Executive summary

The HCSF (*Haut Conseil de stabilité financière* – High Council for Financial Stability) annual report is traditionally the occasion to present the actions taken by the HCSF throughout the year, as well as to assess the financial situation of both the French non-financial sector (households and firms) and the financial sector (banks, insurers, asset management companies, and investment funds). Because of the economic and financial crisis brought about by the Covid-19 pandemic, it was decided to postpone the publication of this annual report to September, in order to allow for a first assessment of the crisis' effects on financial stability, in addition to the usual developments regarding the situation of economic sectors in 2019. These analyses are supplemented with three topical chapters which take a deeper look at some aspects of the HCSF's work.

Developments in 2019 were indicative of an expansion phase in the financial cycle

In 2019, household debt grew strongly in France. While this increase was in part a reflection of the low-rate environment, the debt path of French households is rather singular in the euro area, both in level and in evolution. Furthermore, the rise in real estate debt was accompanied by a deterioration in lending standards. Household savings rate, however, remained high over the period, with financial savings mostly allocated toward liquid and low-risk deposits and securities (such as overnight deposits, regulated savings accounts, and life insurance in euros).

The situation of firms continued to improve in 2019 with a rise in value added and profit margin. Their financial position also strengthened, as shown by a decrease in the share of lower-rated firms in the Banque de France rating system. Corporate debt grew sharply, similarly to that of households, with a rise in both bank loans and bonds issuance in financial markets. Nonetheless, this was accompanied by an accumulation of liquid assets which allowed for a contained rise in net debt, as well as by a strengthening of equity, with firm leverage remaining stable.

Finally, valuations have continued to progress in financial markets and reached high levels with respect to their long-term averages. With regards to stocks, the CAC 40 Index rose by almost 30%, its best performance in twenty years, against a backdrop of bullish global stock markets. With regards to bonds, the global stock of negative-rate debt reached an all-time high.

Financial institutions entered the current crisis in a much stronger position than before the 2008 financial crisis

At the end of 2019, the financial situation of French banks was sound. They had strengthened their capital position and improved their asset quality since the financial crisis of 2008, which allowed them to be more resilient to financial shocks. However, profitability remained subdued, especially in comparison with American banks, and margins were low in some activities.

In the insurance sector, net inflows stabilised in 2019 as the growth in gross premium inflows was accompanied by a small rise in life insurance pay-outs and a marked increase in claims in the non-life segment. French insurers continued to improve their solvency in 2019, despite the low-rate environment putting a drag on profits.

Finally, asset management activities resumed their growth in 2019, with a rise in the amounts under management as well as in the number of asset management companies registered in France.

The HCSF had taken steps to prevent and contain risks to financial stability

In June 2018, the HCSF adopted a measure to limit the exposure of French systemic banks to highly-leveraged firms, by capping it at 5% of the bank's capital. This measure is presented in the second topical chapter of this annual report. Its main goal was to reinforce bank resilience against the risk of large firm defaults, while serving as a way to awareness about the threats posed by excessive debt growth. Available data for the period show that the debt of large firms continued to grow, but that risk concentration remained low. It is worth noting that this measure was not meant to constrain credit supply to firms, but rather to encourage them to diversify lenders. Because the crisis has led to higher corporate debt and stronger default probability, the HCSF decided in June to extend the rule for a year, until the end of June 2021.

The HCSF has also been paying close attention to developments in residential real estate debt. Lending standards have deteriorated continuously over the past few years, with an increase in both debt-service-to-income ratios and loan maturities. In October 2019, the HCSF published an assessment of risks which was subjected to a public consultation. Then, in December 2019, it adopted a recommendation on lending standards for residential real estate loans, underlining the importance of following good practices for both the debt-service-to-income ratio (which should not exceed 33% of revenue) and the maturity (which should not exceed 25 years). Credit institutions are given a 15% flexibility margin with regards to those criteria to allow for a balanced implementation of the recommendation. The third topical chapter of this annual report is dedicated to this measure. It details how the measure was conceived by the HCSF based on the analysis of individual data supplied by INSEE and explains how the recommendation has been implemented.

The Covid-19 pandemic has had an immediate and pronounced impact on the financial sector

The crisis brought about by the Covid-19 pandemic has had an immediate and massively negative impact on financial markets. The CAC 40 lost nearly 40% between mid-February and mid-March. Over the same period, bond issuances diminished considerably and the high-yield segment was frozen for nearly six weeks. The crisis also had a pronounced impact on the collective portfolio management sector, in particular with regards to equity and money market funds, which respectively faced a large drop in asset value and a high rise in outflows. Banks were confronted with higher refinancing costs and an increase in the cost of risk, in particular with regards to loans to firms. Nonetheless, they withstood the shock rather well overall, and were able to answer the large demand for credit caused by the crisis. The effect of the crisis on insurance institutions was mostly felt through the drop in asset value, while the impact on claims varied across activities.

The crisis also shed some light on the importance of interconnections between financial institutions. Interconnections and shock transmission across the French financial system are important areas of work of the HCSF. In 2018, it published a working paper on interconnections between French asset management companies and the rest of the French financial system, and devoted a chapter to it in the 2018 annual report. It published in June 2020 a new working paper which studies the transmission of shocks across the entire French financial network. The results, which are detailed in the first topical chapter of this annual report, underline the importance of contagion by showing that it can induce losses three times larger than the initial shock to the financial sector. The analysis also highlights the systemic nature of some entities, especially large banks. These studies allow for a better understanding of the transmission mechanisms of shocks across the financial system, and should, therefore, be continued and refined.

Financial conditions have dramatically improved, thanks to the rapid and massive public intervention

The combined action of governments, regulators and central banks in Europe and in the United States has led to a gradual normalisation of financial conditions. Stock indexes have recouped part of the losses incurred in March, and the bond primary market has returned to normal functioning. Central banks have loosened their monetary stances in order to curb tensions on bond markets (through the PEPP – or

Pandemic Emergency Purchase Programme – for the European Central Bank) and to support liquidity conditions in the financial sector (with the new TLTRO programme – or Targeted Long Term Refinancing Operations*)*. Supervisory authorities have activated the regulatory flexibilities, which allowed banks to use their capital buffers, while asking banks and insurers to refrain from distributing dividends. The HCSF played its role by deciding to completely release the countercyclical capital buffer in March 2020 to enable banks to meet credit demand.

Finally, fiscal authorities have taken important steps to limit the impact of the crisis on the economy and to foster a rebound in activity. In France, measures amounting to €450bn were adopted, including a €300bn package of state-guaranteed loans, the so-called *prêts garantis par l'État* (or PGE). At the European level, the Next Generation EU program is set to distribute €750bn over the 2021-2027 period in order to support up national recovery plans.

Risks to financial stability remain high

The crisis brought about by the Covid-19 pandemic led to an unprecedented drop in the gross domestic product (GDP) of most developed countries. In France, GDP dropped by 6% in the first quarter and 14% in the second quarter, according to the latest INSEE estimates. According to Banque de France forecasts published in June, the French GDP might decrease by 10.3% in 2020. The crisis led to a temporary drop in household consumption, while revenue was largely preserved, notably thanks to the partial-activity scheme. This has led to the constitution of important forced household savings.

The economic shock has been especially brutal for firms. It has strongly reduced their activity and left many of them with large cash shortages. Therefore, numerous businesses were led to increase their debt levels, for example by taking advantage of the favourable conditions of the PGE scheme. The increase of risk in banks' household and corporate loan portfolios represents an important risk factor which the HCSF will closely monitor.

The action of the HCSF

The HCSF met on five occasions since the last annual report was published in June 2019. The release of the 2020 annual report was postponed to September to allow for a first assessment of the impact of the Covid-19-related public health and economic crisis on financial stability.

Over the past year, the HCSF has continued to monitor the risks and potential vulnerabilities which could affect the French financial sector. Even before the start of the Covid-19 crisis, the HCSF had noticed a rise in some of the risks to financial stability. Those risks stemmed from an increase in the level of debt of the non-financial private sector, from the high valuation of some assets in the financial markets, and from the pressure put by the low-rate environment on the profitability and assets-liabilities management of financial institutions. The HCSF also closely monitored the effects of the United Kingdom's exit from the European Union on the French financial sector, and encouraged the private sector to complete its preparation.

The HCSF published its first recommendation regarding residential real estate lending standards in December 2019

The HCSF has mentioned several times the particular care with which it had been monitoring real estate loans. It believed that, even though the risk appeared contained, the observed trend could represent a vulnerability in the long run. A chapter of the HCSF 2019 annual report was devoted to this topic. Medium-run vulnerabilities in the French residential real estate sector were also the subject of a warning issued by the European Systemic Risk Board (ESRB) in September 2019.

In October 2019, the HCSF published an assessment of the risks existing in the residential real estate sector, in which it especially noted the slow but continuous loosening of lending standards and the low profitability of loans. This assessment was subjected to a public consultation which widely confirmed its conclusions. During the December 2019 meeting, the HCSF adopted a plan aiming at reinforcing the French model of real estate financing and issued a recommendation to credit institutions regarding lending standards of real estate loans. This recommendation asks credit institutions to abide by good practices in lending standards, *i.e.* to target a maximum debt-service-to-income ratio of 33%, and a maturity no longer than 25 years. Up to 15% of loan production can exceed those thresholds, of which three-quarters must be reserved to first-time-buyers and those who purchase their main homes, subjected to a debt-to-income ratio not exceeding seven years.

The HCSF asked the French prudential authority (Autorité de contrôle prudentiel et de résolution, or ACPR) to set up a detailed reporting in order to follow the measure's implementation. This monitoring, which has been delayed because of the Covid-19 crisis, will yield its first results in late September 2020. A notice explained the concepts and definitions used in the recommendation was also published in December 2019, and updated in August 2020, to provide additional details and clarifications following discussions with several stakeholders.

The December 2019 recommendation is expected to promote healthy practices in order to ensure the resilience of the French real estate financing model and to support home buying. The analyses which underpin this recommendation are presented in Chapter 6 of the present annual report.

As an answer to the impact of the Covid-19-related crisis on financial stability, the HCSF completely released the countercyclical capital buffer

During its March meeting, the HCSF updated its assessment in the light of the latest developments of the Covid-19 pandemic and of the measures passed in France, in the European Union, and in the world to check its progress. It noted the sharp increase in risks to the financial system but emphasized that the reforms implemented over the past ten years have allowed the French financial sector to enter the crisis in a stronger position.

On 1 April, the HCSF decided to fully release the countercyclical capital buffer (CCyB). Its rate then stood at 0.25% and was scheduled to increase to 0.5% on 2 April 2020, in line with decision n° D-HCSF-2019-2 of 2 April 2019. The release was implemented immediately, and the buffer rate will remain at 0% until further notice. This should allow banks to maintain their credit supply, especially to small and medium enterprises which are the most dependent on bank financing (see Box 1).

Furthermore, during its June meeting, the HCSF decided to renew its 11 May 2018 decision relative to the large exposures of systemic institutions, starting 1 July 2020. This measure aims at curbing the excess concentration of banks' counterparty risk with highly-leveraged firms, an objective which remains particularly relevant in the present context. The HCSF made sure that the measure did not impede the implementation of the public schemes designed to support corporate financing. Early elements regarding the measure's impact are presented in Chapter 5 of this annual report.

The HCSF also recommended that banks and insurers behave in a responsible manner regarding dividend distribution, share buybacks, and variable pay.

Finally, on top of using the macroprudential tools at its disposal, the HCSF served as a place for dialogue and coordination between French financial authorities during the crisis.

Other work

Over the past year, the HCSF has also continued its work regarding the risks posed by interconnections in the financial system. After publishing a working paper in 2018 which examined the links between the asset management sector and the rest of the financial system in France[1], further work was conducted in order to refine the analysis and to examine how an exogenous shock on asset valuation would transmit to the whole financial sector. A second working paper was published in June 2020[2]; its main results are presented in Chapter 4 of this annual report.

The HCSF also participated in the consultation led by the European Banking Authority (EBA) regarding the application of the Systemic Risk Buffer (SRB) for sectoral exposures. This updated macroprudential tool will be deployed when the Capital Requirements Directive (CRD V) enters into force in late 2020. It will give the HCSF a flexible instrument to increase capital requirements in financial institutions in a targeted manner and on certain types of exposure.

Finally, the HCSF published its internal rules and regulations on its website and adopted its work programme for 2020-2021 during its June meeting. Priority will be given to the analysis of the consequences and the policy responses to the crisis.

[1] Benhami K., Le Moign C., Salakhova D. et Vinel A., "Les interconnexions entre le secteur de la gestion d'actifs français et le reste du système financier français", June 2018 (document on the HCSF website, in French).

[2] Chrétien É, Darpeix P.-E., Gallet S., Grillet-Aubert L., Lalanne G., Malessan A., Novakovic M., Salakhova D., Samegni-Kepgnou B. et Vansteenberghe É, "Exposures through common portfolio and contagion via bilateral cross-holdings among funds, banks and insurance companies", June 2020 (document on the HCSF website).

Table 1 – Decisions taken by the HCSF for financial stability

Date of the decision	Date of entry into force*	Macroprudential tool	Decision
10/03/2019	02/04/2020	Countercyclical capital buffer	The buffer rate for France is kept at 0.5% starting 2 April 2020.
10/07/2019	12/07/2019	Systemic risk buffer	Reciprocity of the measure adopted by the Estonian Financial Supervision Authority which sets up a systemic risk capital buffer of 1%.
10/07/2019	12/07/2019	Calculation of risk weightings	Reciprocity of the measure adopted by the Swedish Financial Supervisory Authority imposing a minimum risk weighting threshold of 25% on real estate loans to individual counterparties when purchasing a home located in Sweden.
07/10/2019	02/04/2020	Countercyclical capital buffer	The rate for France is kept at 0.5% starting 2 April 2020.
13/01/2019	02/04/2020	Countercyclical capital buffer	The rate for France is kept at 0.5% starting 2 April 2020.
01/04/2019	02/04/2020	Countercyclical capital buffer	The rate for France is lowered at 0% starting 2 April 2020.
01/07/2020	01/07/2020	Countercyclical capital buffer	The rate for France is kept at 0%.
01/07/2020	01/07/2020	Limitation of large exposures	Decision n° D-HCSF-2018-2 of the HCSF dated 11 May 2018 relative to high risks of systemic institutions is extended to 30 June 2021.

* With regards to decisions on the countercyclical capital buffer, banks are usually given twelve months from the date the decision is published to implement a larger buffer. The implementation is immediate in the case of a smaller buffer.