

## **Jean-Claude Trichet: Economic and financial review in France**

Presentation of the 2002 Annual Report of the French Banking Commission (Commission Bancaire) by Mr Jean-Claude Trichet, Governor of the Bank of France and Chairman of the French Banking Commission, Paris, 2 June 2003.

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### **1. 2002 showed that French credit institutions were capable of withstanding a less favourable economic and financial environment**

Measured on a parent-company basis, the aggregate net income of French credit institutions in 2002 was similar to 2001's figure of nearly 18 billion euro. This result is all the more remarkable because it was achieved despite negative cyclical developments. Once again, domestic retail banking was the mainstay of profitability.

#### **1.1 *Slower economic growth and high equity market volatility formed the backdrop for 2002***

Although the world economy picked up slightly in 2002, expanding by 3.0 per cent compared with 2.3 per cent in 2001, it was much more sluggish than in 2000, when growth came in at 4.7 per cent. Furthermore, in the euro area, GDP growth continued to slow, decelerating from 3.4 per cent in 2000 to 1.4 per cent in 2001 and 0.8 per cent in 2002.

As in 2001, France's economy grew slightly faster than average, with 1.2 per cent.

Sector-related problems fostered a climate of uncertainty that affected growth. They resulted chiefly from the bursting of the Internet bubble, developments in telecommunications, transport and energy, and entrenched geopolitical tensions in Latin America and the Middle East. This naturally impacted the financial health of the corporate sector, and business failure rates rose to levels comparable to those of the early 1990s.

These economic trends, combined with the discovery of egregious shortcomings in corporate governance, fuelled misgivings about stockmarkets. And amid a global bear market, equity volatility soared. Consequently, as in 2001, capital market business in the broad sense of the term - securities, mergers and acquisitions, and the fees and commissions charged for these activities - were adversely affected.

#### **1.2 *Despite an unfavourable climate in 2002, French credit institutions reported net income on a par with 2001.***

French credit institutions reported net income of 17.7 billion euro in 2002, the same as in 2001. This works out to a return on equity of 9.4 per cent for the industry as a whole. As in previous years, these results were largely attributable to retail banking business in France. Consumer credit and home loans continued to grow, along with specialised financial services. In addition, falling interest rates had a positive effect on interbank business - which in France has always been significant - and drove down the net expense on these transactions. By contrast, capital market activities and asset management were hit by financial market turbulence, giving rise to substantial provisions in some cases. Furthermore, for the second year running, fees and commissions contracted as a percentage of net banking income, falling to 26 per cent compared with nearly 30 per cent in 2000.

#### **1.3 *Diversification has helped French credit institutions to offset negative cyclical trends***

As in previous years, conventional retail banking activities cushioned the negative impact of trends in investment banking and asset management in 2002. On the international front, too, retail banking was a major avenue of development for leading French banks.

It must be stressed, however, that the consolidated accounts of France's largest banks were slightly less positive in 2002, even though the overall situation was satisfactory. In this regard, the dollar-euro

exchange rate had an impact on the foreign activities of these banks, denominated in euros, which were also exposed to the negative earnings momentum of subsidiaries specialising in equity-related businesses.

## **2. French banks must buttress the elements that have allowed them to withstand cyclical contingencies for the past few years**

In addition to diversifying their business lines - and I am pleased to note that securities analysts are now taking this factor into account when assessing different banking industries - French banks have improved their capacity to withstand cyclical contingencies. That ability must naturally be maintained and strengthened.

### **2.1 French banks used the healthy profits of the late 1990s to strengthen their capital base**

French credit institutions have entered the cyclical downswing on a sounder financial footing. To illustrate that point, a review of the French banking system since the late 1960s is included in the appendixes to this Annual Report. Book capital is now equivalent to 5.2 per cent of total assets, compared with 4.2 per cent in the mid-1990s. The Commission Bancaire is at pains to ensure that all French banks - small and large - build up their capital gradually but steadily until it well exceeds the regulatory minimum. Furthermore, provision cover for doubtful loans now stands at 60.4 per cent. The industry must pursue this prudential policy. In particular, as we have been urging for several years, it must capitalise on the progress made in future risk analysis, based on statistical databases and stress testing, to adopt a more forward-looking provisioning policy. This has already been accomplished in several areas of sectoral or geographical risk. That being said, we firmly believe that international accounting standards should move in this direction, fostering the widespread use of forward-looking provisions and thereby contributing immensely to financial stability.

In a context of economic crisis, the constant strengthening of French credit institutions' financial structure gives them an appreciable safety margin, which could also allow them to play a part in the consolidation of Europe's financial industry.

### **2.2 Priority has rightly been placed on controlling risks and ordinary profitability**

The other fundamental elements that contribute to the resilience of French banks' earnings are risk management and control over operating conditions.

As you know, the Commission Bancaire places a premium on ensuring that French banks, and credit institutions in general, generate satisfactory profits at operating level. Gross operating income is the first fall-back - before regulatory capital - for satisfying provisioning requirements, which naturally become more acute when economic conditions turn down. Accordingly, final operating margins must be sufficiently wide. This is also essential so that banks can tap the markets, at optimal cost and with sufficient independence, for the financing they need to develop and to secure their future. To that end, the Commission Bancaire makes sure that cost-to-income ratios, which measure operating expenses as a percentage of overall operating profit, are not excessive. Spontaneous action by banks themselves has naturally been crucial in this respect.

This trend must continue. The same applies to efforts to improve the selection, monitoring and control of risk. Thanks partly to those efforts, it has been possible to confine loss-risk and provisioning requirements to securities portfolios and capital market business in general, as well as to some large corporate loans, particularly in the USA. Further improvements in internal controls, at the instigation of the Commission Bancaire, are naturally of major importance.

When the economic and financial environment is dominated by uncertainty, the only cogent strategy is to reduce the factors that produce risk. Apparently there is room for further improvement in areas such as the spreading of credit risk. Furthermore, stricter internal controls could be applied to capital market intermediation and to the management of specific factors such as operating risk.

### **3. With tighter control over processes, information systems, operations and risk, French credit institutions should be able to cope with future developments**

Aside from the cyclical aspects I have just mentioned, the short-term outlook is characterised by both the increasing interplay between the financial and non-financial spheres, owing to the development of new risk-transfer instruments, and by closer harmonisation of the rules applicable to different economic agents.

#### **3.1 Careful attention must be paid to the characteristics and consequences of risk transfer transactions**

Credit derivatives, and products and techniques like securitisation that produce similar results, are a means of reducing the loan-loss exposure of credit institutions, which are net risk-sellers. These instruments can be useful for mitigating risk exposure, provided naturally that banks act as protection buyers. However, the characteristics and consequences of the development of these products must be closely scrutinised, both by credit institutions operating in these markets and by the authorities responsible for maintaining financial stability. Institutions must pay particular attention to the real impact of risk transfer. They must also keep close watch on the resulting counterparty risk that attaches to the protection seller. The question of risk transfer is also under scrutiny because of the treatment of the special purpose vehicles to which assets are sold. On this point, the accounting rules currently under review at the international level seem to focus quite rightly on the reality of risk transfer.

Credit institutions must therefore analyse this criterion in greater detail. The issue is also of interest to the authorities responsible for financial stability. As standardised risk-transfer instruments develop, they are likely to come into wider use. So far, market participants have not properly identified or analysed the likely knock-on effects, whether direct or indirect. For this reason, there is a vital need for improvements in the prudential reporting and market transparency of these transactions; there is also a need for greater harmonisation of the rules and regulations applicable to institutions in different countries and to different types of company. The aim should be to record the risk where it is actually borne, both economically and financially. In addition, the authorities responsible for different financial sectors must coordinate their efforts to jointly identify where risks lie and to measure their extent. The Banque de France and the Commission Bancaire are working to that end with their counterparts in the insurance industry and the securities markets.

#### **3.2 The future solvency ratio will better reflect the economic realities of banking risk**

The finishing touches are being put to the solvency ratio, due to come into force in 2006. The new ratio will cover a broad spectrum of activities and risks, based on an approach tailored to the degree of sophistication of financial market participants, both in the G10 and beyond. From a prudential standpoint, the ratio will capitalise on the progress already made in improving risk supervision and control, while making it easier to compare methods at the international level. Accordingly, it is clearly important that credit institutions should actively pursue the work they have done so far. In this respect, I think it is safe to say that French banks operating in the international arena are making every effort to ready themselves for 2006.

#### **3.3 New accounting standards should foster international harmonisation and promote greater financial transparency**

The introduction of new accounting standards is a major undertaking for companies in general and for credit institutions in particular. The aim of this project is highly ambitious, namely to arrive at worldwide standards that can improve financial security and accounting transparency. This is necessary to restore confidence in financial markets. At the internal level, credit institutions must quickly adapt their information systems to these new requirements. However, there are in-depth discussions at present about the draft standards applicable to financial instruments. We have taken part in these discussions and advocated caution, in particular, in view of the strong temptation to give precedence to the mark-to-market and mark-to-model approaches, which are more sensitive to calculation parameters than to the actual situation of the reporting entity, with the result that earnings and equity likely to become abnormally volatile. I hope that the outcome of these discussions will lead to accounting procedures that take into consideration the realities of credit institutions' operations and business practices.

As you are aware, the quality of the accounting rules applicable by banks is of fundamental importance for supervisors. Moreover, the appendixes to this Annual Report include a study of the prudential consequences of the international accounting standards that will apply in Europe from 2005 onwards.

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In sum, French credit institutions in 2002 amply displayed their ability to withstand cyclical contingencies. Improvements can still be made in terms of risk spreading and surveillance. This is one of the factors to which the Commission Bancaire will play close attention as banks prepare and phase in information systems ahead of the introduction of Basel 2 and new accounting standards.

In addition to the two studies I have already mentioned, the appendices of the Annual Report include a review of risk management in financial conglomerates. Let me also mention that a summary of the Commission Bancaire's judicial decisions is being published at the same time as the Annual Report. This first edition will be updated yearly.