9 March 2018

Assessment of the French notification in accordance with Article 458 of Regulation (EU) No 575/2013 concerning the application of a stricter national measure as regards requirements for large exposures

Introduction

On 13 February 2018 the European Systemic Risk Board (ESRB), in accordance with Article 458(2)(d)(ii) of the Capital Requirements Regulation (CRR)[1], received an official notification from the French High Council for Financial Stability (*Le Haut Conseil de stabilité financière* – HCSF), stating its intention to adopt a national measure so as to limit concentration risk with regard to highly indebted large French non-financial corporations (NFCs). The HCSF is designated as the authority in charge of the application of Article 458 of the CRR in France[2]. Pursuant to Article 458(4) of the CRR, the ESRB must provide the Council, the European Commission and France with an opinion within one month of receiving the notification. The opinion must be accompanied by an assessment of the national measure against the points mentioned under Article 458(2) of the CRR.

The ESRB's assessment focuses on the net benefits of the national measure for maintaining financial stability. In Decision ESRB/2015/4[3], the ESRB clarifies the procedural framework for the provision of opinions under Article 458 of the CRR. In particular, the ESRB has assessed the rationale and merit of the measure against the following criteria.

- **Justification:** Has there been a change in the intensity of systemic risk and does it pose a threat to financial stability at the national level? Can alternative instruments provided for under the Capital Requirements Directive (CRD IV)[4] and the CRR adequately address the risk, taking into account their relative effectiveness?
- **Effectiveness:** Is the measure likely to achieve its intended objective?
- **Efficiency:** Will the measure achieve its objective in a cost-efficient way, i.e. are the instrument and calibration appropriate?
- **Proportionality and impact on the internal market:** Is there an appropriate balance between the costs resulting from the measure and the problem it aims to address, also

1 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.

2 According to Article L.631-2-1, sub-paragraph 4, of the French monetary and financial code (*Code monétaire et financier*), the HCSF, on a proposal from the Governor of the Banque de France, who is also President of the French Prudential Supervision and Resolution Authority (*Autorité de Contrôle Prudentiel et de Résolution* – ACPR), has the power to take measures related to Article 458 of the CRR.

3 Decision of the European Systemic Risk Board of 16 December 2015 on a coordination framework for the notification of national macroprudential policy measures by relevant authorities, the issuing of opinions and recommendations by the ESRB, and repealing Decision ESRB/2014/2.

4 Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC.

taking into account any potential cross-border spillover effects? Where appropriate, the ESRB may suggest amendments to the measure to mitigate potential negative spillover effects.

The ESRB assessment draws extensively on information provided by the HCSF, in addition to informal interaction with staff from HCSF member institutions, i.e. the Banque de France, the ACPR and the Ministry for the Economy and Finance.

Section 1: Description of and background to the measure

The draft measure consists in a tightening of limits for large exposures of French systemically important credit institutions to highly indebted large NFCs that have their registered office in France. The measure falls under Article 458(2)(d)(ii) of the CRR, i.e. a draft national measure for domestically authorised institutions, or a subset of those institutions, intended to mitigate the changes in the intensity of risk and concerning the requirements for large exposures laid down in Article 392 and Articles 395 to 403 of the CRR. This is the first instance of an authority requesting the use of this Article to set stricter large exposures limits.

The limit requires systemically important French credit institutions to ensure that large exposures limits for highly indebted large NFCs are no greater than 5% of their eligible capital. The institutions directly impacted by the measures are the six institutions[5] that have been defined as either globally or otherwise systemically important pursuant to Article 131 of the CRD, as transposed into French national law through the Code monétaire et financier[6].

The exposures are determined at the highest level of consolidation of the banking prudential perimeter of the institution concerned. Large exposures are to be defined in line with Articles 389 and 390 of the CRR. The draft measure defines an NFC[7] as large if the aforementioned exposures, before taking into account the effect of credit risk mitigation techniques and exemptions in line with the supervisory reporting obligations set out in Article 9 of the Commission Implementing Regulation (EU) No 680/2014[8], are at least €300 million. As of the end September 2017, 109 companies (two-thirds listed, one-third non-listed) as reported by the six impacted institutions met this criterion.

An NFC is to be classified as highly indebted if its ultimate parent company has a net leverage ratio[9] greater than 100% and its interest coverage ratio[10] is below three. These thresholds have been calibrated by the HCSF based on the evolution of both indicators for a sample of 103 NFCs and covering several recession periods. The number of large NFCs that have breached both financial criteria has varied between 30 and 40 in the past few years. For NFCs whose ultimate parent is French, the large exposures limit applies to the exposures of NFCs with a registered office in France, which includes the net exposures towards the entire group

5 (i) BNP Paribas, (ii) Groupe Crédit Agricole, (iii) Société Générale, (iv) Groupe BPCE, (v) Groupe Crédit Mutuel and (vi) La Banque Postale.

6 Article L511-41-1 A VII of the French Monetary and Financial Code (*Code monétaire et financier*) and *arrêté* of 3 November 2014.

7 Non-financial corporations, all natural persons and private law legal entities in the non-financial corporations sector, as defined in Section 2.45 of Annex A to Regulation (EU) No 549/2013 of the European Parliament and of the Council of 21 May 2013.

8 Commission Implementing Regulation (EU) No 680/2014 of 16 April 2014 laying down implementing technical standards with regard to supervisory reporting of institutions according to Regulation (EU) No 575/2013 of the European Parliament and of the Council.

9 Defined as total financial debt less outstanding liquid assets over total equity.

10 Defined as earnings before interest and taxes/interest expenses.

of connected clients[11] (irrespective of where they have their registered office). For those NFCs with a registered office in France and belonging to a foreign group, the limit applies to the net exposures of NFCs with a registered office in France as well as any of their connected clients that have their registered office in France and all their subsidiaries (whether they have their registered office in France or not).

Since the tightening of the large exposures limits would result in a level below 15%, Article 458(10) of the CRR does not apply.

The main motivation for introducing the measure is given as preserving the overall resilience of the systemically important French banks in the event of a default by large and highly indebted NFCs. Furthermore, it is envisaged that it will act as a signal to financial institutions and investors with respect to the risks associated with the increased leverage of large French NFCs.

The draft measure will be introduced through a decision to be published in the Official Journal of the French Republic (*Journal officiel de la République Française* – JORF), according to Article R. 631-6 of the French Monetary and Financial Code. The HCSF will officially adopt the measure and publish it on its website once the European notification and opinion procedure is complete. Furthermore, guidelines regarding the implementation of the measure by the institutions will be issued to them directly, in advance of the implementation date.

In 2009 the French authorities (the ACPR, formerly the Commission Bancaire) issued an informal recommendation that reduced the large exposures limit a credit institution may have to a client or group of connected clients, after taking into account the effect of the credit risk mitigation in accordance with Articles 399 to 403 of the CRR, from 25% to 10% (of eligible capital). The measure was not specifically directed at large corporates with their registered office in France.

The ESRB has also received a preliminary request from the HCSF to recommend the reciprocation of the draft measure by other Member States under Recommendation ESRB/2015/2[12]. This request will only be considered by the ESRB following completion of the notification and approval procedure and provided that the draft measure has been effectively adopted by the French authorities. A possible ESRB Recommendation for reciprocation is therefore not considered in this opinion.

Section 2: Analysis of the underlying systemic risks

The HCSF is of the view that credit losses on the debt of large NFCs could have a substantial negative impact on the solvency position of the French systemically important institutions, should their exposures become too high. If the trend of increasing NFC indebtedness were to persist, the vulnerability of highly indebted NFCs to either an interest rate reversal or an abrupt repricing of risk premia would increase, thus creating debt sustainability issues. Unsustainable debt levels of large NCFs may have a substantial negative impact on the systemically important institutions' solvency positions, if such exposures were to become significant. This could in turn have a negative impact the real economy, through second round effects triggered by banks' reactions (restriction of credit), which might have systemic consequences.

[11] In line with the CRR, the group of connected clients includes the NFC itself and all the connected clients. The definition of "connected clients" covers two types of interconnections, i.e. the control relationships (i.e. the subsidiaries of the NFC) and the economic dependencies.

[12] Recommendation of the European Systemic Risk Board of 15 December 2015 on the assessment of cross-border effects of and voluntary reciprocity for macroprudential policy measures.

2.1 Developments in French NFCs' debt

Overall, while NFC debt in France is close to euro area levels, developments differ given that France is not experiencing a relative stabilisation or any decrease in levels as is observed in some other large European countries. According to HCSF research, since the end of 2010, the ratio of NFC debt to GDP in the euro area declined by 1.7 percentage points, whereas in France it increased by 11.5 percentage points. Looking at Q2 2017, French NFC debt over GDP was 7.3 percentage points higher than in the euro area. For the six institutions impacted directly by the draft measure, in particular, total outstanding NFC loans grew by more than 30% between the end of 2014 and the end of 2017, accounting for around 11% of the banks' balance sheets[13]. The business plans of the six targeted banks also indicate that sustained new NFC lending can be expected over the coming years. The notification outlines that the significant majority of financing for large NFCs[14] is market-based financing (i.e. as of Q2 2017, more than 80% of the outstanding debt of large NFCs consists in debt securities).

More specifically**, the growth in the outstanding debt of large corporates contributed to the overall trend of increasing NFC debt in France** as, according to the notification, large corporate debt increased by €225 billion between 2010 and 2017, compared to a total increase in NFC debt of €410 billion. More specifically, in Q2 2017, large NFC debt amounted to €685 billion out of a total €1,615 billion in debt (comprised of bank loans and debt securities). Large NFCs are considered to have been an important driver of debt growth in recent years, with large corporates increasing their debt at an average annual rate of 7.5% between 2011 and 2016, whereas the average annual rate for all NFCs was 4.9%.

Other authorities have also noted the increase in French NFC debt. It was identified in the September 2017 IMF Country Report for France, and flagged in the ECB Economic Bulletin (Issue 4/2017), that credit to NFCs had increased. Potential continued growth in these loans, in conjunction with already high levels of indebtedness, has prompted the French authorities to interpret this as an area in which to remain vigilant, and so to consider it appropriate to implement a pre-emptive, backstop measure.

A large share of highly indebted large NFCs in France are active in the real estate sector. In the past few years, the share of highly indebted large NFCs active in the real estate sector has been at least 25%, followed by the industrial goods and services sector (10%); the remaining companies are distributed quite evenly across the other economic sectors. Earlier work by the ESRB has stressed the importance of developments in the real estate sector for financial stability[15].

13 For the purpose of this assessment the term "bank" has the same meaning as "credit institution" as defined in Article 4 of the CRR.

14 In this section, consistently with the risk analysis reported in the HCSF notification and the HCSF background report, an NFC is defined as "large" based on the definition of the French decree no. 2008-1354 of 18 December 2008 on criteria for determining the category of ownership of an enterprise for the purposes of statistical and economic analysis. According to this decree, a large company is an enterprise that cannot be classified in other (smaller size) categories – namely those of micro-enterprise, small and medium-sized enterprise (SME), medium-sized enterprise (which does not belong to the SME category). This corresponds to a NFC fulfilling one of the two following criteria: (i) having a workforce of more than 5,000 or (ii) an annual turnover higher than or equal to €1,500 million and a balance sheet total of more than €2,000 million.

15 ESRB, *Report on residential real estate and financial stability in the EU* and *Report on commercial real estate and financial stability in the EU,* December 2015.

2.2 Low interest rate environment

The continuing low interest rate environment could pose a systemic risk to the French financial system, in particular with respect to the growth in the outstanding debt of large corporates. Any consideration of the identified increase in the debt levels of NFCs must be considered in the context of the significantly low interest rate environment experienced since 2011. According to the French notification, the low financial burden of French NFCs could potentially be challenged by a rise in borrowing rates. A significant portion of bank loans to NFCs is extended at variable rates and so an increase in rates would have a direct and immediate impact here; debt securities of NFCs, by contrast, are mostly issued with long-term fixed rates. Furthermore, in contrast to households, NFCs tend to refinance their debt obligations, resulting in greater sensitivity to an increase in interest rates. It is acknowledged that while a rise in rates may be offset by benefits accrued from increased earnings, previously built-up liquidity buffers may be not sufficient.

2.3 Role of investment and leveraged buyouts

A trend towards financing investment activities, such as mergers and acquisitions, with borrowed money has become more prevalent in the NFC sector in recent years, sometimes involving leveraged buyout operations.

According to figures provided by the French authorities, the investment rate of NFCs (which is the ratio of investment to value added) has increased sharply since 2012, standing at 22% in 2016, the highest rate for over 30 years. It is necessary to consider the self-financing rate (which is the ratio of savings to investment flows and changes in inventories) in conjunction with this. With figures suggesting that the financing of investment is now only covered by corporate savings of up to 80%, the reason for the trend in recourse to debt is evident.

While the average default rate of leveraged buy-out transactions financed by French banks remains below the average for the euro area (around 8% versus 10.2%), the noted trend is sensitive to a turnaround given that a large portion of the loans are set to mature in 2018/2019. As of September 2017, according to the figures available for the main four French banks[16] most involved in this activity, the worldwide gross exposure to leveraged buy-outs amounted to €31.4 billion.

Moreover, the French authorities have identified a gradual loosening of covenants: an increased importance of debt rollover, sometimes on more aggressive conditions than before the rollover, and significant competition, with an increase in the share of financing from non-bank participants.

Section 3: Effectiveness and efficiency of the measure

Further guidance will be provided by the French authorities as regards the practicalities of the draft measure. While the institutions targeted directly by the draft measure will be required to compute the financial indicators used to identify the appropriate NFCs, guidelines and specifications will be made available by the French authorities for computing these. Ideally, such guidelines could have been made available to the ESRB already, at the time of the notification, in order to provide the General Board with a full picture of the measure and its possible impact. These guidelines are also important for the relevant authorities, where necessary in the case of reciprocation, to determine if the banks are appropriately identifying the NFCs. It has been argued that if there is ambiguity around one or more of the indicators, institutions are to assume the thresholds have been met and to subsequently treat the NFC as

[16] (i) BNP Paribas, (ii) Groupe Crédit Agricole, (iii) Société Générale and (iv) Groupe BPCE.

large and highly indebted and so within the scope of the measure. Furthermore, the HCSF does not consider that any additional supervisory reporting requirements from the institutions will be necessary.

3.1 How the measure addresses the identified risk

The draft measure follows an earlier initiative introduced in France in 2009 whereby the large exposures limit was reduced to 10% through an informal recommendation. This limit differs from the limit of the planned macroprudential measure in that it is not specifically targeted at NFC debt and is microprudential in nature. According to informal interaction with the French authorities, the six supervised institutions comply with the 10% limit.

The primary objective of the draft macroprudential measure is to preserve the resilience of the French banking system in case of the default of large, highly indebted NFCs. This is to enable the French banking system to withstand potential losses in the event that large and highly indebted NFCs default on their debt obligations. Given that exposures of significant French institutions to these companies would be limited following the implementation of the measure, there would be a muted knock-on impact on the rest of the financial system in case of any defaults.

The specificities of the calculation of the limit are deemed appropriate according to the French authorities as **the large exposures limit encompasses all the banks' exposures to NFCs, taking into account both on-balance-sheet and off-balance sheet activities**. This is necessary to capture the overall credit risk as large NFCs often rely on sources of financing other than bank borrowing, such as market-based finance.

The indicators used to assess how indebted an NFC is (leverage ratio and interest coverage ratio) are considered appropriate by the HCSF as they are commonly used ratios (which contributes to their consistent application) and they take into account the entire debt level, including credit issued by foreign institutions and market-based financing.

As previously mentioned, **the measure targets institutions that are defined as either globally or otherwise systemically important in France in accordance with Article 131 of the CRD**. As these banks represent 95% of the NFC loan market of all French banks and are more prone to causing contagion in the event of default, the HCSF is of the opinion that they are the appropriate institutions to focus on. Moreover, the other financial institutions in the sector tend to have different business models and finance small and medium-sized enterprises (SMEs) rather than large NFCs. Nonetheless, the HCSF has committed to conducting close monitoring of the impact of the measure on banks that are not subject to the exposure limit.

Consequently, the measure would currently affect six banks (on a consolidated basis). These institutions are significant institutions that are directly supervised by the ECB under the Single Supervisory Mechanism (SSM) Regulation[17]. Overall, the solvency and liquidity position of these institutions has strengthened since the onset of the financial crisis. Their CET1 ratio ranges between 12% and 16% and is on average around 14% (figures as at the end of December 2017).

Considering the identified increase regarding highly leveraged NFCs, **the HCSF specifically calculated a large exposures limit to restrain potential future increases in lending to this sector**. A limit of 5% of eligible capital was calibrated following an impact analysis based on a number of cases in which institutions exceeded a 3%, 4% and 5% limit. Of importance to the analysis of the results was the fact that the measure is intended to act a as backstop, such that it is forward-looking, with the aim of preventing a build-up of excessive vulnerabilities, but

[17] Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions.

does not act as an impediment to the normal functioning of the real economy. Ultimately, consideration was given to the resilience objective and the preventative aspect of the measure (i.e. not being too restrictive, to avoid excessive and undesirable deleveraging). The 5% limit showed that no NFC would be directly impacted during the period concerned (December 2015 – September 2017) which coincides with the intention of the measure being a backstop. However the French authorities have indicated that upon reviewing the measure they would be willing, if necessary, to reduce the exposure limit to enhance the resilience of the financial system.

As a second objective, the **French authorities also consider the draft measure to be a highly important signal of impending risks to financial stability.** The draft measure signals to the banking sector and the public at large (also including insurance companies and foreign jurisdictions), that concerns over developments in the leverage of the NFC sector persist, particularly for large NFCs. The HCSF previously published a press release and a report highlighting concerns regarding the indebtedness of NFCs in France[18] and the French authorities are confident about the positive impact of the combination of various communications with the introduction of the draft measure.

It is inferred from discussions with the French authorities that the monitoring and compliance of the measure would be under the responsibility of the designated authority for Article 458 of the CRR (i.e. the HCSF) – with delegated powers given to the ACPR. Reporting is to coincide with the supervisory reporting obligations under the large exposures regime, in that it will be received on a quarterly basis. Any breach in the tighter large exposures limit will result in the procedure as described in Article 396 of the CRR. Accordingly, any breach must be reported to the supervisor immediately, with an explanation of the justification. Efforts are to be made to quickly comply with the limit (increasing the level of capital and/or reducing the level of exposures).

3.2 How the measure relates to possible alternatives

As required under Article 458 of the CRR, this section assesses whether other available macroprudential instruments under the CRD IV and CRR could adequately address the increase in systemic risk, taking into account their relative effectiveness. These instruments need to be considered before resorting to Article 458 of the CRR to adopt stricter national measures.

a) Increasing the risk weights for banks applying the standardised approach to credit risk (Article 124 of the CRR)

On the basis of financial stability considerations, the competent authority is allowed, under Pillar 1, to impose higher risk weights on banks that apply the standardised approach to their exposures secured by mortgages on immovable property, from 35% to up to 150%, or to apply stricter criteria for the application of the 35% risk weight.

Given that the draft measure pertains to exposures to the NFC sector and limiting the risk from the increasing indebtedness of these corporates, Article 124 of the CRR is not appropriate as it aims to address risks related to the real estate sector.

b) Increasing the loss given default (LGD) floor for banks applying the internal rating based (IRB) approach for credit risk (Article 164 of the CRR)

On the basis of financial stability considerations, the competent authority is empowered, under Pillar 1, to increase the exposure-weighted average LGD floor of IRB banks for their retail exposures secured by residential property. The LGD is one of the parameters used in the

[18] HCSF, press release and report "*Etat des lieux de l'endettement des agents privés non financiers*", dated 15 December 2017.

risk weight function. Increasing the LGD indirectly increases the risk weight and resulting capital requirements.

Similarly to Article 124 of the CRR, **Article 164 of the CRR relates to the real estate sector and so is not deemed relevant or able to preserve the resilience of the French financial system to the indebtedness of the NFC sector.**

c) Using the countercyclical capital buffer (Article 136 of the CRD IV)

The CRD IV provides for the introduction of a countercyclical capital buffer to address some of the procyclicality in the financial system. The countercyclical capital buffer is a requirement for domestic exposures. The rate for the countercyclical capital buffer is set on a quarterly basis by the designated authority and there is typically a 12-month lead time from the announcement of an increase in the rate until banks have to apply it.

The countercyclical capital buffer would apply to all French credit exposures, not just to a specific cohort of corporates. It is therefore determined that this measure would not appropriately target the risk identified by the French authorities. However, the use of the countercyclical capital buffer may be considered complementary to the current proposal depending on developments in the financial cycle. The HCSF announced, in December 2017, that it would consider an increase of the countercyclical capital buffer should cyclical risks remain at the current levels in the coming months

d) Using Pillar 2 (Articles 101, 103, 104 and 105 of the CRD IV)

Under the supervisory review and evaluation process (SREP or Pillar 2 of the CRD/CRR), the competent authority can implement a wide range of supervisory measures to address any risks or elements of them that are not sufficiently covered by Pillar 1 and to provide incentives for banks to enhance their risk management (see Article 104 of the CRD). Furthermore, the CRD allows the use of Pillar 2 for macroprudential purposes (see Article 103 of the CRD).

The HCSF has put forward several arguments in favour of using a Pillar 1 measure instead of a Pillar 2 measure, mainly relating to their relative effectiveness and governance. The ESRB agrees with these arguments.

- **Macroprudential nature of the measure:** The SREP has a microprudential focus and therefore may not be effective in capturing macroprudential concerns. On a bank-by-bank basis, the French authorities did not identify any risks stemming from the increase in NFC indebtedness. However, such a continuous increase has been identified by the HCSF as a macroprudential or systemic risk that poses a threat to financial stability at national level (Articles 102, 103 and 104 of the CRD IV).
- **Effectiveness of the measure:** Article 105 of the CRD IV specifically deals with provisions introduced to tackle liquidity risk when considering the particular business model of the institution. It is therefore not considered appropriate for addressing concerns about the exposures of banks to increasingly indebted French companies, which by nature are related to credit risk. Considering the latest reviews of the credit risk models used by the supervised institutions directly impacted by the draft measure, no concerns arise regarding a breach of Article 101 the CRR. Finally, any increase in the Pillar 2 CET1 capital ratio through the SREP to reflect the amount of capital needed to cover concentration risk in the NFC segment would also affect the capital requirements related to credit exposures other than loans to large NFCs. Moreover, a Pillar 2 capital add-on is more static in nature, based on a time-specific assessment of the outstanding stock of NFC loans, whereas the draft measure applies to both the outstanding stock and the flow of new loans to large NFCs.
- **Transparency:** There is a noted lack of disclosure underlying the Pillar 2 requirements, which would not allow for raising public awareness of the issue related to the growing

debt of French corporates through a signalling effect (Articles 103 and 104 of the CRD). Indeed, the previous SREP decisions made by the ECB for significant institutions under which Pillar 2 requirements were imposed were not made public.

- **Institutional set-up:** Pursuant to the SSM Regulation, it is the ECB, and not the HCSF or ACPR, that is the competent authority for the application of Articles 101 to 105 of the CRD IV to the French significant institutions, as covered by the draft measure.

e) Using the systemic risk buffer (Article 133 of the CRD IV)

Member States may introduce a systemic risk buffer to address long term non-cyclical systemic or macroprudential risks not covered by the CRR. The systemic risk buffer can be applied to all banks or to a subset of banks.

The HCSF views the identified risks as cyclical in nature since exposures to large and highly indebted NFCs have followed an increasing trend over the past few years, in line with the growing trend in NFCs' indebtedness and the acceleration of the French financial cycle. The HCSF further points to the cyclicality of the criteria (the leverage ratio and the interest coverage ratio) that are used to trigger the activation of the tighter exposure limits. However, it can be argued that, because of its backstop nature, the measure has also a structural dimension. The measure's backstop function is another argument for not imposing any additional capital requirements, such as a systemic risk buffer, under the current circumstances.

The HCSF considers it appropriate to target a subset of exposures (those of highly indebted large NFCs) to tackle the identified systemic risk. Therefore, as the calculation base for a systemic risk buffer would have been all banks' exposures (total exposures or domestic exposures), that buffer was deemed inappropriate as it might hamper lending to all NFCs, including the less indebted ones and SMEs. However, the ESRB notes that other Member States already use the systemic risk buffer to target a cohort of banks and/or a subset of exposures, for example by making buffer levels dependent on the relative importance of a subset of the targeted banks' exposures.

Section 4: Analysis of the net benefits of the measure

4.1 Effects on financial stability, financial system resilience and economic growth

Tightening the limit on the permitted exposures of systemically important institutions in France to highly indebted, large corporates will maintain the resilience of the financial system to any sudden failure of those NFCs as the impact on the banks' balance sheets is mitigated, reducing the possibility of a negative knock-on effect on the remainder of the domestic and European financial system. The impact of the draft measure on its main objective may be limited though if institutions not directly targeted by the measure decide to ignore the implicit warning from the French authorities, instead amending their business models and increasing their financing to these highly leveraged NFCs, as they are not bound by the limits within this measure. The impact of any failure of the large NFCs may therefore also potentially impact the stability of the financial system through these other institutions' exposures in the absence of additional measures. The HCSF, however, committed to monitoring potential leakage through institutions not directly targeted by the measure.

By preserving the resilience of the six targeted institutions, a positive contribution is made to the resilience of other Member States' financial systems. Indeed, several of the six institutions are part of large cross-border financial groups that control multiple systemically important institutions in other Member States; financial difficulties in the French institutions concerned may therefore potentially have negative spillover effects on the financial systems of other Member States. It should also be noted that, under the procedure laid down in Article 4 of Decision ESRB/2015/4, no member of the General Board raised any material concerns regarding negative externalities of the measure in the form of adverse cross-border spillover effects.

No information is available on the possible impact of the measure on economic growth, however given that this is intended to be a pre-emptive, backstop measure, the expected impact would be rather small. For the same reason, the expected impact, if any, on growth in other Member States would also be minimal.

4.2 Effects on both domestic and cross-border lending

It is still too early to assess the effective impact of the draft measure on banks' credit standards and lending behaviour. The draft measure was only announced in December 2017 therefore it is too soon to observe any effective changes in banks' behaviour. The French authorities, however, expect a minimal reaction given that, according to their analysis, the proposed limits are not currently breached by the targeted institutions.

It may be the case that NFCs identified by the indicators for this measure would ultimately source financing from institutions outside of the scope of the measure. This could result in an increase of cross-border lending from banks outside of France; therefore the need for reciprocation to successfully implement the limit is emphasised. In its notification of the measure, the HCSF requested that the ESRB recommend that other Member States reciprocate the measure. This request will only be considered by the ESRB if and when the measure has been effectively adopted by the French authorities. In that respect, the ESRB notes that EU credit institutions operating in France through branches and direct cross-border lending are estimated to have a market share (among EU credit institutions) of around 18% of NFC bank lending in France[19], with the home countries of the most significant players being Germany, Spain, Italy, the Netherlands and the United Kingdom. However, a substantial part of NFC lending in France is also provided by non-EU banks (in particular institutions from the United States and Japan), which would not be covered by any ESRB recommendation for reciprocity.

Another potential channel that may affect the effectiveness of the measure consists of the insurance and asset management sectors, which are reported to hold a substantial amount of French corporate debt, but which are nevertheless not covered by the measure. The ESRB notes that for now the French authorities do not consider the risks associated with the exposures of these sectors to large NFCs to be excessive; furthermore, the HCSF lacks the relevant macroprudential tools to address such risks if they do start to emerge.

4.3 Effects on banking groups' intragroup behaviour

Some of the institutions targeted are part of financial conglomerates[20], thus potentially creating the risk of shifting NFC financing from banking entities to insurance entities within the same group. The HCSF acknowledges the potential reaction of insurance companies to the draft measure. However, it considers that the signalling effect as well as the indirect effect on market-based debt as far as insurance companies are concerned will also prevail for a financial

---

19 Source: COREP and the EBA Transparency Exercise. Owing to differences in the coverage of institutions and the scope of the data, the figure of 18% cannot be directly compared to the 95% mentioned earlier and which refers to the market share of the six institutions among all French credit institutions.

20 https://esas-joint-committee.europa.eu/Publications/Guidelines/List%20of%20financial%20conglomerates%202017.pdf

conglomerate. As a consequence, the HCSF does not foresee any specific additional risk associated with financial conglomerates and that could be addressed by using available tools. However it recognises the potentially lower efficiency of the measure at group level in mitigating the risk identified. The HCSF confirms that it stands ready to monitor developments in financial conglomerates in order to avoid the adoption of such a strategy.

There are a limited number of foreign banks with a presence in France in the form of both a subsidiary and a branch. The risk of shifting NFC finance from one corporate form to the other, in order to reduce the impact of the measure for the foreign bank, is therefore limited, but should nevertheless be monitored.

Conclusions

According to the assessment by the HCSF, the trend towards increasing indebtedness of NFCs, in particular among large corporates and in the form of market-based finance, requires early intervention by the authorities. Such early intervention aims to preserve the resilience of banks in a preventive way and to send a strong signal to the market that risks resulting from this increasing leverage are building up.

The ESRB very much welcomes the early intervention by the French authorities in the face of increasing risks. Macroprudential decision-making has a natural tendency towards inaction given the visible short-term costs and the less obvious longer-term benefits. Early intervention (e.g. by issuing warnings or introducing backstop measures) is therefore advisable. Given that the 5% threshold for the large exposures limit envisaged by the French authorities, at this point in time, does not constrain any of the six institutions affected, the ESRB for now sees the warning aspect of the measure as its main impact. The French authorities are relying to a large extent on this signalling effect, through which they expect the measure to impact all segments of the financial sector and not only the banks directly targeted by the measure.

The ESRB acknowledges the limitations of the present macroprudential toolkit of the French authorities to address the sources of the identified risk, and therefore their rather particular approach to addressing the risk. The ESRB is not aware of any previous use of large exposures limits to a client or a group of connected clients as a macroprudential instrument in the EU. Nevertheless, the use of such limits for macroprudential purposes is explicitly recognised in Article 458(2)(d)(ii) of the CRR. Moreover, in addition to direct bank lending such limits also capture market-based finance of NFCs held by banks and therefore address one of the underlying factors in the risk development. Also the measure illustrates that there are other ways to preserve the resilience of banks than only increasing regulatory capital. This is further emphasised by the fact that the six targeted institutions now have regulatory capital ratios in place that are well above the required minimum. A recent stress test by the ACPR that included an adverse scenario with an acceleration of NFC debt further demonstrated the high resilience of the banking and insurance sectors.

The ESRB is of the view that the alternative macroprudential instruments listed in Article 458 of the CRR, which must be considered before any stricter national measure can be taken, would not adequately address the risk at hand. Measures such as those listed in Articles 124 and 164 of the CRR, as well as the systemic risk buffer or the countercyclical capital buffer, are considered to be inadequate: either they do not provide the intended incentives, they are too broad-based, or they do not address the relevant type of risk, exposure or bank. The ESRB also found that the measure does not entail disproportionate adverse effects on the internal market or other national financial systems.

The ESRB is therefore of the opinion that, at this point in time, the stricter measure is warranted. However, the ESRB also identified a number of issues that require close follow-up by the French authorities in order to ensure the effectiveness of the measure.

First, given the peculiar nature of the draft measure and the limitations of the macroprudential toolkit of the French authorities, close monitoring of the impact of the measure and the evolution of the risk is needed. The ESRB sees several potential channels that could undermine the effectiveness of the draft measure, in particular if the 5% threshold for large exposures were to be exceeded. These include the role of banks from other Member States and third countries as well as domestic and foreign non-bank institutional investors in providing market-based finance to large NFCs. An enhanced monitoring of the evolution of NFC financing through these alternative channels vis-à-vis the six targeted institutions, and the corporate debt market more generally, is therefore needed.

Second, the draft measure illustrates the limitations of the present macroprudential toolkit of the French authorities in addressing the sources of the identified risk. The ESRB would therefore encourage the French authorities to take the necessary initiatives to further expand their toolkit in order to be able to better address the identified risk through the aforementioned alternative channels, in particular if the risk continues to develop unfavourably. One avenue that could be explored, for example, is the introduction of borrower-based instruments for large NFCs that would also cover debt issuance.

Third, even within the limitations of the existing toolkit, the ESRB would suggest that the French authorities explore additional initiatives to complement the draft measure. These could include enhanced transparency, improving the risk awareness of investors, and better risk management practices for banks and institutional investors. While some of these initiatives may not necessarily be labelled as macroprudential in nature, they may nevertheless also be effective in helping to further curtail the identified risk.

Fourth, while the French authorities do not deem it desirable to define strict criteria for the extension or deactivation of the measure, for reasons of transparency and accountability it would be helpful if they would be **more specific in clarifying the criteria they would apply or indicators to be used for such decisions.**