FINANCIAL STABILITY REPORT

Assessment of risks and vulnerabilities in the financial system

JUNE 2024

BANQUE DE FRANCE

EUROSYSTÈME

Overview

The strong resilience of the French and European financial systems during the period of monetary tightening, coupled with the continued decline in inflation observed since December, have increased the likelihood of a "soft landing" for the French and European economies. Against this backdrop, our perception of the risks attached to the French financial system remains stable versus December 2023, although we cannot rule out a deterioration in the macroeconomic or geopolitical environment.

The European Central Bank (ECB) lowered its three key rates by 25 basis points on 6 June, and the pass-through of past rate hikes to non-financial sector loan rates now appears to be complete. Regarding the *credit channel* of monetary policy transmission, flows of new loans to the non-financial sector appear relatively stable, and outstanding loans are also stabilising, although loan volumes are primarily determined by demand which means that the pass-through of monetary policy to volumes is slower than it is to rates.

Past interest rate hikes are continuing to be passed through to non-financial corporation (NFC) balance sheets. French NFCs' average cost of debt tends to be relatively sticky as they mainly borrow at fixed rates, which delays the transmission of past rate hikes to their financial situation. However, compared to their Eurosystem peers, who carry a higher share of floating-rate debt, they will also be slower to benefit from any further rate cuts in 2024 and 2025.

As with any period of uncertainty, the upheaval of the French electoral calendar in June 2024 opened a period of market volatility, affecting French sovereign debt yields and stock market valuations (especially those of financial intermediaries). Owing to the cut-off date for the finalisation of this report, it does not provide an analysis of these recent developments.

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Vulnerabilities remain significant for those non-financial agents most exposed to higher interest rates, but the real estate market adjustment is proving orderly

Risks to NFCs are continuing to rise. The number of corporate bankruptcies is continuing to rise and is nearing its long-term trend, although figures vary according to business size and sector of activity. A special chapter in the report focuses on the financial situation of large companies in the face of higher interest rates. Their debt service ratio had already increased in 2023 and should rise even further in 2024 as they gradually refinance their outstanding debt at higher rates. However, this vulnerability is offset by high cash levels, although individual situations are highly heterogeneous.

The marked rise in interest rates since July 2022 has also put pressure on the residential and commercial real estate sectors. Price falls in the residential real estate market, which accounts for the bulk of banks' real estate exposure, have now become significant. However, the sector is showing signs of improvement and poses limited risks to financial stability, owing to the prevailing household debt structure and macroprudential standards. The correction in the commercial real estate market is proving more substantial and may be linked to structural factors. Nonetheless, the risks posed by the segment remain contained as banks and insurers have limited direct exposure and investment funds have put in place liquidity management tools.

Sovereign risk remains a focus of concern for France in a challenging fiscal environment. The announcement of a widening of the budget deficit and of Standard & Poor's downgrade of France's credit rating did not immediately trigger a significant reaction in spreads or sovereign credit default swaps (CDS). However, the environment of uncertainty poses a higher risk to French debt yields – as demonstrated by the recent widening of the OAT-Bund spread.

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Despite the deteriorated geopolitical environment and an uncertain political and macroeconomic context, the high levels of equity market valuations reflect solid corporate results, while risk aversion in bond markets has declined

Risk premia remain very low while the valuations of the main stock market indices stand at historically high levels. However, in France as well as other countries, these valuations still appear to be driven by a limited number of sectors (tech and luxury in France). The current rise in valuations for the US technology sector, driven by optimistic expectations for artificial intelligence, has all the appearances of being a speculative phenomenon; yet an orderly correction is unlikely to pose any real risk to financial stability, especially if it is concentrated on a few stocks. Elsewhere, valuation indicators for French NFC stocks appear consistent with the excellent results posted in 2023, which were boosted by high profit margins in an inflationary environment.

Consequently, there is still a risk of a disorderly adjustment in valuations, in part due to geopolitical risks and the threat of a macroeconomic deterioration. Geopolitical risks remain high, but, as of June 2024, have not led to heightened volatility, either in commodity or global equity markets. However, new geopolitical shocks could trigger an abrupt rise in risk premia, along with supply chain disruptions and disorderly stock market corrections for those firms most exposed.

Corporate market funding is benefiting from a decline in corporate credit risk aversion among market participants. In particular, corporate credit spreads (between high yield and investment grade bonds) have narrowed, confirming investors' appetite for NFC debt securities. However, this spread compression essentially concerns lower risk tranches.

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Banks and insurers have confirmed their resilience in the face of rising funding costs and non-financial sector risks

Monetary policy tightening in the euro area has not led to a reduction in French banks' balance sheets – in fact they have expanded slightly over the past two years, in contrast with those of their Eurosystem peers which have shrunk slightly over the same period. New lending by French banks has continued to rise, albeit at a slower pace, financed by higher deposits and by the issuance of debt securities to replace ECB refinancing operations (TLTROs). Despite favourable financing conditions, however, the interest banks pay on their liabilities has risen faster than that earned on their assets, which in part explains the decline in their net interest margins. The specific features of the French financing model have also played a role: as the majority of lending is at fixed rates, the interest banks earn on their assets depends on the speed of loan renewal.

French banks' liquidity and solvency ratios remain well above regulatory requirements, and are higher than in 2023. The average liquidity coverage ratio (LCR) rose to 147% in 2023, well above the regulatory threshold of 100%, helped by the issuance of debt securities. French banks have a diversified financing structure and investor base. The average Common Equity Tier 1 (CET1) ratio also stands above the regulatory requirement.

The cost of risk remains limited, although there has been a slight deterioration in overall asset quality, notably due to a rise in the non-performing loan ratio on corporate lending. However, the outstanding amount of non-performing loans remains low. French banks' exposure to commercial real estate remains contained and is primarily domestic. Their exposure to leveraged loans also appears to be limited and has declined. Finally, the structure of lending for house purchases in France helps to limit the associated risks for banks.

French insurers confirmed their robust solvency levels in 2023, although there is still some heterogeneity across the sector. Insurers' average solvency capital coverage ratio remains above regulatory requirements, but declined slightly over 2023 (256% in the first half of 2023 compared with 250% in the second half), mainly as a result of bank-insurers and non-life undertakings. The returns on their investment portfolios are also improving, and unrealised capital losses appear to be more limited. Higher interest rates have allowed their bond portfolios to yield higher income. Against this backdrop, we have also observed an increase in revaluation rates on individual life insurance contracts, with returns rising to 2.6% in 2023 from 2% in 2022. Finally, the rise in rates has triggered limited numbers of policy redemptions. The life insurance segment has been supported by positive net inflows into unit-linked products.

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Cyber and climate risks remain key financial stability issues

The number and share of cyberattacks targeting the financial sector are rising, increasing the risk that a financial institution might suffer tail losses. Generative artificial intelligence can be used to create increasingly complex and hard to detect attacks, making cyberthreats the top risk globally for businesses in 2024. At the European level, the entry into application of the Digital Operational Resilience Act (DORA Regulation) in January 2025 should help to increase firms' resilience. A special chapter in this report looks in depth at the potential benefits and risks of artificial intelligence (AI) for financial stability. In addition to cyber risks, depending on how it is deployed, AI could increase financial market volatility and procyclicality and generate a risk of concentration of market participants.

As climate risks continue to rise, the Intergovernmental Panel on Climate Change (IPCC) has highlighted the growing vulnerability of populations and ecosystems to global warming. Physical risks (such as natural disasters or extreme temperatures) are on the rise. Supervisors are therefore monitoring financial institutions' ability to withstand these risks and incorporate them into their risk management strategy. At the level of the financial system as a whole, dedicated stress tests are carried out to estimate the banking and insurance sectors' exposure to climate risks

FINANCIAL STABILITY REPORT | JUNE 2024

CYCLICAL			STRUCTURAL	
Disorderly market correction in the event of a geopolitical or macroeconomic shock	**Debt sustainability of non-financial participants**	**Risk of deterioration in the asset quality of financial intermediaries**	**Cyber threats exacerbated by geopolitical tensions**	**Climate change-related exposures**

Vulnerabilities

Disorderly market correction in the event of a geopolitical or macroeconomic shock

- High valuations
- Risks of a correction in cyclical expectations
- Non-bank participants exposed via leverage and liquidity risk

Debt sustainability of non-financial participants

- Commercial real estate market adjustment
- Deterioration in NFC vulnerabilities
- Very high public debt

Risk of deterioration in the asset quality of financial intermediaries

- Activity and income sensitivity to the macroeconomic context
- Rise in financing costs
- Digital transformation cost

Cyber threats exacerbated by geopolitical tensions

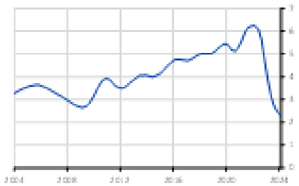
- Expanded digital exposure area
- Loopholes exploitation eased by artificial intelligences

Climate change-related exposures

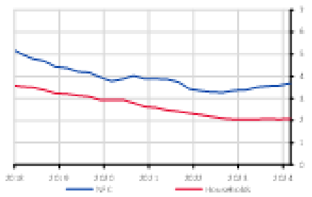
- Risks of disorderly transition as adaptation actions and policies are delayed
- Impact of climate disasters

Implied volatility of Treasury rates (MOVE)

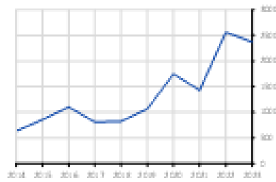
NFC interest coverage ratio



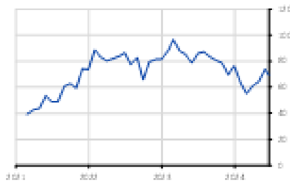
Share of non-performing loans



Publicly reported cyberattacks worldwide



Spot price of EU emissions allowances (EUR per ton of CO_2)



Factors of resilience

Disorderly market correction in the event of a geopolitical or macroeconomic shock

- Market structure with diverse investors and market participants

Debt sustainability of non-financial participants

- Predominantly medium/long-term debt and fixed rate debt
- Credit standards for home loans
- High cash levels (NFC) and savings (households)

Risk of deterioration in the asset quality of financial intermediaries

- High solvency
- High liquidity and diversified funding
- Stability of asset quality

Cyber threats exacerbated by geopolitical tensions

- Stress exercises
- Regulatory work
- Cyber security investment

Climate change-related exposures

- National efforts and european coordination
- Stress tests

Future path (horizon)

Disorderly market correction	Debt sustainability	Asset quality	Cyber threats	Climate change
ST	ST	ST	ST to LT	ST to LT

Very high risk | High risk | Moderate risk | Future path (horizon)

Measures taken by authorities

On 6 June 2024, the Governing Council decided to lower the three key ECB interest rates by 25 basis points. The deposit facility rate, main refinancing operations rate and marginal lending rate have thus been cut respectively to 3.75%, 4.25% and 4.50%. Based on an updated assessment of the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission, the Council considers that it is now appropriate to moderate the degree of monetary policy restriction. It also reiterated its determination to ensure the timely return of inflation to its 2% medium-term target, and committed to keeping policy rates sufficiently restrictive for as long as necessary to achieve this target. The Governing Council will continue to follow a data-dependent and meeting-by-meeting approach to appropriately set the level and duration of restriction.

In addition, since 1 March 2023, the Eurosystem has been reducing its asset purchase programme (APP) portfolio at a measured and predictable pace and, since July 2023, has no longer reinvested in full the principal payments from maturing securities. Regarding the pandemic emergency purchase programme (PEPP), the Governing Council announced that it would reduce the portfolio by an average of EUR 7.5 billion per month in the second half of 2024, while remaining flexible in reinvestments. It intends to discontinue reinvestments under the PEPP at the end of 2024.

On 13 March 2024, the Governing Council also announced[1] a series of changes to the operational framework for implementing monetary policy. The revision confirms the steering of short-term money market rates through the adjustment of the deposit facility rate (DFR) and the provision of abundant liquidity by the Eurosystem using a broad range of instruments. One of the key changes is a reduction in the spread between the main refinancing operations (MRO) rate and the DFR from 50 to 15 basis points as from 18 September 2024.

Regarding French macroprudential policy, the main measures were kept in place in the first half of 2024. The increase in the credit protection reserve rate[2] (countercyclical capital buffer of CCyB) from 0.5% to 1%, announced in December 2022,[3] took effect on 2 January 2024. The sectoral systemic risk buffer (sSyRB) that came into effect on 1 August 2023[4] remains in force. The measure requires systemically important French banks to maintain a buffer amounting to 3% of their exposures to heavily indebted French companies,[5] if such exposures exceed 5% of their Tier 1 capital.[6] For residential real estate, the rules on housing credit standards[7] remain in application, and the three technical adjustments decided by the *Haut Conseil de Stabilité Financière* (HCSF – High Council for Financial Stability) at its meeting of 4 December 2023[8] entered into application on 1 January 2024.

At the European level, the banking sector has been strengthened by the adoption in April 2024 of the "banking package",[9] which transposes the Basel III accord into European Union law. The main provisions of the package regulation should come into application on 1 January 2025, while those of the directive should come into force on 1 January 2026. The banking package also strengthens[10] European supervisory harmonisation and paves the way for better recognition of so-called "emerging" risks, linked to climate change or crypto-assets. Work on the reform of the crisis management and deposit guarantee frameworks is also progressing, with the adoption by the European Parliament, at a plenary session at end-April 2024,[11] of an amended version of the Commission's

[1] Changes to the operational framework for implementing monetary policy (europa.eu)
[2] CCyB indicators.pdf (economie.gouv.fr)
[3] PR_2022_12_13.pdf (economie.gouv.fr) and decision No.D-HCSF-2022-06.
[4] 2023-07-31_PR_SyRB.pdf (economie.gouv.fr) and Decision No. D-HCSF-2023-3.
[5] In other words, those whose total debt-to-EBITDA ratio at the highest level of consolidation is strictly higher than 6 or negative.
[6] See explanatory note: 20230830_HCSF_Notice_sSyRB.pdf (economie.gouv.fr)
[7] Decision No. D-HCSF-2021-7 (economie.gouv.fr)
[8] HCSF_20231204_PR.pdf (economie.gouv.fr) and Decision No. D-HCSF-2023-6.
[9] European Parliament plenary debate on the banking package (europa.eu)
[10] For further details of the measure, see: The banking package and its challenges (banque-france.fr)
[11] Texts adopted by plenary on economic and financial matters, first reading closed |European Parliament

proposal to extend the resolution framework to more small and medium-sized banks and limit the involvement of deposit guarantee funds.

Significant progress was also made in talks on insurance sector regulations, with co-legislators reaching a political agreement on 13 December 2023 on the revisions to Solvency II.[12] The Parliament's ECON Commission voted to ratify the agreement on 23 April 2024, and the revised directive should be adopted by the autumn of 2024. The agreement includes measures[13] to channel the financial savings managed by insurers towards financing the economy, improve the management of sustainability risks and introduce a macroprudential framework to strengthen financial stability. The measures are expected to come into force in the autumn of 2026.

Significant advances were also made in Europe in the first half of 2024 in the regulation of other non-bank financial intermediation (NBFI) players, with the revision[14] of the Alternative Investment Fund Managers Directive (AIFMD) and of the regulation on undertakings for collective investment in transferable securities (UCITS). Fund managers are now required to have at least one or two liquidity management tools (LMT) in place, depending on the fund type, from a pre-defined list. The rules governing the granting of loans by alternative investment funds (AIF) have also been harmonised,[15] and requirements for reporting to supervisory authorities and investors have been extended. In February 2024, European legislators also reached a provisional agreement on the adoption of EMIR 3,[16] the principal aim of which is to reduce the EU's exposure to systemic third-country central counterparties. More broadly, and as underlined by the ECB in its May 2024 financial stability review,[17] increasing the resilience of the NBFI sector is a prerequisite for advancing the European capital markets union, an objective that has received renewed impetus since the start of 2024. It is useful to note also that on 22 May 2024, the European Commission launched[18] a public consultation on macroprudential policies for non-bank intermediation.

International work is also continuing on enhancing the resilience of the investment fund sector: in particular, the Financial Stability Board (FSB) is working on the implementation of reforms relating to money market funds,[19] the liquidity preparedness of non-bank players for margin and collateral calls,[20] the risks linked to excessive leverage,[21] and the interlinkages between non-bank players and the rest of the financial sector.

French and European authorities are also taking steps to minimise structural risks affecting the financial system, particularly in the digital space. The DORA Regulation, which came into force in January 2023 and will apply from January 2025, establishes a comprehensive framework for the digital operational resilience of EU financial entities and addresses in particular the financial sector's dependency on tech companies as well as cyber risk.

In March 2024, the EU adopted the AI Act which establishes a framework for the use of AI, depending on the level of risk it poses. The regulation concerns banking and insurance services that are considered "high" risk: before these systems can be put on the market, a registration and compliance process will be required. In France,

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[12] Solvency II and the Insurance Recovery and Resolution Directive IRRD: Council and Parliament agree on new rules for the insurance sector - Consilium (europa.eu)

[13] For details of the measure, see: 20240325_revue_acpr_article_s2.pdf (banque-france.fr)

[14] Directive (EU) 2024/927 of the European Parliament and of the Council of 13 March 2024 amending Directives 2011/61/EU and 2009/65/EC as regards delegation arrangements, liquidity risk management, supervisory reporting, the provision of depositary and custody services and loan origination by alternative investment funds (europa.eu)

[15] The European Union has created a minimal harmonisation framework for the granting of loans by AIFs. It notably requires AIFs to retain 5% of the risk in the event of transfer of the loan, sets an investment limit per entity of 20% of the fund's capital, and gives each Member State the option of banning AIFs from lending to individuals. Funds whose main activity is lending are subject to increased requirements: they must be closed (except if the loan amounts are under 50% of their NAV) and are subject to leverage limits (300% for closed funds and 175% for open funds).

[16] Capital markets Union: Council and Parliament agree on improvements to EU clearing services (europa.eu)

[17] Financial Stability Review – ECB, May 2024, , see also Déclaration du Conseil des gouverneurs de la BCE sur les progrès vers l'Union des marchés de capitaux | Banque de France (banque-france.fr)

[18] Commission launches consultation on macroprudential policies for Non-Bank Financial Intermediation - European Commission

[19] Thematic Review on Money Market Fund Reforms: Peer review report - Financial Stability Board (fsb.org)

[20] Liquidity Preparedness for Margin and Collateral Calls: Consultation report - Financial Stability Board (fsb.org)

[21] FSB Work Programme for 2024 - Financial Stability Board

the ACPR will be the competent authority tasked with monitoring how banks and insurers use these systems. The risks to financial stability from AI are examined in detail in a special chapter in this report.

Following the entry into force of the Markets in Crypto-Assets (MiCA) Regulation in June 2023, the European Commission adopted four delegated acts on the regulation of digital assets in February 2024.

The first half of 2024 also saw the completion of several regulatory initiatives to address the financial risks linked to climate change and environmental challenges. The Corporate Sustainability Reporting Directive (CSRD), which was transposed into French law in December 2023, considerably extends the nature and scope of application of corporate sustainability reporting requirements. The new rules came into application in January 2024. In February 2024, co-legislators also reached a provisional agreement on the regulation on the transparency and integrity of environmental, sustainability and governance (ESG) rating activities. The European regulation establishing a pan-European label for green bonds (EuGBS), together with transparency rules for sustainable financial instruments, will enter into force in December 2024.

The "Fit-for-55" legislative package adopted by the Council in June 2022, aims to reduce EU greenhouse gas (GHG) emissions by 55% by 2030 compared with 1990. In 2024, the Commission asked European supervisory authorities to carry out stress tests to assess the financial sector's ability to finance this transition, as well as its exposure to transition risks. Three scenarios designed by the European Systemic Risk Board (ESRB) are being tested, including a shock to brown assets linked to an abrupt transition, and a shock combining climate risks and standard market turbulence. Seventy EU banks, including seven large French banks, are taking part in the exercise. Its aim is to enhance the development of methodologies and scenarios, both for supervised entities and supervisory authorities. These scenarios are vital to ensure a detailed, long-term analysis of climate risks. The results should be finalised by September 2024 and are expected to be published in early 2025 in a joint report by the ESRB, ECB and European supervisory authorities.

At COP26 in 2021, more than 500 financial institutions committed to achieving carbon neutrality by 2050 under the Glasgow Alliance for Net Zero. The agreement requires them to establish transition plans comprising intermediate milestones for achieving net zero. This obligation to align with the Paris Agreement trajectories already applied to certain financial players under the 2019 French Climate and Energy Law. However, CSRD extended its scope of application and requires all subject companies (including banks and insurers) to publish transition plans, while CRD6 has introduced the requirement for banks to publish and stick to transition plans, which have thus become key tools for managing climate risks. Supervisors will regularly assess banks' exposures to these risks and will have enhanced supervisory powers. They will now be able to demand that institutions adjust their strategies, governance or risk management, or reinforce the targets, measures and actions in their transition plans.

CRD6 has tasked the European Banking Authority (EBA) with drawing up guidelines on the content of transition plans. In January 2024, the EBA published a consultation document on ESG risks, setting out banks' obligations to identify, measure, manage and monitor them. It also specifies minimum requirements for the content of transition plans (methodological prerequisites, targets, metrics). The document should be finalised by December 2024.

The obligation to develop transition plans has been incorporated into the Solvency II directive for insurers, albeit with different terminology. Insurers will have to develop "specific plans, quantifiable targets, and processes to monitor and address the financial risks arising in the short, medium, and long-term from sustainability factors, including those arising from the process of adjustment and transition trends towards the relevant Member States and Union regulatory objectives and legal acts in relation to sustainability factors, in particular those set out in Regulation (EU) 2021/1119 (European Climate Law)". Details also need to be provided on how these plans will be operationalised.

Beyond climate issues, the topic of nature-related financial risks has been gaining momentum since the adoption of the Kunming-Montreal Global Biodiversity Framework at COP15 in 2022. “Target 15” of the framework encourages private sector players (notably multinationals and financial institutions) to measure and disclose their risks, dependencies and impacts on biodiversity. French and European standards (2019 Energy and Climate Law in France, and the 2023 CSRD in Europe) have recently reinforced requirements for financial institutions to report on how they take climate and biodiversity risks into account in their investment policy, and on the resources implemented to contribute to the ecological transition. The Nature Task Force set up by the central banks and supervisors Network for Greening the Financial Sector (NGFS) is notably pushing to include nature-related financial risks in ESG risks.