French banks: comforting Q3 results but it's not over.

French banks should end 2020 with decent overall credit metrics. They posted comforting third-quarter asset-quality figures and improved earnings. For the four largest banks, third quarter net income came close to 2019-2020 quarterly average levels. With solid financial positions, they are well placed to face the inevitable rise of problem loans over the next few quarters.

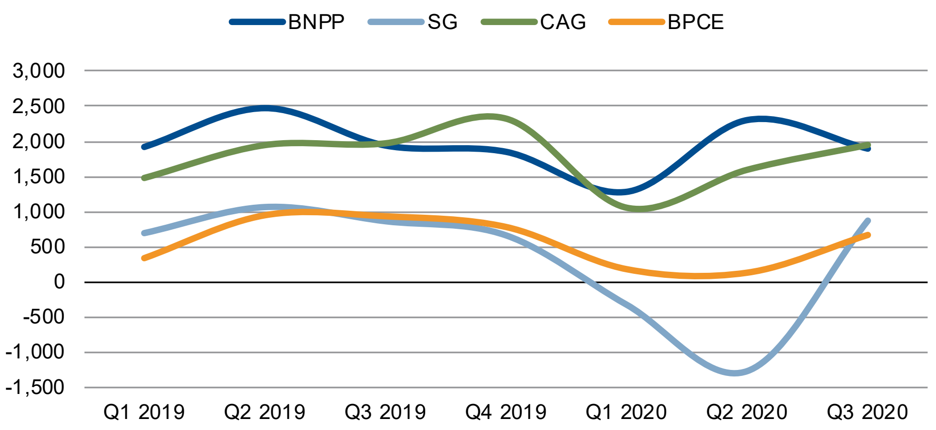
Many factors support Scope's positive views of the resilience of French banks. They are building provisions and capital buffers; the dividend ban has boosted loss-absorption capacity; while continuing market access for refinancing allows them to issue subordinated debt, protecting senior creditors. Liquidity support from the ECB, too, is massive. In the meantime, the required adjustments to business models continue.

Strategies put in place to prevent the rise of problem loans are similar across Europe. They combine government support measures, in particular government-backed loans, accommodating monetary and regulatory initiatives to facilitate bank lending, and accommodating loan moratoriums. In France, with EUR 255bn of loans under moratorium as of June 2020, and EUR 125bn of government-backed loans already granted under the PGE (prêts garantis par l'Etat) programme, support measures have been the biggest in Europe.

The impact of the Covid crisis on banks remains uncertain. There are many moving parts, from the modelling of infection waves and the severity of lockdown measures to the permanence of support measures. Deteriorating asset quality will remain under control for French banks assuming an effective economic rebound in 2021. Scope anticipates GDP growth of 6.8% in 2021 (versus a contraction of 10.1% in 2020). The likelihood of vaccine solutions early 2021 supports this scenario.

The impact of the crisis across sectors is uneven, and concentrations in corporate loan portfolios should receive close attention. It would justify a cautious approach to dividend payments until spring 2021. The moderate deterioration of unemployment, reaching 11% in 2021 (from 8.5% in 2019), underpins the resilience of the retail banking segment.

Figure 1: Reported quarterly net income (EUR m.)



Source: banks, Scope Ratings

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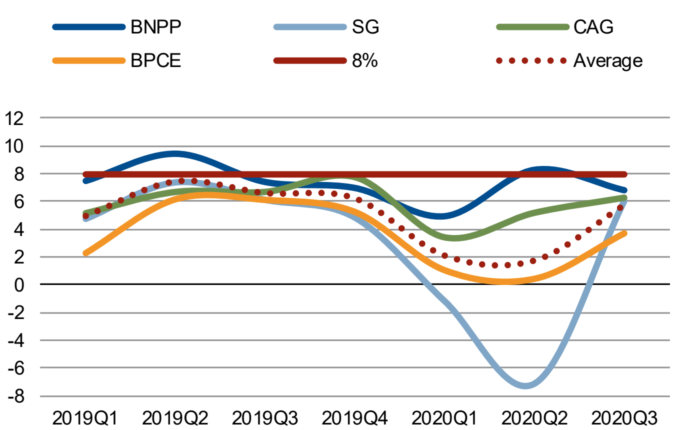
Adjustments to business models continue due to the pressure on efficiency and profitability

French banks should end this year with decent overall credit metrics. Revenue generation in the third quarter benefited from the wave of optimism and catch-up effect after the first lockdown. The second part of the year has so far been immune from the combination of adverse and unexpected events experienced in the first half: an oil price shock, volatile financial markets, poor performance of the equity derivatives segment (where French banks have leading market positions), or goodwill impairment (e.g. EUR 684m for SG in Q2). The second lockdown is less constraining and expected to be largely lifted during December.

Since the beginning of the year, banks have lent to the real economy, built loss absorption buffers, controlled the rise of problem loans and, thanks to resilient revenue generation, posted positive contributions albeit with some divergences. With the anticipation of a brighter economic outlook, the debate on the resumption of dividend payments is on the agenda. We see room for a case-by-case approach taking into account individual net exposures to pockets of risk. In the meantime, low efficiency and profitability indicators remain a relative rating weakness for French banks in comparison to international peers. This is being addressed incrementally but will take time to materialise and execution risk has increased.

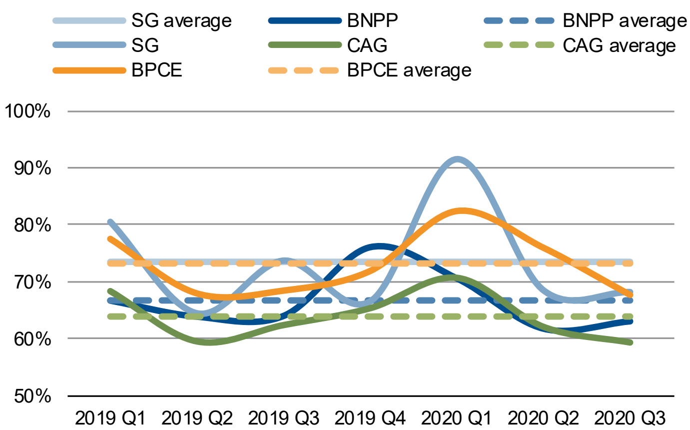
French banks benefit from large balance sheets and critical size in some segments, but they also face legacy over-capacity in other segments, such as retail distribution channels. Société Générale plans to merge its domestic retail networks (i.e. with Crédit du Nord). Société Générale and BPCE are both taking measures to adjust the volatile risk-return profile of some business lines, such as equity derivatives. The diversification of revenues by geography or product, for instance in flow businesses, from payment services to asset management, has become an increasingly visible strategic priority and a reaction to the low-for-long interest rates and the maturing bancassurance model. Crédit Agricole is pursuing efforts to strengthen its presence in Italy, its target second home market, with the proposed acquisition of Credito Valtellinese (EUR 24bn in total assets).

Figure 2: Quarterly return on average equity (%)



Source: SNL, Scope Ratings

Figure 3: Quarterly cost-income ratios (%)

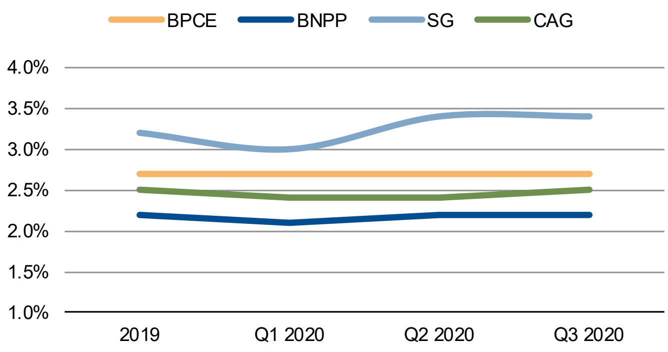


Source: SNL, Scope Ratings

Key asset-quality metrics: so far, so good

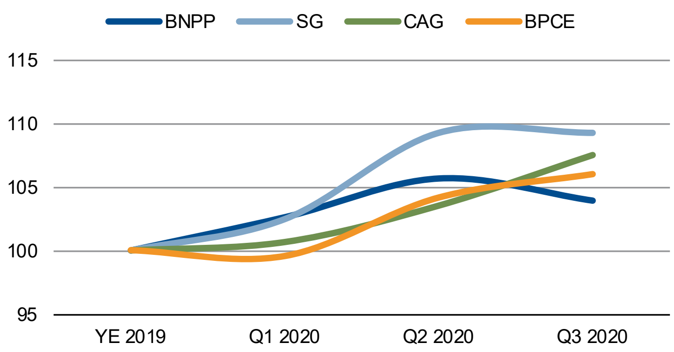
Reported non-performing loan (NPL) ratios have remained flat since the beginning of the year (Figure 4), in the 2.2%-3.6% range – low to average by European standards. This stability should be seen in the context of dynamic loan production, boosted by the government-backed lending programme. The rise of problem loans is modest in volume and controlled (Figure 5). The stock of NPLs at the start of the crisis was also at a low in the current credit cycle.

Figure 4: Reported impaired loans ratio (%)



Source: banks, Scope Ratings

Figure 5: Reported impaired loans (outstanding, 100 = end 2019)



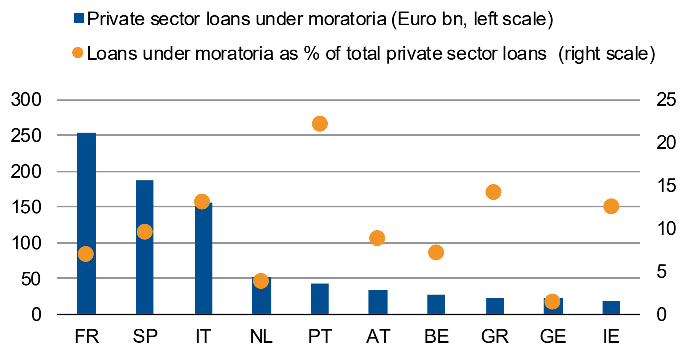
Source: banks, Scope Ratings

Granting EUR 255bn of moratoriums helped overcome first lockdown

French banks have been among the largest providers of loan moratoriums by volume in Europe. This is noticeable in the absence of State-directed measures in the form of legislative schemes. According to EBA data, French banks granted EUR 255bn of moratoriums as of June 2020, representing 7.1% of loans to the private sector (households and non-financial corporations). By category of borrowers, loans under moratorium accounted for 3.3% of mortgage loans, 12.6% of loans to non-financial corporations (21.2% for SMEs). The reported amount of non-performing loans to loans under moratorium was also small, just above 1%. As of June, about 60% of moratoriums were due to expire within three-months, less than 3% after nine months.

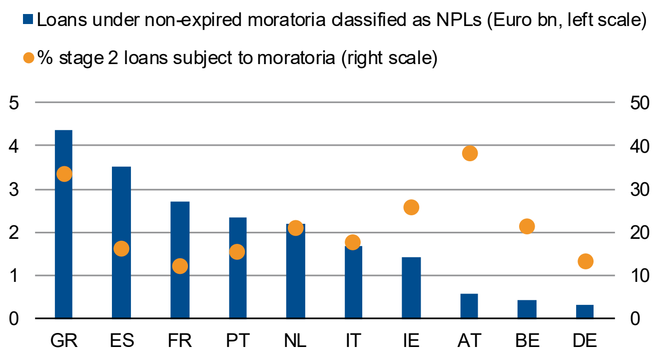
Maintaining support initiatives until the economic recovery kicks-in is critical to prevent a surge of problem loans onto bank' balance sheets. On November 25, the European Central Bank warned that "*a premature end of government guarantees, and moratoria could lead to an additional wave of losses".* The accommodating EBA rules for the classification of loans under moratorium were phased out in September, then reinstalled. The aim of this phasing out was to help transition back to pre-crisis practices. However, the second lockdown has renewed pressure on some borrowers. It remains to be seen how the most fragile clients will be able to continue benefiting from this flexibility.

Figure 6: Volumes and percentage of loans under moratorium in selected European countries as of June 2020.



Source: EBA, Scope Ratings.

Figure 7: Overview of asset-quality indicators for loans under moratorium in selected European countries as of June 2020.



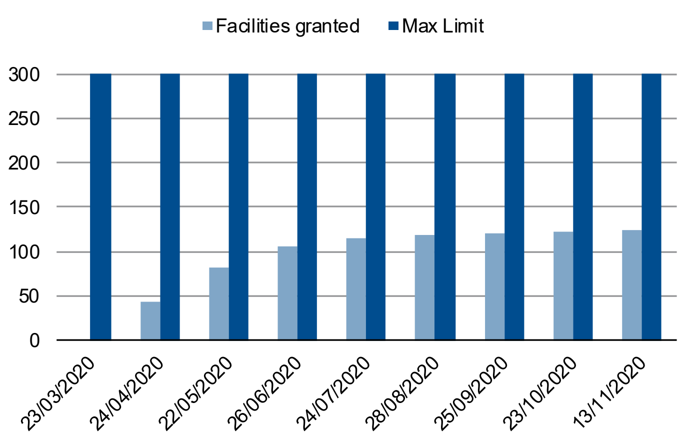
Source: EBA, Scope Ratings.

Tightening underwriting criteria expected after a dynamic loan growth inflated by government support measures

Corporate loans outstanding will likely decrease in the coming quarters, after the peak reached this summer which was boosted by support measures. Year-to-date, total lending to domestic non-financial corporations grew by an amount equivalent to the outstanding amount of the PGE government-guaranteed loan programme put in place in March and channelled via banks. Since July, lending has increased only marginally, now standing at about EUR 125bn. The deadline for loan subscriptions was extended from December 2020 to June 2021 but there has been no second rally following the second lockdown. This can be explained by the cap on lending, linked to past turnover data. The clients most exposed to the Covid crisis and eligible for loans have already subscribed to the programme.

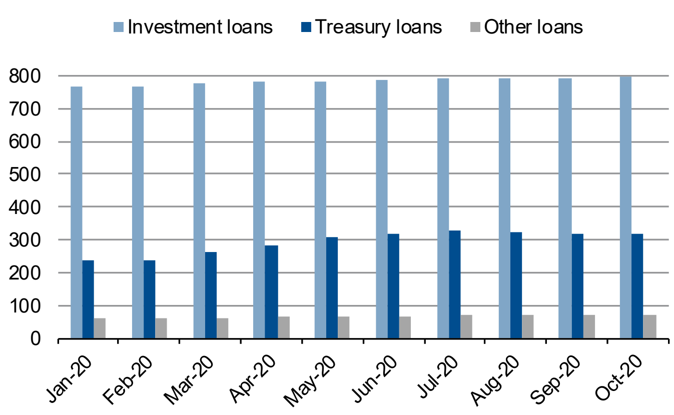
The decreasing amount of outstandings should be driven by a reduction of treasury loans. Companies that have built precautionary cash positions and see a normalisation of operating conditions will limit recourse to credit lines. In the meantime, banks will likely become increasingly selective given the expected shape of the recovery i.e. a gradual return to pre-crisis levels over a prolonged period.

Figure 8: State-guaranteed loan programme (PGE, EUR bn)



Source: French Ministry of Economy, Scope Ratings.

Figure 9: Total loans to non-financial corporations (EUR bn)



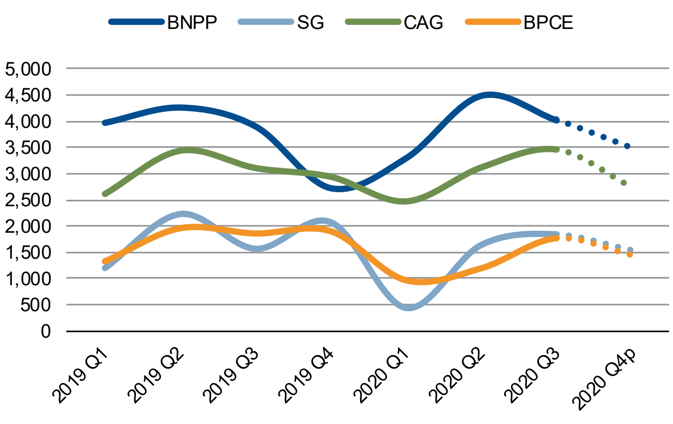
Source: Banque de France, Scope Ratings.

Expectation of resilient 2020 performance balances prospects for gradual convergence to pre-crisis levels

Thanks to the sequencing of events since the beginning of 2020 and to support measures, French banks will likely enter 2021 with their credit standing preserved. The following assumptions for the fourth quarter shed light on the likely performance of French banks over 2020, given latest developments:

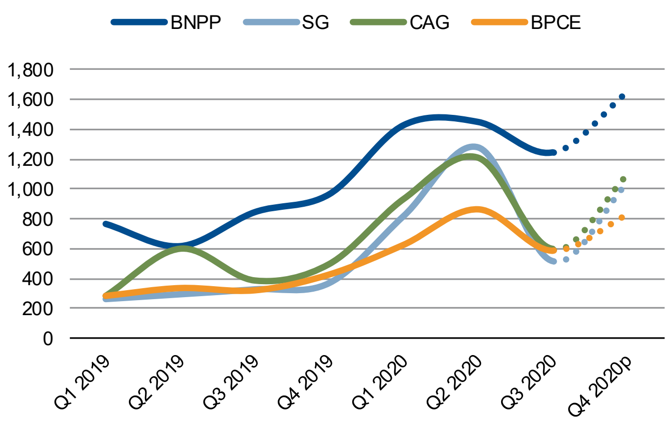
- Quarterly operating revenue 10% lower than the quarterly average since early 2019, excluding the highest and the lowest quarters. This assumption balances the effect of a less stringent second lockdown, likely eased in December, and a higher level of economic activity over the quarter, with some positive seasonality effects.
- Quarterly cost of risk 20% higher than the average of the first three quarters of 2020. For the most vulnerable economic sectors, pressure on cash positions will be more acute. Large uncertainties around the rate of recovery in 2021 could entail some more precautionary forward-looking provisions. This approach does not lead to materially different cost of risk levels compared to annualised impairment charges for the first nine months of the year – 38bp by Crédit Agricole and BPCE, 57bp by BNP Paribas and 67bp by Société Générale.

Figure 10: Quarterly operating revenues (actual and projected, EUR m.)



Source: banks, Scope Ratings.

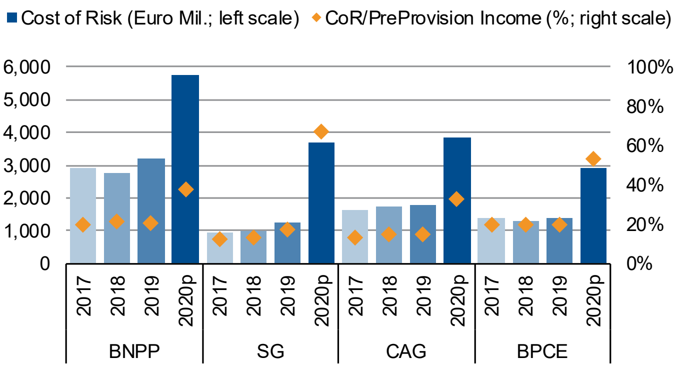
Figure 11: Quarterly cost of risk (actual and projected, EUR m)



Source: banks, Scope Ratings.

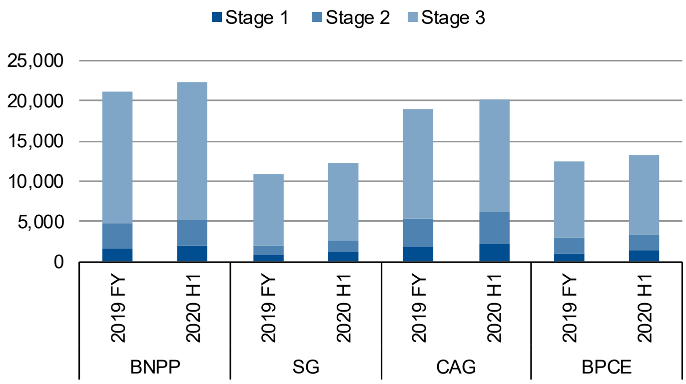
Under this scenario, banks display resilient revenue generation and a manageable increase of the cost of risk. Despite the more than doubling in the impairment charge this year, from a relatively low level in 2019, there is still room for negative exceptional items before hurting capital levels (Figure 12, below). Of note, part of 2020 provisioning efforts also relate to precautionary provisions (about 25% on average) which will help in 2021 with loan migration (Figure 13, below).

Figure 32: Cost of risk and comparison with pre-provision income (EUR m.)



Source: banks, Scope Ratings

Figure 43: Breakdown of loan-loss reserves according to IFRS 9 classification (EUR bn, as of June 2020)



Source: banks, Scope Ratings

Banks display adequate loss-absorption capacity; risks to the downside (including tail risk) require conservative approach

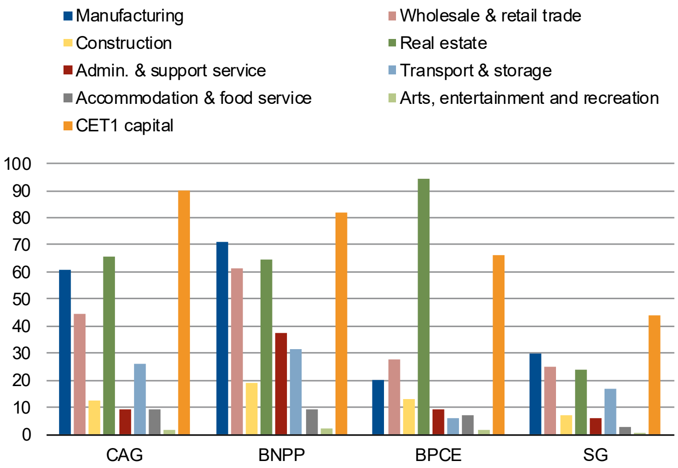
The capacity of banks to absorb a certain level of credit losses until the economic rebound kicks in underpins our views on their credit resilience. A default of a few large borrowers in the most fragile economic sectors is the main source of risk for banks.

For the moment, based on the expectation of a limited deterioration of unemployment in France, and existing safety nets, the retail segment should not add materially to asset-quality deterioration. Most retail exposure is made up of secured mortgage loans, and the property market is holding up well. The remainder is made up of consumer loans: riskier but priced accordingly or secured by assets for the portion relating to car financing. The second-hand car market also remains active.

As a result, corporate loan books attract most attention. Their granularity generally supports French banks' creditworthiness. As the impact of this crisis is uneven on economic sectors, bank-specific credit concentration and diversification of revenue are likely to be the main differentiating factor among banks. As long as there is no accumulation of large corporate defaults, banks should be able to navigate the crisis. Large non-financial corporates are also the most susceptible to receive targeted government support measures. Government support will be redirected to ailing sectors when the recovery kicks in.

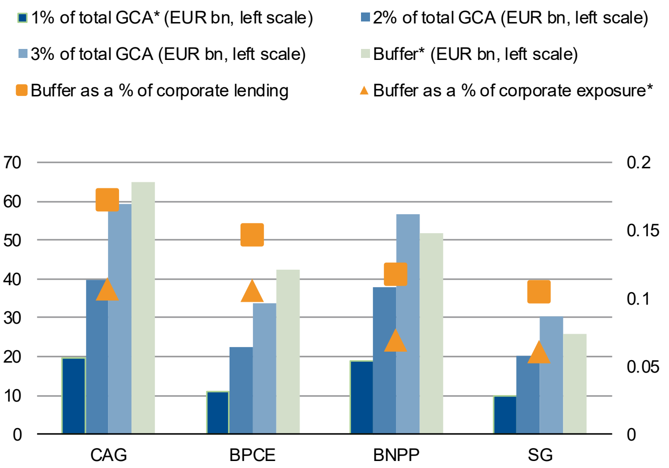
The breakdown of corporate loan books indicates limited sector concentration or a relatively low exposure to the most sensitive sectors (e.g. leisure, hospitality, airlines) in comparison to available loss-absorption buffers (Figure 14). As a proxy, we estimate that the four largest French banks have the capacity to absorb a loss equivalent to 2% or 3% of their total credit exposure (gross carrying amount as per Pillar 3 disclosures) with their buffer made of stage 1 and stage 2 provisions plus excess CET1 capital over the sum of pillar 1 and pillar 2 requirements (Figure 15).

Figure 14: Exposure to most sensitive corporate sectors compared to CET1 ratios (EUR bn, as of June 2020)



Source: EBA spring transparency exercise, banks, Scope Ratings

Figure 15: Loss absorption capacity in relation to credit exposures (as of June 2020)

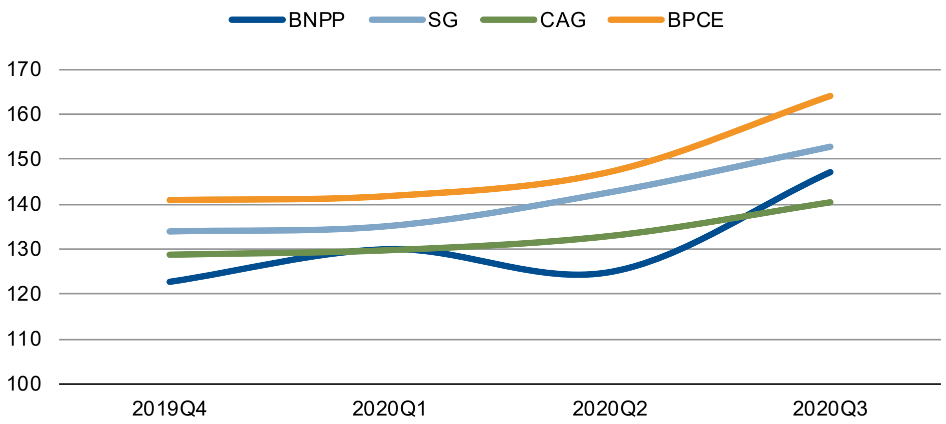


GCA: gross carrying amount. Buffer: sum of Stage 1 and Stage 2 provisions plus excess CET1 above Pillar 1 and Pillar 2 requirements. Corporate exposure: on and off-balance sheet. See Pillar 3 disclosures. Source: banks, Scope Ratings

French banks have built buffers above regulatory requirements

Banks have benefited from the revision of some regulatory rules for the calculation of capital buffers, but this did not fundamentally change the distance to minimum requirements. Uncertainty about the permanence of these features has also forced banks to keep a conservative approach to manage future requirements and market expectations. Beyond capital adequacy; funding and liquidity metrics have also improved with the inflows of customer deposits and ECB intervention. Liquidity Coverage Ratios have moved from a 120%-140% range to a 140%-160% range.

Figure 16: Reported liquidity coverage ratios (LCR, %)



Source: banks, Scope Ratings.

Markets are open and the abundant liquidity explains the early completion and downward adjustment of debt issuance this year. Excess deposits, most of them non-remunerated but potentially placed at negative rates, are not helping to improve net interest margins. Negative rates have not been extended to a large portion of the customer base.

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