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October 8, 1999

To: Members of the Executive Board

From: The Secretary

Subject: **France—Selected Issues**

This paper provides background information to the staff report on the 1999 Article IV consultation discussions with France, which was circulated as SM/99/250 on October 1, 1999.

Mr. Zanello (ext. 34708) and Mr. Ubide (ext. 34408) are available to answer technical or factual questions relating to this paper prior to the Board discussion.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat on Tuesday, October 19, 1999; and to the European Commission, the Food and Agriculture Organization, the Organisation for Economic Cooperation and Development, and the World Food Programme, following its consideration by the Executive Board.

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INTERNATIONAL MONETARY FUND

FRANCE

Selected Issues

Prepared by Claudia Dziobek (MAE), Olivier Jeanne (RES),
and Angel Ubide (EU1)

Approved by European I Department

October 7, 1999

Contents | Page

Text Boxes

Figures

Tables

Appendices

Appendix Table

France: Recent Developments and Issues in Banking and Financial Markets[1]

I. Introduction and Summary

1. The French financial system has undergone a fundamental transformation in the past two decades. Before the mid-1980s, three features made the financial sector a clear example of state-directed finance: (i) the banking sector was tightly regulated and essentially governed by quantitative credit controls; (ii) the majority of banks were owned by the state and channeled funds to the largely state-owned industrial sector; and (iii) government debt was largely non-negotiable and hampered the development of capital markets.

2. A substantive overhaul of the structure and supervision of the financial sector came about as a result of a major policy reorientation, European integration, and international competitive pressures. By the late 1990s, the French financial sector had freed itself of most of the institutional features that impaired its efficiency in allocating capital.

3. This paper provides an overview of the transition from a state-directed to a market-based financial system. It adopts a comprehensive approach and discusses the outcome of this transition in banking, insurance, and capital markets. After providing a historical *tour d'horizon* that highlights the sequencing of financial sector modernization, the paper addresses inter alia the following questions:

- What are the reasons for the relatively low profitability and high concentration of the banking sector?
- What is the role of insurance companies in the management of long-term savings?
- What are the implications of EMU for money and capital markets?
- How should the supervisory architecture be organized to meet the challenges posed by the consolidation and international integration of financial institutions?
- Is market disclosure appropriate for effective financial surveillance?

4. The main conclusion of the paper is that, on balance, France has successfully modernized its financial industry through a well-managed transition over the last 15 years. Looking forward, the policy agenda should address three main issues:

- Even after an ambitious privatization program, the legacy of state intervention in the banking sector has created an uneven playing field, has hampered profitability, and indirectly has led to a highly concentrated market.

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[1] Prepared by Claudia Dziobek, Olivier Jeanne, and Angel Ubide.

- The development of corporate bond and stock markets—which lags behind that of the thriving money and government bond markets—should be fostered by further improvement in accounting and disclosure practices.

- The main challenge facing the current supervisory architecture is how to deal with increasingly larger, more complex, and more international institutions. The debate over the need for an integrated authority is ongoing, as is the appropriate organization of supervision and lender of last resort at the European level.

5. The rest of the paper is organized as follows: Section II overviews the sequencing of reforms; Section III presents a global view of the current state of the French financial sector, and compares it with other major industrialized countries; Section IV discusses in detail developments in the banking and insurance sectors; Section V analyzes money and capital markets; Section VI presents developments in the supervisory architecture; finally, Section VII summarizes the main conclusions of the paper.

II. Sequencing of Financial Sector Liberalization

6. The past two decades of French financial market development constitute an interesting case study of a successfully managed transition from a state-directed to a market-based financial system. This section provides an historical overview of the major policies since the mid-1980s, with a special focus on the authorities' efforts to develop the government bond market.

7. Until 1984, state-owned banks held close to 90 percent of deposits and extended about 80 percent of credit.[2] Almost half of French industry was also owned by the state, supporting close linkages between corporate finance and government.[3] The financial system was further stifled by the fact that government debt was largely non negotiable.

8. The transition to market-based banking was a deliberate policy choice and the evolution of the financial sector can be traced back to numerous policy initiatives (see Box 1). The **1984 banking law,** placing most financial institutions under a single set of prudential rules, marked the beginning of a radical transformation of the financial sector. **Privatization of banks,** which took place in three waves starting in 1986, was another building block of financial sector liberalization. The most recent developments are the privatization of Crédit Lyonnais and the reform of the savings banks.

9. The creation of markets for **commercial paper** (1985), **futures, and options** (1986 and 1987) at a relatively early stage of liberalization was an important complement, permitting more efficient liquidity management and supporting a framework for more effective monetary policy implementation. The legal framework for **money market instruments** was streamlined and opened access to a broader audience over the course of several years. The emphasis on money market development, including money market funds, is a key characteristic of French financial markets. In this regard, France differs from other euro-area countries, notably

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[2] The biggest banks had already been nationalized in 1945. Banking services were oriented to serving the goals set in the national economic plans of the government (J-P. Patat and M. Lutfalla (1986) and Plihon (1998)). A second wave of nationalizations took place in 1982.

[3] The starting point for deregulation was different in other industrial countries. For example, in the United States, regulatory barriers for banks in the early 1980s were the separation between commercial and investment banking and barriers across state lines. In Germany, the notion of "bank group competition" erected barriers between commercial, cooperative, and state-owned banks. However, in both countries commercial banking has always been predominantly in private hands.

Box 1. Major Policies for Financial Sector Liberalization

1984	New Banking Law placing all credit institutions under a single set of prudential rules.
1985	Creation of a commercial paper market in France (*titres de créance négociables* (TCN).
1986–87	First wave of privatization; abolishment of directed credit. Creation of futures market (MATIF) and options market (MONEP).
1987	Stock exchange is transformed into a commercial entity (*Société des bourses françaises*), accessible to a broad group of financial institutions. Strengthening of securities supervision.
1990	Capital account liberalization within the European Community.
1993–94	Second wave of privatization Banque Nationale de Paris (BNP).
1996	Implementation of EU directive on investment services. Simplification of securities issuance. Banking supervision extended to include investment firms. Creation of a *Comité de Liaison des Autorités Monétaires et Financières* (CLAMEF) to coordinate supervisory activity of money, capital, and credit activity.
1997	Supervision of bank-internal risk models.
1997–99	Third wave of privatization (including. Crédit Lyonnais and Crédit Foncier). Reform of the savings banks.
1999	Redenomination of major financial instruments in euro. Introduction of a single central bank reference rate in the euro area. EU-wide introduction of deposit insurance for banks, insurance, and investment houses.

from Germany, where emphasis was on the development of long-term bond instruments. Capital markets were promoted by more liberal access to the stock exchange and significant strengthening of **securities supervision** since the mid-1980s. In 1996, a new segment of the stock exchange, the ***Nouveau Marché***, was set up specifically to support high-growth firms, and initial listings have been relatively successful. Yet, as in other euro-area countries, private stock and, especially, private bond markets remain relatively underdeveloped. Insufficient disclosure or high transactions costs for smaller firms has been identified as a stumbling block by the authorities and by the European Commission.[4] The predominant role of banks in investment banking (a core characteristic of continental Europe) may also present a barrier to more dynamic markets.[5]

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[4] See EU Commission (1998), *Commission Bancaire*/COB (1998), and Black, S. and M. Moersch (1998).

[5] See Black, S. and M. Moersch (1998).

10. Developments in the French financial sector proceeded in the context of the Single European Act (1986), which played a catalytic role in financial sector development.[6] The broad harmonization of prudential rules to support the creation of a Single European Financial Market was given high priority among European Union members. The recent implementation of the European Investment directive in 1996, simplifying the procedures for securities issues, is expected to help promote **European capital market integration**. On the macroeconomic side, capital account liberalization in 1990 constituted an important step toward financial liberalization. Subsequently, the Maastricht Treaty and the Stability and Growth Pact, in the run-up of the final stage of European Economic and Monetary Union (EMU), provided another important boost to financial sector development, as it helped banks focus on core business and global positioning.

11. The policy of phasing out direct state involvement in banking was supported by the parallel **strengthening of prudential oversight**. Prudential regulation has evolved significantly during the past 20 years, and increasing emphasis on **prevention** has led to new instruments that allow more efficient on- and off-site supervision. Another noteworthy step was the creation of a **liaison committee** to bring together representatives of the various French agencies involved in financial market supervision. The 1996 establishment of the *Comité de Liaison des Autorités Monétaires et Financières* (CLAMEF) underscored a more broad-based approach to supervising all aspects of universal banking and financial markets. The CLAMEF is designed to coordinate the activities of banking, insurance, and capital markets supervisors. Furthermore, the jurisdiction of the Commission Bancaire was expanded to include investment firms. Like other industrial countries, France introduced the supervision of banks' **internal risk models,** which allows banks greater autonomy and some leeway in establishing their own prudential norms. Supervisors are also active in guiding banks to **improve disclosure standards,** giving French banks some choice in adopting international accounting standards.[7]

12. **Exit policy** (closure of insolvent banks) and **restructuring procedures** for problem banks have been important elements of financial sector liberalization. The ground rules for addressing problem banks and exit were laid down in the 1984 banking law and are actively applied. The ability of bank supervisors to take action in this regard appears to be effective.[8] A

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[6] A global dimension to financial sector liberalization was provided by the Basle Capital Accord (1986), establishing the ground rules for capital adequacy among G-10 countries.

[7] For example, one large French bank has chosen to publish its financial statements using U.S. accounting principles made compatible with French rules and European Union directives.

[8] In this respect, the banking problems related to real estate and small enterprise loans in the mid-1990s posed a particular challenge to supervisors. Furthermore, the failure of *Crédit*

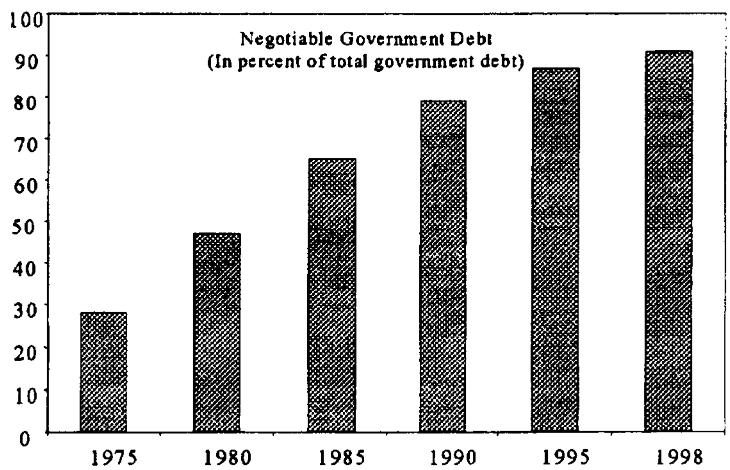
(continued...)

recent regulatory innovation is the power to restrict dividend payments under certain conditions. The newly established insurance fund for banks, insurance companies, and investment houses strengthens the safety net of French financial firms.

13. The advent of **Stage III of EMU** has had an immediate impact on national financial markets. The introduction of the euro and a single reference interest rate in January 1999 has tightened the links among European money markets. EMU fostered convergence of government bond spreads, and a single yield curve is providing a unified benchmark across the euro area. The uniform reserve requirement as well as the European payment system (TARGET) set the stage for greatly increased volumes of cross-border interbank transactions.

The development of the government bond market

14. An efficient, deep, and liquid government bond market is an important element of a market-based financial system. Until the early 1980s, however, the French government relied strongly on deposits from the public to finance its debt. In 1975, savings from the public collected by the state (through the savings banks, *La Poste*, and the *Trésor's* own network) covered about 60 percent of its borrowing needs.[9] Negotiable government paper was primarily short-term instruments (*bons du Trésor*) used for liquidity management purposes.[10]



15. Developing the primary and secondary government bond markets became an **explicit policy objective** to better serve the government's borrowing needs and to support the expansion of domestic financial markets.

Lyonnais was instrumental in introducing more stringent rules, particularly concerning banks' internal risk control (See Section IV below and SM/96/249, Supplement 1).

[9] It is difficult to compare negotiability of government debt across countries. In Germany, Bundesschatzbriefe are nonnegotiable (but redeemable on demand) and represented about 4 percent of outstanding public debt in 1975 and 3 percent in 1999. The United States issues debt at a noncompetitive tender rate (treasury bills sold in small amounts and to individuals), but its share in public debt varies according to demand and is not subject to a specific debt management policy.

[10] See, for example, Pons, Jean-François (1988).

Thus, government debt management was refocused toward negotiable debt instruments. The figure above indicates that in 1975 only about 30 percent of outstanding debt was tradable (negotiable), whereas two decades later more than 90 percent of total debt is traded in the market. The establishment of the government bond market took place in an environment of expanding government debt (rising from 25 percent of GDP to about 60 percent in 1998), which facilitated the move toward negotiable instruments. In addition, the conversion process was also supported by means of direct exchanges of nonnegotiable credit lines for negotiable bonds during 1992.

16. Key policy measures in the development of French government bond markets are summarized in Box 2. The building of the market was a **step-by-step process**, starting with 15-year bonds and slowly adding additional maturities, at both the longer and the shorter ends of the maturity spectrum, adding depth by introducing and supporting derivatives activity. ECU-denominated debt also played a significant role in anticipation of an integrated euro-area financial sector.

17. France's **debt management strategy** focuses on transparency, predictability (of new issues), liquidity, and innovation. This strategy is implemented through a policy of public announcements concerning planned debt issuance, with frequent auctions (weekly and monthly) held according to a set calendar. An example of innovation was the introduction of inflation-indexed bonds, a pioneer in the euro area. For comparison, the German bond market strategy has not explicitly emphasized innovation, although German bond markets are characterized by a broader range of bonds including, for example, mortgage-based securities (Pfandbriefe) that do not exist in France.[11] An indicator of successful market building is the share of foreign holders of domestic debt. During the 1990s, the share of foreign (nonresident) holders of French government debt increased significantly from about 15 percent in 1997 to about 21 percent in 1999. While a breakdown by origin of nonresidents is not available, this rapid change probably reflects the disappearing exchange rate risk within the euro area and bespeaks the integration of French government bonds within the euro area.

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[11] However, a legal framework for mortgage bonds has been recently introduced in France, and the first issues are expected by end-1999.

Box 2. Major Steps in the Development of the Government Bond Market Since 1984

1985 First issue of negotiable government bonds (*Obligation assimilable du Trésor*, OAT) (15-year bonds with fixed and variable rates).

1986 First MATIF government bond futures contract, whose pool of underlying instruments is made up of OATs. Creation of a group of French primary dealers (*Spécialistes en Valeurs du Trésor* or SVTs), modeled on the U.S. system.

1989 First 30-year OAT issued. First ECU-denominated issue.

1990 First publication of government securities monthly bulletin.

1991 First reverse auction to repurchase securities. First offer to exchange a 1997 OAT for a 2002 OAT. Treasury authorizes stripping (separate trading of a the principal and interest of a bond).

1992 Creation of a securities reserve as part of the Government Debt Management Fund (FSR) to increase liquidity. Large public offer to exchange 45 illiquid lines of government debt for three new OATs.

1993 First issue of an ECU-denominated five-year BTAN (*Bon du Trésor à taux fixe et intérêts annuels*). Five-year government bond issue for retail investors, which raised over F 110 billion.

1994 Bimonthly auctions in ECU introduced. A group of primary dealers in repos on French government securities was formed. Monthly OAT sales to retail investors through commercial banks.

1995 First two-year ECU-denominated BTAN was issued.

1996 Monthly auctions of ECU-denominated OAT and BTAN. New OAT indexed to the TEC 10 index, an average yield of fixed-coupon OATs with a constant maturity of 10 years.

1997 First five-year MATIF contract, based on the market for BTANs and OATs with a residual maturity of 4 to 5 ½ years.

1998 New group of primary dealers selected. First inflation-indexed bond issued (OATi).

1999 Government debt is redenominated in euros (EUR 560.2 billion). MATIF launched a dual-issuer 10-year Euro-notional contract, supported by OATs and Bunds eligible for delivery.

18. The French experience highlights a few lessons from a successful transition to a market-based system:

- Successful liberalization is a long-term and ongoing effort that requires appropriate sequencing.
- Rapid privatization must be accompanied by enhanced prudential oversight.
- A clear policy to deal with distressed banks is crucial to establish “credible threats” and an environment encouraging prudence.
- While liberalization may not always proceed smoothly, banking problems often catalyze the development of efficient problem-solving techniques.
- A liquid and efficient government bond market is an important backbone of banking by promoting maturity transformation and money market activity.
- Finally, when banks are allowed to offer a wide range of financial services through a universal banking model, coordination of bank and securities markets oversight is essential.

III. AN OVERVIEW OF THE FINANCIAL SECTOR

19. The previous section has outlined how the French financial system has achieved a drastic transformation over the last 15 years. In order to gauge its relative stage of advancement, this section discusses the current structure of the financial sector in a **cross-country context.**

20. The structure of financial markets changes as economies mature and become more integrated: direct finance tends to become more important as asymmetric information, a key reason for bank intermediation, loses importance and corporations are able to access markets directly by issuing tradable debt and equity. By the same token, the array of savings instruments broadens, as savers invest in a wider range of instruments.[12]

21. Table 1 shows that, in terms of end-1998 total outstanding stock, the money market is the largest segment in the French financial sector, followed by traditional bank lending, stocks, and bonds. Funds held by insurance companies are also significant.

Table 1. Financial Market Activity
(End-1998; in billions of euro and percent)

	Total Stock	Percent of Total
Bank loans	1,009	27
Money market	1,324	36
Capital market		
Stocks	825	22
Bonds 1/	529	14
Total (without derivatives)	3,687	100
Memorandum item:		
Funds of insurance companies	587	16

Sources: Banque de France, Monthly Bulletin (various issues); Commission Bancaire, Annual Report, 1998.
1/ Exclusive of bank bonds (EUR 216 billion).

[12] Gurley and Shaw (1956); Saunders and Walter (1994); Steinherr (1994); Dziobek and Garrett (1998). As pointed out in this literature, bank-based financial systems tend to develop markets that are dominated by banks, and may experience difficulties in fully developing capital markets.

Since insurance funds are invested in money and capital markets, these are only shown as a memorandum item.[13] These figures must be interpreted with caution: stocks are expressed in terms of market prices, rather than book value, and are therefore subject to greater variability than the other market segments. With asset prices currently at historical highs, a longer term view would give somewhat less weight to stock markets in the French financial sector. On the other hand, bond markets are somewhat understated because they do not include bank bonds.

22. Table 2 provides some **cross-country comparative data** for France, Germany, the euro area, and the United States. The first set of indicators reflects the extent of **bank intermediation**. Bank credit is less important in France than in Germany or the euro area, but somewhat more important than in the United States. In terms of bank deposits (sight deposits and savings accounts), the data suggest that, as a percentage of GDP, deposits collected by French banks are the lowest in the sample. Including deposits collected by the Trésor and La Poste, the figure would be somewhat higher (about 60 percent of GDP) but still low compared to the other countries. This finding is puzzling: although it could be explained by the relatively high importance of money market instruments in France, money market funds are also well developed in the United States, where bank deposits are also higher than in France as a percentage of GDP. The ratio of the monetary aggregate M3 to GDP is another indicator of financial development, which is relatively low for France and Germany compared with the United States.[14]

23. The relative size of direct and indirect finance may be used as a rough indicator of financial sector development. The more advanced an economy, the more developed corporate stock and bond markets would be relative to bank-intermediated credit, and the lower the bank-loan to GDP ratio.[15] One might also expect bank-loan-to-GDP ratios to fall with

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[13] Table 2 does not attempt to fully reflect the scope of financial sector activity. Some adjustments were made to represent a significant portion of financial markets and to avoid double counting. Bank bonds (which finance bank credit) were deducted from bonds and insurance funds (which are invested in stocks and bonds) are noted as a memorandum item.

[14] These calculations are based on IFS data, which use national definitions that may not be fully comparable.

[15] The reasons are well known: large firms, which are accustomed to publicly disclosing details on their financial conditions, do not need banks as intermediaries in part because agency problems arising from asymmetric information are not an issue. Furthermore, borrowing directly in the market should be cheaper than borrowing through banks because there are no ongoing charges for credit monitoring. Following this logic, advanced financial systems should have relatively high ratios of corporate stocks and bonds to GDP. However, higher transactions costs may make bank loans cheaper than corporate bonds for smaller firms.

increasing financial development but transactions costs may be high, making bank loans competitive with corporate bonds for mid-sized and smaller firms.

Table 2. International Indicators of Financial Market Depth: France, Germany, Euro Area, and the United States

(Percent of GDP, 1998)

Indicator	France	Germany	Euro Area	United States
Bank Intermediation				
Credit to private sector	79	107	97	71
Bank deposits	56	95	130	81
M3/GDP	64	56	77	71
Money Markets				
Money market instruments 1/	20	2	7	10
Interbank liabilities				
(in percent of total assets)	25	20	30	33
Money market funds	13	1	n.a.	16
Capital Markets				
Stock market capitalization 2/	67	40	63	151
Domestic debt securities 3/				
Private sector	30	60	41	73
Public sector	45	50	62	93
Insurance				
Premiums 4/	6	2	3	4

Sources: IMF, *International Financial Statistics*; national central banks; BIS; and OECD.
1/ Includes only money market instruments held by banks.
2/ For the United States, the data comprise NASDAQ, NYSE and Amex.
3/ Total outstanding, as of March 1999.
4/ Life insurance, net written premiums, 1995.

24. French **money markets** are highly developed. France has the highest bank holdings of money market instruments. This contrasts with the United States, where money markets are very well developed but banks are not the major participants. Interbank activity, another indicator of market depth, seems to be broadly similar across countries. Finally, money market funds are also important in France and in the United States, but virtually nonexistent in

Germany.[16] This is confirmed by the fact that there are 720 money market funds in France and only 41 in Germany.[17]

25. **Stock market capitalization** as a percent of GDP is higher in France than in Germany and the euro-area average, but smaller than in the United States. In France, recent privatizations appear to have contributed to this result: data for 1997 show that stock market capitalization was about 50 percent of GDP in France and 40 percent in Germany. Other indicators, such as the market capitalization and the turnover of the five largest firms in France, confirm the result that the French stock market is among the most developed in the euro area.

26. As regards the **corporate bond market**, France appears to lag behind. The value of outstanding corporate bonds relative to GDP is lowest in France (30 percent of GDP), compared with 41 percent in the euro area, 60 percent in Germany, and 73 percent in the United States.[18] In addition, an important segment of this market, mortgage-backed securities, has only recently been introduced in France.

27. Finally, France has the highest ratio of **premiums collected by life insurance** to GDP. As discussed below, this may be related to tax advantages that make life insurance products attractive instruments for tax-deferred investments, particularly in the absence of private pension funds.

28. Some conclusions can be drawn from this comparison:

- French **core banking services** are relatively undersupplied: French deposit and credit activities are indeed low compared with Germany, the United States, and the euro-area average.

- French **money markets** are highly developed. The important weight of money market funds, which often are close substitutes for deposits, may in part explain the relative underdevelopment of core banking services.

- French **capital markets** are relatively shallow in comparison with the United States, but do not differ significantly from other euro-area countries.

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[16] The underdevelopment of money market funds in Germany is in part a result of an explicit Bundesbank policy (see Deutsche Bundesbank, 1994, p. 42), which has recently changed.

[17] There are, however, about 460 money market funds in Luxembourg, where German banks have a very significant market share.

[18] German figures may somewhat overstate the importance of corporate bonds, however, because bank bonds appear to account for a large share.

- The relative underdevelopment of capital markets is related to the banks' dominance in all aspects of financial services in France (and other euro-area countries). For example, since money market funds in France are marketed at the retail level by banks, these continue to be the dominant players in the financial sector, in spite of the growing importance of market-based products—such as money market funds.

IV. Banking and Insurance

29. Sections II and III have focused on the history of liberalization policies and the overall outcome they have produced. This section and the next analyze in detail each of the main segments of the financial sector, starting with banking and insurance, whose close intertwining in France warrants a discussion in tandem.

A. The Banking Sector

30. As shown in Section II, the French banking system has undergone a sweeping transformation throughout the past two decades. It can be convincingly argued that the roots of this transformation can be traced to: (i) the virtually complete state-ownership of the banking sector in 1982; and (ii) the enactment of the new banking law in 1984, which standardized all banking activities and fundamentally changed the rules of the game.

31. These events became the defining starting points of an ongoing transformation of the French banking sector, because of their far-reaching consequences in three dimensions:

- The 1984 banking law created a universal bank model, with two effects: (i) by consolidating the network structure of cooperative and saving banks, it led to a high level of **concentration** in the banking system; and (ii) by removing the barriers to the provision of certain services that existed for cooperative and savings banks while maintaining their privileges, it set the stage for an **unlevel playing field** in banking.

- This unlevel playing field, together with the less constraining governance structure of cooperative and saving banks, led to fierce competition and **low profitability** in commercial banking.

- Nationalization allowed the authorities to redesign the ownership structure of the industry with the process of **privatization**, which took place in three waves and culminated in 1999.

32. These issues are addressed sequentially in this section. First, the market structure designed by the 1984 banking law is presented. Second, the management of the privatization process and its influence in the current state of concentration is discussed. Finally, the market conduct and performance, including barriers to competition and profitability, are examined.

Market structure: concentration and market shares

33. In 1998, there were 1,237 credit institutions established in France, of which 562 were banks, 649 were finance companies and securities houses, and 26 were specialized financial institutions.[19] In terms of assets, the French banking sector is clearly dominated by banks. In 1998, commercial banks accounted for half of the balance sheet of the consolidated banking sector, cooperative banks accounted for about 20 percent, and savings banks accounted for about 9 percent. The structure is similar in terms of total loans. The picture changes, however, as regards the shares in total deposits: commercial banks collect about 39 percent of total deposits, the same share as cooperative banks, and savings banks collect another 21 percent. This distribution has evolved over time, and AFB banks have significantly lost market share in deposits in favor of cooperative banks (see Figure 1).

The French Banking Sector: Market Shares in 1998

	In Percent of Total Assets	In Percent of Total Deposits	In Percent of Total Loans
AFB banks	54.1	38.4	43.5
Cooperative and mutual banks	19.2	39.6	29.1
Savings banks	9.2	20.5	7.4
Finance societies	11.5	1.3	8.5
Specialized financial institutions	5.9	0.1	11.3

Source: Commission Bancaire.

34. This description must be qualified by the fact that, unlike in other large European countries,[20] the cooperative and mutual banks, as well as the savings banks, are organized in five large groups. This leads to a **high level of concentration** in the French banking sector: 50 percent of total assets of the banking sector are

Concentration: Share of the Five Largest Credit Institutions

	In Percent of Total Assets		In Percent of Total Loans		In Percent of Total Deposits	
	1990	1997	1990	1997	1990	1997
France	42.5	40.3	44.7	48.3	58.7	68.6
Germany	13.9	16.7	13.5	13.7	11.6	14.2
Italy	19.1	24.6	15.1	26.0	18.6	36.7
UK	27.0	28.0	25.0	26.0	25.0	26.0
Spain	34.9	43.6	33.4	42.1	31.4	38.2

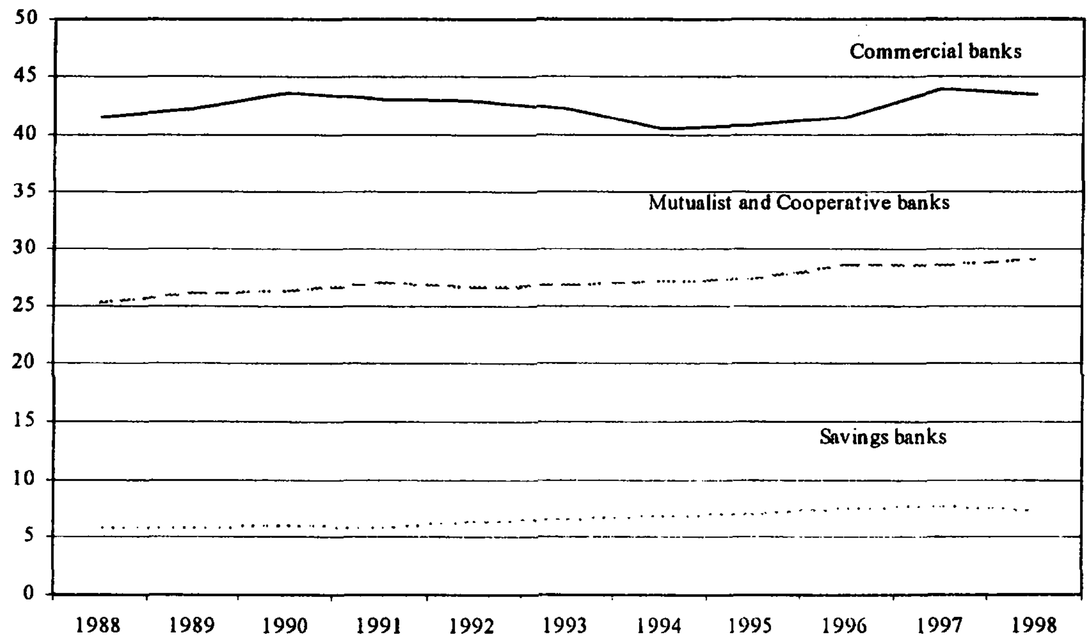
Source: *ECB Bulletin*, February 1999.

[19] The 1984 banking law defined three types of institutions:(i) credit establishments authorized to accept deposits at sight or with less than two years' maturity (commercial banks affiliated with the *Association Française des Banques* (AFB), mutual and cooperative banks, savings banks and municipal credit societies); (ii) credit establishments that may not accept deposits with a maturity of less than two years (financial holding companies); and (iii) credit establishments to which the state has given a permanent mission to serve public interest (specialized financial institutions).

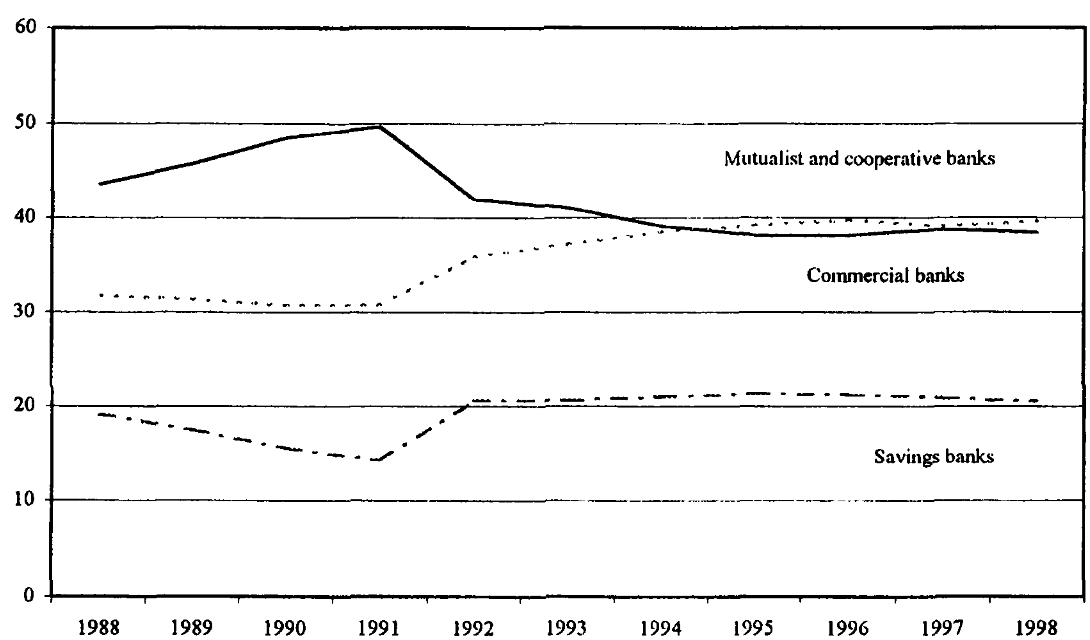
[20] The market shares of mutual and savings banks are similar to those of other major European countries. They account for 60 percent of deposits in Germany and 50 percent in Italy and Spain. However, in none of these countries is the sector concentrated in a few major groups.

Figure 1. France. Evolution of Market Shares
(In percent)

Total loans



Total deposits



Source: *Bank Profitability*, OECD 1998.

concentrated in the three major commercial banks (*BNP, Crédit Lyonnais and Société Générale*), the four cooperative networks, and the savings banks group. Among Europe's largest countries, only Spain, which has also undergone a significant process of consolidation, shows a comparable level of concentration. The process of **consolidation intensified further in 1997–98**, especially with the acquisition of *Indosuez* by *Crédit Agricole* and *Natexis* by *Banques Populaires*.

35. This high level of concentration may be considered the **outcome of the government's policy** aimed at creating large domestic banking groups to prevent foreign concerns from taking control.[21] By nationalizing the banking sector, the government could: (i) merge institutions so as to acquire the desired size before privatizing them; or (ii) manage the privatization process toward the creation of "national champions."

The Ten Major Banking Groups

(As of end-1998, millions of U.S. dollars)

	Tier 1 Capital	Assets	Capital/Assets	ROC 1/	ROA 2/	Cost/Income	BIS Ratio
Credit Agricole Group	25,930	457,037	5.7	15.2	0.8	65.1	11.0
BNP	12,824	397,046	3.4	13.9	0.5	68.1	9.9
Societe Generale	12,521	447,545	2.8	17.5	0.5	73.5	11.2
Credit Mutuel	10,737	286,461	3.8	12.4	0.4	68.6	11.5
Savings Banks Group	10,124	235,660	4.3	8.2	0.4	75.9	16.8
Compagnie Financiere Paribas	9,919	309,364	3.2	17.7	0.5	..	11.1
Credit Lyonnais	7,749	243,708	3.2	7.6	0.2	74.8	10.4
Banques Populaires Group	7,272	190,112	3.8	16.6	0.6	64.9	9.9
CCF	3,330	73,247	4.6	17.6	0.8	74.8	11.6
Natexis	2,097	49,561	4.2	5.3	0.2	58.6	9.2
Memorandum item:							
Total assets of the banking sector		3,399,151					

Source: The Banker (June 1999)
1/ Return on capital.
2/ Return on assets.

36. In this respect, it is interesting to highlight three **key features of the latest wave of privatizations**: (i) the government has retained certain rights by using a certain type of *golden share*; (ii) the government has followed a strategy of selling large stakes to a stable core group of reliable shareholders (*Groupe d'actionnaires partenaires,* GAP), usually led by a large French group, to ensure a stable management and business plan but also to offer protection against takeovers, particularly from foreign concerns; (iii) the social dimension—and in particular, the preservation of jobs—of the proposed post-privatization business plan has weighed heavily in the selection of the main shareholder of the GAP.

37. These three features have been present in the allocation of controlling stakes in recently privatized banks to large cooperative groups—*Crédit Industriel et Commercial* was purchased by *Crédit Mutuel*, *Crédit Lyonnais* by *Crédit Agricole*, and *Crédit Foncier* by the

[21] The reasons for this approach are varied, ranging from the possible strategic nature of the sector to mistrust about foreign supervisory skills under the home country rule. The firm opposition of the Portuguese authorities to the BSCH-Champalimaud agreement is another example.

savings banks—which has significantly fostered concentration.[22] This privatization strategy in favor of mutual banks—BNP had tried unsuccessfully to purchase a controlling stake in both *Crédit Industriel et Commercial* and *Crédit* Lyonnais—was one of the main reasons behind the hostile bid of BNP over both *Société Générale* and *Paribas* in 1999 (see Box 3).[23]

Box 3. The BNP–SociétéGénérale–Paribas Affaire

This hostile bid, the first one in the history of French banking—where large mergers have been traditionally brokered by the government—was largely motivated by the absence of suitable domestic merger partners for BNP to achieve the size necessary both to compete at the European level and to avoid being the prey of foreign banks. Of the top ten banks by market capitalization, excluding BNP, Société Générale and Paribas, only two were commercial—Crédit Commercial de France (CCF) and Crédit Lyonnais— of which only the former was listed in the stock exchange. A BNP-CCF merger would not have addressed BNP's size-oriented strategy, as it would have created only the second largest bank in the domestic market, still small at the European level. As for the remaining large banks, they could not be acquired because they were shielded from takeovers by their mutual or saving bank status.

Thus, once Crédit Lyonnais was allocated to Crédit Agricole, the only remaining choice for BNP was to take over *Société Générale*. Since *Société Générale* had just agreed on a merger with *Paribas*, BNP had to take over both banks, in an operation that would have created the largest world bank, and the only one —at the time—with over US$1 trillion assets. Had BNP succeeded in its bid, the French banking sector would have been dominated by one major commercial bank (BNP-*Société Générale-Paribas*) and one major cooperative group (*Crédit Agricole-Crédit Lyonnais*), which together would have controlled half of the assets of the banking sector, and the five largest banking groups would have controlled about 75 percent, thus placing France at the top of the large industrialized countries in terms of banking concentration.

The **involvement of the authorities** in this process has been intense, in a way that could be argued goes beyond purely prudential concerns. Despite the independent status of the *Banque de France*, the government has intervened in two main ways: (i) through **public statements** in the press, the government endorsed the initial Société Générale-Paribas merger, as it represented another step in their strategy toward the creation of major domestic, French-owned banks. However, immediately after the announcement of BNP's hostile bid, the Ministry of Finance and the central bank issued an unusual joint statement where, invoking the national interest, they announced that they would scrutinize the impact of the bid on the proper functioning of the French banking and financial system; and (ii) through **the role played by the *Comité des établissements de crédit et des entreprises d'investissement* (CECEI)**, the agency responsible for granting authorizations for new institutions and major changes in existing institutions. Chaired by the Governor of the *Banque de France* and with strong government participation—represented by the Director of the Treasury as a permanent member and six other members nominated by the Ministry of Finance for three-year terms—it has played a crucial role in shaping the structure of the banking sector. It tried several times to broker an agreement among the banks before authorizing the takeover conditional on a majority stake—over 50 percent of voting rights—by any of the parts. As BNP only obtained a minority stake in *Société Générale*, the CECEI summoned representatives of both banks to explain their projects, before finally deciding against authorizing the minority control in order to protect the stability of the banking sector.

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[22] After three bail-outs over six years—with an estimated cost of about F 170 billion (2 percent of 1999 GDP)—*Crédit Lyonnais* was privatized in 1999. The government retained 10 percent of the capital, and the majority stake in the GAP was given to *Crédit Agricole*.

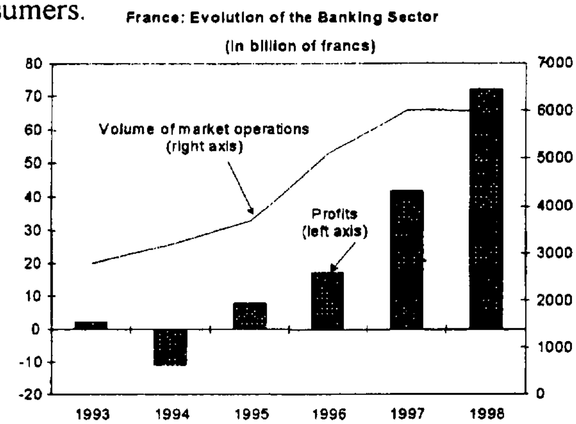
[23] BNP's bid was part of the ongoing process of consolidation in the European banking industry. Other major cases include the merger of Banco de Santander with BCH in Spain and the creation of three large domestic groups in Italy, Gruppo Intesa, Unicredito Italiano, and Gruppo SanPaolo-IMI.

38. Two **prudential issues** arise from this quest for national champions. As regards concentration, the French authorities did not consider the merger as a threat to competition, for the following reasons: although the new bank would have controlled about 25 percent of the French banking sector's assets, it would have captured only about 4 percent of the European market. This is a debatable view, because these banks operate largely at the domestic level and, although the market is theoretically open to foreign competitors, it is de facto dominated by French banks. More worrisome, however, is the fact that these large banks would immediately be considered of systemic importance and "too big to fail," thus representing an important potential liability for the public finances.[24]

Market conduct and performance

39. In the recent history of the French banking system, the last two years can be considered as the **turning point** that concludes the long period of poor results that followed the two main banking crises of the early 1990s (linked to a collapse in the real estate market and widespread failures of small and medium enterprises). The effect of these two crises was the appearance of a significant imbalance between supply and demand of banking services, with a depressed loan demand emerging from the increase in the capacity of self-financing of firms and the surge in the indebtedness of consumers. Thus, the period 1993–95 witnessed a stabilization of volumes and a decline in margins.

France: Evolution of the Banking Sector
(In billion of francs)

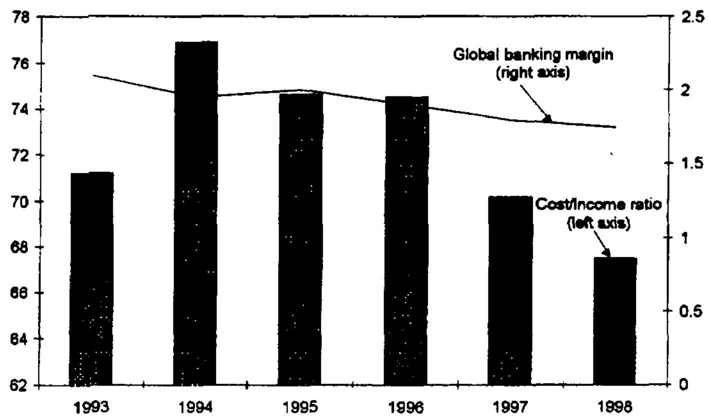


40. The *Banque de France* analyzed the situation in 1995, and concluded that the lack of adequate instruments for internal control and price determination had been the main reason underlying this poor performance. Hence, regulation was issued in this respect, and the *Commission Bancaire* intensified its efforts to monitor banks with abnormal conditions of operation, in particular those with recurrent low profits. These new regulations, together with the resumption of economic growth, reversed the trend. As a result, French banks have since achieved important productivity gains, retail operations have boomed alongside private consumption, and

[24] With a current equity value of about 2.5 percent of GDP, and considering that the rescue of *Crédit Lyonnais* could cost as much as twice its 1993 equity value, a failure of a bank of the size of BNP-*Société Générale-Paribas* could cost French taxpayers over 5 percent of GDP.

declining domestic provisioning has allowed for an **improvement in profits.**[25] In 1997 trading operations and international investments allowed banks to realize substantial gains. The good performance continued in 1998, although the roles were reversed as revenues from domestic intermediation were offset by increased provisions resulting from the emerging market crises.

France: Evolution of Margins and Costs



41. However, the development of traditional banking activities as the core component of profits has been hampered by negative price effects stemming from the **extremely competitive stance of the French banking system**: despite increasing loan demand and decreasing costs of funds, domestic intermediation experienced an important decline in margins which put extra pressure on the containment of costs.

42. In this regard, the Senate issued a report in 1997 that highlights two main barriers to competition in the French banking sector: (i) the **ownership structure of the mutual and savings banks**, which does not pose stringent profitability constraints on their management (in fact, the *parts sociales* are remunerated at a fixed rate; see Box 4) and shields them from takeovers, and (ii) the **structure of administered savings**, which allocates monopoly rights in the distribution of certain saving products, and interferes with the market mechanism in the determination of interest rates. These two issues are analyzed in turn.

The ownership structure of mutual and savings banks

43. The ownership structure of cooperative and savings banks has been highlighted as a **major competitive advantage** against commercial banks, for three reasons:[26] (i) the ceiling

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[25] Nonperforming loans in the banking system peaked at over 9 percent in 1994, and have declined to about 6.5 percent in 1998. Thus, provisions for domestic nonperforming loans decreased from a peak of 100 percent of gross profits in 1994 to about 30 percent in 1998.

[26] Savings and cooperative banks adopt a variety of ownership structures in Europe. In the U.K. and the Netherlands, the savings banks have disappeared. They were transformed into banks and subsequently absorbed by large banking groups (for example, Fortis). A similar process is happening in Italy. In Belgium they were transformed into cooperatives, while in Spain they are still nonprofit organizations. The building societies in the U.K. were

(continued...)

on the distribution of dividends in the cooperative sector and the nonprofit nature of the savings banks may have biased their behavior towards a market-share strategy at the expense of profitability, thus exerting extra pressure on commercial banks; (ii) their less stringent profitability constraints have allowed cooperative and savings banks to build up a large capital and reserve base; and (iii) they have been able to participate in recent privatizations with post-acquisition business plans that largely conserve employment, something extremely difficult to match for a commercial bank seeking synergies and cost reductions. Indeed, AFB banks have complained that both the availability of cash stemming from the large reserve base and the absence of cost-cutting plans have been crucial in the allocation of the recently privatized banks to cooperative banks, which in turn has given them a boost in market share.

Box 4. The Governance of Cooperative and Savings Banks

Mutual and Cooperative Banks: These banks developed a century ago to facilitate credit to the sectors of society excluded from the industrial revolution. Thus service, and not profitability, was their major objective. They are currently regulated by the 1947 cooperative law, and coordinated by a central body that is responsible for the solvency and liquidity of the group. Three characteristics of their **legal status** stand out: (i) they are owned by their customers-members under the rule of "one person, one vote"; (ii) their capital is in the form of *parts sociales*, interpreted as permanent loans to the enterprise remunerated at a fixed rate (related to the long-term government bond rate) independent of profits; and (iii) any surplus is either distributed among members in proportion to their volume of business with the cooperative (and not in proportion to their capital) or allocated to reserves. These reserves are the basis for the joint financial responsibility of the members, the guarantee of the depositors, and the financing of the development of the firm, and hence are indivisible. The sector has consolidated around four large groups: *Crédit Agricole*, *Crédit Mutuel*, *Banques Populaires* and *Crédit Cooperatif*.

The Savings Banks: The *Caisses d'Epargne et de Prévoyance* (CEPs) are organized into a three-tier network: local, regional, and national. At the local level, they are **non-profit** credit institutions with an equity base composed of a "social fund" (amounting to about F 65 billion in 1998, or ¾ of 1 percent of GDP) which is not formally owned by anybody. They engage in all types of banking activities, and share with *La Poste* the monopoly of the distribution of the tax-exempted *Livret A*. At the regional level, the network has been significantly consolidated through mergers, from over 300 firms in 1988 to about 34 in 1998. At the national level, the *Centre National des Caisses d'Epargne et de Prévoyance* is the central body, whose capital is subscribed by the local CEPs (65 percent) and the *Caisse des Dépôts et Consignations* (35 percent). The savings banks have been recently reformed and converted into a cooperative network.

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demutualized and converted into corporates. In Germany there are both public and private savings banks, and are organized at the regional level through the Landesbanken.

44. However, the cooperative structure is not without **drawbacks**. In particular, it could be argued that a cooperative status does not provide an adequate governance framework to manage banks of the size of *Crédit Agricole*, the largest euro-area bank by capitalization and one of the five largest by assets. In addition, it poses limits to an expansionary strategy to achieve the volume necessary to compete in the increasingly integrated capital markets, as cooperative banks cannot tap the stock exchange for fresh capital and cannot engage in mergers and acquisitions involving share swaps. In fact, the special interest showed by mutual banks in recent privatizations may be symptomatic of their need to gain access to capital markets.

The structure of administered savings

45. The large-scale regulation of savings products is another characteristic of the French banking system with no parallel elsewhere in Europe (see Box 5). Covering about half the deposits of the banking sector, this policy has three main objectives: (i) social support, including the promotion of popular (low income) savings through the tax-exempted saving accounts,[27] the "democratization" of home ownership, through the *comptes d'épargne-logement,* and the implementation of the right to housing through the financing of social housing with the funds of the *Livret A*; (ii) the development of the industrial sector through subsidized loans to local government and small firms (the funds collected from the CODEVI are allocated to this purpose); and (iii) the financing of pensions, through the provision of fiscal advantages for long-term saving vehicles such as the *Plan d'Epargne Populaire.*

46. There are three **main features of the administered savings system:** the monopoly rights in the distribution of certain tax-exempt saving products, the determination of the reference interest rates by the government, and the centralization of the management of these savings in a public institution with social objectives.[28]

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[27] The low-income characteristics of these saving accounts should be played down, however, as all of them, except the *Livret d'Epargne Populaire* (LEP), are available to the general public. In addition, about half of the *Livret A* accounts are close to their ceiling of F 100,000.

[28] There are a few cases in Europe where some of these features are found. For example, the Treasury and the Postal system enjoy monopoly distribution of some saving products in the U.K. and Italy, as do the mortgage-saving banks in Germany. Some of these interest rates are also determined by the government. However, in none of these cases is the distribution of administered savings so widespread nor does the interest rate act as a reference rate.

Box 5. Administered Savings in France

Administered savings accounts can be classified according to their fiscal treatment and the modalities of their distribution:

Tax Exempt:

Monopoly distribution:

- *Livret A*. Distributed by the savings banks and *La Poste*, is the most popular, with about 45 million accounts. Its rate is fixed by the government and serves as benchmark on which all the other deposit rates are indexed.
- *Livret Bleu*. Distributed by *Crédit Mutuel*, can be held by both individuals and corporations. Its remuneration is that of the *Livret A*. A third of the interest payments is taxed, although this tax is assumed by *Crédit Mutuel*, and hence it is tax free for the customers.

Free distribution:

- CODEVI. Reserved for French resident individuals, its distribution has been liberalized and it is remunerated at the rate of the *Livret A*.
- *Livret d'Epargne Populaire* (LEP). Created in the early 1980s in a context of devaluation of the franc and freeze of salaries, it is targeted to low-income individuals. The income ceiling is updated every year.
- *Livret Jeune*. Created in 1996, it is targeted on individuals between 12 and 25 years old. Its remuneration was liberalized in 1998, with a floor at the rate of the *Livret A*.

Subject to Taxes:

- *Plan Epargne-Logement* (PEL). Created in 1969, its term is between four and ten years. It permits to obtain, after three years, a loan—limited to F 600,000—for the purchase or renovation of a house. The interest rate is determined by the government.
- *Compte Epargne-Logement* (CEL). Created in 1965, it is similar to the PEL but with a lower loan ceiling, F 150,000.
- *Plan Epargne Populaire* (PEP). Created in 1990, replaced the *Plan Epargne Retraite*. It can take the form of a savings account or an insurance contract, and the interest rate is contractual.

- The most popular of these tax-exempted accounts, the *Livret A* and the *Livret Bleu*, are **distributed exclusively** by the savings banks, the postal system and the *Crédit Mutuel.* Just the *Livret A* has 45 million customers (basically every French adult), which provides a broad customer base for the sale of a diversified range of products.[29]

[29] This is even more important for the market for individuals and small firms, where clustering practices—consumers acquiring products in bundles rather than individually—are predominant. Evidence for the United States and Canada, for example, shows that 70 percent of customers buy mortgage and credit cards from their primary deposit institution, which in general is the local bank (Kwast 1999).

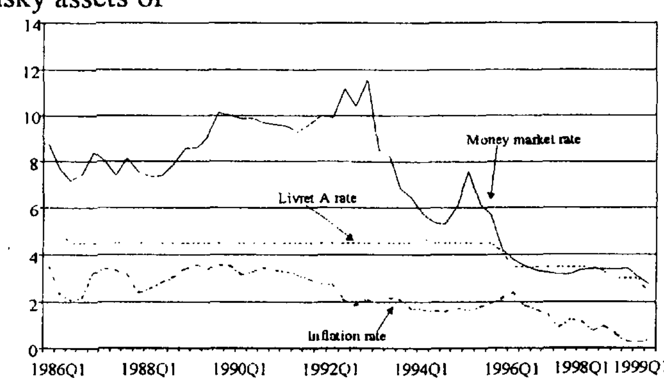
France: Administered Savings Accounts

			Remuneration (percent)					
			1996-98		Reform 6/98		Reform 7/99	
	Ceiling	Amount 1/	Gross	Net	Gross	Net	Gross	Net
Livret A and *Bleu*	100,000	805.5	3.5	3.5	3.0	3.0	2.25	2.25
Codevi	30,000	230.4	3.5	3.5	3.0	3.0	2.25	2.25
LEP	40,000	237.7	4.75	4.75	4.75	4.75	4.0	4.0
Livret Jeune	10,000	31.8	4.75	4.75	At least equal to the rate of Livret A			
CEL	100,000	170.0	2.25	2.0	2.0	1.8	1.5	1.35
PEL	400,000	1,152.0	4.25	3.8	4.0	3.6	3.6	3.25
Memorandum items:								
Total deposits: 5,761 1/								
M3+P1: 7,877 1/								

Source: Banque de France.
1/ End-1998, in billions of French francs.

- The **interest rate on the *Livret A*** is the reference rate of all these saving products, and is determined by the government. After its reduction in 1996, it was at the same level as the money market rate, thus altering the hierarchy between risky and nonrisky assets of comparable liquidity. In order to better link this rate to the evolution of the market, the government reduced it in 1998 and set up a committee in charge of finding the balance between the fair remuneration of savings and the efficient financing of social housing. The committee would meet every time that the consumer price index or the short-term interest rate had varied more than 0.5 percentage points since the time of the previous modification of the rates. In addition, the reform established a corridor for the rate of the *Livret A*, with a floor at the inflation rate plus 1 point and a ceiling at the short-term interest rate minus 0.5 points. Following these rules, the committee met in March 1999 and recommended a cut in the rate of 0.75 percentage points, which was dismissed by the government. The committee met again in July 1999 and recommended a cut of 1.25 percentage points (which would have left the rate at the level of the money market accounts (SICAV), about 1.7 percent); however, the government decided to cut the rate by only 0.75 percentage points, to 2.25 percent, just outside the current values of the corridor

France: Selected rates



[1.3, 2.2]. Because of its role as reference deposit rate,[30] the banks reduced both their deposit and base lending rates upon announcement of this revision.[31]

- All the funds collected from tax-exempt saving accounts are transferred to the *Caisse des Dépôts et Consignations* (CDC.)[32] It remunerates depositors and pays a commission to banks amounting to 1.2 percent.[33] A large portion of these funds serve to finance public housing schemes. In recent years, however, the high interest rates on public housing loans resulting from the high rates of the *Livret A* have decreased the appeal of these loans, and barely half of the collected deposits—a historical low—were on-lent, thus failing to fully accomplish the major objective of the system.

47. In addition to the regulatory barriers, two other factors have influenced the degree of competition and profitability of the banking sector. First, the process of **disintermediation** brought about by the development of short-term securities markets in the mid-1980s and the tax benefits accorded to life insurance products (see below), which diverted retail deposits away from banks and lowered loan demand. Second, the significant **compression of intermediation margins** resulting, inter alia, from the decline in interest rates, the pressure of

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[30] In fact, the interest rate on the *Livret A* is reported by the authorities to the IMF as the reference deposit rate for its International Financial Statistics.

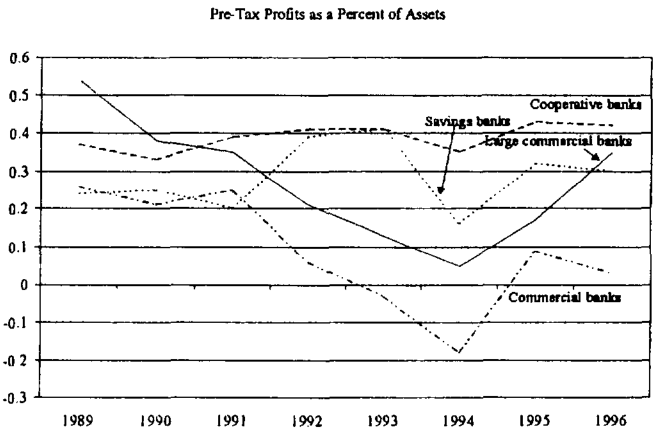
[31] According to the *Banque de France* (Bulletin June 1999), one of the main reasons for the positive spread of deposit interest rates with respect to the euro area is the rigid system of administered rates, which prevents them from adjusting to market developments. Because of its links with the housing market, it may also be responsible for the higher cost of mortgages in France.

[32] The *Caisse des Dépôts et Consignations* is a state-owned bank which engages in open-market banking and financial activities and carries out a public service role at the state's behest. Because of its privileged access to liquidity, it has become the leading French institutional investor, and its powerful funding base has provided the state with a venue to intervene in the industrial and financial sectors as "shareholder of last resort" (see Section IV).

[33] This arrangement effectively sets the floor for the cost of subsidized housing loans at the rate of the *Livret A* plus 1.2 percent, thus playing indirectly the role of reference rate for the mortgage loan market.

competition on lending rates,[34] and the high and rigid deposit rates maintained because of the administered rates.[35]

48. The combination of all of these factors has hampered the profitability of French banks, and in particular of commercial banks, which have consistently underperformed cooperative banks in terms of profitability.



49. **From an international perspective,** the banking sector compares unfavorably, as Figures 2 and 3 show: the cost-to-income ratio is one of the highest in Europe, and the relative worse quality of their loan portfolios has required a high level of provisions, thus putting a drag on profits. French banks have also experienced an important deterioration in interest income, which was only partially offset by fee-related income. Overall, these factors have placed French banks among the less profitable internationally and their return on capital has been on average below the yield on risk-free government bonds (OATs).[36]

50. However, once all of these constrains on profits are taken into account, it seems that French banks are **efficient at managing their available resources**. A recent study (*Caisse des Dépôts et Consignations* 1999) using banks' micro data shows that the French AFB banks can be described, over the period 1994–97, as highly efficient firms which suffer from an unfavorable environment and hence achieve low growth and profitability. This result is corroborated by a study by the *Commission Bancaire* (Bulletin, April 1999), which finds a negative correlation between cost-efficiency and profitability: the most efficient banks are the least profitable. This suggests, according to the study, that the efforts of certain banks to

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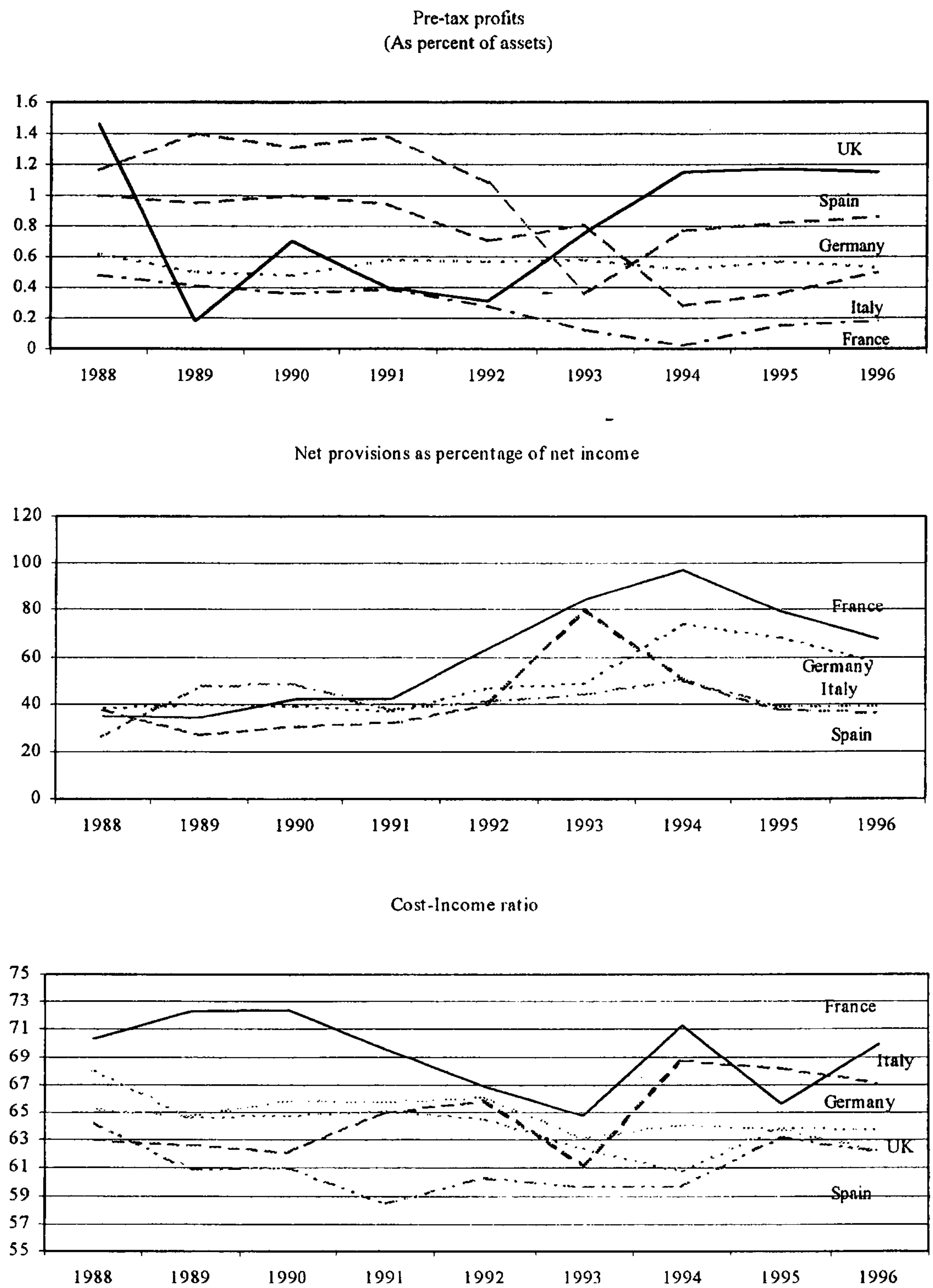
[34] Anecdotal evidence shows that a substantial number of loans are extended at rates below the official reference value linked to government bond yields (banks must report quarterly their new loans with maturity over a year which are granted at a rate below that of the OATs plus 60 basis points).

[35] In an environment of declining interest rates, loans are in general repriced more quickly than deposits, hence contributing to the compression in margins.

[36] These developments led the French authorities to publicly warn in 1997 (Rapport de la Commission Bancaire, 1997) about the dangers of excessive competition with regard to domestic lending, where "near-dumping" practices in order to gain market share were becoming widespread, especially in the mortgage and consumer loans market, with the result being a deterioration in the quality of portfolios and the level of profits.

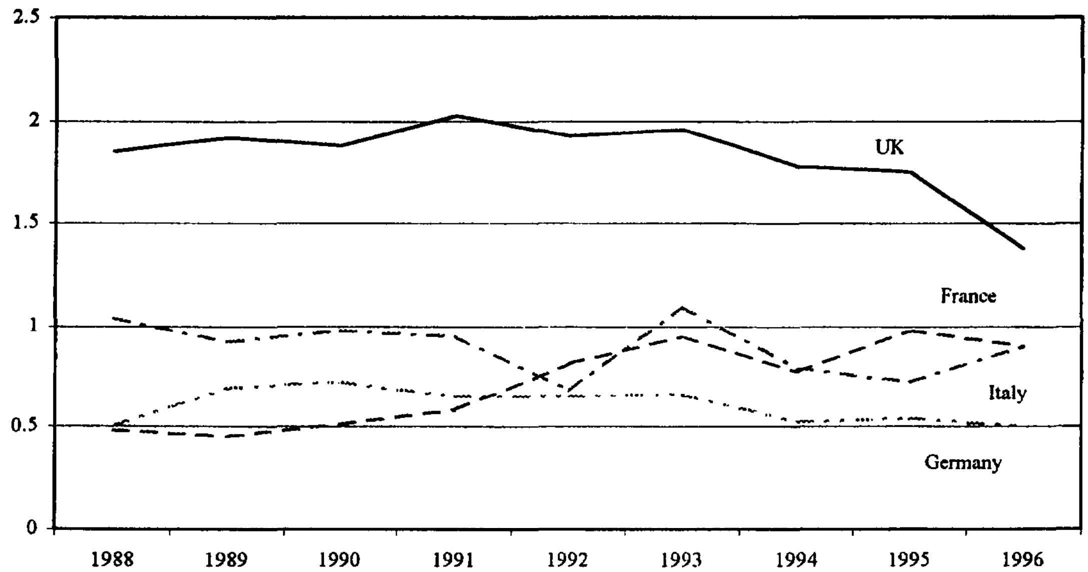
Figure 2. France: International Profitability of Banks



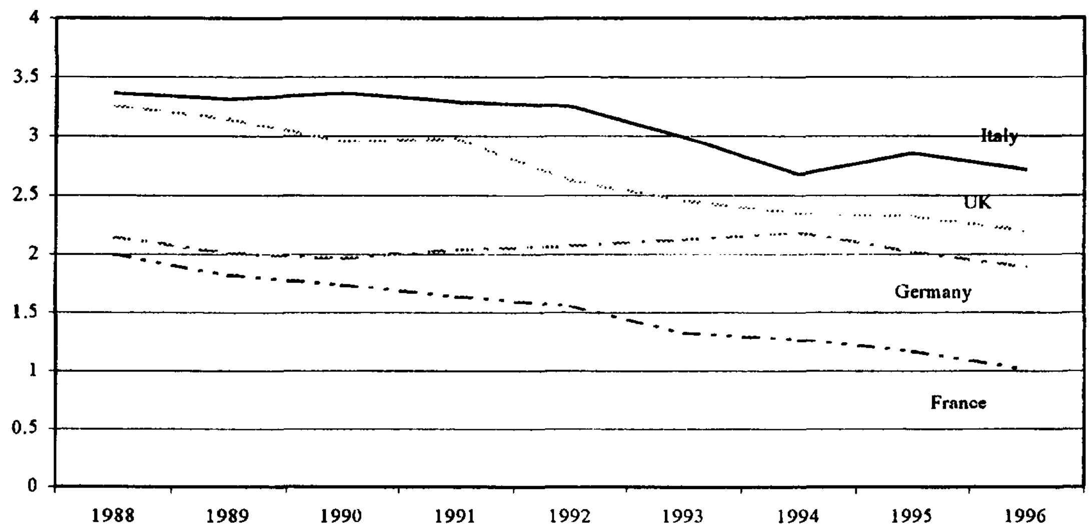
Source: *Bank Profitability*, OECD 1998.

Figure 3. France: Interest and Fee Income

Non interest income
(In percent of assets)



Interest Income
(In percentage of assets)



Source: *Bank Profitability*, OECD 1998.

increase productivity do not translate into higher profits because of the dominant position of other banks—which achieve high profits and have no incentive to improve productivity.

51. The existence of excessive competition has been consistently presented by AFB banks as one of the sources of their poor past performance, but has also been recognized by the authorities. Thus, some **reforms** have been undertaken in the direction of removing unfair advantages and bringing price formation closer to the market mechanism: (i) AFB banks were allowed to distribute the *Livret Jeune*; (ii) the monopoly distribution on subsidized low income housing loans was phased out and are now largely offered across the banking sector; (iii) a committee was created for the determination of the *Livret A* interest rates, in order to avoid long-standing deviations from market rates (see above); and (iv) the savings banks were reformed, in the direction of adopting a cooperative structure (see Box 6).

Box 6. The Reform of the Savings Banks

Following a series of studies that pointed to the nonprofit ownership structure of the savings banks as one of the hurdles to competition in the banking sector, the government decided in 1999 to approach the **reform of the savings banks**, opting for a mutualization that would mimic the structure of Crédit Agricole. The capital of the savings banks will be offered to depositors in the form of *parts sociales*. At the local level, small cooperatives, the *sociétés locales d'epargne,* will be created ex-novo, comprising at least 2000 *sociétaires* and where local governments will be allowed to own up to 20 percent. These *sociétés locales* will be grouped into the *caisses régionales d'Epargne*, which will provide a full range of banking services. At the national level, the new *Caisse Nationale des Caisses d'epargne* (CNCE), owned by the *caisses régionales* (majority stake) and the CDC (35 percent), will represent and coordinate the group and will be responsible for its liquidity and solvency. The new legal status of the CNCE will allow the group to expand its business by negotiating partnerships, including exchanges of shares if necessary, with other financial institutions.

This reform constitutes a useful first step in normalizing the operations of savings banks. However, it has been **criticized** as inadequate from several angles. First, although the savings bank will have to significantly increase their profitability to be able to adequately remunerate the holders of the *parts sociales*, this constraint remains softer than it would be had the savings banks been converted into joint stock companies. Second, the privileges of the distribution of the *Livret A* have been maintained. Third, the authorities still keep a strong hold on their management, through three channels: (i) the nomination of the president of the CNCE by the Minister of Finance; (ii) the stakes of local governments in the *sociétés locales*; and (iii) the 35 percent stake of CDC in the CNCE, which makes it probably the largest shareholder.

In this respect it is interesting to compare this with the recent **reform in Italy.** In 1990 the savings banks were converted into joint stock companies, with the previous owners, mainly foundations, retaining majority stakes. In 1998, a new law forced the foundations to reduce their stakes to less than 50 percent in six years, to increase efficiency and diminish political influence on management. This new structure has allowed the savings banks to actively participate in the consolidation process of the Italian banking sector and join major banking groups.

52. However, some of these reforms have failed to fully address the problems—the mechanism for the determination of the interest rate of the *Livret A* is still very rigid and short of a market mechanism, and the reform of the savings banks has maintained their monopoly

distribution of the *Livret A*—and some other distortions, such as the "Ni-Ni clause," which prohibits the remuneration of sight deposits and check-processing fees to customers, have not been considered.

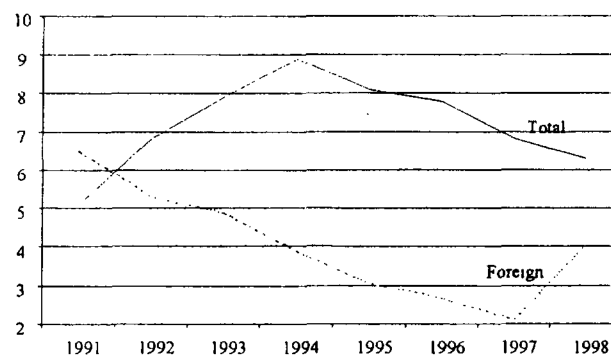
53. One of the consequences of the highly-competitive, low-profit domestic banking environment was the increase in **external exposures** in search of profit opportunities. As Figure 4 shows, French banks expanded abroad significantly, and in 1996 the assets of foreign branches and subsidiaries of French banks abroad represented about 30 percent of total domestic assets.[37] Foreign operations helped support profits while domestic activity was weak, but had the opposite effect once the aftermath of the domestic real estate crisis had faded. Although foreign exposures were curtailed after the Asian crisis, external nonperforming loans (NPLs) doubled in 1998, from 2.1 percent of gross loans to 4 percent, and higher provisions for external loans masked the recovery of domestic activity in 1997–98.

Exposures to Emerging Markets
(In millions of U.S. dollars))

	France	Germany	Italy
	December 1997		
Total	119,948	190,467	37,959
Eastern Europ	10,488	50,058	5,598
Latin America	25,013	36,635	12,193
Asia	42,856	48,656	4,282
	December 1998		
Total	109,812	215,856	41,755
Eastern Europ	10,334	56,710	6,365
Latin America	22,029	40,919	13,449
Asia	33,758	39,796	3,936

Source: BIS.

NPLs in Percent of Gross Loans



B. The Insurance Sector

54. The French insurance sector plays an important role in financial intermediation through capital investments and linkages with banks' networks (largely as the result of an exceptional expansion in life insurance since the early 1990s). This is an international trend, which has been especially pronounced in France, as witnessed by the worldwide use of a French term, *bancassurance*, for integrated banking and insurance businesses. This section presents information on the structure of the French insurance sector; its evolving role in financial intermediation; and the nature of its linkages with other components of the financial sector.

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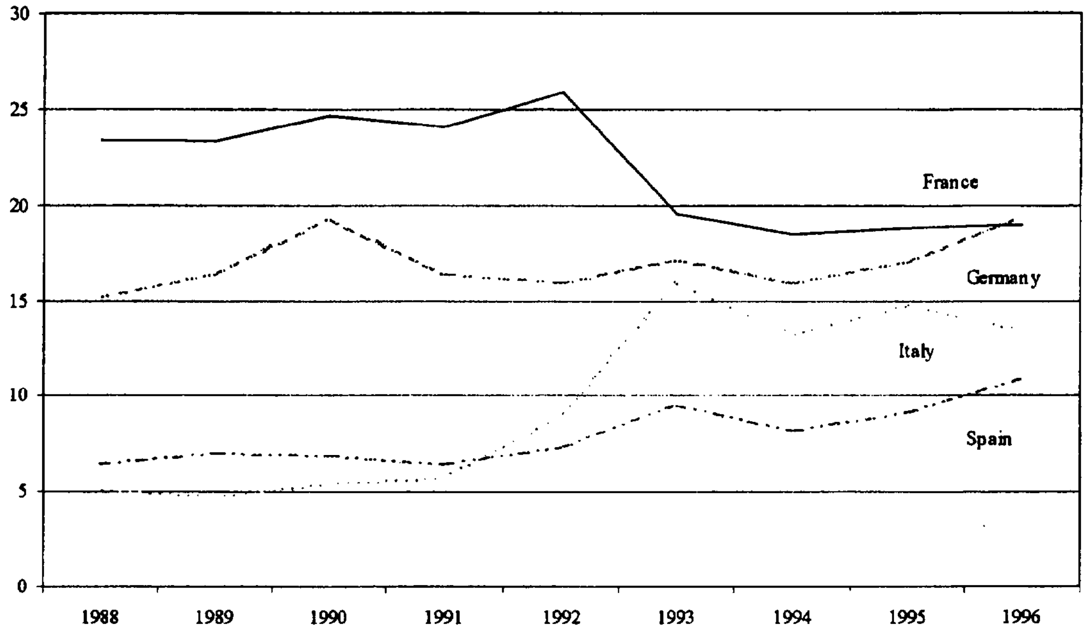
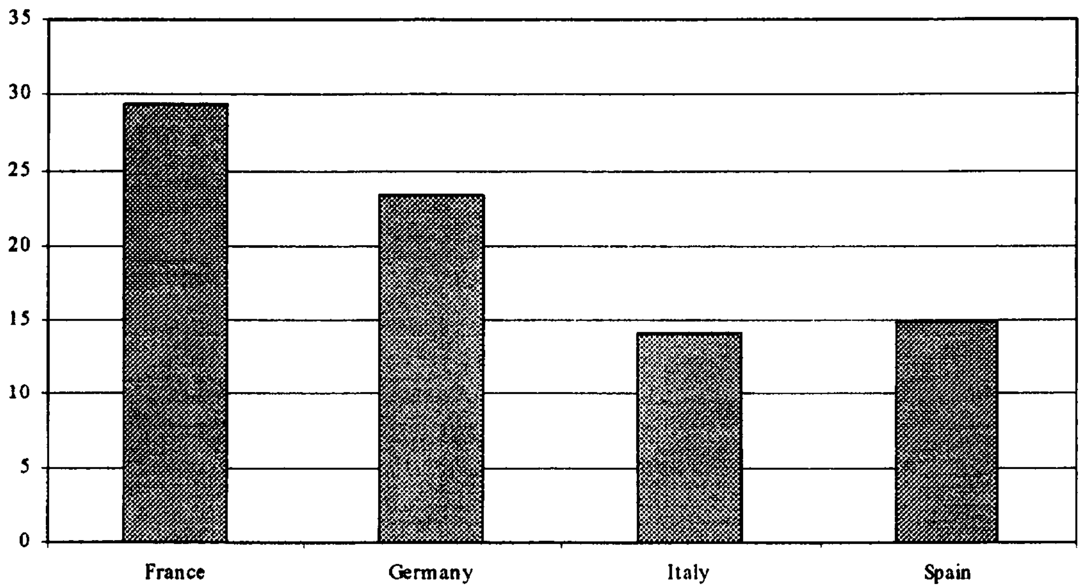
[37] In 1998, some major French banks, such as *Crédit Lyonnais* and *Société Générale*, had net exposures to the Asian crisis countries amounting to 50 percent of their equity. Provisions covered about 20 percent of these risks.

Figure 4. France. Indicators of External Exposure

Claims on nonresidents as percent of assets



Total assets of branches and subsidiaries of domestic institutions in foreign countries
(in percent of total domestic assets, 1996)



Source: *Bank Profitability*, OECD 1998.

55. The French insurance market has two main components, property/casualty insurance and life insurance, the second being by far the largest (with almost two-thirds of total insurance premiums in 1998). The French insurance market has a large number of companies (539 in 1998), but it is fairly concentrated, especially in life insurance, where the three front-runners, AXA-UAP, Caisse Nationale de Prévoyance (CNP), and ALLIANZ-AGF together control 41 percent of the market.

56. The insurance industry is marked by an increasing internationalization, fostered at the European level by the completion of the "single insurance market" in 1994 and more recently by the prospects associated with the launching of the euro. The share of foreign companies in the French insurance market is larger than in the banking sector, especially since the takeover of AGF by ALLIANZ (Germany) in 1998. Conversely, the foreign premium income of French companies represents a sizable and increasing share of their total premium income (from 22 percent in 1995 to 27 percent in 1998), a trend that can be largely accounted for by the rapid international expansion of the French largest insurer, AXA.

57. As in banking, the **presence of the state** in the insurance sector has decreased with privatization, but remains significant through the *Caisse Nationale de Prévoyance* (CNP), a subsidiary of *Caisse des Dépôts et Consignations*,[38] and the distribution network of *La Poste* and the *Trésor*. Thirty-four insurance companies (about one half of the sector) were nationalized in 1946, and later consolidated into three groups, UAP, GF and GAN. These groups were privatized between 1994 and 1998 and rapidly absorbed by larger competitors; UAP is now in the AXA group and AGF was taken over by ALLIANZ at the end of 1997. The public sector remains a major competitor in the insurance market with CNP, whose leadership in the life insurance sector—with around 20 percent of the market—is backed by its privileged access to the distribution networks of *La Poste*, the savings banks and the *Trésor*. The implicit subsidies and softer budget constraints involved in the activity of the public sector raise the same types of complaints from private competitors as in the banking sector.

58. The flexibility of life insurance products—and their exceptionally favorable tax regime—made them the natural answer to the void opened by the **absence of private pension funds** in France. In many respects, life insurance products are long-term savings instruments offering the same flexibility as noninsurance financial products. The payment to the insurance holder is not necessarily linked to the realization of an individual risk, and options to withdraw before the term of the contract are common. One can distinguish between insurance investment certificates (*contrats en francs*), which guarantee a specified capital amount on contract maturity, unit-linked contracts (*contrats en unité de compte*), whose guarantees are

[38] In September 1998 CNP was introduced in the Paris stock exchange, with a public offering of 22 percent of the company's capital. The Caisse des Dépôts et Consignations is the main shareholder of CNP, with 40 percent of the capital. Other shareholders include *La Poste* (20 percent) and the savings banks (12.5 percent).

tied to one or more underlying investments (shares, securities or real estate), and multi-investment contracts (*contrats multisupports*), combining features of the previous two. Taken together, life insurance products with savings elements represent more than one-half of total insurance premiums in France.

59. Life insurance products have benefited from a **very attractive fiscal regime** in the early 1990s, with a panoply of tax advantages including: generous income tax credits on premiums; total tax exemption of income from life insurance contracts with more than eight years of maturity; and total exemption of inheritance taxation on term life insurance. The inheritance tax exemption was unlimited in size, which made it especially attractive for wealthy individuals.[39] These advantages have been restricted in several steps since 1995: the total tax exemption of income from life insurance contracts with maturities above eight years was removed in 1998, and replaced by a 7.5 percent tax;[40] the exemption of inheritance taxation on term life insurance has been progressively reduced, most recently with the introduction in 1999 of a 20 percent tax on the sum received by each beneficiary in excess of F 1 million. As a result of the generous fiscal regime of the early 1990s, the share of insurance products in household net financial investment flows has increased from less than one half at the beginning of the decade to about three-fourths in the recent period, and the share of insurance in household total financial assets has almost doubled over the same period (Table 3). This evolution slowed down by the mid-1990s, with signs of reversal appearing in 1997, when the share of insurance in savings flows declined for the first time in the decade,[41] mainly as a result of the progressive elimination of fiscal advantages on life insurance.

[39] However, the tax exemption was subject to a ceiling for life insurance premiums paid after the age of 70.

[40] Income from life insurance is now taxed at rates ranging from 7.5 to 45 percent, depending on the maturity of the contract. The exemption was maintained, however, for the "DSK contracts"—life insurance contracts with more than 50 percent of their underlying portfolio invested in stocks, of which 5 percent must be "risky" (i.e., of firms that are not quoted or quoted on the *Nouveau Marché*).

[41] The premiums collected by the life insurance industry fell by 18 percent in 1998.

Table 3. Share of Insurance Products in Household Savings					
	1990	1994	1995	1996	1997
			(In percent)		
Share in net financial investment flows	44.9	67.0	76.0	80.0	77.3
Share in financial assets	12.5	17.6	19.5	21.0	21.6

Source: Conseil des Impôts, 1999, *La fiscalité des revenus de l'épargne*, p. 18.

60. The **financial portfolio** of the insurance sector is large, and mostly invested in the bond market. As Table 4 shows, the financial assets held by insurance companies amount to almost one-half of GDP, more than two-thirds of which are invested in bonds. The large share of fixed income instruments reflects some precautionary matching with the liabilities resulting from life insurance contracts. The share of stocks has grown recently, but remains moderate, and well below the regulatory ceiling for securities.[42] It might increase further as a result of the introduction of the "DSK" contracts in 1998—a category of life insurance products with more than half of their underlying portfolio invested in stocks. Insurance companies are allowed to invest in stocks or bonds of OECD countries, but the extent of international portfolio diversification is limited by regulatory rules requiring some congruence between the currency composition of their assets and liabilities. This constraint should be considerably relaxed by the introduction of the euro, which will allow insurance companies to diversify their portfolios in the euro area to a larger extent than in the past.

[42] The share of stocks reported in Table 4 is underestimated, as it is based on their book value shown on balance sheets, not their market value. Because of the recent rise in the stock market, the gap between the book value of stocks and their market value may be large. In aggregate, the market value of the portfolio of the insurance sector amounted to F 4,858 billion in 1998, 13.8 percent higher than the acquisition value reported in Table 4.

Table 4. Portfolio Structure of French Insurance Sector					
	1990	1995	1996	1997	1998
Total investment					
Euro billion	187.7	404.5	484.9	572.3	650.5
(percent of GDP)	(18.9)	(34.6)	(40.4)	(46.1)	(49.8)
Of which:					
Bonds	54.4	66.2	68.8	68.6	68.8
Stocks 1/	21.3	15.7	14.8	16.0	18.6
Real estate	12.2	8.1	6.9	5.7	5.2
Loans	1.7	1.8	2.0	1.8	1.5
Commercial paper	8.4	6.9	6.7	7.2	5.4
Miscellaneous	2.0	1.3	0.8	0.7	0.5

Source: Fédération Française des Sociétés d'Assurances, 1999, *L'Assurance française en 1998*, p.92.
1/ Stock values are reported at their acquisition value shown on balance sheet.

61. The development of the life insurance market has been associated with an increasing **involvement of banks**. Banks took advantage of the extension of their operations permitted by the 1984 banking law to distribute life insurance products, for which they became a major network of distribution. Almost all large retail banks have life insurance subsidiaries, and many banks entered agreements of distribution with insurance companies, sometimes based on joint ventures (see Table 5). As a result, the share of banks, *La Poste* and the *Trésor* in the distribution of life insurance grew from 40 percent at the beginning of the decade to around 60 percent in the recent period—a very high level by international standards. The involvement of insurance companies in the banking sector is more subdued, although some large institutions own small banking subsidiaries, and exert some influence on developments in the banking industry through their shareholdings in banks.[43]

[43] Thus it has been argued that AXA's shareholdings in BNP and Paribas (of about 7 percent and 8 percent, respectively) gave it a pivotal role in the recent "battle of the banks."

Table 5. Involvement of Banks in the Life Insurance Sector		
Parent Bank	Life Insurance Subsidiary	Share of Life Insurance Market (In percent, 1998)
Crédit Agricole	Prédica	9.1
Crédit Mutuel	ACM-Vie	4.4
Banque Nationale de Paris	Natio-Vie	4.2
Société-Générale	Sogecap	4.0
Crédit Lyonnais	Assurances Fédérales-Vie	3.3

Sources: Staff calculations based on FFSA (1999); and companies annual reports.

V. Money and Capital Markets

62. Besides liberalizing the banking sector, policy making aimed explicitly at deepening financial markets. This effort has been relatively more successful in the money and government bond markets—two segments of financial markets that are bound to evolve quickly with the advent of EMU. As documented in Section III, corporate bond and stock markets, which are less directly influenced by policy, have lagged behind. From this angle, this section explores in detail the current state of money and capital markets.

A. Money Markets

63. Money markets serve three main purposes: (i) they are the main vehicle for the maturity transformation by financial intermediaries; (ii) they are used for government and corporate liquidity management; and (iii) they are the primary arena for the conduct of monetary policy. By its nature, money market activity is short term (generally less than six months), involves large volumes, and it is channeled through the payment system.

64. French money markets are well developed and—unlike in other euro-area countries—have been an explicit target of policy. However, the **advent of the Stage III of EMU** has significantly reoriented money market activity toward the euro area, and will force national governments to cast their market policies in the context of the euro-wide money market. Three main recent developments deserve to be highlighted:

- National interbank rates were replaced by the Euro Interbank Offered Rate (Euribor), providing a **single reference rate for interbank activity** across the euro area;

- All outstanding securities were **redenominated in euros**, and banks began to publish key market data in euro. With the euro having the legal status of national currency both exchange risk and transaction costs disappear, facilitating the conduct of open market operations at the euro area level;

- A single set of **central bank reference rates**, replacing previously existing national central bank rates, created a central focus point for money market operations. Of particular importance is EONIA (European overnight index average), the rate on the European Central Bank's main refinancing operations.[44]

65. Table 6 provides a breakdown of French money market by instrument. The first three items, required reserves, repo transactions, and interbank liabilities, have been the most

[44] EONIA is the weighted average of the rates on unsecured overnight contracts reported by a panel of major banks in the euro area.

affected by EMU, and are discussed in turn below. Money market funds are added as a memorandum item in light of their significance as a substitute for bank deposits. This appears to have affected the cost of funds for banks.[45]

Table 6. Total Stock of Core Money Market Instruments 1/
(May 1999, in billions of euro)

Required reserves	22
Repos	329
Interbank liabilities	758
Secured money market instruments	
Negotiable medium term notes(NTM)	63
Certificates of deposit (CD)	111
Commercial paper (CP)	41
Total	1,324
Memorandum item:	
Money market funds	200

Source: Banque de France.
1/Excludes derivatives and foreign currency instruments.

Required reserves

66. As part of the new monetary instruments of the European System of Central Banks (ESCB), a uniform **reserve requirement** across the euro area was introduced in October 1998. A rate of 2 percent applies to interbank and money market activities, deposits, and borrowed funds of maturities up to two years. The group of institutions subject to the reserve requirement has been broadened with respect to the previous French scheme. Furthermore, the modalities of operation of the uniform reserve requirement were designed to encourage its use for liquidity management purposes: reserves are remunerated at market

[45] Money market funds which are remunerated at close to market rates tend to be less profitable for banks than bank deposits which carry low remuneration. A recent study (Pfister and Grunspan, 1999) shows that, in 1984, French banks remunerated 39 percent of their liabilities at market rates while, in 1997, 45 percent of liabilities were remunerated at market rates. This suggests that cost of funds increased with expanding market-based financial activity.

rates and averaging is permitted. Since virtually all euro-area monetary and financial institutions are subject to the same system of reserve requirements, this new instrument has become a flexible tool for money market transactions across the euro area. As a result, the new reserve requirement led to an increase of required reserves in France from about EUR 3 billion—of which EUR 2.25 billion were held in the form of securities—to about EUR 22 billion fully paid in (see Table 6).[46]

Repo auctions and collateral

67. A **repo transaction** is equivalent to a very short-term loan secured by collateral. Since repo auctions are the primary instrument of the European Central Bank (ECB) for open market operations, the advent of EMU has significantly affected this segment of the market. An immediate effect has been a diversification of banks' collateral portfolios, which has affected the demand for various types of eligible assets and may create a core of widely accepted collateral across the euro area.

68. ECB's bylaws specify that the collateral must satisfy certain minimum conditions of quality, and give national central banks an important role in assessing these conditions. In this regard, an important role is played by the *Banque de France*'s own **credit risk data base**, which includes information on a large number of enterprises that are not listed on the stock exchange and that do not necessarily publish sufficient information. This instrument could play a crucial role in the future development of capital markets, as private credit risk data bases develop and promote further the acceptance of assets from nonlisted firms as eligible instruments.

Interbank activity and the European payment system (TARGET)

69. Interbank activity—the unsecured, over-the-counter market among credit institutions—is the largest segment of money markets. The stock of interbank lending and borrowing typically represents as much as 30 percent of total banks' assets in major industrial countries, and this figure is often much higher for very large banks. It is a very active market: about 70 percent of the entire stock of outstanding interbank liabilities turns over each month.

70. Interbank transactions take place through the payment system. The Trans European Automated Real-time Gross Settlement Express Transfer (TARGET) system, in operation since the beginning of 1999, was designed to facilitate cross-border flows and to reduce settlement risk within the euro area. Before the introduction of TARGET, cross-border payments were complicated by the existence of multiple payment systems within each country.

71. TARGET works through "points of entry" and consists of the national real-time settlement systems of the 15 member states of the European Union and the payment system

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[46] The pool of reserves of the euro area is about EUR 100 billion.

of the ECB. In France, the point of entry is the TBF (*Transferts* Banque de France). Preliminary evaluations of the functioning of TARGET point to the success of the system in integrating money markets across the euro area.[47]

72. TARGET has rapidly become a very important system for domestic and cross-border payments.[48] Table 7 shows that, in France, about 70 percent of total payments are transacted through TARGET, while the rest are transacted through national systems; about 15 percent of total payments are cross border. By comparison, less than 50 percent of payments in Germany are transacted through TARGET, and 25 percent of total payments are cross border.[49] In both countries, the average value of cross-border payments are significantly higher than the euro-area average. This appears to reflect the nature of cross border transactions, primarily among major financial institutions.

Table 7. France and Germany: The Acceptance of TARGET
(May 1999)

	Billions Euros Per Day	In Percent of Total	Average Value Million Euros
France	358	100	9.8
TARGET, cross border	52	15	16.6
TARGET, domestic	190	60	39.9
Other payment systems	127	35	7.6
Germany	343	100	2.8
TARGET, cross border	87	25	9.2
TARGET, domestic	77	22	1.4
Other payment systems	180	53	6.4

Sources: *Banque de France*; and ECB website (www.ecb.de) .

73. The intensification of cross-border payments has led to a **tiering of the market**: while large banks expand their number of counterparts within the euro area, small banks remain with their existing pool of (mainly domestic) correspondents, thus participating only

[47] See Beau, Denis and Jean-François Ducher "An Assessment of Target's First Months of Operations," Banque de France, Bulletin No. 66 (June 1999).

[48] In the first four months of 1999, daily averages of cross-border transfers in the euro area represented about 30 percent of all payment orders.

[49] Total payment volumes per day are of roughly similar size with EUR 358 billion and EUR 343 billion for France and Germany, respectively.

indirectly in the euro-area money market.[50] Tiering of interbank markets is a source of concern if it is due to perceived solvency or liquidity weaknesses. In the context of EMU, however, tiering seems to be the result of scale economies realized by major players. Future developments in money markets as well as banking sector consolidation will shed further light on its implications for smaller banks.

Secured money market instruments

74. Nonbank institutions can also enter the money market and use it for liquidity management purposes. This broadens money market activity, but it also effectively creates competition for bank loans, as corporate paper can become a substitute for bank borrowing, thus squeezing banks' profits. As a result, the relatively well developed money market in France could be a contributing factor to the relatively low profitability of French banks discussed in Section IV.

75. French money market instruments comprise three broad types of securities: Certificates of Deposit (CDs) which are issued by credit institutions and by the *Caisse des Dépôts et Consignations*; Commercial Paper (CP), issued by corporations; and Negotiable Medium-Term Notes (NTMs), issued by both financial and nonfinancial institutions. The legal framework of these money market instruments was reformed in January 1999. The intention was to make their use more flexible while at the same time ensuring high levels of protection and transparency for investors. Measures include the opening of the market to all issuers, intermediaries and investors in the euro area. Nonresident banking institutions are now permitted to issue certificates of deposit in euros and use flexible rates.

B. Capital Market

76. Capital markets are vehicles for investment and therefore differ from money markets, which have primarily a liquidity management function. This section discusses recent policy issues and developments of capital market activity. As French bond markets have already been discussed in some depth (see Section II), this section only briefly characterizes the main government debt instruments and points out some recent efforts to further develop the corporate bond market. On equity markets, the prospects of European integration of stock exchanges are discussed, and the new market segment, the *Nouveau Marché*, is presented. Table 8 provides an overview of French capital markets, where mutual funds are presented as a memorandum item.[51]

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[50] For example, one major French bank has increased the number of counterparts from 10 to 100.

[51] In France, there are about 6,270 mutual funds (*Organismes de Placement Collectif en Valeurs Mobilières*, OPCVM). These include about 1,200 incorporated *Sociétés d'Investissement a Capital Variable* (SICAV) and about 5,000 *Fonds Communs de Placement* (FCP). As of year-end 1998, total assets were about EUR 270 billion for SICAVs, and EUR 260 billion for FCPs.

Table 8. French Capital Market

(May 1999)

	Billions Euros	Percentage
Bonds	**745**	**47**
Government bonds 1/	434	28
Bank bonds	216	14
Corporate bonds	32	2
Stocks	**825**	**53**
Bank stocks	78	5
Insurance	59	4
Others	688	44
Total capital markets (without derivatives)	**1,507**	**100**
Memorandum items: 2/		
SICAVs	270	18
Fonds Communs de Plascement (FCP)	262	17
Stocks and bonds held by banks and insurance companies	587	40

Source: *Banque de France.*
1/ January 1999.
2/ About EUR 200 billion are invested in money market funds rather than in stocks and bonds.

Current structure of the French government bond market

77. As of January 1999, total outstanding government debt was structured as follows: about 60 percent were long-term securities (*Obligations Assimilable du Trésor*, OATs), about 24 percent were medium term (*Bon du Trésor a taux fixe et Interest Annuel*, BTAN) and about 8 percent were short term (*Bon du Trésor a taux fixe et Interest Precomptes*, BTF), while the remaining 8 percent were nonnegotiable instruments. An inflation-indexed bond, (*Obligation Indexee sur l'inflation,* OATi) was introduced in 1998. Most OATs (90 percent) carry a fixed interest rate, the rest are variable rate bonds.[52] The average maturity of all

[52] About 70 percent of OATs can be "stripped" but, at present, only about 10 percent of outstanding OATs are. Stripping is a technique, first introduced in 1985 by the U.S. Treasury, that permits separate trading of registered interest and principal of securities (abbreviated as "STRIP"). The effect of stripping is similar to creating zero-coupon bonds which can have tax advantages (e.g., by accelerating or deferring revenue) or may be used for liquidity management purposes.

outstanding bonds is about 6.5 years, which is considered by the French Treasury as appropriate.

78. Debt management policy is characterizes by a high degree of **transparency.** The French Treasury announces each year a detailed financing program, including amounts, breakdown by type of bonds, and precise auction schedules and rules. For example, the following information was made publicly available for 1999: (i) the government planned to issue new OATs amounting to about EUR 45 billion, two- and five-year BTAN's amounting to EUR 35 billion, and shorter term papers amounting to about EUR 7 billion; (ii) about 40 percent of the total would be used to cover the current budget deficit and the remainder to pay off maturing debt; (iii) the auction schedule was: OATs were to be issued on the first Thursday of each week at 11 a.m., BTANs every third Thursday, and BTFs every Monday; and (iv) most offers would in the form of tender auctions whose rules were published.[53]

Corporate bond markets and the introduction of mortgage-based securities

79. The French corporate bond market is not well developed. Table 8 shows that corporate bonds outstanding represent about 12 percent of outstanding bonds. By comparison, corporate bonds represent 37 percent in the United States.[54] The authorities expect this market to expand significantly in the next few years, as the number of ratings increases and the single currency expands the market. In fact, some major bond issues were recently launched across the euro area, a phenomenon which has been interpreted as the beginning of a longer term trend toward more activity in this market. Another major development in this area has been the recent introduction of the legal framework allowing for the issuance of mortgage-based securities. It is expected that first issues will be floated in 1999.[55]

The French stock exchange and the effects of EMU

80. The French stock exchange has three segments, the "*Premier Marché*", the "*Second Marché*", and the "*Nouveau Marché*", each catering to a somewhat different group of investors and companies.[56] In early 1999, the first two segments had 345 and 368 listings respectively, and the *Nouveau Marché*, which was created in 1996, had about 100 listings. In

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[53] See, for example, www.oat.finances.gouv.fr.

[54] Lehman Brothers Euromarket Update, June 1999.

[55] Some market participants have observed that the French legal definition of mortgage-based securities carries less stringent conditions than the German counterparts. However, this could turn out to be a strength, as French mortgage bonds add diversity to the mortgage-based market.

[56] This section draws on *Commission des Operations de Bourse* (COB), *Rapport Annuel 1998*; and on *Banque de France, Bulletin* (various issues).

terms of capitalization, the *Premier Marché* has the lion share (94 percent); the second market, whose function appears to be increasingly less defined, has shrunk from about 6 percent of total stock market capitalization in 1996 to less than 5 percent in 1999.

81. The ***Nouveau Marché*** is designed to provide access to capital markets for small, innovative firms. It has enjoyed recently very high growth rates, but remains nevertheless a marginal segment, accounting for less than one percent of stock market capitalization at the end of 1998. The *Nouveau Marché* was created as part of the Euro.NM network, a European economic interest group, comprising Amsterdam, Brussels, Frankfurt, and Paris, which enables simultaneous listings in markets whose conditions of admission and rules have been harmonized (see OECD, 1999). A recent study suggests that the *Nouveaux Marché* has been less successful than similar markets in other euro-area countries, in particular the Frankfurt-based Neuer Markt. The latter seems somewhat more selective, limiting access to larger firms. It also has tighter rules and more stringent enforcement with regard to disclosure as it excludes noncompliant firms immediately from trading screens.

82. The advent of Stage III of EMU has intensified the potential for **integration of stock markets in the euro area**. Since January 4, 1999, all stock exchange systems (orders, delivery, etc.) are denominated in euro. Similarly, the futures and options markets (MONEP and MATIF) have switched to euro interest rates and euro indexes as the underlying assets for contracts.[57] MATIF has adapted its derivative products so as to reflect the unified yield curve. Contracts based on the Paris Interbank Offer Rate (PIBOR) were replaced by EURIBOR contracts.

83. While these are important changes favoring closer cooperation among stock exchanges in the euro area, **significant obstacles remain**. In particular, attempts to unify listings across the euro area by establishing a "single bourse" have not been successful. While there are plans to create a web of connections among eight major stock exchanges through one electronic interface, it is doubtful that these technical improvements will suffice to create the single trading system needed to realize significant scale economies. In addition to technical issues, it appears that differing accounting and disclosure rules, tax treatments of capital gains, and a host of other factors difficult the unification of stock exchanges across the euro area[58].

[57] There are several indices of European stocks such as Dow-Jones Stoxx and DJ Euro Stoxx, which cover large numbers of European stocks and are comparable to the Standard and Poors 500 index in the United States. DJ Stoxx 30 and DJ Euro Stoxx 50 are "blue chip" indicators, including only major publicly listed corporations.

[58] EU Commission, 1998.

VI. Recent Developments in Financial Sector Oversight

84. The French authorities have accompanied the transition of the financial sector toward a more market-based structure with a parallel evolution in its system of oversight. This is an ongoing process, as changes in the environment of the French financial industry—in particular the stimulus to international integration that will be provided by the introduction of the euro—will raise new challenges. This chapter reviews some issues related to the French system of financial sector oversight. It focuses first on recent developments in its institutional structure; and, second, on the challenges that may be raised, in the longer term, by the increasing integration of the financial system—both internationally and across sectors of financial activities. It concludes with a discussion of important specific issues raised by disclosure standards and practices.

A. Institutional Structure of Financial Sector Oversight

85. The French system of financial oversight underwent a significant transformation in 1996, with the adoption of the Financial Activity Modernization Act (*Loi de modernisation des activités financières*). It has evolved again this year, with the Saving and Financial Security Act (*Loi relative a l'épargne et à la sécurite financière*), which introduces important changes in the French system of financial safety nets. We review in this section the supervisory and safety nets arrangements in the banking sector, the insurance sector and financial markets.

86. The architecture of the financial oversight system involves a number of institutions. It is organized around three pillars: one for the banking sector, with the *Banque de France* and the *Commission Bancaire* as the chief institutions, one for the insurance sector, dominated by the Ministry of Finance and the *Commission de Contrôle des Assurances*, and one for financial markets, with the *Commission des Opérations de Bourse* as the main agency.[59]

Banking sector

87. The oversight of the banking sector involves three agencies, the *Commission Bancaire*, the *Comité de Réglementation Bancaire et Financière* and the *Comité des Etablissements de Crédit et des Entreprises d'Investissement*, all three closely connected to the Banque de France. Their field of jurisdiction, as defined by the Financial Activity Modernization Act of 1996, includes all credit institutions and investment firms other than portfolio management companies.[60] This excludes, however, one important institution, the

[59] A more detailed presentation of the different agencies involved in financial oversight can be found in Appendix I.

[60] The French authorities supervise the branches of foreign institutions having their head office outside the EU. The branches of foreign institutions headquartered in the EU operate in France under the "European passport"; they are supervised by foreign authorities.

Caisse des Dépôts et Consignations, which is supervised, as a group, by the State Audit Office—an institution whose main function and area of expertise are in monitoring the regularity and efficiency of public expenditures.[61] The *Caisse des Dépôts*, however, voluntary complies with the oversight of *Commission Bancaire*, and its banking, insurance or investment subsidiaries are supervised by the agencies in charge of their respective sectors.

88. The agency in charge of supervising the banking sector is the *Commission Bancaire*. It examines the operations of credit institutions and investment service providers, and monitors the soundness of their financial situation through call forms filed by institutions and through on-site supervision. The "legislative power" in the supervisory system lies in the *Comité de Réglementation Bancaire et Financière* (CRBF). The CRBF has very broad statutory powers to lay down general regulations applicable to credit institutions and investment firms. It is entitled to define capital requirements, accounting rules, prudential ratios, and reserve requirements. The *Comité des Etablissements de Crédit et des Entreprises d'Investissement* (CECEI) is the body responsible for granting individual licenses and authorizations to credit institutions and investment firms. It grants authorizations for new institutions and for major changes in the circumstances of an authorized institution—such as changes in the legal form, in ownership or in the type of activity—an attribution that has been an important source of leverage for the authorities in the recent battle between *Société Générale* and *Banque Nationale de Paris*.

89. The *Banque de France* is a pivotal institution in the general governance and day-to-day operations of the agencies involved in banking regulation and supervision. Its governor chairs the *Commission Bancaire* and the CECEI, and also has a seat at the CRBF. These agencies also depend heavily on the central bank for staffing and logistical support. The CRBF and the CECEI rely on the departments of the central bank for the preparation and implementation of their decisions. The *Commission Bancaire* has its own staff, but it is mainly composed of personnel seconded from the *Banque de France*.[62]

90. The French banking supervisory system has achieved a high level of international recognition, as shown by the fact that the *Commission Bancaire* is very involved in setting international standards at the Bank of International Settlements and the Basle Committee. In carrying out banking supervision, increased emphasis has been placed on enhancing the banks' own internal risk models, preventive action, and market discipline. In October 1997, a

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[61] The financial activities of *La Poste* are also outside the jurisdiction of the *Commission Bancaire* and its sister agencies.

[62] Some additional recruitment is made to implement some specialized tasks. In order to ensure that those working for the supervisory body have a good understanding of market practices and to stimulate an exchange of views between supervisors and the supervised, an exchange arrangement has been in operation for some years, allowing temporary job swaps between the main banks and the *Secrétariat Général of the Commission Bancaire*.

new regulation permitting the supervision of banks' own internal risk analysis went into effect. This gives the *Commission Bancaire* expanded powers in assessing the banks' own ability to control risk and in taking action when internal controls are considered to be deficient. Preventive action is fostered particularly by three new instruments developed by the *Commission Bancaire* in cooperation with the Banque de France (see Box 7).

Box 7. The *Commission Bancaire*'s New Tools

The *Commission Bancaire* has developed three new analytical tools allowing the on-site or off-site analysis of "homogeneous groups." **ORAP** is a tool for analyzing individual banks and to generate a profile of a single bank within its economic environment. The databases of the Banque de France and the *Commission Bancaire*, complemented by market data, are used in this exercise. It has some similarities with the U.S. CAMEL system but incorporates qualitative analysis by supervisors. **SAABA** is an expert system to produce risk profiles of banks and analyses of potential weaknesses. For instance, its loan portfolio analysis draws on the Banque de France central risk database which provides detailed information on loan amounts, beneficiary, granting institutions, etc. Other databases provide information on important legal and other events, and creditworthiness scores for sectors and individual borrowers, allowing a detailed analysis of asset quality. For on-site inspections, a third system, **SIGAL** has been designed to support bank supervisors in the field, to generate time series and cross-bank and sectoral analysis of bank credits.

Insurance sector

91. The oversight of the insurance sector is exercised by the *Trésor* at the Ministry of Finance and the *Commission de Contrôle des Assurances*. Their jurisdiction covers all insurance companies, except for a small mutualist sector involved mainly in health insurance.[63] The rules concerning the supervision of branches of foreign companies are similar to those for the banking sector. Since the completion of the single insurance market in 1994, insurance companies licensed in a given EU member state can sell contracts in other EU countries, and the prudential supervision of their business comes under the sole competence of the head office country. Branches of foreign companies having their head office outside the European Economic Area are supervised by the French authorities.

[63] These are mutual societies governed by the mutual insurance code and welfare benefit societies, supervised by the *Commission du contrôle des mutuelles et des institutions de prévoyance*.

92. The *Trésor* drafts the regulation concerning the insurance sector, embodied in the Insurance Code. It is also responsible for granting licenses, and authorizing transfers of portfolio contracts among insurance companies or changes in their ownership structure. Regulation must comply with EU-wide prudential norms on the minimum level of technical provisions and capital, and on the list of permitted assets and ceilings for the share of each type of assets in the portfolio. The French rules are stricter, in the latter respect, than required by European directives. The *Commission de Contrôle des Assurances* is in charge of supervising the insurance sector. It assesses the compliance of insurance companies with the Insurance Code and can impose sanctions against companies that have infringed regulation or put their solvency at risk. The *Commission* is an independent administrative authority which depends for its staff on the Ministry of Finance.

Money and capital markets

93. General oversight of financial markets is shared by the *Commission des Opérations de Bourse* (COB), the *Conseil des Marchés Financiers* (CMF) and the *Banque de France*. The COB and the CMF have broad competencies to regulate, authorize and supervise the financial market activities of the institutions whose operations come within their respective scopes of intervention. The COB is in charge of the prudential regulation and supervision of portfolio management companies. The CMF supervises investment service providers other than portfolio management companies. The *Banque de France* retains a residual supervisory role in the negotiable debt instrument markets and monitors the unregulated money market.

94. Founded in 1967 and patterned after the Securities and Exchange Commission in the United States, the COB is the market watchdog, with the status of an independent administrative authority. It has broad powers to protect private savings, inform investors, and ensure orderly market operation. The COB's key functions are: verifying information published by companies; authorizing the creation of unit trusts and mutual funds; licensing credit institutions and investment service providers to act as portfolio management companies; and supervising compliance with French law, which imposes penalties on insider trading and market manipulation. The COB enjoys financial autonomy; its budget is financed by contributions of market participants whose activities come within its jurisdiction.

95. The *Conseil des Marchés Financiers*, established by the 1996 Financial Activity Modernization Act,[64] is responsible for regulating and monitoring investment services other than third-party asset management, as provided by credit institutions or investment companies. Its main assignments include the supervision of regulated markets; the acceptance of business plans and licensing of intermediaries offering investment services

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[64] The CMF replaced the *Conseil des Bourses de Valeurs* and the *Conseil des Marchés à Terme*, the agencies formerly in charge of stock exchange markets and futures markets, respectively.

(excluding portfolio management companies); and the acceptance and administration of public offerings and takeover bids.

Financial safety nets

96. The framework of financial safety nets is determined by two provisions of the 1984 Banking Law, one on deposit insurance and the other on the provision of emergency financial assistance to banks in distress. All banks must join a deposit guarantee scheme aimed at compensating depositors if their deposits become unavailable. There are nine deposit guarantee schemes of varying scope, the largest being the scheme for commercial banks, managed by their professional association, the *Association Française des Banques* (AFB). Mutual and cooperative banks are self-insured by group-wide deposit guarantee schemes managed by their central bodies—each *caisse* of the *Crédit Agricole*, for example, is insured by the *Caisse Nationale de Crédit Agricole* scheme. Although the rules differ across arrangements, most of these schemes (including the AFB's) are not pre-funded; upon the failure of a bank, deposit insurance is arranged *ex post* by contributions from the members of the scheme.

97. The provision of emergency financial assistance to banks in distress relies on discretionary packages arranged under the auspices of the *Banque de France*. Under Article 52, first paragraph, of the Banking Act, the Governor of the *Banque de France*, if he deems it appropriate, may in his capacity as Chairman of the *Commission Bancaire* call upon the shareholders to provide the distressed bank with the needed support. Credit institutions are required to have a "reference shareholder" to which the *Commission Bancaire* can turn before all other shareholders in the event of a liquidity or solvency crisis.[65] The commitment of the reference shareholder is not legally binding, however, and the Governor's "power of invitation" is not backed by any explicit sanction on the shareholders who fail to comply.

98. This system, with its emphasis on constructive ambiguity and shareholder responsibility, was well designed to limit moral hazard, but it also had deficiencies. The segmentation of the deposit insurance system restricted somewhat artificially the scope of insurance, especially in the mutual and cooperative sector. The ability of the *Commission Bancaire* to organize the emergency rescue of banks with their shareholders turned out to be limited in some cases—as the failure of *Banque Pallas Stern* showed in 1995.[66] Bank rescue

[65] The term "reference shareholder" has never been explicitly defined by the supervisory authorities—although a 20 percent shareholding is often cited as the level which triggers reference status. When a bank has no shareholder or group of shareholders with the required financial resources or experience in banking, the shareholders are asked to find a new shareholding "godfather" partner, preferably a bank.

[66] *Banque Pallas Stern* (F 14.4 billion of balance sheet) ran into trouble in 1995 as a consequence of huge commitments to the troubled French commercial real estate sector. The *Banque de France* is said to have had difficulties putting pressure on non-bank shareholders

(continued...)

efforts, as a consequence, resulted too often in pressures on the *Caisse des Dépôts et Consignations* to act as the "shareholder of last resort." Finally, the absence of an explicit guarantee scheme for insurance contract holders came to be viewed as a problem in 1997 when, following the failure of a small life insurance company, *Europavie*, the profession had to arrange compensation for contract holders on an *ad hoc* basis.

99. The 1999 Saving and Financial Security Act (*Loi relative a l'épargne et à la sécurité financière*) introduces a major reform in the French system of financial safety nets, by instituting three pre-funded guarantee schemes for bank deposits, investment firms, and insurance companies respectively. The insurance deposit fund will be financed by credit institutions according to rules to be specified by the CRBF, and will cover a much broader range of institutions than previous arrangements, including commercial, mutual and cooperative banks. In order to limit moral hazard the fund is managed by representatives of credit institutions, but intervenes upon request by the *Commission Bancaire*. It is also empowered to deal with banking problems in a preventive fashion, by lending to or taking a stake in banks in distress—a measure which is likely to replace, for all practical purposes, the provision of Article 52 of the 1984 Banking Law allowing the *Commission Bancaire* to bail in existing shareholders.

The supervision of an integrated financial system

100. As in other developed economies, the French supervisory authorities are faced with the challenge of keeping up with the rapid pace of financial liberalization, innovation—which undermines to some extent the significance of the traditional barriers between financial activities—and international integration. These developments are likely to be enhanced by the introduction of the euro. They may require changes not only in the methods of supervision but also in its institutional structure. This section reviews recent developments in the coordination between the supervisory agencies in France, and discusses, in a longer run perspective, the trade-offs involved in the choice of an integrated supervisory model of the type recently adopted in the United Kingdom.

Coordination between supervisory agencies

101. Some cohesion between the different agencies involved in financial oversight is provided, in the banking sector, by the ubiquitous involvement of the Banque de France, and to a lesser extent, in the financial sector at large, by the existence of the *Comité de Liaison des Autorités Monétaires et Financières* (CLAMEF). This committee bring together representatives of the Ministry of Finance, the *Banque de France*, the *Commission des Opérations de Bourse* and the *Conseil des Marchés Financiers* for exchange of views and

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to provide the necessary support, most notably Elf Aquitaine—which held 11 percent of the shares. *Banque Pallas Stern* was put into compulsory liquidation in 1997 after a variety of rescue packages were turned down.

information several times a year. It has no regulatory or supervisory powers and no independent permanent staff to rely on. The exchange of information on conglomerates involved in different sectors of financial activity, thus, is largely left at the discretion and initiative of supervisors—the different supervisory authorities have a right to communicate, but no right of access to each other proprietary information.

102. The 1999 Saving and Financial Security Act aims at strengthening the cooperation among supervisors by creating a collegium of supervisory authorities (*Collège des Autorités de Contrôle du Secteur Financier*) comprising the chairmen of the *Commission Bancaire*, the *Commission de Contrôle des Assurances*, the *Commission des Opérations de Bourse* and the *Conseil des Marchés Financiers*. This new committee, which replaces the CLAMEF, must meet at least three times a year. Its mission is to enhance exchanges of information between supervisors of financial conglomerates involved in banking, insurance and investment activities, and deal with all questions related to the coordination of the supervision of such conglomerates. Like the CLAMEF, however, the new committee is not endowed with the staff and the logistic support that would allow it to take on supervisory responsibilities. The new law also extends the scope for cooperation between the *Commission Bancaire*, the *Commission de Contrôle des Assurances*, and their counterparts outside the European Economic Area.

An integrated supervisory authority?

103. The supervisory architecture in the euro area is built on the idea that the supervisory function should be maintained at the national level, in conformity with the subsidiarity principle. The main arguments in favor of a decentralized structure have been laid out in the last annual report of the *Commission Bancaire*: national features remain largely prevalent in banking, especially in retail activities, and keeping supervisors geographically close to the institutions they supervise is key for effective surveillance. It has been argued, on the other hand, that increasing international financial integration and the benefits of keeping supervision close to the center of monetary policy will make the need to integrate supervision at the euro area level increasingly apparent.[67]

104. A decentralized supervisory architecture at the euro-area level, if maintained, implies that the question of the optimal institutional structure will have to be addressed at the national level. Some countries outside the euro area, most notably the United Kingdom, have moved toward an integrated model of supervision, in which the different components of the financial sector—banks, insurance companies, and financial markets—are supervised by a single agency (see Box 8). These reforms were implemented as a response to popular perception of weaknesses in supervision after a number of financial scandals, but they were also justified by general arguments—such as the waning significance of the traditional division between financial activities—which are more universal in nature (Bartolini, 1999).

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[67] See Prati and Schinasi, (1999) and Padoa-Schioppa, (1999).

Box 8. The Integrated Model of Supervision

In response to financial turbulence, several countries (including the U.K., Japan, Korea, and Australia) have recently considered or instituted integrated supervisory agencies covering the different sectors of financial activity. The most notable example is the creation of the Financial Services Authority (FSA) in the U.K., in October 1997. It was instituted in response to a series of incidents in financial markets that had wounded the credibility of the previous regime, most notably accusations to the Bank of England of slowness in spotting the frauds which led to the July 1991 closing of the Bank of Credit and Commerce International (BCCI), and the collapse of the Maxwell empire in 1992. Against this background, foremost in the government regulatory agenda was the desire to implement a framework that would be more transparent and lead to a clear attribution of responsibilities, accountability of decision-making, and simplicity and homogeneity of regulation. These objectives were sought by granting to a single body the supervisory functions hitherto dispersed among nine authorities.

The FSA combines the main functions of oversight: it regulates, grants licenses and authorizations, implements supervision, and deals with violations of the rules, including possible imposition of fines and revocation of licenses. The FSA oversight encompasses a wide variety of financial firms: banks, investment houses, and 16,000 firms whose main activity is not business investment but have some minor involvement therein (accountants, actuaries), as well as insurance companies, financial markets, and wholesale markets in over-the-counter derivatives.

105. The main argument for an integrated supervisory structure is that it makes it easier to have a complete picture of the risks involved at the level of an institution, when the latter is involved in several sectors. The increasing linkages between financial activities hitherto viewed as separate—a phenomenon observed in all developed countries following the deregulatory initiatives of the 1980s—is especially important in France, most notably between banking and insurance. Under current arrangements, French *bancassurance* groups have their activities supervised by either two agencies—the *Commission Bancaire* for their banking activity, the *Commission de Contrôle des Assurances* for their insurance activity—or five if the supervision of the *Commission des Opérations de Bourse*, the *Conseil des Marchés Financiers* and the *Banque de France* on their financial market activities is considered.

106. There are other arguments for an integrated supervisory structure. First, to the extent that banks and insurance companies are subject to similar risks, there might be economies of scope in developing a joint expertise for the analysis of these risks. Second, making the supervisory structure simpler and more transparent reduces transaction costs (e.g., the cost of identifying the relevant supervisor, or of dealing with several supervisors in case of supervisory overlap) which may be a valuable comparative advantage in the international competition between financial centers. Third, an integrated supervisory structure might enhance accountability, to the extent that the responsibility for the supervision of integrated groups is clear and undivided. Fourth, having one agent responsible for supervision in each country of the euro area might facilitate cooperation between national supervisors: the

European supervisory architecture, decentralized as it is, might be more stable if its national base is less fragmented. Finally, an integrated structure lowers the risk of regulatory capture.

107. It is far from clear, however, that these benefits are large enough to justify reforming a system that performs well—and has already undergone two reforms since 1996. Many argue that the expertise involved in the banking and insurance sectors remain too different to expect large economies of scope from joint supervision—noting, in particular, that the internal structure of the U.K. Financial Services Authority reproduces the traditional division between banking, insurance, and financial markets. In addition, excessive homogenization of supervisory practices across heterogeneous activities might turn out to decrease the overall quality of supervision. A single agency may not take into account the specificities of different industries, or reflect their concerns in international negotiations, as well as several specialized agencies would. Finally, a case for a decentralized structure rests on the argument that it diversifies risk, making supervision less vulnerable to a management failure in one single agency.

108. In any case, a consolidated assessment of the risks in financial conglomerates does not necessarily imply that their financial activities should all be supervised by the same entity. Rather, the implication is that the supervisory agencies should cooperate closely with each other, in particular by giving each other unrestricted access to their supervisory information. The consolidated supervision of financial conglomerates could be implemented comprehensively by one of the existing agencies provided that it receives all the information it needs from the other ones, or by mixed teams drawing on the resources and expertise of several agencies. The 1999 Saving and Financial Security Act makes a step in this direction by establishing, with the collegium of supervisory authorities, a new channel to secure continued dialogue between them. This may in time provide a background conducive to the development of closer and more institutionalized forms of cooperation. A lot will depend, in this respect, on whether the new possibilities of cooperation will be exploited to the optimal extent; this should be monitored carefully by the authorities.

109. In summary, the French system of supervision has evolved markedly in recent years; the gains from recent reforms have still to be fully reaped and the supervisory landscape certainly does not call for immediate and drastic reform. In a longer term perspective, the question of the optimal supervisory architecture in the euro area and at the national level deserves attention and serious economic analysis. The United Kingdom model of integrated financial supervision sets a benchmark against which other arrangements will be increasingly compared. The successes and difficulties met by the Financial Services Authority—as well as other supervisory arrangements—will have to be scrutinized carefully by the French authorities.

B. Market Disclosure[68]

110. The disclosure of timely and detailed financial information to the public by financial institutions is generally seen as a key component of effective market discipline and thus an important tool supporting prudential oversight. High quality accounting and disclosure standards are also a condition for further development of well-functioning capital markets, which still remain less deep in France than elsewhere. This section briefly presents the French institutional setting for accounting and disclosure, and reviews recent progress in French standards and practices for financial institutions in an international perspective.

111. Under French law, the National Accounting Board (*Conseil National de la Comptabilité*) is responsible for establishing accounting standards. In addition, the *Commission des Opérations de Bourse* (COB) sets forth requirements for French public companies, while the *Ordre des Experts Comptables* publishes accounting opinions. The National Association of Auditors (*Compagnie Nationale des Commissaires aux Comptes*) is responsible for issuing auditing standards and guidelines and—on occasion—opinions regarding accounting and disclosure matters.

112. French disclosure standards and practices are evolving under the pressure of global financial integration. This pressure was apparent following the 1998 turmoil in emerging markets, when the COB requested French banks to adopt the U.S. practice of disclosing their exposure to emerging markets on a country-by-country basis, in a move that was aimed at reassuring international investors. The large and increasing presence of foreign investors in French financial markets induce the authorities and financial institutions to make their standards and practices more comparable to those of the best foreign counterparts. Moreover, in France as in other countries, the trend toward the adoption of international disclosure standards may be as much market-driven as it is the result of changes in domestic standards and international conventions.

113. France is a member of the International Accounting Standards Committee (IAS). The Generally Accepted Accounting Principles (GAAP)—established by the Financial Accounting Standards Board in the United States—are generally viewed as more stringent and detailed, thus elevating them above IAS. A recent revision of accounting and disclosure standards permits French banks to choose between national and international standards as long as the latter conform to certain norms and are compatible with EU directives. This provision also permits internationally active French institutions some flexibility, which is important for foreign subsidiaries. A large French bank, *Banque Nationale de Paris*, has chosen to publish its accounts using a variant of the U.S. GAAP.

114. In December 1998, the *Commission Bancaire* together with the COB published a White Paper on financial transparency that compares disclosure practices by French banks

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[68] This section and Appendix II draws on work by Nancy Rawlings, TRE.

- The transition of capital markets to the Stage III of EMU has been completed, and cross-border activity has intensified. Key factors for this success have been the implementation of a uniform reserve requirement with features favoring its use for interbank transfers, and the smooth operation of the European payment system (TARGET). A by-product of this integration, however, may be the tiering of domestic banking sectors into "large" and "small" banks in terms of their access to interbank funds.

- Financial sector oversight has evolved in line with new challenges posed, and is substantially in compliance with the *Core Principles* put forth by the Basle Committee. Major steps in this direction have been: (i) the supervision of banks' internal control systems; (ii) the emphasis on prevention and macroprudential instruments; (iii) the setting up of a pre-funded deposit guarantee covering banks, insurance companies, and investment houses; and (iv) the intensification of cooperation among supervisors.

- The main challenge facing the current supervisory architecture is how to deal with increasingly larger, more complex, and more international institutions. In this regard, the issue of what makes a bank "too big to fail" in the European scene must be clarified. The debate on whether an integrated authority is needed remains to be resolved, as is the appropriate organization of supervision and lender of last resort at the European level.

- Two issues related to financial oversight remain open. First, the mechanism to deal with distressed banks (based on the *Banque de France*'s Governor "power of invitation" upon the reference shareholder), and the use of the *Caisse des Dépôts and Consignations* as "shareholder of last resort," has shown its limits. These limits may become more apparent as a reform of the *Caisse des Dépôts and Consignations* deprives it of privileged access to liquidity, and as increasingly larger banks engage in cross-border consolidation operations. The new deposit insurance scheme may address this issue. Second, recent hostile takeover attempts have shown the crucial role of the *Comité des etablissements de crédit et des enterprises d'investissement*—with the state represented by the Director of the Treasury as a permanent member and six other members nominated by the Ministry of Finance—in shaping the structure of the banking sector. Direct government involvement in this committee may interfere with the market mechanism, especially as the ongoing European banking consolidation moves to cross-border takeovers.

- In line with recent trends in supervisory best practices, the quality of market disclosure has received special attention. The *Commission Bancaire* and the *Commision des Opérations de Bourse* have issued a joint White Paper on Financial Transparency that provides recommendations for improved disclosure in the areas of earnings and losses and in counterpart risk. A case study presented in this paper confirms these points.

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Agencies Involved in Financial Sector Oversight

Banking Sector

Commission Bancaire (CB)

The *Commission Bancaire* has three essential tasks. It is responsible for verifying compliance by the banks with the laws and regulations that apply to them and for punishing any breaches thereof. It examines the terms on which these institutions conduct their business and makes sure that their financial situation remains satisfactory. It also ensures that the rules of good professional conduct are adhered to.

Six members serve on the *Commission Bancaire*: the Governor of the *Banque de France* or his representative as Chairman, the *Directeur du Trésor* or his representative, plus four other members appointed for a term of six years by the Minister of Finance. The commission meets every two to three weeks. It is assisted by a General Secretariat (*Secrétariat général de la Commission bancaire,* SGCB), to which it issues instructions on the supervision of institutions. The Secretariat drafts and implements the directives and decisions issued by the commission. Most of its staff are *Banque de France* employees seconded under the terms of a Joint Agreement. There are three levels at which supervision takes place: continuous supervision by "data analysis" ("off-site" control), supervision by inspection visits ("on-site" control), and general oversight of the banking system. The Secretariat employs approximately 500 people.

Comité de la Reglementation Bancaire et Financière (CRBF)

The *Comité de la Reglementation Bancaire et Financière* fixes the general regulations applicable to credit institutions and investment firms. In particular, the committee is responsible for determining the conditions under which credit institutions with headquarters in another EU Member State may set up a branch or provide services in France without prior authorization. Since January 1, 1994, this includes credit institutions from countries participating in the agreement on the European Economic Area.

The committee is chaired by the Minister of Finance or his representative and comprises the Governor of the *Banque de France*, who is also the Chairman of the *Commission Bancaire*, as well as five other members appointed for three-year terms. The committee operates under the authority of its Secretary General, using means provided by the *Banque de France*.

Comité des Etablissements de Crédit et des Entreprises d'Investissement (CECEI)

The *Comité des Etablissements de Crédit et des Entreprises d'Investissement* is the body responsible for the granting of individual licenses and authorizations to credit institutions and investment firms. It grants authorizations for new institutions and for major changes in the circumstances of an authorized institution (such as changes in the legal form, in ownership or in the type of activity). It withdraws the authorizations of institutions that no longer fulfill the conditions to which the authorization is subject. It is also the authority in charge of monitoring the European passport procedures for all investment firms except those providing asset management services.

The committee is chaired by the Governor of the *Banque de France*, who is also the Chairman of the *Commission Bancaire*, or his representative. It is made up of the Director of the French Treasury or his representative and the Chairmen of the authorities that approved the activity program submitted by the applicant, as well as six members or their alternates named by the Minister of Finance for three-year terms. The committee also gives a vote to a representative of the industry organization or central body that covers the applicant's line of business. The Credit Institutions Division of the *Banque de France* examines the applications submitted to the committee and provides secretarial services, under the authority of the Secretary General of the committee.

Conseil National du Crédit et du Titre **(CNC)**

The *Conseil National du Crédit et du Titre* examines the operating conditions of the banking and financial systems, particularly regarding relations with customers and management of means of payment, and expresses its views in these areas. It may also be asked to give its opinion on proposed legislation relating to its area of expertise and may be consulted in the preparation of the national economic development plan.

The council is chaired by the Minister of Finance and the Governor of the *Banque de France* serves as Vice-Chairman. There are fifty-one members who are appointed by the government. They represent the State, the National Assembly and the Senate, the French Economic and Social Council, regions, industries, trade unions, credit institutions, and investment firms. There are also six members who are appointed for their economic and financial expertise.

Insurance Sector

Commission de Contrôle des Assurances **(CCA)**

The *Commission de Contrôle des Assurances*' main mission is to supervise insurance companies. It checks the compliance of insurance companies with the regulatory provisions of the *Code des Assurances*, and can pronounce sanctions against companies deemed to have infringed a legislative provision or adopted a behavior endangering the fulfillment of its underwriting liability towards its policyholders.

The commission comprises five members appointed by the Minister of Finance: a senior member of the *Conseil d'Etat* (State Council), who chairs it; three members of *Cour de Cassation* (Supreme Appeals Court) and *Cour des Comptes* (State Audit Office), and two members chosen on account of their experience in insurance and financial matters. The commission is assisted by a Secretariat General employing a special body of insurance supervisors (commissaires contrôleurs) with the status of civil servants of the Ministry of Finance. The body of supervisors comprised, at the end of 1997, 48 sworn civil servants having undergone advanced training in statistics and probability calculations applied to insurance questions. Supervision is organized off-site on an annual basis, and on-site whenever the need arises.

Financial Markets

***Commission des Opérations de Bourse* (COB)**

The *Commission des Opérations de Bourse* is a public independent regulatory agency whose mission is to ensure the protection of investors, whether their investments be in securities or other financial products involving public offerings. The agents that come within its scope of intervention are chiefly issuers of financial instruments, unit trusts, mutual funds and real estate investment companies.

The commission is made up of a Chairman appointed by the government, and nine members, of which three are designated by the principal judicial institutions (*Conseil d'Etat, Cour de Cassation and Cour des Comptes*), one by the Governor of the *Banque de France*, one by the *Conseil des Marchés Financiers*, one by the *Conseil National de la Comptabilité*, and three are distinguished personalities designated on the grounds of their financial and legal expertise. The work of the commission is prepared by a number of departments under the authority of a Director-General. The COB enjoys financial autonomy: it receives contributions to its budget in the form of dues paid by agents whose market activities come within its scope of intervention.

***Conseil des Marchés Financiers* (CMF)**

The *Conseil des marchés financiers* approves the program of operations notified by an investment service provider, establishes the rules regarding the regulated markets and ensures that such rules are obeyed. To ensure shareholder equality and market transparency, the general regulations of the council set forth the rules governing public offerings involving financial instruments traded on a regulated market. Its 16 members are appointed for a four year-term. Fourteen of them are appointed by after consulting the representative trade associations and trade unions. The chairman is elected by the members from amongst their number.

Disclosure Case Study: Comparing a French and a U.S. Bank Disclosure for 1998

This appendix compares the 1998 annual report of a major French commercial bank and the 1998 Form 10-K filed by a major U.S. commercial bank with the U.S. Securities and Exchange Commission. The two banks are broadly of comparable asset size. As of December 31, 1998, the French bank reported assets of EUR 384 billion (about US$450) and the U.S. bank reported assets of approximately US$580 billion. While subject to different accounting and disclosure rules, the two banks potentially compete for the same type of clients and international investors in the global market .

The following analysis compares the extent and quality of disclosure of the two reports on selected aspects of credit and market risks. It looked at basic information on the banks' core business, asset quality (including loan write-offs and provisions), derivative activities, accounting methods, and market and credit risk management policies. In assessing disclosure quality, discrepancies between the two banks were also considered in light of International Accounting Standards (IAS).[1]

Both reports were issued on a timely basis (before April, 1999 for the year ending December 31, 1998) and were made publicly accessible (they can be downloaded from the internet in full text form). The French report, available in English, is clearly written and well structured. Both reports follow best international practice with respect to the presentation of quantitative information, and discuss the main factors determining performance with the appropriate level of detail. While the full U.S. report appears somewhat overwhelming (over 1,000 pages), the sections addressing financial matters are more manageable (130 pages). The French bank's annual report is approximately 100 pages long.

Table 9 summarizes the areas where the French bank provides less detail than could be expected given its size and international importance. On the disclosure of credit risk, the information regarding non-performing loans and related provisions was rather limited. While, for example, the policy for determining and accounting for nonperforming or nonaccrual loans was briefly discussed, quantitative information on these loans remained undisclosed. There was no discussion on the bank's policy regarding the recognition of interest income on nonaccrual loans and their impact on the bank's income. In addition, while the amount of provisions charged to income for losses was disclosed, the amount of provisions charged for write-offs and credited for recoveries was omitted. Provisions for identified risks were not broken down by activity. The U.S. bank's financial statement contained these disclosures.[2]

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[1] IAS 30, Disclosure in the Financial Statement of Banks and Similar Financial Institutions and the *IAS Disclosure Checklist 1998/99*, specifically *Section D,* were used as a framework.

[2] Comparability of loan losses may be difficult due to different bankruptcy laws and court systems. It appears that as in other eurozone countries, the legislation is biased against write-offs, forcing banks to carry nonperforming loans on their books for longer periods than is customary in the United States. Thus, to some extent, comparable disclosure may be difficult for European banks.

On market risks, both banks have relatively detailed discussions of their methods for measuring market risk activities. The French bank reported a summary of its foreign exposure in emerging markets on a country by country basis. This disclosure was made upon the *Commission des Operations de Bourse's* (COB) request in response to the turmoil in emerging markets, however, and the same information may not be reported in the future. The French bank's report contained a limited discussion of its market risk policies in derivative activities. It did not contain sufficient quantitative information to gain an understanding of the effect of these activities on the bank's financial condition. The U.S. bank discussed these issues in greater detail, explaining, in particular, the reasons why the organization conducts these activities and why these activities are risky. It is also unclear, in the French report, whether the amount disclosed with respect to certain derivatives is the notional or fair value. The U.S. bank's disclosures explicitly indicated the notional and fair value of these instruments. In addition, while the French bank reported the contractual repricing or maturity dates for its interest rate contracts, it did not report the related effective interest rate. The U.S. report includes both the date and the rate for these contracts.

Summary

The comparison shows a high quality of disclosure for both banks that were examined. The timeliness, readability and broad coverage of most areas are very good. The study confirms some of the findings of the *Commission Bancaire*' and COB's recently published "White Paper," namely that there are some weaknesses in disclosure on credit and market risks.

Table 9. Comparison of Selected Disclosures for a French and a U.S. Bank

SELECTED DISCLOSURE	U.S. BANK *	FRENCH BANK **
CREDIT RISK		
Nonperforming Loans		
Discussion on policies for Determining and accounting for Nonperforming, Impaired, or Nonaccrual Loans (IAS 30)	Yes	Limited
Discussion on policy regarding Recognizing interest income on non-accrual loans and the impact on income (IAS 30)	Yes	No
Aggregate Amount of Nonperforming or Nonaccrual Loans (IAS 30)	Yes	No
Categories of Nonperforming Impaired or Nonaccrual loans	Yes	No
Loans Past Due 90 days and Still Accruing Interest	Yes	No
Aggregate amount of Charge-offs	Yes	No
Categories of Charge-offs	Yes	No
Provisions		
Discussion of policies for Determining and accounting for provisions and charge-offs (IAS 30)	Yes	Limited
Discussion of policies for Determining and accounting for interest on non-accrual loans (IAS 30)	Yes	No
Aggregate amount of provisions used to determine carrying amount of nonaccrual loans (IAS 30)	Yes	No
Amount of provisions charged to income for losses (IAS 30)	Yes	Yes
Aggregate amount of provisions (IAS 30)	Yes	Unclear
by loan category	Yes	No
Amount of provisions charged for write-offs (IAS 30)	Yes	No
by loan category	Yes	No
Amount of provisions credited for recoveries (IAS 30)	Yes	No
by loan category	Yes	No
Other Disclosures		
Foreign Exposure by Region (i.e. assets)	Yes	Limited
Significant concentrations of Credit Risk (IAS 30)	Yes	No

SELECTED DISCLOSURE	U.S. BANK *	FRENCH BANK **
MARKET RISK		
Discussion of market risk policies and strategies and objectives for engaging in derivatives activities (IAS 32)	Yes	Very limited
Notional amount of off-balance sheet financial instruments (IAS 32)	Yes	Unclear
Fair value of off-balance sheet financial instruments (IAS 32)	Yes	Unclear
Interest rate risk disclosures including contractual repricing or maturity dates and effective interest rates (IAS 32)	Yes	Limited
Total amount of deferred or unrecognized gain or loss on hedging instruments (IAS 32)	Yes	Unclear

* Disclosures for the U.S. bank are either required by U.S. GAAP or SEC

** Disclosures not required by IAS may be required by French accounting standards or French securities regulations