Christian Noyer: France's banking industry in 2006 – key trends

Speech by Mr Christian Noyer, Governor of the Bank of France and Chairman of the French Banking Commission, at the presentation of the 2006 Annual Report of the French Banking Commission, Paris, 29 June 2007.

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Welcome to this press breakfast, organised for the release today of the 2006 Annual Report of the Commission Bancaire. I would like to discuss the key trends that characterised France's banking industry in 2006, not just in terms of structure and performance but also the regulatory environment in which it operates.

It is clear that the framework for financial activity and banking risk management has changed in recent months, confirming the ever more urgent need for new methods of risk assessment and for appropriate supervision that can react swiftly to these changes.

In my view, several factors are important in this respect.

First, in a highly international context, banks' performances are increasingly being judged from the outside, especially by shareholders. Those judgements are sometimes so harsh that they can have a direct structural impact. Consequently, banks can no longer afford simply to post excellent results – as again was the case in 2006 for most major international banks, especially French banks. They must also make sure that the underlying quality of those results is sound. To do this, they must pay special attention to the way they manage risks internally and plan their strategic expansion, and to their capital adequacy policy.

Second, the economic and financial context in which French banks are operating is also a source of risks. Indeed, lessons must be learned from the slowdown in the USA, amply illustrated by the housing downturn, which resulted in higher risk in the sub-prime segments of the retail banking market. It should also be acknowledged that financial markets could become more unsettled. If higher risk aversion were to encourage greater use of risk transfer products, this could drain liquidity from some markets and undermine the efficiency of banks' management. From a supervisory perspective, the problem is all the more acute since the growing reliance on credit risk transfer instruments tends to make it harder to assess the type and degree of risk that banks actually bear when, for example, they arrange complex transactions.

Third, the regulatory environment for French banks is changing radically as a result of the Basel II accords. Banks that have adopted the advanced approaches to risk management must put models in place – usually as early as January 2008 – for the internal rating and assessment of credit risk, market risk and operational risk. On-site inspection teams from the Commission Bancaire are currently scrutinising these models. Their investigations show that, overall, large banking groups have taken the measure of this project early on, so as to be ready for the deadline of the 1st January 2008, even if some improvements need to be made in certain areas. Furthermore, most banks will have to meet the next challenge of fine-tuning their risk management and calculating their economic capital in the coming months, pursuant to Pillar 2.

In sum, these regulatory, economic and financial factors are prompting banks to change the way they manage their risks, meaning that supervisors must be more flexible and more watchful. To clarify these considerations, I would like briefly to address two issues:

1. The results posted by French banks in 2006 are good, but they are not without vulnerabilities.

2. French banks are currently in the final straight as regards the implementation of the new regulation. As the banking supervisor, our role is to support them during this transitional period and to ensure together that the reforms are carried out properly.

French banks' 2006 results are good, but not without vulnerabilities

Like the majority of leading European banks, French credit institutions reported good results for 2006, in line with the previous three years. For the three main banking groups under IFRS, the net banking income grew nearly 19 per cent, more than in 2005. In all, the aggregate net income of the French banking system, under French GAAPS, amounts to nearly €40 billion. This reflects a substantial contribution from foreign subsidiaries and from non-banking business, especially insurance. Moreover, most large French banks made major acquisitions outside their home market in 2006, particularly in regions with strong growth potential.

Retail banking is still the main source of profit for French banks, accounting for nearly 60 per cent of the largest groups' net banking income. That said, the domestic retail market began to decelerate in the last quarter of 2006 and the first quarter of 2007. The net interest margins of several major groups contracted, contributing to downward pressure on 2006 results. To an increasing extent, this margin squeeze is not being offset by the rise in outstanding loans, while fees and commission income has been growing less strongly than in recent years. The outlook for intermediation income in 2007 may be less positive given the persistently intense competition in the credit market and the possibility that the yield curve will remain either flat or shallow. Furthermore, we must learn a cautionary lesson from the increase in borrower default risk observed in the sub-prime segment of the US retail market. The risk may be less pronounced in continental Europe, but I would point out that margins on mortgage lending are already thin and that there is a trend towards longer loan maturities. I am therefore calling on French banks to make sure that they closely monitor their borrower risk exposure.

So far, the earnings slowdown in retail banking has been mitigated by good performances in corporate and investment banking, private banking, and personal asset management, which provided new growth opportunities. Through mergers and acquisitions, including leveraged buy-outs (LBOs), banks were able to increase the proportion of income generated by non intermediation activities.

The recent competitive environment has actually fostered the gradual transformation of banking activities, with a greater emphasis on the "originate and distribute" business model. With this model, credit institutions arrange financings but quickly offload a substantial portion of their risks, for example through securitisation, and take payment – much more so than in the past – in the form of fees and commissions.

But although activity in new products such as LBOs is helping to boost French banks' revenues and earnings, it is also a source of vulnerability. First, in terms of remuneration, fierce competition among credit institutions is not only exerting downward pressure on margins; it is encouraging "covenant-lite" deals – a worrying trend. These complex transactions are also beginning to generate new risks. On this point, there is a tendency towards longer underwriting periods, during which banks bear the bulk of the risk. Banks should also pay attention to the fact that counterparties such as hedge funds are becoming increasingly involved in this type of deals.

Allow me two brief asides, if you will. First, with regard to LBOs, let me refer you to the study appended to the Annual Report. On the topic of hedge funds, I would remind you that the Banque de France devoted a special issue of its financial stability review to this subject and that the Commission Bancaire pays close attention to banks' involvement with this type of counterparty. Let me also say that we now comply fully with the recommendations set out in the Financial Stability Forum report commissioned by the G8 and published on the 19th May 2007.

Getting back to the banking system, I believe that, in light of these developments, banks should adopt an appropriate scale of charges and, more importantly, stricter oversight procedures, in line with the rationale at the heart of Basel II approach.

French banks are currently in the final straight as regards the implementation of the new regulation

Basel II is playing a key role in moves to buttress risk management at credit institutions. The European Council and the Parliament adopted the Capital Requirements Directive on 14 June 2006, a crucial milestone in implementing the Basel II mechanism, established by the Basel Committee for Banking Supervision, within the European Union. The mechanism's three pillars – minimum capital requirements, supervisory review, and market discipline – form a prudential framework that is both more extensive and more sensitive to the risks actually incurred by credit institutions. Above all, Basel II should encourage institutions to improve their internal management and carefully calibrate their capital requirements.

At present, we are concentrating on assessing the implementation of internal ratings-based approaches for credit risk and advanced measurement approaches for operational risk. The Commission Bancaire therefore undertook a series of on-site inspection missions in 2006 and 2007 to evaluate the systems and models developed by French institutions. The missions were initiated after the Commission's General Secretariat had received the findings of the institutions' "internal validations". The purpose was to make sure that institutions were in compliance with the minimum regulatory requirements and, more generally, to check the quality of their information systems and the conditions in which these mechanisms are used and controlled.

These inspections revealed that institutions had indeed already made extensive achievements, but also showed that some of them needed to make further progress on Pillar 1 of Basel II, especially with regard to:

- the collection and estimation of the Basel parameters, particularly probabilities of default (PD) and loss given default (LGD): on this point, it is important that banks should steadily upgrade again their historical data so as to cover full business cycles;
- permanent control and validation of information systems and/or models: implementing thorough benchmarking and back-testing processes is crucial in this context.

With regard to Pillar 2, the Commission Bancaire urges banks to make certain that their Internal Capital Adequacy Assessment Processes capture risks which are covered incompletely or not at all by Pillar 1, especially concentration risk, liquidity risk and overall interest rate risk. In the months ahead, priority must be given to developing stress tests that are more comprehensive, i.e. that encompass the various risks (credit, market, etc.) and that aim for exhaustive coverage of risk exposure.

Banks must also meet their transparency requirements under Pillar 3 (market discipline), for both the content and the frequency of their disclosures. This point is particularly important because the Commission Bancaire's decision on whether to authorise the use of certain approaches may hinge on meeting these requirements, which, moreover, tie in with those in the new IFRS.

It should be underlined that the Commission Bancaire carries out these activities in close cooperation with other European oversight authorities as a member of the Committee of European Banking Supervisors (CEBS) whose objective is to achieve closer convergence of supervisors' regulations and practices. In this regard, CEBS has set up operational networks, known as supervisory colleges, for major cross-border banks. Composed of the home-country and host-country supervisors of Europe's largest banking groups, these networks make it possible to find pragmatic solutions to the main problems encountered when implementing Basel II. Likewise, convergence of supervisory practices must be also materialised by the filing of the first accounting and prudential reports in FINREP and COREP formats, respectively, which form a common framework for Europe.

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Let me say in conclusion that over the past year the French banking system has demonstrated its ability to develop new activities and thus find the fresh sources of growth needed to diversity its revenues. But these positive results are not without certain vulnerabilities, given that margins are slim and some complex financings are exposed to both operational risk and model risk.

It is therefore necessary to ensure that banks’ balance sheets remain robust. To achieve this, naturally, pricing structures must correspond to actual risk exposure, and risk management techniques must be strengthened. But the level and quality of capital must also be appropriate.

Accordingly, confronted with the spread of banking strategies that earn high returns but engender new risks, the Commission Bancaire is constantly on its guard in order to preserve the current levels of resilience and performance of the French banking system as a whole. The Commission Bancaire therefore intends to reinforce its action in order to improve the management and control of these risks, while stepping up its efforts to promote a common culture of supervision in a coherent framework at the European level.