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## **For France's Largest Banks, Capital Will Remain A Neutral Rating Factor, Despite Continuous Improvement**

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### **Table Of Contents**

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The Main Hurdles To Capital Accumulation

Capital And Risk Positions Generally Provide No Rating Uplift

Credit Risk And Insurance Dominate Risk Profiles

Capital Positions, Albeit Improving, Still Lag The European Peer Average

Potential Increase In Regulatory RWAs Could Narrow The Gap To Our RWA Figure

Capital And Earnings Are Unlikely To Move Into The Strong Category

Appendix

Related Criteria And Research

# For France's Largest Banks, Capital Will Remain A Neutral Rating Factor, Despite Continuous Improvement

Large French banks again strengthened their capital cushions in 2015, chiefly because of regulatory developments that support capital build-up. Nevertheless, operating conditions will likely remain difficult for all banks across Europe over the next two years. For this reason, S&P Global Ratings believes a material enhancement of capital ratios in 2016 and 2017 will be harder to achieve. We therefore see the need for banks to adopt a proactive and agile approach to sustain capital growth and manage their balance sheets during that period. Our average risk-adjusted capital (RAC) ratio for France's top five banks--BNP Paribas, BPCE, Credit Agricole, Credit Mutuel, and Societe Generale--was 7.9% at year-end 2015, some distance away from the 8.9% average for their 50 European peers (excluding French banks), and we don't expect it will catch up over that period.

The main threat we see to banks' capacity to improve their capital ratios is the low-interest-rate environment, which reduces future earnings and could encourage them to increase lending volumes to alleviate the strain on margins. In addition, prospective regulatory changes remain a source of uncertainty, not least because of the possible introduction of floors to internal models, widely used in France's banking sector. Such changes are unlikely to affect our RAC ratio, but only the regulatory one, and force banks to optimize the scale of capital-light activities, rethink their universal business model and medium-term growth strategy, and carefully arbitrate their dividend policies. What's more, in our view, not all institutions are fully ready for new loss-absorbing capacity standards and requirements.

## Overview

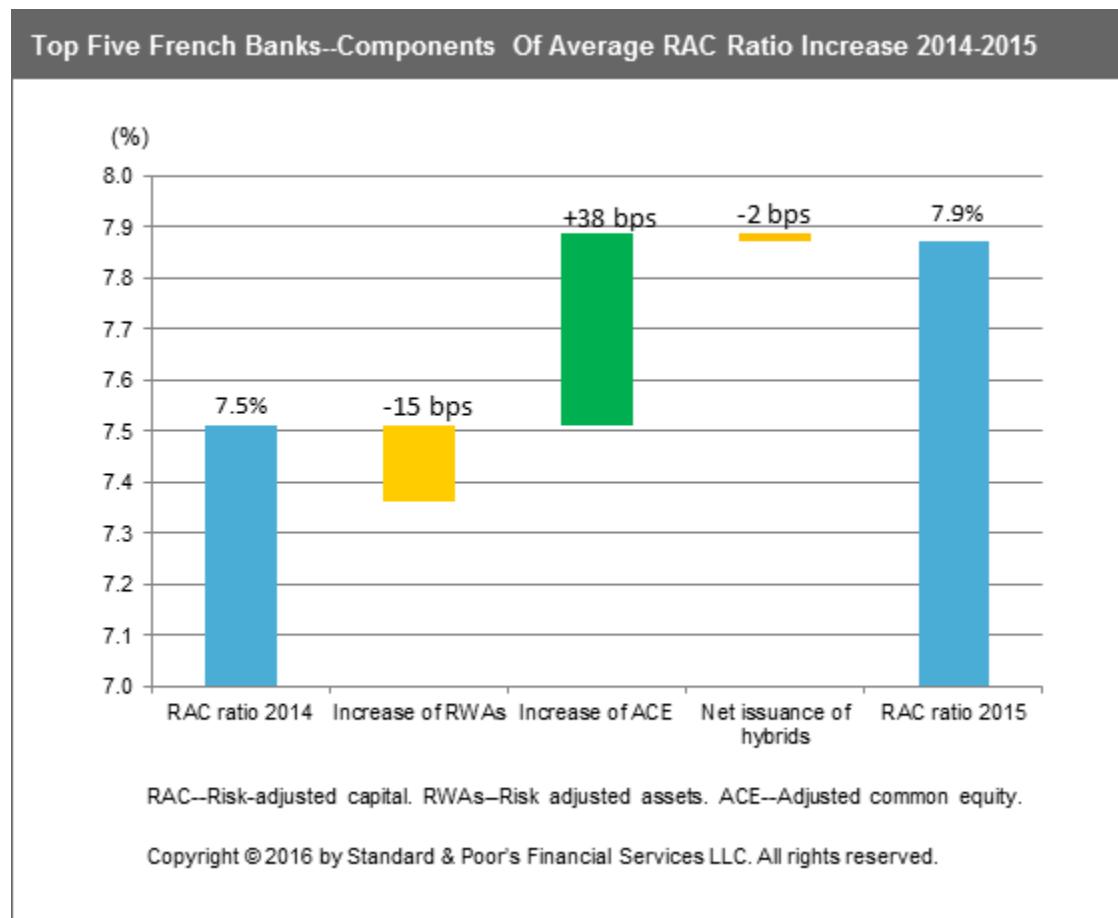
- Large French banks' typical universal banking model, which in some cases includes large insurance and investment banking operations, supports the resilience of their top-line earnings.
- We therefore generally expect their capital bases to keep increasing, in particular due to strong regulatory incentives to do so.
- However, amid the tough operating and economic environment, we don't expect capital and earnings to improve to such an extent that it becomes a credit strength leading to upgrades in the sector over the next 18-24 months.

## The Main Hurdles To Capital Accumulation

Our RAC ratio shows France's top five banks' capitalization to be slightly weaker than that of European peers, despite an average net 36 basis point (bps) increase in 2015 (see chart 1). The average RAC ratio of the 50 largest banks we rate in Europe (excluding French banks) was 8.9% at the end of 2015, whereas that for France's top five was 7.9%. Although we expect French banks will strengthen their capital positions by slightly more than 50bps over the next two years, we think their RAC ratios will remain below the 10% threshold we view as commensurate with a strong capital position. Consequently, we consider that capitalization will remain a credit-neutral factor for the majority of banks we

rate in France, absent significant unexpected developments.

**Chart 1**



In particular, we believe the banks will find it difficult to build capital and still protect their revenues from the increasingly negative effects of low interest rates (in both commercial and retail banking) and subdued client trading activity (corporate and investment banking). Owing to their universal banking model, banks will likely need to continue improving efficiency, while investing in digitalization to better serve customers' needs and streamlining and developing fee-generating activities. Some banks, like BNP Paribas and Credit Agricole, are also exposed to countries where operating conditions remain difficult, like Italy.

Another complication stems from a new set of capital regulations that are yet to be fully implemented. The potential limitation of internal models, which many large French banks use to calculate risk-weighted assets (RWAs), or the introduction of floors to internal models could weigh on regulatory capital ratios. In addition, the current regulatory agenda, which seeks to complete refinements to the Basel III framework and reduce variability and inconsistency in reported RWAs, remains a source of uncertainty for banks' future strategy and capital planning.

Also, banks show varying degrees of preparedness to issue bail-in-able instruments to meet their regulatory total loss-absorbing capacity (TLAC) or minimum requirement for own funds and eligible liabilities (MREL). However, the

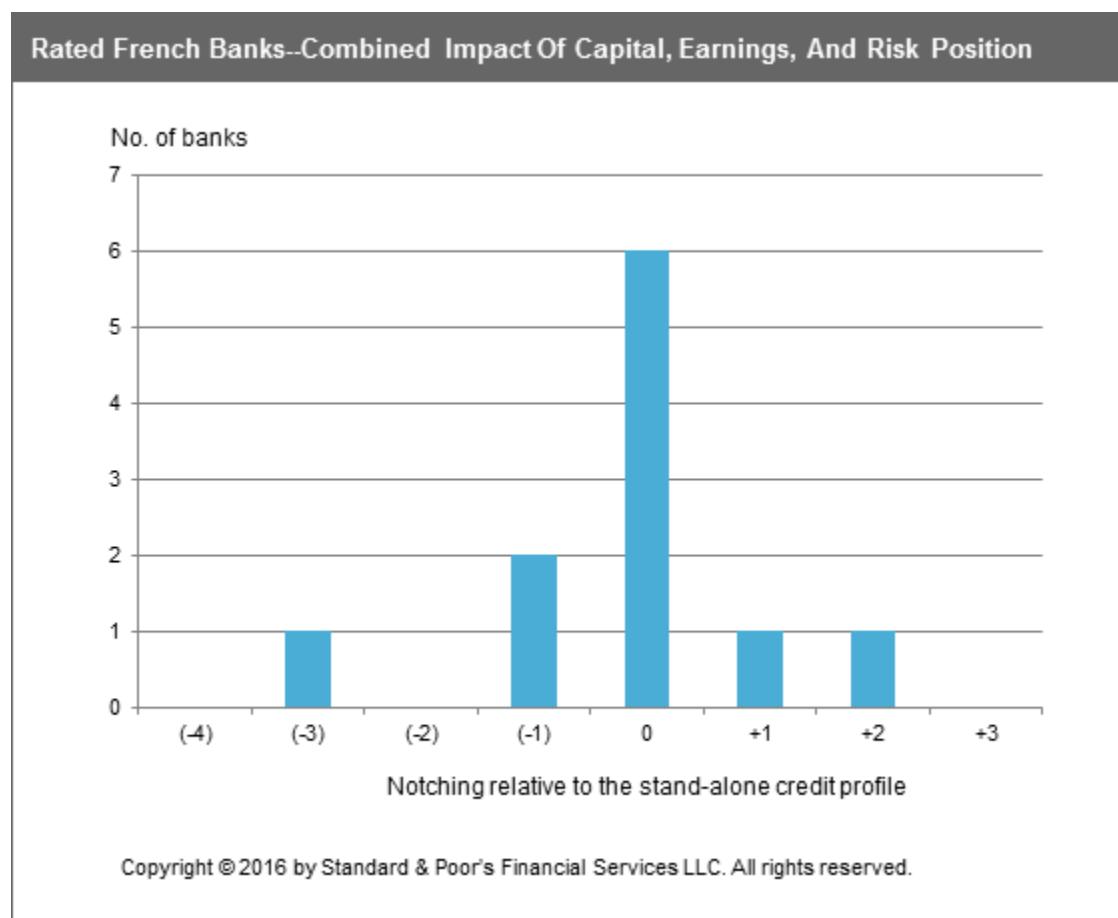
new senior debt type contemplated by the French treasury (Direction Générale du Trésor) could help the country's systemically important banks meet their TLAC/MREL requirements in a cost-effective way in the second half of this year.

In addition to these challenges, banks will be recalibrating their operations, aiming to increase the proportion of capital-light activities without losing ground in other areas, while trying to safeguard their universal banking model.

## Capital And Risk Positions Generally Provide No Rating Uplift

Continued capital strengthening generally augments credit quality. We usually assess a bank's capital strength in conjunction with its risk profile. For most French banks, we believe capital ratios adequately reflect the risks the banks are taking. This is why our combined assessment of capital and earnings, and risks, has no rating impact. There are exceptions, however, where we perceive weaknesses in the risk profile (due to the nature of exposures or concentration risks) and capital strength as indicated by our RAC ratio, such as for Dexia Credit Local, La Banque Postale, and Banque Accord (see table 2 in the appendix).

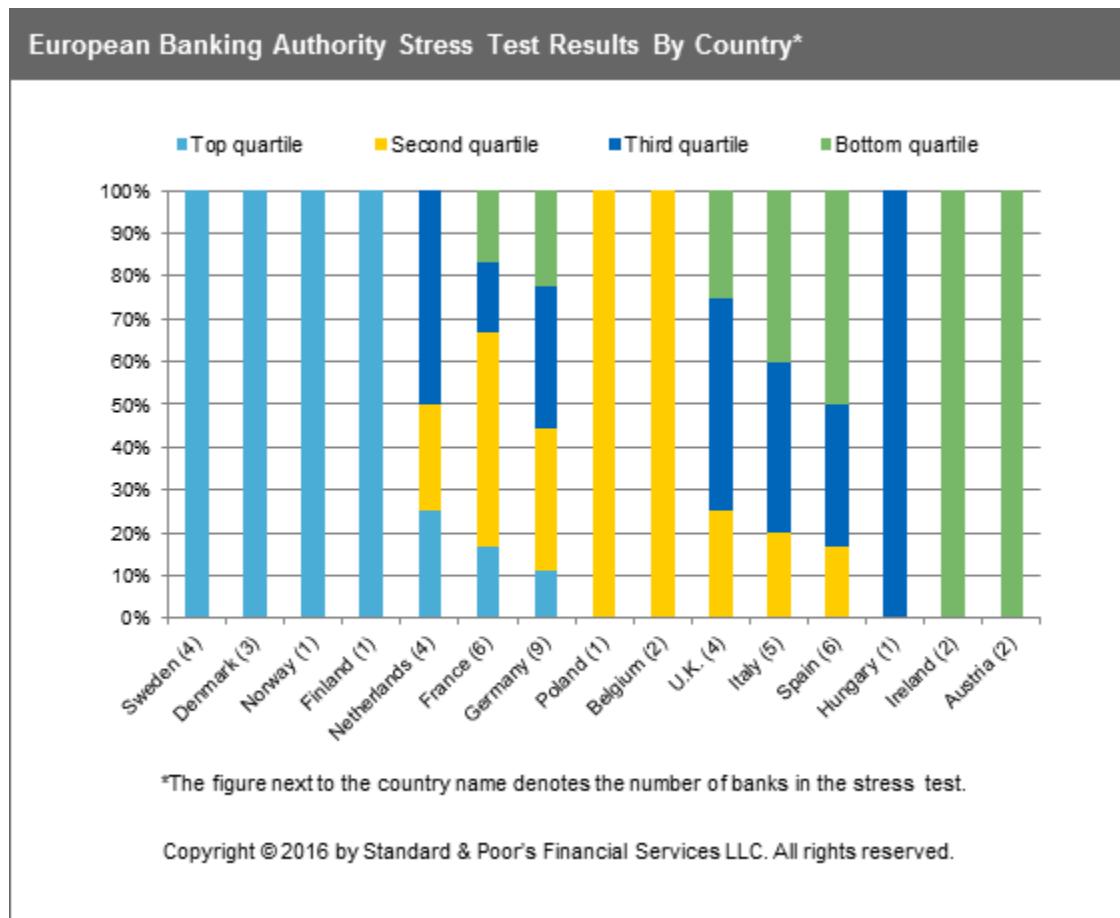
**Chart 2**



We believe this also indicates that, despite reporting slightly weaker regulatory ratios than their European counterparts

on average, large French banks' buffers are commensurate with their risks. In fact, low-risk assets typically dominate their loan and securities portfolios. Importantly, the proportion of revenues from riskier investment-banking activities or exposure to illiquid assets and trading positions has also substantially reduced for banks active in that area, like BNP Paribas and Société Générale, compared with before the financial crisis. The outcome of the European Banking Authority's EU-wide stress test on 51 banks in July this year attests to this view, with four of the six banks in the sample for France in the first or second quartile (see "Europe's Stress Test Results Show That Most Rated Banks Improved Their Resilience," published Aug. 1, 2016, on RatingsDirect).

**Chart 3**



We base our capital and earnings assessment mainly on our RAC ratio, but we also look closely at qualitative assessments, such as earnings capacity and the quality of capital. In analyzing the quality of capital, we examine in particular the volume of deferred tax assets (DTA), minority interests, and hybrid instruments included in total adjusted capital (TAC). We generally consider the quality of capital at French banks to be high. At year-end 2015, DTAs related to temporary timing differences represented only a minor portion (about 5%) of the top five banks' TAC and for hybrids, the figure was a low 7%.

We believe French and EU banks will keep increasing their regulatory capital bases until 2019 in response to stricter regulations and measures by the European Central Bank (ECB). The ECB, in line with the results of the Supervisory

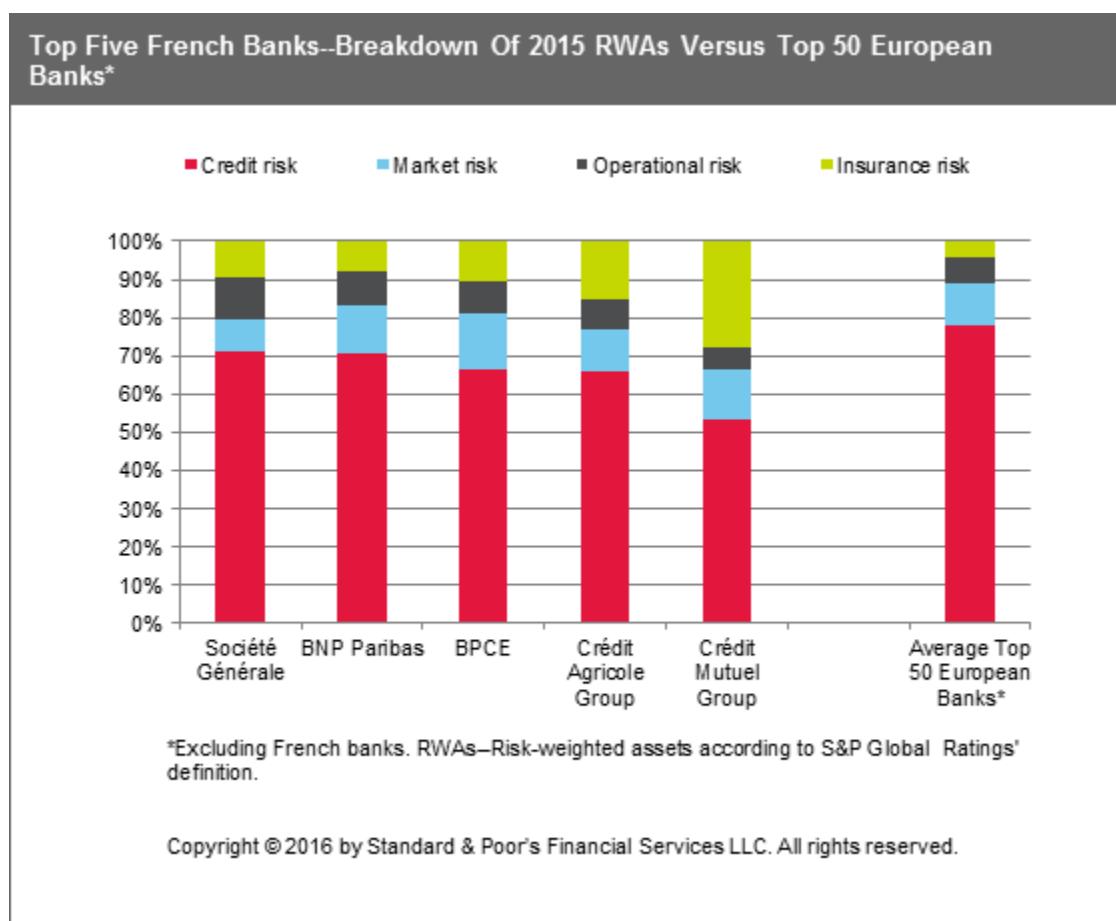
Review and Evaluation Process, will update the transitional and ultimate common equity tier 1 (CET1) ratio requirements for French and other banks. We think organic capital generation will contribute to most of the increase, eventually complemented by small disposals and balance-sheet optimization at some banks. But, in our view, large French banks still have some way to go before we would consider capital strong enough to enhance the ratings.

While the banks have so far been able to preserve their profitability, thanks to decreasing credit losses and lower funding costs, net interest income, particularly in domestic retail banking, is set to decline amid low interest rates. Trading and asset management revenues remained under pressure in the first half of 2016 in the uncertain market environment, which resulted in mixed activity. Besides this, higher regulatory costs and additional investments in digital banking could erode banks' cost efficiency ratios.

## **Credit Risk And Insurance Dominate Risk Profiles**

Most of the risk to French banks stems from credit risks in the banking book and insurance risk, with market and operational risks playing a lesser role (see chart 4). Regulatory reforms will continue to have implications for large banks' business models, such as the sustainability of certain capital-intensive investment banking activities. We expect groups with a larger footprint in capital markets will continue to adapt and adjust their business models to these new rules, even though their operations may already be smaller or less affected than those of European peers.

**Chart 4**



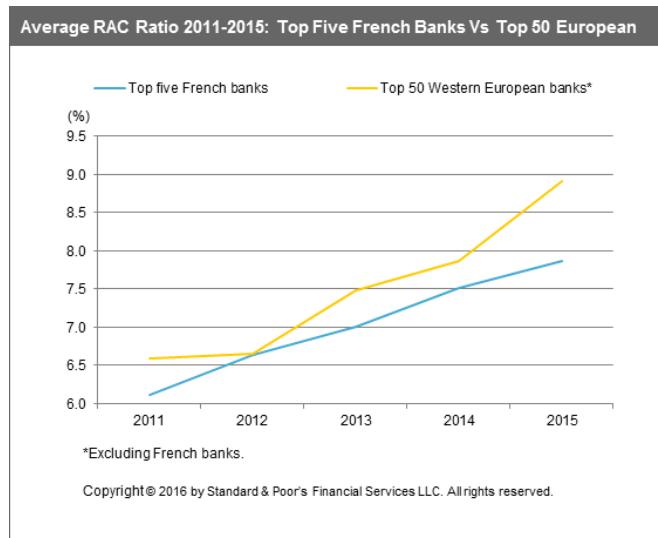
Relatively large insurance exposure is a result of the banks' universal banking model, including integrated insurance activities. Our treatment of insurance subsidiaries within our RAC calculation explains such operations' comparatively significant contribution to banks' RWAs. Under the so-called "Danish compromise," as part of the EU's Capital Requirements Directive (CRD) IV, French banks' regulatory risk weight for investments in insurance subsidiaries is a favorable 370% (compared with a deduction from capital under Basel III), versus the 1,250% that we apply in our RAC framework. Our 1,250% charge is equivalent to a deduction from capital when the RAC ratio is 8%.

Our higher risk weight reflects our view that the capital a bank injects into its regulated insurance subsidiaries is there to back insurance financial liabilities (primarily the funds from insurance policyholders) and would not be available to absorb unexpected losses at the banking group in times of stress. However, we believe this integrated business model is a substantial strength with respect to diversity of earnings, especially due to lower cyclical nature of insurance revenues, its less interest-sensitive nature, and customer loyalty. Our assessments of large French banks' business positions as strong or very strong capture the large share of insurance operations.

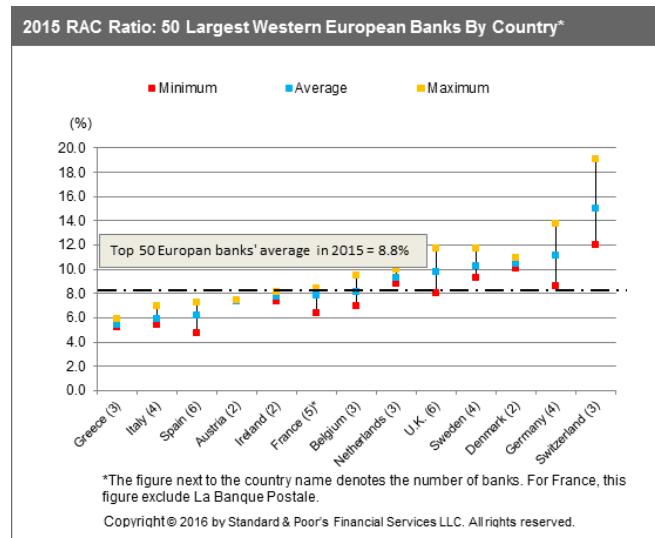
## Capital Positions, Albeit Improving, Still Lag The European Peer Average

We estimate that earnings retention was the main reason for the increase in the average RAC ratio of France's big five banks since 2011 (see chart 5). Deleveraging accounted for a further improvement of 50bps or more for some banks, such as Société Générale. Despite the steady improvement, the banks' capitalization remains lower than the European peer average (see chart 5 and 6).

**Chart 5**



**Chart 6**



The low-interest-rate environment is not conducive to banks' build-up of capital, since it squeezes the revenues from using short-term current accounts and savings to finance longer-term loans. To compensate, some banks may adopt a dynamic loan-origination strategy aiming for higher volumes to partly offset falling margins. This could increase RWAs if not balanced with reductions of capital-intensive business. We see, for instance, that in the first half of 2016, French banks' top-line earnings were subdued, notably domestic retail revenues. But net profit held up relatively well, thanks to very low credit losses and some one-time gains from several institutions' exit from VISA Europe. Although this profitability pressure will inevitably intensify in 2016 and 2017, French banks' universal business model should help them stay more resilient than many European peers (excluding Nordic banks), especially those undergoing a deep restructuring.

Thanks to their cooperative status, BPCE, Credit Agricole, and Credit Mutuel have continued to raise capital through local banks' participating shares ("parts sociales"). Given the depressed stock prices of banks all over Europe, we believe cooperative groups have greater financial flexibility than listed banks like BNP Paribas and Société Générale, even though we don't believe either of the two would need a capital increase. But we think listed banks may find it difficult to achieve a return on equity close to 10%.

## **Potential Increase In Regulatory RWAs Could Narrow The Gap To Our RWA Figure**

We believe the ECB's new single regulator (Single Supervisory Mechanism) aims to better harmonize regulatory RWAs and capital deductions across European banks. This initiative could push French banks' regulatory RWAs upward or reduce possible deviations from the Basel Committee's standards. We also observe that an increasing number of foreign regulators--in Norway, Switzerland, Belgium, and the U.K., for example, but not in France so far--are gradually imposing higher floors or add-ons to risk weights derived from internal models (notably on residential mortgages). We believe it is possible that in the course of reducing national differences, more favorable charges may be phased out, hence increasing banks' RWAs and reducing their Basel III CET1 ratio, absent any offsetting capital measures.

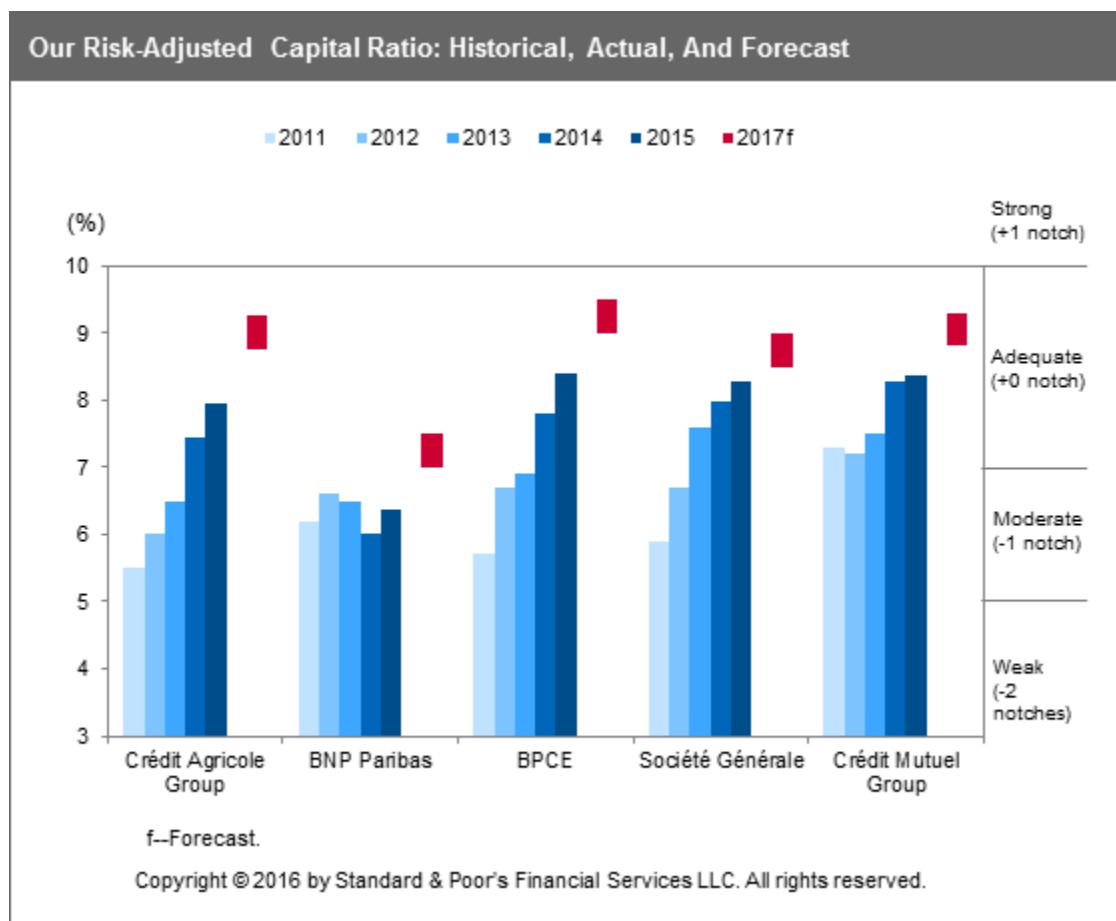
Although we anticipate a gradual convergence of banks' regulatory ratios toward our RAC ratios, due to Basel III implementation and upcoming refinements, the gap has widened somewhat for the top five French banks since 2011 (from 450bps on average to 600bps for the tier 1 regulatory ratio). This is mainly due to:

- The weakening of several Banking Industry Country Risk Assessments in Europe since 2011, including increased economic risk in some countries, as well as the lowering of sovereign ratings. Assuming these assessments had not changed, the increase in the gap would be only 40bps;
- French banks' extensive use of internal models, which tend to feature lower risk weights than in the standardized approach. While in 2011, banks used internal models to calculate RWAs for 70% of the credit risk portfolio, that proportion is now 80% on average; and
- More favorable treatment of certain exposures under CRD IV than under CRD III. The Basel III approach is similar to our RAC framework in some respects, but the treatment of insurance participation, due to the Danish compromise, and that of certain minority equity holdings at subsidiaries for example, is more favorable than under CRD III.

## **Capital And Earnings Are Unlikely To Move Into The Strong Category**

Assuming the upward trend in capital continues, we expect the five banks' RAC ratios will increase to the 8.5%-9.5% range in 2017. One exception is BNP Paribas, whose RAC ratio should be just slightly above 7%. This means their RAC ratios will fall short of the 10% threshold we would consider a positive rating factor that might lead to an upgrade (see chart 7).

Chart 7



That aside, we believe a large cushion of junior bail-in-able instruments may reduce the default risk of some banks' senior unsecured obligations because regulatory authorities can trigger the conversion or write-down of these instruments in resolution, enabling recapitalization through a bail-in (see "Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity," published April 27, 2015). Since we consider a 7% RAC ratio to imply adequate capitalization, any capital contributing to RAC ratios higher than this figure would count as additional loss absorbing capital (ALAC).

We expect that French banks will soon gain another avenue to build ALAC once the Sapin II draft bill for transparency and modernization of the economy is enacted, likely later this year. The bill's article 51 modifies the hierarchy of claims in liquidation, taking a different approach from that in other eurozone countries, notably Germany. France proposes to create a new senior debt category (senior nonprivileged debt) that would give domestic banks a new alternative route to accumulate loss-absorbing instruments that would protect higher-ranking senior obligations, hence helping them fulfill TLAC requirements. BNP Paribas, SocGen, BPCE, and Credit Agricole are all classified as globally systemically important banks and will need to meet this requirement by Jan. 1, 2019.

## Appendix

Table 1

### Rating Effect Of Capital, Earnings, And Risk On A Sample Of French Banks

	Capital and earnings (C&E)	Risk position (RP)	C&E notching effect	RP notching effect	Effect of combined assessment
BNP Paribas	Adequate	Adequate	0	0	0
Banque Accord	Adequate	Moderate	0	(1)	(1)
BPCE	Adequate	Adequate	0	0	0
Crédit Mutuel Group	Adequate	Adequate	0	0	0
Carrefour Banque	Strong	Moderate	1	(1)	0
Crédit Agricole Group	Adequate	Adequate	0	0	0
La Banque Postale	Adequate	Moderate	0	(1)	(1)
RCI Banque	Strong	Adequate	1	0	1
Societe Generale	Adequate	Adequate	0	0	0
Socram Banque	Very strong	Adequate	2	0	2
Dexia Credit Local	Moderate	Weak	(1)	(2)	(3)

Table 2

### The Top Five French Banks--Assessments And RAC Ratios

	Operating company long-term rating	Outlook	SACP	Capital and earnings	Risk position	RAC ratio before diversification (%)*	Regulatory fully loaded CET1 ratio as of 2015 (%)	Forecast RAC ratio range (%)
Crédit Agricole Group	A	Stable	a-	Adequate	Adequate	8.0	13.7	8.8-9.3
BNP Paribas	A	Stable	a	Adequate	Adequate	6.4	10.9	7.0-7.5
BPCE	A	Stable	a-	Adequate	Adequate	8.4	12.8	9.0-9.5
Société Générale	A	Stable	a-	Adequate	Adequate	8.3	10.9	8.5-9.0
Crédit Mutuel Group	A	Negative	a-	Adequate	Adequate	8.4	15.6	8.8-9.3

\*As of end-2015. SACP--stand-alone credit profile. RAC--Risk-adjusted capital. CET--Common equity tier 1.

## Related Criteria And Research

### Related criteria

- Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- Europe's Stress Test Results Show That Most Rated Banks Improved Their Resilience, Aug. 1, 2016

### Related Research

- Top 50 West European Banks: Capital Continues To Rise, But Ranges Widely By Country, Aug. 1, 2016

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