Christian Noyer: France's banking industry in 2007 – 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 2007 Annual Report of the French Banking Commission, Paris, 26 June 2008.

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Welcome to the working breakfast organised for the press on the occasion of the publication of the Commission Bancaire's 2007 Annual Report today. I would like to take this opportunity to speak to you about the major trends seen in the banking industry in 2007. Naturally, the main development last year was the subprime crisis. I will also speak about the lessons learned from the crisis for the future.

Even though the French banking system's overall exposure to the risks revealed by the subprime crisis turned out to be less severe than in other G10 countries, our banking system was still affected, as can be seen in the decline in profitability. On a more encouraging note, however, French banks managed to maintain satisfactory solvency ratios, testifying to the system's resilience and its ability to cope with a very large-scale and complex crisis. However, in addition to the impact on business conditions, the financial crisis calls for an examination of the robustness of some of the banking activities that developed so rapidly over the last ten years. These activities have complicated the task of risk management in major banking groups.

The materialisation of certain risks, the return of volatility on financial markets and uncertainty about the economic outlook have meant that major banks need to make a special effort in three key areas: i) maintaining adequate capital ratios to cushion them from further shocks, which may still occur, ii) strengthening their risk management systems and processes, and iii) pricing credit and liquidity risks appropriately. To explain these developments, I would like to speak to you briefly about the following points.

1. **First of all, the French banking system provided proof of its resilience in the face of financial turmoil in 2007.**
2. **The current economic situation calls for vigilance nonetheless, since banks must be ready to cope with new risks that may occur at any time.**
3. **Finally, as crisis conditions persist, I should like to talk about the main thrusts of the supervisory authorities' actions.**

1. The French banking system provided proof of its resilience in the face of financial turmoil in 2007

After posting good performances since 2003, **the French banking system was hit by the fall-out from the subprime crisis starting in mid 2007, as were the banking systems in the other leading developed countries**. This led to an extended period of strong turbulence. The impact of the crisis on banks' earnings first shows up in the third quarter financial statements and then more clearly in the fourth-quarter statements. **French banks were affected through several channels:**

- First, through their direct exposures to American households in the subprime category or through indirect exposures in portfolios of structured financial instruments, such as residential mortgage backed securities (RMBS) and collateralised debt obligations (CDOs) that are in turn exposed to subprime risks. As was the case for the rest of the banking system in Europe, indirect exposures accounted for much greater amounts than direct exposures and therefore for the bulk of the losses; the lessons that this situation holds for more refined risk management need to be learned quickly.

- Secondly, through exposures to securitisation vehicles (conduits or structured investment vehicles) and particularly through liquidity lines, which need to be managed more rigorously going forward.
- Thirdly, through exposures to assets taken back from securitisation vehicles, or even collective investment schemes, that ran into liquidity problems; this type of reintermediation needs to be given more consideration in terms of capital requirements.
- Fourthly, through their exposures to monoline insurers, which insured some products and were themselves hard-hit by the crisis and thus epitomise “wrong-way” counterparty risks, which need to be assessed more carefully.
- Finally, though exposures to leveraged buy-outs, or more generally by credit-risk-related costs on the most vulnerable companies, which are starting to rise.

Consequently, French banks have not escaped the **overall slowdown in net banking income growth** affecting major international banking groups. The net banking income of the three leading groups using IFRS grew by only 3.8 per cent in 2007, after rising by 18 per cent in 2006. However, the aggregate net profit under French accounting standards for the French banking system in 2007 reached nearly €27 billion, making it possible to generate income that is used in part to strengthen the institutions’ financial foundations, thereby contributing to the financial stability of the Paris market.

The diversification of French banking groups’ activities has proven to be a strength. Several business lines are showing positive trends, with further gains in retail banking, which posted growth of 9.1 per cent (particularly in foreign operations, with an increase of 22 per cent compared to 2006), and project financing. Retail banking is still a core business for French banks and it played a critical role in stabilising income sources since the beginning of the financial crisis. Origination of new loans for non-financial agents remained high. Proper pricing of risks according to the credit quality of borrowers is therefore a key issue in France’s highly competitive lending market.

By contrast, corporate and investment banking activities had a broadly negative impact on earnings, due to the combined effects of asset impairment and falling profits. Losses from asset management vary more significantly from one institution to another.

What can we learn from the major banks’ first quarter earnings in 2008? Earnings are obviously following the same trend as in 2007 and reflect the persistent effects of the risks associated with the subprime crisis, with valuation losses on assets and higher risk-related costs. A compound indicator, such as ROE shows a decline in profitability, but it still stands at an average of 14 per cent, compared to 18.9 per cent for the three largest banking groups in the first quarter of 2007. On this point, I would like to put this decline into context. It follows several years of exceptional profits, which raised questions about their sustainability.

Despite declining income, the French banking system is still financially sound: the Tier 1 solvency ratio based on original own funds stood at an average of 7.1 per cent for the three largest banking groups at the end of 2007, much higher than the minimum ratio of 4 per cent set under Pillar 1 of the Basel II Accord. Banks increased their solvency ratios in the first quarter of 2008 and the Commission Bancaire attaches a great deal of importance to this effort.

The benefits of business diversification, the effectiveness of the measures taken to limit risk exposures and the satisfactory capital levels **have also enabled the major banking groups to remain highly rated by the leading international agencies.**

2. The current economic situation calls for vigilance nonetheless, since banks must be ready to cope with new risks that may occur at any time.

The sources of risks related to the crisis are being closely monitored, but **the French banking system, like any other, cannot be fully protected against new negative developments stemming from the crisis. In today's globalised financial markets, the contagion of financial turmoil can spread through many channels.** Therefore, extreme vigilance is called for.

For example, **let me say a few words about hedge fund risks**, since an increase in counterparty risk exposure to these unregulated entities may still occur, **and it could be combined with "commodities" risk**. In this respect, I would like to stress that it is critical for banks to ensure that their hedge fund exposures are adequately collateralised at all times. I am aware that hedge funds are attractive customers that no credit institution can afford to ignore today, and that prime brokerage activities are a path to growth for many of our institutions. Similarly, no bank can afford to ignore the growth of the financial markets linked to commodities and energy. However, it must not be forgotten that hedge funds are also very active in these highly volatile markets. It is therefore critical to avoid risk concentration and a combination of vulnerabilities stemming from these two rapidly growing sectors.

Even though we have not taken a second-round shock to the real economy stemming from the financial crisis as our central scenario for the euro area, **a high degree of uncertainty is still the distinguishing characteristic of the banking business in 2008. Banks are obviously faced with solving a complex equation**: i) maintaining a positive contribution to net income from financial services and retail banking as risk-related costs rise, ii) controlling the risk profile of corporate and investment banking activities, while maintaining a good profitability level, iii) coping with the impact of the aftershocks of the crisis on banks' balance sheets. In this regard, let me stress liquidity management, as market conditions remain tense, with the attendant consequences for management of hedging transactions more generally.

On this last point, I should add that their diversified business model means that French banks are not among the most dependent on market financing. **Therefore, the leading French banking groups were able to manage their liquidity needs effectively**, even during the periods of greatest tension on the markets. Yet, the tightening-up of access to liquidity in the wake of the crisis did show how critical risk management has become.

3. As crisis conditions persist, I should like to talk about the main thrusts of the supervisory authorities' actions.

We have always maintained that the practical implementation of the new Basel II solvency ratio would primarily ensure that banks measure their risks more accurately both in ordinary times as well as during crises.

The new Basel II framework has been a reality in France since the beginning of the year. It is noteworthy that a large proportion of French banks use "internal-ratings based" approaches to credit risk. Such approaches were used for more than 80 per cent of the relevant banking assets at 1 January 2008.

I would also like to point out that the impact of Basel II on credit institutions' capital goes beyond the capital requirement calculation stipulated in Pillar 1 (even though it provides more comprehensive coverage than Basel I of new risks, such as securitisation activities). Regarding Pillar 2, the new regulations call for major additional arrangements to **refine banks' risk management and planning for capital cushions.** This could lead to additional capital requirements, or other appropriate measures to enhance bank stability by considering risks that are not dealt with or are inadequately dealt with under Pillar 1. By the end of the year, this approach should lead to individual ratios for each institution that the Commission Bancaire sets on the basis of structured dialogue with each institution.

We have also undertaken a series of major actions that are directly in line with the general framework of the recommendations made by the Financial Stability Forum. Many spheres of action have been defined, but I would like to speak about three that I think are priorities, starting with transparency and valuation, followed by adapting the capital requirements set by Basel II for certain instruments, and finally, liquidity risk.

First of all, **enhancing transparency and financial disclosure** was quickly identified as one of the key requirements for ending the crisis. We have urged French banks, in conjunction with the national institute of statutory auditors, the CNCC, to provide detailed disclosures of their subprime exposures. A joint working group made up of staff from the Commission Bancaire, the Autorité des Marchés Financiers and the French Banking Federation has defined best practices in this area. Institutions have started implementing them in a satisfactory manner and practices should be further improved in the financial statements for first-half 2008. In 2009, the Basel Committee is planning to publish recommendations on information to be disseminated under the requirements of Pillar 3 of Basel II. **In-depth discussions with banks led to a convergence of practices for asset valuation**, including the priority on relying on prices and directly observable market data. Where banks have had to use valuation models because liquid prices disappeared in some markets, the recommendations deal with consideration of all risks – including liquidity risk and counterparty risk – and the rigorousness of the process for determining such prices.

With regard to adapting the Basel II requirements, we are also playing a very active role in the various international working groups led by the Basel Committee to give greater consideration, where necessary, to the capital requirements related to some liquidity lines or to the securitisation rules.

Finally, the crisis has highlighted the need for banks to improve their analysis, measurement and management of liquidity risk. A review of how refinancing risk could arise across all of a bank's business lines is a priority; as is an analysis of how refinancing risk interacts with market risk, credit risk and concentration risk. The Committee of European Banking Supervisors and the Basel Committee, at the global level, are currently reviewing the principles governing liquidity risk management.

On a final note, I would like to add that the crisis has highlighted the need to **enhance internal control systems and to improve the circulation of information about risks, especially for senior managers.** The exceptional case of fraud affecting Société Générale has strengthened our resolve in this matter. **In France, this should lead to the amendment of Regulation 97.02 on internal control**, with provisions on managing operating risk, along with specific efforts to fight fraud. This reform is connected to moves to ensure greater involvement of banks' highest governance bodies in monitoring their internal control systems.

All these initiatives draw on the lessons learned from the past, but they are also forward-looking. Their purpose is to establish the principles of risk management. These principles do not eliminate all risks, but they enhance the resilience of the system when tensions do emerge. This is the objective of the reforms, which I am sure will contribute to greater financial stability in the long run.

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The Commission Bancaire therefore intends to continue its action to enhance management and control of these risks, not only within France but at the international level as well, naturally, within a European banking supervision structure that emphasises real convergence in supervisory practices. The practical implementation of supervisory colleges needs to be stepped up in order to achieve this objective. Supervisory colleges are the keystone for the supervision of large cross-border groups in Europe. The resolutely European thrust of our action, which is naturally in line with the international development of banking activities and of the sources of vulnerability for financial stability, will lead to the incorporation of a European convergence objective into the mandates of domestic supervisors. From my point of view, this objective will be a major motivation for the supervisory community as a whole.