French banks well placed to avoid a hard landing as operating conditions normalise

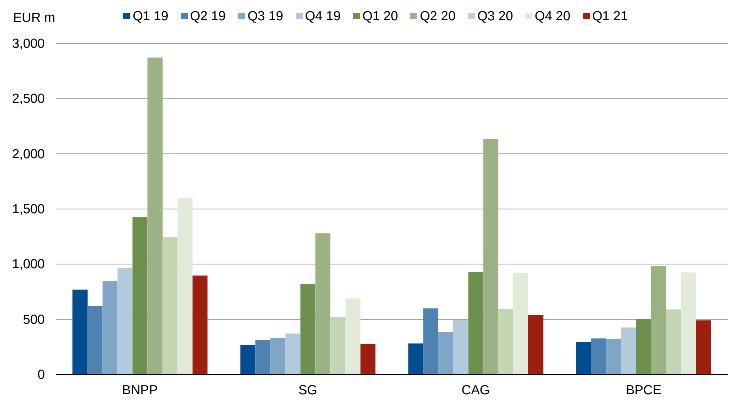
We expect operating conditions for French banks to normalise as the local economy recovers. Problem loans will increase only moderately even with a more gradual economic recovery than initially anticipated, and they will be concentrated in vulnerable sectors or idiosyncratic. The large banks are in good shape to avoid a hard landing on asset quality, supported by a gradual phase-out of support measures and regulatory exemptions.

The latest figures published by French banks for 2021 show that their cost of risk and net income are broadly in line with pre-crisis levels (Figures 1 and 2). Banks accumulated precautionary provisions in 2020 and built extra capital through retained earnings. As the economy rebounds, revenues will improve, increasing the banks' capacity to absorb losses. With the continuation of this positive trend, dividend payments may resume in the fourth quarter, provided of course that the ECB lifts its ban.

In this context, we look at two frequently asked questions about French banks:

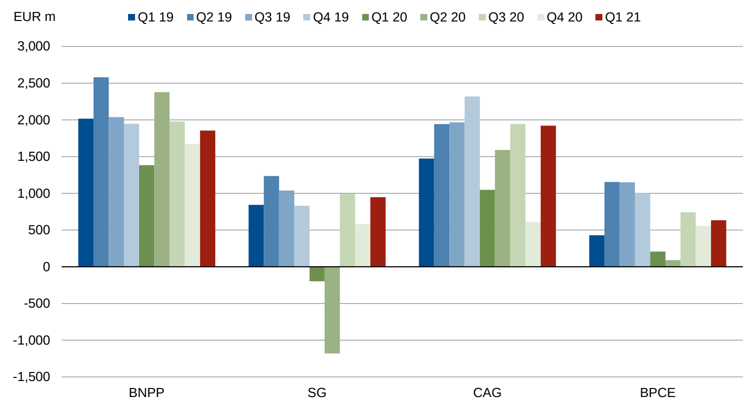
- Credit risk seems to be receding without much damage to the economy and to banks' balance-sheets. Is it too early to tell or just too good to be true?
- If operating conditions do normalise and banks resume dividend payments, what will it take to end accommodating support measures?

Figure 1: French banks' normalising cost of risk



Source: banks, Scope Ratings.

Figure 2: French banks' normalising quarterly net income



Source: banks, Scope Ratings.

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Receding credit risk: too early or too good to be true?

The pace of recovery is uncertain but the most adverse scenarios are fading

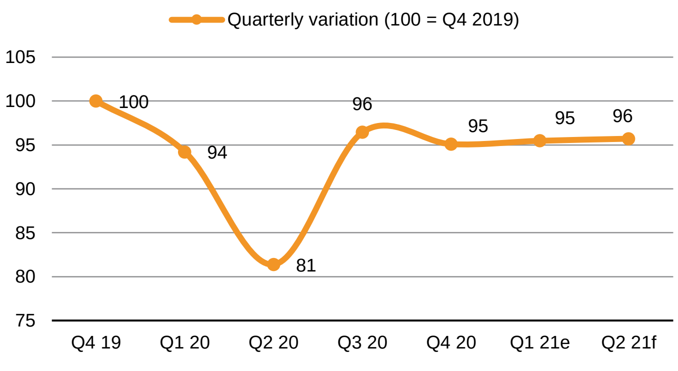
A less bullish but more certain pace of recovery

France is only expected to return to pre-crisis GDP levels in late 2022 or 2023.The government's statistical body (INSEE) expects only marginal progress during the first and second quarters of this year (Figure 3). While the right side of the V-shaped recovery has flattened, the economic rebound has not faltered. After an 8% decline in GDP in 2020, Scope expects France to grow by 5% and 4% respectively in 2021 and 2022.

There are other tangible signs of a resilient economy and an improving operating environment, which are credit positives for banks:

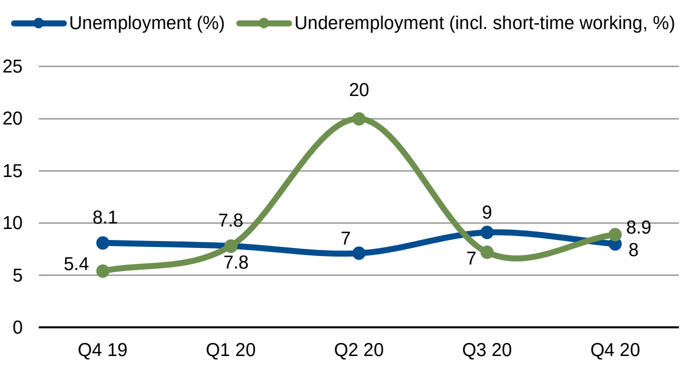
- Unemployment remains under control. Scope anticipates it will deteriorate moderately in 2021-2022 to reach 9.2%, which would be close to 2018 levels. Short-time working has come down materially even if it remains above pre-crisis levels, at just below 10% as of end-2020 (Figure 4).
- The retail property market remains dynamic both in terms of prices and loan production. Retail borrowers are benefiting from record low interest rates, paying 1.15% for new home loans on average in April.
- The 'as much as it takes' support approach has preserved the capacity of the economy to rebound. As such, we do not expect an abrupt withdrawal of economic and regulatory support measures. The debate on the direction of inflation and interest rates is gaining traction. For the moment, monetary authorities anticipate a temporary surge of inflation without any immediate need to adjust policy rates.

Figure 3: French GDP



Source: INSEE, Economic outlook, May 2021, Scope Ratings.

Figure 4: Unemployment and under-employment in France

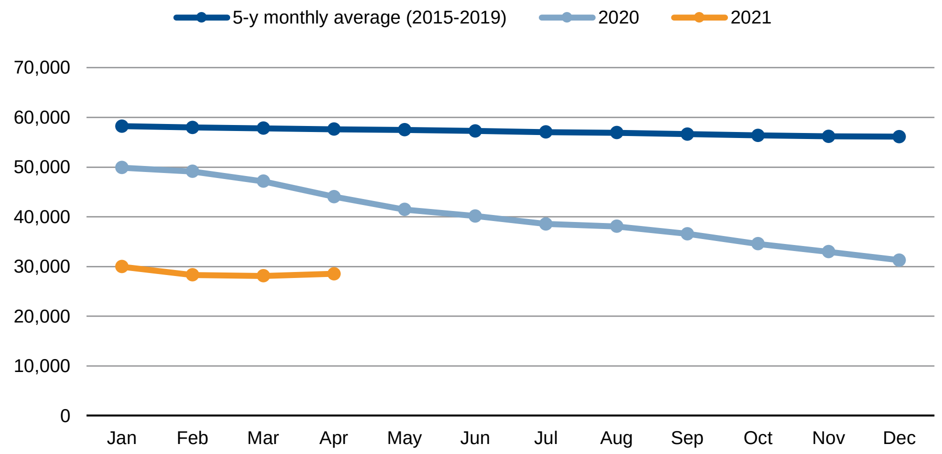


Source: INSEE, Labour Force Survey, Scope Ratings.

The disconnect between economic activity and asset quality cannot continue for ever

Given the magnitude of the decline in GDP in 2020 (-8%) and the only gradual normalisation of economic conditions and only by late 2022, it is hard to see how the banks can avoid a surge in problem loans. Massive support measures have delayed the emergence of problem loans but they have not eliminated them. The abnormally low number of bankruptcies, about 40% below past figures, best exemplifies this situation.

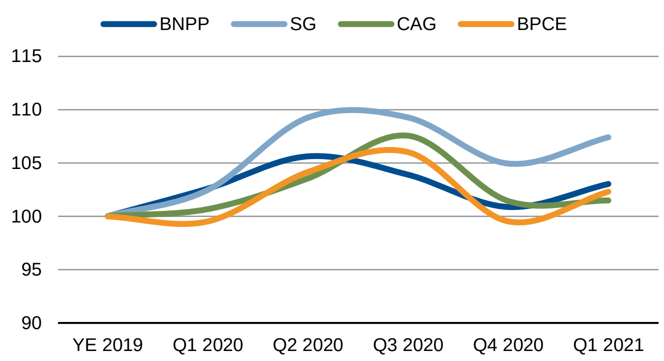
Figure 5: an abnormally low level of bankruptcies



Source: Banque de France, Scope Ratings.

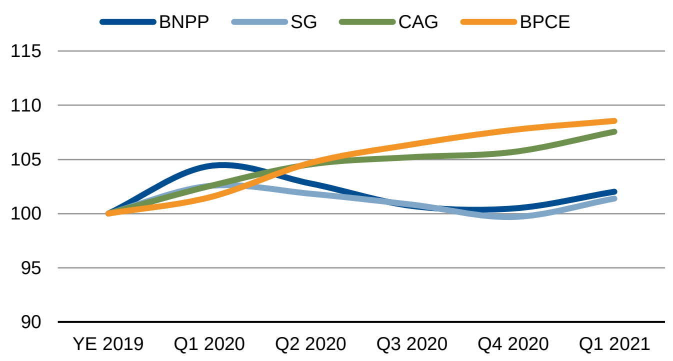
French banks' reported non-performing loans have been stable since 2019 (Figure 6), owing to active management of NPL portfolios and loan growth. Monitoring the absolute amount of NPLs matters because loan-book expansion has been dynamic since the end of 2019 (Figure 7). This has contributed mechanistically to the stability of NPL ratios (as the denominator of the NPL ratios), and qualitatively because continuing credit supply, partly in the form of State-guaranteed loans, underpins the resilience of the economy.

Figure 6: Problem loans are under control (100=Q4 2019)



Source: banks, Scope Ratings.

Figure 7: Credit supply is on the rise (100=Q4 2019)



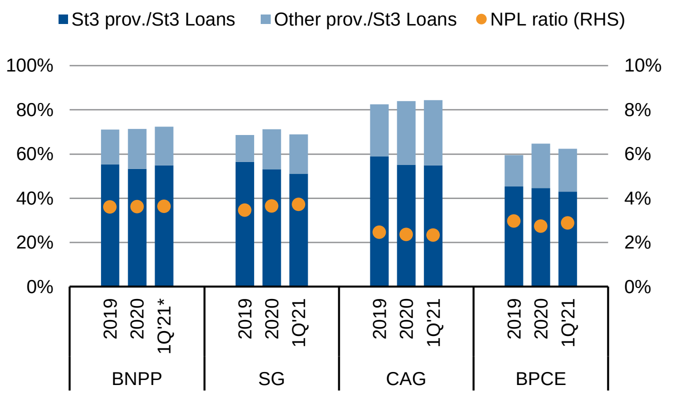
Net loans to customer at amortized cost. Source: SNL, Scope Ratings.

From total disconnect to a moderate catch-up: the turning point for asset-quality metrics

Although French banks' consolidated NPL data remains broadly flat and well covered compared to European averages (Figure 8), the sectors most sensitive to the side-effects of the pandemic, such as tourism and transportation or those impacted by the shift to digital, are starting to deteriorate. This deterioration is very much contained and evidence is rather anecdotal, but it is an early warning signal. Another trend to monitor is the pace at which the pace of bankruptcies normalises.

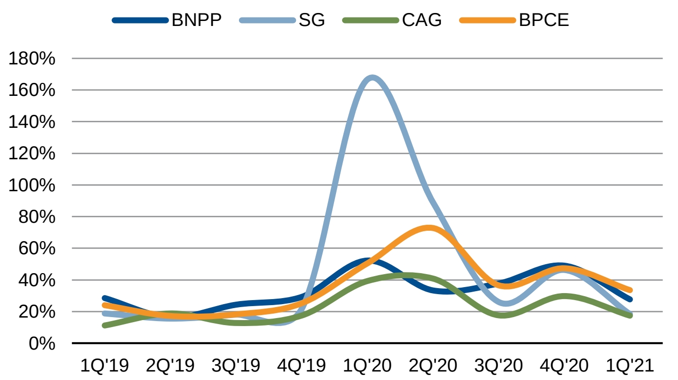
Despite the expected catch-up, we believe credit risk is receding because the prospect of a hard landing looks increasingly remote. The impact on banks should be moderate. The emergence of problem loans should be minimal for the most resilient and dynamic sectors and concentrated in the most fragile economic sectors. The scope of the most vulnerable sectors should also narrow, while banks' revenue generation and consequently their loss-absorption capacity improve further. The capacity to cover cost of risk with pre-impairment operating revenues has been preserved (Figure 9).

Figure 8: French banks' NPL ratios and provision coverage



*Estimated based on end 2020 disclosures; Source: banks, Scope Ratings

Figure 9: French banks' credit impairment as % of pre-impairment operating profit (PIOP)



Source: banks, Scope Ratings

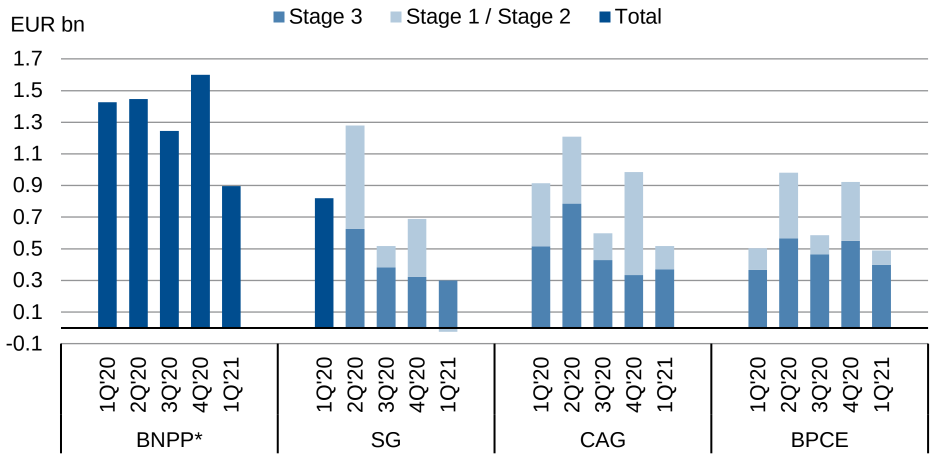
Banks have the capacity to manage these exposures and limit further loan losses, given their size (Figure 10) and the credit mitigants already in place. Despite the brighter economic outlook, banks have not yet reversed or used their precautionary provisions for stage 1 and stage 2 loans accumulated since 2020 (Figure 11). We expect releases from this buffer as well as retained earnings to be gradual and subject to scrutiny by regulatory authorities. In addition, State guarantees on loans made during the pandemic are also protecting banks' asset quality.

Figure 10: Selected disclosures on sensitive credit exposure amounts

	BPCE	BNPP	SG	CAG
Wholesale & retail trade (non food)	1.2%			
Retail, distribution (non food)				1.3%
Non-food retail		0.6%	0.4%	
Tourism, hotel, catering	1.2%			
Tourism, hospitality, restaurants				0.8%
Hotels, tourism, leisure		0.7%		
Hotels & catering			0.6%	
Oil & gas	0.7%*	1.9%	2.1%	2.1%
Transport & storage (excl. Shipping)		2.8%		
Shipping			<1%	1.3%
Aviation	0.3%*	0.7%	<0.5%	1.6%
Automobile	0.7%		1.0%	2.0%
Denominator	Group gross exposure	Gross commitment	Group EAD	Group EAD

*Natixis scope only, estimates based on net EAD. Data as of March 2021, except BNPP (YE 2020). Source: banks, Scope Ratings

Figure 11: Cost of risk and precautionary provision



*BNPP: quarterly breakdown not available. In 2020, CoR amounted to EUR 5.7bn, including EUR 1.4bn relating to precautionary provisions (16 bps). Source: banks, Scope Ratings

What does it take to end accommodating support measures?

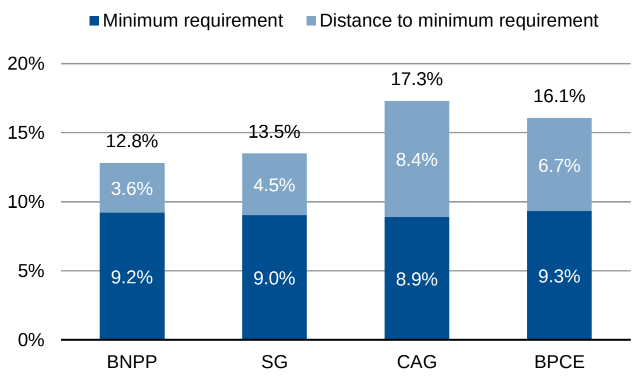
As operating conditions normalise, expectations are mounting that restrictions on dividend payments should be lifted in the fall. As far as 2019 and 2020 results are concerned, the European Central Bank has recommended that banks limit dividend payment until the end of September 2021 to 15% of accumulated profits or 20 basis points of CET1 ratios. The ECB does not expect banks to pay dividends on 2021 results until end of September 2021.

But dividend suspension is only part of a set of extraordinary measures implemented by regulatory and supervisory authorities in reaction to the pandemic. They range from operational relief measures to financial relief measures. Flagship measures included relief in the leverage ratio, the postponement of regulatory deadlines to submit data or take remediation actions, accommodating rules on forbearance recognition for loans under moratorium, or the possibility to operate with depleted capital or liquidity buffers. Ending restrictions on dividends implies that certain relief measures are also likely to be lifted in a co-ordinated manner.

Like most European banks, large French banks have benefited from these measures, but did not rely on them to continue operating. They have the capacity to adapt to a removal of these support measures. Their balance-sheets have been preserved and they have built up and maintained excess buffers above minimum regulatory requirements. Figures 12 and 13 show the available buffers above minimum requirements for CET1 and leverage ratios. Other regulatory requirements like the liquidity coverage ratio benefited from pandemic TLTROs. The lowest reported ratio among French banks was 136%, compared to a minimum of 100%.

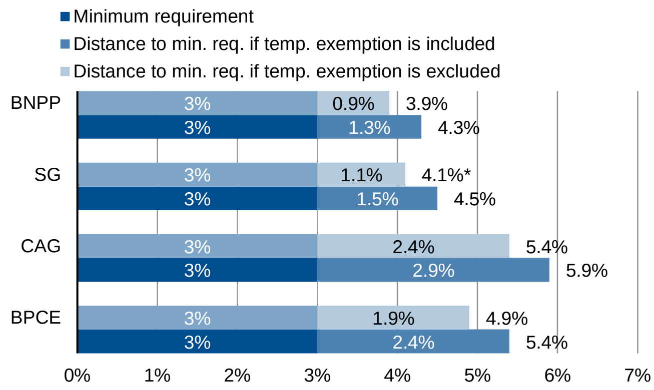
Removing these temporary measures that were applied across the board is a European issue not a France-specific issue. At some stage, a more tailored approach may be needed given the uneven impact of the pandemic and uneven pace of recovery across banks and countries.

Figure 12: Phased-in CET1 ratios and distance to SREP requirements at end March 2021



SREP: supervisory review and evaluation process. Source: banks, Scope Ratings.

Figure 13: Leverage ratios at end March 2021 (with and without temporary exemption of central bank exposures)

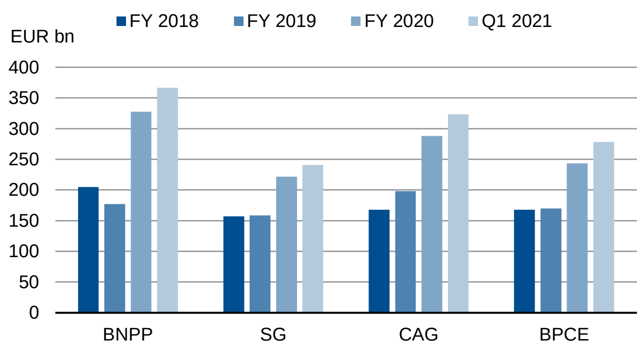


*Estimated based on end 2020 disclosures. Source: banks, Scope Ratings.

While dividend payment could resume immediately, many support measures will continue to benefit banks for an extended period of time either because authorities opt for a prolonged transitory period or because by design they span a prolonged period of time. For instance, leverage ratio relief has just been extended until March 2022. It was due to expire by the end of June 2021. Similarly, under the State-guaranteed loan programme (PGE, prêts garantis par l'Etat, EUR 139.5bn at end May 2021), companies can repay the loans over a five-year period.

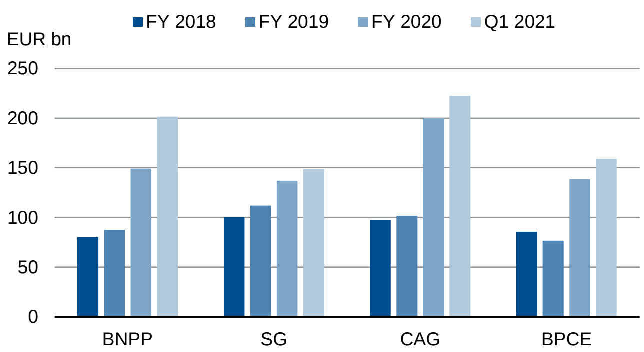
The reimbursement of the massive TLTRO III drawdowns in the next few years also raises questions over available refinancing options. The gradual phasing out of this liquidity support mechanism and how banks are adapting to this will remain under scrutiny. As a precautionary step, large inflows of central bank money visible on the liability side of balance sheets (Figure 15) have been parked to a large extent on the asset side (Figure 14).

Figure 14: Cash & central banks (asset side)



Source: banks, Scope Ratings.

Figure 15: Deposits from banks (liability side)



Source: banks, Scope Ratings.

Regarding operational relief, it will likely take some time to resume on-site inspections or mobilise full capacity for data gathering exercises. The frequency of the EBA's EU-wide transparency exercise has been adjusted accordingly with a single reporting in Autumn. Running other large-scale initiatives like the climate stress test in 2022 or working towards the implementation of the green asset ratio are ambitious goals in this context but back on track. The results of the 2021 EU-wide stress test led by EBA are still expected by the end of July.

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