French banks and the benefits of rising rates: the risk of slow motion in 2023

We expect French banks to achieve reasonable results this year, although they will likely come in below 2022 levels. Excluding exceptional measures taken in relation to Russian and Ukrainian exposures, underlying results in 2022 were satisfactory.

This year will be a year of transition for French banks due to a combination of headwinds:

- An anticipated economic slowdown,
- Country-specific characteristics delaying the positive effects of rising interest rates,
- Pressure on cost bases from inflation, and
- Weakening asset quality (although this should be contained).

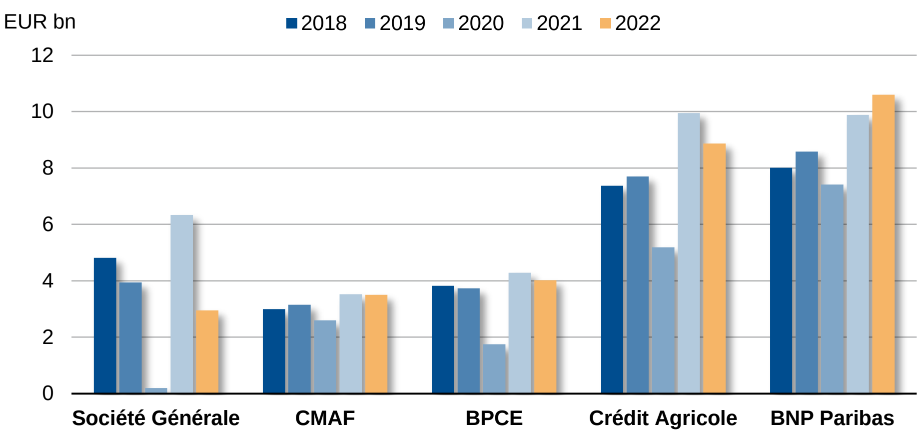
These developments contrast with other European banking sectors such as Italy, Spain and the UK, where balance sheets are repricing more rapidly, already leading to sharp increases in interest revenues (see related research section on p.8).

In 2022, French banks benefited from supportive lending dynamics, a strong contribution from capital market activities and controlled cost of risk. Leaving aside 2021, which was a catch-up year with exceptionally strong results, French banks' performance was positive, even if the second half was less buoyant.

The fourth quarter did not signal any new adverse developments, crystallisation of risk or revision of strategic ambitions.

Return on average equity remains in the lower range compared to European peers, ranging from roughly 4% to below 9%. The most recent average ROE figure published by the European Banking Authority was 7.7%.

Figure 1: Resilient earnings but some exceptional items (EUR bn, reported)



Crédit Agricole: Crédit Agricole Group; BPCE: BPCE Group; CMAF: Crédit Mutuel Alliance Fédérale (part of Crédit Mutuel Group). Source: banks, SNL, Scope Ratings

Analysts

Nicolas Hardy
n.hardy@scoperatingscom

Tatiana Fomenko
t.fomenko@scoperatings.com

Team leader

Marco Troiano, CFA
m.troiano@scoperatings.com

Media

Keith Mullin
k.mullin@scopegroup.com

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Scope Ratings GmbH

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

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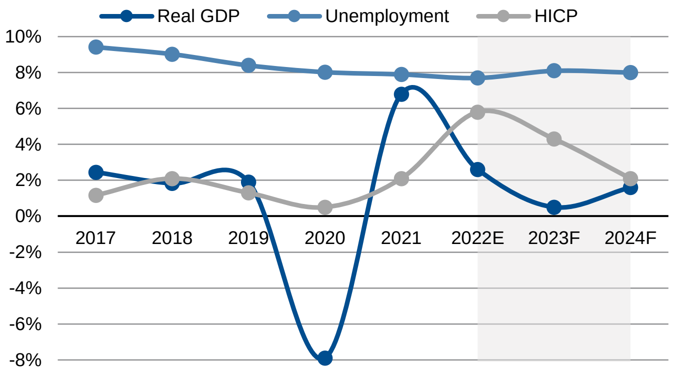
Baseline macroeconomic scenarios: not bright, but comforting for banks

Macroeconomic prospects remain supportive of banking activities. Our baseline scenario points to a drastic slowdown in 2023 and a rebound in 2024. By the end of next year, GDP growth should converge towards France's medium-run potential. Importantly, under this scenario, unemployment does not deteriorate meaningfully.

The increase in corporate bankruptcies continues, starting this year close to where it was prior to the Covid outbreak. At this point, it looks like normalisation, because convergence to the historical average has been gradual. A catch-up effect is not our central scenario because support measures, like State-guaranteed loans, will be removed over several years. Still, corporate margins are being squeezed by inflation and tightened financial conditions, which could prevent bankruptcies from stabilising.

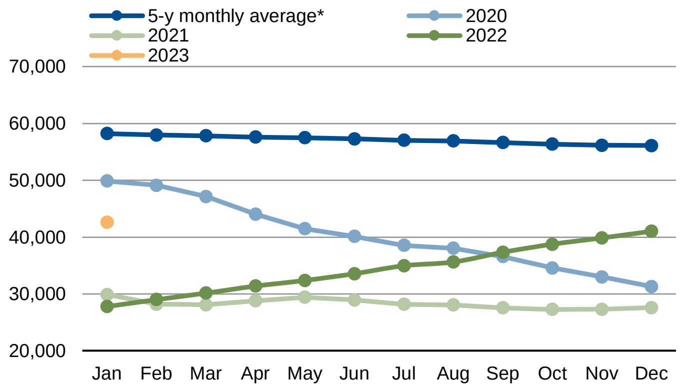
The baseline macroeconomic scenarios that French banks used to calibrate expected credit losses follow a similar growth pattern. The probability weighting applied by banks to their adverse macro-scenarios is contained, ranging from 16% to 35%. This explains expectations for an average cost of risk in 2023. The baseline macroeconomic assumptions prepared by the European Systemic Risk Board for the ECB/EBA 2023 stress test exercise are also broadly aligned.

Figure 2: France main economic indicators – base case



HICP: Harmonised Index of Consumer Prices. Grey area: Scope Ratings forecast as of December 2022. E: Estimated; F: Forecast. Source: IMF, Scope Ratings

Figure 3: Normalising corporate bankruptcies in France



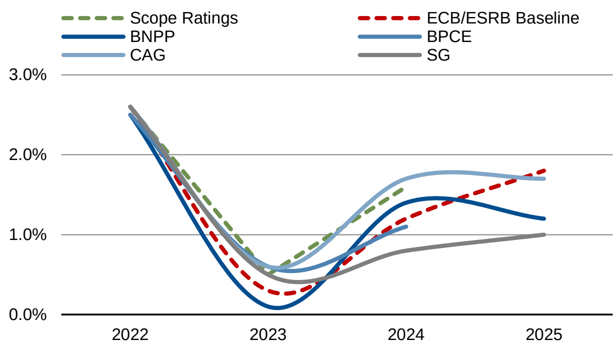
Aggregate number of monthly corporate bankruptcies over the last 12 months. *Average for 2015-19. Source: Banque de France, Scope Ratings

Figure 4: Baseline scenarios used to calibrate expected credit losses

GDP growth rate for France - Baseline Scenarios				
	2022	2023	2024	2025
Scope Ratings - Baseline	**2.6%**	**0.5%**	**1.6%**	**-**
ECB/ESRB Baseline growth	2.6%	0.3%	1.2%	1.8%
ECB/ESRB Adverse growth	2.60%	-2.90%	-3.90%	1.10%
BNPP	2.5%	0.1%	1.4%	1.2%
BPCE	2.5%	0.6%	1.1%	-
Crédit Agricole	2.6%	0.6%	1.7%	1.7%
SG	2.6%	0.5%	0.8%	1.0%

HICP: Harmonised Index of Consumer Prices. Grey area: Scope Ratings forecast as of December 2022. Source: IMF, Scope Ratings

Figure 5: Baseline GDP scenarios for France



Aggregate number of monthly corporate bankruptcies over the last 12 months. *Average for 2015-19. Source: Banque de France, Scope Ratings

Headwind n°1: interest revenues moving up slowly because of country-specific characteristics

Margins are squeezed

The French retail segment, which represents a significant portion of French bank balance sheets and P&L, combines unique characteristics that are squeezing margins. There are legal caps in place to smooth the impact of rising interest rates on borrowers. The formula used to reset maximum acceptable rates ('usury rates') is based on recently observed rates (a backward-looking measure).

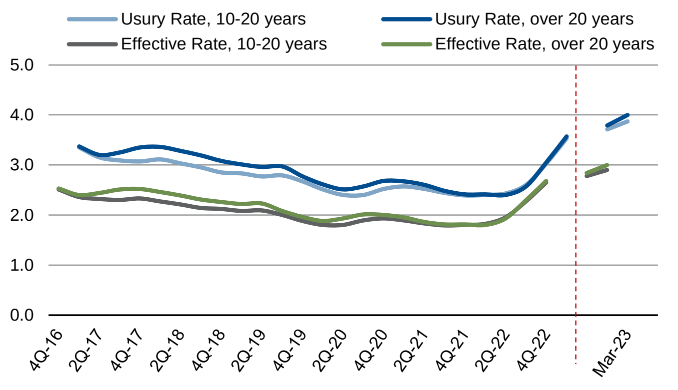
Mortgages are mainly at fixed rates for the entire life. When interest rates go up, loan repricing can only happen when a new mortgage is granted. The return on regulated savings (e.g. Livret A, EUR 343bn, 19% of total bank deposits as of December 2022) is inflation-linked, adjusting more quickly than normal rates (usury rates).

While most Livret A deposits are channelled to Caisse des Dépôts et Consignations, banks do pay interest on retained portions. And Livret A is largely seen as a benchmark rate for retail savings. The same can be said of wholesale funding, which moves in tandem with policy rates, making funding more expensive more rapidly.

These characteristics are protective for borrowers and depositors but they can significantly delay the benefits of higher interest rates for banks. Rates in this context move slowly in comparison to inflation.

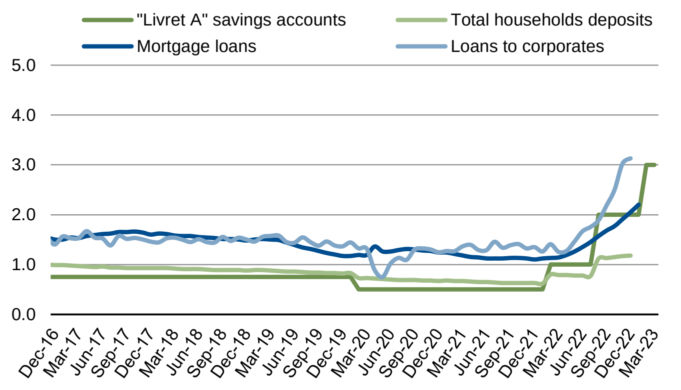
On a positive note, the frequency with which 'usury rates' are being revised was increased recently from quarterly to monthly, although for a limited period of time only (the next six months). This will have a positive effect on loan production because banks did become increasingly reluctant to grant loans at low rates, waiting for rates to increase.

Figure 6: Usury rates adjusting slowly (%)



Fixed-rate loans for house purchase. Average effective rate. Quarterly series were replaced by monthly data starting from February 2023. Source: Banque de France, Scope Ratings

Figure 7: Interest rates on customer loans and deposits (%)



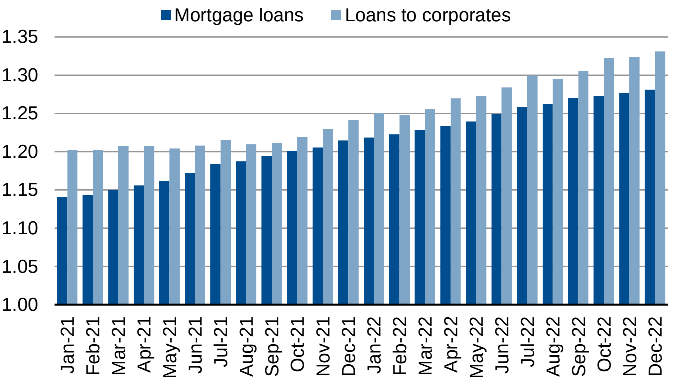
Interest rates on loans: all maturities, annualised agreed rate. Average rate on total households deposits, annualised agreed rate. Source: Banque de France, Scope Ratings

But no sign of a credit crunch

Slowly adjusting rates combined with falling new lending volumes would be an issue for banks. So far, though, there is no indication that tightened financial conditions are having a massive effect on new loan production, although we do anticipate some ups and downs in relation to monthly new loan production. Corporate and household loan production remains steady, rising by 7% and 5% in 2022. Mortgage origination has slowed since June 2022 but net flows are resilient. Consumer loan production is also resilient.

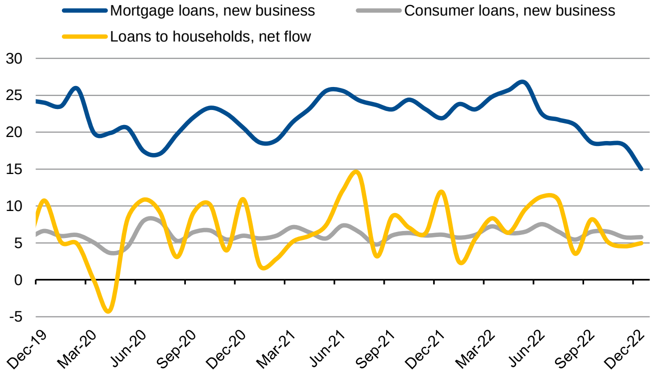
Mortgage rates are getting back to 2015 levels. This will result in affordability issues but only at the margins. Crédit Logement, the main provider of financial guarantees on home loans in France, anticipates a 15% reduction in loan production in 2023. In the meantime, house prices are holding up well.

Figure 8: Outstanding loans to private sector at historical high, (EUR trn)



Source: Banque de France, Scope Ratings

Figure 9: Slowing new retail loan production (monthly, EUR bn)



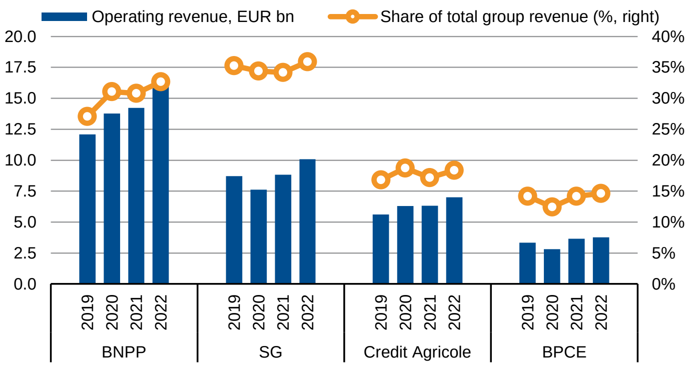
Source: Banque de France, Scope Ratings

Two other elements will add pressure on revenue growth in 2023. First, banks active in corporate and investment banking anticipate a normalisation of activities in 2023 after a significant contribution in 2022 that is unlikely to be sustained. Lower capital market revenues, inherently volatile, are the main reason.

Second, the accelerated repayment of TLTRO drawdowns which have boosted interest revenues since 2020. We expect that outstanding amounts will be repaid at maturity this year and next, in an orderly manner.

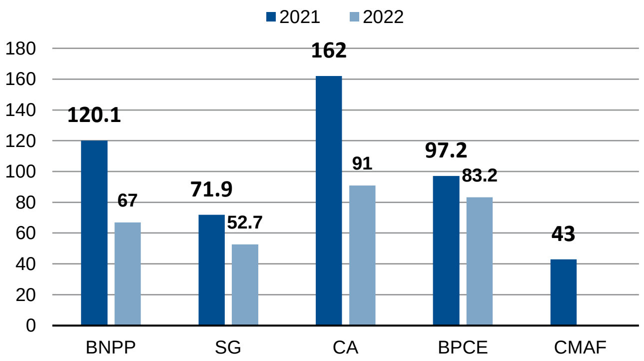
Meanwhile, French banks have made significant progress with their funding plans for this year, taking advantage of good access to the wholesale market. They had all achieved at least 40% of their funding plans by end-February and as a group have been active in AT1 and Tier 2 as well as senior non-preferred and senior preferred segments.

Figure 10: Contribution of Corporate and Investment banking: continuation of the trend unlikely



Source: banks, Scope Ratings

Figure 11: TLTRO repayment making progress

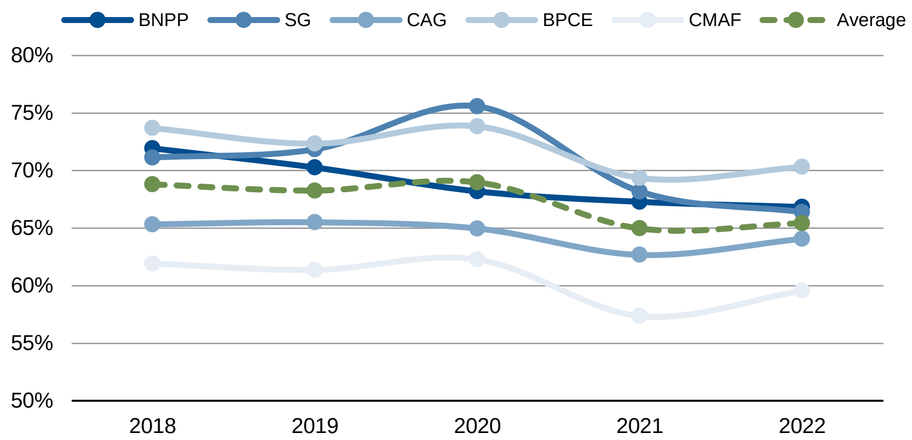


CMAF: not yet available at end 2022. Source: banks, Scope Ratings

Headwind n°2: the challenge of maintaining cost discipline in an inflationary environment

French banks have above average cost-to-income ratios compared to peers so better cost efficiency was a broad-based strategic focus in the low interest-rate environment. Progress made so far has been modest, however.

Figure 12: Upside pressure on cost-to-income ratios

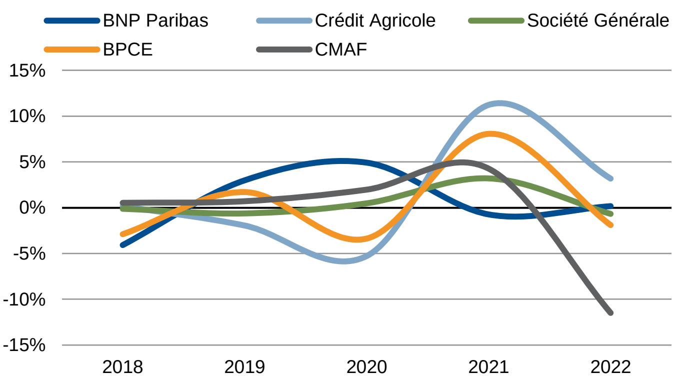


Operating income and operating expense as reported. Source: banks, Scope Ratings

In 2023, in the context of persistent inflationary pressure and potentially lower revenues, growing operating revenues more rapidly than operating expenses will be a challenge. Figure 13 highlights the jaws ratio (revenue growth rate minus expense growth rate, in percentage points) and shows that 2022 was already an inflexion point.

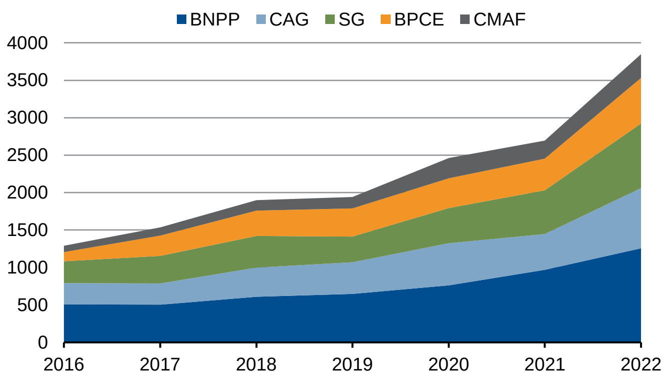
French banks have been vocal about the negative effects of continuously rising contributions to resolution funds. These rose by 43% in 2022 and will continue to impact expenses in 2023. A conservative estimate for 2023 would be a level equivalent to 2022.

Figure 13: Jaws effect: the challenge of remaining in positive territory



Revenue growth rate minus expense growth rate, in percentage points. Source: banks, Scope Ratings

Figure 14: Rising contributions to resolution funds

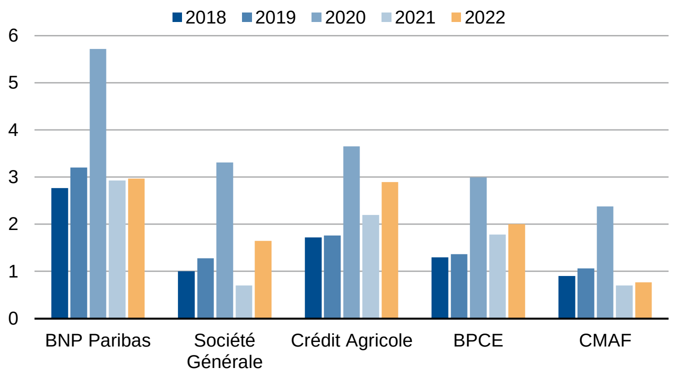


EUR m estimates. Source: banks, Scope Ratings

Headwind n°3: asset quality, less of concern thanks to lasting efforts to improve balance-sheet quality

Cost of risk was satisfactory in 2022, aside from Russian and Ukrainian credit exposures. The banks continued to build provisions in anticipation of more challenging operating conditions. Guidance for 2023 is conservative, only slightly up compared to 2022 and in line with long-term averages or medium-term strategic objectives. Guidance reflects diversified lending portfolios, including for most banks a material share of granular, low-risk mortgages but also an absence of noticeable asset-quality deterioration among the most vulnerable categories of borrowers (from SMEs to consumer finance) or residual exposure to Russia and Ukraine.

Figure 15: Still average cost of risk (EUR bn)



Crédit Agricole: Crédit Agricole Group; BPCE: BPCE Group; CMAF: Crédit Mutuel Alliance Fédérale (part of Crédit Mutuel Group).
Source: banks, Scope Ratings

Figure 16: Banks' guidance on cost of risk

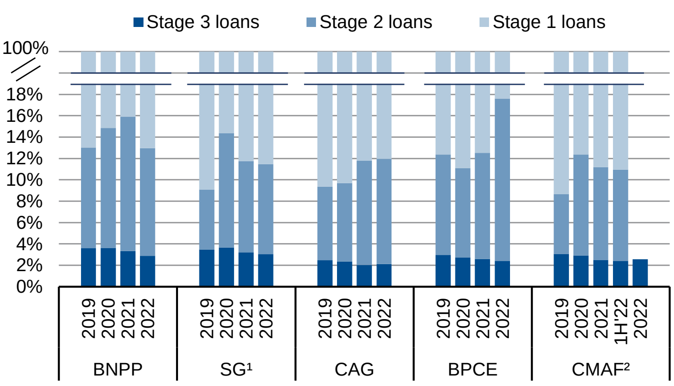
	Actual in 2022	Guidance for 2023
BNP Paribas	34bp	40bp
Crédit Agricole Group	25bp	40bp
BPCE Group	23bp	25bp
Société Générale	28bp	35bp
CMAF	16bp	-

Source: banks, Scope Ratings

Problem loans (Stage 3) are now below the 3% mark for all banks. The share of Stage 2 loans had generally reduced by the end of 2022, representing about 10% of customer loans, in line with the European average. The increase reported by BPCE was already accounted for at the end of June, reflecting a change in methodology for Stage 2 classification.

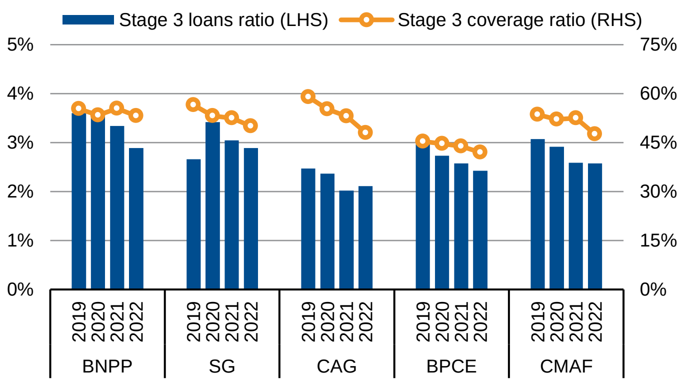
In parallel, banks have kept large buffers on performing exposures, which were initially put in place in 2020. We estimate that Stage 2 provisions add up to EUR 6bn for the five large French banking groups, in excess of the level reported at the end of 2019.

Figure 17: Loan portfolios by IFRS9 stages



(1) SG: Estimated Stage 1 and Stage 2 customer loans; (2) CMAF: as of June 2022, breakdown not yet available for 2022 YE. Customer loans at amortized cost. Source: banks, Scope Ratings

Figure 18: Stage 3 ratios and coverage of Stage 3 loans

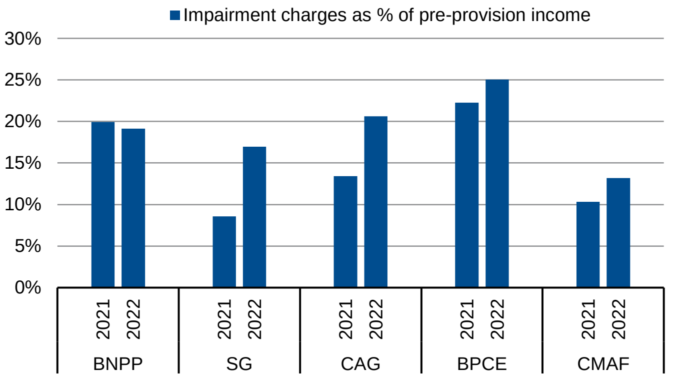


Source: banks, SNL, Scope Ratings

Preserved loss absorption capacity

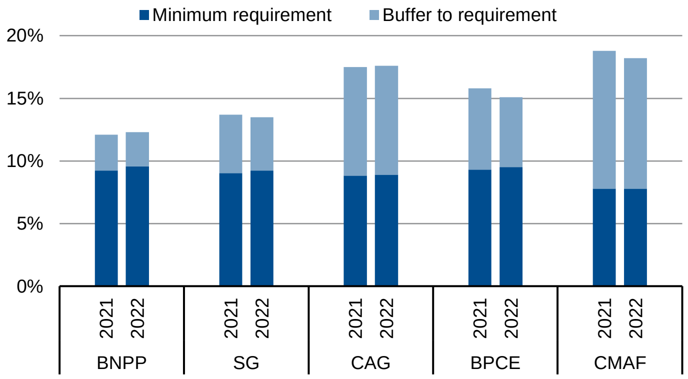
French banks have adequate-to-comfortable first and second lines of defence. These include capacity to materially increase impairment charges if necessary or an adequate to comfortable distance to minimum regulatory requirements. There are no excessive capital optimisation strategies in place.

Figure 19: Low impairment charges as a % of pre-impairment income



BNPP: BNP Paribas; SG: Société Générale; CAG: Crédit Agricole Group; BPCE: BPCE Group; CMAF: Crédit Mutuel Alliance Fédérale (part of Crédit Mutuel Group) Source: SNL, Scope Ratings

Figure 20: CET1 ratios at an adequate to comfortable distance to requirements



. Source: banks, Scope Ratings

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Scope Ratings GmbH

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris
10 avenue de Messine
FR-75008 Paris

Phone +33 6 6289 3512

Oslo
Karenslyst allé 53
N-0279 Oslo

Phone +47 21 62 31 42

Madrid
Paseo de la Castellana 141
E-28046 Madrid

Phone +34 91 572 67 11

Milan
Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 30315 814

Scope Ratings UK Limited

London
52 Grosvenor Gardens
London SW1W 0AU

Phone +44 (0)20 7824 5180

info@scoperatings.com
www.scoperatings.com