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On This Year's Menu For French Banks: Digitalization And Efficiency Gains

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French banks are going to try to serve up two seemingly conflicting goals in this and in coming years: greater efficiency and digital transformation. While the first naturally brings cost cutting to mind, namely a reduction in the role and number of bank branches--the second requires investment into digital replacements for the same. Banks in France are betting that the dual approach will pay off now by containing costs and result in their long-term transformation into digital players.

While in the 10 years since the global financial crisis French banks have been slower than some European banks in reducing costs, they have kept pace with other big changes that have made them generally more resilient: they operate with higher and better quality capital and more substantial liquidity cushions. In addition, French banks have adjusted to more stringent regulatory rules and refocused their business models on less capital-intensive activities. Their diversified business model largely explains their resilience and continues to buffer the impact of still very low interest rates, particularly in domestic retail operations where net interest margins (NIMs) have squeezed revenues.

Overview

- Our outlooks on French banks are mostly stable, but we believe upside for the ratings could come from a structural reduction of risks or stronger loss absorption capacities that lead to enhanced financial profiles.
- Consolidated results for large French banks have been holding firm thanks to their diversified activities, by business and geography. However, we still expect decreasing NIMs for domestic retail operations for most of 2018, with a possible pickup only toward the end of the year.
- We see evidence of the digital disruption to customer loyalty and fee resilience with the entrance of Orange Bank and other fintechs, to which established French banks are likely to respond with accelerated digitalization.
- We believe French banks are now becoming more active in adjusting their business models, cutting costs, closing more domestic branches, and rationalizing back office capacity.

Heading into 2018, S&P Global Ratings expects French bank fundamentals to continue improving. As other European banks, they are benefiting in several ways from economic recovery in Europe and especially in France. Asset quality is set to remain good with a low cost of risk, helped by low interest rates. In the eurozone, interest rates should start to increase this year, with a reduction and eventual end to monetary stimulus that could aid bank interest margins in 2019 onward.

Most of the outlooks on our ratings on French banks are stable, attesting to our view of the resilience of the industry that we expect in 2018. We do not rule out some upward pressure on the ratings of those banks that can demonstrate superior financial profile characteristics, such as issuance of loss absorption capital or a structural reduction of their risk profile.

The Basel Committee on Banking Supervision announced revised capital standards on Dec. 7, 2017, in a key regulatory development that ended a long wait for banks. We consider these revised standards as manageable for large French banks. A number of the final rules are less stringent than in the original proposals--keeping the risk weight approach more risk-sensitive than in the initial proposals--and because the standards allow for a long period for implementation (see "The Basel Capital Compromise For Banks: Less Impact Than Meets The Eye," published on Dec. 8, 2017). In response, we believe French banks will continue to build capital mostly through retained earnings, as well as cushions of additional loss-absorbing capacity (ALAC), but probably at a slower pace than in the past three to four years.

Below, through a series of charts, we explore key influencing factors that we anticipate will be important for French banks in the coming year.

Creditworthiness: The Average Rating Is In The 'A' Category

The average rating on French banks is in the 'A' category and most carry stable outlooks. That's close to the average rating of banks in the Benelux region, slightly better than for U.K. banks, but also lower than for the average of Scandinavian, Canadian, and Swiss bank ratings.

We include one notch of uplift in the ratings of those systemically important French banking groups that we see building sizable buffers of bail-in loss-absorbing instruments (what we call additional loss-absorbing capacity or ALAC) to protect senior creditors. To build these buffers, French banks will likely to pursue issuance of senior nonpreferred notes, the new debt class created under the French law, Sapin II, at the end of 2016. More than €30 billion of these notes have been issued as of end-2017. Annual issuance volume in 2018 is expected to be even higher, reaching levels that will leave little room for the issuance of senior preferred for some issuers. We expect AT1 issuance to be modest.

Chart 1

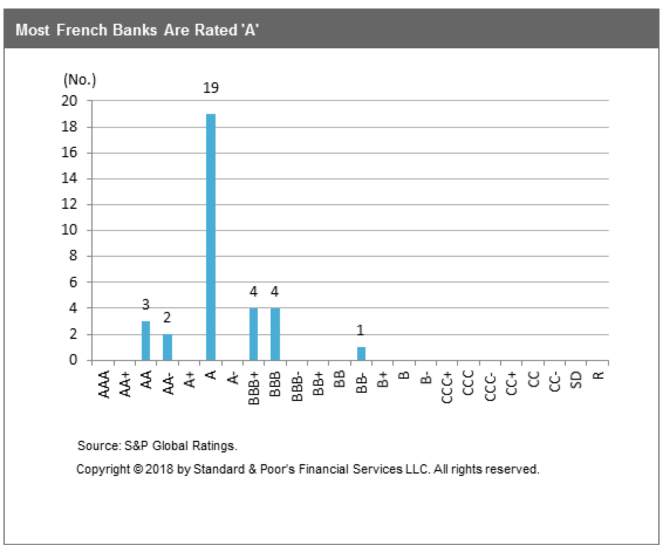


Chart 2

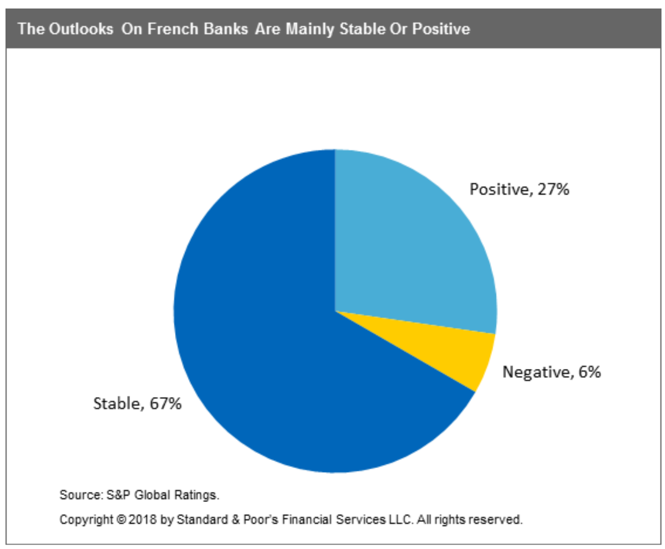
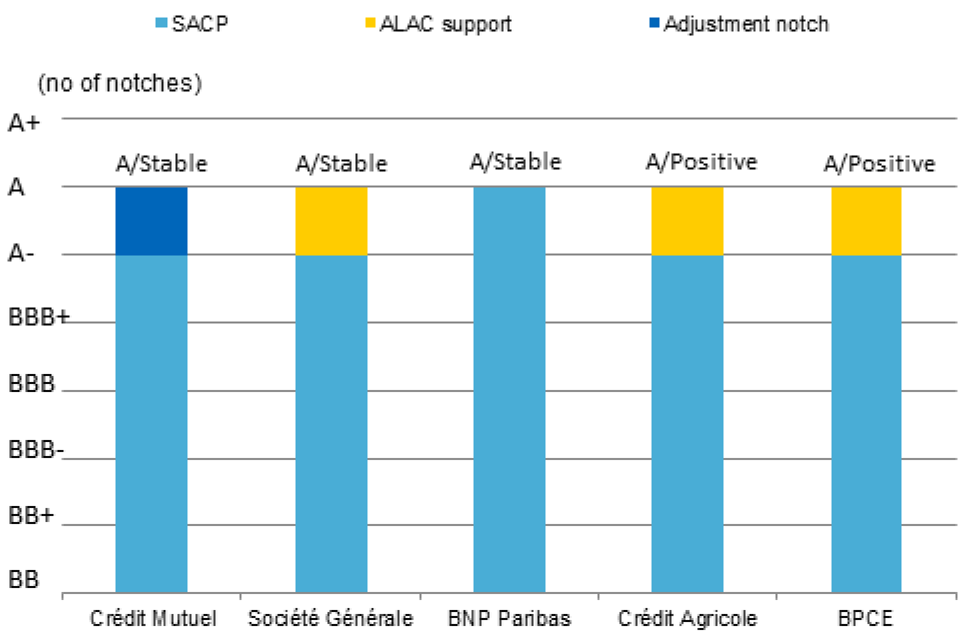


Chart 3

Credit Agricole And BPCE Have Carried A Positive Outlook Since October 2017

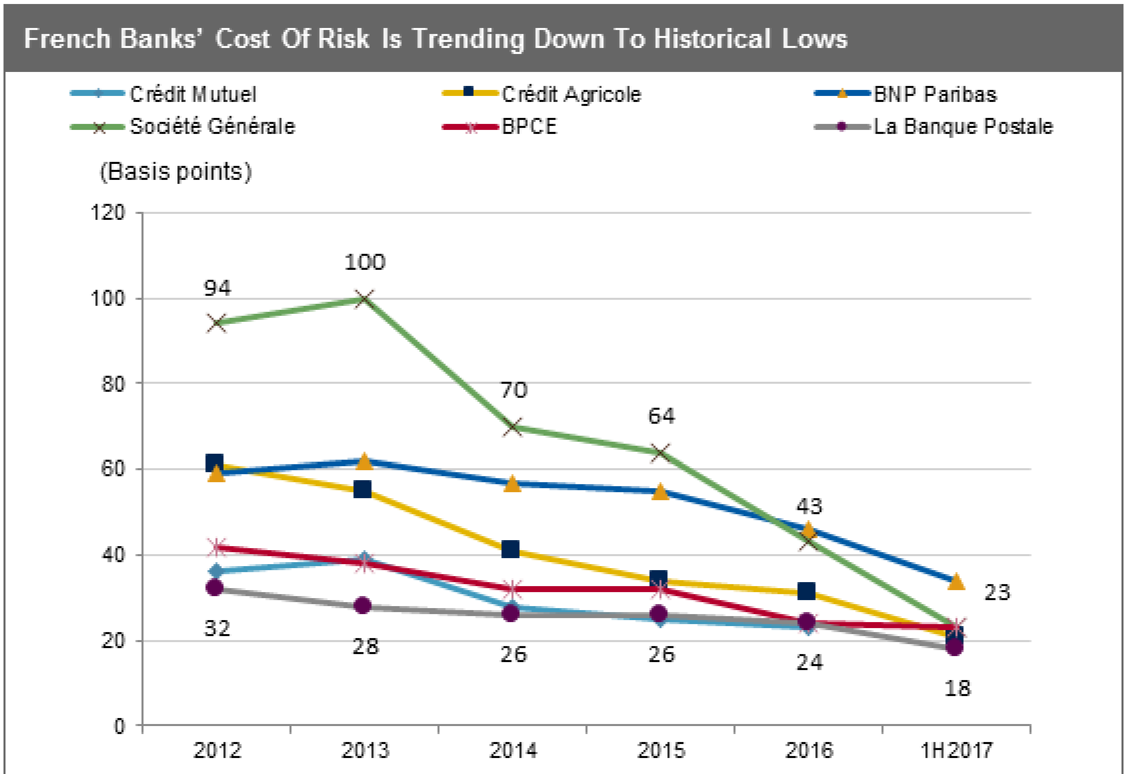


ALAC--Additional loss-absorbing capacity. SACP--Stand-alone credit profile. Source: S&P Global Ratings.

Asset Quality: Cost of Risk Has Little Room To Fall Further

Large French banks continue to exhibit good asset quality overall (see chart 4). In fact, the cost of risk may have reached an historical low in 2017. We expect cost of risk to increase slightly this year, while remaining low compared with the long-term average. Cost of risk should hover between 20 and 40 basis points for the large French universal banks in 2018, though in the lower end of the range for more retail-oriented ones. Large banks' lending exposures tend to be well diversified by counterparty and geography. Nevertheless, given their international dimension, they are exposed to more vulnerable sectors like metals, oil and gas, or to geographies outside Europe, leaving them structurally vulnerable to occasional pockets of risk. In addition, they feature exposure to some large heavily indebted French corporates, which we also address below.

Chart 4



Sources: Banks' financial statements, S&P Global Ratings calculations.

Credit Growth: Lending To Corporates Has Surged

French loan demand has remained healthy, even during the eurozone financial crisis, and what's more accelerated in 2016 and 2017, pushing on toward annual increases in credit growth of approximately 6% (see chart 5). This has placed France among the strongest in Europe for some time now.

Strong bank lending to corporates has recently caught the attention of French regulators because of a spike in corporate indebtedness. While it has remained more or less stable across the eurozone, the indebtedness of nonfinancial corporations in France rose by 8 percentage points of GDP between 2012 and 2016 (see chart 6). Large companies have been raising money by issuing heavily in the capital markets, but have also had recourse to bank loans. The French High Council for Financial Stability recently called on banks to limit their individual corporate exposure to highly indebted corporates to less than 5% of their capital (own funds) as a move to protect the economy against the risk that failure of a highly indebted large corporate could have on overexposed, systematically important banks.

Chart 5

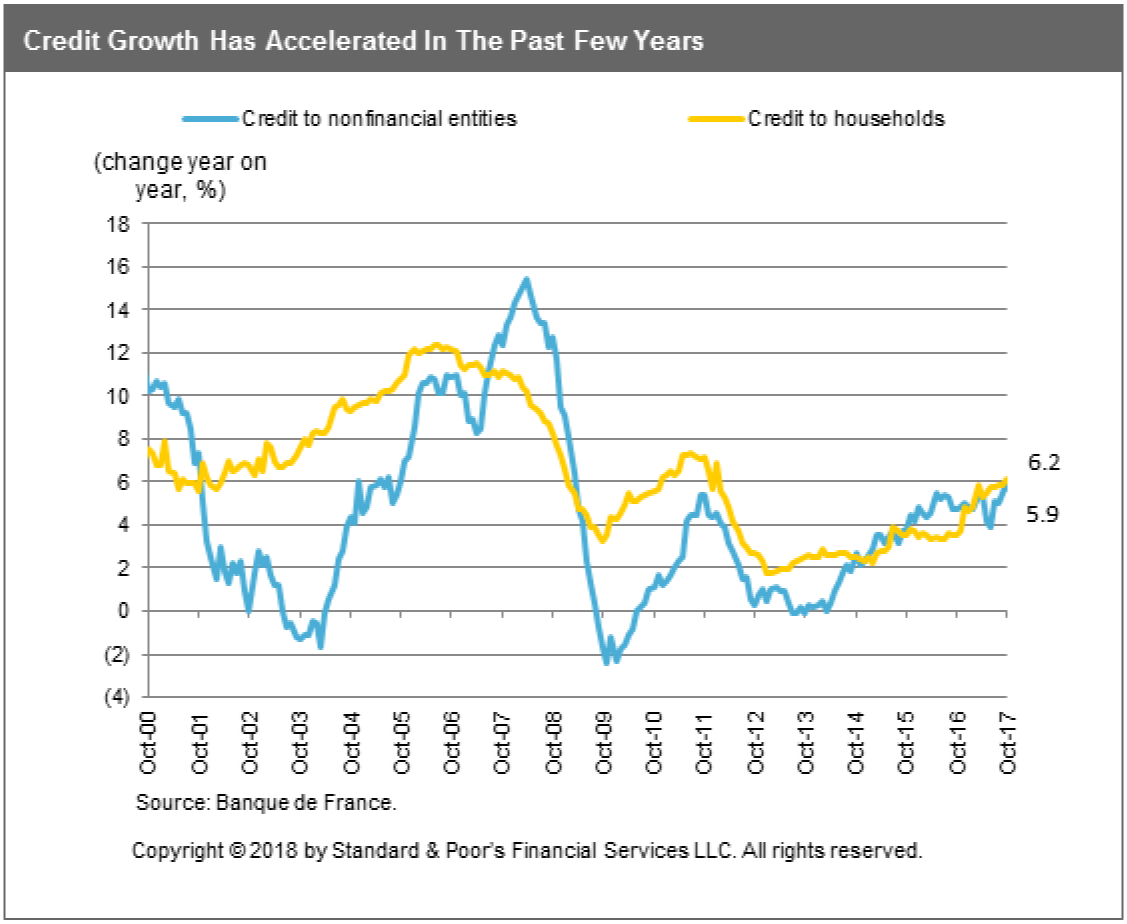


Chart 6.1

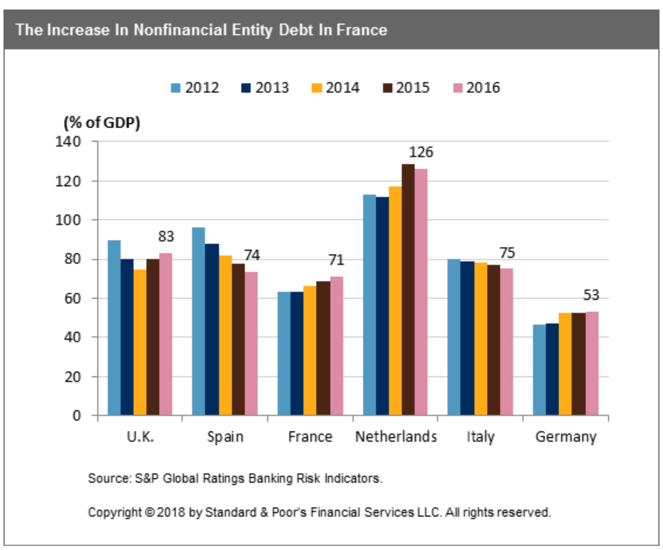
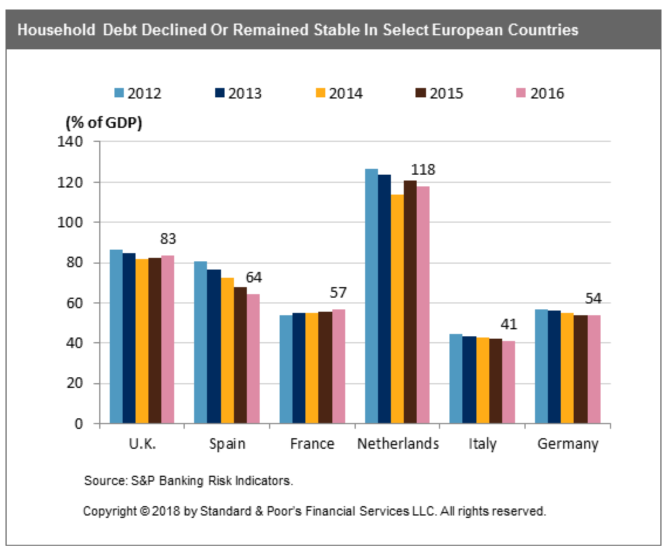


Chart 6.2

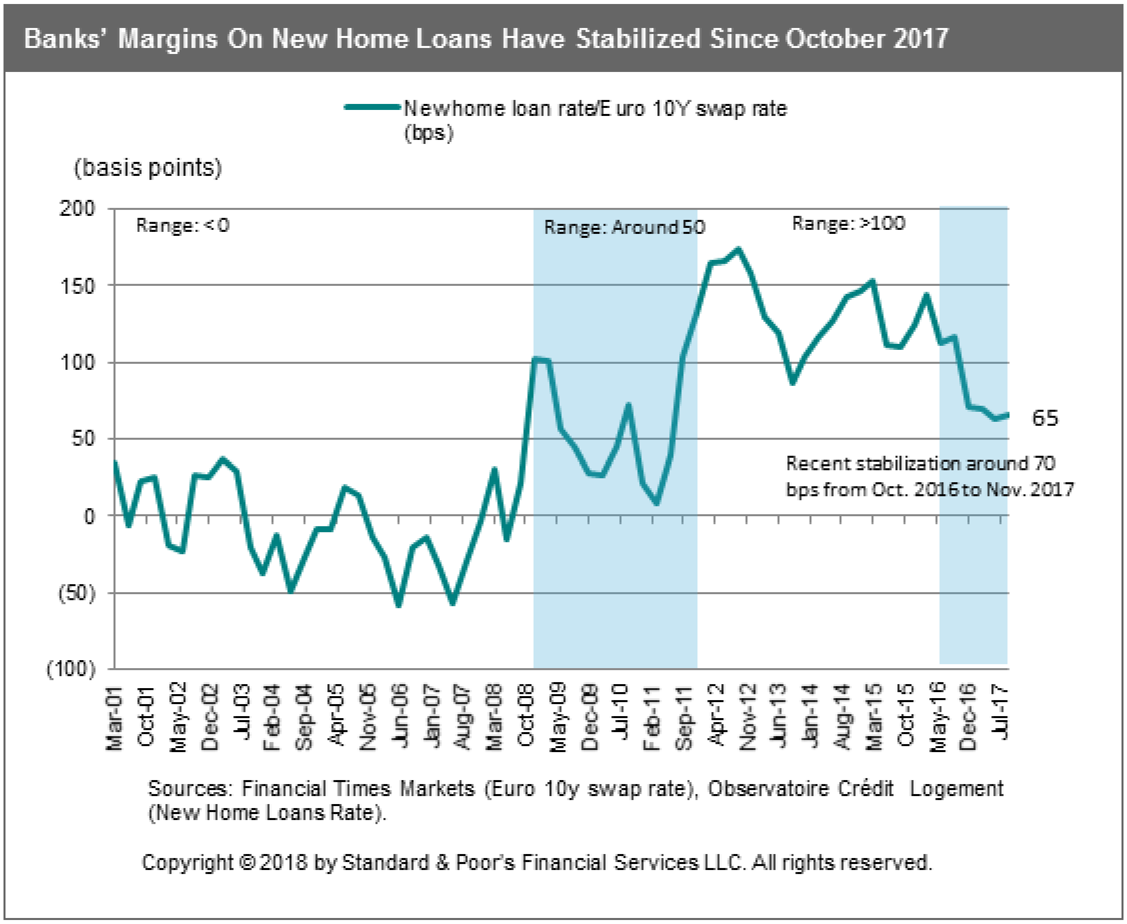


NIMs Will Unlikely Turn Upward In 2018

We do not expect a swift turnaround of French banks' NIMs on domestic retail activities in 2018. Stiff price competition among banks will definitely continue in 2018 as they continue to try to counter the effect of low interest rates on margins by pushing for bigger volumes. Illustrating the highly consolidated nature of the French market, engaged in fierce price competition to grow credit volumes, is the narrowing spread between interest on residential loans when the loan is granted by the bank and the 10-year interest swap rate. We use this index as a proxy for the cost of funding (without aiming at determining the NIM of French banks on residential loans), which illustrates how pricing conditions have evolved over the years (see chart 7).

What we see is that from below zero before mid-2008, the spread differential improved to above 100 basis points until mid-2016, then decreased to 70-80 basis points where it has more or less stabilized. We believe therefore that although banks' growth of residential loans outstanding has been robust, it has been insufficient to offset the reduction of net interest income from domestic operations, specifically a lower reinvestment of deposits and mortgage renegotiations in 2017. Therefore, we do not expect the pressure on French retail banking revenues to disappear immediately in 2018. We expect a stabilization of revenues more toward the end of 2018. If rates increase, the cost of funding in fixed-rate deposit bank markets like France or Germany would suddenly turn higher than the rate of return on the loan portfolio, which takes longer to reprice. Meanwhile, in markets like the U.K. or Italy, where there are more floating-rate banking models, there exists a significant risk of increasing borrower defaults as a result of higher interest payments. In France, the "fixed rate until maturity" nature of the residential loan product protects borrowers from higher payment shocks in case of a sudden rise in interest rates. But it also requires banks to manage the risk linked with interest rate movements as part of their asset-liability management as well as to cope with the impact on the NIM on their loan book.

Chart 7



Growing revenues in other activities such as insurance has been an area of success for French bancassurers, in particular in home and car insurance. Nevertheless, in 2018 and beyond, another insurance revenue stream could be at risk. With French regulatory changes to the creditors' insurance, bancassurers could see the contribution of one of their most profitable business lines shrinking (see "Creditor Insurance Policies: The End Of Easy Money For French Bancassurers," published on Jan. 22, 2018).

Investment banking activities suffered in 2017 from low volatility, which typically drives market-derived revenues. Operating conditions are, we believe, still difficult to predict. Business models have switched to less risky products and services as well as more transactional activities, involving fewer market activities. We expect in turn a less profitable business than in the past, but more stable revenues in the long run.

Competition And Efficiency: The Push And Pull On Costs

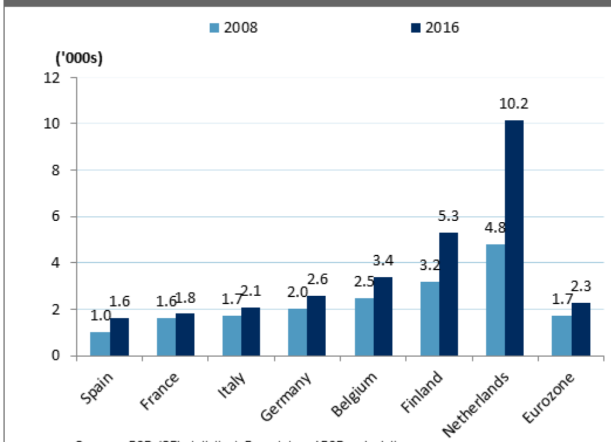
Large investments in digital capabilities and efforts to improve efficiency metrics will remain a key theme for French banks. In fact, the latest strategic plans unveiled in November 2017 by BPCE and Société Générale both emphasize a radically changing competitive landscape and the need for banks to adapt to new technologies—and these plans are very much like those published by BNP Paribas and Credit Agricole earlier. Indeed, we see greater competition from new entrants and technologies, especially on price, and ease of use for customers. This competition is likely to put continuous pressure on traditional bank fees earned on payment services, for example, limiting revenue growth in domestic retail activities.

French banks haven't been at the European forefront in the shift away from branch banking as customer needs have changed (see chart 8). They have reduced the number of agencies, but at a much slower pace than in other European markets. Reducing staff remains a challenge for banks but may be inevitable as they digitalize. The number of French banks employees declined 0.35% in 2016 to 370,300 after falling by 0.6% in 2015, according to the French Banking Association. Reflecting these challenges, the cost-to-income ratios of French banks remain higher than the average of the top 50 European banks that we rate, and is likely to stay there as banks make investments into creating digital products and services for customers (see chart 9).

We have no doubt that over the next few years French banks will leverage technology, including big data and artificial intelligence, to simplify processes and products. For the time being, customers have remained loyal to traditional banks, which have kept close watch over the financial needs of their clients. The effect of the Macron Law last year on banking mobility, where banks are now required to take care of all the formalities for clients who are switching banks, has not resulted in substantial switchovers, illustrating for the time being the faithfulness of the client base to their banks--at least until new offerings and services start to test their loyalty.

Chart 8

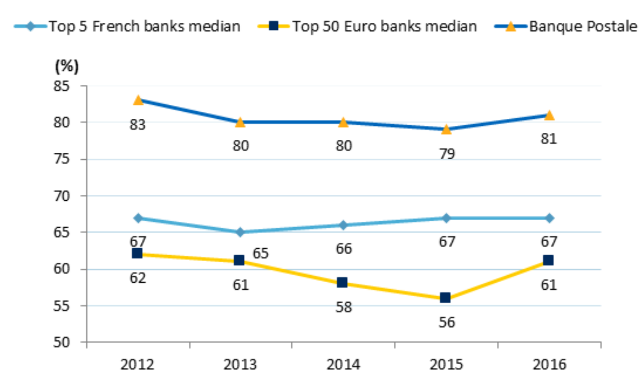
France Still Has A Substantial Number Of Bank Branches



Sources: ECB (SFI statistics), Eurostat, and ECB calculations.

Chart 9

French Banks' Cost-To-Income Ratios Remain Higher Than Top 50 European Banks



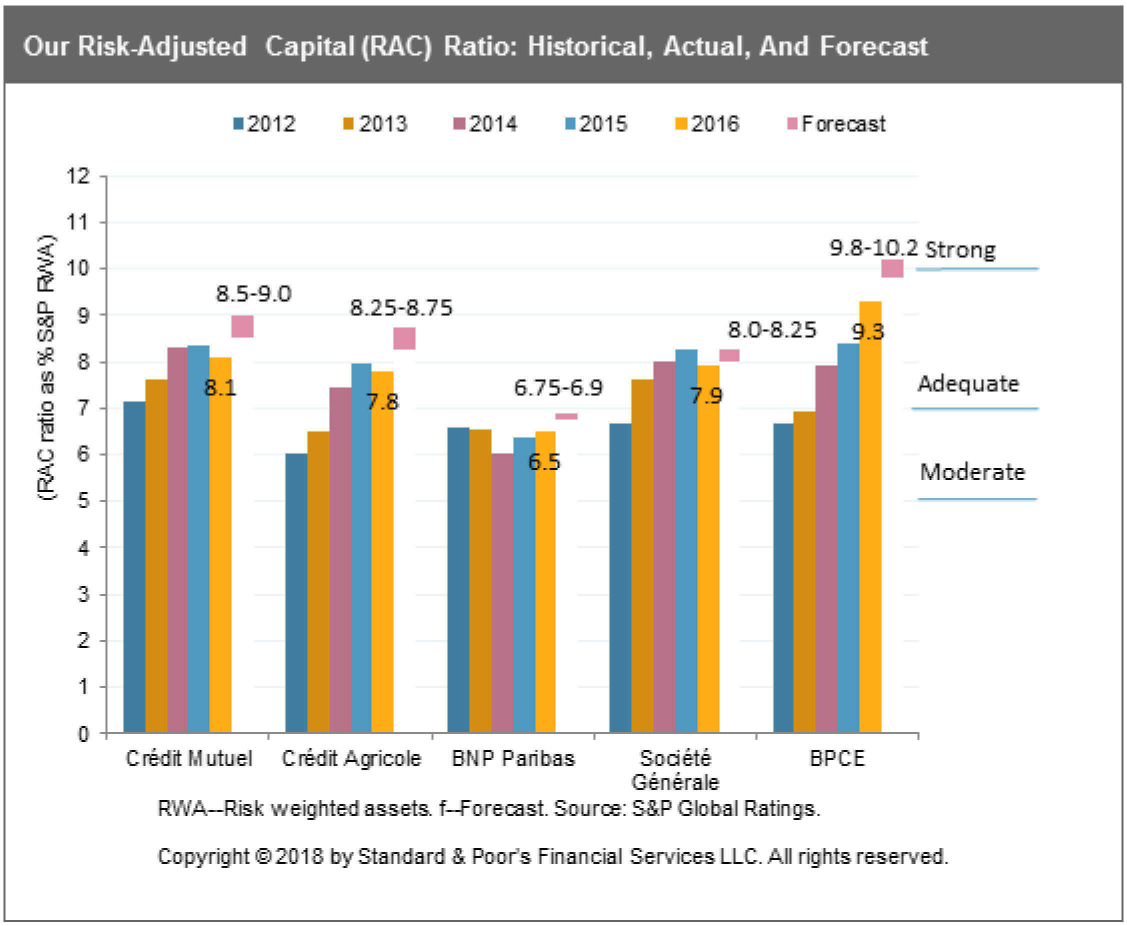
Sources: Banks' financial statements, S&P Global Ratings calculations.

Capital: Ratios For Large French Banks Have Diverged

French banks remain adequately capitalized in a European context, in line with their counterparts in Belgium and Austria. However, their risk-adjusted capital (RAC) ratios that we calculate according to our methodology fall short compared with peers in Scandinavia, the U.K., Switzerland, and the Netherlands.

Capitalization at French banks is weighed down by their relatively large insurance exposures, owing to their universal banking model that integrates insurance activities. Our treatment of insurance subsidiaries under the RAC methodology is less favorable than under Basel III's so-called "Danish compromise." French banks' regulatory risk-weighted investments in insurance subsidiaries stand at a favorable 370%, versus the deduction from our capital measure that we apply under our RAC framework, which is akin a 1250% risk weight. Most large French banks still have some way to go before we would consider their capital strong enough to warrant an upgrade. What's notable is that large French banks' RAC trajectories have already significantly diverged (see chart 10). In particular, since 2012, BPCE has increased its capitalization more significantly than peers. For details about our RAC calculations and trends for French banks see "Does French Banks' Capital Buildup Stop Here?" published on Jan. 18, 2018.

Chart 10



Today, our combined capital and risk assessment is neutral for most large French. We do not expect the first-time application of IFRS9 to reveal issues that we have not identified so far--such as previously unidentified material weaknesses in provisioning policies. That said, the impact from first-time application could reduce our key measure of capital, total adjusted capital (TAC), the numerator in our risk-adjusted capital (RAC) ratio. Possible subsequent changes in provisioning needs could also alter our measure of capital along the credit risk cycle. That said, we do not expect a rating impact where the application of IFRS 9 does not reveal additional fragilities that we haven't identified so far, such as previously unidentified material weaknesses in provisioning policies. All else being equal, we may not change our view about our combined capital and earnings assessment, which measures the bank's ability to absorb losses relative to our risk position assessment.

As for ALAC, we expect our end-2017 metrics to show more evidence of progress, compared with end-2016 levels, based upon strong levels of ALAC-eligible issuance during 2017. We assume that such issuance will remain strong in 2018.

Table 1

Additional Loss-Absorbing Capacity

	No. of notches	(%)	
	ALAC	ALAC ratio, Dec. 31, 2016	Threshold for 1 notch
Crédit Mutuel	0 (*)	2.9	5.00
Crédit Agricole	1	3.4	4.75
BNP Paribas	0	2.8	5.25
Société Générale	1	4.0	5.00
BPCE	1	5.7	5.00

*Transitional notch toward 1 notch of ALAC uplift. Source: S&P Global Ratings.

Leveraging Technology Where Necessary

While 2017 saw strong momentum overall for large French banks' commercial activities, lower net interest income from domestic retail activities hit full-year results. Domestic retail revenues have been penalized by the low interest rate environment and the wave of residential loan renegotiations. In 2018, large banks are facing an economic and financial environment that should gradually become more favorable. At the same time, they are embarking on significant investment plans to adopt digital technologies. We believe the journey for efficiency gains is not over as French banks accelerate their digital transformation and offerings to clients as they start to face potential new entrants, particularly the so-called fintechs. Faced with rapid customer adoption of digital interfaces with their banks, we see French banks, like their European peers, leveraging technology where necessary to fundamentally reengineer their operations and adapt to the digital era.

We do not anticipate any large or transformational pan-European merger or acquisition by any of the large French banks. One of the main reasons is that it could distract management as they executive digital strategies. Nevertheless, we believe appetite for organic growth may gradually increase now that Basel rules are clearer.

Related Research

- Creditor Insurance Policies: The End Of Easy Money For French Bancassurers, Jan. 22, 2018
- Does French Banks' Capital Buildup Stop Here? Jan. 18, 2018
- The Basel Capital Compromise For Banks: Less Impact Than Meets The Eye, Dec. 8, 2017