Q&A for the Thoughtful Bank Investor

A Potential Game Changer: Five Minutes on French Banks and the Presidential Elections

This coming weekend the first round of the much-awaited French presidential elections will take place, followed by the second round two weeks later. This is a major political event, potentially with a transformational impact on both France and Europe, coming in the aftermath of the massive upsets of the Brexit referendum and the US elections. Not surprisingly, the credit markets have been showing growing apprehension with widening spreads. Many investors are rightly questioning what will be in store for the country's banking sector.

Depending on their outcome, Scope Ratings views the elections as a potential game changer for the French banking sector and for the country's hopes to boost the role of Paris as a major financial capital. This brief Q&A highlights our thoughts on the topic.

Q: What outcomes of the forthcoming elections can pose a problem for France's banking sector?

In terms of the worst case, market observers have pointed out that a Front National (FN) victory could spell trouble for the French banking sector. If victorious, Marine Le Pen would aim at a referendum on the euro, with a view of potentially exiting the euro area (EA). We note, however, that even with Le Pen as president the odds for Frexit are not that favourable. First, there is the hurdle of legislative elections in June (the FN needs enough parliamentary power for that, which is even more unlikely than a Le Pen win). Second, current polls show that a reassuring majority in France prefers to keep the euro. This in our view should comfort the markets regarding an extreme outcome in France any time soon, even in the unlikely event that Le Pen won.

However, market sentiment is never black or white, it is mostly different shades of grey, and thus a Le Pen win would very probably hurt it with respect to France, especially since this is the opposite of the base scenario currently being anticipated by most. Spreads on French public-sector and corporate debt would very plausibly suffer and we have no reason to believe that French banks' spreads would in any way be spared. This would be particularly inauspicious because, during the next years, French banks will need to raise more non-preferred senior unsecured debt to build their MREL and TLAC cushions. More elevated marginal funding costs are not likely to help French banks' profitability, which is not high to begin with.

Clouded as this scenario would be for French banks, it is in fact possible that a victory of Jean-Luc Mélenchon, the hard-left-wing candidate, could end up being a worse one. If somehow Mélenchon manages to reach the second round, surpassing both Emmanuel Macron and François Fillon – not that likely, but less implausible than a few weeks ago – he could possibly win the presidency, by rallying willy-nilly the anti-FN voters (although their numbers may be diminished by the prospect of a hard-left president as the alternative to the FN). In general, administrations committed to left-wing ideologies are not particularly friendly to large banking groups, and with a still weak economy and lingering anti-bank resentment in the aftermath of the crisis, this is likely to remain the case. In particular, Mélenchon has been criticising the large banks and the profits they make, also suggesting forcing a split between retail and investment banking, and even not excluding a nationalisation scenario.

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This indeed can be concerning, because it is very probable that the next several years will be crucial for the overdue but necessary adjustment of the large French banks' structure and business model to the digital world. The millennials, who most often are digital natives, represent a growing population segment – in France as elsewhere in Europe – and it is expected that banking operations' physical branch usage will shrink further with no way back. The analytical argument is often about the competition between traditional banks and fintechs, but the broader issue is that of changing customer expectations. Specifically, customer preference is moving irretrievably towards the digital offer by the banks – whether the latter compete with fintechs or not. Consequently, a significant shrinkage in the large banks' branch structures and back offices is a sine qua non (it has started already), with potentially material consequences on staff reduction – both front and back office. If, with a left-wing or populist administration in place, the large French banks are prevented from adjusting and reducing excess capacity in accordance with the new business realities – which remains fully possible in France's political environment, in which the social actors show very little interest to compromise – their cost structure and efficiency will continue to suffer, increasingly so as other European and global competitors will be less constrained to do exactly that.

Cost-income ratios of the large French banks

	2012	2013	2014	2015	2016
BNP Paribas	67.09%	66.74%	66.73%	65.20%	67.02%
Credit Agricole	65.76%	63.08%	63.86%	62.21%	66.10%
Société Générale	69.98%	71.17%	68.62%	65.06%	68.49%
BPCE	70.65%	69.47%	69.00%	66.86%	69.66%

Source: Scope Ratings

As another troubling consequence, it is also possible that, under either a Le Pen or Mélenchon presidency – which could affect France's image in the markets – the large French banks' global wholesale activities may retrench, with the banks being reined in more into domestic activities (e.g. more loans to French businesses and individuals, likely at less attractive rates in order to artificially stimulate weak demand). This aspect could affect primarily BNP Paribas and Société Générale, which have preserved more extensive global wholesale franchises.

Q: What election outcomes could be more favourable for French banks?

It is probable that an electoral victory for either Macron or Fillon – which in fact are currently the two most likely outcomes, especially the former – would be positive for market confidence and hence for the French banks. Both are pro-EU and pro-euro, although the former marginally more than the latter, and both view economic reforms and economic growth as top priorities. Certainly, the large banks would not have a carte blanche, but by and large France's banking establishment knows by now and accepts the country's political realities and dynamics and is not out there to challenge them – as may be the case in other markets. Steps to reduce capacity, as mentioned above, would certainly occur, but most probably in a manner avoiding social upheavals face-on. Preventing outright political interference in the banks' business model-adjustment efforts would in our view be a significant factor for confidence and predictability – both needed by bank investors.

Q: What about a potential impact on regulations?

French banks and French policymakers have adjusted relatively well to the new EU regulatory architecture for banks, in the form of the European Banking Union. At the very least, the banks' criticism of the new framework has been relatively more subdued that what could have been expected, given the new requirements by the ECB – the top EU supervisor – and the Single Supervisory Mechanism. The large French banks – four of them being designated by the Financial Stability Board as global systemically important banks (the second-biggest number worldwide of banking groups in one country after the US) – have fared reassuringly well in terms of prudential metrics (capital and liquidity). Their universal-bank business model has been properly understood and accepted by the ECB. Thus, there is no reason to believe that the regulatory framework as it stands will be reconsidered following the French presidential elections, at least not for as long as the EU financial architecture (including the existence of an EA) remains unchallenged. Were this no longer to be the case one day (a big if as we highlighted above) all bets would be off – but then again, under a doomsday scenario the stakes would go far beyond EU bank regulations.

At the same time, however, it is fair to assume that going forward, even if populism does not take hold of the political structure across the EU, the national imprint in the EU-wide bank regulations may end up being boosted. Even Macron, probably the most EU-driven candidate in the French election process, is on record saying that national policymakers should have a more prominent role in setting up bank regulations. Politicians across the EU, including in France, very much see banks as key conduits for economic growth, thus having a vested interest in spurring them to finance their countries' real economy. The fear of insufficient prudential protection against another bank crisis has abated, and politicians are now pushing against excessive bank regulations – the opposite from nearly a decade ago when the crisis erupted. This trend has been more visible in the US following the November elections, but it is equally visible across Europe – very much so in France as well.

That said, we can expect that a Le Pen or Mélenchon presidency could push back more forcefully against pan-EU regulations than a Macron or Fillon one. Were this to occur in a more significant manner, the entire EU bank regulatory architecture could come under stress. We hasten to add, however, that such a scenario, at this time, is unlikely in our view.

Q: And finally, could there be consequences for France's plans to see a bigger position of Paris as an international financial centre in the aftermath of Brexit?

Again, a win by either Le Pen or Mélenchon could indeed throw a massive monkey wrench into the French establishment's plans to build Paris as a bigger financial centre after Brexit. Hard-hat populism, hard-left socialism or in-your-face nationalism is likely to dampen the enthusiasm of international investors or financial institutions considering relocation to Paris when alternatives across Europe are available (Frankfurt, Amsterdam, Dublin, Brussels, etc.). France already has some of the most rigid labour legislations across the EU, and further constraints in this direction would not help.

French bank ratings as of 18 April 2017

Bank	ICSR	Outlook	Senior unsecured		Short-Term Rating	Short-Term Rating Outlook	Capital securities	
			MREL/ TLAC eligible	Other			AT1	Tier 2
BNP Paribas SA	AA-	Stable	A+	AA-	S-1	Stable	BBB	A-
BPCE SA	AA-	Stable	A+	AA-	S-1	Stable		A-
Credit Agricole SA	AA-	Stable	A+	AA-	S-1	Stable	BBB-	A-
Credit Foncier de France SA [1]	AA-	Stable						
Credit Mutuel SA	A+	Stable	A	A+	S-1	Stable		BBB+
Société Générale SA	A+	Stable	A	A+	S-1	Stable	BBB-	BBB+

[1] Rating based on guarantee and solidarity mechanism within BPCE Group

Source: Scope Ratings

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