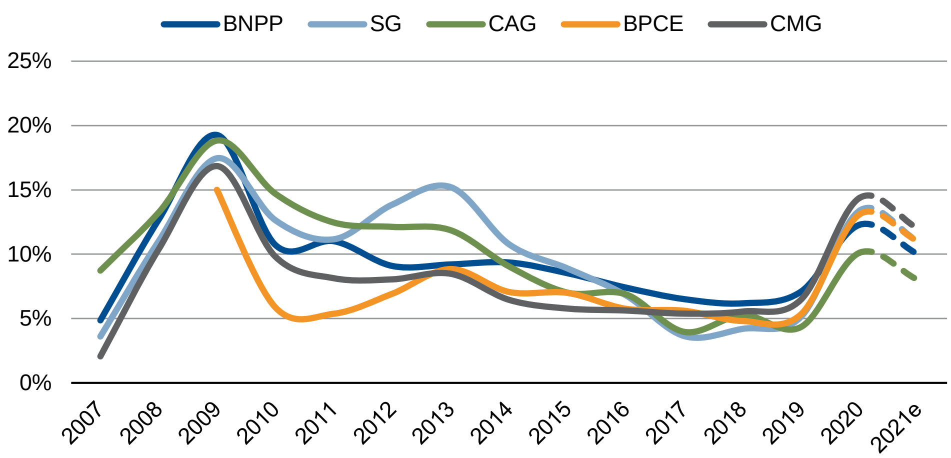
The apparent de-linkage between asset-quality and the economic shock remains puzzling. French GDP contracted by 8.2% in 2020 whereas we estimate the simple average ratio of problem loans to total gross loans for large French banks barely fell, from 3.11% at the end of 2019 to 3.06% at the end of 2020. The number of bankruptcies in France was 39% below the 2019 figure. The Banque de France said this 'cannot be analysed from an economic point of view'.

Massive support measures, which resulted in expanding loan books (the denominator of the problem loan ratio), as well as balance sheet management explain the resilience of asset quality. So far, the increase in the cost of risk is very much controlled, representing between 10% and 15% of 2020 operating income (Figure 1). French banks anticipate a lower cost of risk in 2021, close to the through-the-cycle level, which is credible. The perspective of a strong economic rebound in 2021 is losing momentum but there are solid reasons behind these assumptions, from vaccinations to the maintenance of government support measures, the strengthened loss-absorption capacity of banks, the dynamics of the residential property market, as well as the generally granular credit exposures to the economic sectors most sensitive to the Covid-19 crisis.

In this report, we look in detail at five Frequently Asked Questions about French banks:

1. Was increased cost of risk the main driver of poor financial performance in 2020?
2. Are there any early warning signs of asset-quality deterioration?
3. Is the banks' optimism towards prospects in 2021 premature?
4. Did health measures have broader consequences on banks' performance in 2020?
5. What strategic adjustments were undertaken to adapt to the Covid-19 crisis, to low interest rates and mounting expectations around ESG?

**Figure 1: cost of risk as % of operating income**




BPCE: established in 2009. CMG 2020 data are estimates. 2021e: general trend figuring -2 pp. Source: SNL, Scope Ratings

**Analyst**

Nicolas Hardy
n.hardy@scoperatings.com

**Team Leader**

Dierk Brandenburg
d.brandenburg@scoperatings.com

**Media**

Keith Mullin
k.mullin@scopegroup.com

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**Scope Ratings GmbH**

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

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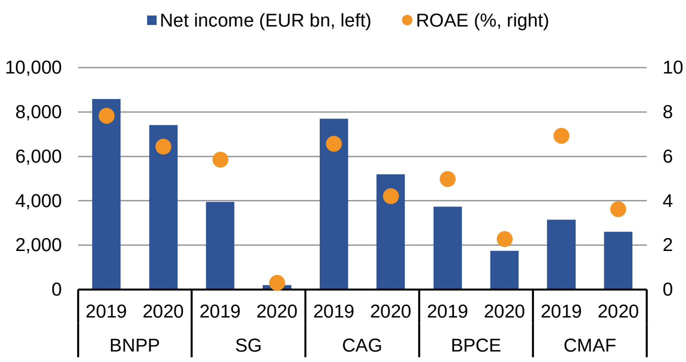
## Q1: was increased cost of risk the main driver of poor financial performance in 2020?

Cost of risk more than doubled in 2020 on average for large French banks (2.2x 2019 levels). This was the main driver of their poor financial performance. Return on equity dropped to 3.4% on average from 6.4% at end 2019.

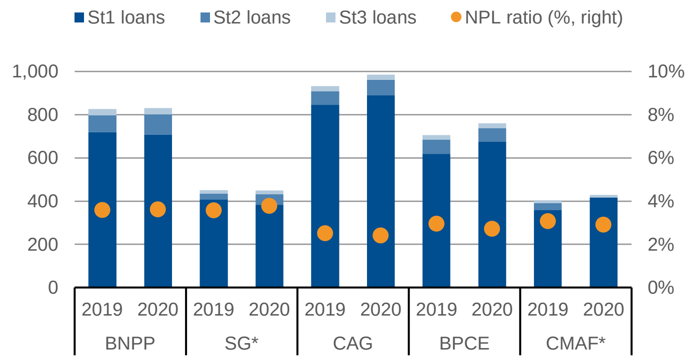
Customer loan portfolios continued to increase throughout the year (Figure 3). Mortgage financing remained dynamic in France and participation in State-guaranteed loans (SGL) also contributed to total loan growth. We expect this trend to stabilise in 2021.

**Figure 2: net income and return on equity**




ROAE: return on average equity. Source: SNL; Scope Ratings

**Figure 3: loan portfolios and NPL ratios**




Customer loans at amortized cost (EUR bn). *Estimated St1/St2 breakdown. Breakdown not available for CMAF at end 2020. Source: SNL, banks, Scope Ratings

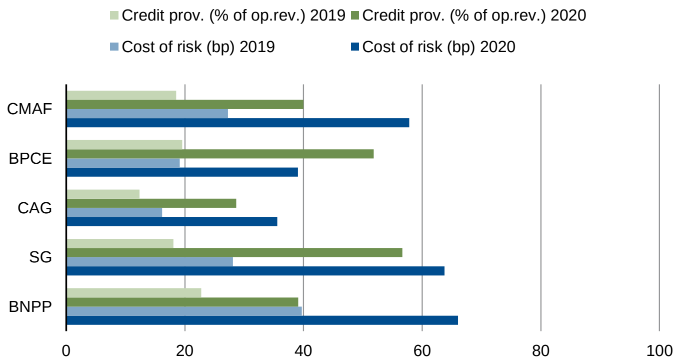
## Q2: are there any early warning signs of asset quality deterioration?

**Asset-quality indicators holding up**

Nine months after the outbreak of the pandemic, asset-quality indicators held up well. Cost of risk as a percentage of operating revenue increased only moderately, and from a low base (see Figure 1). On average, cost of risk increased 2.2x compared to 2019, but banks ended 2020 with cost of risk at the low end or even below their initial forecast range (from 38bp to 66bp, Figure 4). It is still too early to determine to what extent asset quality will deteriorate. Drawing conclusions from the evolution of cost of risk must be nuanced:

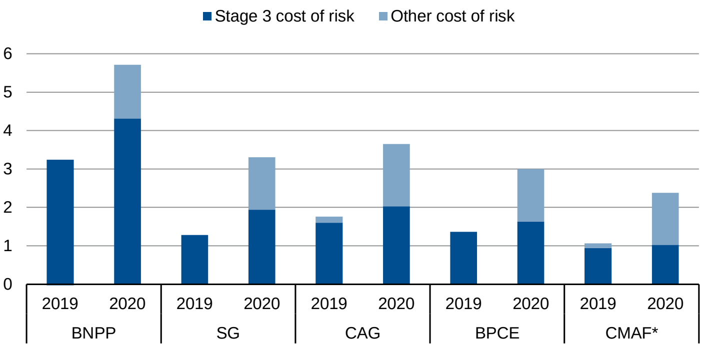
- A significant portion of 2020 cost of risk corresponds to Stage 1 and Stage 2 loans, ranging from c. 25% at BNP Paribas and 57% at Crédit Mutuel Alliance Fédérale (CMAF, the largest sub-group within Crédit Mutuel) – Figure 5. This relates to performing loans; classifications that are made in anticipation of potential future losses. Efforts to build up ex ante or precautionary provisions is credit positive because it allows banks to strengthen buffers ahead of the credit cycle. But part of the precautionary provisioning process is a matter of judgement and banks across Europe already made some reversals in the second half of the year, questioning the permanence of these buffers. Moreover, if massive forward-looking provisions prove to be the correct anticipation of rising problem loans, it provides no extra comfort in the form of genuine excess buffers.

**Figure 4: evolution of cost of risk**




Source: SNL, banks, Scope Ratings

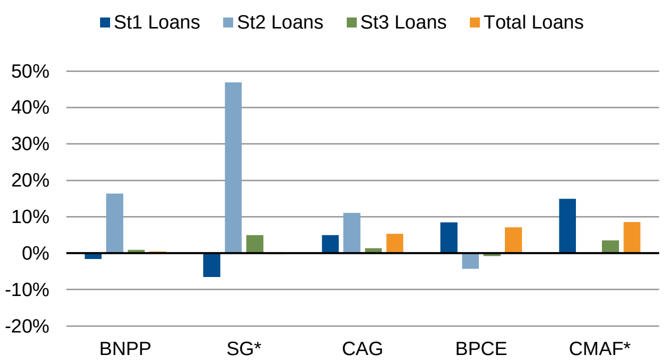
**Figure 5: breakdown of cost of risk by stage**




Source: banks, Scope Ratings

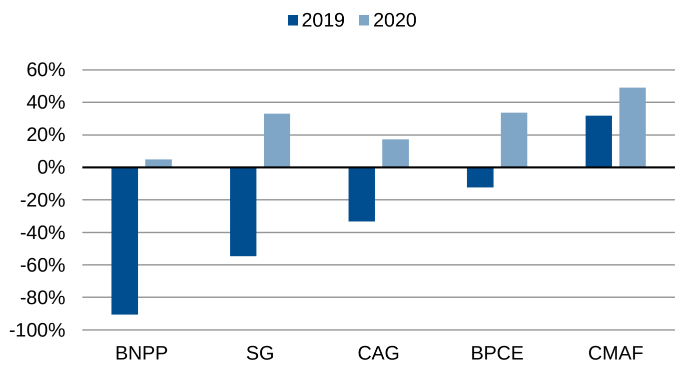
- The increase of stage 3 loans (problem loans) remains moderate at 1.3x 2019 levels (Figure 6). This is due to the extraordinary government support measures but also to active management of NPL stocks. Figure 7 illustrates how reserve policies (cost of risk charged to the P&L) correspond to higher credit loss impairment on customer loans (on the asset side of the balance sheet) i.e. on a net basis. In 2019, most banks used cost of risk to clean balance sheets, resulting in a net decrease in total credit loss impairment. We note the reversal in 2020, which is mainly linked to the increase in stage1/stage2 impairment. But it still represents only a portion of total cost of risk, meaning that most of it was also used to offload problem loans.

**Figure 6: customer loans (year-on-year change by stage)**




Estimated St1/St2 breakdown. Breakdown not available for CMAF at end 2020.
Source: SNL, banks, Scope Ratings

**Figure 7: net credit impairment as % of cost of risk**




Source: SNL, Scope Ratings

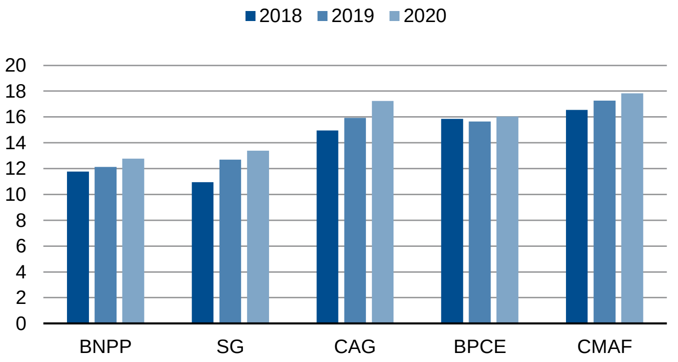
## Q3: is the banks' optimism about prospects in 2021 premature?

In their 2020 results announcements, many European banks, including French banks, were confident about the economic outlook and cost of risk in 2021. Banks expect cost of risk will likely settle around the through-the-cycle average, hence lower than in 2020. The following elements also underpin our views on asset quality and the creditworthiness of French banks.

- Macroeconomic assumptions point to an economic rebound in 2021-2022. But the time horizon to return to pre-pandemic GDP level is a moving target. Banks now anticipate a later return to pre-crisis levels, by end 2022 at the earliest or in 2023. Delays to vaccinations are not helping.

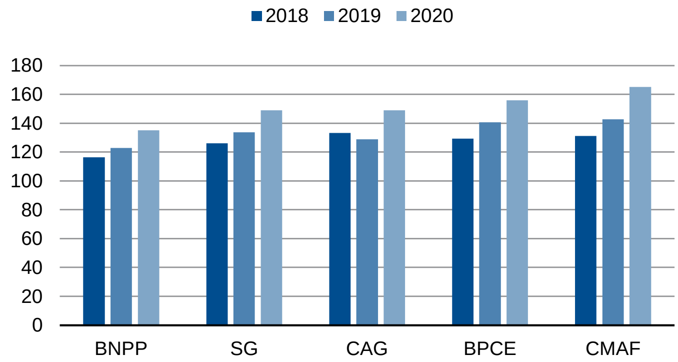
- Distance to minimum regulatory requirements is not a concern. Capital ratios and loss-absorption buffers are generally on the rise, benefiting from flexible regulatory measures and dividend suspension. We view positively the limits on dividend payments put in place in 2020 and the prudent approach decided for 2021 given the difficulties of estimating the future increase in problem loans. Uncertainties about how extraordinary support measures will be phased out is a major issue. Liquidity ratios improved massively across the board, thanks to central bank money (especially TLTRO) and inflows of customer deposits.

**Figure 8: CET1 ratios (transitional, %)**




Source: SNL, Scope Ratings

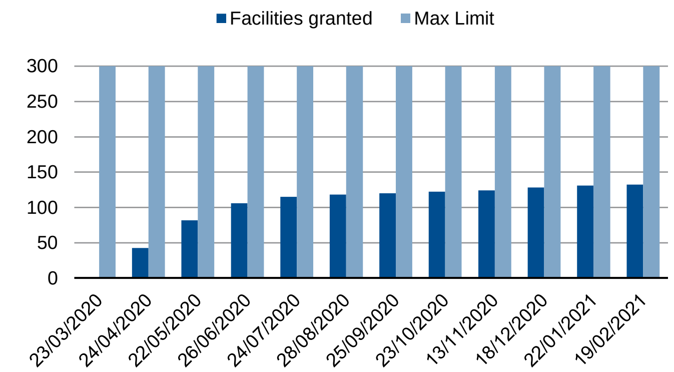
**Figure 9: Liquidity Coverage Ratios (LCR, %)**




Source: SNL, Scope Ratings

- The sectors of the economy most sensitive to the Covid-19 crisis continue to benefit from target measures. For banks, exposure to sectors most directly impacted by health measures tends to be granular, and credit risk manageable given loss-absorption buffers.
- The resilience of asset-quality indicators is primarily due to massive extraordinary support measures. The support toolkit adopted in France is relatively standard compared to other European countries, mainly made up of State-guaranteed loans and payment holidays. Drawdowns under the PGE (prêts garantis par l'Etat) programme continue to increase moderately, reaching EUR 134.9bn as of March 5, 2021 (Figure 10). We do not expect recourse to PGE to increase massively because of the caps put in place (linked to 2019 turnover). As of June 2020, moratoriums granted by the five largest French banking groups exceeded EUR 220bn (Figure 12). Most clients resumed payments on time. The government initiative to introduce a EUR 20bn participative loan (equity-like) programme, to support corporates is under active discussion.
- There is no obvious conclusion to draw at this stage from the recourse to SGLs or moratoriums. The main risk for banks remains extending credit facilities to businesses that are not sustainable in the long run. So far, most borrowers resumed payments as expected. Less than 5% of loans under moratoriums was classified as stage 3.

**Figure 10: SGL programme in France (PGE)**



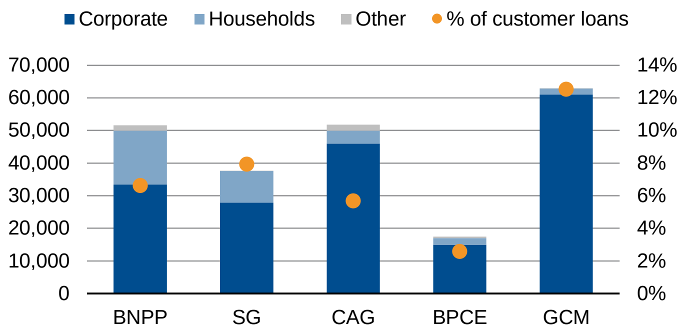

Source: French Ministry of Finance, Scope Ratings

**Figure 11: Update on participation in SGL at end 2020**

| Update on state-guaranteed loans (SGL) at end 2020 | |
|---|---|
| **BNPP** | More than 120,000 SGL granted by retail networks at end 2020, incl. close to €17.9bn in France (69,000 loans) |
| **SG** | EUR 19bn of SGL granted in all geographies o.w. EUR 18bn in France. Net exposure in France at c. EUR 2bn. at end 2020. 2.3% of SGL are in Stage 3 |
| **CAG** | EUR 28.7bn in France. EUR 2bn of payment holidays and SGL at CA Italia |
| **BPCE** | More than EUR 30bn disbursed as at early February 2021 |
| **CMG** | CMAF reported EUR 19.5bn of SGL (130,000 loans), incl. EUR 12.6bn at CIC and EUR 3.3bn at CM network |

Source: banks, Scope Ratings

**Figure 12: loans under moratorium at end June 2020 (EUR bn)**




Source: EBA transparency exercise, Scope Ratings

**Figure 13: Update on loans under moratorium at end 2020.**

| Update on loans under moratoria | |
|---|---|
| **BNPP** | More than 80% of moratoria already expired in total outstandings. More than 98%3 of loans under expired moratoria are performing. |
| **SG** | EUR 35bn outstanding at end Sept. 2020. EUR 5bn non expired at end 2020. EUR 7.5bn of outstandings classified in Stage 2, 730 m in Stage 3. |
| **CAG** | EUR 4.2bn in deferred maturities corresponding to a remaining capital share of €58.5bn (data as of July 2020). |
| **BPCE** | EUR 25.2bn of moratoria granted. 1.8% classified as stage 3 loans (EUR 460m.). |
| **CMG** | CMAF reported 1,600,000 payment holidays (as of March 2020). |

Source: banks, Scope Ratings

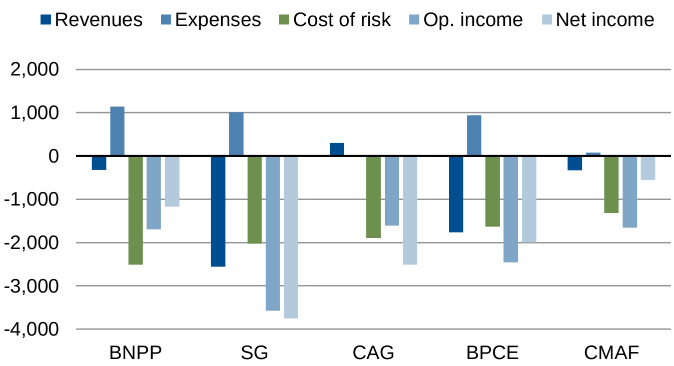
## Q4: did health measures have broader consequences on the banks' performance in 2020?

The resilience of operating revenues was uneven among banks (first bar in Figure 14) and drove performance. Lower revenue generation was more pronounced at Société Générale and BPCE mainly due to the poor performance of corporate and investment banking activities in the first half of the year. Other banking groups either benefited from more diversified CIB activities (BNPP and Crédit Agricole), or a different business mix, traditionally less volatile (Crédit Mutuel).

Even though there was loan growth, interest income came under further pressure due to the low-rate environment and a combination of other factors. These factors include payment holidays, SGLs granted at cost and inflows of customer deposits. Banks do not charge negative interest rates on retail customer deposits and this is unlikely to be introduced any time soon.

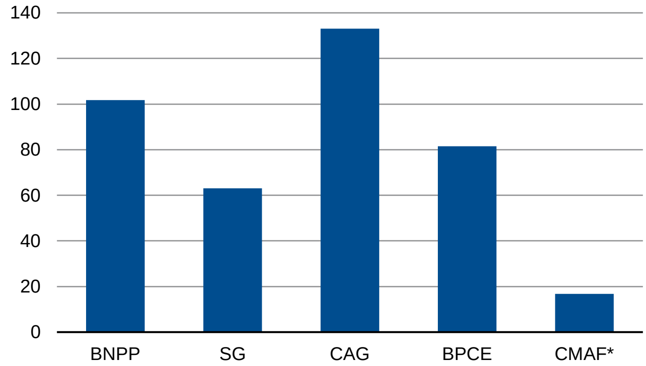
The positive impact of the favourable rates offered by the ECB as part of TLTROs are not negligible given the sizable increase of the amounts borrowed by banks over 2020 (close to EUR 400bn outstanding for the five large French banks, Figure 15). Benefiting from the best rates depends on the banks' ability to meet required lending targets. The bancassurance model is a credit strength in this context, but income generation in this segment was also hit by the poor performance of financial markets in the first half of 2020 and operating constraints under lockdowns.

**Figure 14: P&L items (EUR bn)**




Source: SNL, Scope Ratings

**Figure 15: TLTRO outstandings at end 2020**




*data as of June 2020. Source: banks, Scope Ratings

Good cost control provided some relief but there is no indication that it could happen again in 2021. Some operational costs fell because of the Covid-19 situation, such as travel expenses. These may not be permanent features. In the meantime, the permanence year on year of significant restructuring charges, categorised as exceptional, brings into question their categorisation as non-recurring (beyond their accounting treatment). Many exceptional items reflect the structural transformation of business models, like the sale of buildings or IT investments, which will continue in years to come.

**Figure 16: Highlights of main 2020 exceptional P&L items**

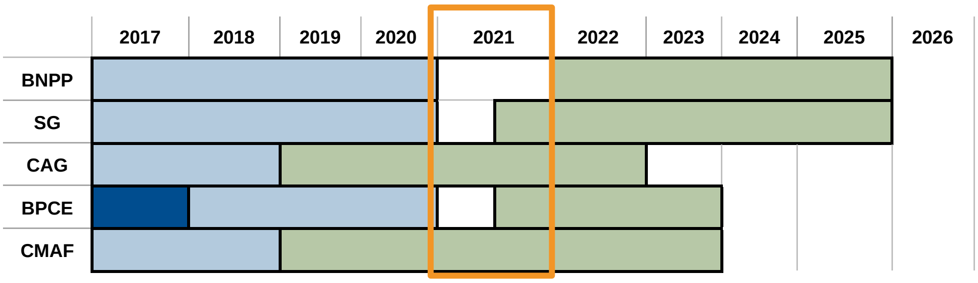
| | Positive | Negative |
|---|---|---|
| **BNPP** | EUR+699m sale of buildings<br>EUR+371m capital gain on Allfunds | EUR-211m restructuring costs<br>EUR-130m goodwill impairment<br>EUR-178m IT reinforcement costs |
| **CAG** | | EUR-965m change in value of goodwill incl. EUR-884m CA Italia<br>(net income group share impact) |
| **SG** | EUR+650m DTA impairment (positive impact on income tax) | EUR-684m goodwill impairment<br>EUR-212m group refocusing plan<br>EUR-210m (gross) restructuring charges (o/w GBIS EUR-157m) |
| **BPCE** | | EUR-566m transformation costs<br>EUR-203m Coface (divestment) |
| **CMAF** | EUR+530m (estimate) disposal of Euro Information Telecom | |

Source: banks, Scope Ratings

## Q5: what strategic adjustments were undertaken to adapt to the Covid-19 crisis, to low interest rates and mounting expectations around ESG?

Last year was supposed to be a year of transition for several banking groups (Figure 17). The unexpected operating conditions caused by the pandemic and the exceptional public health measures led some banks to pause the roll-over of medium-term plans. This was not due to operational constraints or difficulties in implementing changes. As the pandemic accelerates business transformation, banks are performing a more fundamental review of targets and operations. Communication around strategic plans will resume later in 2021.

**Figure 17: overview of French banks' roll-over of medium-term strategies**




Source: banks, Scope Ratings

Many exceptional P&L items reported during 2020 (Figure 16) reflect strategic initiatives and the ongoing transformation of business models. Ranging from restructuring measures, goodwill impairment, or sale of assets, they provide insights into forthcoming medium-term strategic plans. We see the following recurring themes ranking high on strategic agendas:

- **Reshuffling of retail banking operations**. The pandemic has given a push to accelerate the streamlining of retail activities, the turn to digital, transforming relationships with clients but also internal processes. We see Société Générale's project to merge its dual domestic networks (SG network and Crédit du Nord network) a pioneering initiative. The maintenance of dual domestic networks is a common characteristic of French banking groups.
- **Improving the efficiency of CIB activities**. This remains a key strategic objective for Société Générale. It is also part of BPCE's reorganisation project (including the delisting of Natixis).
- **Increasing economy of scale in asset management**, either internally by leveraging market position for the largest players, or by creating synergies in the form of partnerships.
- **Developing leasing activities**, in particular car financing, to accompany the switch from ownership to usership and technological innovation. BNP Paribas and Société Générale have growth ambitions for Arval and ALD Automotive. Crédit Agricole announced the creation of a new entity in this segment: CA Rent.
- **Strengthening the bancassurance business model** which had already reached a certain degree of maturity. The recent combination of La Banque Postale and CNP Assurances is making progress leading to the emergence of a sixth large national champion with renewed growth ambitions.
- **Further integrating ESG factors** in day-to-day operations now permeates all business lines. Banks are competing with many other stakeholders to establish the right standards, either to conduct banking activities in a sustainable manner, or to disclose the proper sustainability metrics. Regulatory initiatives at EU level, including the introduction of a green asset ratio, are pushing hard in this direction.

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## Scope Ratings GmbH

### Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

### Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

### Paris
23 Boulevard des Capucines
F-75002 Paris

Phone +33 1 8288 5557

### Oslo
Karenslyst allé 53
N-0279 Oslo

Phone +47 21 62 31 42

### Madrid
Edificio Torre Europa
Paseo de la Castellana 95
E-28046 Madrid

Phone +34 914 186 973

### Milan
Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 30315 814

## Scope Ratings UK Limited

111 Buckingham Palace Road
London SW1W 0SR

Phone +44 (0)20 7340 6347

info@scoperatings.com
**www.scoperatings.com**


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