Financial Institutions

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French bank quarterly

Heated political climate a business drawback

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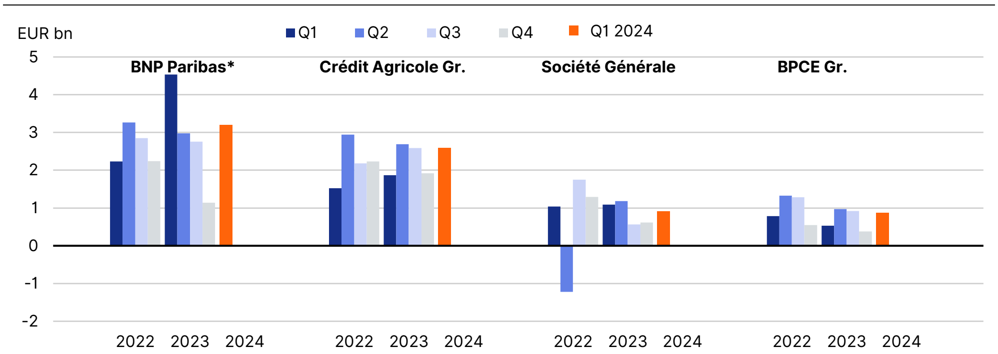
Interest-rate cuts boosting loan demand and improving net interest margins were supposed to drive French banks' performance in the second half of the year. However, heightened political uncertainty is a serious drawback to business dynamism, putting investment decisions on hold. Mortgage demand was already hesitant. Before the elections we were already projecting lacklustre 0.8% real GDP growth for France in 2024, below growth potential. The risks of more pronounced tensions in civil society have receded but the equilibrium remains fragile.

Large French banks have solid credit fundamentals and can withstand a more pronounced economic slowdown. As long as the slowdown is temporary, it is unlikely to change our assessment of the supportive operating environment for banking activities in France. Banks reported positive momentum in the first quarter, although performance for most was below 2023 (Figure 1). The resilience of French banks' business models lies in their high, albeit uneven, degree of business diversification. Despite indications of moderate deterioration, asset-quality metrics remain robust, in line with through-the-cycle averages.

In the short term, though, the current backdrop will hinder banks efforts to improve operational efficiency (which is low compared to peers) or to implement strategic initiatives. Net interest margins remain surprisingly flat, and prospects for near-term improvement may be less certain if lending momentum fades.

Political uncertainty in France has begun to raise investor concerns about the potential nexus between domestic sovereign risk and French banks' creditworthiness. This primarily impacts funding costs, reflected in higher credit default swap levels, but we do not consider it an asset-quality issue given France's sovereign rating (AA/Negative).

Figure 1: Quarterly net income (EUR bn)



*BNPP: Q1 2023 included EUR 2.947bn capital gain from the sale of Bank of the West. Not restated for accounting changes.
Source: SNL, banks, Scope Ratings

Our expectations of 2024 trends for French banks		
Profitability	Mildly negative because of potentially muted loan demand	↘
Asset quality	Mildly negative given the economic slowdown	↘
Funding and liquidity	Stable thanks to lower deposit migration, limited additional wholesale funding needs, liquid balance-sheets	→
Capital	Stable buffers, marginal increase in regulatory requirements	→

Profitability: heated political climate not helping to improve efficiency

For French banks, profitability prospects remain a function of net interest margins, which have so far been surprisingly flat since June 2022, when interest rates started to rise (Figure 2). But net interest margins are expected to increase in the second half of the year as loans continue to reprice at levels above historical averages and the significant migration of customer deposits from non-remunerated to remunerated accounts slows down (Figure 4).

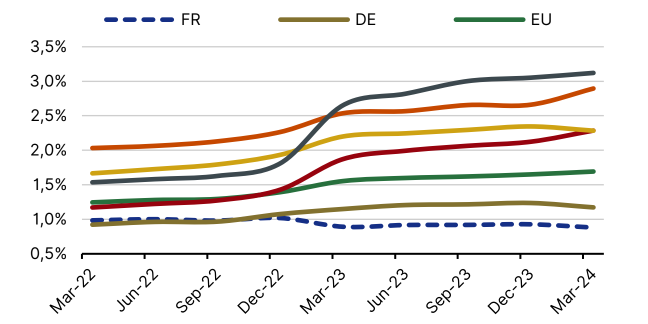
Higher wholesale funding costs weigh on profitability

The surge in refinancing costs in the wholesale market, fully correlated with market perceptions of sovereign risk (given an uncertain policy agenda) will likely abate but will remain higher than in the recent past. Market sensitivity and volatility will likely remain for months. Banks will retain good market access but it will be more costly.

Lower net interest income due to weaker net interest margins and declining mortgage production was partially offset by higher net fees and commissions, while the continuing trend of weak results in French retail was partly offset by a better performance of corporate and investment banking activities. But the latter are prone to volatility and may not be sustained. Stronger results on a net basis were supported by the end of contributions to the Single Resolution Fund (SRF). However, operating expenses (excluding the SRF) increased on an annual basis for most banks.

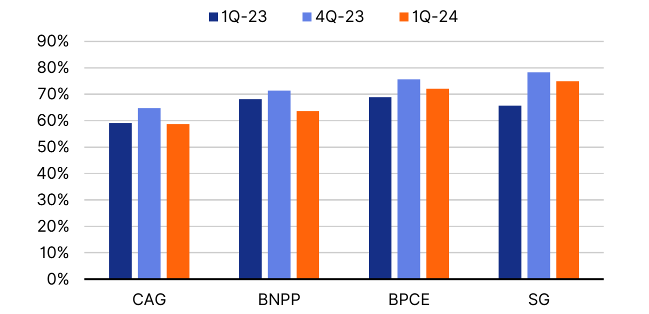
Low operating efficiency remains the main structural credit weakness for French banks compared to peers. According to the European Banking Authority's latest risk dashboard, the average cost-to-income ratio for banks operating in France was 70.4% at the end of the first quarter of 2024. That was the highest by a notable margin of the large EU/EEA economies and the second-highest of all EU/EEA economies (exceeded only by Lithuania). This compares with an average of 54.6% for the full sample. The latter stood at 63.2% two years ago, just before interest rates started to rise, showing consistent improvement since then.

Figure 2: Net interest margin



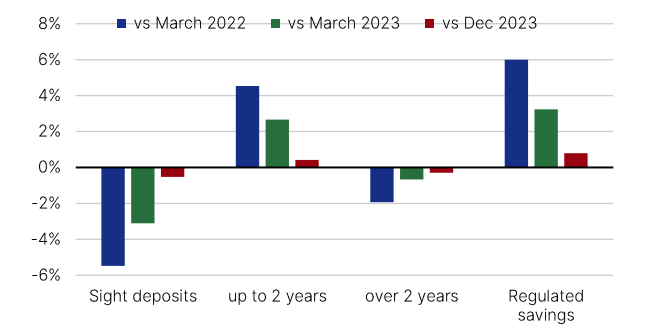
Source: European Banking Authority, Scope Ratings

Figure 3: Cost-to-income ratios



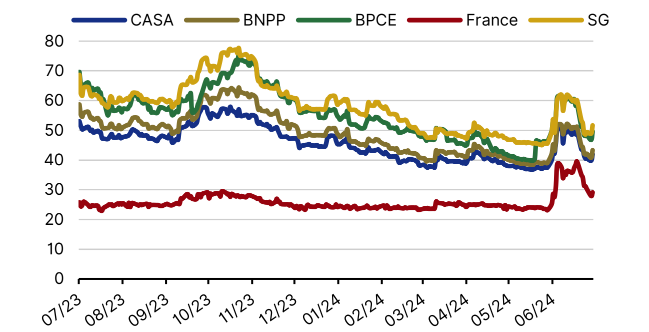
Adjusted for SRF contributions. Source: banks, Scope Ratings.

Figure 4: Change in customer deposits composition in 1Q24



Change in the share of main deposit categories in household deposits.
Source: Banque de France, Scope Ratings

Figure 5: Credit Default Swaps



CDS on 5 year senior bonds, last 12 months. Source: SNL, Scope Ratings

Lending dynamics: entering a period of wait-and-see

Net interest margins remain under pressure, particularly in French retail, which is a key driver of French banks' profitability. Rates on new mortgages are declining from their peak reached in the fourth quarter of 2023. Despite the upward adjustment in usury rates (the legal cap on interest rates was set at 6.39% for the second quarter, up from 6.29% in Q1) rates are trending down due to tough competition in this segment, muted demand, and expectations of lower policy rates.

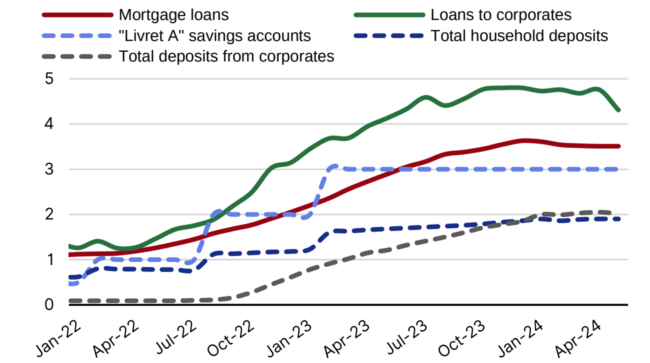
Expected recovery in mortgage demand may be delayed

The slowdown in the production of new mortgages continued in the first quarter, with the volume of new loans falling each month. Interest-rate cuts in the second half of the year should lead to a gradual recovery in mortgage demand. However, political uncertainty may delay this potential recovery.

Scope's pre-election macroeconomic projections factored in stable unemployment, declining inflation and a mild economic rebound, with real GDP growing by 1.3% in 2025, after a modest 0.8% in 2024. However, this projection could be revised if political uncertainty and the general wait-and-see attitude lead to a more pronounced economic slowdown towards the end of the year. Based on pre-election estimates, INSEE, the French national statistical office, estimated that the Olympic games could have a 0.3pp positive effect on growth in the third quarter.

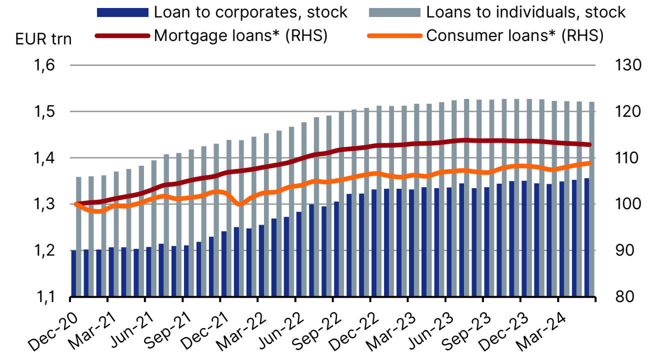
Corporate bankruptcies continue to normalise and are now in line with historical averages. They are likely to continue to increase but at a moderate pace, helping banks manage the associated costs.

Figure 6: Interest rates on loans (straight lines) and deposits (dashed lines), %



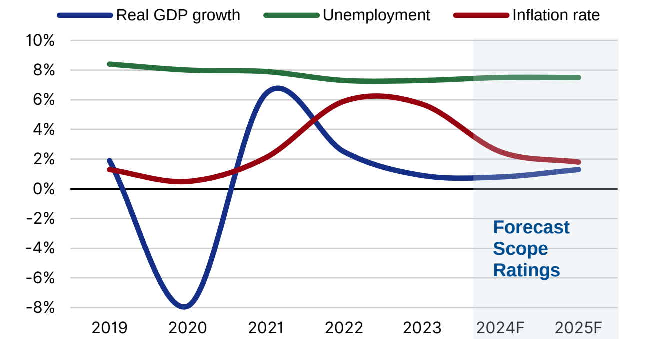
Source: Interest rates on loans: new business, all maturities, annualised agreed rate.
Source: Banque de France, Scope Ratings

Figure 7: Lending dynamics



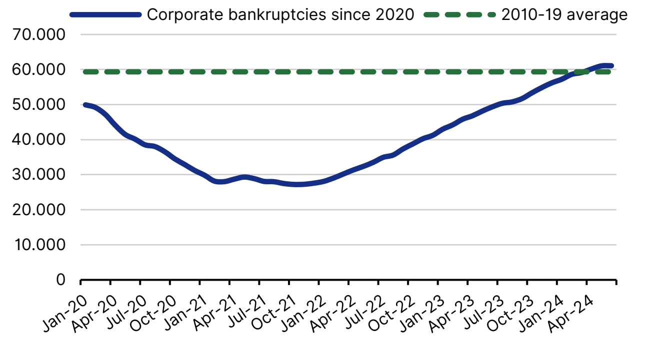
Source: Banque de France, Scope Ratings

Figure 8: Macroeconomic projections



Shaded area represents forecasted values. Inflation rate: annual average Harmonised Index of Consumer Prices. Source: IMF, Scope Ratings

Figure 9: Corporate bankruptcies



Source: Banque de France, Scope Ratings

Asset quality: moderate normalisation to continue

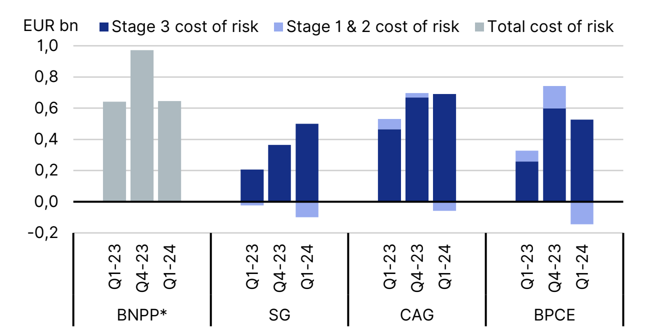
The gradual normalisation of asset quality continues at a moderate pace. On a positive note, there has been no widespread or accelerated deterioration in asset-quality metrics. The stock of impaired loans increased slightly but asset quality ratios remained stable.

Net cost of risk also remained stable for most banks in the first quarter, and banks' CoR guidance was below or at the level of their historical averages. Higher impairment charges for stage 3 loans were partially offset by stage 1 and 2 releases. A more pronounced economic slowdown could lead to a more broad-based deterioration in asset quality, starting with the more vulnerable SME sector. This would likely accentuate trends already observed in the real estate and construction sectors which were caused by higher funding costs.

Given the increased pressure on France's creditworthiness, the potential for contagion effect between the State and the banks has again come to the fore. Scope's view of the creditworthiness of France is stronger than that of any individual French bank. We do not consider French banks' modest holdings of French sovereign debt to be a pressure point in terms of asset quality.

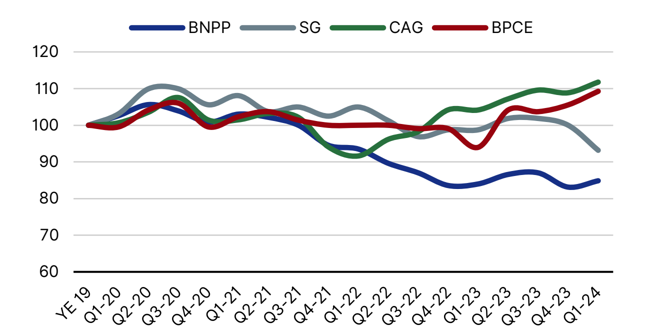
However, the banks' and the sovereign's creditworthiness are sensitive to a more pronounced and sustained economic slowdown. A crystallisation of this risk could lead us to consider that the operating environment for banking activities in France is becoming less supportive. At the moment, we do not believe that a drastic revision of bank fundamentals is warranted or that the likelihood of this scenario has increased significantly.

Figure 10: Cost of risk



Source: banks, Scope Ratings

Figure 11: Impaired loans (stock)



Source: banks, Scope Ratings

Figure 12: Heatmap - corporate 10 largest NFC

NACE code	Dec-19	Dec-20	Dec-21	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Quarterly change	3 months	6 months	12 months	Sector as % of total loans
J Information and communication	4.5%	3.2%	2.0%	1.9%	1.9%	2.1%	2.5%	3.1%	3.8%		0.7%	1.3%	1.9%	3.2%
M Professional, scientific, technical	3.4%	4.0%	4.1%	3.7%	4.0%	4.0%	4.0%	4.6%	5.3%		0.6%	1.3%	1.2%	6.0%
C Manufacturing	4.2%	5.0%	4.1%	3.9%	4.0%	3.9%	4.0%	3.9%	4.3%		0.4%	0.3%	0.3%	12.5%
F Construction	8.7%	7.7%	7.2%	7.0%	7.0%	7.1%	7.4%	7.7%	8.1%		0.4%	0.7%	1.1%	4.5%
A Agriculture, forestry and fishing	4.5%	4.6%	4.2%	4.0%	4.0%	3.9%	3.8%	3.7%	3.9%		0.3%	0.1%	0.0%	3.8%
B Mining and quarrying	3.9%	5.0%	3.5%	3.7%	2.9%	3.8%	3.8%	4.0%	4.2%		0.3%	0.5%	1.3%	1.4%
L Real estate activities	2.9%	2.4%	2.1%	1.9%	1.8%	2.0%	2.2%	2.4%	2.5%		0.1%	0.3%	0.7%	23.6%
N Administrative, support	2.2%	2.7%	2.9%	2.8%	3.1%	2.8%	2.8%	2.2%	2.3%		0.1%	-0.4%	-0.8%	5.4%
G Wholesale and retail trade	4.9%	4.8%	4.2%	4.0%	3.8%	4.2%	4.2%	4.2%	4.3%		0.1%	0.1%	0.5%	12.7%
Q Health, social work activities	1.9%	2.2%	1.8%	9.0%	9.5%	10.6%	10.5%	9.0%	9.1%		0.1%	-1.4%	-0.4%	2.0%
D Electricity, gas, other	2.3%	1.3%	0.9%	1.1%	1.4%	1.6%	1.7%	1.9%	1.9%		0.0%	0.1%	0.5%	4.7%
H Transport and storage	3.5%	4.3%	4.2%	4.0%	3.9%	3.5%	3.5%	3.1%	3.1%		0.0%	-0.4%	-0.8%	5.4%
I Accommodation, food service	7.5%	8.4%	9.4%	8.5%	8.7%	9.0%	9.2%	8.8%	8.5%		-0.3%	-0.7%	-0.3%	2.5%
K Financial and insurance	3.4%	2.7%	2.3%	2.1%	2.2%	2.7%	2.5%	2.7%	2.2%		-0.4%	-0.3%	0.0%	6.6%
S Other services	3.9%	3.0%	2.8%	3.2%	3.7%	3.4%	2.6%	2.7%	2.0%		-0.7%	-0.6%	-1.7%	4.0%

Source: European Banking Authority, Scope Ratings

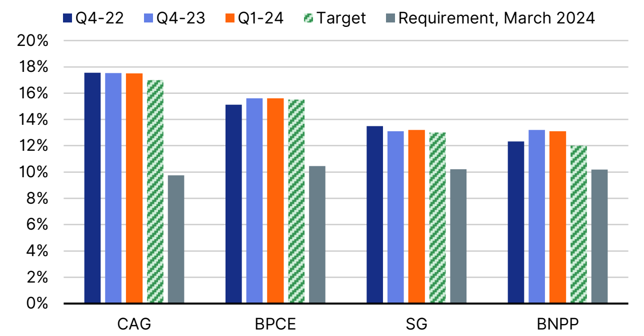
Distance to regulatory requirements: prudential metrics are managed in line with expectations and strategic targets

Maintaining supportive loss-absorption buffers is paramount in our overall assessment of French banks' creditworthiness and is even more important at times of uncertainty. We understand the need to optimise capital resources for listed banks, as long as earnings capacity remains an effective first line of defence. We continue to consider the leverage ratios for BNP Paribas and Société Générale to be tightly managed in comparison to domestic and international peers.

Funding and liquidity metrics continue to evolve within an expected corridor (Figure 14). There is no uniform pattern of change in the liquidity coverage ratios of French banks but movements are within the expected conservative range. We have already highlighted that the shift in the customer deposit base is slowing down. This has a negative impact on funding costs but beyond this shift the deposit base remains sticky.

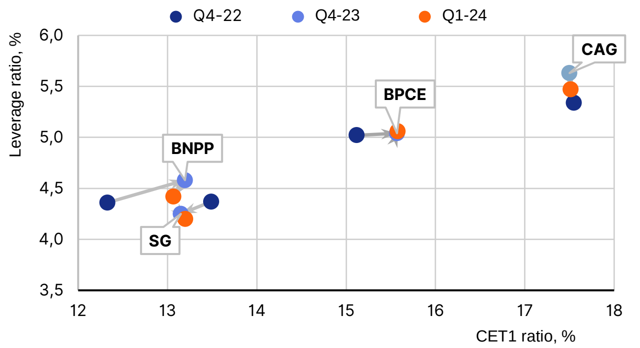
French banks were proactive in bond issuance at the start of the year, making significant progress on their wholesale debt issuance plans for the year (Figure 15). The slowdown in issuance in the second quarter was significant and likely to continue in the third quarter.

Figure 13: CET1 (ranking by CET1 ratio in 1Q 2024)



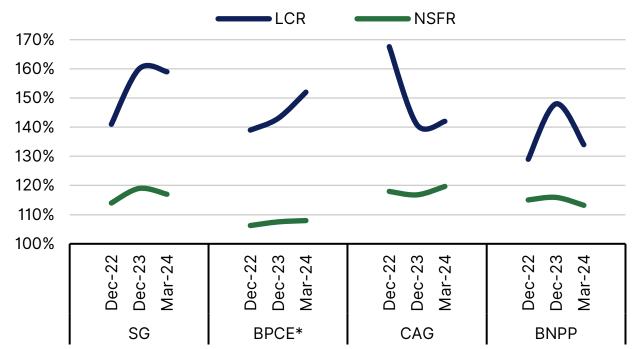
Source: banks, Scope Ratings

Figure 14: CET1 and leverage



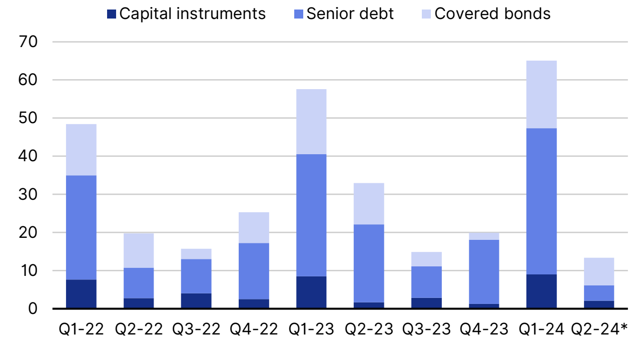
Source: banks, Scope Ratings

Figure 15: Funding and liquidity ratios (ranking by LCR)



LCR: end-of period Liquidity Coverage Ratio; NSFR: Net Stable Funding Ratio.
*BPCE: LCR based on average end-of month ratios during the quarter.
Source: banks, Scope Ratings

Figure 16: Quarterly debt issuance, historical (USD bn)



*From April to June 19th. Issuance activity of French banking groups in our sample. Only large public international bond issues predominantly in EUR, USD and GBP. Excludes private placements, retained issuance, debt documented and sold privately.
Source: Bond Radar, Scope Ratings

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