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RESEARCH

Large French Banks Should Remain Resilient To 2016's More Complex Operating Conditions

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Large French Banks Should Remain Resilient To 2016's More Complex Operating Conditions

Large French banks have taken a number of steps over the past five years to shore up their balance sheets and improve their funding and liquidity positions, but it's not the end of the journey. Standard & Poor's Ratings Services believes that they are well positioned to take advantage of the moderate eurozone economic recovery and address the remaining pieces of the global regulatory agenda--one of which is building sufficient cushions of loss-absorbing debt. This comes after meeting stricter regulatory requirements by reinforcing their financial structures and paring their portfolios of businesses, disposing of legacy assets, and scaling down or exiting activities with low cross-selling potential or where access to funding has been scarce. However, the size and spectrum of investment banking activities will continue to come under scrutiny, not only because of their capital intensity but also because ever stricter regulatory requirements could become unsupportive to certain of these activities.

Global and regional economic conditions will remain challenging this year, despite a modest recovery in the eurozone. The slowdown in emerging markets, volatile financial markets, heightened geopolitical risks, and low commodity prices that are hurting the oil & gas and commodities sector, to which French banks have some direct and indirect exposure, are making for a more complex operating environment than just a few months ago.

Overview

- Most of our rating outlooks for French banks are stable, with better fundamentals overcoming headwinds.
- We project a modest increase in bottom-line earnings, and expect only a moderate deterioration in credit quality.
- Large French banks face the challenges of protecting their revenues from the effects of low interest rates and of continuing to improve efficiency, but are well placed to keep streamlining and develop fee-generating activities thanks to their universal banking model.
- We forecast a further increase in our risk-adjusted capital ratios, arising from low single-digit growth in risk-weighted assets, restrained dividend payout policies, and increasing earnings.
- The French Treasury's recent proposal for a new senior debt type could help the country's global systemically important banks cost-effectively meet their TLAC requirements in a cost-effective way.

In France, low interest rates will continue to drive a spike in profitability. The country's high regulated interest rate on certain savings accounts distorts deposit pricing and weighs on retail net interest margins. Add to that the effect of borrowers refinancing their residential loans, as they did last year, which is also dampening retail net interest margins and earnings generation. However, we project French banks will keep asset quality under control, which could deteriorate because of some emerging pockets of risk, starting, however, from benign levels reached in 2015. Plus, while maintaining strict underwriting criteria, the banks will aim to extend more loans and credit to prop up revenues. Therefore, we project rising but still modest loan impairment charges overall for the large French banks. They will continue to streamline their operating models, targeting lower overhead costs, and restructure certain businesses to enhance operating efficiency and help bottom-line earnings. Large banks in France operate under a universal banking model, and thus will benefit again in 2016 from the contribution of solid franchises in wealth management, asset management, insurance, and specialized financial services (consumer finance, leasing). To offset the impact of a low interest rate environment on their profitability, improving operational agility and cost control will nevertheless remain key.

In response to more stringent regulatory requirements, we see large French banks continuing to strengthen their capital bases and cushions of loss-absorbing instruments, in a banking landscape where we see government support as now less predictable for systemically important banks.

Most Outlooks Are Stable

We rate 24 banks in France. The country's large French banks are rated in the single 'A' range. Almost two-thirds of our issuer credit ratings have a stable outlook (see charts 1 and 2, and table 4 at the end of this report). This represents a huge swing from last year at this time, when two-thirds carried a negative outlook. What happened in the meantime was that in early December 2015, we removed notches built into the ratings for extraordinary government support for systemic banks, recognizing that the bank resolution framework is now well advanced in France. In fact, we believe that such support is now more uncertain in almost all European banking systems. At the same time, we included one notch of uplift in the ratings of systemically important French banking groups that we expect will hold or will likely build sizable volumes buffers of bail-in loss-absorbing instruments (additional loss-absorbing capacity or ALAC) to protect senior creditors in the coming years, or that we believe are in a positive transition on the back of increasing capitalization and ALAC. This notch of ALAC uplift has therefore offset the loss of one notch of extraordinary government support for large French systemic banks.

We believe the downside risk to banks' intrinsic creditworthiness has diminished, as the drop in negative outlooks from a year ago indicates. French banks have generally made progress in building core capitalization and in raising their funding and liquidity metrics, and we expect this trend to continue. We already factor in this improvement, notably gradually improving loss absorbency, in the majority of our stable outlooks. Slightly better fundamentals are therefore unlikely to result in widespread positive rating actions on French banks.

Chart 1

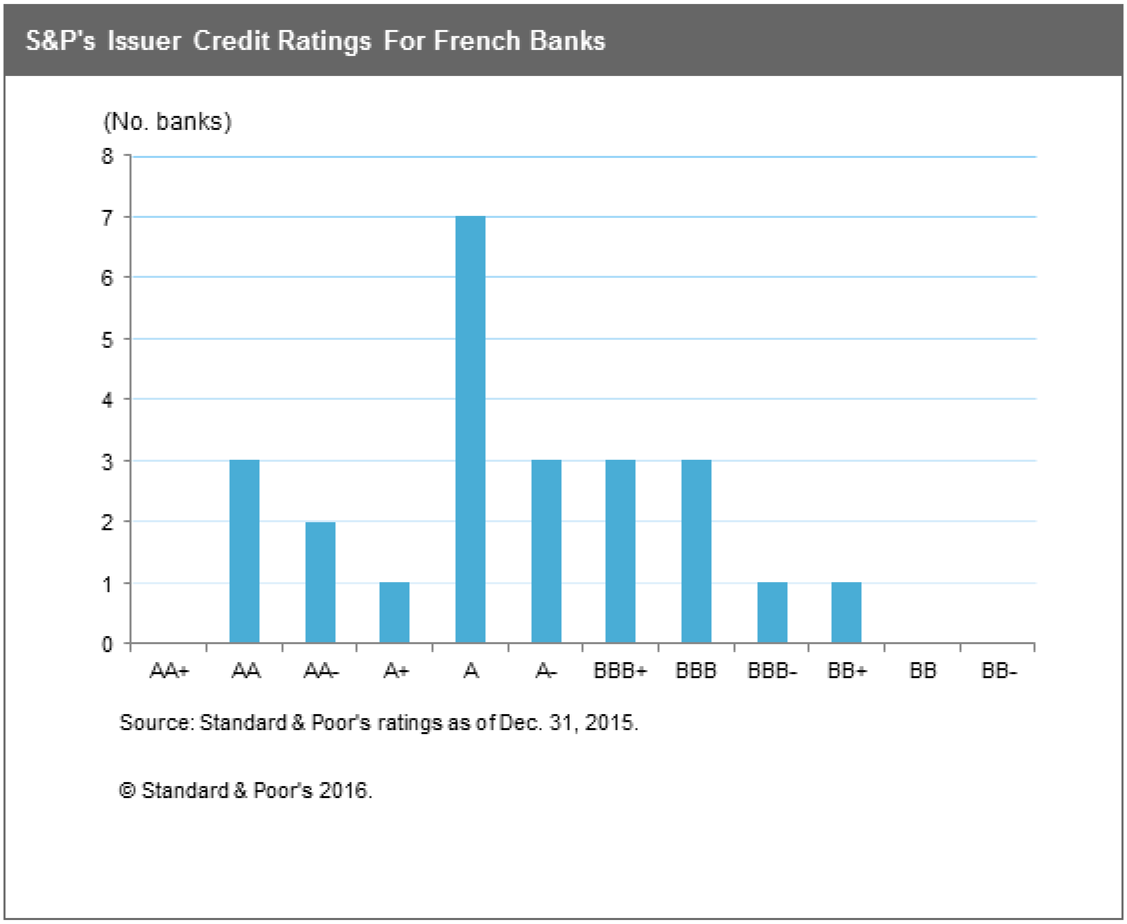
S&P's Issuer Credit Ratings For French Banks
(No. banks)
8
7
6
5
4
3
2
1
0
AA+
AA
AA-
A+
A
A-
BBB+
BBB
BBB-
BB+
BB
BB-
Source: Standard & Poor's ratings as of Dec. 31, 2015.
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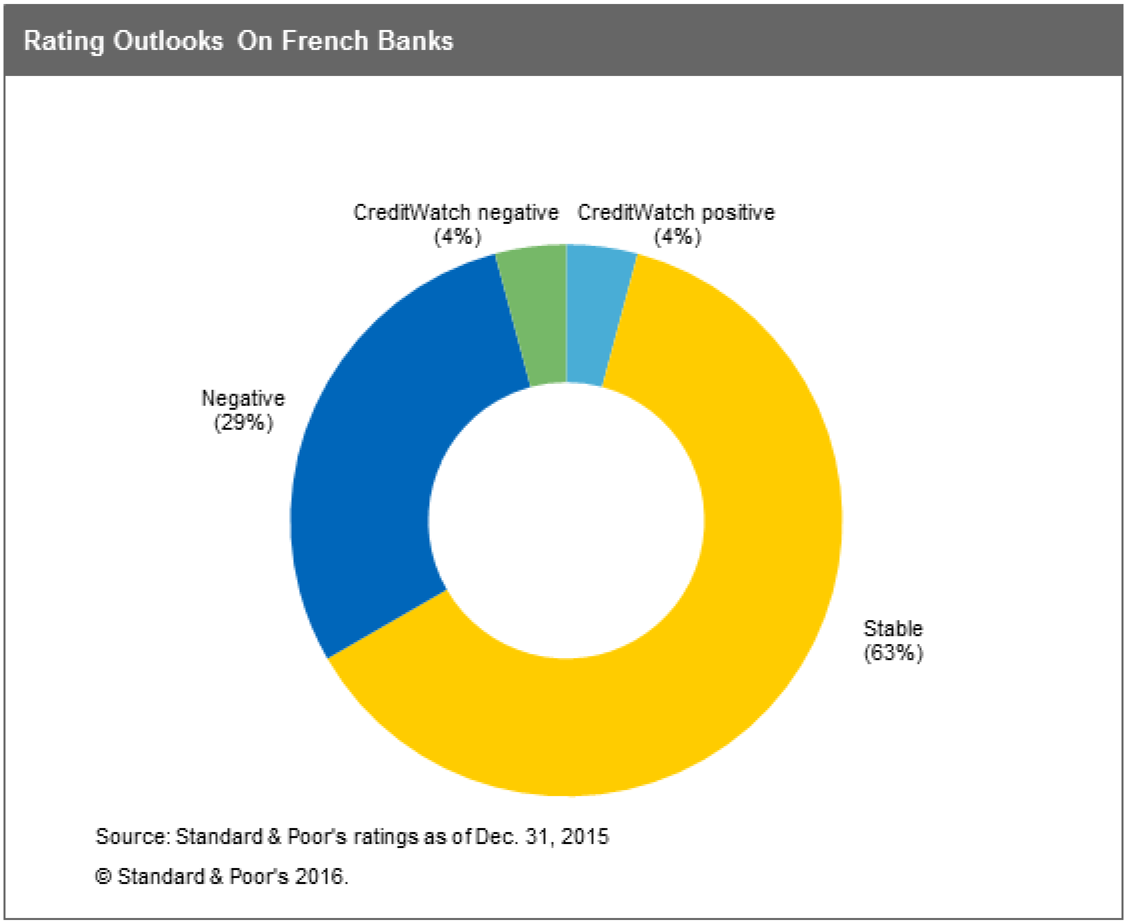
Chart 2



Our Expectations For 2016

For 2016, we expect large French banks to continue to prudently expand in their areas of expertise, reinforcing cross-selling while focusing on enhancing their return on equity (ROE). This is illustrated by some ROE targets of more than 10%. In our view, achieving this objective could prove difficult, considering the regulatory, interest rate, and economic trends we mentioned. Cost control remains at the center of the strategy of these banks. We believe that modifications in the pricing of services could also help revenue resilience.

For 2016, we more specifically expect:

- The rate of overall revenue and earnings growth will stay in the single digits, supported by the contributions of solid franchises in businesses such as wealth management, asset management, insurance, and specialized financial services (such as consumer finance or leasing).
- Retail net interest margins will likely remain soft given low interest rates. It will remain to be seen whether large banks can offset margin pressure with credit growth, and fee and commission income.
- Credit risks will likely start to pick up, though from a low point in 2015, reflecting growth in new loans and possible deterioration across specific industry loan portfolios (oil & gas, commodities) or in certain geographies (emerging

markets).

- We anticipate that French banks will aim to maintain a moderate increase in their risk-weighted assets (RWAs; targeted growth is usually between 2.5% and 3.0%). We think they might try to offset the effects resulting from credit growth or any European Central Bank-led revision of the calculation of regulatory RWA by, for example, further rationalizing noncore activities or managing the impact on RWAs, on the basis of an "originate to distribute" approach.
- Further improvement in our capital and earnings assessment is unlikely to drive higher ratings at this stage. Our risk-adjusted capital ratios (RACs) for French banks will continue to improve in 2016, reducing downside risks for some ratings. However, the capital ratios of large French banks still lag those of peers: in the U.K., the Nordic region, Switzerland, and Germany. We believe that the capacity of BPCE, Crédit Agricole, and Crédit Mutuel to generate capital is supported by their cooperative status, reflecting more limited requirements for dividend payments, and somewhat by their ability to raise some equity through local banks (via "parts sociales").
- Most large French banks have been steadily issuing Tier 1 and Tier 2 debt in past years. We expect that French banks will issue more subordinated debt in the near future, notably Tier 2, which will add to buffers to protect senior bondholders and meet future regulatory requirements. Four of the six major French banks are global systemically important banks (G-SIBs) subject to total loss-absorbing capacity (TLAC) requirements. The recently proposed initiative by the French Treasury to create a new class of senior debt (senior-junior) would likely enhance French banks' ability to issue loss-absorbing instruments protecting more senior obligations (see "Proposed New Class Of Senior Debt Could Enable Large French Banks To Increase Their Loss-Absorbing Capacity," published on Jan. 12, 2016).

Despite The Recovery, Risks Remain

Absent any shock to business or consumer confidence within the eurozone, we expect domestic operating conditions to improve slightly over the next 12 to 18 months. This, combined with the European Central Bank's accommodative monetary policy stance, will help support spending and investment. In the context of generally better economic prospects, credit conditions in Europe are easing, and banks are gradually resuming lending (see "Eurozone Recovery: Hangin' In There Despite Weak Foreign Demand," published on Nov. 25, 2015). That said, France has been enjoying resilient credit growth in past years compared that of the other largest eurozone countries. With GDP improvement, credit origination slightly accelerated in 2015, and we expect low single-digit loan growth in 2016. We note also that for France, large corporates and to a certain degree midsize companies are supplementing their bank credit with market financing.

Our forecast for real GDP growth this year in France is 1.6% (versus the 1.1% we expect for 2015), slightly below our average forecast for the eurozone at 1.8% in 2016.

- Household consumption should be supported by a gradual decline in precautionary savings with the stabilization of France's fiscal framework, and a stable, if not declining, unemployment rate.
- Investments should accelerate, boosted by government measures as well as by external factors like low oil prices and a weaker euro, and favorable financing conditions. We do not see financing as a roadblock to a rebound in investment.

The main risks to our scenario of a gradual recovery for the French economy are a delayed turnaround in household investment and a loss in consumer or business confidence related to rising risks in emerging markets that would boost household savings or delay corporate investment. Another particularly adverse though unlikely scenario, we believe, would involve a fast and big rise in interest rates.

The Threats To Earnings Growth

Weaker earnings, against the backdrop of low interest rates, constitutes the main risk to growth this year, but the universal model of French banks that features solid franchises in fee-generating activities is a mitigant. The pressure on earnings is coming primarily from low interest rates, compounded by the spike in mortgage loan renegotiation and refinancing in 2015. But it's also coming from the maintenance of liquidity buffers, which are weighing on interest revenues in the low-return environment. Overall, we expect that net interest margins will continue to narrow, with funding costs having less room to fall further and regulated saving rates that distort deposit repricing. In response, French banks are searching for new sources of revenue, such as charges for current accounts, and building activities with high added value.

The intensification in loan refinancing and lower reinvestment yields will likely again weigh on banks' interest margins in 2016. A return to credit growth has only partly offset the loss in revenue, even though early repayment fees on mortgages supported revenues in 2015.

All of this together means that we expect pressure on earnings growth to persist through 2016. We're forecasting moderate earnings growth in the low single digits, reflecting continued pressure on margins. We expect operating profits to grow at a rate similar to 2015's, thanks to contained costs. Banks are likely to continue expanding their fee-generating businesses, including rapidly developing their insurance activities (life insurance, personal protection, and property/casualty) and asset management. Plus, they'll probably increase lending in specialized activities with wider margins (consumer financing, leasing, and factoring).

Customer deposit growth has been outstripping loan growth for the past several years as banks have been building liquidity and diversifying their funding. We expect deposits will continue to support retail and commercial loan growth. That said, we believe a portion of sight deposits may be more volatile should interest rates rise, as clients may shop around for better investment opportunities.

Risk Appetites Are Likely To Rise Only Moderately

French banks will continue to exhibit good asset quality overall, we believe, due to conservative underwriting. Low interest rates typically lead to an increase in risk appetite in the search for higher yields to push up revenues. However, we believe French banks will only moderately raise their risk appetites.

Large French banks have managed to improve asset quality despite weak economic growth (see table 1). Their exposures tend to be well diversified (by counterparty and geography). However, this year we may begin to see asset quality deterioration and ultimately defaults of companies in some loss-making sectors. This could translate into a higher cost of risk overall for French banks, though starting from a low point at end-2015 (see table 1).

Table 1

Cost Of Credit Risk For Selected French Banks														
(basis points)	**Q2 - 2012**	**Q3 - 2012**	**Q4 - 2012**	**Q1 - 2013**	**Q2 - 2013**	**Q3 - 2013**	**Q4 - 2013**	**Q1 - 2014**	**Q2 - 2014**	**Q3 - 2014**	**Q4 - 2014**	**Q1 - 2015**	**Q2 - 2015**	**Q3 - 2015**
BPCE	45	30	44	33	36	31	38	29	33	27	28	41	25	23
Crédit Agricole	61	50	54	55	45	40	50	45	37	34	30	34	30	25
Société Générale	75	71	84	75	67	69	89	65	57	58	62	55	44	46
BNP Paribas	50	55	72	56	64	52	64	68	53	47	60	61	51	50

Source: Banks' financial presentations.

French banks' domestic loan books, dominated by residential mortgages and long-term corporate loans, feature relatively low risk. The housing market correction that started in 2012 and continued through 2015 only marginally reduced home loan credit quality. That's because of banks' conservative underwriting criteria based on affordability, we believe. As a result, no direct link exists between housing prices and the residential mortgage default rate. We forecast that home prices will stagnate in 2016 and rebound in 2017, with perhaps less uniform price movements in certain parts of the country.

The large size and international nature of some corporate loans that French banks hold mean that they are exposed to some degree of risk, given today's geopolitical tensions, slowdown in emerging-market economies, and tough operating environment in some countries and industries.

Our base case assumes that weak commodity prices will continue to hurt oil & gas producers, and metals and mining companies. We expect the resulting credit deterioration for French banks to be manageable, especially since these exposures are relatively small considering the size of the banks and now that other risks, such as to lending activities in Italy, have receded. Indeed, the French banks we rate lend to the oil & gas industry, including to the large, diversified, highly rated oil majors. But we expect more credit vulnerability from firms that are exposed to reduced capital spending by the oil majors. Credit deterioration would also likely hit leveraged producers, oilfield services companies, and equipment manufacturers in the sector. The collateralized nature of a large part of this lending activity and its short-term nature (trade finance) also mitigate some of the risks. Nevertheless, we believe that because commodity prices have been so low for so long, asset quality will deteriorate somewhat. Indeed, in third-quarter 2015, most French banks announced a prudent risk appetite for the sector, with a downsizing of their commodities-related exposures, which we view positively.

We believe that other, non-credit-related risks such as conduct will continue to attract greater scrutiny from regulators. It's difficult for us to estimate the litigation costs, but we believe misconduct risk will loom over large banks in the coming years. We see heightened risk in commercial international and trading activities (existing cases on interest and foreign exchange markets, energy), but don't believe that retail activities are necessarily immune.

Regulation Is Still Shaping Strategy

Regulatory reforms will continue to have implications for large banks' business models, such as the sustainability of certain capital-intensive investment banking activities. We expect those with larger investment banking footprints to continue to adapt and adjust their business models to these new rules, even though their operations may be already smaller or less affected than those of other European peers.

We also see continuing uncertainty about the final shape of bank capital requirements. These include potential changes intended to enhance the comparability of regulatory RWAs, the potential introduction of standardized risk-weight floors, revised risk weights for operational risks, the fundamental review of the trading book, and new risk weights for interest rate risk in the banking book.

We believe French and EU banks will keep building capital until 2019, in response to stricter regulations and efforts by the European Central Bank (see chart 3). The central bank recently published, alongside the results of the Supervisory Review and Evaluation Process, the transitional and ultimate capital ratios that French banks will need to maintain (see table 2). As a result of these requirements and the buffer that individual banks will likely aim to maintain above the prescribed levels, the market will see regular increases in capitalization until 2019. We believe that organic capital generation will largely contribute to that increase, eventually complemented by small disposals and balance sheet optimization at some banks.

Chart 3

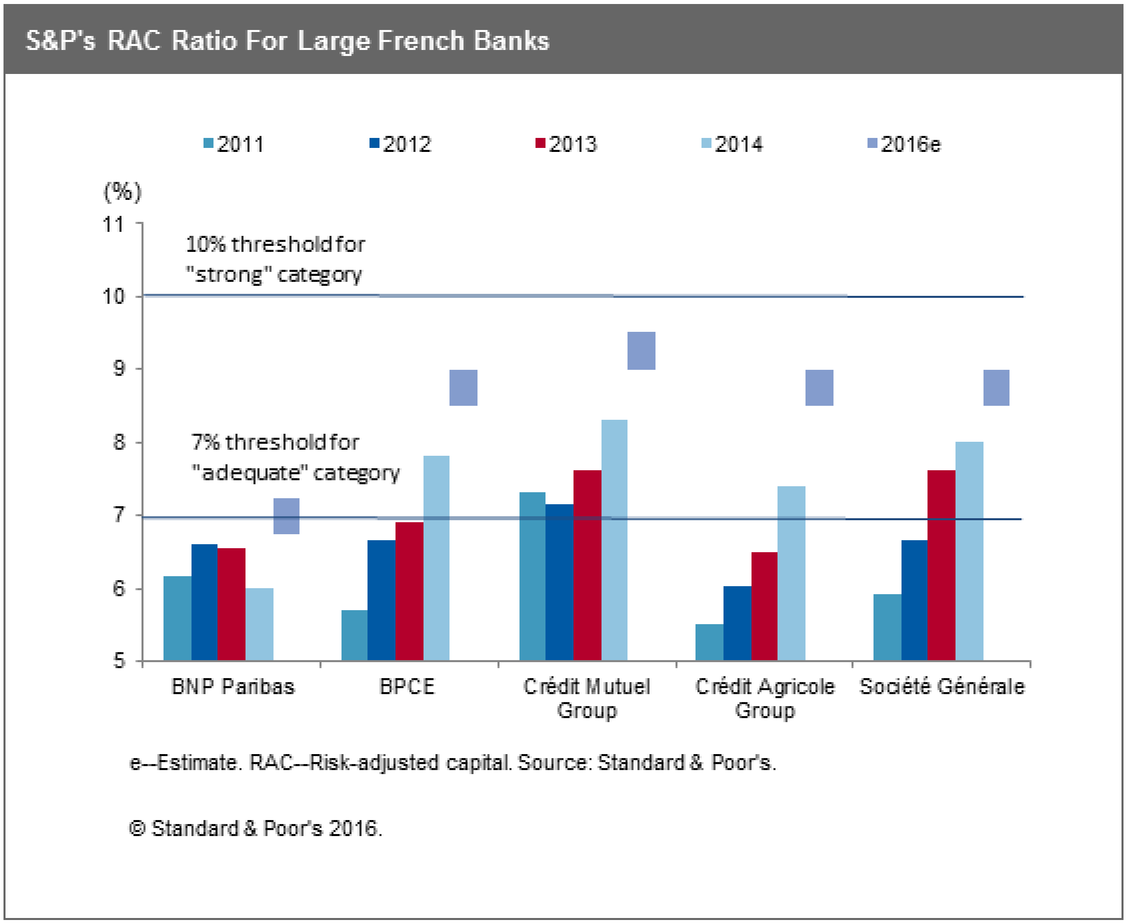


Table 2

Capital Requirements For Large French Banks

(%)	SREP	SREP+G-SIB in 2016	CET1 3Q2015	SREP+G-SIB in 2019
BNP Paribas	9.50	10.00	10.90	11.50
Société Générale	9.50	9.75	11.10	10.50
Crédit Agricole	9.50	9.75	13.30	10.50
BPCE	9.50	9.75	12.70	10.00

CET1--Common Equity Tier I. G-SIB--Globally systemically important bank. SREP--Supervisory Review and Evaluation Process. Sources: Banks disclosures, European Banking Authority (Supervisory Review and Evaluation Process).

Table 2

Capital Requirements For Large French Banks

(%)	SREP	SREP+G-SIB in 2016	CET1 3Q2015	SREP+G-SIB in 2019
BNP Paribas	9.50	10.00	10.90	11.50
Société Générale	9.50	9.75	11.10	10.50
Crédit Agricole	9.50	9.75	13.30	10.50
BPCE	9.50	9.75	12.70	10.00

CET1--Common Equity Tier I. G-SIB--Globally systemically important bank. SREP--Supervisory Review and Evaluation Process. Sources: Banks disclosures, European Banking Authority (Supervisory Review and Evaluation Process).

All in all, regulatory trends are likely to shape the credit quality of large French banks in 2016 (see table 3). Our expectation is that they will increase ALAC and their capital bases. If a bank's ramp-up of ALAC appears likely to fall short of our expectations or face a material delay, we could take a negative rating action (see "How Standard & Poor's Applied Its Government Support And ALAC Criteria To European Banks In December 2015," Dec. 2, 2015).

Table 3

S&P's ALAC Ratio For Large French Banks

(%)	ALAC, end-2015, S&P estimate	ALAC needed for one notch of ratings uplift
BNP Paribas	1.20	5.00
Crédit Mutuel	2.50	4.00
Crédit Agricole	3.50	4.50
Société Générale	3.50	5.00
BPCE	3.30	4.75
La Banque Postale	3.00	4.00

ALAC--Additional loss-absorbing capital.

Last year, French banks potentially gained another avenue to build ALAC. On Dec. 27, 2015, France's Ministry of Finance announced its intention to modify the hierarchy of claims in liquidation during the course of 2016, taking a new approach than in other eurozone countries, notably Germany. France proposes to create a new senior debt category (senior-junior) that would give domestic banks another way to build loss-absorbing instruments that would protect higher-ranking senior obligations, and hence fulfill the TLAC requirement that four out of the six large French banks will need to meet by Jan. 1, 2019. In our view, the French Treasury's initiative is consistent with the aim to facilitate banks' issuance of new or innovative instruments to comply with the Financial Stability Board's TLAC requirements. We believe that the senior-junior instruments might be eligible for inclusion in our measure of ALAC, depending on the final version of the law and details in legal documentation for the issues. In addition, with more clarity about the ranking of claims in case of resolution, investors would be better able to assess where a debt instrument stands in the resolution waterfall and its level of credit protection. Finally, the ability to issue senior-junior unsecured securities would support French banks' access to funding, and perhaps more cost effectively (see "Proposed New Class Of Senior Debt Could Enable Large French Banks To Increase Their Loss-Absorbing Capacity" published Jan. 12, 2016).

Investment Is Increasing To Meet The FinTech Threat

The franchises of large financial institutions haven't really suffered from digital competition. While the competitive threat from FinTech (technology-enabled, nonbank providers of financial services) is real, it is not yet a threat to the ratings (see "The Future Of Banking: How FinTech Could Disrupt Bank Ratings" published on Dec. 15, 2015).

French banks are not standing by, but are moving ahead with a focus on developing a multi-channel offering. Digitalization is indeed a response to retail customer behavior, which is manifesting itself not only in fewer branch visits, but also in higher expectations for the performance of routine transactions and for a customized delivery of banking services. Therefore, we expect that French banks will gradually trim their branch networks or improve efficiencies. Société Générale, for instance, announced a reduction of its network by 20% over the next five years.

Large French banks are boosting investments in technology, and some are re-evaluating their product offerings and delivery channels. They are starting to collaborate and engage by acquiring or partnering with FinTech companies, or are incubating or launching their own digital finance companies.

Banking authorities have generally welcomed this new form of competition. They are pushing banks to facilitate free bank account transfers, for instance.

Technology-related developments represent an emerging area of risk. Cybersecurity breaches could also have a significant impact on affected banks, both in terms of direct financial losses as well as reputational or legal damage (see "How Ready Are Banks For The Rapidly Rising Threat Of Cyberattack?" published on Sept. 28, 2015).

Table 4

Rating Components For Selected French Banks

		Rating components						No. of notches of support				
Bank Name	**Issuer credit rating**	**Anchor**	**Business position**	**Capital & earnings**	**Risk position**	**Funding & liquidity**	**SACP**	**ALAC**	**GRE**	**Group**	**Sovereign**	**Add'l factor adj.**
BNP Paribas	A+/Watch Neg/ A-1	bbb+	Very Strong	Adequate	Adequate	Average/Adequate	a	+1	0	0	0	0
Banque Accord	A-/Negative/A-2	bbb+	Weak (-2)	Adequate	Moderate	Below Average/Adequate	bb	0	0	+5	0	0
Banque PSA Finance	BB+/Stable/B	bbb+	Weak (-3)	Adequate	Adequate	Average/Adequate	bb+	0	0	0	0	0
Banque Solfea	BBB-/Negative/A-3	bbb+	Weak (-3)	Adequate	Weak (-2)	Below Average/Adequate	b+	0	0	+3	0	+1
BPCE	A/Stable/A-1	bbb+	Strong	Adequate	Adequate	Average/Adequate	a-	+1	0	0	0	0
Caisse Centrale du Credit Mutuel	A/Negative/A-1	bbb+	Strong	Adequate	Adequate	Average/Adequate	a-	0	0	0	0	+1
Carrefour Banque	BBB+/Stable/A-2	bbb+	Weak (-2)	Strong	Moderate	Below Average/Adequate	bb+	0	0	+3	0	0
Credit Agricole S.A.	A/Stable/A-1	bbb+	Strong	Adequate	Adequate	Average/Adequate	a-	+1	0	0	0	0
Dexia Credit Local	BBB/Stable/A-2	bbb+	Adequate	Moderate	Weak	Below Average/Weak	b	0	+3	0	+3	0
Goldman Sachs Paris Inc. Et Cie	A-/Watch Pos/A-2	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
La Banque Postale	A/Stable/A-1	bbb+	Adequate	Adequate	Moderate	Above Average/Strong	bbb+	0	0	+2	0	0
RCI Banque	BBB/Negative/A-2	bbb+	Weak (-2)	Strong	Adequate	Below Average/Adequate	bbb-	0	0	0	0	+1
Societe de Financement Local (SFIL)	AA/Negative/A-1+	bbb+	Moderate	Strong	Very Weak	Average/Adequate	bb-	0	+10	0	0	0
Societe Generale	A/Stable/A-1	bbb+	Strong	Adequate	Adequate	Average/Adequate	a-	+1	0	0	0	0
Socram Banque	BBB+/Stable/A-2	bbb+	Weak (-2)	Very Strong	Adequate	Below Average/Adequate	bbb	0	0	+1	0	0

GRE-Government-related entity. Source: Standard & Poor's. Data as of Dec. 31, 2015.

Related Criteria And Research

Related research

- Proposed New Class Of Senior Debt Could Enable Large French Banks To Increase Their Loss-Absorbing Capacity, Jan. 12, 2016
- The Future Of Banking: How FinTech Could Disrupt Bank Ratings, Dec. 15, 2015
- How Standard & Poor's Applied Its Government Support And ALAC Criteria To European Banks In December 2015, Dec. 2, 2015
- Eurozone Recovery: Hangin' In There Despite Weak Foreign Demand, Nov. 25, 2015
- How Ready Are Banks For The Rapidly Rising Threat Of Cyberattack? Sept. 28, 2015
- Banking Industry Country Risk Assessment: France, July 6, 2015

We have determined, based solely on the developments described herein, that no rating actions are currently warranted. Only a rating committee may determine a rating action and, as these developments were not viewed as material to the ratings, neither they nor this report were reviewed by a rating committee.