French banks quarterly: sobering times

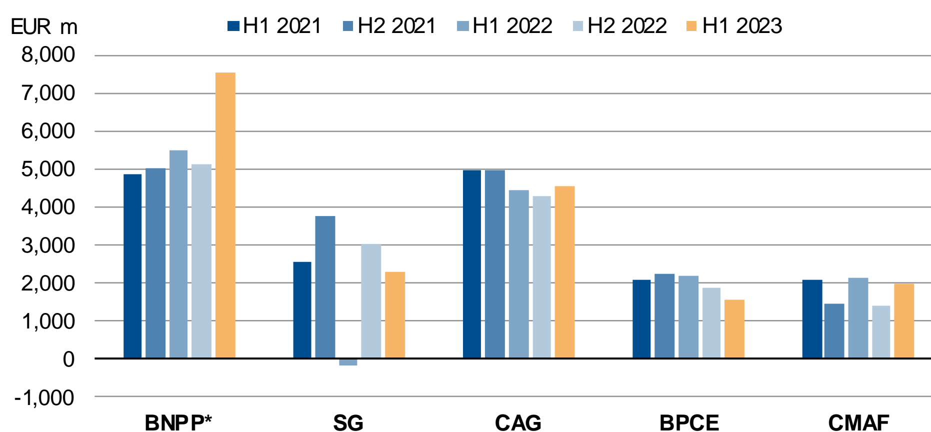
This year continues to be a year of transition for French banks. Net interest margins in domestic retail banking are being squeezed and are a drag on profitability. Net income will remain within an acceptable range for the full year, though, thanks to low cost of risk, solid contributions from other business lines and limited growth of the expense base.

Financial tightening is working its way through the system. Loan production is slowing down, and while economic activity in France may be better than expected in 2023, the V-shaped recovery over 2022-2024 could be closer to an L-shaped trajectory. Restrained balance-sheet repricing should continue to unfold without creating major credit issues as long as low-return activities remain low-risk.

The banks' half-year numbers demonstrated a very mixed bottom-line performance (Figure 1). Core operating income declined for all banks except Crédit Agricole. Material exceptional items across the sector include TLTRO accounting as well as changing perimeters i.e. BNP Paribas' sale of BankWest; SG's acquisition of LeasePlan. The first-time application of accounting standard IFRS 17 for insurances activities, which are large for French banks, limits comparison with past performance.

Modelling balance-sheet repricing in French retail banking to optimise interest revenue is this year's challenge. Banks need to predict policy changes, both at EU and national levels, as well as customer behaviour at a time of rising interest rates. Factors such as accelerated repayment of TLTRO III, unexpected revisions to the remuneration of mandatory reserves, and a change of approach to setting usury rates and rates on benchmark regulated savings have a big impact on asset and liability management and are a constant source of surprises. Credit demand is adjusting and corporates and households are increasingly looking for better remunerated products, adding to the banks' margin pressures. Geographic and business diversification is a key mitigating factor in this context and a differentiating factor among banks.

Figure 1: mixed half-year results



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

Figure 2: trends for French banks	
Profitability	Mildly Negative ➘
Asset quality	Stable ➔
Funding and liquidity	Mildly Negative ➘
Capital and resolution buffers	Stable ➔

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See page 6

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Bloomberg: RESP SCOP

Profitability: mildly negative because of French retail

Pressure on NIM will persist

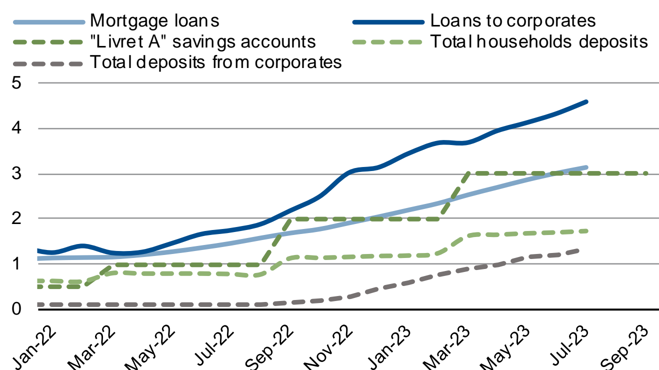
French retail activities are characterised by weaker interest margins and a slowdown in new loan generation. The decline in revenues is material and will continue into 2024 because large fixed-rate mortgage portfolios are repricing very slowly. The decision to pause rate increases on benchmark regulated savings was positive for banks, but this relief appeared short-lived following the ECB decision to revise the remuneration on mandatory reserves. The average net interest margin on financial assets is trending down below 100bp. Pressure on net interest margins is being counterbalanced less and less by loan growth, although the latter is still a positive factor.

Business diversification, the differentiating factor

Business diversification limits downside pressure on revenue growth. The presence of French banks in countries where lending dynamics are more favourable, such as Italy for BNP Paribas and Credit Agricole, is an asset. Well-integrated bancassurance business models have also performed well this year and increasing synergies is this area are a strategic pillar for all banks. Corporate and investment banking, especially in the first quarter, was another source of relief. A further normalisation of CIB activities is now expected but the third quarter should not be disappointing.

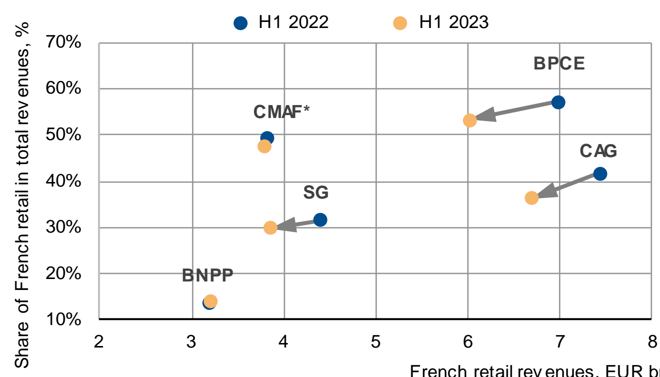
Growth in operating expenses is contained, increasing below inflation for most banks. While there is still room to get closer to the European average cost-to-income (around 60%) by reducing costs, pressure is stemming from the denominator (income).

Figure 3: Interest rates on loans (straight lines) and deposits (dashed lines) (%)



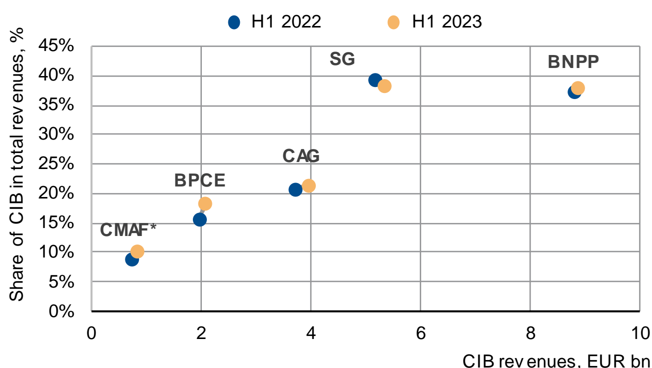
Interest rates on loans: all maturities, annualised agreed rate. Average rate on total households' and corporates' deposits, annualised agreed rate. Source: Banque de France, Scope Ratings

Figure 4: Revenues from French retail, YoY change



H1 2022 proforma. *CMAF: Crédit Mutuel local banks and CIC Banking networks. Source: SNL, Scope Ratings

Figure 5: CIB revenues again at high level in H123



H1 2022 restated for IFRS 17 and IFRS 9. *CMAF: includes corporate banking, capital markets and private equity. Source: banks, Scope Ratings

Figure 6: Cost-to-income ratios

H1 2023 vs. H1 2022 % change	BNPP	SG	CAG	BPCE	CMAF
Operating revenue	-0.04%	-7.1%	4.2%	-7.4%	3.9%
Operating expense*	3.5%	0.4%	2.4%	-1.2%	6.7%
Operating income	-7.1%	-22.9%	7.1%	-21.6%	0.4%
Cost-to-income ratio, H1 2023	68.7%	73.3%	60.3%	74.3%	58.2%
Cost-to-income ratio, H1 2022	66.4%	67.8%	61.4%	69.7%	56.7%
Cost-to-income ratio, ppt change	2.4%	5.5%	-1.1%	4.6%	1.5%

Not adjusted for SRF contributions and other exceptional items. Source: banks, Scope Ratings

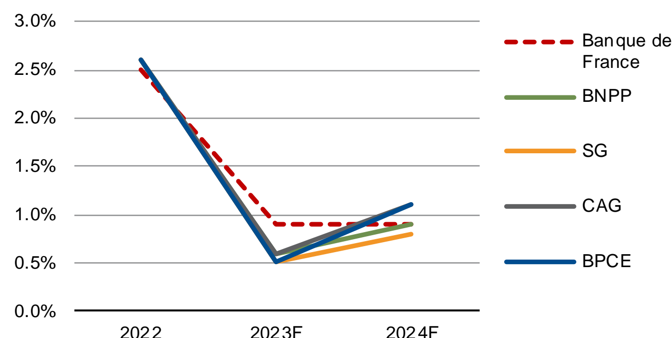
Asset quality: stable with prospects of economic rebound in 2024

Standstill for model-based credit provisions

Credit conditions remain sound in France. Economic activity for full-year 2023 may turn to be better than initially expected based on most recent forecast, but 2024 does not look terrific, with GDP growth below potential. Financial tightening will continue in 2024. Employment levels are holding up well while bankruptcy rates are back at 2019 levels and there has been no catch-up effect. As a result, at mid-year the banks have seen **no need to recalibrate model-based provisions this year** in relation to performing exposures. Accumulated buffers remain in place. This partly explains the modest overall provisioning effort this year**. The bulk of the cost of risk was in relation to problem loans** for some specific files rather than broad-based sector issues.

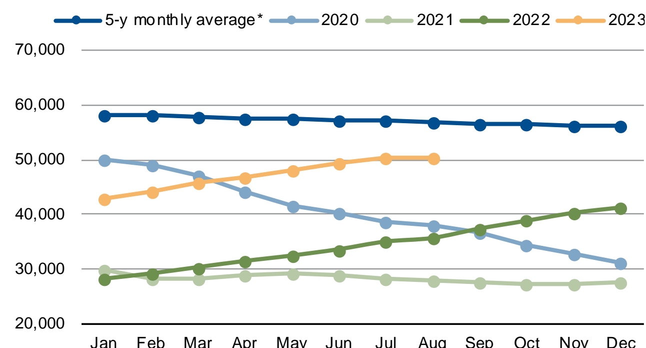
Lending dynamics continue broadly positive in comparison to countries where rising interest rates have had more drastic impact. Mortgage demand in France is significantly lower compared to last year (down 45% as of August) but mortgage stocks are still growing by 3%-4%. Outstanding corporate loans remain stable at high levels. Banque de France consolidated corporate loan data points only to a reduction in treasury loans. Loans granted under the State-guaranteed loan programme are amortising. The proportion of problem loans will mechanically increase but this is not a source of concern for banks given the granularity of the portfolios and the actionable State guarantee.

Figure 7: V-shaped economic scenario supports stable expected credit loss calibration



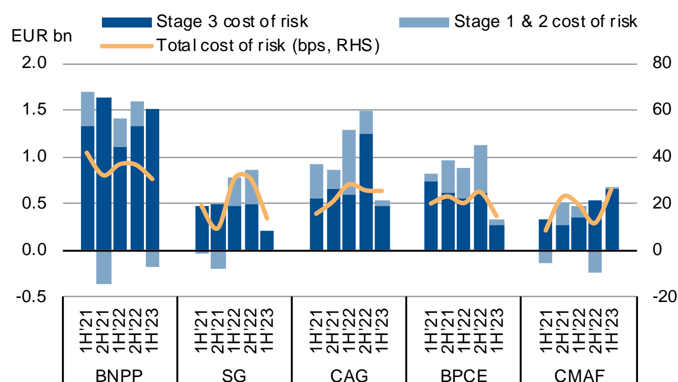
BdF projections published 18/09/23.
Source: banks, Banque de France, Scope Ratings

Figure 81: Corporate bankruptcies now in line with 2019



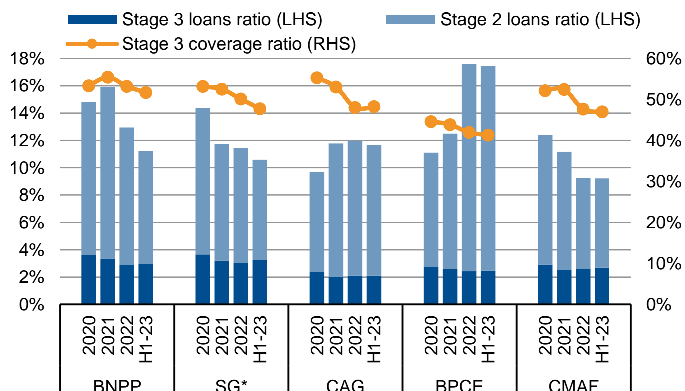
Source: Banque de France, Scope Ratings

Figure 9: Modest cost of risk mainly on Stage 3 loans



Source: banks, SNL, Scope Ratings

Figure 10: Stable asset quality indicators



*SG: estimated evolution of Stage 1 and 2 customer loans. Source: banks, Scope Ratings

Funding and liquidity: mildly negative due to financial tightening

Banks had to adapt to two impactful factors in the first half: accelerated TLTRO repayments and customers looking for better remunerated investment opportunities; common themes for European banks. Combined, they explain most of the changes in the banks' liability structures in the first half (Figure 11).

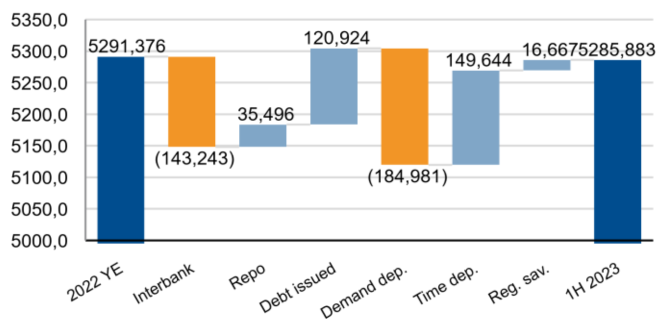
Transition to market funding

Recourse to TLTRO was massive in absolute terms (close to EUR 500bn at the peak) but by June had reduced by two-thirds (Figure 12). However, balance-sheet deleveraging is marginal, which is a positive sign. Firstly, banks are able to replace central bank funding with market funding. This happened mainly in the first quarter. Secondly, liquidity reserves remain adequate. Recent market events have pushed banks to remain extra-cautious about liquidity metrics. Thirdly, the absence of balance-sheet contraction shows the resilience of the economy. But it also indicates that quantitative tightening is still a work in progress and could become more painful.

More costly but sticky customer deposits

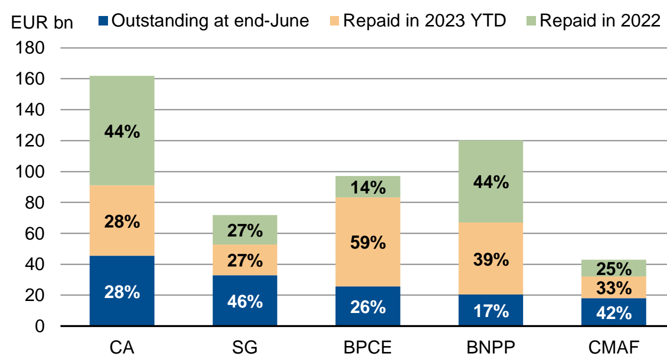
Despite the higher cost of living, there has been no material depletion in customer deposits, the main source of stable funding for banks. Trends in retail deposits have remained positive, although corporate deposits shrank by 4% in the first half according to Banque de France data. But there is no clear direction or diverging trajectories among the banks. Refinancing has become more expensive as funds migrate from sight deposits to remunerated term deposits.

Figure 11: Dynamic change in liability structure



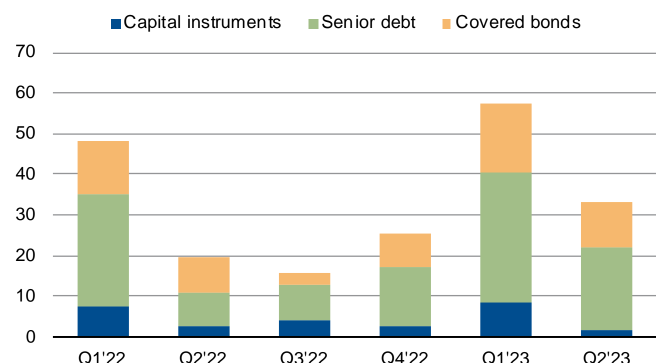
Source: banks, Scope Ratings

Figure 12: TLTRO III repayment largely executed



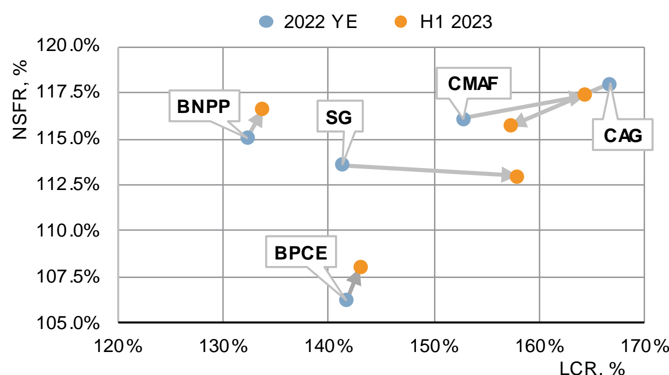
Source: banks, Scope Ratings

Figure 132: Very active debt issuance during the first half



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

Figure 14: No radical change of regulatory funding and liquidity metrics in this context



Source: banks, SNL, Scope Ratings

Loss absorption buffers stable, in line with conservative approach

End of TLTRO does not result in balance-sheet deleveraging

There were no major changes in terms of distance to regulatory capital requirements, or revision of medium-term targets in the second quarter. CET1 requirements slightly increased due to the higher countercyclical buffer in France (0.5% applicable since April). Minimum leverage ratio requirements went up following the introduction of the G-SIB add-on. Credit Agricole, BNP Paribas and Credit Mutuel Alliance Fédérale reported higher leverage ratios thanks to earnings retention. A more dynamic evolution of AT1 stocks or risk-weighted assets explain why CET1 ratios were more volatile than leverage ratios, albeit all remaining within expectations (Figure 15).

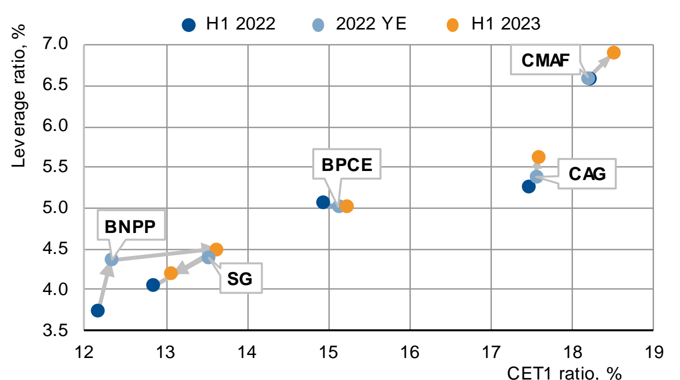
Strategic M&A initiatives have limited impact on capital ratios. BNPP intends to invest part of the proceeds of its sale of BankWest in bolt-on acquisitions (the CFO indicated: "nothing with the word 'bank' on it"). SG's integration of LeasePlan in May resulted in a negative 36bp impact on its CET1 ratio. Crédit Agricole indicated that the planned acquisition of Degroof Petercam could have a negative 30bp impact on Crédit Agricole S.A. in 2024.

Distribution policies remain unchanged, including share buyback programmes pre-approved by regulatory authorities, indicating confidence in the future. **Issuance of subordinated debt resumed in the second quarter** and into the third quarter with Tier 2 instruments plus a US dollar AT1 from BNPP in August, following active issuance in the first quarter and a limited amount of maturing or callable instruments.

ECB stress test exercise: sound discipline but hard to transpose

The ECB stress test produced mixed results for French banks, with large drawdowns for the best capitalised mutual groups and smaller drawdowns but more penalising outcomes for the listed banks. Under the adverse scenario, SG and BNPP's CET1 ratios would, by 2025, stand below their current CET1 SREP requirements. We value the additional transparency and insights the stress test provided on risk profiles, and the disciplined approach. But the ability to generalise results is constrained by the unique nature of the exercise (e.g. specific macroeconomic assumptions, absence of management actions throughout the period).

Figure 15: Conservative management of capital ratios



Transitional capital ratios. Source: banks, Scope Ratings

Figure 16: Large drawdowns under ECB 2023 stress test

Bank	CET1 (FL) 2022 YE	CET1 (FL) 2025 YE		Drawdown under adverse scenario
		Baseline Scenario	Adverse Scenario	
CNCM	18.78%	19.53%	11.43%	7.35%
CAG	17.24%	15.83%	9.94%	7.30%
BPCE	15.12%	14.81%	9.92%	5.20%
SG	13.32%	12.37%	8.19%	5.13%
BNPP	12.27%	13.15%	8.35%	3.92%

Rated banks only. CNCM: Confédération Nationale du Crédit Mutuel. FL: Fully loaded. Source: EBA, ECB, Scope Ratings

Selected research available on ScopeRatings.com:

Spanish Bank Quarterly: earnings solid but limited room for growth from here, August 2023

Italian Bank Quarterly: record Q2 results will be hard to repeat as windfall tax looms, August 2023

Norwegian banks: material CRE exposure manageable despite pressures, August 2023

UK banks: stress test provides some reassurance, July 2023

European Bank Capital Quarterly: funding and liquidity under the spotlight, July 2023

French banks: sound credit profiles resilient against tighter financial conditions, June 2023

Scope affirms France’s AA long-term credit ratings; revises Outlook to Negative from Stable, May 2023

Issuer rating reports available to ScopeOne subscribers:

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