New challenges for financing the economy

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Abstract:
Contrary to other euro area countries, the credit crunch overlooked France during the financial crisis. Levels of access to credit remained very high, backed by positive lending conditions. France was also the sole euro area country where the taxpayer was spared the cost.[1] French banks weathered the crisis well, enjoying higher and less volatile returns than those of their European counterparts, although profitability has since declined. Paradoxically, US banks have emerged stronger, despite the crisis having emanated from their shores.
Over the last decade, banks have had to contend with significant changes to regulation. The banking union has been put into effect, providing the euro area with supervisory mechanisms as well as preventive and management provisions in the event of a crisis. The only one of its kind, it has brought greater security to the financial system. Systemically important banks have considerably bulked up their core capital and reduced risks to their balance sheets while continuing to provide vibrant support to the economy.
European banks must now adopt a new management model for financing the economy, involving more market-based financing and less credit. Post-crisis regulation, particularly the Basel Accords, favour the US model. They oblige European banks to address important economic, regulatory and digital challenges against a lasting backdrop of low interest rates, although digitization does provide a unique opportunity to improve services for customers.

[1] ECB, "The fiscal impact of financial sector support during the crisis", Economic Bulletin no.6, 17 September 2015

English version: Translation Centre of the French economy and finance ministries

Maintaining the capacity of French banks to finance the economy at home and in Europe

Corporate financing: the strategic priority of French banks

Corporate financing is the strategic priority of French banks. Corporate development is the linchpin of growth, employment and a vibrant French economy. The original universal banking model of French banks provides a wide and comprehensive variety of financial services to assist companies with their financing needs.

The growth of corporate credit in France has outstripped the rest of Europe, up 6.3% against 1.9% in the euro area end-2017.[2] Company borrowing stands at €965bn (up 6.2% year-on-year), of which €679bn for investment (up 6.8% year-on-year) and €227bn for treasury (up 5.3% year-on-year).[3]

Credit in France is predominantly sound. The ratio of French banks' non-performing loans (NPL) is far below the average for euro area banks (3.10% in Q4 2017).[4] The cost of risk to the six largest French banks amounted to €10.3bn in 2016, down 20% year-on-year.[5]

Risk management in French banks facilitates better lending rates than those in other major OECD countries, as the interest rate for French SMEs is set at 1.78%, compared to over 3.3% in the UK and the US.[6]

Bank loans are the major source of financing in France and Europe, representing almost two thirds of corporate debt in the euro area, compared to not even a third in the US.[7] This is why, as a direct consequence of post-crisis regulation, the first steps towards the Capital Markets Union (CMU) are insufficient. More decisive European intervention is required in order to provide greater market-based financing and less credit.

Ensuring the proper functioning of the banking union

The banking union ensured stability in the euro area financial sector after the crash and made in-depth reforms to its supervision. The Single Supervisory Mechanism (SSM), the first of the banking union's pillars, was put into effect on 4 November 2014. The purpose of the second pillar, the Single Resolution Mechanism (SRM), is to end the dangerous banking-sovereign debt nexus and protect taxpayers from banking complications. Its provisions involve bond and shareholders, rather than governments and taxpayers, and require banks

[2] ECB, December 2017
[3] Banque de France, December 2017
[4] EBA
[5] The French Prudential Supervision and Resolution Authority (ACPR)
[6] OECD 2015 (latest available statistics)
[7] ECB and FED

not only to build up internal bailout reserves, but external resolution funds as well, on which they can draw in the event of insufficient in-house reserves. Brussels is currently working on the common deposit guarantee system, the third banking union pillar.

At present, the banking union is in a quandary. In practice, banking systems are greatly influenced by national supervisors and largely remain nationwide. The present interbank system is once again fragmenting,[8] making it difficult for banks to direct savings to areas in need of investment. This blocks sound financing channels to the European economy. Moreover, the current trend is to enforce very restrictive rules on big banks. The balance sheets of the euro area's global systemically important banks (G-SIBs) display 46% retail loans and 40% corporate loans.

Adapting and incorporating international prudential requirements into the European economy

As regards regulation, the final Basel III reform on 7 December 2017 set the rules for bank capital. For Europe to incorporate these measures, certain European specificities must be taken into account, particularly (i) mortgages (for which the French system is largely based on fixed-rate credits granted according to the borrower's solvency), (ii) specialised financing (particularly vital for long-term infrastructure against a backdrop of the energy transition) and (iii) nonrated companies, (contrary to the US, the vast majority of European companies are not rated).

The Basel III Accord is expected to increase constraints on European banks by 15% whereas throughout the rest of the world its impact is by and large neutral. European banks were united in contesting the US-inspired Accord, which puts their system at a disadvantage even though the US model presents greater risks.

Other regulatory texts carry particular significance. The new reporting standard IFRS 9, introduced on 1 January 2018, defines new regulations for credit risk impairment which could weigh heavily on SME credit by making loans subject to the provision of statistical risk of loss.

The second EU banking resolution directive, the BRRD2, expands on the provisions for preventing and resolving banking issues. It introduces the Total loss-absorbing capacity (TLAC) into European law, clarifies how to calculate the Minimum requirement for Own Funds and Eligible Liabilities (MREL) and sets out the hierarchy of banking creditors. Some points have yet to be resolved to avoid a double penalty for those big banks obliged to apply both the MREL and TLAC ratios.

[8] EBA

Developing capital markets in Europe

Given the strain on bank credit from the new prudential demands, market financing will need to take on a larger role in fuelling the European economy. The purpose of the Capital Markets Union (CMU) is to facilitate access to market financing for all types of EU companies, thereby providing an effective supplement to bank credit. In the context of Brexit, further CMU consolidation is all the more urgent. London is the European leader for financial market trading and clearing, whereas Paris heads the industry in the euro area.

An imbalance exists in the EU between surplus savings in some countries and lack of investment in others. This derives from market fragmentation as national markets at varying stages of development stand side by side. Despite European corporate and investment banks having sound knowledge of these markets and the requirements of their clients, they are not yet as developed as the major banks in the US. Furthermore, US banks benefit from a dominant domestic market and regulation adapted to their corporate financing model, which mainly operates through the markets. Thus capital markets in the US represent 150% of GDP compared to 70% in the EU.[9]

Reviving the CMU is vital for financing the European economy. Banking regulation leans heavily towards market-based financing and Europe must therefore find ways to bolster its development. In order to up the tempo, the next European Commission mandate must include the expansion of capital markets, and an initiative involving a committee of experts would be useful for bringing down the barriers between markets and identifying reference assets in order to ensure market liquidity.

Capital markets must be driven by solid and perennial financial players in Europe, yet US corporate and investment banks have captured a share of the European market. A survey by the European think tank Bruegel[10] reveals that in under ten years the domestic market share of European corporate and investment banks dropped to 46%, losing virtually 10% almost exclusively to their US counterparts, whose share rose from 37 to 45% over the same period. Though the financial crash originated from US banks, particularly Wall Street corporate and investment banks when Lehman Brothers went bankrupt, transatlantic banking mergers have created financial titans which have laid siege to Europe. Moreover, regulation is generally inclined towards their structural organisation. Strengthening European banks is therefore paramount for reasons of sovereignty and resilience. The 2011 crisis showed the brutal reduction of US banking exposure in Europe.

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[9] Recent Developments in European Capital Markets, Key findings from 2017 ECMI Statistical Package, December 2017.

[10] Bruegel, Charges Goodhart, Dirk Schoenmaker, "The United Sates dominates global investment banking: Does it matter for Europe?" Policy contribution, 2016/06, March 2016.

In Europe, short shrift has been given to the component of the CMU dealing with the distribution of savings products to clients. The MiFID II directive, which was meant to resolve this issue, has in fact dissuaded players from proposing shares to retail customers. The directive aims to ensure that clients are better informed about their risks, but the burdensome procedures it involves restrict savings diversification and excessively standardise customer relations.

Digital revolution

Digitisation represents one of the banking sector's greatest challenges. As digital players, banks are transformed from the inside, their inherent culture of permanent innovation always at the service of customers.

By proposing a broader range of products and services 24/7, digitisation strengthens the French retail banking model by providing banks with new possibilities for deeper customer insight. Complementarity emerges from a bank's network of branches and its digital offers, which constantly improve the satisfaction of customer expectations.

Banks have accomplished their digital revolution. In the face of new competition, they hold a major asset, putting them at a net advantage: their financial advisors, whose role is central for a multi-channel, global and lasting relationship.

From this environment of new banking opportunities arises a vital issue: cybersecurity. Banks are particularly sensitive to security issues, which are never subject to compromise.

Cybersecurity

Banks are wholly dedicated to the fight against money laundering and terrorism, which is an absolute priority for the French banking sector.

In the face of risks of drift and fraud, banks increasingly focus on security in a broad sense. They are proactive to legitimate concerns, taking numerous initiatives and investing massively in fund and personal data protection in order to preserve client trust and reinforce their security systems. As they are fully aware of the reality of cyber threats, security is permanently at the core of their digital transformation strategies.

The second directive on payment services (DSP 2) set a precedent by granting free access to payment account data to two new categories of service providers: account information services and payment initiation services. This directive is a challenge for banks which are responsible for their clients' accounts. It is the sole text worldwide which permits such open access.

Competition from non-banking players

The emergence of new actors into the world of banking presents an opportunity for the banking system, provided that all financial operators receive equal treatment.

Banks have naturally taken the lead in the financial digital sector and are reaping the benefits of the technological and fintech ecosystem by providing incubators, working partnerships and finance. The extraordinary innovation in these fields has enabled banks to reinvent their services for clients and the economy.

Nevertheless, if new actors do not make the necessary investments, such innovation also opens up weaknesses in cybersecurity. Banks make colossal investments to ensure not only the protection of their clients' personal data, but the integrity of the financial system.

Such innovation also makes banks vulnerable to the high-tech giants, which could collide more directly with the banking model while not being subjected to any prudential regulation.

In this context, the European approach to digitization should also view data from the perspective of the banking sector, not simply as an issue concerning consumers. A more closely knit association between all the stakeholders should be borne in mind when drafting the relevant standards.

Conclusion

Ten years after Lehman Brothers collapsed, the robustness of French banks is now indisputable. For them, the crisis belongs to the past.

Can we therefore rule out the possibility of another crisis? This is a delicate issue. If another crisis were to take place, the likelihood of it originating from the banking sector is minimal, banks having emerged stronger from the past decade. From what we have observed, risks of a crisis run far higher in the constantly expanding shadow banking sector than in banks themselves. This raises issues about the equality of competition and financial stability.