Large French Banks' Profitability Is Unlikely To Strengthen Significantly In 2019

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Key Takeaways

- We expect the economic environment to remain relatively supportive for French banks in 2019, although it is likely to be less benign than in 2017 and 2018.
- Extreme volatility in the capital markets may reoccur in 2019 due to political and external risks. This could weaken the performance of the sizable investment banking businesses of some large French banks.
- Market volatility is one reason why we expect French banks' profitability to remain under pressure in 2019.
- Other factors are still-low interest rates, intense competition in domestic retail banking, banks' below-average cost efficiency, and likely rising credit losses in 2019.
- Nevertheless, large French banks are well placed to face with this tougher environment and rising pockets of risk. The banks' balance sheets are increasingly robust and their asset quality is sound.

The economic environment should remain supportive of the French banking industry in 2019, although less so than in 2017 and 2018, with little scope for banks' profitability to improve significantly. In addition, the extreme volatility that characterized the capital markets in the fourth quarter of 2018 could reoccur and weaken the sizable investment banking businesses of some large French banks.

Market volatility will maintain the pressure on French banks' profitability in 2019, along with persistently low interest rates and intense competition in domestic retail banking. Banks' below-average cost efficiency and a likely rise in credit losses will also contribute to the pressure.

Nevertheless, S&P Global Ratings believes that, overall, large French banks are in a good position to face the tougher environment and rising risks. Banks' balance sheets are increasingly robust, and they have improved capital and liquidity. Diversification in credit exposure and a measured risk appetite have resulted in sound asset quality, with the cost of risk now at historical, albeit unsustainable, lows.

Overall, we expect our ratings on French banks to remain largely unchanged in 2019. Where there are positive rating actions, we expect them to result from stronger external support from a parent or a build-up of bail-inable debt, rather than from improvements in stand-alone credit profiles (SACPs). Downward rating pressure could arise for banks whose managements fail to address a structural erosion of profitability. Pressure could also arise if banks fail to offset the additional cost of liabilities (including senior nonpreferred debt), ultimately harming their internal capital generation.

Solid Balance Sheets Will Help Banks Withstand Potential Market Turbulence

We see some negative market sentiment toward the European banking sector, including large French banks, continuing in 2019, especially from an equity perspective. Price-to-book ratios (see chart 1) are low for the European banking sector as a whole, but French banks look unloved by equity investors.

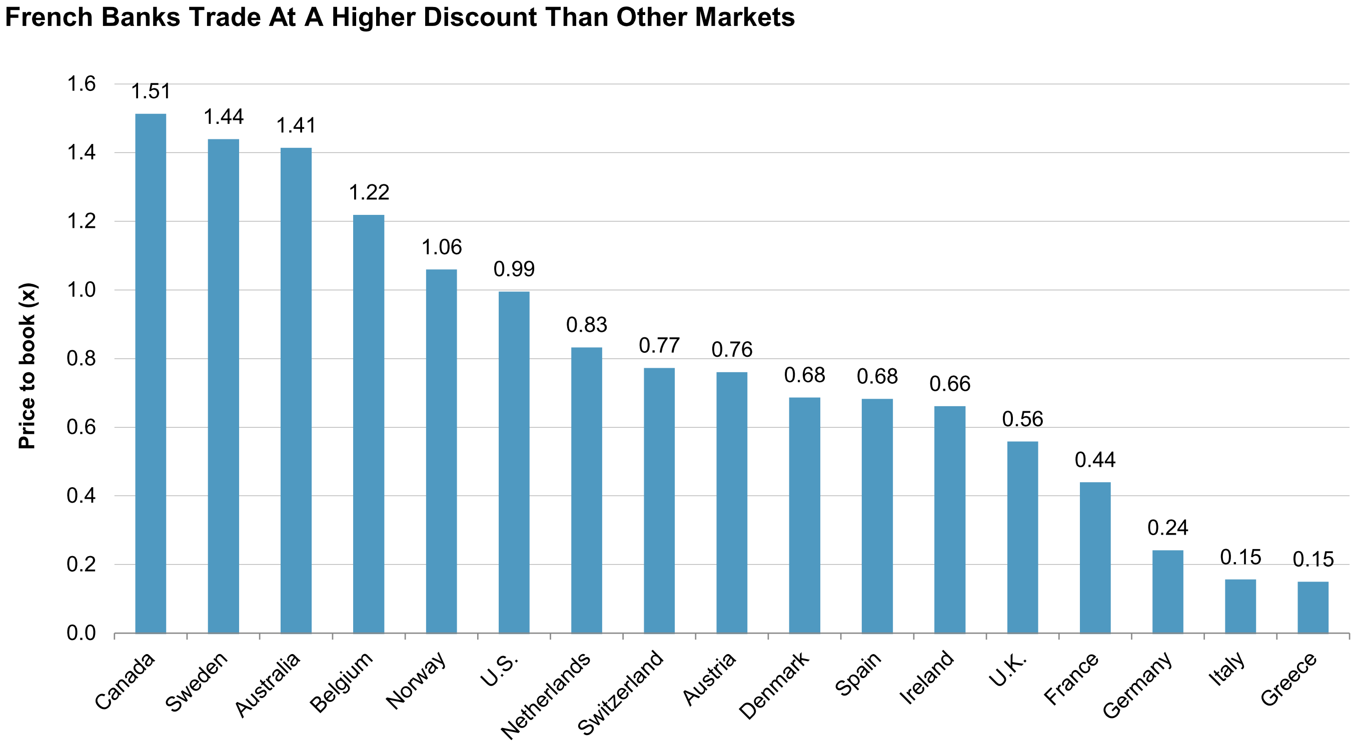
Such aversion from the equity markets seems to derive partly from equity investors' concerns about French banks' future profitability, particularly their capacity to improve cost efficiency.

The long-term impact of banking capital regulations is still hard to assess, but the implementation phase that will run from 2022 to 2027 is long enough to allow for business model adaptation.

The diversification of French banks' activities by geography and business is a clear strength, especially for the four globally systemically important banks--BNP Paribas (BNPP), Société Générale, Crédit Agricole S.A., and BPCE. However, this diversification also exposes French banks to several pockets of risk that from time to time raise market concerns and result in litigation, fines, revenue volatility, or impairments in riskier markets--such as Italy for BNPP and Crédit Agricole, Turkey for BNPP, and Russia and Romania for Société Générale.

Moreover, disruption risks, particularly for tech banking companies, and potentially tech banking titans in the future, put some structural pressure on revenues. At the same time, the information technology banking sector's investment and staff training needs are high in order to strengthen the banks' business models.

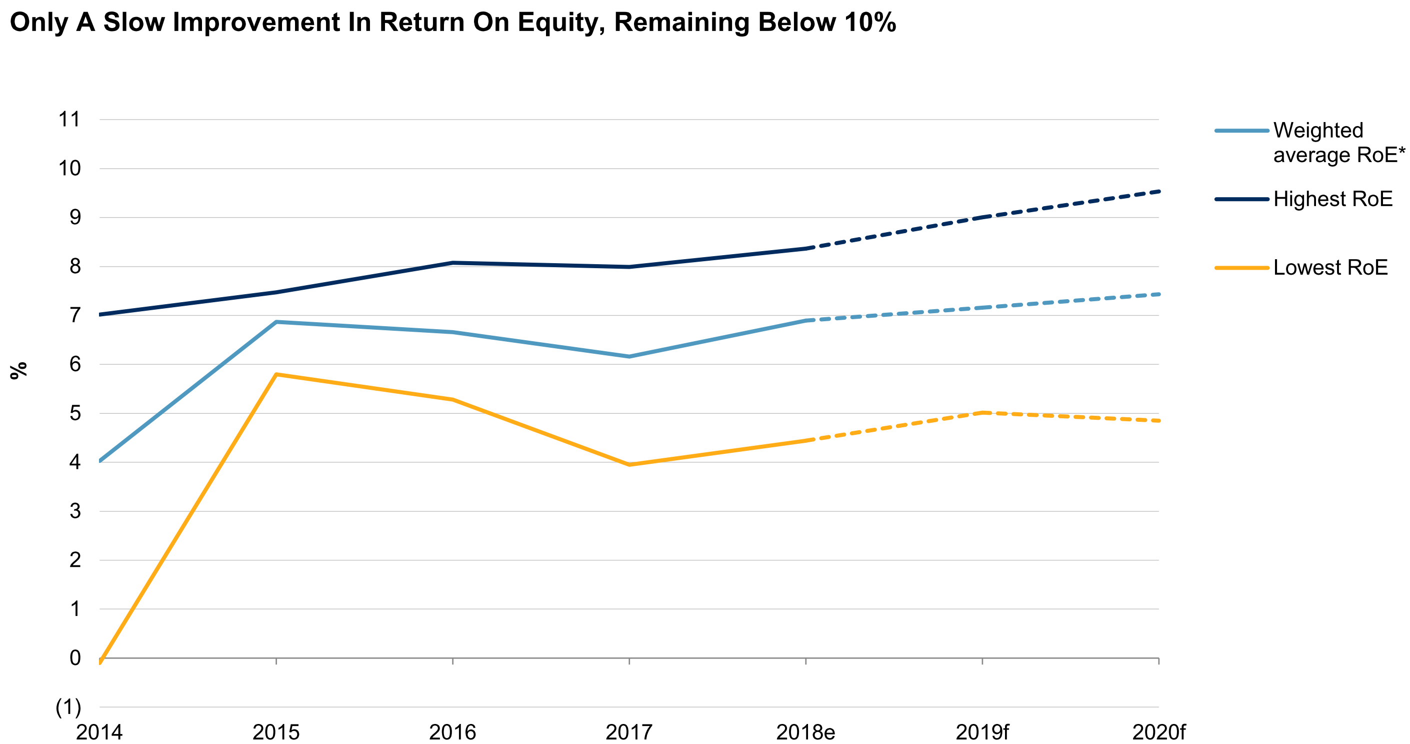
Chart 1



Data covers European top 50 banks (where available), plus selected U.S., Canadian, and Australian major banks for comparison purposes.
Data as of Jan. 4, 2019. Source: S&P Global Ratings, Capital IQ.

French banks' balance sheets have become more resilient to, although not immune from, risks, but return on equity (RoE) is far below the level before the financial crisis of 2008-2009, and below listed banks' target of 10%. We expect only slow improvements in the short term, if any. The depressed equity valuations of listed banks and difficulties in improving RoE could cause shareholders to start asking questions of the listed banks' management. Listed French banks have diverse owners, and so far, we have not observed any tension between managements and large shareholders about banks' strategy or a need to adjust their strategic plans more materially. However, we cannot completely rule out risks related to more activist shareholders should equity valuations remain low, especially in a peer bank context.

Chart 2



e--Estimate. f--Forecast. RoE--Return on equity. *Weighted by total assets for five banks (BNP Paribas, Société Générale, Groupe Crédit Mutuel, Groupe Crédit Agricole, and BPCE). Source: S&P Global Ratings database and definitions.

The Economy Remains Supportive

The French economy is set to grow by about 1.6% in the next two years, supported by a favorable domestic backdrop. Consumers will benefit from tax cuts, lower inflation on the back of weaker energy prices, and further acceleration in wage growth as the labor market tightens further.

Nevertheless, we see the main risks as coming from heightened market turbulence caused by geopolitical events and the political agenda. For a start, if trade tensions reappear--particularly with the U.S. and other parts of the world--this could translate into a worsening of the external outlook and weigh on economic growth. Faster monetary policy tightening would also hurt financial conditions in France, especially as large French multinationals have relied increasingly on corporate debt in recent years. Finally, prolonged social unrest will likely slow the reform agenda and thus stymie France's potential growth.

Table 1

S&P Global Ratings Economic Outlook For France

%	2016	2017	2018e	2019e	2020e	2021e
Real GDP growth	1.1	2.3	1.6	1.6	1.6	1.5

Table 1

S&P Global Ratings Economic Outlook For France (cont.)

%	2016	2017	2018e	2019e	2020e	2021e
CPI inflation	0.3	1.2	2.0	1.5	1.5	1.7
Unemployment rate	10.1	9.4	9.2	8.9	8.7	8.5
Short-term interest rate	0.0	0.0	0.0	0.1	0.5	1.0
Long-term interest rate	0.5	0.8	0.8	1.1	1.7	2.3
Nominal house prices	1.6	3.3	2.7	2.0	2.0	2.0

Source: Oxford Economics, S&P Global Ratings. CPI--Consumer price index. e--Estimate.

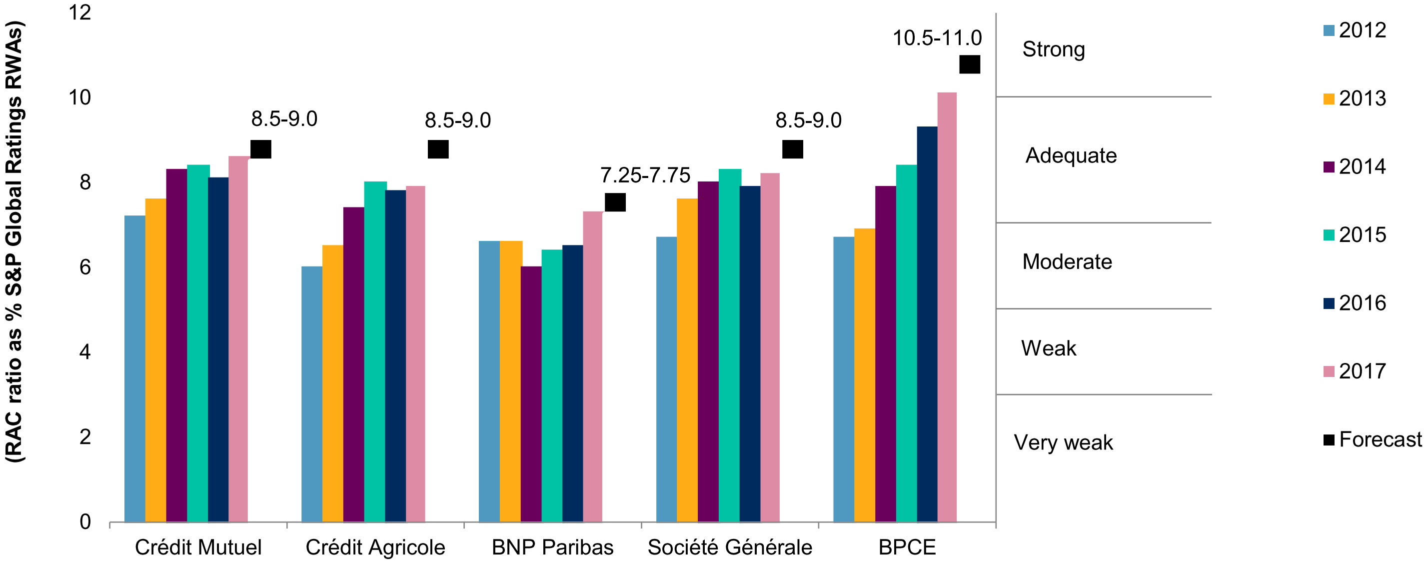
Large Banks' Capital Ratios Are Diverging

We expect French banks' capital levels to increase more slowly in 2019 and 2020 than in previous years. Banks will strengthen their capital bases mainly through retained earnings. Depressed share prices bring about a risk of an increase in listed banks' dividend payouts, which we will monitor in 2019. We also expect growth in risk-weighted assets (RWAs) to remain robust on the back of dynamic financing--loans and credit--to French households and corporates and a significant increase in market RWAs in times of volatility.

Notably, large French banks' risk-adjusted capital (RAC) trajectories have already diverged significantly (see chart 3). In particular, since 2012, BPCE has increased its capitalization more significantly than its peers have. BPCE is the only French bank for which we view capital and earnings as a rating strength. We expect the other banks' RAC levels to remain in the 7.5%-9.0% range, broadly consistent with our current assessment of their capital and earnings as neutral to the ratings.

Chart 3

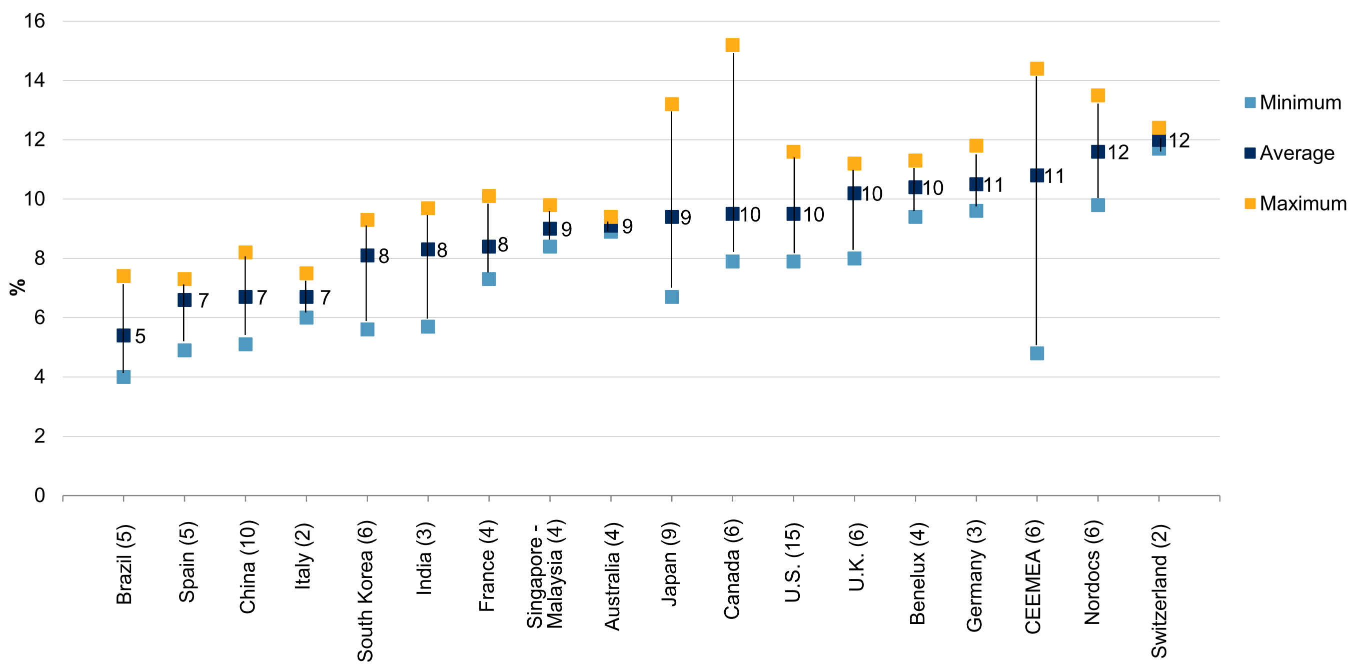
Our Risk-Adjusted Capital Ratio: Historical, Actual, And Forecast



RAC--Risk-adjusted capital. RWAs--Risk weighted assets. Source: S&P Global Ratings.

Chart 4

2017 RAC Ratios For The World's Top 100 Rated Banks, By Country



Numbers in brackets represent the number of banks in that country/region in the sample. RAC--Risk-adjusted capital. Source: S&P Global Ratings.

French banks remain adequately capitalized in a European context, more or less in line with their counterparts in Belgium or Austria. However, their RAC ratios (calculated according to our methodology) are lower than those of their peers in Scandinavia, the U.K., Switzerland, and the Netherlands. French banks' relatively large insurance exposures weigh down their capitalization, owing to their universal banking model that integrates insurance activities and, in some cases, large market activities.

The Private Sector's Indebtedness Continues To Rise

Contrary to trends in the other major euro area countries, there has been no lasting reduction in the ratio of private sector debt to GDP in France since the financial crisis of 2008-2009. Banks have welcomed credit volume as it has helped them to offset margin compression, but this is now likely to stabilize, at least for household credit. That said, credit growth in 2019 is likely to continue to outpace French economic growth, partly as financing conditions remain very attractive.

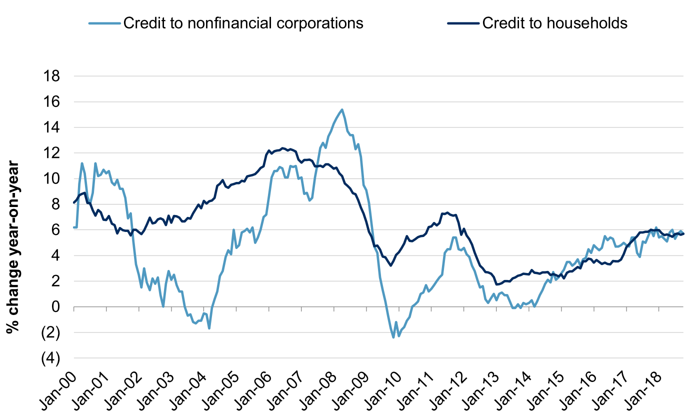
The total debt of nonfinancial corporations (NFCs) amounted to €1.6 trillion in October 2018, up 5.6% year-on-year. This debt comprises €653 billion of debt securities issued on the financial markets and €1,004 billion in loans from French banks. The robust growth in bank lending to NFCs is irrespective of the NFCs' size. Since the middle of 2014, bank credit to the NFCs has grown by between 4% and 6% per year, a much higher rate than French GDP, and is not sustainable over time. However, we do not see a risk of a credit bubble. Indeed, the low interest rates have prompted some NFCs to accumulate cash as a precaution and pursue more foreign investment, taking advantage of a brighter macroeconomic environment abroad, and these factors partly offset the risk of higher debt.

NCFs also continue to benefit from favorable conditions, and the costs of bank credit and bond financing have converged (see chart 6). In our view, this is not the result of an aggressive decline in the cost of bank credit--which is already historically low--but more a rise in the rate at which companies are financing themselves on the markets. Uncertainties in the economic outlook, a possible turn in the credit cycle, and investors anticipating the end of the European Central Bank's accommodative policy, have led to higher bond margins. We note that a similar shift has not yet happened in bank credit, but such a repricing is likely to happen at some stage. If this does not happen, it could signify that banks are mispricing risks.

Corporate indebtedness continues to attract the attention of the French regulators, who, for the first time in 2018, introduced a countercyclical buffer for banks on French corporate lending (25 basis points from June 2019). The regulators are also paying more attention to leveraged finance, although outstanding amounts remain limited on banks' balance sheets. Banque de France estimated the amount at €128 billion at the end of June 2018 for the large French banks, equating to between 7% and 12% of their corporate exposures. At the same time, individual banks' exposures to these highly leveraged corporates are typically much lower after syndication.

Chart 5

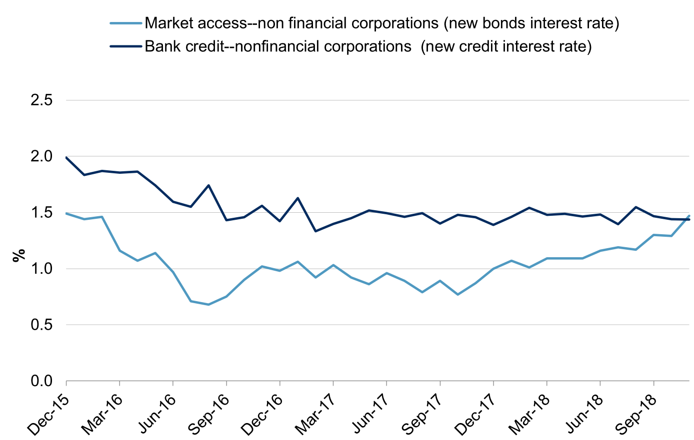
Credit Growth In France Has Remained Robust



Source: Banque de France.

Chart 6

Bank Credit Is Now On A Par With Market Funding



Source: Banque de France.

The Cost of Risk Will Increase From A Low Level

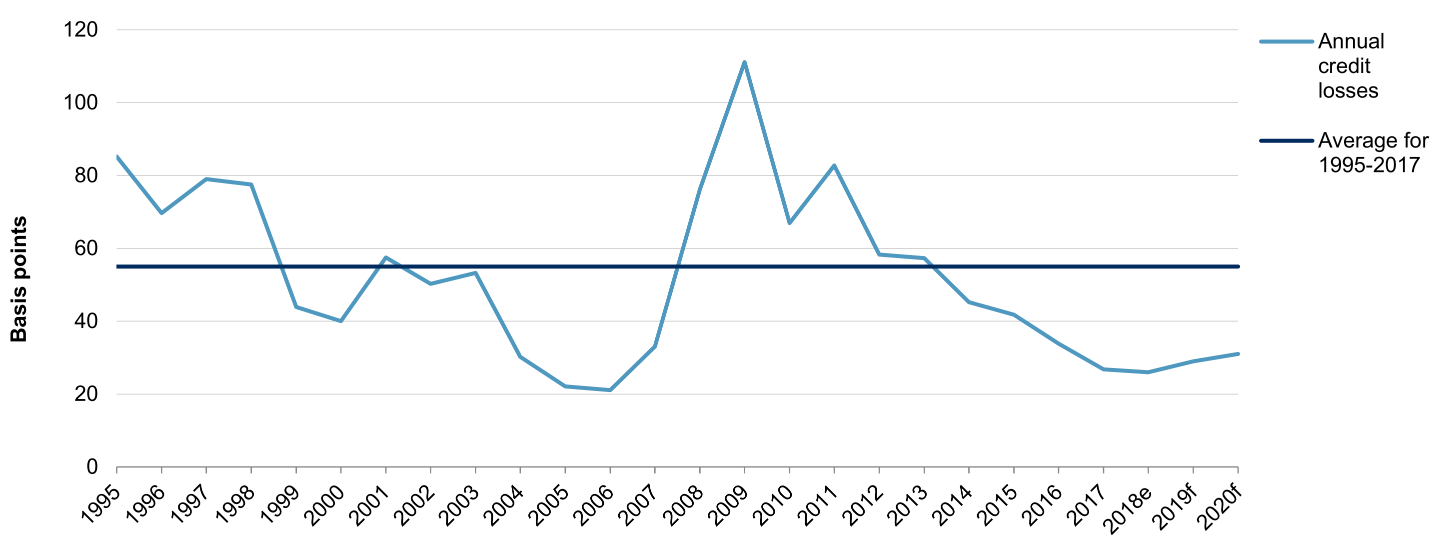
Large French banks continue to exhibit good asset quality overall in their domestic operations and most of their international operations. In fact, the cost of risk may have reached historical and unsustainable lows in 2018, and we expect it to increase slightly this year (see chart 7). The domestic cost of risk could rise modestly in consumer finance business or small-to-midsize enterprise exposures, and more rapidly if economic growth decelerates more drastically and unemployment grows again.

Large French banks' exposures tend to be well diversified by counterparty and geography. Nevertheless, given their international dimension, large French banks have exposures in more vulnerable banking sectors or jurisdictions. BNPP and Crédit Agricole have exposure to Italy, which for both banks represents less than 10% of consolidated exposures. Furthermore, BNPP runs operations in Turkey, and Société Générale in Russia and Romania, which are riskier areas, but small in the group context.

Finally, we believe that other, noncredit-related risks, such as misconduct or cyber risk, will continue to attract greater scrutiny and result in additional costs due to the need to invest in compliance and information technology (IT), including cybersecurity. Société Générale made significant progress in the settlement of legal disputes in 2018. It is difficult for us to estimate large banks' future litigation costs, but we believe that misconduct or litigation risk will continue to loom over large banks in coming years. We see heightened risk in commercial internal and trading activities, nor do we believe that retail activities are necessarily immune from such risk.

Chart 7

Credit Losses To Average Customer Loans For The Largest French Banking Groups



Data based on customer loans weighted average for BNP Paribas, Crédit Agricole, Société Générale, BPCE (data prior to 2008 are based on Caisse d'Epargne Group and Banque Populaire Group), and Crédit Mutuel (only since 2012). e--Estimate. f--Forecast.

Operating Conditions For Investment Banking Are Difficult To Predict

Corporate and investment banking continues to be subject to structural headwinds, with higher capital requirements allocated to these activities. In January 2019, the Basel Committee on Banking Supervision's oversight body, the Group of Central Bank Governors and Heads of Supervision, endorsed a set of revisions to the market risk framework. The revisions would result in a weighted average increase of about 22% in total market risk capital requirements versus the Basel 2.5 framework, according to the Basel Committee's impact analysis. By contrast, before these revisions, the weighted average increase was an estimated 40%. While the revision is less than initially planned, higher capital requirements will weigh negatively on banks' profitability prospects.

French banks' global market business models have switched to less risky products and services and more transactional business involving fewer secondary market activities and less profitable business than in the past. There have been recent rumors in the press that BNPP and Société Générale are considering closing their proprietary trading activities, which have become less attractive for management and less desirable to allocate capital to.

More importantly from a revenue perspective, the prospects for market activities have been difficult and uncertain, as the equity markets fell abruptly. Market volatility bounced from a historical low to multi-year highs in 2018. Such turbulent markets have led to an increase in the risk of one-off trading losses for global banks. In recent weeks, Natixis S.A. reported $290 million in losses linked to Asian equity derivatives, while the press has reported that BNPP is subject to an $80 million loss in derivative trades connected to its trading desk in the U.S.

These one-off losses raise questions about banks' risk management, but also highlight the difficulties in modeling the risks of certain products--under extreme market conditions--that banks sell to investors. Overall, we consider that global market activities represent higher-risk segments for a bank. Business models involving a sizable share of capital market activities expose the bank's consolidated revenue to market volatility.

Société Générale announced recently that its performance in the fourth quarter of 2018, and hence its full-year 2018 results, will be affected by the challenging conditions in the global capital markets (see our bulletin titled "Volatile Market Conditions Weigh On Societe Generale's Financial Performance," published Jan. 22, 2019). Therefore, managements, especially those of BNPP and Société Générale, will have to find a good balance between the revenues and costs of capital market activities. French banks remain important players in the capital markets in Europe, but are less developed than global Tier 1 banks.

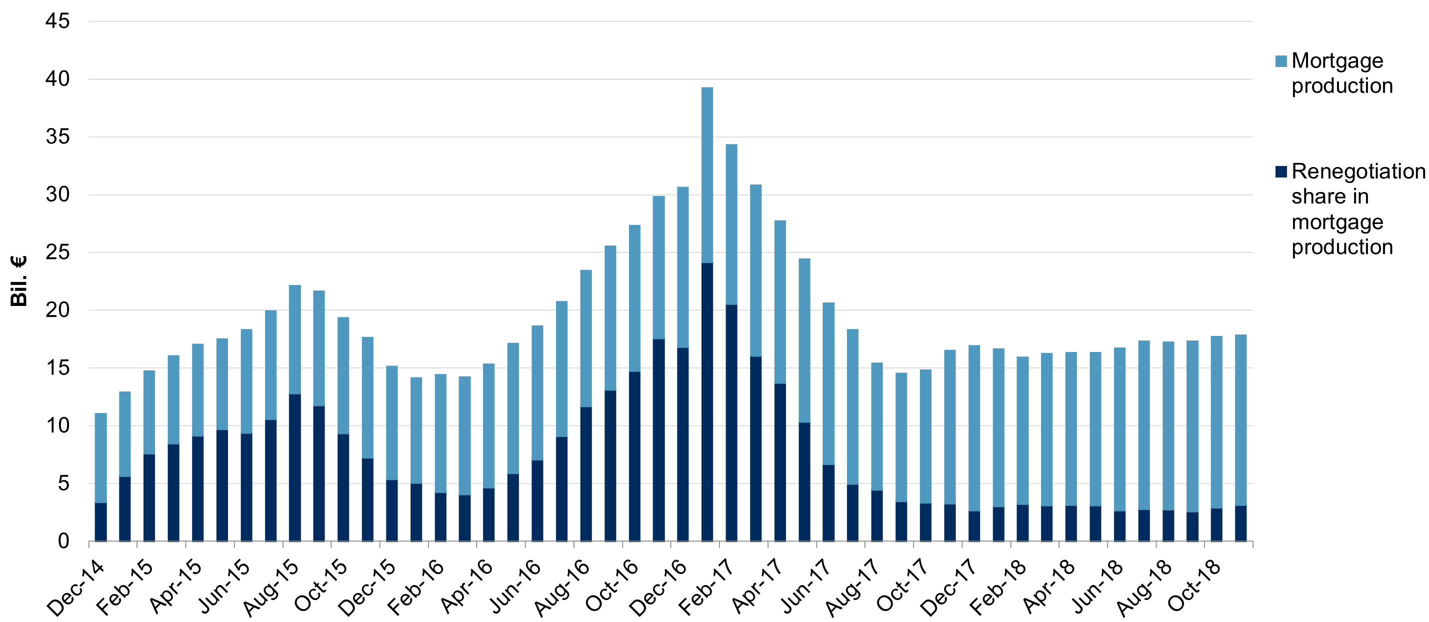
A Modest Rise In Interest Rates Is Unlikely To Boost Profitability

We do not expect a swift turnaround of French banks' net interest margin in 2019, particularly in domestic retail activities. That said, the decline in interest income might end in 2019, supported by dynamic new loan volumes and higher revenues on structural hedges that will emerge, albeit slowly amid rising interest rates, due to the typically long-term nature of hedging programs. The drop in revenues from the wave of residential loan renegotiations of previous years is now behind the banks as renegotiations have ended (see chart 8).

That said, in domestic retail banking, the pressure might well have moved on to commissions, with segments such as asset management facing more adverse conditions or competitive pressure from nonbanks or payment transfer platforms. We also expect more cost pressure from banks' investments in IT or digital capabilities and ongoing staff training in large banks, while material cost reductions will be increasingly difficult to achieve. The key challenge for French banks remains to improve their operating efficiency while investment costs for compliance, IT, and regulation, among others, continue to grow.

Chart 8

The Wave Of Loan Renegotiations Has Ended



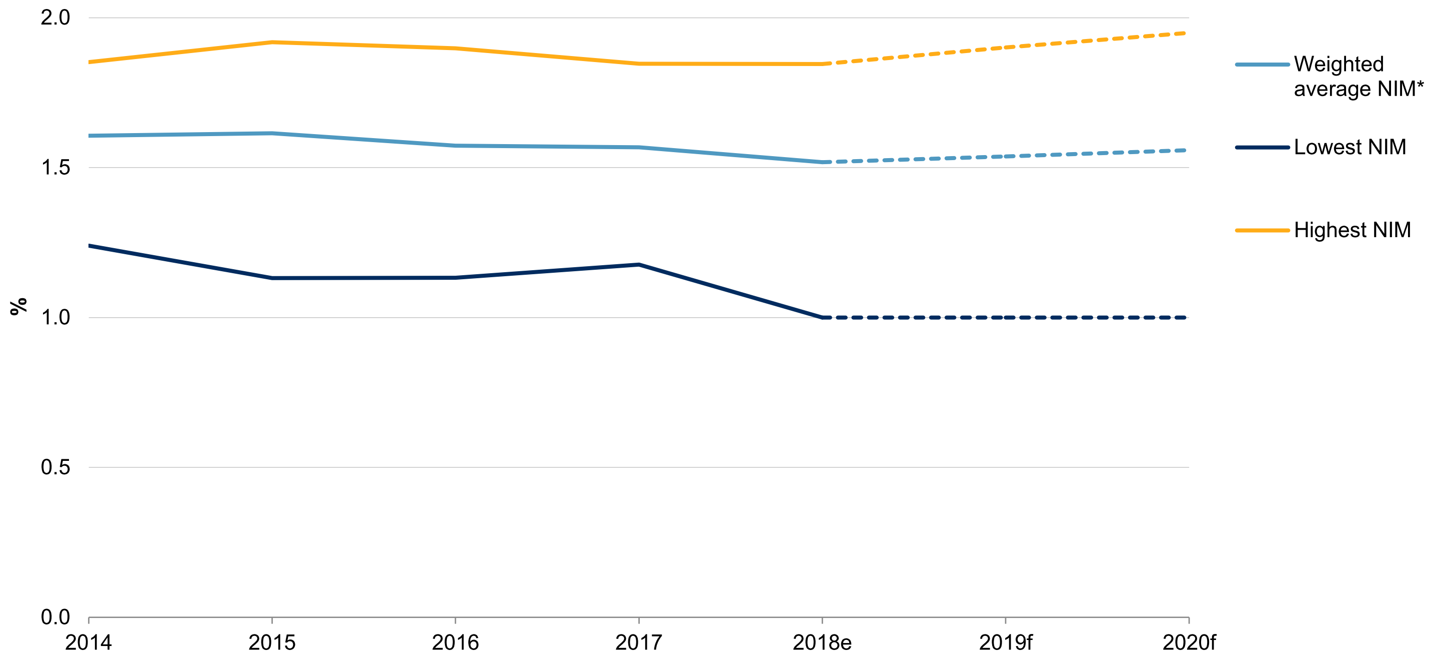
Source: Banque de France.

If interest rates were to rise modestly, they might not immediately fully support banks' margins. The absence of attractive alternative placements for retail investors has accentuated a rapid surge in sight deposits over the past few years, much faster than historical trends. The risk is that depositors will turn once again to remunerated products and longer-dated instruments once interest rates rise. Any rapid flow from sight deposits to more remunerated deposits would counterbalance gains on new loan production. Since, at the same time, depositors could benefit from an easier transfer than in the past, competition in future could be also stronger on deposits.

At the same time, following recent waves of mortgage renegotiations, these residential loans will yield low interest for a long time. This will impede banks' ability to benefit rapidly from steepening yield curves versus other banking systems. French banks rely on their asset-liability management to measure their exposure to and hedge against the interest rate risk resulting from the cost of resources increasing while the interest received from their loan books remains largely frozen.

Chart 9

French Banks' Net Interest Margin

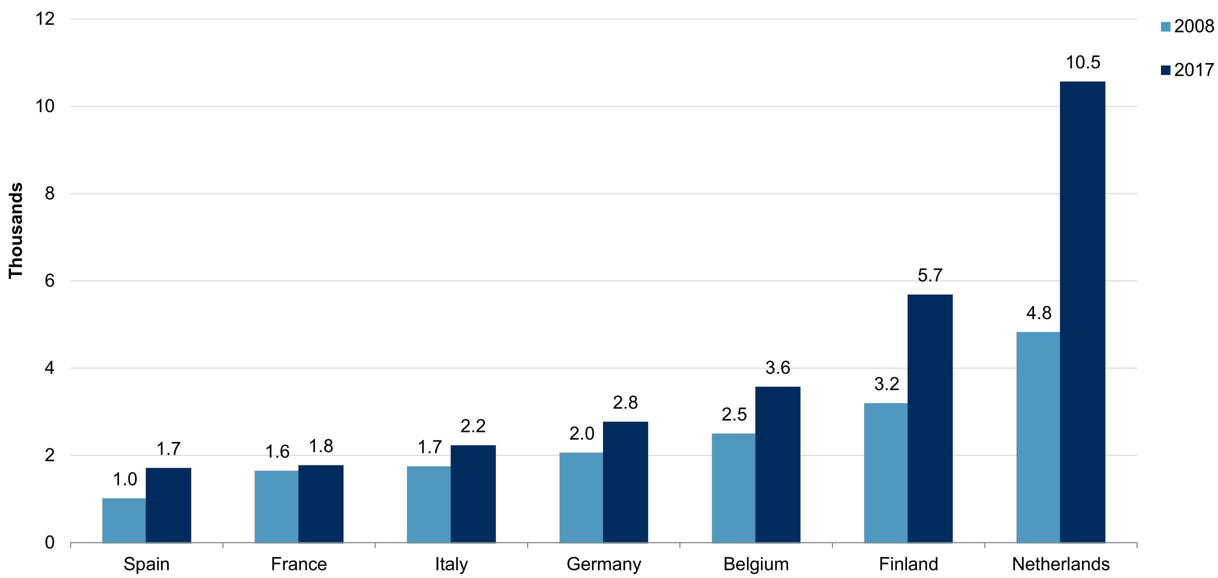


e--Estimate. f--Forecast. NIM--Net interest margin. *By total assets for five banks (BNP Paribas, Société Générale, Groupe Crédit Mutuel, Groupe Crédit Agricole, and BPCE). Source: S&P Global Ratings database and definitions.

French banks have not been at the forefront of the shift away from branch banking as customer requirements have changed (see chart 10). Although French banks may have reduced the number of branches to reduce costs, this is happening at a much slower pace than in other European markets. That said, it has proved difficult to translate these efforts into better efficiency metrics (see chart 11). French banks' cost-to-income ratios remain higher than the average of the top 50 European banks that we rate, and their large investments in digital offerings to customers is maintaining these higher ratios.

Chart 10

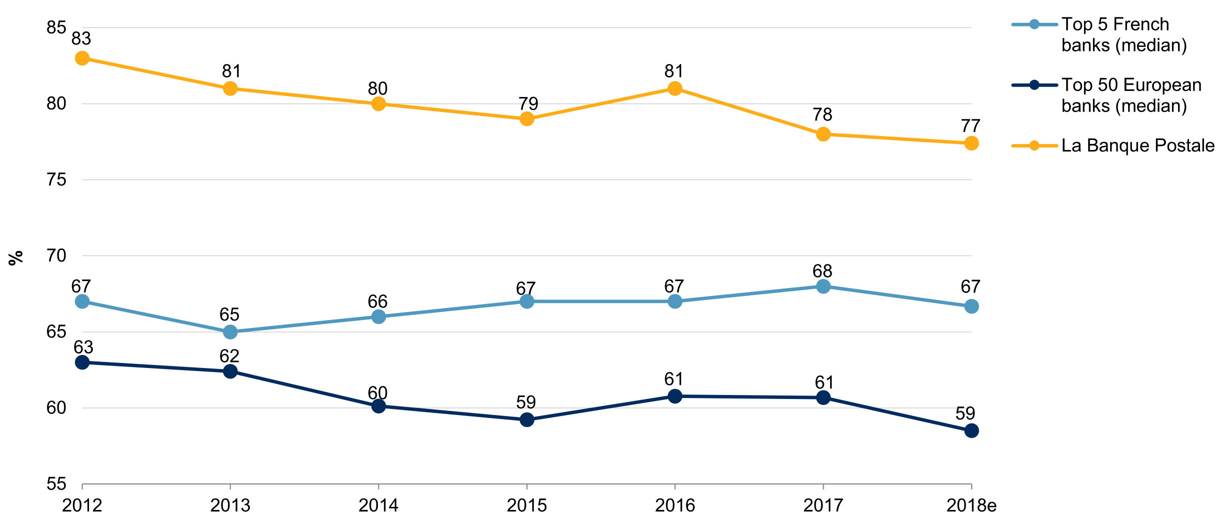
Population Per Local Branch By Country



Sources: European Central Bank (Structural Financial Indicator statistics), Eurostat, and S&P Global Ratings calculations.

Chart 11

French Banks Demonstrate A Higher Cost-To-Income Ratio



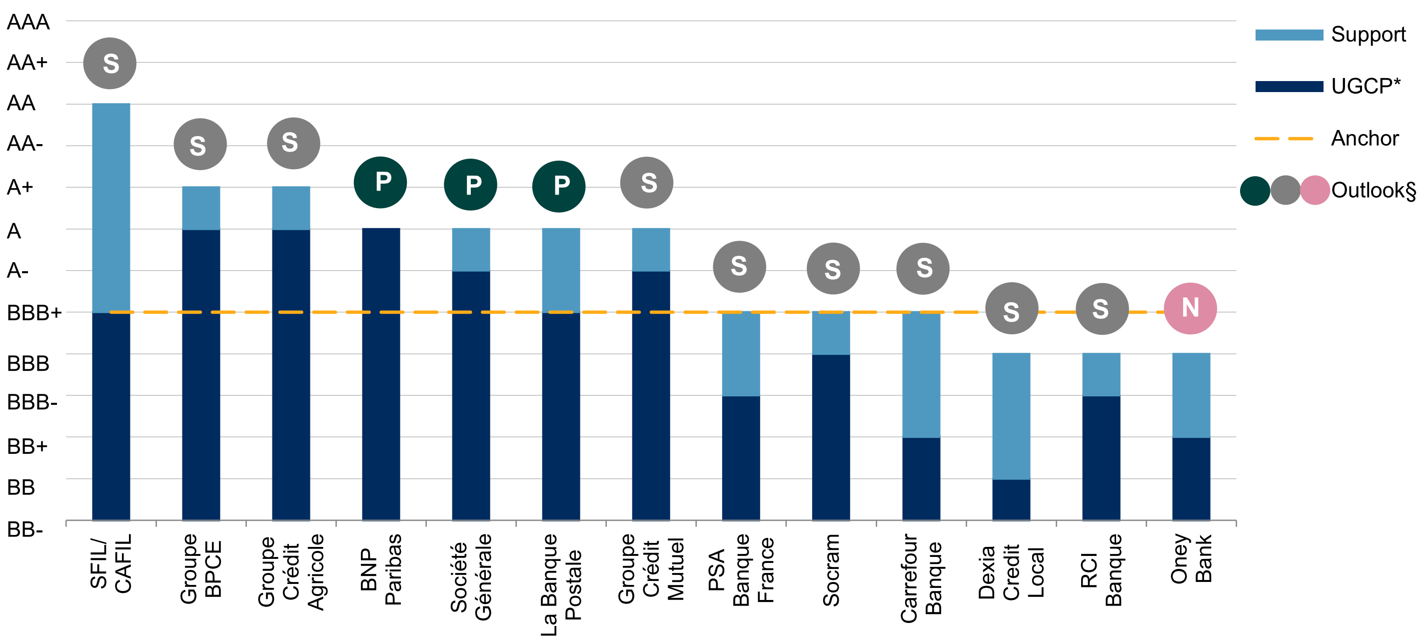
e--Estimate. Source: Banks' financial statements and S&P Global Ratings calculations.

French Bank Ratings Should Remain Largely Unchanged In 2019

The French banking sector is highly concentrated, with five large universal banking groups dominating in what is a relatively wealthy and stable economy. This is why, although the large banks have different business profiles, all have strong ratings in a global context, with 'A' category long-term issuer credit ratings and SACPs between 'a' and 'a-'.

Chart 12

Stronger Large French Banks' Ratings, With Three Positive Outlooks



*Unsupported group credit profile. §N--Negative, P=Positive, S=Stable. All ratings relate to the main operating company as of Jan. 30, 2019. Table 2 in the appendix section sets out the detailed rating component scores for selected French rated banking group. Source: S&P Global Ratings.

Crédit Agricole and BPCE

Following the upgrades of Crédit Agricole and BPCE to 'A+' in 2018, and considering the already-high ratings, we see limited ratings upside in the next two years, hence the stable outlooks on both entities. We maintain an 'AA-' rating on only a very few other peer banks, including some in Scandinavia, and outside Europe, in Canada.

La Banque Postale

The outlook on La Banque Postale mirrors that on its parent La Poste and factors in the potential benefit for both entities of the integration of France's No. 1 life insurer CNP Assurances.

Banque Federative du Crédit Mutuel (Crédit Mutuel)

We maintain a stable outlook on Crédit Mutuel, but a negative outlook on Crédit Mutuel Arkéa. At this stage, to consider an outlook revision to stable on Crédit Mutuel Arkéa, we would first need to get more visibility on the future of Crédit Mutuel Arkéa within the wider group. We still view the uncertainty around the group's cohesiveness as limiting the potential rating upside for the group credit profile.

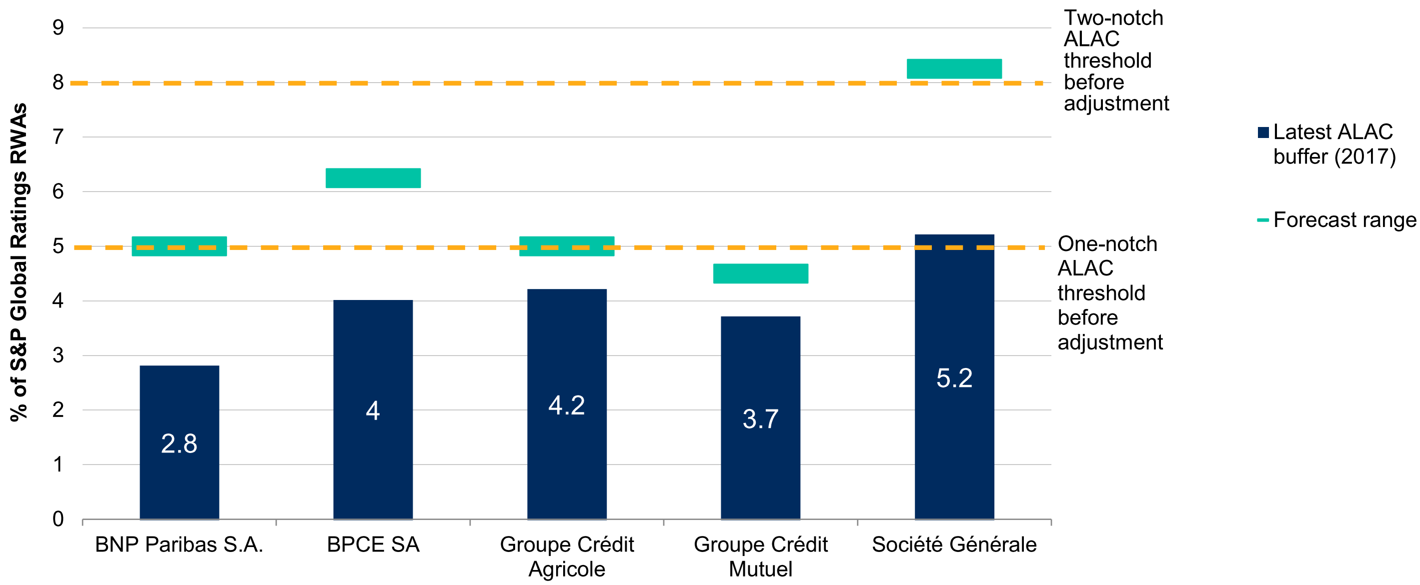
BNPP and Société Générale

Our positive outlooks on BNPP and Société Générale reflect our expectations of the loss-absorbing buffer they will reach. Société Générale could receive two notches of ratings uplift if it builds up a sustainable buffer of bail-inable debt to protect senior creditors representing an equivalent of at least 8% of our risk-weighted assets (RWAs). We would also need to observe that profitability and efficiency are improving in line with Société Générale's medium-term strategic targets, thereby closing the gap with the bank's 'A+' rated peers, before considering an upgrade.

We include one notch of uplift in the ratings on systemically important French banking groups that we see as building or as having now reached sizable buffers of bail-in loss-absorbing instruments (additional loss-absorbing capacity) to protect senior creditors (see chart 13). To build, or for some banks, maintain these buffers above our threshold to qualify for uplift of the issuer credit rating, French banks are likely to pursue issuance of senior nonpreferred notes in 2019. This is the new debt class created under the French law "Sapin II" at the end of 2016. Other European jurisdictions are now implementing this type of debt, which has become a well-accepted bail-inable instrument for investors. It helps banking groups without a nonoperating holding company structure to meet their total loss-absorbing capacity or minimum loss-absorbing capacity requirements in an effective way.

Chart 13

Large French Banks Are Building An ALAC Buffer



ALAC--Additional loss-absorbing capacity. RWAs--Risk-weighted assets. Source: S&P Global Ratings.

Table 2

Rating Components For Selected French Banks

		Rating components						No. of notches of support			
Bank	Long-term ICR/outlook/short-term ICR	Anchor	Business position	Capital and earnings	Risk position	Funding and liquidity	SACP	ALAC support	GRE	Group	Additional factors adjustment
BNP Paribas	A/Positive/ A-1	bbb+	Very Strong	Adequate	Adequate	Average/Adequate	a	0	0	0	0
Oney Bank	BBB/Negative/A-2	bbb+	Weak (-2)	Strong	Moderate	Below Average/Adequate	bb+	0	0	2	0
BPCE	A+/Stable/A-1	bbb+	Strong	Strong	Adequate	Average/Adequate	a	+1	0	0	0
Caisse Centrale du Crédit Mutuel	A/Stable/A-1	bbb+	Strong	Adequate	Adequate	Average/Adequate	a-	0	0	0	+1
Carrefour Banque	BBB+/Stable/A-2	bbb+	Weak (-2)	Strong	Moderate	Below Average/Adequate	bb+	0	0	+3	0
Crédit Agricole S.A.	A+/Positive/A-1	bbb+	Strong	Adequate	Strong	Average/Adequate	a	+1	0	0	0

Table 2

Rating Components For Selected French Banks (cont.)

		Rating components						No. of notches of support			
Bank	Long-term ICR/outlook/short-term ICR	Anchor	Business position	Capital and earnings	Risk position	Funding and liquidity	SACP	ALAC support	GRE	Group	Additional factors adjustment
Dexia Credit Local	BBB/Stable/A-2	bbb+	Adequate	Adequate	Weak(-2)	Below Average/Moderate	bb	0	+3	0	0
La Banque Postale	A/Positive/A-1	bbb+	Adequate	Adequate	Moderate	Above Average/Strong	bbb+	0	0	+2	0
RCI Banque	BBB/Stable/A-2	bbb+	Weak (-2)	Strong	Adequate	Below Average/Adequate	bbb-	0	0	+1	0
PSA Banque France	BBB+/Stable/A-2	bbb+	Weak (-2)	Strong	Adequate	Below Average/Adequate	bbb-	0	0	2	
SFIL	AA/Stable/A-1+	bbb+	Moderate	Very Strong	Moderate	Average/Adequate	bbb+	0	5	0	0
Société Generale	A/Positive/A-1	bbb+	Strong	Adequate	Adequate	Average/Adequate	a-	+1	0	0	0
Socram Banque	BBB+/Stable/A-2	bbb+	Weak (-2)	Very Strong	Adequate	Below Average/Adequate	bbb	0	0	+1	0

ALAC--Additional loss-absorbing capacity. GRE--Government-related entity. ICR--Issuer credit rating. SACP--Stand-alone credit profile. Source: S&P Global Ratings. Data as of January 28, 2019.

Related Research

- Volatile Market Conditions Weigh On Societe Generale's Financial Performance, Jan. 22, 2019

This report does not constitute a rating action.