Profitability woes drive a deterioration in the credit profile of French banks

by NUS-CRI Market Monitoring Team

- **NUS-CRI Agg PD of French banks decoupled from its European peers over the past year, surging higher towards the BB upper bound, as its profit growth remained limited**
- **NUS-CRI Forward PD of French banks suggests that although profitability pressures may persist, the banks' favorable capital and liquidity positions potentially shield them from a significant worsening in credit quality over the coming 12 months**

The French banking sub-sector has seen its credit risk profile worsen substantially since the beginning of last year. As seen in Figure 1a, the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) for French banks has increased by close to 70bps since Jan-2022, closing in on the BB upper bound when referenced to PDiR2.0 bounds[1]. The sector has been facing a plethora of challenges including increased pressure on its profitability due to squeezed net interest income margins and an unfavorable macroeconomic funding environment. The NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD[2]) in Figure 1b suggests that the impact on financial performance is likely to burden the sub-sector's aggregate credit profile over the next six months, however, the pressures are unlikely to downgrade the banking sector well into the BB upper bound, potentially as French banks' capital positions, and liquidity and solvency profiles, remain robust.

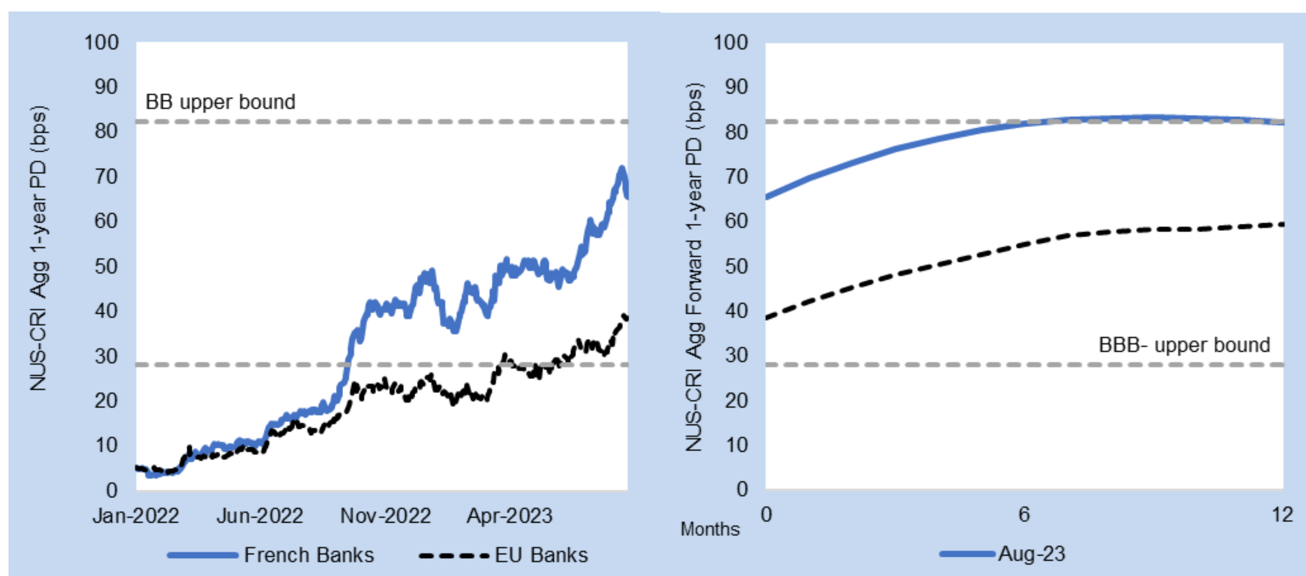

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for French and Eurozone banks, with reference to PDiR2.0 bounds. Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for French and Eurozone banks as of Aug-2023, with reference to PDiR2.0 bounds. *Source: NUS-CRI*

While most European banks have reaped significant gains from the European Central Bank's (ECB) rate hikes, French banks have been unable to enjoy the same profit surge as their EU counterparts. The reason behind this is the presence of a usury[3] law in France that limits the rate at which loan prices can grow. Consequently, as the rates on new mortgage loans remain capped, French banks find their profitability hampered because they can't raise rates in tandem with the ECB's rate increases. As seen in Figure 2a, home loan rates offered by French banks have consistently lagged their European counterparts. Furthermore, French banks have

[1] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation by mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.
[2] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similar to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 18 months, conditional on the firm's survival in the next 6 months.
[3] The usury rate is the highest interest rate that lenders are legally permitted to charge borrowers on a loan.

experienced higher funding costs due to rising deposit rates, especially in popular regulated savings accounts known as the Livret A accounts which ensure that growth in deposit rates reflects the surge in inflation. Consequently, French banks have seen their net interest margins squeezed, with the combined net interest income of three of the largest French banks declining by 10% QoQ in the first quarter of 2023.

However, French banks' credit profile does benefit from its robust liquidity and solvency position. As of Mar-2023, on the back of the financial crisis plaguing the majority of banks in the EU due to SVB's failure and Credit Suisse's distressed takeover by UBS, French banks' liquidity position, though marginally declining, remained well above the regulatory requirements. French banks' liquidity coverage ratio (LCR) declined by 6 percentage points YoY to 146% (minimum LCR requirement: 100%). French banks' net stable funding ratios (NSFR) also marginally declined by 4.3 percentage points to 115.1% (minimum NSFR requirement: 100%) due to the shorter maturity of available financing by the ECB's TLTRO III funding program[4]. Though the end of the TLTRO III funding program provides some headwinds to French banks, especially in finding alternative sources of similarly cheap funding, the encumbered assets ratio for French banks fell by 2.5 percentage points, allowing them to deploy a greater proportion of their balance sheet to secure funding. As of Mar-2023, French banks' capital adequacy ratio also improved by 70bps YoY on the back of higher common equity tier 1 capital and lower risk-weighted assets. To maintain strong capital ratios, the French regulator, the High Council for Financial Stability (HCSF), is also requiring banks to hold additional buffers against loans disbursed to highly indebted companies. Should their exposure to highly indebted companies, those with debt to earnings ratio of above 6%, comprise more than 5% of their equity base, an additional 3% increase in capital buffers will now be required, providing a safety net if credit risk across non-financial corporates in France increases leading to higher non-performing assets. As such, the Forward PD for French banks, although reflective of the deterioration in the credit profile of French banks, does suggest that excess liquidity and sufficient capital buffers may limit the downside risk over the next twelve months.

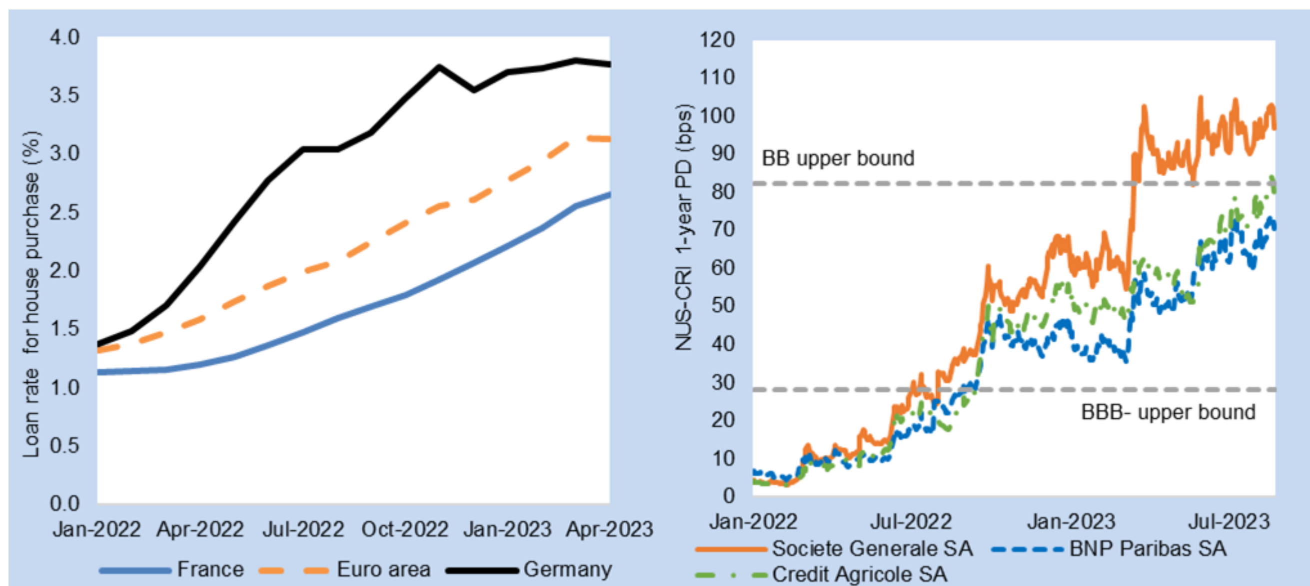

Figure 2a (LHS): Regional loan rate for house purchase for loans with a maturity higher than 10 years. Figure 2b (RHS): NUS-CRI 1-year PD for Societe Generale SA, BNP Paribas SA, and Credit Agricole SA, with reference to PDiR2.0 bounds. *Source: Bloomberg, NUS-CRI*

As shown in Figure 2b, the PD of the three biggest listed French banks, Credit Agricole SA (CASA), BNP Paribas (BNP), and Societe Generale (SocGen) follow a similar trend as the Agg PD of French banks, though at a higher level. The PD of SocGen increased significantly right after the SVB's collapse in Mar-2023, crossing over the BB upper bound, while both BNP and CASA saw relatively muted increases in their PD. With the highest proportion of revenue generated by the domestic retail banking business among its peers, SocGen is more susceptible to the squeeze in NII faced by the sub-sector. On the other hand, BNP, with less exposure to the domestic retail business, demonstrates a better credit profile compared to its two counterparts. Although the interbank funding facilities have contributed to the resilience of the French banks, the high partial default correlations, calculated by NUS-CRI, among the three biggest French banks might uncover the overall systemic vulnerability of the banking industry to continued macroeconomic headwinds, and may even suggest a higher likelihood of potential cross defaults. Specifically, the partial default correlation between BNP and CASA is

[4] TLTROs are long-term refinancing operations that provide financing to credit institutions. They keep borrowing terms favorable for banks and encourage them to lend to the real economy.

significantly higher than their respective correlations with SocGen (0.187 vs 0.023 and 0.024), also suggested from the PD comovements in Figure 2b.

Suffice it to say that squeezed profitability margins, in conjunction with fewer low-cost financing channels, are poised to continue pressuring the credit risk profile of French banks. The sub-sector has felt the brunt of the Mar-2023 financial crisis, with the market's sentiment towards French domestic banks souring since; worsened by the reputational damage caused due to raids by French authorities on the largest banks on potential tax fraud. However, strong fundamentals do provide some reprieve and anchor the aggregate credit profile of French banks largely in the BB+ upper bound according to PDiR2.0 over the next six to twelve months.

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Credit News

Emerging-market funding gets creative as dollar bonds dry up

Aug 27. The sale of dollar bonds from emerging markets has dropped to the lowest level since 2021, with only USD 1.4bn raised in emerging debt this month compared to an average monthly issuance of USD 15.4bn this year. The trend is pushing borrowers and investors towards alternative funding routes such as loan syndication, conservation-linked securities, and local-currency bonds. This shift is being driven by tighter global monetary conditions, rising global yields, and a desire among some countries to reduce their dependence on the US dollar. The focus on alternative borrowing instruments is attracting more investors pursuing environmental, social, and governance (ESG) targets. (Bloomberg)

T-Bill deluge risks draining bank reserves, St. Louis Fed warns

Aug 27. The US Federal Reserve may need to pause its efforts to shrink its balance sheet if the US Treasury's heavy borrowing in the bills market leads to too much cash being withdrawn from the banking system, according to economists at the St. Louis Fed. The Treasury has sold about USD 1tn of bills since June, and the cash to buy these government debts often comes from money market funds. However, money market funds have been holding back on purchasing bills due to higher returns available through the Fed's overnight reverse repurchase facility (ON RRP). If the banking system loses too many reserves to meet regulatory requirements, the Fed may have to halt its quantitative tightening program to ensure financial stability. (Bloomberg)

Sweden bets it can isolate real estate risks to troubled SBB

Aug 25. Sweden faces a real estate crisis reminiscent of the 1990s crash, but authorities, including the government and central bank, are confident about containment. Amid declining property prices and rising financing costs, officials believe they can manage the turmoil without widespread intervention. Despite the risk of a deeper recession, the government's stance is supported by well-capitalized banks and regulators, minimizing spillover into the broader financial system. However, international markets are less assured, with concerns affecting the Swedish krona. Embattled real estate companies like SBB grapple with funding gaps, while a slump in funding routes and smaller firms facing financing difficulties add to the strain. SBB remains at the crisis's core due to high debt and slower fundraising. Despite fears, the government prioritizes aiding mortgage holders and the construction sector over overextended landlords. (Bloomberg)

Junkiest debt rallies as investors brush off Fed

Aug 27. Credit investors defy the Federal Reserve's rate stance, driving strong gains in leveraged loans and CCC-rated junk bonds, outpacing investment-grade counterparts amid receding recession risks. Despite Fed Chair Powell's rate hike signals, the economy's resilience surprises, benefiting corporate cash flows. An economic soft landing could help, but prolonged high rates may strain highly leveraged firms, especially in the leveraged loan market. Rate cut expectations shift to May 2024. This favors floating-rate assets like US leveraged loans. The sentiment brings leveraged buyout loans to ease deal supply shortages. Rising corporate failures raise concerns about weaker investor protections. Recoveries on soured leveraged loans are expected lower. (Bloomberg)

China’s interest rate caution shines light on USD 56tn banking system

Aug 22. Despite recent unfavorable economic data, China saw a conservative adjustment in lending rates, which are influenced by a consortium of leading commercial banks in the nation. Surprisingly, the five-year loan prime rate, which influences mortgage rates, remained unchanged, contrary to unanimous predictions of a reduction. As indicated in a monetary policy report by China's central bank, it is expected that the exposure of lending risks in banks will take some time, and therefore, they should maintain sufficient financial reserves and risk buffers. Concerns about the profitability of predominantly state-owned Chinese banks played a pivotal role in this decision, raising questions about the government's willingness to implement substantial stimulus measures. (FT)

US department stores see higher credit delinquencies amid strained spending (Reuters)

No real fix to the sharp rise in public debt loads, economists say (Reuters)

Mexico's Pemex the biggest liquidity worry among peers - Fitch (Reuters)

Regulatory Updates

At Jackson Hole, post-inflation challenges vex central bankers

Aug 28. The world's leading central bankers have underscored the importance of maintaining high interest rates until inflation is effectively controlled. They also highlighted the complexities of adapting to broader economic shifts that are increasingly beyond the influence of monetary authorities. The Federal Reserve (Fed) and the European Central Bank (ECB) find themselves embroiled in similar debates about whether to raise borrowing costs at upcoming policy meetings. During his speech, Fed Chair Jerome Powell remained somewhat ambiguous about whether the Fed would raise its benchmark interest rate again. However, he cautioned that "if there is further evidence of sustained growth above the expected trend, it could jeopardize progress in controlling inflation and necessitate further tightening of monetary policy." (Bloomberg)

Bank of England warns on corporate default risk

Aug 23. The Bank of England has issued a warning that British businesses are facing an increased risk of corporate defaults, which could jeopardize investments and jobs, due to the escalation of interest rates. According to an analysis published on the Bank of England's blog, the percentage of non-financial UK companies struggling with debt-servicing challenges, indicated by a low earnings-to-interest expenses ratio, is expected to climb to 50 percent by the end of the year, up from 45% in 2022. For medium-sized companies with annual turnovers ranging from GBP 10mn to GBP 500 mn, this proportion could surge to 70%. This scenario would mark the highest level of corporate debt stress since the 2008-09 financial crisis. (FT)

Weak yen puts pressure on BoJ to tighten policy (FT)

UK challenger banks bemoan regulator foot-dragging on model approval (FT)

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