Financial Institutions

DBRS: Home Loan Renegotiations and the Long Term Impact on Large French Banks

Insight beyond the rating

Summary:

- French banks have experienced a sustained decline in the average yield on their home loan portfolios. This may appear somewhat surprising, as most home loans in France are fixed rate. However, since late 2014, but particularly in late 2016 and early 2017, French banks have been exposed to a significant increase in renegotiations and repurchases of home loans.
- Renegotiations and repurchases of home loans are at lower rates than the overall portfolio yields, contributing to a decline in net interest margin (NIM) and lower revenues in banks' domestic retail operations. Aggregate revenues from domestic retail banking of the six largest banking groups in France declined by 3% YoY in 2016 and profit before tax by 12%.
- In DBRS's opinion, home loan renegotiations and repurchases are likely to have a long term impact on the profitability of the French home loans portfolio. Given banks cannot reprice fixed rate home loans, the effects of the current renegotiation are likely to persist, even if market rates recover from their current low, as the pace of renegotiation would be expected to slow rapidly with higher rates.
- DBRS expects that the impact of renegotiations and repurchases will be manageable for the largest French banking groups rated by DBRS: Groupe Crédit Agricole (CA), BNP Paribas (BNPP) and Société Générale (SG) as they have significantly diversified businesses. French retail revenues represented 15% of the 2016 group revenues for BNPP, 33% for SG and 52% for CA. In addition, their domestic retail revenues are well diversified.

Rapid decline in French home loans' average interest rate

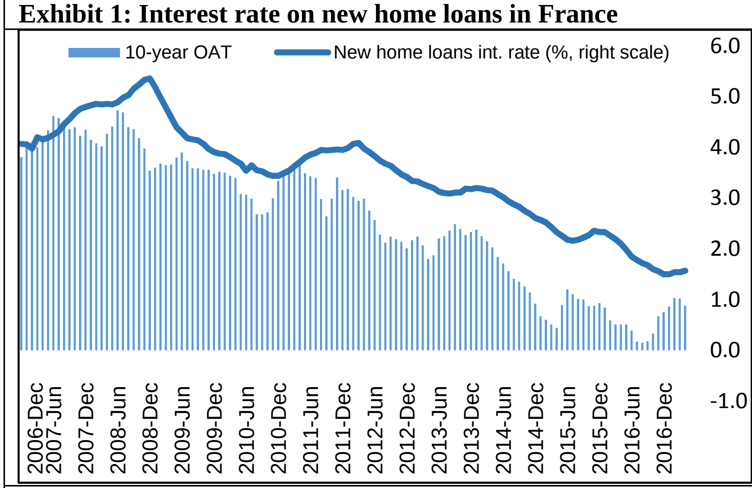
The low interest rate environment continues to exert downward pressure on the yield on the home loan portfolios of French banks, even though around 90% of home loans in France are fixed rate. This has been driven by a steady decline in interest rates on new housing loans, which prompted repurchases between banks and renegotiations of outstanding home loans.

In setting the pricing on new home loans, French banks take into account their cost of funding that reflects market rates. For fixed rate contracts, the 10-year rate on Obligations Assimilables du Trésor (OAT) i.e. obligations of the French government, is often quoted as a useful benchmark. The sustained decline of the OAT rate has led to a reduction in rates on new home loans (See Exhibit 1).

Attractive rates on new home loans have triggered a wave of home loan renegotiations. Renegotiation volumes picked up towards the end of 2014 and became particularly strong in late 2016 and early 2017. Based on DBRS' estimates, the volume of renegotiations during 12 months to April 2017 (for which latest statistics are available), represented 18% of outstanding home loans at end-April 2017.

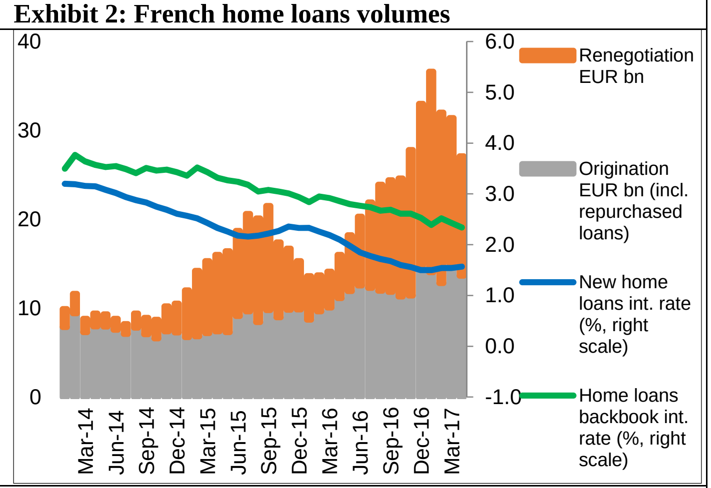
New home loans (which include home loans repurchased between banks) originated in the same period, were equivalent to 17% of the end-April 2017 outstandings. As a result, around one-third of the outstandings were newly originated, repurchased or renegotiated loans, priced during 12 months to April-2017 when the average interest rate on new home loans was in the 1.5-2.0% range. In the same period, the average interest rate on the entire outstandings declined to 2.34% from 2.86%. The significant volume of renegotiations contributed to a continued reduction in the average interest rate on outstanding home loans (See Exhibit 2).

Exhibit 1: Interest rate on new home loans in France



Source: ACPR, DBRS estimates.

Exhibit 2: French home loans volumes



Source: ACPR, ECB, DBRS estimates

The yield on home loan portfolios is an important driver of domestic retail banking profitability. These loans represent almost half of total loans and around 80% of outstanding retail loans in the French banking system. The decline of the yield generated by the home loans portfolio has contributed to a decline in French retail's NIM, as banks' ability to reprice deposits, the principal funding source, to the same extent is limited, especially when around one-third of deposits have regulated rates. As a consequence, revenues from French retail banking declined by 3% YoY and profit before tax by 12% YoY in 2016[1].

DBRS notes that current revenue levels from the domestic retail business may not yet fully reflect the decline in the yield on home loans because of the additional fees banks earn on early loan repayments (when a home loan is repurchased by another bank) and loan renegotiations (customer keeps his home loan with the same bank, but its interest rate is reduced to a lower level).

DBRS estimates that around 2-5% of French retail banking revenues in 2016 were due to home renegotiation or early repayment (early repayment fees are earned also when another bank repurchases a loan). Another mitigating factor has been healthy growth in home loan outstandings (See Exhibit 3), which DBRS attributes in part to the decline in interest rates.

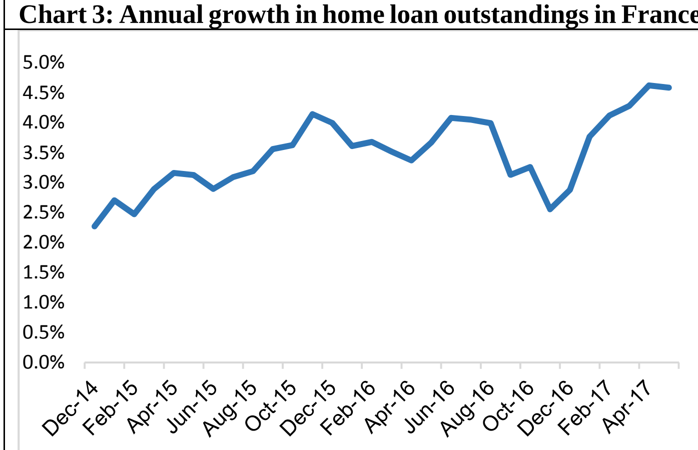
The impact of home loan renegotiations on French banking groups rated by DBRS is likely to be long term but manageable

In DBRS's opinion, home loan renegotiations and repurchases are likely to have a long term impact on the profitability of the home loan portfolios for French banks. The outstanding home loans' average contractual maturity in France is around 18 years and the effective maturity between 6 and 7 years. Around 90% are based on fixed rate. Given that banks are not in a position to reprice fixed rate home loans, the effects of the current renegotiation are likely to persist, even if in the long-term market rates recover from their current lows.

Home loan renegotiations should be manageable for French banking groups rated by DBRS. DBRS publicly rates CA (rated A (high) with Positive Trend), BNPP (rated AA (low) with Stable Trend), and SG (rated A(high) with Stable Trend). The three franchises benefit from significant diversification. French retail revenues represented 15% of BNPP's 2016 Group revenues, 33% for SG and 52% for CA. The remaining revenue contribution is from diverse sources, including foreign retail, specialized financing, asset management, insurance, and corporate and investment banking.

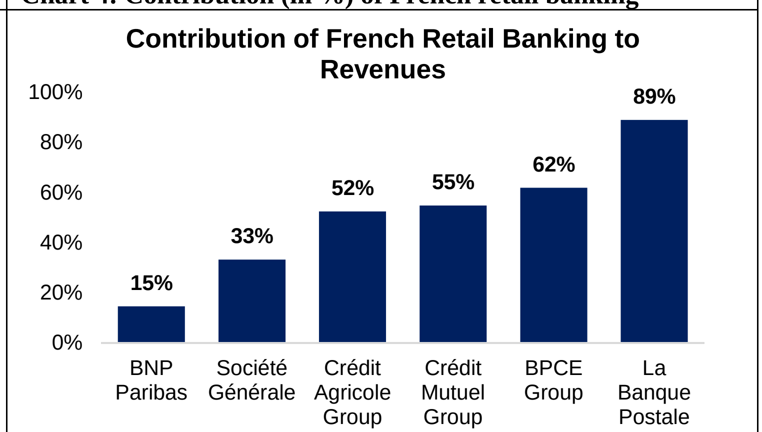
DBRS notes that the domestic retail banking revenues reported by the large French banks publicly rated by DBRS are in many cases well diversified. They are not limited to revenues from pure retail and, depending on the bank, can include income related to other services offered in the network, such as SME banking, specialized lending, asset and wealth management, securities transactions, or insurance.

Chart 3: Annual growth in home loan outstandings in France



Source: APCR

Chart 4: Contribution (in %) of French retail banking



Source: DBRS estimates, APCR, French banks. Based on 2016 data

French banks' have been successfully developing fee-based businesses. As reported by SG, individual customer interest margin represented around 30% of revenues of its French Retail Banking division in 2016[2].

The contribution of NII to group revenues in the case of large French banking groups is typically lower than for some of their European peers. In 2016 the contribution of NII to revenues of revenues of the six largest banking groups in France was 46% for the major French

[1] Change in aggregate revenues and profit before tax for the six largest banking groups in France (BNP Paribas, Société Générale, Groupe Crédit Agricole, Groupe BPCE, Groupe Crédit Mutuel and La Banque Postale). Source: «La situation des grands groupes bancaires français à fin 2016» (ACPR)

[2] Societe Generale: Full-Year and fourth quarter 2016 results presentation

banks versus around 65% for major European banks[3]. Finally, from the point of view of profitability, persistence of low rates on the home loans portfolio should be supportive of the cost of risk, partially offsetting the impact of compressed margins on the overall profitability.

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[3] ACPR : "La situation des grands groupes bancaires français à fin 2016"