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Paris, 19 th of June 2003

**GLOBALISATION : THE ROLE OF INSTITUTION BUILDING IN THE FINANCIAL  
SECTOR : THE FRENCH BANKING SYSTEM**

In twenty years, the French banking system has undergone sweeping changes. The rationalisation of banking structures has created a much more liberalised environment, in which credit institutions are now operating. It also resulted in diversification of their business and greater openness to international markets in an increasingly competitive environment.

At the same time, the number of credit institutions has constantly decreased, creating a more concentrated market place, while some important institutions which had played a major role in French banking history have disappeared. On the other hand, the openness of the French banking system has greatly improved, foreign banks reaching a significant market share in some business sectors and foreign ownership of French credit institutions being much more widespread.

Governments' initiatives have been of great help to help French credit institutions in adapting to their changing environment. However, the State role has also considerably changed. After the parenthesis of the 1982 nationalisation, the direct intervention of government in the banking sector has constantly decreased, leading to different waves of privatisation. At the same time, mutual and cooperative banks have been animated by a new dynamism.

Developments in the institutional and regulatory environment had a major influence on these structural changes, particularly in terms of organisation and profitability. After the recessions, of 1973 and the early 1990's, credit institutions' earnings improved steadily until 2001. However, since then market insatiability and slower economic growth have depressed earnings and given rise to new risks, even if the global resilience of the French banking sector compared to its neighbours remains satisfactory.

During this lapse of time, the offer of banking products and services has also considerably changed, since control on prices, administration of credit and foreign exchange control have all disappeared. In front of all these changes, the role of institutions has been fundamental. In less than 20 years, French banking system has shifted from a status characterised by heavy State involvement to a nearly complete privatisation.

The aim of that paper is to give a synthetic view of the way French authorities managed this liberalisation. In this respect, one has to underscore the fundamental role of the 1984 Banking Act.

## I. The first steps towards liberalisation before 1984

Before 1984, French banking system was marked by a heavy involvement of public authorities. However, a first step towards liberalisation had already been made in 1966-1967.

### A. An administration of credit built by the Laws of 1941 and 1945

#### 1. France's banking industry was compartmentalised

The crises faced by the banking sector in the 1930s has lead French authorities to reinforce the institutional framework. The Act of 13th June 1941, as amended in 1945, created a control institution; the *Conseil national du crédit*. This Act also distinguished between deposit banks, investment banks, medium and long-term credit banks and financial institutions. All of these entities are now classified as commercial banks, after being known as "AFB banks" (banks belonging to the French Bankers' Association – AFB). The old classification restricted the role of each category of bank. The compartmentalisation of business activities was based on the time horizon of transactions, which meant that deposit banks were only allowed to engage in short-term transactions, as opposed to medium- and long-term credit banks. The purpose of this principle was to control lending and to regulate monetary creation and the allocation of savings.

#### 2. Large parts if the banking sector were under government control

The nationalisation of the Banque de France and the four leading deposit banks (*Crédit Lyonnais, Société Générale, Banque Nationale pour le Commerce et l'Industrie and Comptoir d'Escompte de Paris*) after the war gave the government a predominant role in France's banking industry. Later, the Act of 11 February 1982, which nationalised 36 deposit banks, further increased the influence of the government, since virtually all banks were owned by the State. The government's purpose was to control financial flows in France and to ensure the support of a key economic sector for the recovery in the country's growth.

Consequently, the banking business was severely constrained for a long time as a result of lending restrictions, regulated savings schemes and restrictions on the types of business that each category of bank was allowed to engage in. These constraints shaped the development of France's banking system. Yet, in 1965, the government first showed signs of wanting to disengage gradually from the financial system and this shift initiated the development of a modern banking system.

### B. The constraining framework was partly reformed by the decrees of 1966 and 1967

#### 1. Rules were made more flexible, and the reform put an end to specialisation,...

The reforms instituted in 1966 and 1967 played a key role by making rules more flexible and promoting "despecialisation". They led to rapid growth of deposits, especially after it became easier to open new branches. The number of bank branches doubled between 1967 and 1975. The three main purposes of these reforms were to ease banking restrictions associated with specialisation, to stimulate competition between banks by giving them the freedom to open new branches, and to improve financial techniques.

France's banking system started expanding more rapidly. Despecialisation gave rise to the concept of universal banking.

## 2. ...enhancing domestic concentration and opening the market to foreign banks

The decline in the number of registered banks was uneven. It resulted from two diverging trends, as many local banks were closed down and foreign banks opened up large numbers of subsidiaries and branches.

Until 1966, foreign banks had played a small role in France's banking system. But starting in 1967, their presence increased substantially. In 1970, they accounted for slightly fewer than 10% of the banks in France and this figure rose to about 15% in 1980.

As many local banks were shut down or merged into larger banks, the average size of banks increased and concentration intensified. For example, the 1966 merger of Banque Nationale pour le Commerce et l'Industrie and Comptoir National de Paris, gave birth to Banque Nationale de Paris (BNP).

Despite these changes, many economists still felt that France's banking system was not flexible enough and that the excessively compartmentalised market was a barrier to entry, hampering the expansion of bank financing.

## II. The Banking Act of 1984 gave the real impetus to French banking liberalisation

The main goal of the new law was to create the conditions of a fair competition and to spur the modernisation of banks. In that respect the new French Banking Act is based on universalism. However the diversity of the French banks status did not allow a complete universality.

### A. The principle of universality

The willingness of unifying French banking system led a single definition of the different institutions which were from then on submitted to the same authorities.

#### 1. A new legal framework based on the definition of credit institutions

The 1984 Banking Act created a single legal framework for all financial entities, henceforward called "credit institutions". The first article of Banking Act states that « credit institutions are legal persons carrying out banking operations as their regular business. Banking operations comprise the receipt of funds from the public, credit operations and making available to customers or administrating means of payment ». Credit institutions are also allowed to carry out some operations related to their business. A distinction is made between different type of credit institutions defined in the article 18 which follows.

- 1) Only the following institutions shall be generally entitled to receive funds from the public at sight or at less than two years' term :
- 2) **Banks** may carry out all banking operations. **Mutual or co-operative banks, savings and provident institutions** and **municipal credit banks** may carry out all banking operations subject to the restrictions arising under the laws and regulations governing them.

Unless authorized to do so by way of a secondary activity in accordance with the conditions laid down by the *Comité de Réglementation bancaire et Financière*, financial companies and specialized financial institutions may not receive funds from the public at sight or at less than two years' term.

**Financial compagnies** may carry out only such banking operations as are covered by the decision authorizing them to operate or by the laws and regulations applying to them.

**Securities houses** are financial companies whose principal business is to manage securities portfolios on their customers' behalf, receiving funds together with a management authority for this purpose, or to assist on a *del credere* basis in the placement of such securities.

**Specialized financial institutions** are credit institutions carrying out a permanent public-interest task assigned to them by the State. They may not carry out banking operations other than those relating to this task, except as a secondary activity.

The new Act still provided for several categories of credit institutions,<sup>1</sup> but it promoted greater uniformity of banking products and services.

## 2. The Banking Act submitted every credit institutions to the same authorities :

Namely

€ The *Conseil national du crédit et du titre*-CNCT

The CNCT studies the working of the banking and financial system, particularly as regards customers relations and the administrating of means of payment. It may issue opinions in these areas.

€ The *Comité de la réglementation bancaire et financière*-CRBF

The CRBF has very broad statutory powers to lay down general regulations applicable to all credit institutions. It is entitled to define capital requirements, conditions relating to banking operations, operational standards which institutions must adhere to, prudential ratios, reserve requirements and so on.

€ The *Comité des Etablissements de Crédit et des Entreprises d'Investissement*-CECEI

The CECEI is the authority responsible for granting individual licenses and authorizations to credit institutions and investment firms.

€ The *Commission bancaire*-CB

The *Commission Bancaire* is responsible for the supervision of credit institutions. It has powers to take disciplinary action against any breach of the Banking Act and the regulation laid down by the *Comité de la réglementation bancaire et financière*. It examines the operations of credit institutions and monitors the soundness of their financial condition through periodic returns filed by credit institutions and via on-site supervision.

## B. An incomplete harmonisation

Despite the large number of institutions concerned by the Banking Act, its universalism was not complete. The Treasury, the *Banque de France*, the financial services of the Post Office, the *Institut d'Emission des Départements d'Outre-Mer*, the *Institut d'Emission d'Outre –Mer* and the *Caisse des dépôts et consignations* can carry out banking operations without being considered as credit institutions.

The regulatory environment continued to change after the Act was implemented, but the trend was always towards greater harmonisation. The 1999 Savings and Financial Security Act validated the new by-laws for savings and provident institutions, which became mutual banks, and the creation of mortgage credit institutions, as well as instituting a single deposit insurance fund covering all French credit institutions. As a result, the French banking industry has become more uniform, even though some institutions still maintain some specific individual features, such as the regulated passbook savings accounts offered by savings and provident institutions and *Crédit Mutuel*.

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### III. The banking Act of 1984 induced a total reshaping of French banking system

#### A. Disintermediation has nurtured the competition between credit institutions and financial markets :

The gradual liberalisation of financial markets that started in the mid-1980s increased competition from non-banks, such as mutual funds and insurance companies, but more especially, it stimulated competition from markets.

Economic agents were given the right to issue money market instruments in 1985 and 1986, which opened up new possibilities for market financing. Furthermore, the transposition of the European Directive of 24 June 1988 on the free movement of capital into national law eliminated lending restrictions and currency controls and removed many of the administrative barriers that had compartmentalised credit institutions' business in European countries.

This had a particularly big impact on traditional banking intermediation business. It gave rise to disintermediation in lending and an alignment of bank lending rates and terms on those of the market. The financial intermediation ratio, which measures the proportion total lending to non-financial agents obtained from resident financial intermediaries, fell from 71% in 1978 to less than 41% in 2001. The stock market decline over the last eighteen months has reversed this trend and more businesses are returning to traditional bank financing.

#### B. Deregulation backed the concentration of the sector with the rise of powerful banking groups

##### 1. The industry underwent a gradual concentration :

Up until the beginning of the 1980s, the number of credit institutions grew, as many foreign banks arrived on the French market and new institutions were created to specialise in specific business lines and types of financing. After that, one of the main changes in the French banking industry was a substantial decrease in the population of banks. Since 1984, the number of credit institutions located in France (excluding Monaco) and authorised by the Comité des Établissements de Crédit et des Entreprises d'Investissement (French Credit Institutions and Investment Companies Committee – CECEI) shrank from 2,001 to 974. After remaining stable at 2,027 institutions until 1990, the population has declined steadily up until the present.

The shrinking population of banks results from the closing down of institutions that had no prospects for expansion in a more competitive environment and from mergers of institutions with similar characteristics. A wave of reorganisation and renovation of banking structures also reduced the numbers of institutions. All in all, the leading institutions have steadily grown bigger in recent years, but this has not harmed the interests of economic agents, who still have the same number of branches available. The proportion of total banking assets held by the top twenty institutions rose from 65.1% in 1988 to 78.4% in 2002, on the basis of parent company balance sheets. On the basis of consolidated balance sheets, which record the assets of subsidiaries as well, the top five banking groups in France account for more than 64% of lending and 75% of deposits. It could be said that the top ten banking groups control more than 85% of the total retail banking business in France.

Ongoing renewal of the French banking system's composition over the last ten years has led to extensive changes in ownership. These changes reveal the disengagement of the government, the growing role of mutual and cooperative institutions and the emergence of some groups of European or international scope.

## 2. State ownership and family ownership have nearly disappeared

The number of government-owned banks has decreased sharply. After several successive waves of privatisations in 1986 and 1987, then in 1993 and, finally, at the end of the 1990s, most of the state-owned credit institutions had either been listed on the stock market or bought by other banks. At the same time, the number of family-owned banks dwindled. There were only 7 such banks left in 2001, as opposed to 34 in 1984. This illustrates a major change in the French banking industry, which is now dominated by large groups, leaving most small, family-owned banks without the resources they need to sustain their business and achieve sound growth.

## 3. Restructuring of the banking industry has affected all types of institutions

The market share of large groups has increased along with the role of mutual and cooperative groups. In addition to enjoying organic growth, mutual and cooperative banks have played an active part in restructuring the French banking industry. The Crédit Agricole group took over Indosuez in 1996, and the Crédit Mutuel group bought the CIC group when it was privatised in 1998. Other examples include Banques Populaires' successive acquisitions of equity stakes in Natexis and the Caisses d'Épargne network's stake in Crédit Foncier de France. Recent moves include Crédit Agricole's bid to take over the Crédit Lyonnais. The CECEI approved the takeover on 13 March 2003. This takeover marks a major change in France's banking industry and confirms the mutual group's leading share of the retail banking business in France. Other bank mergers and takeovers include Société Générale's acquisition of Crédit du Nord in 1997, CCF's acquisition of Société Marseillaise de Crédit in 1998, and BNP's takeover of Paribas in 1999. Eight groups now dominate France's banking system: BNP-Paribas, Crédit Agricole, Société Générale, Crédit Lyonnais, CCF-HSBC, Banques Populaires, Caisses d'Épargne, Crédit Mutuel-CIC.

BNP-Paribas has become the sixth largest European bank in terms of market capitalisation and the biggest bank in the euro area. Yet, the accession of French banks to the top ranks of international banks is a very recent development. The traditional ownership structure of credit institutions did not lend itself to emergence of very large market capitalisations. Furthermore, the Paris financial centre was not necessarily big enough to facilitate French issuers' accession to the top ranks. And French credit institutions were long hampered by an image problem stemming from low operating profits. This situation has changed recently, as the leading credit institutions have restructured and improved their operating profitability, putting them more than on par with their EU partners, particularly during the last few years.

## IV. The role of the prudential framework

### 1. The influence of domestic and international regulatory bodies has promoted more harmonised prudential rules:

The greater uniformity of business conditions in banking also stems from the efforts of international and European bodies to introduce regulatory standards. The Basel Committee has played a key role in these efforts. The work of the committee has led to adaptations in European and domestic regulations. In the late 1980s, regulations were tightened up with the transposition of the European Capital Adequacy Directive into French law. The new regulations established the minimum ratio of regulatory funds ("own funds") to all credit risks at 8%.<sup>2</sup> In 1996, an additional capital requirement was established to cover market risks. The European Directive on deposit guarantee schemes enhanced protection for depositors and led to unification of the various deposit guarantee schemes in the French banking system in 1999.

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European Directives that have been transposed into French laws and regulations include the Investment Services Directive, which resulted in the 1996 Financial Activity Modernisation Act. This Act provides for a single institutional framework for all types of investment service providers in France. In order to take up this business, providers must now obtain the authorisation of the CECEI or that of France's securities regulator, the Commission des Opérations de Bourse (COB), in the case of portfolio management companies. The Act introduced a new category of undertakings called investment companies. On 1 January 1998, the former category of securities houses was abolished and the undertakings in it were classified in the new category. These companies are subject to the prudential supervision of the Commission Bancaire, except for portfolio management companies, which are supervised by the COB. The new category covers a wide variety of lines of business and corporate cultures and the companies in it vary in size and ownership structure.

## 2. The cross-sector cooperation between supervisory authorities :

Naturally, this change is linked to the productivity gains achieved by the leading banks since the 1990s. It is also the result of strong encouragement from prudential authorities, which intensified when the Comité de la Réglementation Bancaire et Financière (Banking and Financial Regulation Committee – CRBF) adopted Regulation 97-02 relating to internal control. This highly innovative Regulation, which the Basel Committee has cited in its best practices recommendations for internal control, spurred credit institutions to acquire effective structures for recording, monitoring and managing risks.

The Regulation outlines the minimum requirements for sound management, the responsibilities of directors and the main organisational principles for internal control. It also defines the function of “internal auditor” and insists on the need to analyse the geographical and sectoral aspects of credit and market risks, along with their segmentation, management and even their profitability (Article 20). This Regulation has had a real impact on the way credit institutions are structured. It has disseminated a control culture, which has become critical in some cases with the expansion trading activities and the lack of transparency in some transactions. This has led to substantial improvements in transparency, productivity and efficiency.

France has opted for separate and specialised supervisors for the banking sector, the insurance sector and for financial markets. This specialisation, however, is set within a framework of greater co-operation between supervisors. The Commission Bancaire and the Insurance supervisor, Commission de Contrôle des Assurances (CCA) formalised their efforts to enhance co-operation by approving and signing a Memorandum of Understanding on their co-operation framework on the 24th October 2001. The charter defines practical co-operation procedures between the two supervisors in order to facilitate performance of their respective statutory duties.

The Commission Bancaire, the CCA, the Commission des Opérations de Bourse (COB) and the Conseil des Marchés Financiers (CMF) also meet several times a year to exchange information and co-ordinate their action. The COB and the Commission Bancaire recently published a series of joint recommendations on deconsolidation and derecognition of assets for French institutions in a preventive move following problems that arose with practices allowable under foreign accounting rules.

The true importance of this cooperation becomes fully apparent in the fight against money laundering and terrorist financing. Authorities have been given wider powers in this fight since 2001. The Commission Bancaire is responsible for ensuring that credit institutions comply with all of the measures for preventing and detecting transactions for the purposes of laundering the proceeds of drug trafficking and organised crime.<sup>3</sup> It ensures that procedures are in place to prevent criminal funds from entering or circulating through the financial system. In this task, it works in close cooperation with national and international authorities.

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It is in contact with Tracfin, France's financial intelligence unit, customs, the Gendarmerie, law enforcement authorities and administrative authorities working with the Commission Bancaire (CCA, COB, CMF, etc.).

At the international level, it works in collaboration with other supervisors and international co-operation bodies such as the Basel Committee, the Financial Action Task Force (FATF), the International Monetary Fund (IMF) and the Financial Stability Forum (FSF).

### 3. Description of recent institutional changes :

The recent adoption of the *loi de sécurité financière* will strengthen and simplify supervision of financial services in France. Financial regulators will be reorganized according to the so-called "twin peaks" architecture : strict separation between market authorities, in charge of the supervision of exchanges, financial operations and the protection of savings, on the one hand, and prudential authorities in charge of the prudential regulation of the banking and insurance sectors, on the other hand.

A new market authority, the *Autorité des marchés financiers* (AMF) will be created and will replace the *Commission des opérations de bourse* (COB), the *Conseil des marchés financiers* (CMF) and the *Conseil de discipline de la gestion financière* (CDGF) (in charge of the supervision of the deontology of portfolio management companies), simplifying the regulatory system for exchanges. Both the prudential regulation of the banking sector and insurance sector will be reorganized. For each of these sectors there will be three authorities : one in charge of regulation (the Minister of Finance assisted by a consultative comity), one in charge of granting individual licenses and authorizations to credit institutions and investment firms (CECEI) or to insurance companies (the *Comité des entreprises d'assurance*, CEA), and one in charge of supervision, the *Commission bancaire* (CB) for the banking sector and the *Commission de contrôle des assurances des mutuelles et des institutions de prévoyance* (CCAMIP) for the insurance sector.

The LSF will also improve corporate governance and consumer protection, and clarify the authority for banking system competition policy.