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French Banks: Credit Losses Pose Less Of A Risk Than Low Margins On Home Loans In 2020

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PRIMARY CREDIT ANALYST

Nicolas Malaterre
Paris
(33) 1-4420-7324
nicolas.malaterre@spglobal.com

SECONDARY CONTACTS

Pierre Gautier
Paris
(33) 1-4420-6711
pierre.gautier@spglobal.com

Sylvie Dalmaz, PhD
Paris
(33) 1-4420-6682
sylvie.dalmaz@spglobal.com

ADDITIONAL CONTACT

Financial Institutions Ratings Europe
FIG_Europe@spglobal.com

Key Takeaways

- We estimate that systemwide French domestic credit losses will be just below 25 basis points (bps) of domestic lending in 2020--only a slight increase from the record-low of an estimated 17 bps in 2018 and an estimated 20 bps in 2019.
- Large French banks should maintain low credit losses over the next two years, thanks to their diversification in credit exposure both in and outside France, persistent low interest rates in the eurozone, and relatively supportive economic conditions in France.
- Nevertheless, growth in French private debt has been far outpacing growth in French GDP, indicating a gradual build-up of risks for banks, and attracting scrutiny from authorities.
- More specifically, in our view, "low-for-longer" interest rates mean banks are in danger of mispricing risks, which we see as more of a concern than pure asset-quality deterioration.
- Banks' margins on home loans are very low in a European context and could rapidly undermine the profitability of a large part of the banking system.

French banks enjoyed another year of benign credit losses in 2019, and we believe that they will maintain low losses over the next two years. This is thanks to the banks' diversification in credit exposure, both in and outside France, persistent low interest rates in the eurozone, and abundant liquidity. We estimate that systemwide French domestic credit losses will be around 20 basis points (bps) of domestic lending in 2019 and 23 bps in 2020--only a modest increase from the recent record-low level of an estimated 17 bps in 2018.

The French economy is less reliant on external demand for growth than more open economies, and its GDP growth benefits from domestic consumer spending and private investment. However, although we expect to see some resilience in 2020, the French economy, and by association, banks' asset quality, will not be immune to the slowdown across economies worldwide and disruptions in some corporate sectors.

Yet S&P Global Ratings sees French banks as being more at risk from the continued decline in gross margins on home loans than a deterioration in asset quality. Gross margins were around 1%

at the end of 2019, according to data from the European Central Bank, and lower than in most other European countries. The reason is that the cost of deposits in France is higher and more rigid, particularly due to the regulated (tax-exempt) nature of savings. At the same time, banks charge very low interest rates to home loan borrowers in France, as competition on such products is extremely fierce to attract customers. An erosion of the profitability of French banks' operations is the main downside risk for our ratings in 2020.

Domestic Credit Losses Have Bottomed And Are Only Slowly Reverting To The Long-Term Average

Across the French banking sector as a whole, we estimate that domestic loan losses were around 20 basis points (bps) of domestic loans in 2019. While this loss rate is a little higher than in 2017 and 2018, it is still low and we expect it to remain so in 2020 and 2021. The slight uptick in loss rates in 2019 was partly due to moderate additional provisioning on credit exposures to some large corporate entities suffering from specific difficulties. This ended a very favorable, maybe even abnormal, period of reversal of loan loss provisions, particularly in corporate and investment banking.

The specific drivers of low credit losses remain largely unchanged from recent years. These include very low interest rates and their beneficial impact on borrowers' debt-servicing costs. In addition, government measures to improve training for the unemployed and make the labor market more flexible have helped reduce the unemployment rate. Job creation in the private sector has begun to accelerate, and we project that the unemployment rate will fall toward 8% in 2022 (see table 1). However, structural unemployment is still high, and higher than in most neighboring countries.

Table 1

France Base-Case Assumptions

%	2016	2017	2018	2019f	2020f	2021f	2022f
Real GDP growth	1.1	2.3	1.7	1.3	1.3	1.3	1.4
CPI inflation	0.3	1.2	2.1	1.3	1.1	1.4	1.6
Unemployment rate	10.1	9.4	9.1	8.5	8.3	8.1	8
Long-term interest rate--10-year bond yield	0.5	0.8	0.8	0.1	0.2	0.5	0.8
Nominal house prices (% change year on year)	1.5	3.2	3.3	3.4	3.1	2.7	2

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

In 2020 and 2021, we expect continued robust domestic credit growth of about 5%, much higher than French GDP, with only a marginal impact from the French authorities' introduction of a countercyclical buffer of 0.25% from July 2019, with a further increase to 0.5% from April 2020. We also expect only marginally higher domestic credit losses, at 23 bps in 2020 and 25 bps in 2021 (see table 2). If these increases materialize, domestic credit losses would still be well below their long-term average of about 35 bps.

Table 2

Actual And Projected Domestic Credit Losses

	Credit losses (% of total loans)							
	2014e	2015e	2016e	2017e	2018e	2019f	2020f	2021f
Corporate	0.4	0.43	0.36	0.32	0.3	0.35	0.4	0.45
SMEs and entrepreneurs	0.7	0.6	0.65	0.35	0.3	0.4	0.45	0.5
Individuals--others	0.68	0.7	0.55	0.48	0.48	0.5	0.55	0.6
Individuals--mortgage	0.06	0.06	0.05	0.05	0.05	0.05	0.06	0.07
Other agents*	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.02
Total	0.32	0.26	0.23	0.18	0.17	0.2	0.23	0.25

*Other financial nonbanking agents and other nonfinancial agents such as local authorities. e--Estimate. f--Forecast. SMEs--Small and midsize enterprises. Source: S&P Global Ratings.

We acknowledge that the domestic sector has become more leveraged as credit volumes have increased faster than French GDP for several years, although this trend is not specific to France. However, in our view, this has increased France's vulnerability to an abrupt economic downturn.

Domestic Conditions Remain Supportive, But Indebtedness Is Growing Faster Than French GDP

Domestic credit to the private sector increased faster than GDP again in 2019, and we expect this will remain the case in 2020-2021. In a "low-for-longer" interest rate environment, one way of banks maintaining revenue stability is by boosting new business volumes (see table 3). Although the private sector's indebtedness does not suggest a generalized financial risk at this stage, the fact that growth in credit has outpaced GDP growth for so long poses risks for banks' overall risk profile, and we are monitoring this uninterrupted increase closely. The upward trend of domestic private debt to GDP also contrasts with the trends in other countries, except Germany (see chart 1).

Table 3

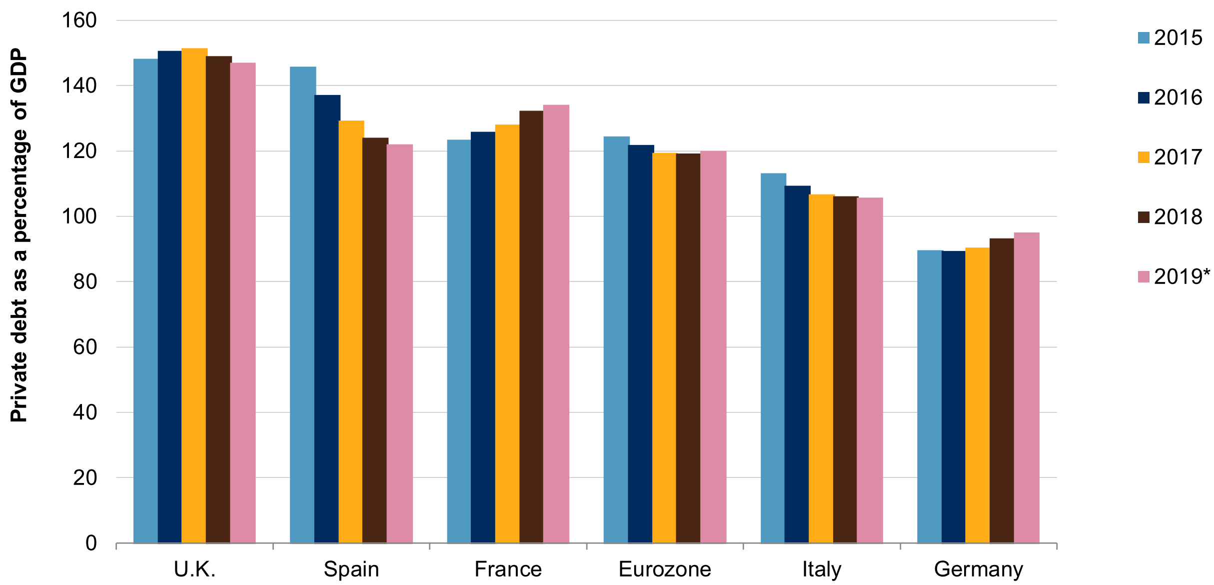
French Domestic Loan Book By Asset Class

	Amounts outstanding (bil. €)	12-month growth rate (%)
Loans to domestic households and nonprofit institutions serving households by domestic credit institutions	1,460	6.2
Of which consumer credit	200	6.5
Of which housing loans	1,175	6.6
Loans to domestic nonfinancial institutions	1,041	6.2
Small and midsize enterprises	430	6.2
Mid-tier enterprises	284	3.8
Large enterprises	146	6.7
SCI and other	181	9.7

Data as of Sept. 30, 2019. SCI--Selective capital increase. Source: Banque de France.

Chart 1

French Domestic Private Debt To GDP Is Up



*Estimate as of June 30. Source: Banque de France.

At this stage, we don't see growth in corporate debt as alarming in the wider context of firms' global investment strategies. However, we believe it leaves banks exposed to sporadic defaults of single entities or in some segments, such as leveraged loans, which carry an intrinsically higher risk of default due to the considerable amount of debt. Some corporates remain exposed to changes in technology or consumer preferences and tensions in global trade. The second half of 2019 saw the fallout from a tougher environment and digital disruption with the failure of U.K. travel agent Thomas Cook and the safeguard procedure for Rallye, the holding company of French retailer Casino.

The home loan default rate is low...

In home loan lending, French households' default rate remains very low. Real estate prices have been rising at a relatively strong pace in large cities, albeit with large regional disparities. We consider that the market is overvalued compared to long-term trends--by around 20% based on the price-to-income ratio. However, the price dynamic of the French residential real estate market largely reflects the long-lasting low interest rates and borrowers' good access to funding.

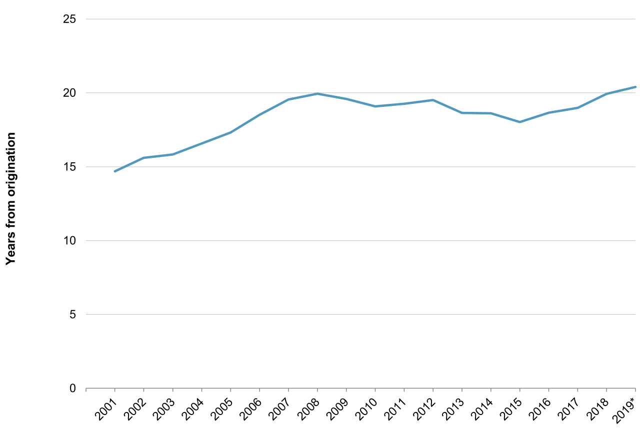
French banks' lending practices are conservative as they focus on the borrower's ability to repay the loan rather than on the property valuation. Home loans have fixed interest rates in France, which protects borrowers from rate rises, and banks typically follow historically strict limits on affordability to mitigate the solvency risk of individual borrowers. Finally, the social security system remains protective in the event of unemployment, and more than half of outstanding loans are covered by loan guarantees. Guarantors are either the subsidiaries of one bank, or in the case of Credit Logement, several banks.

...But underwriting criteria are gradually becoming laxer

At the same time, underwriting criteria have eroded, with longer loan maturities and deteriorating debt service-to-income (DSTI) ratios, in other words, a rising share of income allocated to debt repayments. Based on the latest report from French regulator ACPR, the average loan maturity is now around 20.5 years, an increase of two years since 2015. Home loan debt now represents about five years' income, compared with just above four years in 2015, while the DSTI ratio rose to 30.4% in September 2019, around a 1% increase from 2015 (see charts 2 and 3). The ratio may have increased more rapidly if banks had not extended loan maturities at the same time, with 25-year maturities becoming more commonplace.

Chart 2

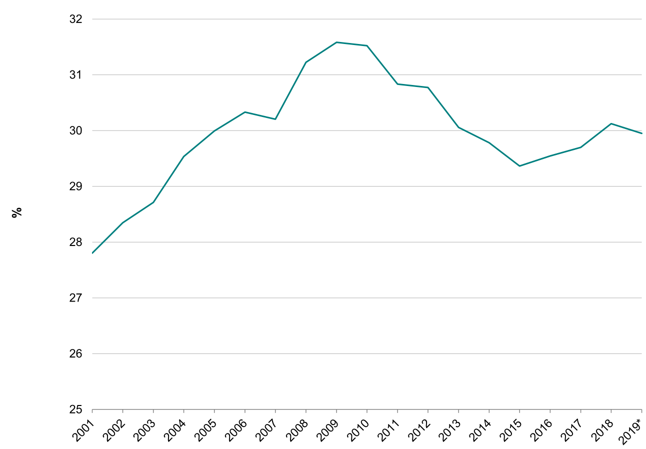
Average Maturity Of Home Loans



*Estimate as of Sept. 30. Source: French Prudential Supervision and Resolution Authority (ACPR).

Chart 3

Average Debt Service-To-Income Ratio (Taux d'Effort)



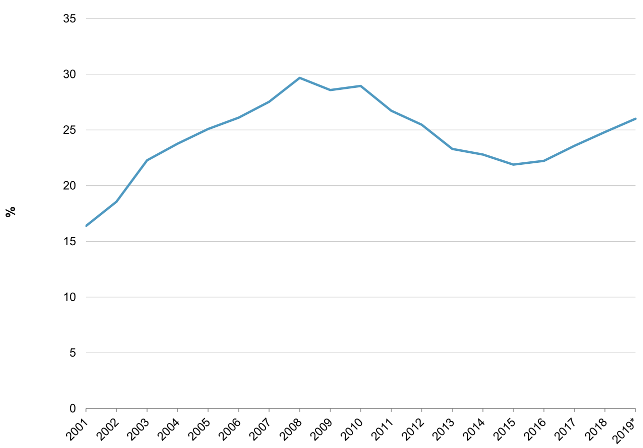
*Estimate as of Sept. 30. Source: French Prudential Supervision and Resolution Authority (ACPR).

As the High Council for Financial Stability (HCFS) pointed out in December 2019, 5% of new home loans now have maturities of more than 25 years, and 26% have affordability ratios of more than 35%, with first buyers specifically contributing to this rise (see chart 4). In response, the HCSF has recommended measures to mitigate risk, specifically, a ratio of maximum debt service to income of 33% and loan maturities of no more than 25 years. The HCSF's communication also reiterated the importance of adequately pricing of home loans to cover banks' risks and costs.

At the same time, loan to value (LTV) at origination is 87.3%, a 1.6% increase since 2015 (see chart 5). Having said that, since loans typically amortize annually, the average LTV of outstanding loans is much lower, at 69%.

Chart 4

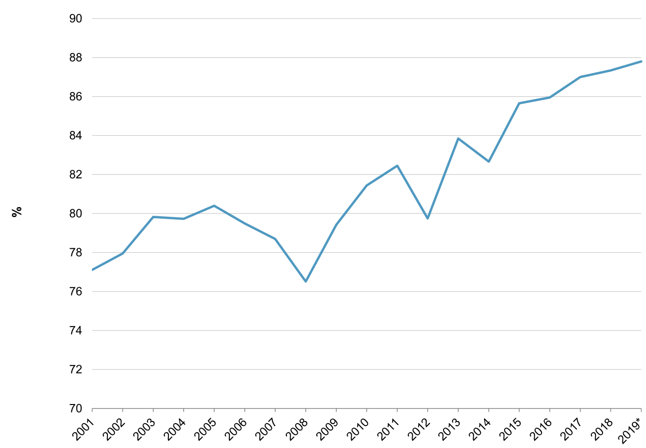
Percentage Of Borrowers With A Debt Service-To-Income Ratio (Taux d'Effort) Above 35%



*Estimate as of Sept. 30. Source: French Prudential Supervision and Resolution Authority (ACPR).

Chart 5

Loan To Value At Origination



*Estimate as of Sept. 30. Source: French Prudential Supervision and Resolution Authority (ACPR).

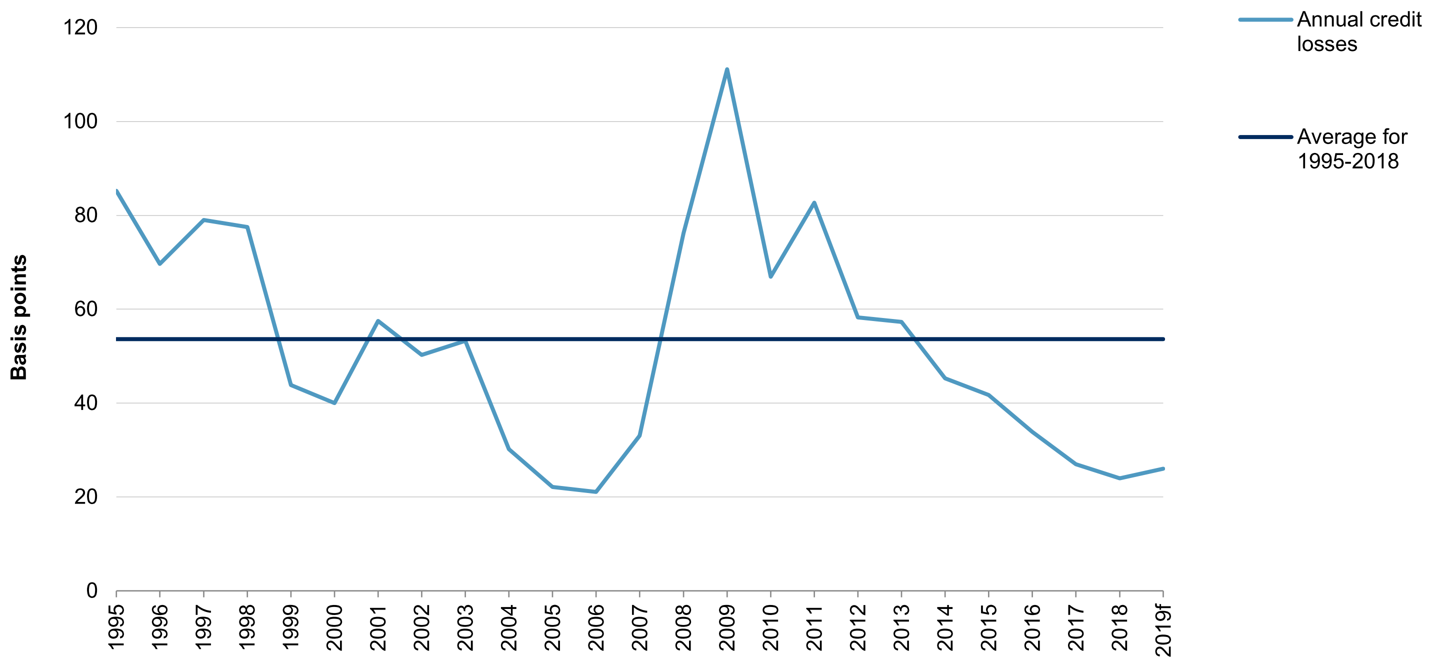
A gradual loosening of underwriting criteria is not surprising in the context of low interest rates, and the fixed-rate nature of home loans in France strongly mitigates the risk of future defaults. However, we monitor developments closely, as at some point, banks will have to make a choice. Either they can drop out of the race to increase volumes, thereby risking a decline in topline profitability as margins remain very low, or they can continue to increase their risk while securing their immediate profitability.

French Banks' Credit Losses Will Rise, But Not Far

As we assume that large French banks' consolidated credit losses will remain low compared to the long-term average, they are not our main area of concern over the next couple of years (see chart 6). The low credit losses are partly thanks to banks' diversification of their loan books both in and outside France. We see this diversification as a strength. Only Italy represents a large risk for banks, higher than the risk in France, especially for BNP Paribas and Credit Agricole. Exposure to Turkey (BNP Paribas), Russia and Romania (Societe Generale), and Ukraine (Credit Agricole) is very small in the group context. However, this diversification explains why large French banks' cost of risk is slightly higher for their international activities than for their domestic activities.

Chart 6

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



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

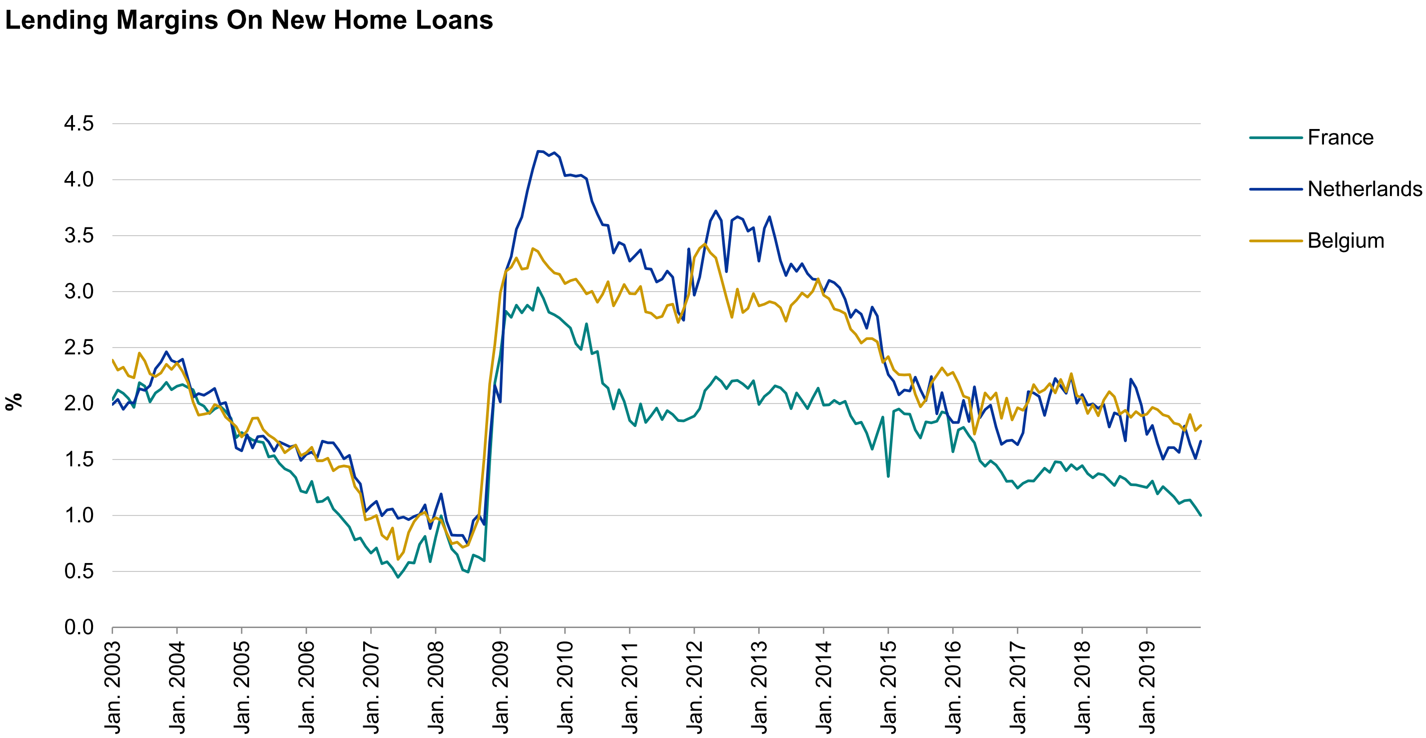
French banks' corporate exposures feature some concentration on large domestic and European companies. These companies generally have high credit quality, but are not exempt from risk, especially those in sectors exposed to disruption or secular transformation, like travel, tourism (Thomas Cook), or retail (Rallye/Casino).

The domestic cost of risk could rise modestly on exposures to consumer finance or small-to-midsize enterprises, and more rapidly if economic growth decelerated more drastically. Yet French banks' exposure to unsecured loans is modest. Therefore, we expect banks' actual credit losses to remain well below the normalized credit losses generated from our risk-adjusted capital framework. Normalized credit losses are a calculation of long-term average annualized credit-related losses.

French Residential Lending: Overly Tight Pricing, Not Asset Quality, Is The Main Risk For Banks

According to data from the European Central Bank, gross margins on new home loans in France continued to decline to a very low level of around 1% at the end of 2019, much lower than in other markets such as Netherlands and Belgium (see chart 7). The gross margin is computed as the interest charged on new home loans and the interest paid on the liabilities (new deposits from both companies and individuals). In reality, banks' individual margins differ in light of the differences in liabilities, while the interest rates that banks charge to borrowers of home loans are more homogenous.

Chart 7



Lending margins are measured as the difference between interest rates on new loans and a weighted average rate of new housing and corporate deposits. Source: European Central Bank.

French banks' ability to pass on declining interest rates on new loans and their funding costs are asymmetrical. Strong competition typically means that a drop in interest rates benefits borrowers quickly and reduces banks' interest revenues. At the same time, the cost of banks' resources is more rigid, particularly due to regulated savings and sight deposits, while negative interest rates are not passed on to retail customers.

In addition, falling interest rates in France came with a wave of borrower renegotiations, which weighed significantly on banks' retail interest income. For example, banks replaced an existing 3% interest rate on home loans with a new rate of 1%, or borrowers simply changed banks as they sought home loans at the lowest possible rate. This is close to a downward variable-rate system, which penalizes the bank's revenues as interest rates decrease. We believe that tight home loan pricing is a real weakness for French banks compared to several other home loan markets. Moreover, the margin on home loans is nearly zero when accounting for the cost of hedging interest risk. Without such hedges, banks would face interest rate risk since deposits do not mature at the same time as the loans.

Large French banks suffer from lower margins on home loans than in other countries, as large banks compete fiercely on such products to attract new customers. Banks have also compensated for low interest rates by increasing lending volumes. Banks are granting home loans with very low, sometimes even negative, margins, as they view the home loans as a "hook" and an opportunity to cross-sell other more profitable services, such as insurance--including home loan insurance--current accounts, and other banking services, to their clients. We believe this low-margin pricing strategy is not sustainable and creates a risk of severe profitability issues, especially as French banks do not enjoy the lean cost bases of their peers in the Nordics or Spain for instance.

In its recent communication on December 2019, the HCFS questioned the home loan pricing policy in France. We continue to believe it is an area to watch very closely, especially in light of banks' revenue challenges and high cost bases versus other markets.

For the next 18 months, we do not expect a drastic change in French banks' credit losses or risk appetite, which we believe will remain modest. The supervisory authorities, among others, are monitoring French banks' risk appetite closely. In our view, areas to watch in banks' domestic retail operations are the underpricing of credit, particularly home loans, considering banks' cost bases and difficulties in growing new revenue streams; and possible new interest rate cuts that would bring a new wave of home loan renegotiations. More generally, failure to stabilize earnings and profitability and curb the trend of deteriorating efficiency could increase downside risk for our ratings on French banks in 2020 when we assess individual banks' resilience to an environment of weaker revenues.

Related Research

- Banking Industry Country Risk Assessment: France, Oct. 25, 2019

This report does not constitute a rating action.