

Executive summary

Since the publication of the last annual report of the *Haut Conseil de stabilité financière* (HCSF – High Council for Financial Stability) in September 2021, the economy and the financial system had been going through a normalisation phase after the crisis associated with the Covid-19 pandemic. The war in Ukraine constituted a new major exogenous shock for financial stability, but again the French financial system showed its resilience. Against this backdrop, this 2022 annual report first looks at the financial situation of households, businesses and the French financial sectors' main players (banks, insurance companies, asset managers, financial markets, etc.). It then reviews the HCSF's activities over the past year and provides an analysis of the main measures it has taken. Lastly, two thematic chapters consider some of the topics examined by the HCSF as part of its remit: the analytical framework behind the countercyclical capital buffer decision-making process and the risks that crypto-assets pose to financial stability.

The macroeconomic environment has deteriorated significantly due to the war in Ukraine, exacerbating pressures on commodities and leading to a slowdown in growth

2021 saw a rapid rebound in activity after the sharp fall in GDP the previous year. However, this momentum faltered at the beginning of 2022 due to the conflict in Ukraine, leading to a downward revision of the outlook for growth in both France and other European countries. The war also added to already significant inflationary pressures due to its effect on energy prices. Thus, inflation hit levels that had not been seen since the 1980s.

The financial markets, which were pursuing a very positive trend in 2021, have corrected sharply since the beginning of 2022. Nevertheless, the correction has been orderly, despite tensions in certain segments, particularly the commodities markets. In response to the upswing in inflation and the normalisation of monetary policy, market interest rates have risen sharply. This rise in interest rates has had a sweeping impact across all markets, with, for instance, a significant increase in sovereign and corporate bond rates along with a sharp drop in equity market valuations, and more generally, price corrections across the entire spectrum of risky assets.

For the time being, households and businesses have been relatively unaffected, but their vulnerabilities are likely to be tested in the medium term as financing conditions tighten significantly

French households emerged from the Covid crisis with a large savings surplus. The war in Ukraine should chip away at these savings though, affecting the purchasing power of households to varying degrees depending on their income and socio-economic conditions. In terms of credit, the risk that households will default appears limited due to the specific characteristics of French housing loans and the structure of the debt (fixed rates, loan guarantees, monitoring of debt service to income ratios, etc.), while new housing loans remained at a record high in the first half of 2022. However, this trend could be curbed by the gradual rise in interest rates that started at the beginning of the year.

The 2021 financial statements of French businesses were robust, thanks to government support measures introduced during the Covid crisis, while financing conditions remained favourable during the period. Financing conditions have deteriorated since the beginning of the war in Ukraine, however. While the risks of default on existing debts appear limited, business lending rates have started to go up and bond-financing volumes have declined, particularly amongst lowest rated companies. Furthermore, inflation

should affect businesses in different ways depending on their capacity to pass on their higher costs to prices.

Banks and insurers will have to adapt to a new higher interest rate environment, which should be favourable to them in the longer term

French banks' profits recovered strongly in 2021. Although the Covid crisis pushed up provisioning during 2020, it did not result in a significant deterioration in the quality of bank assets, thanks in particular to the government's support measures. Therefore, French banks still hold high levels of equity capital and liquidity that are well above the regulatory requirements. Nevertheless, the war in Ukraine will affect their business activity. Their direct exposure to the conflict is limited but the deteriorating macroeconomic environment reduces their prospects for profitability in the short term. However, they should benefit from the rise in interest rates, which will help them to restore their net intermediation margins that had been put under pressure in recent years by the very low interest rate environment.

As for French insurance companies, they recorded brisk inflows in 2021 and strengthened their solvency. Switching from euro-denominated funds to unit-linked products continued during the year and could accelerate in 2022 in an inflationary environment.

In asset management, 2021 was a very positive year for French-domiciled funds, after a more modest performance in 2020, due to significant valuation effects. However, this trend could reverse in 2022, as the war in Ukraine and the sharp rise in inflation have led to a significant correction in equity markets since the beginning of the year and a drop in bond prices.

The HCSF is closely monitoring the evolution of risks for the French financial system and has raised the countercyclical buffer rate

Following the crisis associated with the Covid-19 pandemic that had justified its relaxation, the HCSF considered that the economic conditions and the level of risk warranted the normalisation of the countercyclical buffer to at least its pre-crisis level. At its March 2022 meeting, the HCSF therefore decided to raise the buffer rate from 0% to its prevailing rate prior to its relaxation in March 2020 of 0.5%. During its September 2022 meeting, it pre-announced its forthcoming decision to raise the buffer rate to 1% at its December meeting, unless there was a sharp and unanticipated downturn in the banking system's capacity to meet the economy's financing requirements. The HCSF's decisions regarding the setting of the countercyclical buffer rate are based on an analytical framework that is reviewed and enhanced in light of experience gained over recent years. It is the focus of a chapter of this annual report. The analytical framework is structured around four stages: identifying the financial stability risks; estimating the buffer rate that should be targeted in response to these risks; evaluating the timeliness of raising the buffer; and analysing the impact that such an adjustment would have.

The HCSF continues to monitor the emergence of new risks for financial stability, such as those associated with crypto-assets

The HCSF also examined the emerging risks for financial stability posed by climate change or crypto-assets. A theme-based chapter of this annual report is devoted to the latter. The substantial growth in crypto-asset markets during the past two years raises the question of the risk they pose to financial stability. These risks have been in the spotlight in recent months: in a context of price correction, several major crypto-asset players (Terra, Celsius lending platform, etc.) have collapsed, adding to the already considerable volatility and causing substantial losses for some. This turmoil shows that the authorities' repeated calls for caution with regard to crypto-assets are entirely valid. However, the financial system's exposure is not such that these developments threaten financial stability. The adoption of a European

regulation on markets in crypto-assets (MiCA) is a necessary first step towards overseeing these players while safeguarding their capacity for innovation.