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December 2012
IMF Country Report No. 12/341

France: Financial System Stability Assessment

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FRANCE

Financial System Stability Assessment

Prepared by the Monetary and Capital Markets and European Departments

Approved by José Viñals and Reza Moghadam

December 7, 2012

This report summarizes the findings of the Financial Sector Assessment Program (FSAP) Update for France. The assessment was undertaken in January and June 2012. The findings were further discussed with the authorities during the Article IV consultation mission in October 2012.

The key macro-relevant findings of the Financial System Stability Assessment (FSSA) are as follows:

- France's financial system has shown resilience to severe market pressures but faces challenges. While its structure has contributed to solid profit generation, the crisis exposed the risks posed by the banks' size, complexity, and dependence on wholesale funding. The larger banks have been actively restructuring their balance sheets—moving to more stable sources of funding; reducing their cross-border presence; and building up capital. They remain, however, vulnerable to sustained disruptions in funding markets and reduced profitability, which would cause delays in meeting capital-raising plans.

- The regulatory and supervisory regime for banks, insurance and securities markets, and market infrastructures is of a very high standard. Areas for improvement include greater de jure independence of supervisory authorities; disclosure of the capital treatment and related financial interactions within complex banking groups; a move toward a more economic risk-focused approach to insurance regulation and supervision; and enhanced supervision of investment service providers and financial advisors.

- French banks, and listed companies more generally, make extensive public financial disclosures under IFRS, and as a result of bank regulations (Pillar III of Basel II). Nonetheless, disclosure of financial sector data falls short of best international practice and enhancements would be highly desirable. Market discipline would benefit from the publication of regular and comparable data on an institution-by-institution basis, as well as detailed official analyses of financial sector developments in France.

The FSAP team comprised Robert Sheehy (mission chief), Marina Moretti (operational mission chief), Bernard J. Laurens (deputy mission chief), Amadou Sy, Ana Carvajal, Katharine Seal, Elias Kazarian, Liliana Schumacher, Sònia Muñoz, Hélène Poirson, Ivan Guerra (all IMF); and Thomas Karp, Theodor Kockelkoren, Nicholas Le Pan, Göran Lind, and Donald McIsaac (external experts).

FSAP assessments are designed to assess the stability of the financial system as a whole and not that of individual institutions. They have been developed to help countries identify and remedy weaknesses in their financial sector structure, thereby enhancing their resilience to macroeconomic shocks and cross-border contagion. FSAP assessments do not cover risks that are specific to individual institutions such as asset quality, operational or legal risks, or fraud.

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GLOSSARY

ABS	Asset-backed security
ACP	*Autorité de Contrôle Prudentiel*
AMF	*Autorité des Marchés Financiers*
AML/CFT	Anti-Money Laundering/Combating the Financing of Terrorism
ANC	*Autorité des Normes Comptables*
BCP	Basel Core Principles for Effective Banking Supervision
BdF	Banque de France
BIS	Bank for International Settlements
BU	Bottom up (stress test)
CC&G	Cassa di Compensazione e Garanzia
CCP	Central counterparty
CDC	*Caisse des Dépots et Consignations*
CDO	Collateralized debt obligation
CDS	Credit default swaps
CET1	Common equity Tier 1
CIB	Corporate and investment banking
CIF	*Crédit Immobilier de France*
CMBS	Commercial mortgage-backed security
Corefris	*Conseil de Régulation Financière et du Risque Systémique*
CPSS	Committee on Payment and Settlement Systems
CRA	Credit rating agency
CRD	Capital Requirements Directive
CRE	Commercial real estate
CRR	Capital Requirements Regulation
DGT	*Direction Générale du Trésor*
DSS	*Direction de la Securité Sociale*
EBA	European Banking Authority
ECB	European Central Bank
EEA	European Economic Area
ERM	Enterprise-wide risk management
EIOPA	European Insurance and Occupational Pensions Authority
ESMA	European Securities and Markets Authority
FATF	Financial Action Task Force
FDG	*Fonds de Garantie des Dépôts*
FIA	Financial investment advisor
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSIs	Financial soundness indicators
GAAP	Generally Accepted Accouning Principles
GAPC	*Gestion active des portefeuilles cantonnés*

GBP	*Groupe Banque Populaire*
GCC	Gulf Cooperation Council
GCE	*Groupe Caisse d'Épargne*
GDP	Gross Domestic Product
G-SIBs	Global systemically important banks
H3C	*Haut Conseil du Commissariat aux Comptes*
IAIS	International Association of Insurance Supervisors
ICP	Insurance Core Principle
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commission
ISP	Investment service provider
LBO	Leveraged buyout
LCR	Liquidity coverage ratio
LTRO	Long term refinancing operations
LTV	Loan-to-value
MiFID	Market in Financial Instruments Directive
MoF	Ministry of Economy, Finance, and Trade
MoU	Memorandum of Understanding
MTF	Multilateral trading facility
NPL	Nonperforming loan
NSFR	Net stable funding ratio
NYSE	New York Stock Exchange
OMTF	Organized multilateral trading facility
OPCVM	*Organisme de Placement Collectif en Valeurs Mobilières*
OTC	Over-the-counter
PD	Probability of default
PMC	Portfolio management company
P&A	Purchase & assumption
RMBS	Residential mortgage-backed security
ROA	Return on assets (average assets)
ROE	Return on equity (average equity)
RRP	Recovery and resolution plan
RWA	Risk-weighted assets
SFEF	*Société de Financement de l'Économie Française*
SIFI	Systemically important financial institution
SME	Small- and medium-sized enterprise
SPPE	*Société de Prise de Participations de l'État*
SRO	Self-regulatory organization
SSM	Single supervisory mechanism
TD	Top-down (stress test)
WEO	World Economic Outlook

EXECUTIVE SUMMARY

French banks have shown significant resilience during the global financial crisis, but face challenges. While their diversified structure has contributed to solid profit generation, the crisis exposed the risks posed by their size and complexity. A permanent change in the regulatory landscape and operating environment has exposed an overreliance on wholesale funding, and recent events in Europe are putting pressure on their regional and international activities in both retail and capital markets. Significant uncertainties remain on the resolution of the eurozone crisis, and how it may affect the French financial system and economy.

French banks are addressing these challenges by actively seeking to restructure their balance sheets, but the process is not yet complete. They are increasing liquidity and reducing their dependence on short-term and U.S. dollar wholesale funding, including through deleveraging abroad; reducing their cross-border presence in Europe and elsewhere; raising solvency ratios, mainly through retained earnings and lower dividends; and reducing activities that are dependent on short-term funding, capital intensive, and less profitable. So far, deleveraging does not appear to have weighed on the real economy, but the future path is likely to be more challenging, particularly if the eurozone crisis intensifies.

The main short-term risks to financial stability are the possibility of a sustained closure of funding markets and reduced profitability. Stress tests suggest that banks' regulatory capital is sufficient to cope with a range of adverse macroeconomic scenarios, including a downturn in the housing market, and exposures to vulnerable European sovereigns seem manageable. Nonetheless, as for other banks in Europe, the market value of equity of some French banks remains below book value, suggesting continued market concerns. In particular, an intensification of the euro-zone crisis could cause a significant shock to private sector activity in the region and put capital pressures on some banks. Stress tests also suggest that French banks remain vulnerable to sustained disruptions in funding markets, despite improvements in liquidity positions and the relief provided by ECB long-term funding. Adequate collateral to access liquidity through the secured debt market and/or central bank facilities will be important in helping banks manage potential stress events.

The authorities' focus on requiring banks to continue to build up adequate capital and liquidity buffers is therefore appropriate. The large French banks have announced plans to meet Basel III Common Equity Tier 1 (CET1) capital targets during 2013, and have divested noncore assets. Given the uncertainties of the current environment, the authorities should continue to monitor banks' capital and liquidity plans closely, including through stress tests, and be ready to impose capital conservation measures (such as suspension of dividend and bonus payments), should banks encounter difficulties in meeting the agreed targets.

The risks stemming from the size, complexity, and interconnectedness of French banks put a premium on high-quality supervision. Banking supervisory practices are of very high standard, but more timely feedback and strengthened follow-up mechanisms are needed to ensure banks act upon any weaknesses identified in the supervisory process. Supervisory effectiveness would also be enhanced through legislative changes, notably to strengthen ACP's powers to set requirements for Board responsibilities, and to suspend or dismiss unsuitable Board members; and to give the ACP formal powers to approve foreign acquisitions by French banks outside the European Economic Area. Finally, the bank capital treatment in place and the related financial interactions within complex groups require fuller and more consistent disclosure. It will be important, going forward, that the reform agenda foreseen by the new government be clarified to eliminate regulatory uncertainty.

The current thorough approach to insurance regulation and supervision has led to financially sound insurers. Persistently low interest rates and competition from other savings products are key challenges for the industry. On the regulatory side, preparations for Solvency II are underway, which will require important changes in regulatory requirements and supervisory assessments of insurers' financial soundness, governance, and risk management. The authorities should work toward early introduction of specific Board requirements in the areas of risk-appetite statements, risk management, delineation of responsibilities between the Board and key persons in control functions, remuneration policy, and a duty to act in the interests of policyholders.

Oversight of securities regulation and market infrastructure is of a high standard. Areas for further improvement include the supervision of investment service providers and financial investment advisors; greater enforcement of securities regulation; and higher intensity of onsite inspections of the central counterparty by all relevant authorities.

Cross-Board memberships among financial authorities support cooperation and information sharing but could blur transparency and accountability. The treasury, which has overall responsibilities for preparing legislation and secondary regulations in the financial field (except in the securities sector), attends the meetings of several supervisory bodies, though it has no voting rights. This involvement supports cooperation between authorities but could undermine the independence of supervisory bodies, though there is no evidence of problems to date. Consideration should be given to establishing separate coordination arrangements to ensure that effective advice, knowledge about crucial supervisory decisions, and the reasoning behind proposed regulatory changes still occur, but in a manner that avoids the perception of potential threats to supervisory independence.

France lags behind many other countries in the public disclosure of financial sector data. To enable effective market discipline, the ACP should enforce publication of regular and comparable data on an institution-basis for banks, insurance companies, and securities firms, including data from prudential returns, as appropriate. Publication of a Financial Stability Report covering in detail financial sector developments in France, along with results from systemic risk analysis, would also be desirable.

Table 1. France: FSAP Update—Main Recommendations

Recommendations	Priority (H/M)	Timing (S/M)
Overall Financial Sector Oversight		
Enhance public disclosure of financial institution conditions and risks.	H	S
Give serious consideration to modifying MoF participation in the Boards of ACP and AMF to support independence of the supervisory process.	M	M
Eliminate limits on headcount for ACP, AMF, and H3C.	M	M
Banking Supervision		
Continue monitoring banks' funding position and availability of collateral to access liquidity through the secured debt market and/or central bank facilities.	H	H
Give ACP powers to assess the suitability of Board members (of both banks and insurance companies) and to require removal of all unsuitable Board members.	H	M
Give ACP powers to ensure it receives prior notification of major acquisitions and is, therefore, able to consider them ex ante.	H	S
Require full and consistent disclosure of the capital treatment in place and the related financial interactions within complex groups.	H	S
Insurance Supervision		
Introduce enforceable legal and regulatory corporate governance requirements.	H	M
Require insurance companies to have internal audit and actuarial control functions.	H	M
Enhance insurance companies' disclosures, including on valuation of technical provisions; risk exposures and concentrations; risk management; corporate governance; and sensitivity results from forms of stress testing.	H	S
Securities Regulation		
Establish stronger conflict-of-interest arrangements to govern industry participation in the AMF Board.	H	M
Strengthen AMF's supervision of investment service providers and financial advisors by increasing onsite work, including inspections.	H	S
Provide greater enforcement powers to the H3C and increase its staffing levels.	M	M
Resolution Framework		
Modify composition of Fonds de Garantie des Dépôts (FGD) Board to limit the potential for conflict of interest.	H	M
Expand FDG's powers in the resolution process, so as to assume assets and liabilities from a failing bank.	H	S
Central Counterparties		
LCH.Clearnet SA should measure its exposures continuously throughout the business day.	H	S
Carry out annually an external audit of LCH.Clearnet SA business continuity plan, including that of the in-sourcing company.	H	M
AML/CFT		
Strengthen the implementation of AML/CFT measures in the overseas territories.	H	M
Complete legislation to enable the authorities to seize laundered property.	H	M

1/ H/M: indicates high or medium priority level. S/M: indicates the time span in which the recommendation could be implemented (short or medium term).

I. Introduction

1. **France's financial system is large, sophisticated, and integrated both vertically and internationally.** It is dominated by five banking groups that are regionally and globally systemic and among the largest in the world, and of which four have been identified as global systemically important banks (G-SIBs). Total assets of the system amounted to €10 trillion at end-2011, or five times France's GDP (Appendix Table 2). France has one of the largest insurance markets in the world; the second largest mutual fund industry in Europe after Luxembourg in terms of the number of funds (and the first in Europe in terms of the number of management companies); and well developed securities markets and infrastructures that are fully integrated into Europe. French banks are among the largest counterparties in international equity derivatives markets.

2. **Before the crisis, the French financial system created a robust income generating capacity, but also became more vulnerable to shocks (Figure 1).** Rapid balance sheet growth during the second half of the 2000s was driven by the banks' expansion into international corporate and investment banking (CIB) and derivatives products, funded in the wholesale market, and a more limited international retail expansion, particularly in high-yield Euro area countries. When the global financial crisis hit in 2008, margins from domestic retail activity and asset-gathering operations covered losses on CIB activities, helping French banks weather the turmoil. But with the worsening of the European sovereign debt crisis in 2011, market perceptions of French banks deteriorated sharply due to high leverage and reliance on wholesale funding, high exposure to potential losses in high-yield Euro area countries, and capital levels below the international average. The solvency and liquidity situation of French banks has since improved, although dependence on wholesale funding remains a key risk.

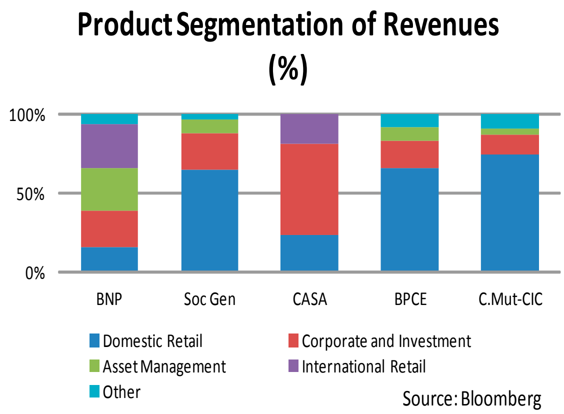
3. **As a result, the large French banks are in the midst of significant balance sheet adjustments.** Deleveraging plans were announced by the five largest banks in mid-2011, which focused primarily on disposing of noncore, dollar-funded international assets. Disposal of remaining legacy assets from the first phase of the crisis also accelerated to free up regulatory capital. Domestic credit activity was largely maintained and continues to grow, albeit at declining rates owing to slower demand for bank loans.

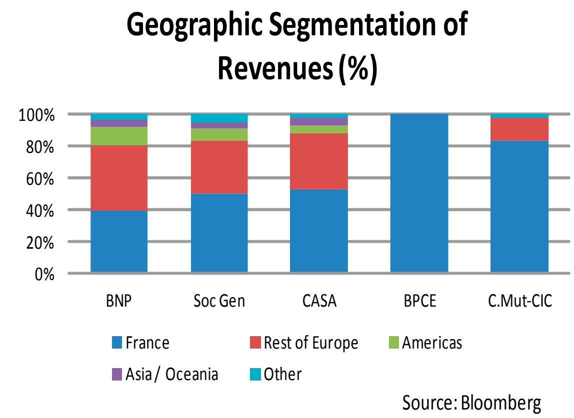
4. **Against this background, this report concentrates on three related issues:**

- The current soundness of France's financial system, and short-term risks and vulnerabilities arising from the crisis;
- The adjustments to French banks' business models, which will be necessary in the medium term to adapt to the new economic and regulatory environment; and
- Improvements in the oversight framework to support a safer and sounder financial system going forward.

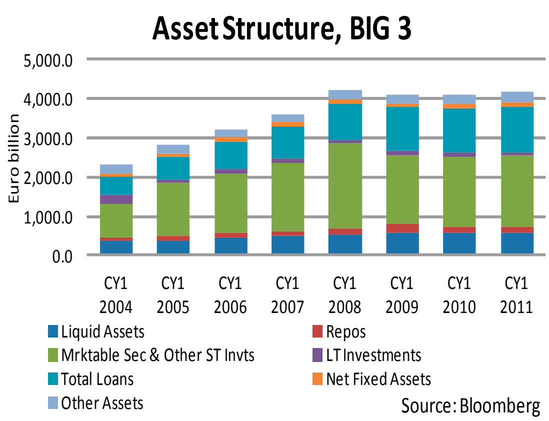
Figure 1. France: Financial System Landscape, 2011

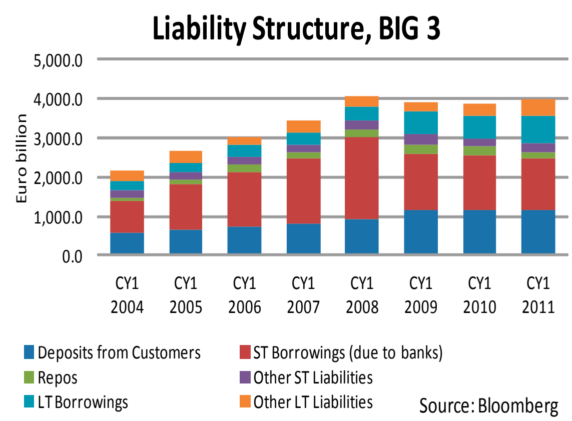
France's financial system is large, sophisticated, and both vertically and internationally integrated



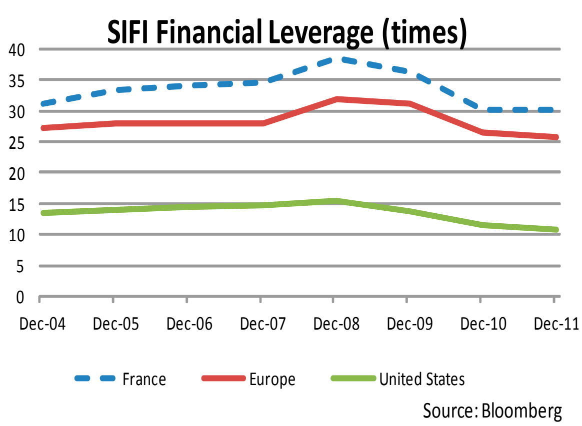


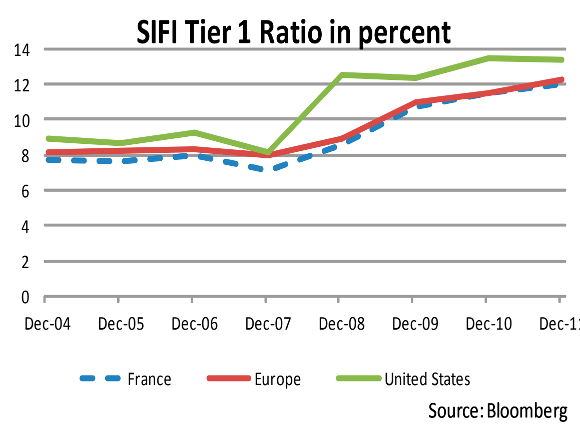
Rapid balance sheet growth was driven by corporate and investment banking (CIB) and funded in the wholesale market...





After sharp losses during the crisis, French banks started managing legacy assets ……which helped to free up regulatory capital





Note: French BIG 3 SIFI includes BNP, Credit Agricole and Société Générale.

II. Soundness of the Financial System and Potential Risks

A. Financial Crisis and Policy Response

5. **The French banking system weathered the 2007–09 global financial crisis well.** The large banks came under significant funding pressures as interbank and foreign exchange markets seized, necessitating policy actions. Reliance on wholesale funding and exposures to securitized assets fed perceptions of counterparty risk, contributing to funding problems. Despite large losses, most banks were able to maintain net profits thanks to solid earnings from traditional domestic retail banking.

6. **The authorities acted decisively to contain the crisis, complementing steps by the ECB to support euro-wide liquidity.** Key measures included:

- *Participating, with Belgium and Luxembourg in a €6.4 billion recapitalization of the Dexia Group in 2008*. The French government contributed €1 billion and the Caisse des Dépôts et Consignations (CDC) contributed €2 billion. The governments of France, Belgium, and Luxembourg issued guarantees on Dexia's obligations (€90 billion at the peak). Dexia continued operating before a new round of intervention in 2011 (see Box 4).

- *Setting up the Société de Financement de l'Économie Française (SFEF)* to undertake refinancing operations up to €265 billion. SFEF issued government-guaranteed bonds equivalent to €77 billion (about 4 percent of GDP), which were on-lent to banks in proportion to market shares. French banks again started issuing bonds without government guarantees in the summer of 2009; the scheme expired at end-2009.

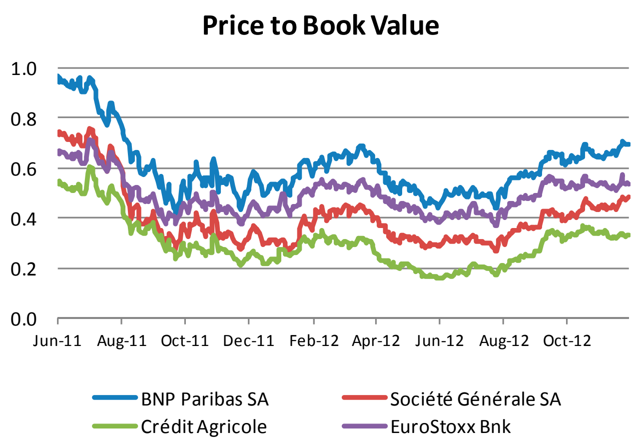
- *Setting up the Société de Prise de Participations de l'État (SPPE)* for bank recapitalization purposes, endowed with up to €40 billion. About half of this amount was injected into the six largest French banks in the form of subordinated debt securities and preference shares. All banks, except Dexia, have since repaid the state.

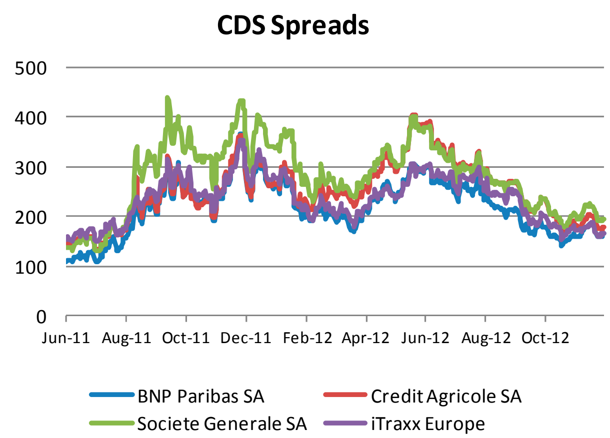
- *Supporting the creation of the BPCE group* from the merger of Groupe Caisse d'Épargne and Groupe Banque Populaire, with a capital injection of €5 billion by SPPE.

7. **In this environment, French banks started a gradual process of balance sheet adjustment while preserving credit supply.** After sharp losses during the crisis, most banks started disposing of legacy assets, and outstanding assets net of provisions declined by

10 percent during 2010 (to €96 billion).[1] Tier 1 capital increased due to retained earnings, and, as a result financial leverage declined gradually for most banks during 2008–10.

8. **Market pressures resumed in mid-2011, as the European sovereign debt crisis intensified.** Several features attracted market scrutiny of French banks: their large exposures to high-yield Euro area countries ($677 billion at end-December 2011, of which close to $400 billion to Italy); continued reliance on wholesale funding; and capital levels somewhat below European averages. Bank equity prices fell by 50–60 percent during the summer of 2011 and CDS spreads widened. Senior unsecured markets closed and dollar funding evaporated, with U.S. money market mutual funds cutting exposure to French banks by 80 percent in the second half of 2011. In December 2011, the European Banking Authority (EBA) concluded that French banks needed an extra €7.3 billion in capital by mid-2012, including a temporary buffer against sovereign risk—an objective that was achieved by March 2012.





9. **The ECB's three-year Long-Term Refinancing Operations (LTROs) provided significant temporary relief, but maturities in 2013 and 2014 are looming.** French banks utilized the LTRO to build liquidity buffers—of the €169 billion drawn as of May 2012, close to €140 billion were deposited at the ECB. The authorities have indicated that about half of the collateral posted at BdF remains available for ECB funding. Reliance on emergency liquidity assistance (ELA operations stood at €18.7 billion at end-2011) was limited. Unsecured market access resumed in the first quarter of 2012, and French banks were able to issue €48 billion in the first half of 2012. Together with €19 billion of prefunding done in 2011, French banks were able to cover a large part (about 77 percent) of their 2012 financing needs (close to €84 billion), taking into account deleveraging plans. But with maturing debt in 2013 and 2014 high at €131 billion, refinancing on an unsecured basis

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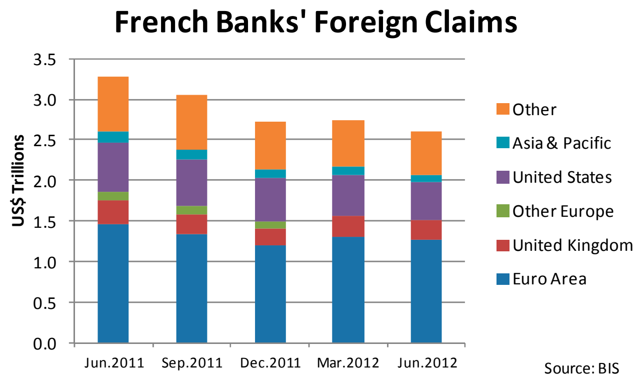
[1] Legacy assets include toxic assets (monolines, CDO subprime, and U.S. RMBS and CMBS), ABS/CDOs, and LBOs. Cumulative losses through 2012 for the five largest French banks reached €34 billion.

will be challenging if market conditions do not improve significantly.[2] However, French banks routinely issue structured notes through private placements and covered bonds.

B. Current Conditions in the Financial System

10. **In response to market and regulatory pressures, banks have accelerated the pace of deleveraging.** They reduced cross-border assets by over half a trillion U.S. dollars in the second half of 2011, and the trend continued in 2012, although at a slower pace. Banks are implementing the deleveraging plans announced in mid-2011, with a focus on noncore assets, particularly dollar-funded business lines in CIB and specialized financial services. Credit at home was maintained in 2012, though loan growth is slowing, due largely to weak demand, and has been substituted in part by corporate bond issuance.

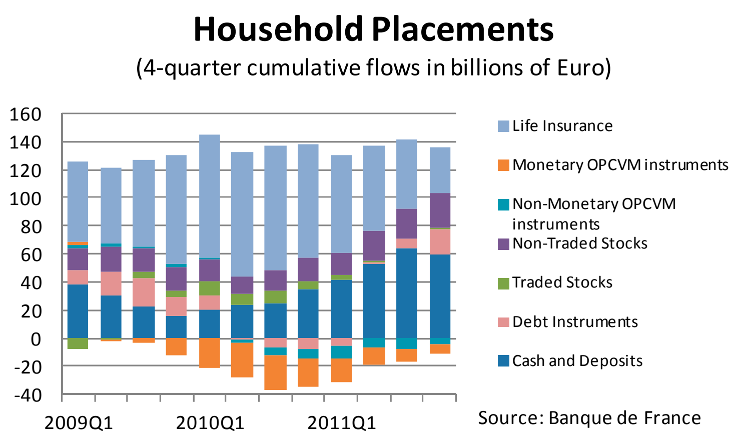


French Banks' Deleveraging, Q1 2012

	Targeted reduction of RWAs (in EUR billions)	Target date	Achieved	Remaining	Targeted Assets
Crédit Agricole Group^	35	December 2012	32	3	SFS/CIB
BNP Paribas	79	December 2012	63	16	CIB/Retail/Other
Société Générale***	16*	December 2012	14.4	1.6	Legacy Assets
BPCE**	25-35*	December 2013	20.5	4-14*	CIB/GAPC

Sources: Company reports and J.P. Morgan estimates. *Notional, **Also has 15.5bn (24bn notional) of RWAs in workout portfolio that is in run-off, ***Further EUR10.9bn of loan sales achieved since summer 2011. ^EUR50bn funding reduction 64 percent complete.

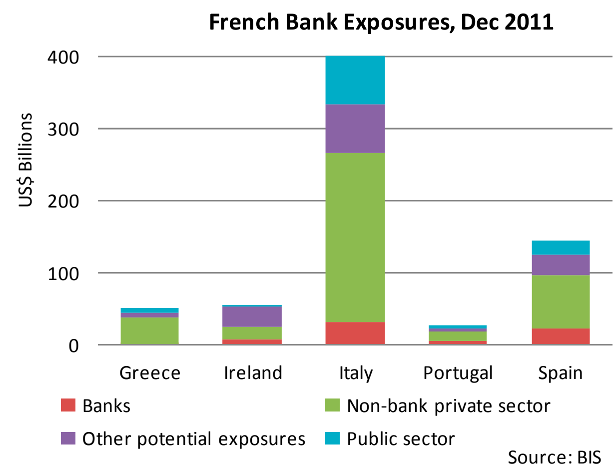
11. **While deleveraging helped, improving banks' funding profile will be challenging (Figure 2).** Partly reflecting their strong presence in market activities, large French banks have one of the lowest shares of retail funding in Europe, with customer deposits a third of total liabilities at end-2011; and wholesale funding concentrated at the short end. Meeting Basel III liquidity ratios will require



[2] U.S. dollar short-term funding was managed through a combination of drawing on deposits at the Federal Reserve, roll-off of dollar short-term debt, the use of EUR/US$ swaps and disposal of U.S. dollar-funded assets. Most of the rolled-over U.S. dollar-denominated debt comes due in the first quarter of 2014.

significant efforts to raise deposits and lengthen funding maturities. Banks are reacting by actively seeking retail deposits, helped by low interest rates and risk aversion that have made insurance and mutual fund placements relatively unattractive. Structural shifts in the allocation of household savings will require a reassessment of tax incentives for long-term savings instruments, notably life insurance and regulated savings products. In the meantime, banks will need to focus on ensuring that they have adequate collateral to access additional funding and liquidity through the secured debt market and/or central bank facilities.

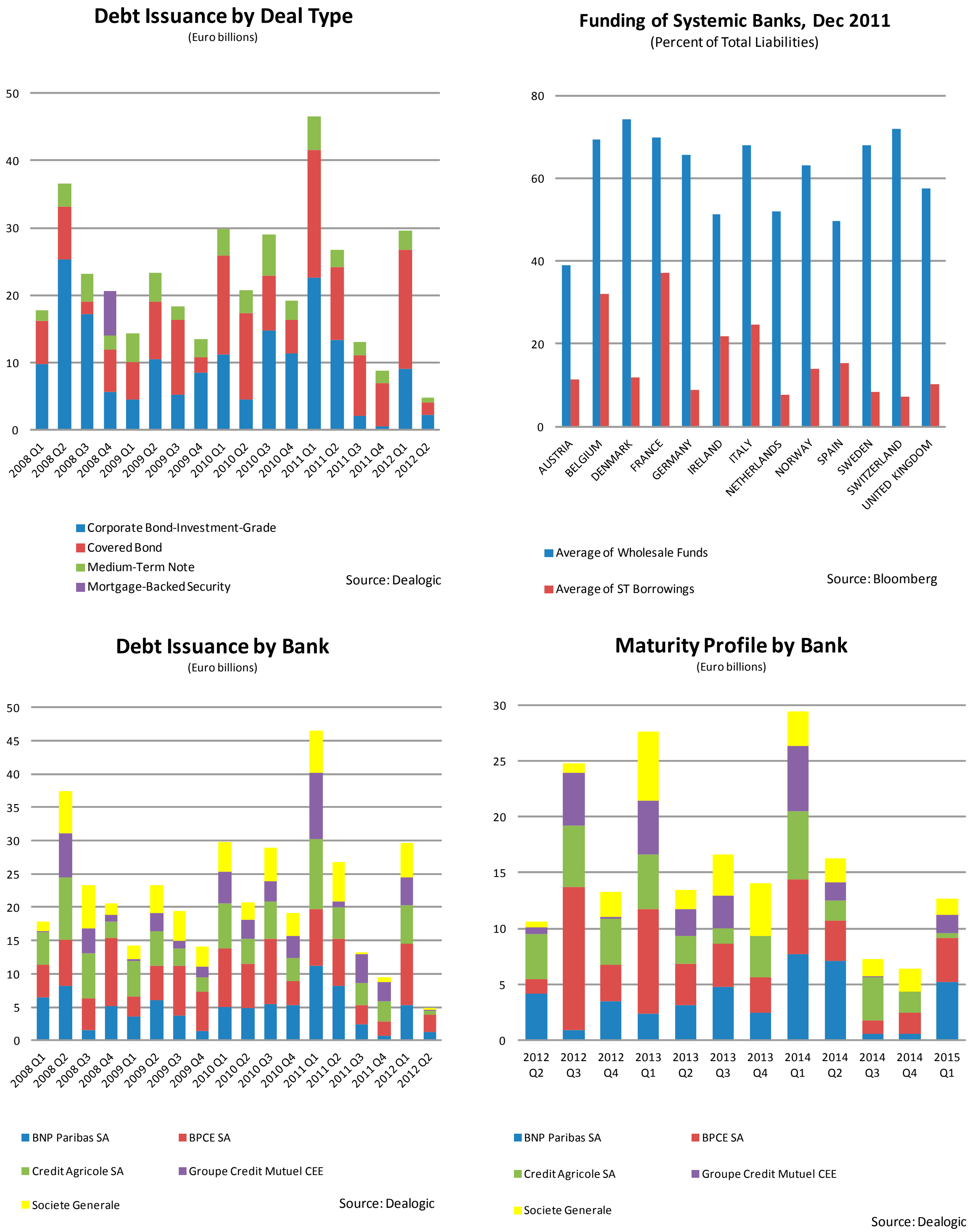
12. **Asset quality concerns stem primarily from exposures to high-yield Euro area countries.** The quality of French banks' domestic assets is high, but overall asset quality has been affected by the banks' large exposures to borrowers in high-yield Euro area countries, particularly Italy, where they own large local operations, and until recently Greece (Appendix Table 3).[3] Sovereign exposures are also sizeable in Italy, although they declined markedly in the second half of 2011. French banks' exposures to Greece have also materially decreased. A worsening of the situation in Europe could lead to rising cost of credit and higher sovereign spreads, which could lead to significant losses for some banks and potentially undermine their efforts to build up capital (Box 1).



13. **Banks appear resilient to a correction in house prices, largely a result of sound underwriting practices and the absence of a "collateral value" channel.** Lending criteria emphasize sustainability of the borrower's income rather than the home value, fixed-rate loans predominate, and financial innovation is limited (Box 2 and Figure 3). As a result, while loan-to-value (LTV) ratios are high compared to other advanced countries, debt service payments for the average household are conservative and arrears have been structurally low. France's well-developed social security system and the use of mortgage insurance and other forms of third-party guarantees have also helped limit the translation of income shocks into credit losses.

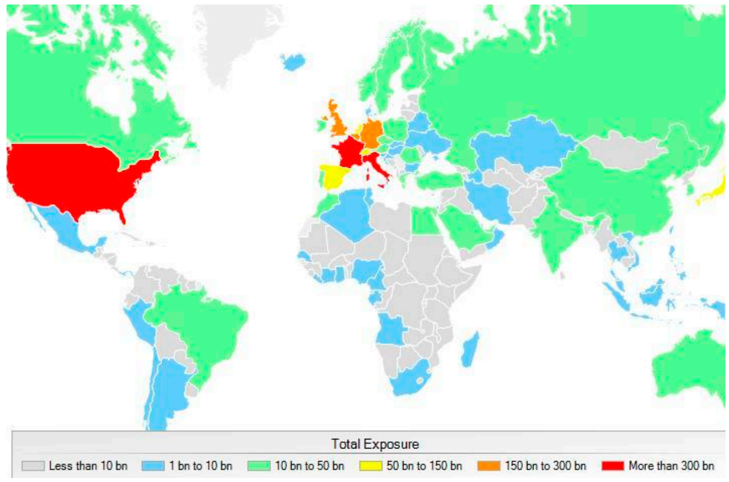
[3] Crédit Agricole agreed to sell its large Greek subsidiary in October 2012.

Figure 2. France: Bank Funding

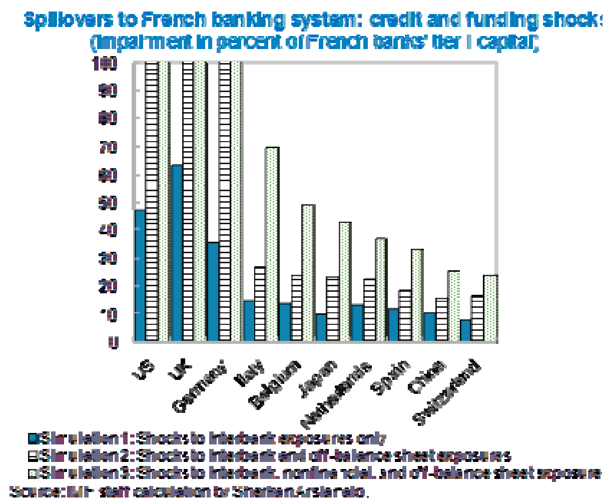


Box 1. Spillover Risk into the Domestic Banking System

Cross-border financial linkages are significant in France, as has been highlighted by the financial crisis. The international activity of French banking groups is a factor of diversification of risks. However, shocks to a country to which French banks have significant exposures (through the interbank market, sovereign holdings, or corporate bonds) could reverberate through the French banking system. Total foreign claims are significant for the French banking system, amounting to about €2.7 trillion as end-June 2011.



Network analysis was undertaken to assess contagion risk from abroad. Spillovers are modeled by: (i) estimating the "domino effects" triggered by the default of a banking system's interbank obligations (credit shock); and (ii) measuring the effects of a credit-plus-funding event, where the default of a banking system also leads to a liquidity squeeze for those countries exposed to funding from the defaulting system (i.e., the credit shock is compounded by a funding shock and associated fire-sale losses). Three simulations were conducted with increasing severity: (1) measuring spillovers only through direct interbank exposures; (2) including additional channels through other potential exposures at default (derivative contracts, guarantees, and credit commitments); and (3) allowing for spillovers from knock-on effects of banking sector problems in the trigger country on its own corporate and sovereign sector assets. For the sake of simplicity, the exercise made the following assumptions: (i) for the credit shock, a loss-given default of 100 percent on interbank exposures; and (ii) for the funding shock, a withdrawal of 35 percent of interbank funding and a haircut of 50 percent on forced asset sales. Under this extreme scenario, corporate and public sector exposures suffer losses of 50 percent and 20 percent, respectively. The exercise includes 30 countries using BIS "consolidated" cross-border banking exposure data as of September 2011.

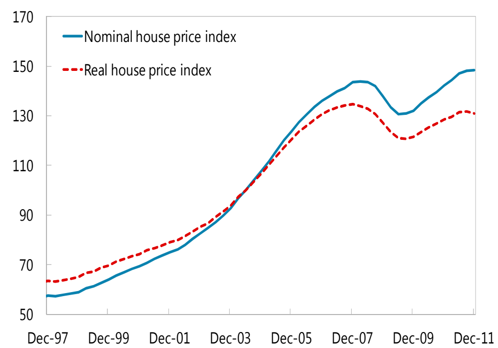


The results suggest that the United States, United Kingdom, and Germany represent the biggest potential systemic risk for the French banking system, followed by Italy. French interbank exposures to the United Kingdom, United States, and Germany are sizable, but small, compared to exposures to derivatives or contingent liabilities, to sovereigns, and especially to foreign corporates. Although the impact of credit and funding shocks through the interbank markets of Italy would be contained to about 30 percent or less of capital, the knock-on effects on banks from the corporate and sovereign sectors would represent 70 percent of capital. Belgium's impact would be about 50 percent of capital.

Figure 3. France: Housing and Mortgage Market Performance

Residential real estate prices continued to recover in 2011...

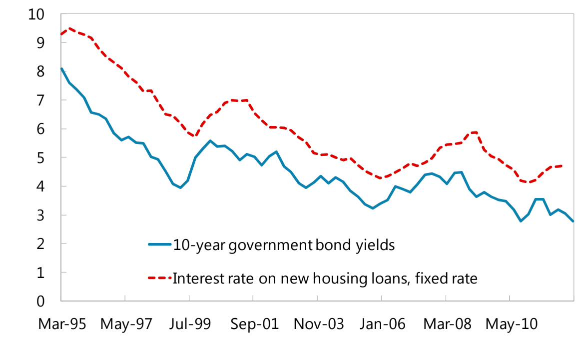
Nominal and Real House Price Indices
(2004Q2=100)



Sources: Haver Analytics; and staff calculations.

...as the rise in mortgage interest rates was contained.

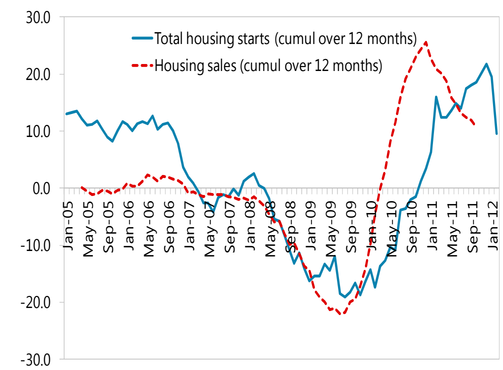
Relative Loan Profitability
(in percent)



Sources: Banque de France and Haver Analytics.

Demand is softening as the rate of new construction is also decreasing.

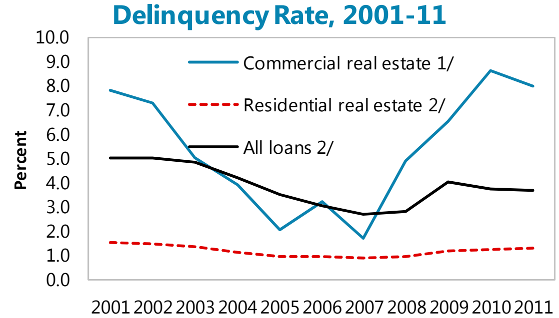
Signs of Softening Demand for Housing
(percent change - y/y)



Sources: Haver Analytics; and CGEDD.

Arrears on housing loans remain structurally low.

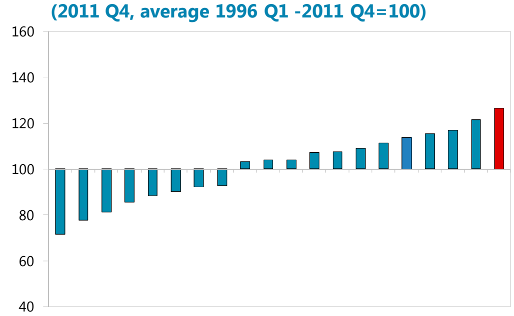
Delinquency Rate, 2001-11



Source: ACP.
1/ On a worldwide basis.
2/ Refers to metropolitan France.

As in several other countries, prices are still above their long-run anchor (incomes...

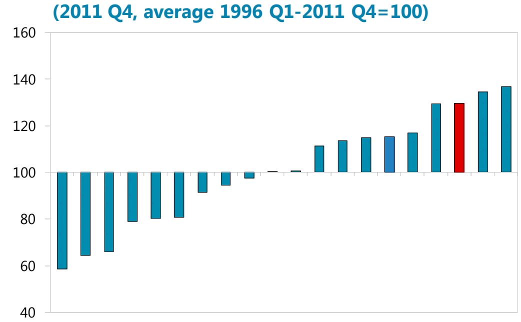
House Prices-to-Income
(2011 Q4, average 1996 Q1 -2011 Q4=100)



Sources: OECD, Global Property Guide, and IMF staff calculations.

...and rents). Thus declines in house prices may still be in the offing.

House Prices-to-Rent
(2011 Q4, average 1996 Q1-2011 Q4=100)



Sources: OECD, Global Property Guide, and IMF staff calculations.

Box 2. Real Estate Risks

Residential real estate prices surged sharply after the mid-1990s (by over 100 percent in real terms), dropped by about 10 percent during the 2008–2009 crisis, and have since recovered to just below their pre-crisis peak (see Figure 3). Most estimates of price overvaluation at end-2011 range from 10 percent to over 20 percent. The length of the downturn in France was relatively short (4 quarters, compared to over 10 quarters for Spain, Ireland, and the United States). Real estate price developments appear to be much more related to credit growth than to the business cycle, supporting the notion that availability or lack of financial resources for real estate projects is a driving force in this market. The residential market has historically borne a very low default risk. Broadly similar developments can be observed for commercial property prices. After decreasing by over 30 percent during the 2008–09 crisis, the CB Richard Ellis Paris office capital value index has risen by more than 20 percent y/y since 2010, supported by sustained rental value growth and the concentration of risk-averse investors on core markets. The rate of capital value growth has started to slow in 2012: Q1. As in other European countries, the commercial real estate (CRE) market—when considering French banks' exposures to CRE worldwide—is struggling with a sharp increase in problem loans.

Although it shares some common factors with recent real estate boom-bust cases in other countries, France differs in several ways.

- Since the mid-1990s, house price inflation in France was lower than in other major European countries with housing booms. Further, there has been no surge in residential investment, reflecting structural constraints, including scarcity of buildable land in dense metropolitan areas and regulatory barriers to new housing construction. Credit growth has also been more tempered in France and targeted at households, not property developers.

- The quality of the underlying lending is also relatively good, stemming primarily from tight underwriting criteria that emphasize sustainability of the borrower's income rather than collateral value. Furthermore, credit institutions and mortgage bond investors rather than households bear most interest rate volatility risks, given the preponderance of fixed-rate or quasi-fixed rate mortgages. Speculative activity is limited: in the residential market, buy-to-let investments represented only 16.3 percent of loans in 2011; in the CRE market, debt financing constraints are binding, and active lenders direct their capital toward high-quality prime core properties. As a result, despite elevated loan-to-value (LTV) ratios—almost half of mortgages originated in 2011 had down-payments of 5 percent or less, and LTV ratios exceeding 100 percent are not uncommon—mortgage asset quality remains high,

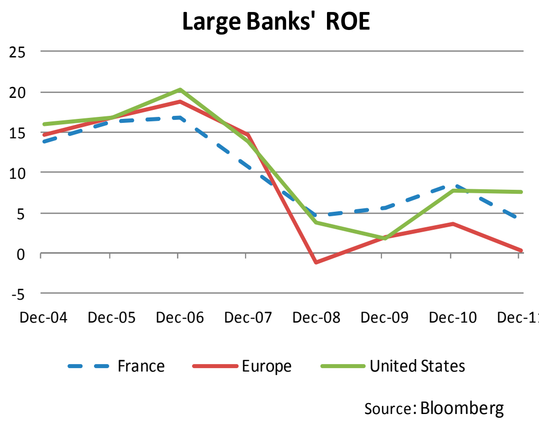
- In addition to low interest rates, house prices are supported by "fundamentals" such as population growth, low supply, and comparatively low household indebtedness.

- Even if prices fall, various factors will attenuate financial stability risks: (i) overall sound underwriting and risk management practices resulting in a prudent debt service to income ratio for the average household; (ii) the absence of nonrecourse loans; and (iii) currently cautious lending criteria for commercial real estate. Sensitivity stress tests of a decline in property prices of 25 percent did not show a significant impact on bank capital ratios.

Against this backdrop, the actions already taken to cool the market, though positive steps, may need to be supplemented given the structural supply-demand imbalance and continued attraction of real estate as a "safe haven" investment. The decline of home prices since the last quarter of 2011 suggests that the steps taken by the authorities have begun to be effective. Recent government measures have reduced tax incentives for buy-to-let investors and new home purchases, and have doubled the holding period for exemption from capital gains tax. The ACP has increased its scrutiny of housing loans through additional reporting from banks, among others, but has not imposed a cap on LTV or debt-to-income ratios. If indicators such as the risk premium for housing investment point to excessive risk-taking again, there may be scope for such macroprudential measures, which have proven useful in combination with other actions in other countries (notably in Asia). LTV ceilings could be particularly helpful to curb demand to avoid a credit-driven price increase while their negative impact on access to credit for some vulnerable categories could be limited by setting tighter limits based on, for example, loan amounts. Increasing the quality and availability of micro data would be a useful precautionary step to help the supervisors, and all market participants, to acquire an in-depth knowledge of the real estate market and enable the use of LTV limits, if necessary.

14. **Banks' large derivatives business is vulnerable to further ratings downgrades.** French banks are among the largest global players in equity derivatives, and income from related businesses accounts for a significant share of their total earnings for some banks. Because such transactions involve exposure to the credit risk of counterparties, restrictive clauses on counterparty ratings are frequently written into derivative contracts. Further credit rating downgrades of the largest global European banks, including some French banks, could thus reduce the willingness or ability of customers to engage in derivatives transactions with French banks without additional (costly) assurances, including collateral or credit backstops.

15. **French banks have benefited from solid profit-generation capacity, but face a difficult operating environment.** Their universal model has helped banks diversify the stream of cash flows, thereby cushioning shocks to any particular business line and supporting earnings above European peers. The current operating environment, however, is less-supportive of earnings generation, due to reduced profitability on CIB and, to some extent, domestic retail activity. Banks' income-generation capacity is also likely to suffer from shedding profitable noncore activities as part of their deleveraging plans. Possible spillovers from the Eurozone crisis clearly present the most significant risk.



16. **The large French banking groups have publicly announced their objective to meet Basel III common equity Tier 1 targets in 2013.** In 2011, banks' capital positions strengthened primarily through retained earnings, lower dividend payouts, and risk-weighted assets (RWA) optimization; capital-intensive activities were reduced; and banks continued to gradually increase their use of advanced approaches for computing capital requirements. The mid-year 2012 EBA capital target of 9 percent Core Tier 1 was achieved without raising additional capital from markets or seeking state support. Nevertheless, the market value of major French banks' equity remains well below book value, similar to other banks in Europe, suggesting continued market concerns. Given the significant uncertainties of the current environment, the authorities should continue to monitor banks' capital plans closely, including through regulatory stress tests, and be ready to impose capital-conservation measures (such as suspension of dividend and bonus payments), should banks encounter difficulties in meeting the agreed targets.

17. **The financial condition of insurance firms has generally been sound but pressure points have emerged.**[4] The industry has faced a decline in total premiums collected due to

[4] Life insurance is dominated by medium- to long-term savings products that offer a guaranteed return plus annually declared earnings rates. Such products in France are viewed as retirement savings vehicles.

persistently low interest rates and competition from other savings products, particularly bank deposits. Revenue from investments and the high cash balances maintained by insurers mean that insurers could absorb much higher rates of surrender without being forced to sell assets. Strong pressures on life insurance contracts could, however, lead to forced sales—including of European Union sovereign bonds that might have declined in value—which would put pressure on capital and profitability.[5] In addition, insurance companies have been reducing the proportion of assets invested in shares and real estate in preparation for Solvency II, which will apply risk weights to such assets that exceed those applied to top-quality debt obligations. Companies may thus be sacrificing yield to meet capital risk objectives.

C. Macroeconomic and Financial Risks

18. **The FSAP team's central scenario was constructed in early-2012 and projected a sharp deceleration in growth in 2012 with sluggish recovery thereafter.** The national savings rate would continue to rise, as a small decrease in private sector savings would be insufficient to offset higher government savings. Credit conditions would tighten further amid banking sector deleveraging, although remaining more favorable than in the euro area as a whole. In view of the continued euro area crisis and high unemployment, external demand, private consumption, and business investment would remain sluggish. Growth would slow to 0.5 percent in 2012 (euro area: -0.3 percent) and rise to 1 percent in 2013, broadly in line with the euro area as a whole. Inflation is set to fall below 2 percent. The central scenario assumed that: sovereign debt market tensions would ease in 2013; ECB intervention would continue to address immediate bank funding pressures; and the impact of bank deleveraging on domestic credit would be contained.

19. **This scenario was viewed as being susceptible to a number of risks (Box 3).**

- *A new or prolonged recession in several advanced economies*. Uncertainty about the growth outlook would partly relate to near-term fiscal tightening in a few advanced economies. In the euro area, the effect of bank deleveraging and fiscal consolidation could be larger than envisaged.

- *A significant deterioration of the euro area crisis*. A re-intensification of adverse loops between banks and sovereign stress would undermine already fragile market confidence, intensify market stress, widen sovereign and bank spreads, and weaken external demand. French banks would be disproportionally affected by heightened stress in high-yield Euro area countries, given their large exposures.

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[5] Under current rules, bonds are not marked-to-market when measuring the solvency of insurance companies.

Box 3. Stress Test Scenarios and Shocks

The macro-scenario stress tests are based on a baseline scenario that follows the February 2012 *World Economic Outlook* update, and an adverse scenario implying a cumulative deviation from the baseline of about two standard deviations of GDP growth for 2012–13 (standard deviation calculated over the last 10 years). The adverse scenario was generated by the Mascotte macroeoconomic model of BdF and calibrated to illustrate the combined impact of four adverse shocks: (1) a reduction in external demand caused by a euro area recession starting in 2012: Q1; (2) a worsening of the European debt crisis that pushes up sovereign spreads (90 bps for France and 160 bps for the euro area) and motivates fiscal consolidation to achieve a reduction of the fiscal deficit to 3 percent of GDP by 2013; (3) a worsening in bank funding costs that leads to a credit contraction by -0.8 percent in 2012 (in addition to current bank deleveraging plans); and (4) an increase in sovereign risk that leads to a repricing of bond holdings in bank portfolios through haircuts. The latter shock was assumed to affect all holdings in the top-down (TD) tests and non-AAA sovereign bonds in the trading and AfS accounts for the bottom up (BU) tests.

France: Macroeconomic Variables under the Scenarios used for the Solvency Tests
(Annual percentage change unless otherwise indicated)

	2011	2012	2013	2014	2015	2016
Real GDP growth						
Baseline	1.7	0.5	1.0	1.8	1.9	1.9
Adverse	1.7	-1.8	0.2	2.4	2.5	2.3
Long-term Interest rate						
Baseline	3.3	3.4	3.4	3.5	3.6	3.7
Adverse	3.3	4.4	4.1	3.5	3.7	4.1
Inflation rate						
Baseline	2.0	2.0	1.3	1.3	1.5	1.7
Adverse	2.0	1.9	1.0	0.6	1.1	1.7
Unemployment rate						
Baseline	9.7	9.9	10.1	10.0	9.7	9.3
Adverse	9.7	10.2	11.0	11.1	10.8	10.5
Fiscal balance (percent of GDP)						
Baseline	-5.7	-5.0	-4.8			
Adverse	-5.7	-3.6	-3.1			
Housing prices						
Baseline	6.2	1.2	0.4	0.2	0.9	0.4
Adverse	6.2	0.1	-4.4	-1.9	2.0	0.1
US dollar per EUR						
Baseline	1.4	1.3	1.3	1.3	1.3	1.3
Adverse	1.4	1.3	1.2	1.2	1.2	1.2

Source: Staff estimates based on analysis from Banque de France.

Single-factor tests in the BU exercise were also conducted to supplement the scenario analysis: (1) liquidation of non-AAA sovereign bonds in the HTM portfolio, by country, assuming that bonds are sold at end-2011 market values with an additional haircut; (2) failure of the largest five corporate exposures by name, and the largest five corporate exposures for the five countries where the each bank is most exposed; (3) an exchange rate shock (US$/euro) of +/- 20 percent; (4) an interest rate shock of 200 bps affecting positions in the banking book, including income and valuation effects; (5) a 25 percent shock to real estate prices; and (6) a reverse liquidity test that assesses the maximum potential loss of wholesale funding, by currency, that each bank can absorb while still meeting contractual obligations, and without access to ECB funding.

Liquidity stress tests, based on a maturity ladder analysis, were undertaken in the BU stress tests. The run-off rates and haircuts on assets were calibrated by type and currency using banks' historical data during crises, benchmarks from previous EBA exercises, and LCR weights.

Network analysis was used by the authorities and the FSAP team on the basis of prudential reporting on large exposures and BIS data to examine contagion risk among French financial institutions and cross-border counterparts.

- *A loss of France's AAA rating*. One rating agency downgraded France to below AAA in January 2012 and another one in November 2012. A further downgrade could potentially result in France becoming ineligible for purposes of some investor guidelines and drive sovereign and bank spreads higher.[6]

- *Renewed bank funding pressures*. While long-term funding improved significantly in the first months of 2012, market conditions have most recently deteriorated and are uncertain for the rest of the year. Renewed market tensions could create funding shortages in the system.

- *A new sharp downturn in the housing market*. Model-based estimates of misalignment suggest that home prices are 10–20 percent above their equilibrium levels, leaving banks vulnerable to losses if macroeconomic developments were to translate into significant income losses for borrowers, leading to higher probabilities of default.

20. **Stress testing analysis was used to capture the most salient risks for both banks and insurers.** Appendix III describes stress-testing methodologies for banks.

- The findings support the current focus of the ACP to require banks to build up adequate capital and liquidity buffers. They suggest that the banking system would be able to meet regulatory ratios under most scenarios, but that there are pockets of vulnerabilities that need to be addressed, in particular regarding liquidity risks.

- The ACP stress tests of the insurance sector indicate resilience, partly thanks to reserve buffers linked to revenues attributed to beneficiaries. While at present assets are not required to be marked to market, supervisors need to remain vigilant regarding the quality of the investment portfolio.

Bank stress testing analysis

21. **The tests covered the largest French banks and were conducted by the banks bottom up (BU), and by the authorities top down (TD).** The BU tests represented the core element of the analysis and were cross-validated by the TD tests. In general, TD results were more macro-sensitive and characterized by lower CET1 ratios than banks' results due to differences in models and assumptions (see Appendix III for details on the methodologies).

22. **Owing to insufficient public disclosure and legal constraints on the authorities' ability to provide supervisory data, the FSAP team could only conduct a partial TD exercise.** Although these constraints limited the confidence that could be placed in the results (hence they are not reported), they broadly supported the conclusion that the system was

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[6] France's downgrade in November 2012 did not have a noticeable impact on yields or banks.

resilient to a wide range of adverse shocks. They also illustrated that this conclusion was sensitive to assumptions, including probabilities of default and the use of capital measures as defined under CRD IV (in some aspects less stringent than Basel III). The exercise also underscored the importance of improving public disclosure of French financial institutions.

23. **The results suggest that banks could cope with a deterioration in the economic environment while phasing in capital requirements under CRD IV (Figure 4).** Effects on capital ratios in 2012 and 2013 were largely driven by credit risk. The adverse scenario affected the probability of default (PD) of corporate and retail customers, forcing higher provisions. Changes in RWA were limited by a mild deleveraging effect embedded in the scenario (credit growth follows nominal GDP and declines by 0.7 percent in 2012) and also by the use of through-the-cycle PDs by the authorities and banks' models. The recovery phase in 2014–16 helped smooth out the impact of the introduction of CRD IV.[7] The largest impact from the introduction of the new regulation took place in 2015 and 2016 (a reduction in CET1 ratio of about 43 bps and 82 bps, respectively, above the impact of the adverse scenario, Figure 4). Sensitivity tests of concentration also pointed to the predominance of credit risk from name concentrations mainly in France, Italy, and the United States.

24. **Banks appeared resilient to market risk and reductions in exposures had limited the impact of sovereign risk.** BU stress tests indicated that shocks to equity and real estate prices have a negligible impact on CET1 ratios. Exposures to high-yield Euro area sovereigns were cut substantially in the second half of 2011 and have reduced French banks' vulnerability to a sovereign shock.[8] Nevertheless, non-AAA sovereign debt holdings in available-for-sale (AFS) and trading accounts remain sizeable, in particular to Italy, and a worsening of the euro crisis would cause losses of about 5 percent of the initial CET1 capital level. In addition, sensitivity analysis showed that an extreme shock affecting all sovereign holdings (including France) in all books would impact the initial aggregate CET1 capital level by a further 5 percent.

25. **Despite improvements in bank funding profiles during 2011, vulnerability to liquidity shocks was material (Table 2).** Liquidity stress tests assessed resilience to a strong shock characterized by run-off rates and haircuts on assets calibrated by type on French historical data, and no market access. Assuming no recourse to ECB liquidity, the significant reliance on short-term funding would result in difficulties for two banks to meet liquidity

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[7] Like previous versions of CRD, the CRD IV/CRR proposals give competent authorities the possibility to permit banks not to deduct insurance holdings under certain conditions. For some banks, this can result in higher Tier 1 capital than would be the case under Basel III.

[8] In the second half of 2011, cross border public sector exposures of French banks fell by 38 percent to Italy, 39 percent to Spain, 39 percent to Greece, 32 percent to Portugal, and 26 percent to Ireland.

needs from outflows (mostly unsecured wholesale funding from banks and other institutions) with available buffers, standby liquidity from inflows, and asset sales. A two-notch bank downgrade under these circumstances could impose added stress through collateral and margin calls, with a significant effect on some banks. All banks would pass the test, assuming access to ECB liquidity. A reverse stress test on the maximum potential loss of wholesale funding, by currency, which each bank could suffer while still meeting contractual obligations showed similar dependence on ECB funding in the event of a closure of funding markets, with three of the banks recurring to central bank liquidity above a 5 percent loss of wholesale funding. With ECB support, four banks would be able to address up to a maximum loss of about 15 percent of all wholesale funding.

26. **Contagion risk appeared limited among French banks, but larger with non-French bank counterparties.** The French banking network is moderately concentrated, with most interbank exposures within it relatively small. In terms of net exposures, while two banks lend 60 percent of all interbank net flows and one bank receives over 40 percent of French interbank flows, these exposures are relatively small (under 3 percent of total assets). Therefore, contagion risk among French banks appears limited and failure of a single bank would result in a CET1 ratio decline to 8.5 percent from 9.9 percent. Larger contagion effects may instead emerge from exposures to non-French bank counterparts in the interbank market. These counterparts include other European banks, U.S. investment banks, and banks from Japan and Gulf Cooperation Council (GCC) countries.

27. **Going forward, more regular use of ACP' stress testing capabilities would help the monitoring of bank capital and liquidity plans.** The ACP has started using bank-by-bank TD stress tests, including as a benchmarking tool for BU tests run by banks, and should refine further the toolkit to assess risks to financial stability to allow projections of losses by risk type and RWAs by asset class, and through collection of more granular bank-by-bank data (for instance, for the calculation of risk parameters related to retail lending).

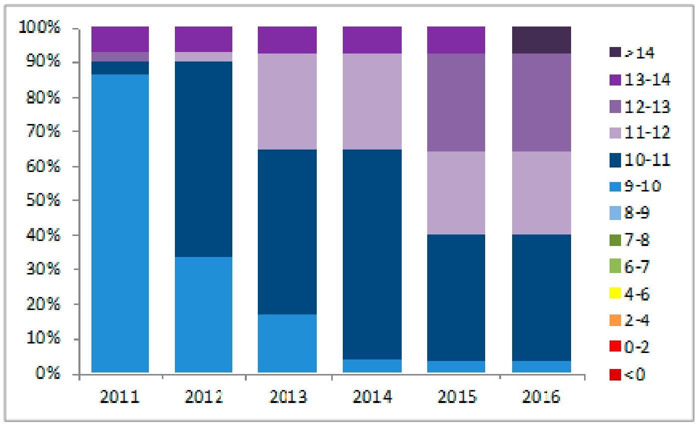
Table 2. France: Bank Liquidity Stress Test Results

Survival period	Up to one day	Greater than one day up to one week	Greater than one week up to one month	Greater than one month up to two months	Greater than two months up to three months	Greater than three months up to six months	Greater than six months up to one year	Greater than one year up to two years
Number of banks meeting contractual obligations without ECB support	7	6	6	6	6	5	5	5
Number of banks meeting contractual obligations with ECB support	7	7	7	7	7	7	7	7

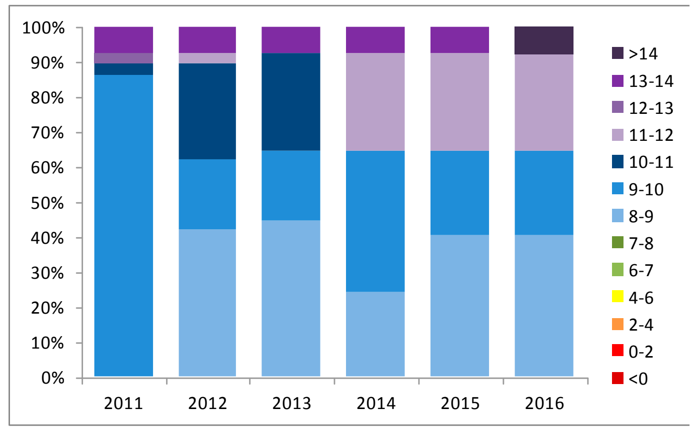
Source: ACP.

Figure 4. France: Bank Solvency Stress Test Results, CET1 Ratios

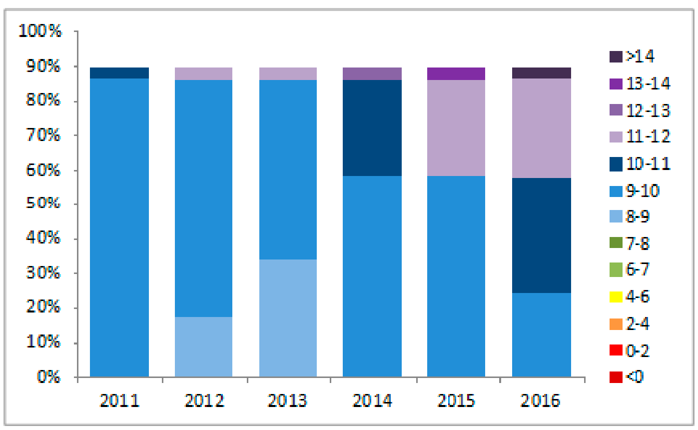
BU: **Baseline Scenario**
(In percent of total assets)



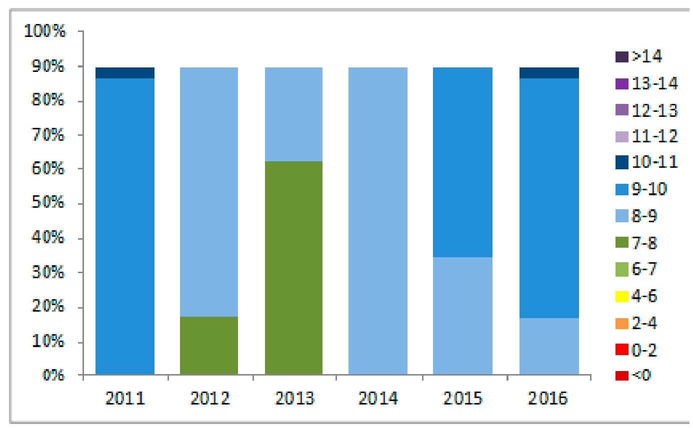
BU: **Adverse Scenario**
(In percent of total assets)



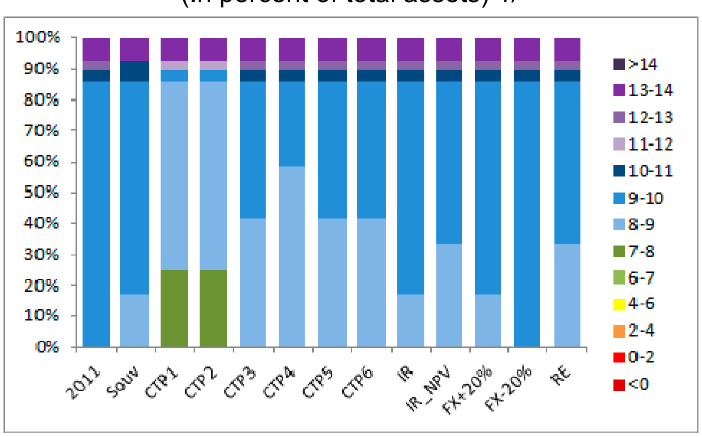
TD: **Baseline Scenario**
(In percent of total assets)



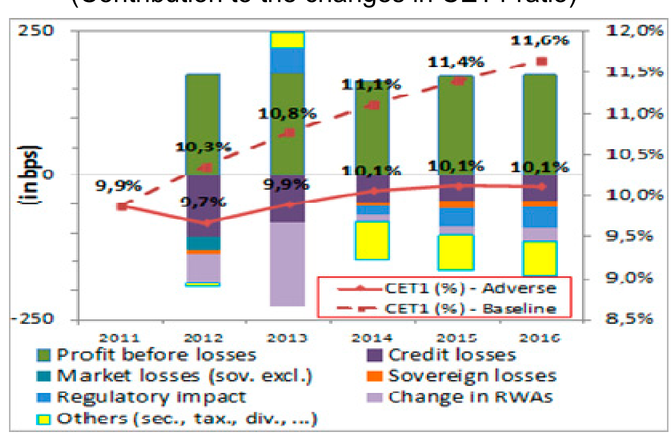
TD: **Adverse Scenario**
(In percent of total assets)



Sensitivity Analysis
(In percent of total assets) 1/



BU: **Adverse Scenario 1/**
(Contribution to the changes in CET1 ratio)

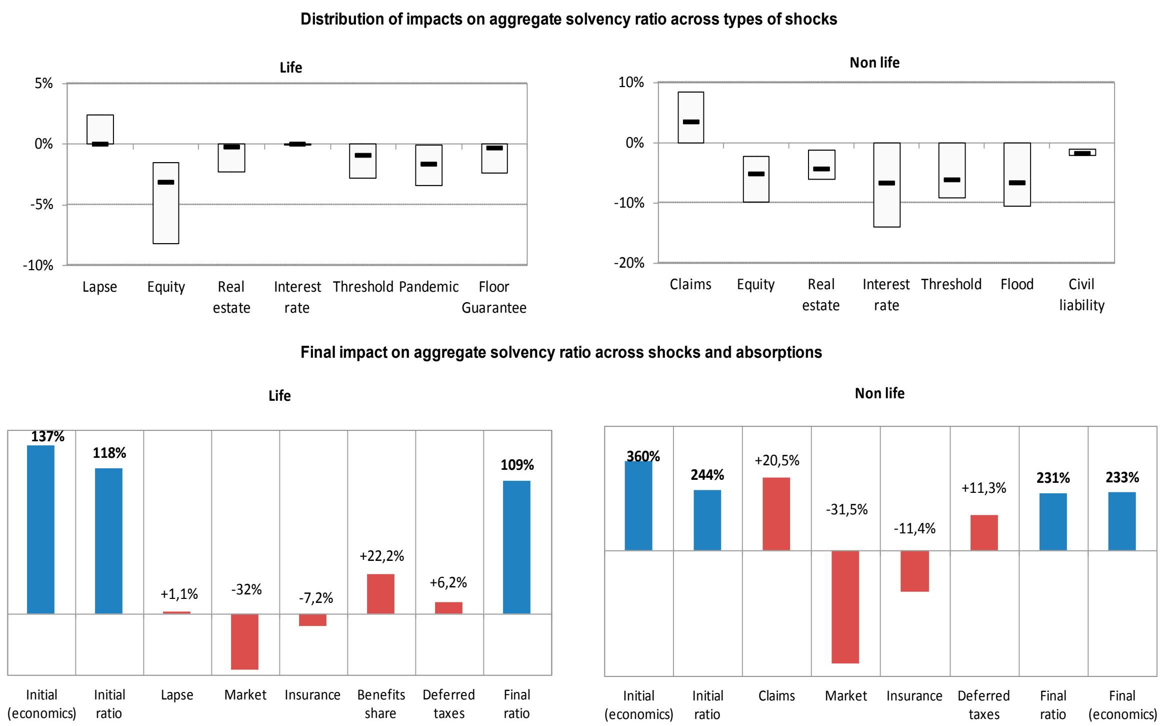


Source: ACP. The results do not include Caisse des Dépôts et Consignations.
1/ For a list of shocks, see Appendix III, Solvency Risk, Bottom-up, Sensitivity Analysis.

Insurance stress-testing analysis

28. **Stress tests suggest that French life insurers are well positioned to overcome liquidity, market, and insurance shocks (Figure 5).** The tests were run on a solo basis on 12 life insurers accounting for 70 percent of the domestic market. Despite an unfavorable environment in 2011, the impact on life insurers' solvency ratios was moderate, thanks to absorption mechanisms linked to revenues attributed to beneficiaries, as companies were able to tap into reserves to offset shocks.[9] Final cash flow was positive for all companies during the year, but some companies chose to hold larger portions of their assets in the form of cash as surrenders were peaking and in the context of high uncertainty regarding the future evolution of fixed income markets (especially due to interest rate changes).[10] Under the most severe application of the global scenario, only two entities would present a solvency ratio below 100 percent and the average solvency margin for the participating companies would approximate 109 percent of current requirements.

Figure 5. France: Insurance Stress Test Results



[9] French life insurance savings products participate in the profits of operation. Each year the client's account is credited with a guaranteed rate of interest plus a bonus amount derived from the company's profits in preceding years. Part of yearly profits are set aside into reserve funds to smooth bonus payments in "bad" years.

[10] Under Solvency I, assets are carried at book value. Barring the need to liquidate assets (or in case of a credit event or default), fluctuations in market value would not have an impact on insurers' portfolios.

29. **The impact on nonlife entities of the market and insurance shocks would be greater, partly because nonlife insurers do not have as many shock-absorption mechanisms as life insurers.** Two nonlife entities would have a solvency ratio below 100 percent after the shocks were applied. As compared to life insurers, insurance shocks are more significant for nonlife insurers. However, the impact of insurance shocks is tempered by the reinsurance coverages that companies maintain, including particularly the national risk pool that gives protection in the event of natural disasters and by the high level of solvency margin. For the participating companies, the solvency margin averages 231 percent of requirements, following the application of shocks, as compared to 244 percent before shock.

III. Toward a Stronger Financial Stability Framework

30. **In the aftermath of the crisis, the French authorities took a number of steps to strengthen their oversight framework (Box 4).** Most importantly:

- The *Autorité de Contrôle Prudentiel* (ACP), attached to BdF, was established, bringing together responsibility for prudential supervision of banks, insurers, investment firms and market infrastructure providers, and a new mandate for consumer protection; and

- The *Conseil de Régulation Financière et du Risque Systémique* (Corefris) was created as an interagency cooperation and coordination mechanism on systemic risk prevention and management, including in crisis times.[11]

31. **As a newly created integrated regulator, ACP is starting to benefit from synergies in banks and insurers supervision.** The benefits from being part of BdF are likely to become more important as systemic considerations are added to micro-prudential supervision, and ACP and BdF are well placed to achieve more day-to-day cooperation on these issues. At the same time, the new consumer protection mandate has used material additional resources. It will be important going, forward not to let consumer protection crowd out the essential micro-prudential contribution of the ACP to financial stability.

32. **The establishment of Corefris is an important step in developing mechanisms to mitigate systemic risk.** Corefris is not a decision-making body, as each individual authority retains responsibility to act in its own right. France has not yet designated an authority with formal powers to conduct macroprudential policy as envisaged by CRR/CRD IV. To be credible, this authority should anchor decision making in analyses of financial stability that help shape the knowledge and expectations of market participants and the general public.

[11] Corefris is chaired by the Minister of Finance and comprises the presidents of ACP (BdF governor), AMF, and *Autorité des Normes Comptables* (ANC), and three qualified persons nominated by the Minister of Finance.

Box 4. Institutional Framework for Financial Sector Oversight

Following the crisis a number of steps were taken to strengthen the oversight framework. Current responsibilities for financial supervision are shown in the table below and discussed in the following paragraph.

	Insurance	Banking	Investment Service Providers	Market Infrastructure Providers	Asset Management
Regulation	**Minister of Finance**	**Minister of Finance**	**AMF**	**AMF**	**AMF**
Rules of conduct 1/	**ACP**	**ACP**	**AMF**	**AMF**	**AMF**
Prudential supervision	**ACP**	**ACP**	**ACP**	**ACP**	**AMF**
Licensing	**ACP**	**ACP**	**ACP**	**ACP**	**AMF**
Consumer protection	**ACP and AMF** (with Joint unit - *Pôle commun*)				

1/ For Banking and Insurance "Rules of Conduct" means "Consumer Protection" for retail banking and insurance clients.

Role of the Ministry of Finance (MoF)

Within the MoF, the Directorate General of Treasury (DGT) prepares financial sector legislation and regulation (except in the securities area), participates in European and international negotiations, and contributes to the implementation of the regulatory framework, in particular via its attendance (with no voting rights) to the ACP, AMF, and H3C Boards' meetings (except deliberative meetings for sanctions). The MoF representative in ACP and AMF can ask for a second deliberation in certain circumstances (except regarding sanctions).

Supervision of banks and insurance companies

ACP is responsible for licensing and prudential supervision, including sanctioning powers, of banks and insurance companies. ACP's statutory objectives are to maintain financial stability through supervision of banking and insurance risks, to provide protection for bank customers, and insurance policyholders and beneficiaries, and to supervise consumer protection, a responsibility that was not held by either of the predecessor organizations. ACP represents France for matters within its jurisdiction, specifically international prudential regulation in the European Union and wider international negotiations such as the Basel Committee for Banking Supervision, and supports the French representatives on the Financial Stability Board (FSB). The ACP General Secretariat operates as a General Directorate of BdF.

Supervision of securities markets

Oversight of securities markets involves ACP and AMF under a twin peaks-type model, and the *Haut Conseil du Commissariat aux Comptes* (H3C). ACP performs the prudential supervision of investment services providers and market infrastructure providers, including regulated markets, multilateral trading facilities, and central clearing counterparties (CCPs). AMF is responsible for market and business conduct supervision of all market participants. It is the prudential supervisor of portfolio management companies and the funds they administer. H3C is in charge of the oversight of external auditors of public interest entities, which includes issuers as well as companies such as banks and insurance companies.

Coordination between the ACP and the AMF on consumer protection issues

In view of shared mandates of ACP and AMF in consumer and investor protection an institutional coordination unit (Joint unit - *Pôle commun*) was established, with no change in the two authorities' respective powers. The unit allows ACP and AMF to alert each other to mis-selling risks, to exchange views on how to prevent such risks, and to take joint action.

33. **In this context, disclosure of conditions and risks in the financial system could be markedly enhanced.** Such disclosures are important for enabling market discipline, and France lags behind many other countries in this area. ACP should publish regular and comparable bank-by-bank data, including data from prudential returns, when appropriate. All major banking groups should publish more detailed quarterly financial information, with disclosures harmonized at both the group and the listed entity level for cooperative banks. While BdF publishes an annual thematic Financial Stability Review, reports of BdF, ACP, and Corefris should provide comprehensive information on financial sector developments in France. Such an exercise is in place, but no decision on publication has been taken.

34. **Cross-Board memberships among financial authorities provide a powerful means for cooperation and information sharing, but could also blur accountabilities.** The close organizational links between the authorities enable coordination, but could also blur transparency and accountability. Furthermore, the treasury, which has overall responsibilities for legislation and secondary regulations in the financial field (except in the securities area), participates, without voting rights, at the meetings of the Boards of several supervisory bodies with the right to ask for a second deliberation in certain circumstances. This involvement, which allows MoF to receive early comprehensive information on trends in individual institutions and in the banking system, could nevertheless present potential conflicts of interest. Consideration should be given to establishing separate coordination arrangements to ensure that effective advice, knowledge about crucial supervisory decisions, and the reasoning behind proposed regulatory changes still occurs, but in a manner that avoids the perception of threats to supervisory independence.

35. **It will be important that the national financial reform agenda be clarified to eliminate regulatory uncertainty.** The agenda put forward in the context of the electoral campaign is being spelt out in more detail by the government, and is likely to include: (i) a phased doubling of the ceiling on the *Livret A* and *Livret de Développement Durable* guaranteed remuneration rate above inflation; (ii) the implementation of internationally agreed standards on banks; (iii) a rearrangement of existing support programs to SMEs and innovation within a new public financial institution; (iv) a broader financial transactions tax in line with the EU Commission's 2011 draft proposal; (v) a reform of the corporate tax; and (vi) the implementation of structural reforms of the banking sector in liaison with the EU timeline, taking into account the recommendations elaborated at the European level by the Liikanen High-Level Expert Group.

A. Banking Supervision

36. **France has a high level of compliance with the Basel Core Principles for Effective Banking Supervision (BCPs).** ACP's supervisory practices are of a very high standard, incorporating many high-quality processes. ACP operates an extensive, detailed, and in-depth program of onsite inspections and high-quality offsite supervisory processes that monitors the individual major bank's financial situation and risk management and

control practices on a consolidated basis, building on constructive home-host relationships. The onsite process is comprehensive and of high quality, but the necessary time taken for due process means that there can be a lag in supervisory recommendations being communicated to the firms. ACP should continue to build on recent developments to put in place a more flexible, timely, focused feedback mechanism as a complement to the already strong onsite process. ACP is at an early stage in assessing the quality of risk governance and feeding it into overall assessments, in part hampered by legal obstacles to interact directly with Boards. There is scope to better define the rating criteria to assist supervisors in forming a judgment on the quality of risk management.

37. **While the intention clearly is for ACP to be independent, certain aspects of the current arrangements have the potential to undermine this objective.** The issues concern potential reputational risk arising from the role of the MoF in the ACP Board, legislative limits on the ACP headcount,[12] and the fact that ACP cannot independently set any prudential rules. These issues affect ACP as a banking and insurance supervisor. ACP could also be given a more formalized role in recommending prudential rules.

38. **The legislative framework is broadly sound, but two deficiencies could hamper supervisory effectiveness.** One is lack of a complete legislative framework related to ACP's powers to regulate the responsibilities of the banks' Board of Directors, as distinct from senior management. This weakness, coupled with ACP's practice of limited direct interaction with the Board, has consequences in several areas, including the integrity of the fit-and-proper process, the inability of ACP to suspend or dismiss Board members (individually or collectively), and ACP's inability to set requirements for Board responsibilities in oversight and risk governance. As a result, the possibility of effective early intervention and the ability to assess whether the Board of Directors of an institution has sound knowledge of the business and risks of a bank is weakened. Irrespective of legislative change, ACP needs to make more use of direct contact with the Board in order to deliver critical supervisory messages as directly and clearly as possible and to ensure that the governance of the bank is appropriate. The second legal issue is that ACP does not have the formal power to approve acquisitions by French banks when the target acquisition is outside France. This can undermine the effectiveness of ACP's otherwise rigorous practice of consolidated supervision. While ACP can react to an unacceptably risky acquisition by a French bank after the fact, this is not as effective as having approval authority ex ante.

39. **While capital requirements are in many ways prudent and appropriate, there are a few areas where current capital regulations in France, pursuant to EU capital rules, fall short of the applicable Basel standards (Basel II.5).** While capital requirements are, in many ways, prudent and appropriate, there are material weaknesses in the definition of capital, and related public reporting vis-à-vis current Basel II/II.5 requirements. This is

[12] However, the BdF has authority to provide resources on top of those from the levy on financial institutions.

particularly the case for bancassurance groups and cross-holdings of banks by certain major internationally active publicly traded entities within some major mutual bank groups. Certain bancassurance groups produce reported Tier 1 capital ratios that are lower than the applicable Basel requirement and can produce reported measures that involve the recognition of capital that may not be available to the banking part of the group, or double counting of capital. For mutual bank groups the overall consolidated group capital calculation is compliant. ACP fully understands the issues and rightly focuses its attention on the consolidated group capital position, on various sub-measures, and on financial relations between the various parts of these groups, and shows an excellent understanding of the situation. However, and despite improvements in the most recent public disclosures after the date of the mission, the current approaches risk confusion for marketplace participants and the authorities should require full and consistent disclosure of the capital treatment in place, and the related financial interactions within complex groups.

- The treatment of bank cross-holdings affects the publicly reported capital of some material internationally active subsidiaries in the affected groups, but does not affect the consolidated capital position of the groups.[13] The result can be double counting of capital in the relevant banking part of the group, or counting as capital amounts that may not be available in the event of need, thus leading to market and investor misunderstanding. This can be exacerbated because of the complexity of the intra-group relations and opacity in disclosures about how the mutual group operates.

- The treatment of insurance investments of bank-insurance conglomerates affects the consolidated Tier 1 capital position, and results in overstatement of this ratio compared to Basel requirements.[14] Total capital ratios for the group are calculated appropriately, but the issue can affect the public disclosures of CET1 ratios by banks within the group.

40. **The ongoing discussions on a single supervisory mechanism (SSM) for euro area banks have the potential to significantly alter supervisory processes in France.** At the time of writing this report, details of the future framework were still being worked out, but the SSM is likely to involve an allocation of supervisory tasks and powers between the center and national authorities. To the extent the key areas of improvement identified may remain a

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[13] For some major mutual groups, cross-holdings of equity between, the main bank, central body (at sub-consolidated level) or main bank's subsidiary and the regional banks that are shareholders of the main bank are not deducted from capital; instead, a risk weight is applied to them.

[14] In France, certain banks have opted to use the EU conglomerate directive method (which Basel II explicitly permits), thereby including insurance entities within the scope of consolidation. Many others deduct insurance cross-holdings, following the preferred approach under Basel II, and allowed by the French and EU rules. However, deductions are from total capital, instead of from Tier 1 and Tier 2 equally.

national responsibility, the recommendations contained herein would help enhance the effectiveness of supervision both before and after the SSM.

B. Insurance Supervision

41. **Insurance regulation and supervision in France is predominantly carried out using a Solvency I approach, though preparations for Solvency II are underway.** The current thorough approach to assessing insurer technical provisions and their coverage by admissible assets, as well as current and likely future solvency of insurers against Solvency I solvency margin requirements, has led to financially sound insurers. The new Solvency II regime is to be more based on economic risk and should provide greater incentives for insurers to properly measure and manage their risks than the current approach; its commencement date, however, is yet to be announced. The ACP's Solvency II preparations are well advanced, and ACP staff have been heavily involved in and have contributed to EU work on Solvency II. As a practical matter, France has been waiting for the finalization of the EU technical standards before moving to implement Solvency II type requirements.

42. **The insurance supervisory framework was assessed against the revised Insurance Core Principles (ICP), issued in October 2011.** This is significant for two reasons: (i) the revised ICPs cover much the same ground as the previous version, but include far more extensive requirements relating to risk management in insurers and macroprudential issues; and, importantly, (ii) the revised ICPs are written in contemplation of the adoption of Solvency II policies and procedures by supervisory authorities.

43. **Regulatory requirements and supervisory assessment of insurer financial soundness, and governance and risk management, will need to change dramatically with Solvency II.** Regulatory and supervisory changes have been delayed until all the details of Solvency II are finalized. It is recommended that there be early introduction of specific requirements for insurer Boards in the areas of risk appetite statements, risk management within the appetites, delineation of responsibilities between the Board and key persons in control functions, remuneration policy, and a duty to act in the interests of policyholders.

44. **Assessment of the suitability of persons involved in insurance operations should be more extensive, covering all key roles in insurers.** Fit-and-proper assessments of persons at licensing, change of control, mergers and acquisition, and when people move should cover all Board members or persons controlling key functions. The EU Solvency II Directive requires that all persons that perform key functions are fit and proper, so changes will need to be made with the implementation of Solvency II. In addition, it is recommended that the ACP's power to remove unsuitable persons be extended to cover all such roles.

45. **Public disclosure requirements on insurers need improving, but changes are also awaiting Solvency II implementation.** Disclosure requirements cover financial statements, including major methodologies and assumptions used. Disclosure of further detail and wider information will also be required with the full implementation of Solvency II.

C. Securities Regulation

46. **France exhibits a high level of implementation of the IOSCO principles.** The legal framework is robust and provides AMF and ACP with broad licensing, supervisory, investigative, and enforcement powers within their respective competencies. There are robust arrangements for cooperation between the two authorities. Offsite mechanisms are in place and risk-scoring frameworks have been developed for investment services providers by ACP, and for portfolio management companies by AMF. The authorities have also established arrangements for the oversight of the French portals of the New York Stock Exchange (NYSE) Euronext and the various related trading platforms. In addition, AMF has robust market surveillance systems and has been active in enforcement of market abuse provisions. Finally, the authorities have achieved concrete results in the implementation of supervisory arrangements in the new areas identified in the current IOSCO principles, in particular, those pertaining to the identification and monitoring of emerging and systemic risks, although best practices in this area have not yet emerged and guidance from IOSCO is limited.

47. **Some areas of supervision and enforcement require strengthening.** AMF should dedicate more resources to onsite work (including inspections) of investment services providers, notably financial investment advisors. Given AMF's well established hands-on enforcement culture, these measures should have a positive impact on the effectiveness of enforcement activities. Regarding ACP, a greater use of stronger enforcement measures, including sanctions whenever necessary, would be desirable to support moral suasion, and more frequent reporting of capital adequacy would enhance the ACP supervisory approach of investment services providers, and, in particular, its early warning mechanism. The effectiveness of H3C in supervising auditors´ oversight is severely constrained due to limited human resources. Increasing staffing levels, as already envisioned, is therefore an urgent priority. In addition, giving H3C greater direct enforcement powers would enhance the overall effectiveness of the auditors' oversight.

48. **Certain aspects of the governance structure of AMF and H3C could potentially undermine independence, though there is no evidence of problems to date.** As for ACP, the treasury participates in all deliberations of the AMF Board (without having a voting right but with the ability to ask for a second deliberation), as well as the AMF enforcement committee (except during deliberations). In addition, the participation of industry representatives—some on active duty—in the Boards of AMF and H3C has the potential to create conflict with commercial interests. While arrangements are in place to address conflicts of interest, alternative mechanisms should be established to ensure that market expertise is brought into the decision-making process. Finally, given the current governance model whereby different interests are represented at the level of the Board, the limited direct representation of retail investors at that level should also be addressed. As for ACP, the current legislative limits to AMF and H3C headcount could potentially affect the ability of the supervisors to command sufficient resources for market supervision.

49. **Finally, market fragmentation poses challenges to transparency and securities markets oversight that should be addressed at the European level.** The implementation of the Markets in Financial Instruments Directive (MiFID) of the European Union has allowed transactions costs in the European securities markets to be reduced. At the same time it has led to market fragmentation, which can only be successfully addressed at the European level. The current review of MiFID provides an opportunity to address these challenges.

D. Soundness and Oversight of Market Infrastructures

50. **LCH.Clearnet SA, the central counterparty (CCP), displays a high level of observance of the CPSS/IOSCO recommendations.** It has a sound and transparent legal basis and an adequate risk management framework to address financial and operational risks. The participant default rules and procedures are comprehensive. Participant assets as well as the CCP's collaterals are safely kept in supervised banks and regulated securities depositories. The liquidity risk is minimized by settling the cash in central bank money and having access to central bank facilities. Its governance arrangements and composition of Boards and management are well defined and adequately staffed.

51. **LCH.Clearnet SA has managed well the challenges of the financial crisis, and enhancement of its functionalities will further contribute to financial stability.** It dealt promptly with the default of some major participants. It also managed effectively the risk of increased price volatility, including of sovereign debt. Nevertheless, its resilience could be further strengthened by monitoring and measuring its exposures continuously throughout the business day and intensifying the use of stress testing and back-testing mechanisms. LCH.Clearnet SA should strengthen its control of the information technology company that supplies and operates the infrastructure and should formalize external audits. Going forward, it is important that the ongoing reorganization of ownership structure and realignment of business lines does not erode LCH.Clearnet SA's decision-making process, so as to enable them to manage risks and meet local market needs.

52. **The regulatory, supervisory, and oversight framework is comprehensive and effective.** As a credit institution, LCH.Clearnet SA is subject to the supervision of the ACP, as a clearing house to the regulation of the AMF, and as a systemically important market infrastructure to the oversight of BdF. The authorities' objectives, policies, and roles are well defined and made public.

53. **Nevertheless, the BdF should have a stronger legal basis to effectively implement its oversight responsibility.** Enforcement of the supervisory and oversight framework can be further improved by increasing the intensity of onsite inspections, including the participation of staff from all relevant authorities. Cooperation and coordination among the relevant domestic authorities have a solid legal basis, including exchange of confidential information. Cross-border cooperation with relevant foreign authorities is well developed and seems to be

effectively implemented, including the existence of comprehensive memoranda of understanding and a college that meets on a regular basis.

E. Crisis Management and Safety Nets

54. **Already before the crisis, France had a comprehensive framework for crisis management and bank resolution, which has allowed the authorities to deal with problem financial institutions effectively (Box 5).** With some exceptions, the framework contains the instruments and measures that now constitute international best practices:

- The ACP has available a broad set of powers to initiate or execute resolution with the aim to restructure the institution or ensure its orderly liquidation, although no specific resolution framework for financial institutions is in place. The formalized framework of interaction between ACP (sometimes also the Fond de Garantie des Dépôts-FGD) and the judicial system will ensure the fair treatment of owners and other rights' holders and the broader interests, such as financial stability, of society at large.

- The ACP's crisis preparation, identification, and management processes are comprehensive and well structured. They allow proper identification of weak banks and requests for appropriate remedial measures to be taken (although with delays in some cases). The ACP actively uses the Basel II Pillar 2 instrument to require add-ons to the minimum regulatory capital requirements on an individual bank basis, reflecting the assessed riskiness of a bank.

- The ACP has at its disposal a wide range of remedial and sanctionary powers (i.e., the right to appoint an interim administrator). Ultimately, it may revoke the license of a bank, which automatically starts the judicial liquidation process. That said, the ACP would benefit from a structured framework for "early action" in which supervisory judgments as well as formal breaches of regulations may lead to remedial measures (as the current focus on formal breaches may lead to delayed action).

55. **Progress is well underway on preparation of recovery and resolution plans (RRPs) for the large banks.** Banks have submitted to the ACP group-wide RRPs, capturing all key dimensions. Related issues have been discussed since 2009 in the core supervisory colleges, among French authorities, and since 2011, in Crisis Management Groups (associating central banks and supervisors from relevant host jurisdictions).

56. **As expected, the specific and only role of BdF in the safety net is the provision of liquidity through standing or extraordinary facilities**. All liquidity provision is subject to the rules and restrictions of the Eurosystem.

Box 5. Recent Interventions in the French Financial Sector

Dexia Group (2008 and 2011–12)

The Dexia Group, owned by a financial holding company controlled by Belgian interests, started facing liquidity pressures in 2008 when market liquidity dried up. A business strategy characterized by long-term lending funded to a large degree by short-term market funding was accompanied by a traditional interest rate hedging strategy. This led to large losses and margin calls, when interest rates turned down after the Lehman crash. Support in 2008 included:

- *Capital support*: €6.4 billion overall, shared by Belgium, France, and Luxembourg. French support consisted of €1 billion from the government and €2 billion from CDC, already a shareholder in Dexia Credit Local France (DCL).
- *Liquidity support and guarantees*: BdF provided liquidity support. State guarantees amounted to €150 billion (shared between Belgium, France, and Luxembourg based on controlling interest), later reduced to €100 billion.
- *Other support*: A first-loss guarantee on a DCL-held portfolio of US-based assets of $12 billion was provided by France and Belgium. This portfolio was sold in 2011 without invoking the guarantee.

During the second half of 2011, funding markets again dried up for Dexia, prompting additional support. A group restructuring in November 2011 entailed state guarantees by France, Belgium, and Luxembourg of up to €90 billion, of which €55 billion received European Commission approval. Additional capital injections into Dexia SA of €5.5 billion by the governments of Belgium (€2.9 billion) and France (€2.6 billion), as well as additional state guarantees (up to €85 billion) under a modified burden sharing key, were proposed in November 2012. The exit strategy for DCL involves its sale, partly or wholly, to other parties having similar lines of activities, such as the CDC and/or the Banque Postale; approval of the plan by the European Union is expected by the end of 2012.

Groupama (2011)

Groupama, one of the largest writers of nonlife insurance in France and ranking among the top five writers of life insurance, experienced financial stress in 2011. An expansion to new lines of business domestically and abroad led to risky investments, exposure to high-yield Euro area countries, and net losses of €1.8 billion in 2011, including €1.55 billion on Greek sovereign debt and €1.5 billion on equity investments. During this period, operating income grew strongly, and the solvency position of the insurance firms remained above 100 percent of statutory requirements.

In order to strengthen its financial position, management of the group was restructured in late 2011 and a restructuring plan is being implemented. The plan includes the sale of subsidiaries abroad. Efforts are also underway to reduce exposure to market risk and volatility in the investment portfolio. The exposure to real estate and equities is being reduced. All sovereign debt positions are being reviewed with a view to reducing these exposures as well.

Crédit Immobilier de France (2012)

The business strategy of Crédit Immobilier de France (CIF)—a wholesale-funded mortgage financial institution—came under stress in 2011. This was due to rising impairment charges and funding costs against a relatively low earning generation capacity, due to a concentration of mortgages on low-income borrowers. The external auditor's unwillingness to attest to the "operating continuity" of CIF led to a suspension of public trading of its bonds by AMF. CIF 2011 accounts were published in May 2012 under going concern principles, and the trading suspension was lifted. While CIF appears to have a relatively strong but declining equity base (Tier 1 Basel II: 14.8 percent at end-2011) and the quality of its loan portfolio appears to be sound, its business model is not considered viable in the long run, given its exclusive reliance on wholesale funding. Discussions are ongoing to find an investor able to provide the backup funding CIF is lacking. While its size is limited (total assets are about €40 billion), difficulties at the CIF could hurt the operation of the French covered bond market (CIF has issued about €25 billion of such obligations), although no impact has been observed so far and investors appear to have identified the specific nature of CIF's problems.

57. **Coordination in monitoring of financial stability and in the prevention and management of crises is likely to be facilitated by the structural relationships between the relevant authorities.** In the current structure, it makes sense to leave the leading role in crisis prevention and management to the ACP, while the BdF leads on wider macrofinancial monitoring. However, best practices for governance and accountability require that the separate views of the relevant agencies, based on their specific objectives, be expressed transparently. Accountability and transparency could be increased by (i) publishing ACP meeting records, except when individual institutions are involved; and (ii) written consultations between the ACP and the BdF on issues pertaining to their respective mandates; or financial stability and macroprudential considerations regarding the ACP. It should be noted that no domestic Memorandum of Understanding specific to crisis management has been agreed.

58. **The *Fonds de Garantie des Dépôts* (FGD) may operate both as a pay-box for compensating depositors and as a scheme to intervene in financial institutions to ensure orderly resolution.** The FGD's decision on whether to provide financial support or pay out depositors in liquidation will be based on "least-cost" considerations. The procedure, in which the ACP recommends but does not compel the FGD to intervene, is appropriate since the ACP has good knowledge of the concerned bank and of the state of the financial sector, and is therefore well placed to assess the chances of a successful intervention. However, it is inappropriate that a privately owned FGD may potentially provide open bank assistance since this may increase the losses to the deposit fund.[15]

59. **Several measures would increase the effectiveness of the FGD:** (i) formalizing the rules on communication from the ACP on problem banks to ensure that information is provided on a timely basis; (ii) modifying the composition of the FGD Board, which contains active bankers, so as to limit the potential for conflict of interest issues; (iii) expanding the powers of the FGD in the resolution process, e.g., the power to subscribe to the capital of a newly established bank ("bridge bank") in order to assume assets and liabilities from a failing bank; and (iv) ensuring that the FGD may only provide open bank assistance after a clear assessment that the bank is viable in the medium to long term.

60. **The authorities intend to move expeditiously with adoption of the proposed EU Resolution Directive, published in June 2012.** Under the draft directive, member states will be required to have a minimum set of resolution tools, including a sale-of-business tool, a bridge institution tool, an asset separation tool, and a statutory bail-in tool.[16] Resolution

[15] The FGD could be also at legal risk in such a case, as one of its criteria when designing a discretionary intervention is to act in such a way that the cumulative costs of the preventative action and a possible pay-out afterwards would reasonably stay in line with the cost of a direct pay-out.

[16] The bail-in tool may only be applied to (i) recapitalize an institution if it would restore regulatory compliance and long-term viability; or (ii) convert to equity or reduce the principal amount of claims or debt instruments

(continued)

authorities will also need to have all legal powers necessary to apply these tools, including powers to force a sale, to write off or cancel shares, to write down or cancel debt, to replace senior management, and to impose a temporary moratorium on the payment of claims. As for the European Union more generally, once implemented, the directive will result in a significant improvement in the bank-resolution capabilities of French authorities.

F. Anti-Money Laundering and Combating the Financing of Terrorism

61. **France has in place a comprehensive legal and institutional framework that achieves a high level of compliance with the Financial Action Task Force (FATF) 40 + 9 Recommendations.**[17] The regime is largely in line with the standard for anti-money laundering and countering the financing of terrorism (AML/CFT) that was in place at the time of the mutual evaluation visit[18] in a number of areas, including the criminalization of money laundering and terrorist financing on the basis of United Nations conventions, and international cooperation and exchange of information. Customer due diligence, record keeping, and suspicious transaction reporting requirements are largely compliant with the standard. Supervision of financial institutions is efficient and effective.

62. **A key remaining challenge is the low level of compliance of the nonfinancial professions.**[19] The supervisory and sanctions regime for nonfinancial professions needs to be enhanced. In response, a national entity was created in 2011 to enhance reporting entities' and especially the nonfinancial professions' involvement in and commitment to the AML/TF process, allowing for the exchange of views between the reporting entities and public authorities on the implementation of the FATF standard. There remain also doubts on how effectively AML/CFT measures are implemented in the overseas territories, suggesting vulnerability in the French AML/CFT system.

63. **Moreover, additional measures are required in some areas.** For example, legislative measures to enable authorities to seize and confiscate laundered property and proceeds of money laundering and predicate offenses should be completed. While dematerialization of securities has reduced risks related to shareholder anonymity, the identification of nonresident shareholders needs to be enhanced. Although it appears that

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that are transferred to a bridge institution with a view to capitalizing the bridge institution. The proposal lists liability that would be excluded from the scope of this tool.

[17] This section draws on the Financial Action Task Force (FATF) Mutual Evaluation Report of France undertaken in early 2010. The report was adopted by FATF plenary in February 2011. The Report on Observance of Standards and Codes is expected to be published in early-2013.

[18] FATF adopted a revised standard on in February 2012.

[19] Notably, casinos; real estate agents; company domiciliation agents; and jewelers.

TRACFIN (the financial intelligence unit-FIU) has made good progress in carrying out its mission of collecting, analyzing, and disseminating suspicious transaction reports to the judicial and law-enforcement authorities, it needs to issue more guidance to the nonfinancial professions and requires additional resources to increase its analytical capacity. TRACFIN has undergone a reorganization since its mutual evaluation to better focus on the core functions of FIUs, and has adopted a more pedagogical approach toward the nonfinancial professions through bilateral engagement in order to foster greater commitment on their part to AML/CFT.

APPENDIX I. MAIN RECOMMENDATIONS OF THE 2004 FSAP

Main Recommendations	Implementation Status
Commercial Banks	
Ongoing efforts to reform the government's influence over savings allocation through various schemes and fiscal incentives should be accelerated with a view to establishing eventually a fully market-based system. In the short term, focus should be on reducing the distortions caused by the schemes and realigning them with current priorities, without triggering instability in the process. In the medium term, the objective should be an orderly phase-out of the schemes.	***Partly done.*** While the 2009 Livret A Reform extended the right to distribute the savings product to all banks in order to comply with European directives, it did not establish a fully market-based system.
Given the level of financial system concentration, continued vigilance is needed to preserve a healthy competition. Ongoing efforts to improve disclosure and pricing transparency requirements for banking services will foster competition and should be continued. Separating La Poste's banking activities and subjecting them to standard prudential requirements is welcome, but care is needed to ensure that it competes on a level playing field with other banks. Competition at the retail level and financial services availability could further be enhanced by introducing a positive credit registry.	***Done.*** La Poste's banking activities were transferred to Banque Postale with no supervisory preferential treatment. Coverage of the credit registry was expanded to cover positive information on bank lending to a wide range of clients (including households), and it is used by the banks.
Corporate governance and risk taking of banks (especially mutual groups) need to be monitored carefully, particularly when they are expanding into unfamiliar activities. Potential pressure on banks to over-expand could be eased by reducing barriers to the return of profits to owners.	***Partly done.*** Risk taking monitoring by ACP has been enhanced, but there is room for improving the supervision of corporate governance. In particular, the crisis has shown that certain mutual groups had expanded into areas that generated significant losses.
Some legal reforms are needed to facilitate the provision of credit by improving creditor rights. The ongoing reform of the corporate bankruptcy legislation should help clarify and limit the liability of creditors, while at the same time enhancing the survival chances of troubled companies. In addition, banks should be allowed to write off nonperforming loans without jeopardizing their legal claim on the debtor.	***Done***. The law n°2005-845 of the 26th July 2005 (*Loi de Sauvegarde*) has deeply reformed the bankruptcy legal framework. It creates two new procedures to deal with difficulties before the insolvency: the "*Conciliation*" which could remain confidential and the "*Sauvegarde*," a public and collective procedure. Regarding creditor rights, the ongoing reform of the corporate bankruptcy legislation would help clarify and limit the liability of creditors, while also enhancing the survival chances of troubled companies. In addition, banks would be allowed to write off NPLs without jeopardizing their legal claim on the debtor.

Main Recommendations	Implementation Status
Insurance	
Regulations on corporate governance, internal controls, and risk management should be upgraded and improved. Additional human resources may help speed up efforts to harmonize the supervisory and regulatory framework across the industry. The supervisory agency should be delegated powers from the Minister of Finance to issue regulations, as is already the case in other supervisory agencies.	***Done***. New regulations were issued covering all topics. Only the MoF can issue regulations, but they are produced through the collaborative efforts of ACP and MoF. The ACP can issue binding directives and guidelines needed to give effect to the regulations. With the establishment of ACP, substantial additional resources have been made available for insurance supervision, and all aspects of the industry are now supervised from a single office.
The supervision of the reinsurance sector should be strengthened and France should anticipate the main elements of recent EU initiatives in this area.	***Done***. ACP requires licensed companies to file an annual reinsurance policy statement. Specific reporting forms are to be filed annually providing details of the company's reinsurance activities. ACP cooperates with supervisors in other EU member states to share information on reinsurance (Helsinki protocol).
Securities Market	
The effectiveness of the securities regulator could be strengthened by *requiring* cooperation across authorities and removing the government's presence on the sanctioning commission.	***Partly done***. The current legal framework requires cooperation. The MoF continues to have presence in the Sanctions Committee, although, in that case, it does not have the right to ask for a second deliberation.
Minimum standards of conduct for marketing collective investment schemes (mutual funds) need to be enhanced, as well as the regulator's resources to inspect investment service providers, especially CIS depositories, and its powers to oversee audits of public companies. The timeliness of disclosure to the public of insider transactions should be strengthened.	***Partly done***. Standards of conduct for CIS have been implemented. Resources for inspections of investment service providers (ISPs) continue to be limited, but the AMF has dedicated significant resources to collective investment scheme (CIS) supervision. The H3C was created with a mandate to oversee auditors, however resources are a challenge, as well as lack of direct enforcement authority. Notifications of insider transactions are now in line with best practices.
Payment and Securities Settlement Systems	
Measures should be taken to protect the financial system against potential disruptions that arise in the multilateral netting systems by implementing, as soon as possible, appropriate safeguards to comply with the international standards.	***Done***. The reforms in market infrastructure have involved the implementation of new systems, which have addressed these issues.
An analysis of concentration risk should be undertaken, given the prevalence of tiering in some systems. The analysis may suggest institutional changes to reduce tiering without loss of efficiency.	***Done***. The reforms in market infrastructure have involved the implementation of new systems which have addressed these issues.

Main Recommendations	Implementation Status
Anti-Money Laundering	
The authorities should expand the financial and human resources allocated to TRACFIN, law enforcement and prosecution authorities, and supervisory authorities. In addition, TRACFIN and supervisory authorities should issue guidelines to assist financial institutions in implementing AML/CFT requirements. The authorities should boost efforts to ensure that reporting entities in the DOM-TOM fully comply with their AML/CFT obligations.	***Partly done***. The resources employed by TRACFIN to conduct analysis remain insufficient to cope with the amount of incoming reports. The resources and capacity of law enforcement and supervisory authorities appear to be adequate in metropolitan France, excluding the insurance supervisor. However, more supervisory and law enforcement resources are still required to control overseas territories' activity. Although detailed, written advice for financial institutions on preparing reports exists, other reporting parties, such as the nonfinancial professions, receive only very general information on how to prepare suspicious transaction reports. In general, the quality of reports still needs to be enhanced. Moreover, the level of implementation of the reporting requirement in insurance and securities and overseas territories remains low. The authorities expect that a recently created national entity composed of representatives of the financial and nonfinancial professions and public authorities, and efforts of TRACFIN, will assist in enhancing compliance with AML/CFT requirements.
The regulatory and supervisory gaps with respect to insurance companies and brokers, and entities under AMF's supervision should be promptly addressed. Further attention should be devoted to managing the risks associated with informal money or value transfer businesses, and to ensuring that complete originator information is contained in wire transfers.	***Partly done***. New customer-due-diligence requirements were issued, applicable to all financial institutions. In 2010 licensing and supervision responsibilities were consolidated under ACP. As a result, two authorities supervise financial institutions' AML/CFT obligations: the ACP and the AMF. The effectiveness of the new supervisory system has yet to be assessed. Regulation on information on the payer accompanying wire transfers is applied in metropolitan France and overseas departments in line with the standard. Additional efforts are required to address the provision of informal money or value transfer services by unauthorized entities. It is too soon to conclude whether the oversight of providers of payment services is effective. The authorities are currently working on strengthening regulation for money and value transfer services.

APPENDIX II. RISK ASSESSMENT MATRIX

<table>
<tr><th rowspan="3">Nature/ Source of Main Threats</th><th colspan="2">Overall Level of Concern</th></tr>
<tr><th>Likelihood of Severe Realization of Threat in the Next 1–3 Years</th><th>Expected Impact on Financial Stability if Threat is Realized</th></tr>
<tr><th>(high, medium or low)</th><th>(high, medium or low)</th></tr>
<tr><td rowspan="2">1. Prolonged recession in advanced economies</td><td>Staff assessment: Medium</td><td>Staff assessment: High</td></tr>
<tr><td>Signs of deceleration in global data and recent European political developments continue to fuel uncertainty.
Given real linkages with the United States, Germany, and large southern Euro Area countries, and financial linkages with the United Kingdom, France is exposed to both export and financial shocks.
A weaker global environment would weaken confidence and lower domestic consumption and investment.</td><td>Bank asset quality (and, consequently, equity value) would be affected.
Bank earnings (and therefore ability to recapitalize using internal resources) would be affected due to lower interest margins and higher provisions on nonperforming loans (NPLs).
Increased financial distress and heightened risk aversion would dampen growth by widening spreads and possibly reducing credit supply, amplifying the recession.</td></tr>
<tr><td rowspan="2">2. Strong intensification of the Euro Area crisis</td><td>Staff assessment: Medium</td><td>Staff assessment: High</td></tr>
<tr><td>The European environment is highly volatile and uncertainties remain on Europe's ability to resolve its debt crisis.
Any widening of the crisis in Europe could result in very weak growth for the Euro Area.
Continuing uncertainty among high-yield Euroa area countries could see sovereign spreads widen further.</td><td>French SIFIs' exposure to high-yield Euro area countries (Italy in particular) is large and could translate into bank losses, via declines in loan quality and lower sovereign bond values.
Further deleveraging by French banks may lower returns if this involves disposing of profitable activities.</td></tr>
</table>

Nature/ Source of Main Threats	Overall Level of Concern	
	Likelihood of Severe Realization of Threat in the Next 1–3 Years	**Expected Impact on Financial Stability if Threat is Realized**
	(high, medium or low)	*(high, medium or low)*
3. *France's sovereign rating downgrade*	***Staff assessment**: **High***	***Staff assessment**: **Medium***
	• France's sovereign rating faces the risk of further reductions because of its relatively high public debt stock and budget deficit relative to other AAA-rated European countries. While the authorities are committed to meeting the fiscal targets of France's Stability Program, additional efforts may be required in 2013, if growth is lower than the current official forecast of 1.7 percent. • One rating agency downgraded France's AAA rating in January 2012 and another one in November 2012. A loss of the AAA rating may result in higher French sovereign spreads.	• As of end-2011, the exposure of the eight largest French banking groups to their sovereign was 2.5 percent of their consolidated assets. • Impact on funding costs of banks and corporates due to contagion could be material if not already factored in by markets. • Possible spillovers from sovereign rating downgrade to banks' ratings. • The downgrade in credit ratings could affect French banks' large derivative business and, through higher margin calls, may put pressure on their liquidity.
4. *Closure of wholesale funding to French banks*	***Staff assessment**: **Medium*** • Long-term funding improved significantly in the first months of 2012, following the ECB's three-year LTROs, but has recently become more difficult. Market conditions are still uncertain for the rest of the year. • French banks have significant refinancing needs in 2013–14, and market access may be challenging. • The business model of some French SIFIs has been called into question, since unavailability of low funding costs puts at risk their global investment banking operations.	***Staff assessment**: **High*** • French banks are reliant on significant amounts of wholesale funding. • The domestic interbank market remains partly frozen. French banks, like other European banks, have increased their access to the ECB window. Potential negative second round-effects relate to cross-border interbank exposures and derivatives positions. This could create conditions for a systemic liquidity shock.

Nature/ Source of Main Threats	Overall Level of Concern	
	Likelihood of Severe Realization of Threat in the Next 1–3 Years	**Expected Impact on Financial Stability if Threat is Realized**
	(high, medium or low)	*(high, medium or low)*
5. *Housing price correction*	***Staff assessment**: **Medium*** • Housing prices have been supported until recently by fundamental factors, asset allocation factors (the perception of real estate as a safe haven), and a low interest rate environment. • Downside risks remain due to high LTV ratios, a worsening of the economic outlook, and a possible unexpected increase in interest rates. • Staff estimates suggest that France's housing prices were 10–25 percent overvalued at end-2010.	***Staff assessment**: **Medium-Low*** • Risks to banks appear limited as French households have comparatively low levels of debt and lending standards are overall sound notwithstanding some relaxation during the boom years. • However, given the large share of real estate in total households' net wealth, there are potentially indirect effects via the impact of a real housing price correction on confidence and, thus, on GDP growth (as evidenced during the 2008–09 down cycle).

1/ The risk assessment matrix shows events that could materially alter the baseline path—the scenario most likely to materialize in the staff's view.

APPENDIX III. OVERVIEW OF STRESS TESTS FOR BANKS

Domain	Assumptions: Bottom-Up by Banks	Assumptions: Top-Down by Authorities	Assumptions: Top-down by FSAP Team
Banking Sector: Solvency Risk			
Institutions included	• Eight major banks (BNP Paribas, Groupe Crédit Agricole, Société Générale, Groupe Crédit Mutuel, Groupe BPCE, HSBC France, Caisse des Dépôts et Consignations, and La Banque Postale).1/	• Five banks (BNP Paribas, Groupe Crédit Agricole, Société Générale, Groupe BPCE, and HSBC France).	• Eight major banks (BNP Paribas, Groupe Crédit Agricole, Société Générale, Groupe Crédit Mutuel, Groupe BPCE, HSBC France, Caisse des Dépôts et Consignations, and La Banque Postale).
Market share	• 97 percent of the banking system.	• 85 percent of the banking system.	• 97 percent of the banking system.
Data and baseline date	• December 2011. • Source: institutions' own granular data. • Scope of consolidation: consolidated banking group.	• December 2011. • Supervisory data. • Scope of consolidation: consolidated banking group.	• December 2011 when available. • Public data: Bankscope, Bloomberg, SNL, Annual Reports, EBA, Fitch Reports. • Scope of consolidation: consolidated banking group.
Methodology	• Banks' internal models with FSAP team guidance. • Sensitivity tests.	• Macro stress tests: Authorities' models.	• Balance sheet-based approach by Schmieder et al. (2011).
Horizon	• 2012–16	• 2012–16	• 2012–16
Shocks	*Scenario analysis* • **Baseline**: February 2012 WEO, real GDP growth rate for 2012 is 0.5 percent and for 2013 is 1.0 percent. • **Adverse**: Cumulative deviation from baseline of 2.1 standard deviation of GDP growth for 2012–13, driven by: (1) reduction of external demand caused by a euro area recession, (2) a fiscal shock resulting from a temporary rise in sovereign spreads and funding cost, (3) worsening in banking funding costs that leads to a credit contraction. • Shocks to sovereign spreads. Size of parallel shift by country: 90 bps for France and 160bps for Euro area (weighted average by gross debt). • Additional assumption of investors' flight to AAA sovereign bonds (haircuts only apply to non-AAA sovereigns--France is excluded— in the trading and AfS books—HTM excluded).	*Scenario analysis* • **Baseline**: February 2012 WEO, real GDP growth rate for 2012 is 0.5 percent and for 2013 is 1.0 percent. • **Adverse**: Cumulative deviation from baseline of 2.1 standard deviation of GDP growth for 2012–13, driven by: (1) reduction of external demand caused by a euro area recession, (2) a fiscal shock resulting from a temporary rise in sovereign spreads and funding cost, (3) worsening in banking funding costs that leads to a credit contraction.	*Scenario analysis* • **Baseline**: February 2012 WEO, real GDP growth rate for 2012 is 0.5 percent, for 2013 1 percent. • **Adverse**: Cumulative deviation from baseline of 2.1 standard deviation of GDP growth for 2012-13, driven by: (1) reduction of external demand caused by a euro area recession, (2) a fiscal shock resulting from a temporary rise in sovereign spreads and funding cost, (3) worsening in banking funding costs that leads to a credit contraction. • Shocks to sovereign spreads. Size of parallel shift by country: 90 bps for France and 160bps for Euro area (weighted average by gross debt). • Haircuts applied to all sovereign holdings in all portfolios.

Domain	Assumptions		
	Bottom-Up by Banks	Top-Down by Authorities	Top-down by FSAP Team
	Sensitivity analysis • *Souv*: Liquidation of non-AAA sovereign bonds in the HTM portfolio, by country, assuming that bonds are sold at market values as of December 2011; and (ii) assuming that market values deteriorated as per agreed haircuts. • *CTP1–6*: Failure of largest five corporate exposures by name, and the largest five corporate exposures for the five countries where the bank is most exposed. Exposures comprise lending to the private sector, and counterparty risk from derivatives. • *FX*: A USD/euro exchange rate shock of +/- 20 percent; • *IR*: an interest rate shock of 200 bps affecting positions in the banking book (in order to stress IRBB). This shock will assess the impact of changes in interest rate on solvency due to banks' duration mismatches (including income and valuation effects). • *RE*: A shock to real estate prices of -25 percent. The maximum potential loss of wholesale funding, by currency that each bank can suffer while still meeting contractual obligations, without access to ECB funding (reverse stress tests of liquidity concentration).	Sensitivity *analysis* • Haircuts applied to AAA sovereign debt holdings in all books.	n.a
Risks/factors assessed	• Credit risk (households and corporates, domestic and foreign exposures). • Sovereign risk for non-AAA government bonds (AfS and TB in scenario, and HTM in sensitivity analysis). • Counterparty risk in the banking book. • Funding risk. • Market risk, including equity and exchange rate risks. • Interest rate risk in the banking book.	• Credit risk (households and corporates, domestic and foreign exposures). • Counterparty risk in the banking book. • Sovereign risk for AAA government bonds in all books.	• Credit risk (to the extent of data availability: households and corporates, domestic and foreign exposures) • Sovereign risk for GIIPS, Belgium, and France government bonds (AfS, TB, and HTM). The inclusion of government bonds was limited to publicly available data for all banks. • Counterparty risk in the banking book. • Funding risk.

Domain	Assumptions		
	Bottom-Up by Banks	Top-Down by Authorities	Top-down by FSAP Team
Calibration of risk parameters	• Banks' models for point in time PDs and income. • RWAs were estimated using through-the-cycle PDs. • Change in valuation due to upward shift of the term structure of sovereign risk. • Sovereign risk shock: ninetieth percentile of historical distribution of changes of daily bonds yields for the adverse scenario, and fiftieth percentile for the baseline, using actual maturities.	• Model for income (ROA). • Transition matrices model and stressed PDs for RWA. • RWAs were estimated using through the cycle PDs.	• Models for credit losses (loss loan provisions) and income. • Quasi-IRB approach for RWA. • RWA were estimated using point in time PDs. • Change in valuation due to upward shift of the term structure of sovereign risk. • Sovereign risk shock: ninetieth percentile of historical distribution of changes of daily bonds yields for the adverse scenario, and fiftieth percentile for the baseline, using an assumption of five-year maturity.
Behavioral adjustments	• Deleveraging assumption. • Zero payout under stress.	• Deleveraging assumption. • Zero payout under stress.	• Deleveraging assumption. • Zero payout under stress.
Regulatory standards	• CRD IV (Common Equity Tier 1, Tier 1, Total Capital, conservation buffer, loss absorbency requirement for G-SIBs) for each year of the risk horizon. • Capital ratios phased in line with Title I of Part Ten of CRR. • Regulatory filter for AfS positions.	• CRD IV (Common Equity Tier 1, conservation buffer, loss absorbency requirement for G-SIBs) for each year of the risk horizon. • Capital ratios phased in in line with Title I of Part Ten of CRR.	• Basel III (Common Equity Tier 1, Tier 1, Total Capital, conservation buffer, loss absorbency requirement for G-SIBs) for each year of the risk horizon. • Capital ratios phased in in line with Basel III.
Banking Sector: **Liquidity Risk**			
Institutions included	• Eight major banks (BNP Paribas, Groupe Crédit Agricole, Société Générale, Groupe Crédit Mutuel, Groupe BPCE, HSBC France, Caisse des Dépôts et Consignations, and La Banque Postale).	n.a.	n.a.
Market share	• Ninety-seven percent of the banking system.		n.a.
Data and baseline date	• December 2011. • Source: institutions' own data (including off-balance sheet funding activities of banks). • Scope of consolidation: consolidated banking group.	n.a.	n.a.

Domain	Assumptions		
	Bottom-Up by Banks	Top-Down by Authorities	Top-down by FSAP Team
Methodology	• Cash flow-based liquidity stress test using maturity buckets. • Assumption on withdrawals based on banks' past crisis experiences, benchmarks from previous EBA exercises, and LCR weights, by source of funding. • Assessment of liquidity buffers. • Haircut on assets if sold.	n.a.	n.a.
Risks	• Funding liquidity. • Market liquidity.	n.a.	n.a.
Regulatory standards	• Ability to respond to withdrawals without having access to ECB facilities.	n.a.	n.a.
Banking Sector: **Financial Contagion and Spillover Risks**			
Institutions included	n.a.	• Seven major banks (BNP Paribas, Groupe Crédit Agricole, Société Générale, Groupe Crédit Mutuel, Groupe BPCE, HSBC France, and La Banque Postale).	• Sovereigns to which French banks are exposed.
Market share		• Ninety-five percent of the banking system.	• One hundred percent of the banking system.
Data and baseline date	n.a.	• December 2011. • Source: Large exposures database by the ACP. • Scope of consolidation: Consolidated banking group.	• September 2011. • BIS data on cross-border consolidated banking exposures.
Methodology	n.a.	• Network analysis model developed by the authorities for French banks.	• Network model for spillovers by Espinosa-Vega and Solé (2010).

1/ The results for CDC are excluded from figures and charts included in the document.

Appendix Table 1. France: Selected Economic Indicators, 2009–17

				Projections					
	2009	2010	2011	2012	2013	2014	2015	2016	2017
Real economy (change in percent)									
Real GDP	-3.1	1.7	1.7	0.2	0.4	1.0	1.5	1.7	1.9
Domestic demand	-2.6	1.6	1.7	-0.4	0.5	1.2	1.3	1.3	1.5
Nominal GDP (billions of euros)	1886	1937	1997	2042	2095	2161	2244	2334	2433
CPI (year average)	0.1	1.5	2.1	2.0	1.6	1.5	1.7	1.8	1.9
Unemployment rate (in percent)	9.5	9.7	9.6	10.3	10.6	10.7	10.5	10.1	9.7
Gross national savings (percent of GDP)	17.6	17.7	18.7	18.5	18.2	18.2	18.7	19.3	19.8
Gross domestic investment (percent of GDP)	18.9	19.3	20.6	20.0	19.7	19.8	19.9	20.0	20.1
Public finance (percent of GDP)									
Central government balance	-6.2	-6.3	-4.4	-3.7	-2.7	-2.1	-1.5	-1.0	-0.2
General government balance	-7.5	-7.1	-5.2	-4.5	-3.5	-2.9	-2.1	-1.2	-0.1
Structural balance (percent of potential GDP)	-4.7	-4.6	-3.5	-2.6	-1.4	-1.1	-0.8	-0.5	0.0
Primary balance	-5.1	-4.7	-2.6	-1.9	-1.0	-0.4	0.4	1.3	2.4
General government gross debt	79.0	82.3	86.0	89.5	90.9	91.3	90.2	88.0	84.6
Money and interest rates (in percent)									
Money market rate 1/	0.7	0.5	0.8	0.1	...	...	...	...	...
Government bond yield 1/	3.6	3.1	3.3	2.6	...	...	...	...	...
Balance of payments (in percent of GDP)									
Exports of goods	18.4	20.2	21.2	21.1	20.6	20.3	20.3	20.5	20.7
Volume growth (in percent)	-12.1	9.6	5.3	2.5	0.6	2.4	4.0	4.5	4.6
Imports of goods	20.7	23.0	24.9	24.2	23.6	23.3	23.0	22.8	22.7
Volume growth (in percent)	-9.6	8.9	4.9	0.2	0.9	2.9	2.9	3.0	3.5
Trade balance	-2.3	-2.7	-3.7	-3.1	-3.0	-3.0	-2.7	-2.3	-2.0
Current account	-1.3	-1.6	-1.9	-1.5	-1.5	-1.6	-1.2	-0.7	-0.3
FDI (net)	-3.2	-1.8	-1.8	-1.7	-1.6	-1.5	-1.4	-1.4	-1.3
Official reserves (US$ billion)	46.6	55.8	48.6	...	...	...	...	...	...
Fund position (as of January 31, 2012)									
Holdings of currency (percent of quota)	80.8	79.7	73.1	70.9	...	...	...	...	...
Holdings of SDRs (percent of allocation)	95.9	96.1	95.5	94.2	...	...	...	...	...
Quota (SDRs million)	10739	10739	10739	10739	...	...	...	...	...
Exchange rates									
Euro per U.S. dollar, period average	0.72	0.75	0.72	...	...	...	...	...	...
Nominal effective rate, ULC-styled (2000=100)	104.8	102.4	102.4	...	...	...	...	...	...
Real effective exchange rate, ULC-based (2000=100)	107.8	105.0	103.8	...	...	...	...	...	...
Potential output and output gap									
Potential output	1.0	0.8	0.5	0.5	0.6	0.6	0.7	0.8	0.8
Output gap	-4.6	-3.8	-2.7	-2.9	-3.1	-2.7	-1.9	-0.9	0.0
Social indicators									

Per capita GDP (2006): US$35,471; Life expectancy at birth (2009): 77.7 (male) and 84.4 (female);
Poverty rate (mid-2000s): 14.1 percent (60 percent line), 7.1 percent (50 percent line);
Income distribution (ratio of income received by top and bottom quintiles, 2004): 4.2.

Sources: French authorities; IMF staff estimates and projections.
1/ For 2012, average for January-April.

Appendix Table 2. France: Financial System Structure, 2004–11

	2004	2005	2006	2007	2008	2009	Estimate 2010	2011
Number								
Banks								
Commercial Banks	326	316	313	312	310	302	290	284
Private	323	312	309	308	307	299	287	281
Domestic	139	131	131	130	136	137	134	128
Foreign	184	181	178	178	171	162	153	153
State-owned 1/	3	4	4	4	3	3	3	3
Credit unions and mutuals	127	125	121	111	105	102	102	96
Other credit institutions								
Finance companies	427	411	388	319	300	300	284	279
of which mortgage institutions	4	4	4	4	5	7	9	10
Specialized financial institutions	11	8	7	7	6	5	3	3
Municipal credit institutions	21	21	20	19	18	19	18	18
Securities firms	124	119	116	105	101	96	94	97
Insurance companies	423	415	407	389	386	376	351	346
Life and retirement	119	119	115	110	107	107	102	103
Non-life	274	267	263	249	250	243	229	224
Reinsurance	30	29	29	30	29	26	20	19
Concentration								
Commercial Banks 2/	10	10	9	9	9	9	8	8
Securities companies 2/	3	2	2	2	2	2	2	2
Life insurance companies 2/	n.a.	n.a.	n.a.	13	12	11	12	12
General insurance companies 2/	n.a.	n.a.	n.a.	23	23	21	20	20
Pension funds 2/	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Assets				(Billions of euros)				
Banks	2,862	3,719	4,284	5,107	5,469	6,012	6,328	6,776
Commercial Banks	2,862	3,719	4,284	5,107	5,469	5,188	5,438	5,752
Private	2,850	3,600	4,159	4,973	5,344	5,004	5,240	5,535
Domestic	2,429	3,005	3,559	4,221	4,510	4,180	4,349	4,511
Foreign	422	595	600	752	834	824	890	1,024
State-owned 1/	11	120	125	135	125	184	199	217
Credit unions and mutuals	1,053	**1,128**	**1,259**	**1,402**	**1,599**	**1,675**	**1,480**	**1,606**
Other credit institutions	**690**	**699**	**851**	**1,094**	**1,081**	**985**	**1,054**	**1,061**
Finance companies	433	405	477	531	573	621	683	737
of which mortgage institutions	107	126	149	186	199	217	234	244
Specialized financial institutions	40	21	20	20	21	23	20	23
Municipal credit institutions	2	2	1	1	1	1	1	1
Securities firms	215	271	354	542	486	340	350	299
Insurance companies (assets)	**1,167**	**1,305**	**1,324**	**1,525**	**1,451**	**1,741**	**1,844**	**1,891**
Life and retirement	985	1,103	1,125	1,306	1,242	1,476	1,580	1,615
Non-life	160	171	167	175	166	204	208	216
Reinsurance	22	31	32	44	43	61	55	59
Total Assets pf the Financial Sector 3/	**5,773**	**6,851**	**7,719**	**9,128**	**9,600**	**9,588**	**9,816**	**10,309**
(in percent of GDP)	349	399	429	484	497	507	508	517

Source: Banque de France, ACP.

1/ Including development banks. Nonbank development finance corporations should be included separately under “Other credit institutions.”
2/ Number of institutions with 75 percent of total assets.
3/ Not including the Caisse de Dépôts et Consignations 9CDC); Total Assets of CDC at end 2010 were 262 billion euro.

Appendix Table 3. France: Core Set of Financial Soundness Indicators 2003–2011

(In percent)

								Estimate	
Indicator	2003	2004	2005	2006	2007	2008	2009	2010	2011
Deposit-taking institutions 1/									
Regulatory capital to risk-weighted assets	11.9	11.5	11.3	10.9	10.2	10.5	12.4	12.5	12.2
Regulatory Tier I capital to risk-weighted assets	9.0	8.8	8.2	8.2	7.7	8.5	10.2	10.7	10.9
Nonperforming loans net of provisions to capital	11.6	9.8	8.6	6.8	6.6	8.2	10.8	10.0	9.2
Bank provisions to Nonperforming loans	n.a.	n.a.	n.a.	170	158.3	131.0	109.5	112.0	115.3
Nonperforming loans to total gross loans	4.8	4.2	3.5	3.0	2.7	2.8	3.6	3.5	3.5
Sectoral distribution of loans to total loans, *of which*									
Deposit-takers	34.2	34.0	30.1	30.6	32.2	33.6	34.1	36.5	40.2
Nonfinancial corporation	18.9	18.7	18.8	18.6	18.1	18.3	17.5	20.5	19.2
Households (including individual firms)	24.5	24.9	26.5	26.6	24.8	24.1	24.5	30.5	28.7
Nonresidents (including financial sectors)	4.3	4.2	4.7	4.2	4.7	4.7	4.6	6.1	5.9
ROA (aggregated data on a parent-company basis) 2/	0.44	0.5	0.6	0.6	0.4	0.0	0.4	0.3	0.0
ROA (main groups on a consolidated basis) 3/	0.39	0.53	0.49	0.57	0.35	0.1	0.3	0.6	0.4
ROE (aggregated data on a parent-company basis) 2/	8.50	10.6	11.8	14.0	9.8	-1.0	8.2	7.9	1.2
ROE (main groups on a consolidated basis) 3/	10.0	12.7	13.5	17.22	13.34	3.8	6.4	11.8	8.2
Interest margin to gross income	35.5	33.2	32.4	28.2	25.3	40.4	34.9	49.4	51.5
Noninterest expenses to gross income	64.4	63.9	64.3	62.4	68.4	84.2	63.1	65.7	67.4
Liquid assets to total assets	21.6	21.3	20.5	19.9	18.9	18.3	18.3	23.0	24.1
Liquid assets to short-term liabilities	153.7	155.1	150.1	146.7	150.3	139.6	150.1	144.4	136.3
Net open position in foreign exchange to capital									
Net open positions in FX (in millions of euros) 4/	4,772	6,669	5275	5,283	7,058	n.a.	n.a.	n.a.	n.a.
Net open positions in equities to Tier I capital	3.5	4.8	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Sources: Banque de France and ACP.

1/ These may be grouped in different peer groups based on control, business lines, or group structure.
2/ All credit institutions' aggregated data on a parent-company basis.
3/ Consolidated data for the seven main banking groups (2005, IFRS).
4/ Impact of the creation of the euro has to be taken into account.

ANNEXES. OBSERVANCE OF FINANCIAL SECTOR STANDARDS AND CODES SUMMARY ASSESSMENTS

This Annex contains the summary assessments of France's observance of financial standards and codes. These assessments help identify the main strengths of the supervisory, regulatory and market infrastructure framework in managing potential risks and vulnerabilities in the financial system. They also point to areas that need strengthening and further reform.

These summaries are based on detailed assessments of the following international standards:

- Basel Core Principles (BCP) for Effective Banking Supervision – by Nicholas Le Pan (external expert) and Katharine Seal (IMF).
- IAIS Insurance Core Principles (ICP) – by Thomas Karp and Donald McIsaac (external experts).
- IOSCO Principles and Objectives of Securities Regulation – by Theodor Kockelkoren (external expert) and Ana Carvajal (IMF).
- CPSS-IOSCO Recommendations for Securities Settlement Systems (RSSS) and for Central Counterparties (RCCP) – by Elias Kazarian (IMF).

Annex I. Compliance with the Basel Core Principles for Effective Banking Supervision

A. Introduction

64. **France has a high level of compliance with the Basel Core Principles for Effective Banking Supervision (BCPs).** The French banking system weathered the 2007-2009 crisis better than a number of other countries, due to the benefits of a diversified banking model and a well-developed regulatory and supervisory structure. More recently, developments in the eurozone and in funding markets, as well as in markets for sovereign debt, have exposed vulnerabilities that are being dealt with by banks and the authorities. Certain weaknesses in risk-management practices were revealed. The supervisory and regulatory system has been under strain, as have banks, in part from these developments coming at the same time as major changes in international rules are being implemented and markets are putting pressure on banks as to how they will respond to the new rules on capital and liquidity. The assessors saw many examples of high-quality initiatives and practices in the ACP, but there are several areas where weaknesses in legislation and regulation need to be addressed to give supervisors the full range of tools, and supervisors need to enhance their practices in a few areas in order to take advantage of these tools and increase their effectiveness. The recent merger of supervisory agencies for prudential regulation of banking and insurance into the ACP, as part of the BdF, should be an important contributor to this enhanced effectiveness, given the prevalence of the bancassurance model in France.

B. Information and Methodology Used

65. **This assessment of implementation of the BCPs in France reflects the regulatory and supervisory framework in place as of the date of the completion of the assessment.** It is not intended to assess the merits of the important policy and implementation issues regarding several aspects of the international regulatory framework that are yet to be decided in international fora, the European Union, and in France. An assessment of the effectiveness of banking supervision requires a review of the legal framework, both generally and as specifically related to the financial sector, and detailed examination of the policies and practices of the institutions responsible for banking regulation and supervision. In line with the BCP methodology, the assessment focused on the major banks and banking groups, and their regulation and supervision, given their importance to the system.

66. **The assessment is done according to the Core Principles (CP) Methodology issued by the Basel Committee on Banking Supervision (Basel Committee) in October 2006.** The current assessment was thus performed according to a revised content and methodological basis as compared with the previous BCP assessment carried out in 2004. The assessment of compliance with each CP is made on a qualitative basis to allow a

judgment on whether the criteria are fulfilled in practice. Effective application of relevant laws and regulations is essential to provide indication that the criteria are met.

67. **To assess compliance, the BCP Methodology uses a set of essential and additional assessment criteria for each principle.** The essential criteria (EC) are the only elements on which to gauge full compliance with a core principle. The additional criteria (AC) are suggested best practices against which the French authorities have agreed to be assessed. Additional criteria are commented on but are not reflected in the grading.

68. **The assessment team reviewed the framework of laws, rules, and guidance.** It held extensive meetings with officials of the ACP, and additional meetings with the BdF, the MoF, and banking sector participants. The team met the industry association representing banks in addition to a number of domestic and nondomestic institutions. The team appreciated the very high quality of cooperation received from the authorities.

C. Preconditions for Effective Banking Supervision

69. **France has a well-developed public infrastructure supporting effective banking supervision.** France has a complete system of business laws, consistently enforced. Accounting standards for listed companies and other consolidated accounts have been prepared to IFRS standards, as adopted by the European Union, for some time. Auditing standards are generally consistent with international auditing standards and there is a French audit oversight body (H3C) that inspects audit firms. Rules to limit potential threats to auditor independence, such as restrictions on non-audit services an audit firm may offer, are tougher in France than in other jurisdictions. H3C has only recently revised its approach to inspections, so that the body itself now inspects audit firms to determine that audits are being conducted consistent with accounting standards applicable in France and French audit standards. Previously, these inspections were done by the professional body under H3C's oversight. H3C will need to continue to enhance its coverage, build its resources, and develop its oversight of audit firms.

70. **French banks, and listed companies more generally, make extensive public financial disclosures under IFRS, and as a result of bank** regulations (Pillar 3 of Basel II). Market analysts that the assessors talked to indicated general satisfaction with disclosure. But they, and the assessment team also noted a few areas of potential improvement or areas where there was inconsistent treatment among banks that made peer comparison difficult. Recent EBA reviews of banks' Pillar III disclosures indicate a similar result. It was also noted that financial literacy in France was lower than in some other major jurisdictions, which might have some implications for consumer protection regulation going forward.

71. **Corefris provides a national framework for cooperation and coordination between authorities, including in crisis time.** It is not a decision making body as each individual authority retains the responsibility to act in its own right. No domestic

memorandum of understanding (MoU) specific to crisis management has been agreed, but the Monetary and Financial Code provides gateways for information sharing and cooperation between the relevant authorities. In addition, coordination in crisis times is likely to be facilitated by the fact that there are structural relationships between a number of these authorities. For example, the BdF Governor is the Chairman of the ACP and that the director of the treasury is represented on the College (decision-making body) of ACP. Hence, the functions of central banking and prudential supervision are separate at staff level but coordinated at decisional level, and the treasury will be fully informed throughout.

72. **France has a deposit guarantee scheme, distinct from the ACP, with two complementary objectives:** (i) paybox: according to EU Directive (94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes, as amended) depositors are guaranteed up to a limit of €100,000 per credit institution; and (ii) preventive action: the FGD can intervene in a credit institution facing difficulties only at the ACP's request. The deposit guarantee scheme is funded on a risk based approach in order to mitigate moral hazard. The pay box function is automatic to protect depositors and protect confidence in the financial system, but the preventive action remains discretionary to avoid moral hazard. The ACP and the FGD are contemplating whether to draw up an MoU.

D. Main Findings

Objectives independence, powers, transparence, and cooperation (CP 1)

73. **As a newly-created integrated regulator, ACP is starting to benefit from synergies in the supervision of banks and insurers but has more to do to fully realize these benefits.** One of its predecessor organizations, the Commission Bancaire, already benefitted from being part of BdF, and those benefits are likely to become more important as many countries add systemic considerations into microprudential supervision. There is room for more day-to-day cooperation on these issues but ACP and BdF are well placed to achieve that. At the same time a consumer protection mandate has been added to the legislative mission of the new organization, and it has used material additional resources in starting up this task. It will be important going forward not to let consumer protection crowd out the essential microprudential contribution of ACP to financial stability.

74. **Certain aspects of the new structure raise concerns about potential independence, sound governance, and access to adequate resources for the supervisor, though there is no evidence of problems to date.** The issues concern the role of the MoF in the ACP College and in controlling resourcing for ACP, legislative limits on ACP headcount, and the fact that ACP cannot independently set any prudential rules or its own assessments on industry. It is important that MoF has information on individual institution issues that are potentially important for financial stability, and information on market developments. It is also important that it has a major role in decisions that affect financial stability. However, there are ways to achieve these aims without the ministry having a right to attend, and

attending, *all* of the ACP College discussions and decisions and having a right to force reconsideration of any issue, even those that do not raise potentially systemic concerns or possible risk to public funds. Also, ACP could be given a more formalized role in recommending prudential rules.

75. **There are two serious legislative deficiencies that affect full compliance with a number of the core principles and hamper supervisory effectiveness.** One is lack of a complete legislative framework related to regulating the responsibilities of the Board of Directors (as distinct from senior management) including inability to apply a fit and proper test to Board members, coupled with ACP practice that has only a limited direct interaction with the decision making body in banks (i.e., the Board). This has consequences for several areas from the integrity of the fit and proper process on changes of ownership in banks, the inability to suspend or dismiss Board members (individually or collectively), to ACP's ability to set separate requirements for Board responsibilities in oversight and risk governance, to the inability of ACP to meet with the nonexecutive members of the Board together to present their supervisory findings and ensure the Board is overseeing the necessary improvements by management. As a result, the possibility of effective early intervention by ACP is impaired on major prudential concerns affecting an individual bank's strategy that *would* normally have to be dealt with at this level. Furthermore, the ability of ACP to assess whether the Board of Directors of an institution has sound knowledge of the business and risks of a bank is impaired. There is considerable room to enhance assessments of Board oversight of risk issues, which is relevant for a number of CPs. The second legislative issue is the fact that the ACP does not have the formal power to approve acquisitions by French banks either in the European Economic Area (EEA) or abroad. The ACP would be highly likely to react to an unacceptably risky acquisition by a French bank, after the fact, with additional restrictions and required capital buffers. However that is not as effective as having approval authority in the first place, as exists in most other jurisdictions. The above mentioned legislative deficiencies are covered in the text below according to the relevant CP under consideration.

76. **Mechanisms are in place for information sharing and cooperation among the authorities.** France benefits in this regards from close links between officials from various authorities.

Licensing and structure (CPs 2–5)

77. **Licensing and structure are given appropriate treatment under France's regulatory regime.** The ACP process and procedures surrounding the licensing function are detailed, thorough, and diligent. There remain, however, some important areas within the legal framework where adjustments are recommended. Please note that some of the issues considered in CPs 2–5 are touched on in the preceding section on CP 1.

78. **ACP should be granted powers to assess, individually and severally, the suitability of Board members as well as the associated powers to suspend or dismiss such individuals (CP 23).** Further, ACP should make more use of direct contact with the Board in order to ensure that the governance of the authorized institution is appropriate as well as to ensure that critical supervisory messages that ACP may need to deliver as the situation warrants can be as directly and clearly communicated as possible. International experience indicates that the suite of powers to approve, dismiss, and communicate without restriction with the Board of Directors is core to supervisory effectiveness.

79. **Acquisitions by banks are not subject to approval by ACP unless the target institution is also authorized by ACP.** Therefore, ACP does not have the systematic power to review major acquisitions by a bank; in particular it does not have the power to review the establishment of cross-border operations. While ACP would act, and has acted assertively, in response to such situations—for example, through the application of higher capital requirements, reinforcement of internal controls, or de-consolidation or ring fencing of such problematic entities—such tools are themselves limited and are a second best option. Consequently, it would not be possible to prevent or impose necessary conditions on a major cross-border acquisition. Such a situation may result in adverse systemic issues, or have possible consequences for supervisory effectiveness. ACP should have formal approval powers or powers to ensure that, at least, it receives prior notification and is thus able to consider ex ante whether the acquisition (or establishment of new branch or subsidiary) is compatible with its effective oversight of the group. Given the significance of the acquisition issue for the practice of effective consolidated supervision, ACP should also be granted the complementary power to insist on divestment of a cross-border entity where such an entity impedes the effective consolidated supervision of the group.

80. **The change of control of a credit institution is clearly specified in French law and subject to appropriate notification to, and approval by, the supervisory authorities.** However, the French regulatory approach provides an exemption for internal group restructuring requiring only a post-notification to the supervisors where the control of the authorized institutions remains within the EEA. This option creates the potential for significant challenges to the effective supervisory process given that internal management and control issues may arise in the restructured group. A pre-notification process should be put in place to ensure that ACP is not put in the position of having to identify remedial supervisory practices after the fact. Notification requirements should also be placed on institutions to notify ACP in situations where the institution becomes aware of material information, which may negatively affect the suitability of a major shareholder.

81. **ACP does not have the power to withdraw an authorization that was granted on the basis of false information.** ACP has powers that are likely to lead to an equivalent outcome, but launching a revocation process would absorb greater supervisory resources than

a direct power to withdraw an authorization that was falsely obtained. It is therefore recommended that ACP is granted this power which is in conformity with provisions in existing EU legislation.

Prudential regulation and requirements (CPs 6–18)

82. **French banks have materially increased the quantity and quality of capital in anticipation of the introduction of the Basel III/CRD IV regulations.** Most major banks have announced their intention to be fully compliant with the new rules (without regard for transition measures), by the beginning of 2013. In addition there are targets for the middle of 2012 resulting from the EBA interim capital strengthening exercise. There are several areas where current capital regulations in France, pursuant to the EU capital rules, fall materially short of the current Basel standard (Basel II.5, which was in place at the time and is the basis for the assessment). These involve issues of how cross-holdings of banks within mutual groups, and cross-holdings of banks and insurance companies, within corporate and mutual groups, are treated for capital purposes. It is a material issue for some, but not all banking groups. The treatment of insurance investments of bancassurance conglomerates affects the consolidated Tier1 capital position, and results in overstatement of this ratio compared to Basel requirements (however total capital ratios are calculated appropriately, but the issue can also affect pro-forma current disclosures of Core Tier 1 ratios by banks). The bank cross-holdings issue affects the publically-reported capital of some material internationally-active subsidiaries in the affected groups, but does not affect the consolidated capital position of the groups. The result can be double counting of capital in the relevant banking part of the group or counting as capital amounts that may not be available, thus leading to market and investor misunderstanding. This can be exacerbated because of the complexity of the intra-group relations and opacity in disclosures about how the group operates (which may already be harder for markets to understand in the case of financial support arrangements in mutual bancassurance groups) although quality of disclosure has been improving since the assessment. ACP rightly focuses its attention on the consolidated group capital position, on various sub-measures and on financial relations between the various parts of these groups, and shows an excellent understanding of the situation. Regardless of how the current policy discussion is resolved about these issues in CRD IV, France should require clearer and full disclosure of the capital treatment in place, and the related financial interactions within complex groups.

83. **France's approach to Pillar 2 has been well developed, formally linked to ACP risk rating of banks, and a part of its system to intervene to reinforce incentives for banks to respond to supervisory interventions.** The current enhanced focus by banks on new capital measures (Core Tier 1) has rendered the existing Pillar 2 measures, based on old capital targets, less effective. The move to Basel III/CRD IV necessitates changes in this

regime which the authorities recognize. They are right to keep the basic principles of their regime but adapt it to the new technicalities as soon as possible.

84. **Globally, shortcomings in enterprise-wide bank risk measurement and risk-management practices have been revealed in the crisis and in recent market, sovereign, and liquidity pressures, and supervisory oversight was not always as effective as desired in identifying those weaknesses and having them remedied.** Major causes have been identified by the global Senior Supervisors Group in which France participates. That is also true in French banks, despite the fact that the extent and impact of these issues has been less than in some other markets. Given the systemic importance and size and complexity of the French banking system, bank risk-management practices, and the French authorities' ability to assess them, must be held to a very high standard. Banks in France are on the right track and are being pushed by recent changes in regulation, and by supervisory intervention, to strengthen enterprise-wide risk measurement and risk management. Risk governance oversight also needs to be enhanced, as does the ability of ACP to assess risk governance. This would be assisted by the legislative changes noted above allowing regulation and supervisory intervention at the level of banks' Boards, as takes place in other leading countries. French banks also need to enhance their internal capital adequacy assessment process and related enterprise-wide stress testing, and ACP should find ways to make its expectations clear in this regard. ACP has an excellent understanding of the major banks it supervises and the strengths and weaknesses in their business models and practices, and possible events that might cause them stress. When ACP is exercising supervisory early intervention in areas where banks may actively resist, it needs to use all channels of influence in order to get prompt action by banks to support financial stability.

85. **Credit risk management, large exposure limits and processes to deal with problem loans and provisioning are well developed in France.** The ACP methodology for credit risk supervision appears sound. ACP decided, as a result of discussion in Corefris, to add more frequent monitoring of the potential risks in this market, and to perform onsite examinations of a variety of smaller and larger banks' residential mortgage portfolios in 2012. ACP needs to make sure banks are identifying the sectors likely to experience most credit stress in the forecast economic slowdown (which may not be the mortgage sector) and are focusing their resources on ensuring that risk rating and provisioning is adequate for those credit exposures.

86. **On country and transfer risk management, recent experiences revealed that these systems were not as robust as banks desired.** However, banks have revamped and extended their risk management and risk governance, including limit setting and taking account of this risk in their capital models. ACP has been actively involved in both offsite supervision and monitoring of the limits and exposures. Onsite verification of the robustness of bank's systems will occur in 2012.

87. **ACP is operating a high quality and proportionate liquidity regime.** Consistent with the evolving demands of the international market place, ACP continues to extend and refine its approach. This has encompassed an intensifying of the supervisory relationship with the systemic banks and onsite review by specialists. Severe stress testing requirements are already applied to the core firms and will be extended to a wider sample. Data requirements are also being refined to ensure greater scope for comparability between firms. ACP should review its existing liquidity regime with respect to the non-advanced banks to ensure that the general requirements and principles of liquidity risk management apply to all banks and not only the advanced firms, as specified in the current Order of May 2009 on liquidity regulation.

88. **French requirements for internal control in banks are longstanding and extensive and ACP's program to assess their implementation is robust.** France's approach to AML/CTF requirements received a positive recent FATF assessment, and the improvements recommended, primarily dealing with French overseas territories and departments, are underway. France makes excellent use of supervisory reporting and benefits from the existence of a well-developed credit register run by BdF.

Methods of ongoing banking supervision (CPs 19–21)

89. **ACP has a thorough understanding of the operation of individual banks and the banking system, focusing on safety and soundness.** It operates an extensive, detailed and in-depth program of onsite inspections and high-quality offsite supervisory process that monitors individual major bank's financial situation and risk management and control practices. As in other countries, the ACP methodologies for risk rating banks are not very responsive to changes in bank conditions and are not very forward looking. There is room to better define the rating criteria to assist supervisors in forming a judgment of the quality of risk management. ACP is at an early stage in assessing the quality of risk governance and feeding it into overall assessments, in part hampered by its inability to interact directly with Boards. While progress has been made there is room to more systematically and formally bring together the insurance and banking risk assessments to obtain an enhanced overall view of the banking groups.

90. **While offsite and onsite supervisory processes are of a high quality, there is room for improvement.** There appear to have been examples where the comprehensiveness of the onsite process has meant it took a long time to reach conclusion and for supervisory recommendations to be communicated to the firms, which appeared to reduce the effectiveness of ACP intervention. In part, this was due to the need for the inspection process to have a formal 'contradictory' part, allowing a right of challenge and reply from the bank before the reports and findings are finalized. While this is understandable when the inspection is to be the basis of formal enforcement, this can stand in the way of effective

timely intervention. ACP needs to build on recent developments to put in place a more flexible, timely, focused, onsite capability as a complement to the existing process.

91. **ACP could reinforce its intervention on material issues at senior levels of the banks, including intervening more at the Board level.** This will necessitate more focus in the process of synthesizing and distilling the details from inspections and offsite work and ratings into crisp overall findings and priority recommendations. Lastly, ACP should publish aggregate results from theme reviews as a way of informing and reminding banks, not just the largest, about its expectations and required practices.

Accounting and disclosure (CP 22)

92. **Audit independence rules such as restrictions on non-audit services are more restrictive in France than in many other countries.** ACP uses its authority to approve auditors' appointment effectively. ACP does not generally use auditors in its supervisory or prudential practices, preferring, understandably, to use its own staff and resources. ACP has productive relations with auditors when it needs to ensure that auditors better take into account issues like extra focus on valuations.

Corrective and remedial powers of supervisors (CP 23)

93. **ACP has a wide range of tools for remedial and corrective measures and the assessors saw evidence that such tools were used in practice.** The powers and sanctions process granted to ACP are broader than those of its predecessor, and ACP is still at early stages of becoming familiar with such a different approach. ACP fully recognizes that it is in the process of distilling practical lessons from its first experiences of the sanctions process and has a concrete plan to analyze recent cases and adapt its practices in order to be as streamlined and as effective as possible. The readiness to be willing to move to a sanctions process is an important dimension in the new ACP culture that ACP is encouraged to build upon, bearing in mind the importance of being able to achieve a timely, effective, and conclusive process.

Consolidated and cross border banking supervision (CPs 24–25)

94. **ACP has a strong legal and regulatory framework, based on the EU legislative framework.** Importantly, this model is applied in practice, both in terms of ensuring the application of prudential standards at consolidated and (as appropriate) sub-consolidated level to ensure adequate distribution of capital across the group. Nonetheless, and as noted in the context of CP 5, ACP's ability to ensure effective global oversight of groups, including all nondomestic establishments and locations, is seriously impeded by its lack of powers to prevent the establishment or acquisition of foreign interests or to require the divestment of

such establishments even in cases where there are obstacles to the supervisor and/or the group's management obtaining sufficient information for their tasks.

95. **ACP has a broad network of MoUs and arrangements with other home or host supervisors supported by a gateways for information exchange and confidentiality provisions.** France is the home jurisdiction to four globally systemically significant banking groups, so there is a premium on the quality of home/host relationships to support home state oversight. Although the practices of supervisory colleges are presently in a major phase of development in order to achieve an ever more meaningful and substantive group wide perspective on the activities of such global groups for all firms, there is clear evidence that ACP has devoted attention to this aspect of supervision and will continue to do so.

Annex Table 1. France: Summary of Compliance with the Basel Core Principles

Basel Core Principle	Comments
1. Objectives, independence, powers, transparency, and cooperation	
1.1 Responsibilities and objectives	The new financial stability and consumer protection mandate risks lack of clarity but ACP is well placed to ensure priority on safety and soundness of institutions. Disclosure by BdF and ACP of financial system and financial institutions conditions and risks could be markedly enhanced.
1.2 Independence, accountability and transparency	The clear intention is to create an independent authority, soundly governed and adequately resourced. Several aspects of the arrangements including the role of MoF in the ACP College and in financing arrangements, and parliamentary limit on ACP headcount, have the potential to undermine this objective, though there is no evidence of problems to date. The benefits of coordination and information sharing could be achieved with lower risks of perceived (or actual) future independence issues
1.3 Legal framework	ACP does not have the ability to publish binding rules without changing laws. Consultative processes lack transparency.
1.4 Legal powers	There is room for improvement in legislative requirements related to Boards of directors' responsibilities and ACP powers over Boards, and improvement in the way ACP establishes direct contact with the Board and in its assessments of Board oversight. There is no ability to apply the fit-and-proper test to directors; there is a lack of assessment of suitability of the Board as a whole; lack of formal specific requirements about Board composition and duties regarding risk management and governance; and lack of an ability to suspend or dismiss Board members, jointly or severally.
3. Licensing criteria	French legislation does not permit the supervisor to withdraw a banking authorization immediately should it become aware that the authorization was granted on the basis of false information.

Basel Core Principle	Comments
4. Transfer of significant ownership	There is no provision for ACP to be notified in advance of an internal group restructuring where the control of the group remains within the EU/EEA. Inability to review changes in control of banking groups that do not change ultimate control could pose problems.
5. Major acquisitions	French legislation does not permit the supervisor to review acquisitions by banks. Acquisitions of EU financial institutions would require approval from the national supervisor of the target entity, as prescribed by EU law, and ACP has other powers it could use, however these elements are not a full or adequate substitute for formal approval.
6. Capital adequacy	While capital requirements are in many ways prudent and appropriate, there are material weaknesses in the definition of capital, and related public reporting at the time of the mission vis à vis current Basel II/II.5 requirements, especially for bancassurance groups and cross-holdings of banks by certain major internationally active publicly traded entities within some major mutual bank groups. The identified bancassurance issues produce reported Tier 1 capital ratios that are less than the applicable Basel requirement and can produce reported measures that involve recognizing capital that may not be available to the banking part of the group, or double counting of capital. For mutual bank groups the overall consolidated group capital calculation is compliant. The assessors do not take a position on the desirability of various policy positions and the implementation of those positions in the move to Basel III and CRD IV. ACP fully understands the issues and is able to meet its prudential mandate. But current approaches risk confusion for market participants.
7. Risk management	Specific rules requiring enterprise-wide risk management are relatively new in France and there has not been sufficient time to test them in practice or for ACP to have fully reviewed their operation. Reviews to date are mixed. There are deficiencies in the extent of implantation in major banks of enterprise-wide risk management (ERM) processes with the necessary strong oversight, including at Board level. Supervisory assessments of risk governance are not well developed. Processes to relate capital to risk exist but need to be strengthened in a number of major banks.
11. Exposure to related parties	Loans at ‘normal’ terms to related parties do not require Board or auditor approval and so may not get adequate scrutiny to ensure terms are reasonable, thus leading to reputation risk for the regulatory system in case of problems.
12. Country and transfer risks	Banks and supervisors in many countries failed to understand fully the potential for country/ transfer risk to materialize. Major enhancements in the systems of risk management and provisioning of this risk have taken place in banks, and ACP monitoring is now extensive. But ACP has not fully reviewed whether the new policies and practices are appropriate and effective, though onsite visits are planned in 2012.
14. Liquidity risk	ACP has intensified the standards of its liquidity regime, particularly with respect to its interaction with the core systemic firms. The program of continuing enhancements needs to be completed, including the extension of severe stress tests to a wider spectrum of banks, greater standardization of data in some areas and the application of proportionate liquidity risk management standards to all banks, not merely advanced firms.

Basel Core Principle	Comments
19. Supervisory approach	Supervisors have excellent understanding of banks. Risk rating criteria for major banks could better promote assessing the adequacy of control and risk governance processes. It could also contain a more explicit forward-looking dimension.
20. Supervisory techniques	ACP performs high quality onsite and offsite supervision. There is evidence that it is not as timely and coordinated as it needs to be for full effectiveness. In addition there is room to improve the effectiveness of ACP interaction with senior bank management and Boards in order to achieve supervisory results. There is room to further formally integrate the view of the insurance risks into the ACP assessment of the risk of the overall banking group and intervention strategy.

Annex Table 2. France: Recommended Action Plan to Improve Compliance with the Basel Core Principles

BCP	Recommended Action
1.4	Give ACP powers to assess, jointly and severally, the suitability (integrity and expertise) of Board members as well as the associated powers to suspend or dismiss such individuals (CP 23). Amend core internal control regulation to specify Board responsibilities for oversight and risk governance. (Relevant also for CPs 3,7,8,13,14,15,16,17, and 23). Enhance ACP meetings with independent Board members and enhance ACP assessments of governance and effectiveness.
5	Grant ACP powers to ensure that it receives prior notification of major acquisitions and is thus able to consider the acquisition (or establishment of new branch or subsidiary) ex ante. ACP should also have powers to require the divestment in an entity where it would prevent the effective supervision of the group for which ACP has responsibility for consolidated supervision.
6	Once new capital rules have stabilized, confirm a graduated phase out of the current preferential treatment of bancassurance and interbank exposures. Provide guidance to ensure enhanced regular accessible and consistent disclosure to allow market assessment of impact of current treatment together with information on relevant intra-group funding and support mechanisms.
1.2	Alter (but do not eliminate) participation of MoF in ACP College, limit MoF right of reconsideration to systemically important issues. Provide ACP formal role in proposing prudential rules and issue more ACP guidance on prudential matters. Allow ACP College to set assessment within maximum to be set by legislation. Provide for periodic formal/public review by ACP of its resource needs.
1.3	Enhance consultative practices in line with EU 'better regulation practices'.
3	Grant ACP the power to withdraw an authorization immediately should ACP become aware that the license was granted on the basis of false information.
4	Ensure, through regulatory changes if necessary, that ACP receives advance notification of internal group restructuring even when control of the overall group remains within the EU/EEA. Impose regulatory requirements for a credit institution to notify ACP in cases where the institution becomes aware of material information which may negatively affect the suitability of a major shareholder.
7	Require banks to enhance and implant ERM processes. Put in place more guidance or regulation on ACP expectations for ERM, for capital planning related to risk, and for Board risk governance and oversight. Subject these to regular detailed ACP assessment and feedback.

12	Finalize supervisory work to assess appropriateness and effectiveness of banks' recently enhanced country/transfer risk process and their process for attributing capital to these risks.
14	Broaden the program of enhanced liquidity risk regime beyond the core systemic banking groups. Ensure that the general principles of liquidity risk management are applied to all institutions, not only advanced approach firms.
20	Improve timeliness and coordination of onsite and offsite supervision to enhance early intervention. Further develop capability to conduct focused onsite/offsite reviews to investigate key issues and follow up on implementation by banks of ACP requirements. Based on new powers vis à vis Boards, intervene at that level in a focused way to ensure adequate risk governance. Formally integrate the view of insurance risks into the overall risk assessment and supervisory intervention of bancassurance groups.
11	Ensure that all lending transactions with related parties above a threshold (whether at normal terms or not) are approved by the Board.

E. Authorities' Response to the Assessment

96. **The French Authorities would like to express their appreciation to the International Monetary Fund and its staff for their thorough analysis of the French financial sector and the very informative exchanges of views within the context of the BCP assessment.** The French Authorities have found the FSAP review of the French regulatory and supervisory banking framework a useful exercise. ACP expresses its most sincere appreciation for the opportunity to further enhance the "peer review culture" in ACP's departments and thanks the IMF and its knowledgeable and experienced assessors for the dedication, time and resources committed to the assessment.

97. **The Authorities welcome the IMF's judgment that France has a high level of compliance with the Basel Core Principles (BCP) and high quality supervision.** The Authorities broadly agree with the IMF findings and assessment.

98. **Regarding the detailed assessment, the Authorities took note of the recommendations regarding ACP powers over the Boards of supervisees (BCP 1.4) and ACP prior approval of major cross border acquisition (BCP 5** – although it should be stressed that cross border acquisition within EU comes under European treaties and the scope for strengthening ACP powers regarding European cross border acquisition is unclear). Indeed, the Authorities are contemplating changes to the regulation in order to strengthen the powers of ACP and works on draft legislation are already engaged.

99. **However, the authorities would like to raise a firmly dissenting view in relation with two of the observations of the IMF BCP assessment regarding the independence of ACP (BCP 1.2) and capital adequacy (BCP 6).**

100. **On ACP independence, while stressing that the clear intention of the authorities is to create an independent supervisory authority, soundly governed and adequately resourced, the IMF raises some concerns.** The Authorities believe that the ACP is indeed

fully independent and the assessment itself emphasizes that no evidence of problems has been found. Regarding the involvement of the Ministry of Finance (through the Directeur General du Trésor or his representative) within ACP Board, it should be noted that the role and powers of the representative of the Ministry of Finance are fully set in the law, which gives no membership status in the Board and Enforcement Committee. This provides for transparency about the position of the Ministry of Finance, to the full knowledge of all stakeholders. The only right attributed by law is to ask for a second deliberation in the Board for matters other than sanctions. The request for a second round of deliberations has no effect on the eventual content of the decision but gives the Board an opportunity to review its decision, within a very short space of time, so as to consider all its consequences and to ensure it is reasonably undisputable. The Authorities believe this arrangement provides a clear framework for ACP and Ministry of Finance effective and timely cooperation, bringing valuable benefits and providing for robust guarantees for the independence of the regulators also in comparison to other examples at the international level.

101. **On capital adequacy (BCP 6), the IMF raises two concerns regarding mutual groups, and banc-insurance groups.**

102. **Regarding mutual groups, the Authorities wish to underline that the ACP applies three levels of supervision to mutual groups while other countries allow mutual groups to perform a simple aggregation at group level.** ACP supervises the French mutual groups on an individual basis (for regional banks which are the operating retail banks), on a sub-consolidated basis (at the level of the central body) and at the consolidated group level. The solo and the consolidated supervision are assessed as perfectly compliant with the Basel II requirements. The supervision at the sub-consolidation level allows the risk-weighting of the investments the central body holds in the regional banks because of the specific capital structure of mutual groups. Indeed the regional banks hold 50 percent or more of their central body capital, while the latter holds more than 20 percent of the regional banks capital. This is linked to legal arrangements which impose a solidarity mechanism by which the central body guarantees the regional banks operations and ensures their liquidity and solvency. Above all, the Authorities insist on the fact that no double-gearing can occur at the consolidated level and that no risks are left unaddressed.

103. **The IMF assessment highlights that market participants may be misled by the "opacity" of some mutual group disclosure.** Although this statement is rather surprising as it should be part of the transparency assessment and because it is at odds with the assessment made by the team of assessors on BCP 22 ("compliant"), ACP repeatedly produced evidence that the 2011 financial statements of mutual groups very clearly explain their structure and intra-group relations. The Authorities therefore do not share the conclusions drawn by the assessors.

104. **Regarding banc-insurance, some banks deduct their insurance holdings following the preferred approach under Basel II and allowed by the French and EU rules.** However, deductions are from total capital as allowed in current applicable EU rules, instead of from Tier 1 and Tier 2 equally. The Authorities insist on the fact that this treatment is (1) neutral for the total capital ratio and (2) is only valid until 31 December 2012 on a transitional basis justified by the development of banc-insurance model in Europe. Moreover, this temporary treatment is fully disclosed by institutions, so that analysts can measure its impact on ratios.

105. **The Authorities also underline that their main concern is to eliminate any double-gearing at the highest level, be it the conglomerate level for banc-insurance groups or the consolidated level for mutual groups, and that they indeed succeed.** Besides, as it reported in the assessment, ACP staff shows an excellent understanding of all the banking groups they supervise even those deemed complex. The Authorities believe that these two achievements demonstrate an "overall effectiveness sufficiently good" and guarantee that "no material risks are left unaddressed"[20] (which define the "largely compliant" assessment). In this context, the Authorities believe that BCP 6 implementation cannot be assessed as "materially non-compliant" which should be given when "there is evidence that supervision has clearly not been effective."

[20] Core Principles Methodology, Basel Committee on Banking Supervision, October 2006, page 9.

ANNEX II. OBSERVANCE OF THE IAIS INSURANCE CORE PRINCIPLES

A. Introduction

106. **The current thorough approach to insurance regulation and supervision has led to financially sound insurers.** Insurance regulation and supervision by ACP is predominantly carried out using a Solvency I approach. While the commencement date of the new Solvency II regime is yet to be announced, ACP's Solvency II preparations are well advanced, and ACP staff have been heavily involved in and have contributed to EU work, particularly that of the European Insurance and Occupational Pensions Authority (EIOPA), on Solvency II. France has been waiting for the finalization of the EU technical standards before moving to implement Solvency II type requirements.

B. Information and Methodology Used

107. **The assessment of France's observance of the IAIS Insurance Core Principles (ICP) was carried out as part of the 2012 FSAP Update.** The assessment employs the revised ICPs issued in October 2011, which limits comparability with the previous assessment. The 2011 ICPs contain 26 core principles, covering much the same subject matter as the 2003 ICPs. Importantly, the new ICPs include far more extensive requirements relating to risk management in insurers, and they include a new specific ICP covering macroprudential issues. The 2011 ICPs contain standards within each ICP against which assessments have to be made; whereas the 2003 ICPs contained essential and advanced criteria within each ICP against which assessments had to be made.

108. **An effective system of insurance supervision needs a number of external elements, or preconditions, which all exist in France.** These preconditions include sound and sustainable macroeconomic and financial sector policies; a well-developed public infrastructure; effective market discipline in financial markets; mechanisms for providing an appropriate level of protection (or public safety net); and efficient financial markets.

109. **The assessment is based on the laws, regulations, and other supervisory requirements and practices in place at the time of the assessment.** This is particularly relevant as France—like numerous other EU countries—is working to develop Solvency II requirements, but as yet has not taken concrete intermediate steps towards implementing similar requirements, especially related to risk-management requirements for insurers.

110. **ACP's comprehensive self-assessment against the ICPs was a major source of information used in the assessment.** The assessors held extensive discussions on the self assessment, regulatory requirements, and supervisory practices with numerous ACP officers. The assessors also met with trade associations for insurers and intermediaries, executives of major life and nonlife insurance companies, ratings agencies, representatives from the accounting profession and the accounting standard setter, representatives from the actuarial

profession and auditors of insurance operations. The willing cooperation of all those visited assisted the assessors in gaining a proper understanding of the French insurance market and how the regulatory system impacts market participants.

C. Main Findings

111. **Insurance regulation and supervision is still predominantly carried out using a Solvency I approach, and the insurance sector remained resilient through the recent global financial crisis.** A thorough approach to assessing insurer technical provisions and their coverage by admissible assets, as well as assessing current and likely future solvency of insurers against Solvency I solvency margin requirements, has led to financially sound insurers. Individual French insurers have not needed any government or industry support.

112. **The independence of ACP, or at least the perception of independence, may be compromised by the involvement of the *Direction Générale du Trésor* (DGT) and *Direction de la Sécurité Sociale* (DSS) representatives in ACP College and Sanctions Committee meetings and the mechanisms for determining industry contributions to ACP funding.** It is recommended that consideration be given to removing the DGT and DSS representatives from ACP meetings; this would remove the potential for one means of governmental influence on ACP decisions and would substantially improve the perception that the ACP is independent. Separate coordination arrangements between the ACP on the one hand, and the DGT and DSS on the other hand, could be established to ensure that effective advice, knowledge about crucial supervisory decisions, and the reasonings behind proposed regulatory changes still occurs. Consideration could also be given to establishing a more transparent mechanism for adjustments to the industry contributions to the funding of ACP. While it has not been a problem to date, such a mechanism would allow ACP to have any future situation of funding constraints dealt with transparently, and thus increase the perception of ACP's independence.

113. **Regulatory requirements and supervisory assessment of insurer financial soundness and governance and risk management will need to change dramatically with the implementation of Solvency II.** A number of ACP staff have been heavily involved in, and contributing to, EU—particularly EIOPA—work on Solvency II. Within ACP, there is a Solvency II project led by a steering committee chaired by the Secretary General. This project involves eight streams of work managed by task forces, covering: international issues; internal models; balance sheet impact; information technology (IT) systems and reporting; transposition to French law; supervisory approach; and industry market preparation. Actual regulatory and supervisory changes have been held off until all the details of Solvency II are finalized. It is recommended that there be early introduction of specific requirements for insurer Boards in the areas of risk appetite statements, risk management within the appetites, delineation of responsibilities between the Board and key persons in control functions, remuneration policy, and a duty to act in the interests of policyholders.

114. **The assessment of the suitability of persons involved in insurance operations is not sufficiently extensive and does not cover enough roles in insurers.** Fit-and-proper assessments of persons at licensing, change of control, mergers, and acquisitions, as well as when people move do not cover all Board members or persons controlling key functions. The EU Solvency II Directive requires that all persons that perform key functions be fit and proper, so changes will need to be made with the implementation of Solvency II. In addition, it is recommended that the ACP power to remove unsuitable persons is extended to cover all such roles. There has been some reluctance for ACP to use such removal powers due to the high burden of proof needed to determine unsuitability. Notwithstanding this, ACP should be more prepared to use these powers, or find other ways of dealing with this issue (e.g., placing onerous requirements on the insurers to assess and regularly certify suitability).

115. **Public disclosure requirements on insurers need improving, but are awaiting Solvency II implementation.** Current disclosure requirements cover the financial statements, including major methodologies and assumptions used. Disclosure of further detail and wider information will also be required with the full implementation of Solvency II. Further details about the valuation of technical provisions, including assumptions used, and the level of uncertainty associated with the amount of provisions should be required. Wider information should also be required, such as: risk types; risk exposures and concentrations; risk-management policies, systems, and procedures; corporate governance framework; and sensitivity results from forms of stress testing.

Annex Table 3. France: Summary of Observance of the Insurance Core Principles

Insurance Core Principle	Comment
ICP1 - Objectives, Powers, Responsibilities of the Supervisor	There is a clearly defined authority responsible for insurance supervision, with appropriate statutory objectives and adequately broad powers.
ICP2 - Supervisor	ACP is an independent administrative authority (with financial autonomy) though it does not have legal personality. Two government officials attend College and the non-deliberative part of Sanction Committee meetings. They have no vote on the College but can request a second deliberation (except on sanctions). While there is no explicit requirement that the reasons for dismissing College members be publicly disclosed, the reasons are provided to the dismissed member, who can appeal the dismissal; an arbitrary dismissal is virtually impossible. ACP is financed by contributions from supervised institutions specified in law and collected by BdF, which can also provide additional funds to ACP. The Parliament sets the range of the rates for industry contributions and sets a total limit on ACP headcount.

Insurance Core Principle	Comment
ICP3 - Information Exchange and Confidentiality Requirements	ACP has the legal authority and power to obtain information from insurance undertakings under its supervision and to exchange supervisory information with relevant authorities.
ICP4 - Licensing	Insurance entities cannot conduct insurance business without an authority to do so from ACP. Insurance and reinsurance entities regularly authorized by an EEA supervisory authority and having their headquarters in the EEA are also authorized to conduct insurance business in France directly or via their branches. A non-EEA entity wanting to undertake insurance business in France via a branch must be specifically authorised by ACP to do so. Fit and proper requirements are applied only to the chair of the Board and to some of the first layer of senior management of the applying entity.
ICP5 - Suitability of Persons	Suitability of persons is assessed at the time of application for authorization to undertake insurance business. When there is a change in senior personnel of an insurer, ACP has no direct authority to object to such a change. There is no suitability assessment of key persons responsible for control functions, or of members of the Board(s) other than the chair. The ACP has powers to require the removal of unsuitable persons, but only those for which it can assess suitability. In instances where the ACP considers an insurance entity has an unsuitable person in a senior or key role, it would approach the entity and request removal or change. In such situations, the ACP would look to use other powers and sanctions it has to achieve a change in personnel.
ICP6 - Changes in Control and Portfolio Transfers	ACP must be notified whenever a party—acting alone or in concert with others—acquires, extends, reduces, or ceases to hold (directly or indirectly) shares in an insurance undertaking. These requirements apply also to insurance holding companies having their head office located in France, as well as mixed financial holding companies having their head office located in France and which belong to a financial conglomerate whose surveillance is coordinated by ACP. The above notification must be prior to any change, and ACP must authorize such increases in shareholdings. When shareholdings are being reduced, ACP checks that the change does not jeopardize the insurance undertakings licence conditions. For cases involving intermediate or ultimate owners outside France, ACP has the power to—and does—exchange information with EU/EEA authorities; but it only exchanges information with authorities outside the EU/EEA when it has a formal MoU.
ICP7 - Corporate Governance	Provisions are in place to deal with the responsibilities of Boards, but these are high-level requirements for all companies, aimed at having Boards determine the direction of the company's business and oversee their implementation. Companies are also required to have an audit committee. Most insurers are required to have a risk committee to deal with risk-management policies, procedures, and systems. Insurers are required to produce annually a Board-approved internal control report, a Board-approved solvency report and a Board-approved reinsurance policy statement. However, Boards are not required to set insurer risk appetites, to define roles and responsibilities between the Board and senior management, or to act in the interests of policyholders.

Insurance Core Principle	Comment
ICP8 - Risk Management and Internal Controls	The Monetary and Financial Code requires most insurers to have a Risk Management Committee; insurers are also required to have an internal control function and to produce an annual internal control report. However, there is no specific requirement for insurers to have a dedicated internal audit function or an actuarial function.
ICP9 - Supervisory Review and Reporting	Data collections and supervisory reviews are comprehensive and reasonably detailed. Much of this will change as the reporting requirements under Solvency II are finalized and implemented across Europe. The way supervisors will be required to assess an insurer's solvency will also change fundamentally and be much more complex. These changes will require significant retraining of supervisory staff and possibly the need to recruit some staff more experienced in the economic valuation approaches underlying Solvency II.
ICP10 - Preventive and Corrective Measures	A wide range of preventive and corrective measures are available and appear to be used.
ICP11 - Enforcement	The supervisor has adequate powers to enforce corrective actions and impose sanctions where needed. These powers are used in practice.
ICP12 - Winding-up and Exit from the Market	Appropriate winding-up and exit provisions exist, and limited policyholder compensation arrangements exist. However, there have been very few cases where they have needed to be used.
ICP13 - Reinsurance and Other Forms of Risk Transfer	Board-approved annual reinsurance policy statements are required. Reinsurance is appropriately considered in supervisory reviews.
ICP14 - Valuation	Solvency II requirements will alter the landscape in a significant manner. For all practical purposes, assets will be valued at their market values. Likewise, the discounting of liabilities will be carried out on the basis of "best estimate" assumptions with a safety margin. Accounts prepared under Solvency II are expected to demonstrate greater volatility than has been seen under Solvency I practices.
ICP15 - Investment	The investment activities of insurance companies are subject to both qualitative and quantitative limitations. The qualitative requirements in the Insurance Code deal with the nature of assets, currency issues, and location. The Code also defines a list of eligible assets and quantitative limits. Limits are imposed on the composition of assets that may be counted towards coverage of technical provisions (the "Coverage" test). In practice, current company holdings are far below regulatory limits.
ICP16 - Enterprise Risk Management for Solvency Purposes	Risk management considerations currently applied are primarily written in the context of existing French practice. The requirement changes and practices expected with Solvency II implementation will be considerable and impact substantially to improve insurer risk management, but also the work of ACP supervisors in assessing insurer compliance with the requirements.

Insurance Core Principle	Comment
ICP17 - Capital Adequacy	Insurers are required to issue a Solvency Report, which is submitted to the ACP and to the external auditor. The Solvency Report must show that technical provisions are calculated in a way that ensures that they are sufficient to meet commitments to policyholders and cedents; explain the investment policy of the insurer; and analyze how the insurer will meet all its commitments in the mid- and long-run. Insurers must assess their financial risks, in particular by stress-testing the potential impact on their balance sheet of changes in interest rates and in stock prices. The methodology of these assessments is determined by ACP and results must be submitted to ACP on a quarterly basis.
	The advent of Solvency II will mean important changes for the supervision of insurance companies in France. The new approach will involve new methods for establishment of values for assets and liabilities, and new techniques for determining the prescribed solvency margin. In all likelihood, the new system will involve solvency control levels which trigger different degrees of intervention by the supervisor.
ICP18 - Intermediaries	Insurance intermediaries are required to register each year. Inspectors from Banque de France collaborate with ACP officials in supervision of the distribution of insurance products.
ICP19 - Conduct of Business	Insurers and intermediaries must comply with general rules protecting consumers, and with specific rules that apply to insurance activities.
ICP20 - Public Disclosure	General public disclosure requirements are in place. Information disclosed to the public does not include the entire package of disclosure contemplated by ICP 20 (though it is more comprehensive on some aspects). Disclosure requirements pursuant to Solvency II will be more extensive.
ICP21 - Countering Fraud in Insurance	Fraud in insurance is covered by the generic provisions of the *Code penal,* which also deals with fraud arising from insurance. Solvency II will introduce the need for companies to report on “Operational Risk,” which is generally presumed to include risk of fraud.
ICP22 - Anti-Money Laundering and Combating the Financing of Terrorism	A recent FATF assessment concluded that France is largely compliant with FATF recommendations.
ICP23 - Group-wide Supervision	Adequate and effective supervision exists for legal entities and on a group-wide basis.
ICP24 - Macroprudential Surveillance and Insurance Supervision	Although macroprudential surveillance is a relatively new area, the ACP has made good progress in establishing such surveillance.

Insurance Core Principle	Comment
ICP25 - Supervisory Cooperation and Coordination	The ACP cooperates with other authorities, both within and outside the EC, in particular by actively participating in supervisory colleges.
ICP26 - Cross-border Cooperation and Coordination on Crisis Management	The ACP operates according to the EU/EEA and EIOPA requirements and guidelines for crisis management.

Annex Table 4. France: Recommended Action Plan to Improve Observance of the Insurance Core Principles

ICP	Recommendation
2	It is recommended that consideration be given to removing government representatives from ACP meetings. This would remove the potential for one means of governmental influence on ACP decisions and would substantially improve the perception that ACP is independent. Separate coordination arrangements between ACP on the one hand, and the government on the other hand, could be established to ensure effective advice, knowledge about crucial supervisory decisions, and the reasonings behind proposed regulatory changes still occurs. Consideration could also be given to establishing a more transparent mechanism for adjustments to the industry contributions to the funding of ACP. While it has not been a problem to date, such a mechanism would allow ACP to have any future situation of funding constraints dealt with transparently, and thus increase the perception of ACP's independence.
3	Consideration should be given to allowing ACP to exchange information with authorities outside the EU/EEA, even if there is no formal agreement is in place.
5	It is recommended that the ACP power to require removal of unsuitable persons be extended to all insurer Board members and all key persons in control functions, but it is noted that this is expected to occur via the transposition of final Solvency II requirements into French law. The ACP should also consider being more proactive in advising other authorities about unsuitable persons.
7	It is recommended that enforceable requirements be introduced for insurer Boards to: • Determine and document their actual risk appetite, and their strategy for keeping their risks within this stated appetite; • Clearly define the roles and responsibilities allocated to the Board, senior management, and key persons in control functions; • Have an appropriate number and mix of individuals to ensure adequate knowledge, skills, and expertise; • Act in the interests of policyholders; and • Adopt an effective remuneration policy, which does not induce excessive or inappropriate

ICP	Recommendation
	risk taking. It is noted that many of these are likely to be required via the implementation of Solvency II requirements.
8	Requirements for insurers to have internal audit and actuarial functions should be introduced. It is noted that they will be required via the Solvency II directive. Consideration should also be given to specifically requiring insurers to retain responsibility for any material function that is outsourced and producing ACP guidelines on the issues, which should be included in outsourcing agreements.
9	It is recommended that there be significant retraining of supervisory staff in the economic valuation approaches underlying Solvency II, the revised Solvency II reporting requirements, and Solvency II ORSA requirements. Consideration should be given to establishing within the ACP a quality-control function aimed at achieving greater consistency of supervisory assessments, and establishing a clear ACP policy or approach aimed at achieving greater consistency in aligning the supervisory response to the seriousness of the supervisory assessment.
14	It is recommended that ACP develop the necessary tools to be used in the supervision of insurance companies such that the valuation of assets and liabilities conforms to Solvency II expectations. For example, for life insurance business, this will imply replacing the current practice of computing policy liabilities using original pricing assumptions with an approach that fixes assumptions based on current estimates plus a margin over current estimates (MOCE).
16	It is recommended that ACP develop expertise in the area of ERM as it will be expected to develop standards and provide guidance to insurance companies in the application of ERM techniques to the measurement of solvency.
17	It is recommended that ACP, in preparing for the implementation of Solvency II, provide training to staff that will be expected to cope with new measures for assessing the adequacy of capital. It will also be necessary to develop a framework of regulatory responses that will involve solvency control levels, which trigger different degrees of intervention by the supervisor.
20	It is recommended that ACP take a more active approach to obliging insurance companies to disclose relevant, comprehensive, and adequate information on a timely basis in order to give policyholders and market participants a clear view of their business activities. Perhaps this could be accomplished by providing public access to specific company data on a website.
24	It is recommended that ACP continue to develop macroprudential surveillance approaches from a multi-disciplinary and cross-sectoral perspective to identify trends and developments in all sectors of the economy that might negatively impact the risk profile of insurers.

D. Authorities' Response to the Assessment

116. **The French authorities welcome the IMF review of the French regulatory and supervisory insurance framework.** The FSAP has been a useful exercise and has further enhanced the "peer review culture" in ACP's departments. ACP expresses its most sincere appreciation and thanks the IMF and its knowledgeable and experienced assessors for the dedication, time and resources committed to the assessment.

117. **The French authorities broadly agree with the IMF assessment. In the view of the French authorities, it has to be underlined that this assessment has been made on the basis of the newly revised ICP (dated October 2011) which made the exercise of observation much more demanding than before.** These ICP partly echo Solvency II requirements and approach, still to enter into force. By construction, some ICP currently regarded as "partly observed" or "largely observed" would probably have been deemed "observed" if Solvency II was already in place.

118. **Besides, there are a few differences of views between IMF and the French authorities. These are as follows.**

119. **On ACP independence (ICP 2), while stressing that the clear intention of the authorities is to create an independent supervisory authority, soundly governed and adequately resourced, the IMF raises some concerns.** The Authorities believe that the ACP is indeed fully independent and the assessment itself emphasises that no evidence of problems has been found. Regarding the involvement of the Ministry of Finance (through the *Directeur général du Trésor* or his representative) within ACP Board, it should be noted that the role and powers of the representative of the Ministry of Finance are fully set in the law, which gives no membership status in the Board and Enforcement Committee. This provides for transparency about the position of the Ministry of Finance, to the full knowledge of all stakeholders. The only right attributed by law is to ask for a second deliberation in the Board for matters other than sanctions. The request for a second round of deliberations has no effect on the eventual content of the decision but gives the Board an opportunity to review its decision, within a very short space of time, so as to consider all its consequences and to ensure it is reasonably undisputable. The Authorities believe this arrangement provides a clear framework for ACP and Ministry of Finance effective and timely cooperation, bringing valuable benefits and providing for robust guarantees for the independence of the regulators also in comparison to other examples at the international level.

120. **On ICP 7 about effective corporate governance framework, we share most of the views of the IMF.** However, it should be noted that provisions are already in place, which define roles and responsibilities of the insurer's governing bodies.

121. **French authorities have already taken steps to deal with the shortfalls detected by IMF.** Most of them will be addressed through the transposition and implementation of the Solvency II regime in French regulation.

Annex III. Implementation of the IOSCO Objectives and Principles of Securities Regulation

A. Introduction

122. **An assessment of the level of implementation of the IOSCO Principles in the French securities market was conducted from January 10 to 27, 2011 as part of the FSAP.** An initial IOSCO assessment was concluded in 2005. Since then, changes have taken place in the French (as well as the European and global) markets and in the institutional structure for the regulation of securities markets. In addition, IOSCO approved a new set of Principles in 2010 and a revised Methodology on September 30, 2011, i.e., France is among the first jurisdictions to be evaluated against the revised Methodology.

123. **France exhibits a high level of implementation of the IOSCO principles.** The legal framework is robust and provides the AMF and the ACP with broad licensing, supervisory, investigative, and enforcement powers within their respective competences. There are robust arrangements for cooperation between the two authorities. Vis-à-vis investment service providers (ISPs), each supervisor has developed offsite monitoring systems, including risk scoring frameworks. They have also set up arrangements for the oversight of the French portals of NYSE Euronext and for the oversight of the various related trading platforms. In addition, the AMF has robust market surveillance systems and has been active in enforcement of market abuse provisions. Finally, the authorities have demonstrated results in the implementation of supervisory arrangements to cover new areas of responsibility required by the principles approved by IOSCO in 2011.

124. **Some areas of supervision and enforcement require strengthening.** AMF should dedicate more resources to onsite work (including inspections) of investment services providers, notably financial investment advisors. Regarding ACP, a greater use of stronger enforcement measures including sanctions whenever necessary, would be desirable to support moral suasion, and more frequent reporting of capital adequacy would enhance the ACP supervisory approach of investment services providers, and in particular its early warning mechanism. The effectiveness of H3C in supervising auditors´ oversight is severely constrained due to limited human resources. Increasing staffing levels, as already envisioned, is therefore an urgent priority. In addition, giving the H3C greater direct enforcement powers would enhance the overall effectiveness of the auditors' oversight.

125. **Certain aspects of the governance structure of AMF and H3C could potentially undermine independence, though there is no evidence of problems to date.** As for the ACP, the treasury participates in all deliberations of the AMF Board (without having a voting right but with the ability to ask for a second deliberation), as well as the AMF enforcement committee (except during deliberations). In addition, the participation of industry representatives—some on active duty—in the Boards of AMF and H3C has the potential to

create conflict with commercial interests. While arrangements are in place to address conflicts of interest, alternative mechanisms should be established to ensure that market expertise is brought into the decision-making process. Finally, given the current governance model whereby different interests are represented at the level of the Board, the limited direct representation of retail investors at that level should also be addressed. As for the ACP, the current legislative limits to AMF and H3C headcount could potentially affect the ability of the supervisors to command sufficient resources for market supervision.

126. **Market fragmentation poses challenges to transparency and securities markets oversight that should be addressed at the European level.** Implementation of MiFID has allowed transactions costs in the European securities markets to be reduced. At the same time it has led to market fragmentation, which can only be successfully addressed at the European level. The current review of MiFID provides an opportunity to address these challenges.

B. Information and Methodology Used

127. **The assessment was conducted based on the IOSCO Principles and Objectives of Securities Regulation approved in 2010 and the Methodology adopted in 2011.** As has been the standard practice, Principle 38 is not assessed due to the existence of a separate standard for securities settlement systems. A technical note on the oversight framework for systemically important financial market infrastructures was delivered to the authorities.

128. **The IOSCO methodology requires that assessors not only look at the legal and regulatory framework in place, but at how it has been implemented in practice.** The recent global financial crisis has reinforced the need for assessors to take a critical look at supervisory practices to determine whether they are effective enough. Among others, such judgment involves a review of the inspection programs for different types of intermediaries; the cycle, scope, and quality of inspections; how issues are prioritized; as well as how the agency follows up on findings, including the use of enforcement actions.

129. **The assessors relied on:** (i) a self-assessment prepared by the AMF with the contribution of the ACP; (ii) the review of relevant laws, reports, and supervisory files; (iii) meetings with staff from AMF, ACP, H3C, the MoF, the Ministry of Justice and the Judiciary, and the European Securities and Markets Authority (ESMA); and (iv) meetings with market participants and other stakeholders. The assessors also relied on the findings of the Basel Core Principles assessment, for their assessment of ACP vis-à-vis Principles 1–5 of the IOSCO Methodology.

130. **The assessors want to thank AMF and ACP for their full cooperation as well as their willingness to engage in very candid conversations regarding the regulatory and supervisory framework in France.** The assessors also want to extend their appreciation to all other public authorities and market participants with whom they met.

C. Institutional Structure

131. **The current regulatory structure is a variation of the twin peaks model.** ACP is primarily in charge for the prudential supervision of ISPs and market infrastructure providers, including regulated markets, multilateral trading facilities (MTFs), and central clearing counterparties (CCPs). On the other hand, the AMF is the markets supervisor and is responsible for conduct supervision of all participants in the securities market including ISPs, portfolio management companies (PMCs), financial investment advisors (FIAs), and market infrastructure providers, and exercises prudential supervision over PMCs and the funds they administer. A third authority, the H3C, is in charge of the oversight of external auditors who conduct audits of public interest entities (including auditors of listed issuers) and non-public interest entities.

132. **Both AMF and ACP are governed by a Board, while a separate enforcement committee is in charge of the imposition of sanctions.** In both Boards, there is representation from different interests, including representatives from specialized public entities, issuers, intermediaries, and, in the case of AMF, investors. The composition of the enforcement committees is also built upon the principle of representation of interest of the various market users or participants. There are conflict-of-interest provisions in place which seek to address the drawbacks of industry representation. While not being formally a member, a representative from the MoF attends the meetings of the Boards as well as the enforcement committees with no voting rights. However, he/she has the power to request a second deliberation, i.e., a second discussion, in decisions taken by the Boards, but not by the enforcement committees.

133. **To carry out their respective mandates, AMF and ACP have been given broad licensing, investigation, supervision, and enforcement powers.** The only limitation in powers relates to rulemaking. AMF has the power to draft its own regulations, which are subject to "homologation" (i.e., stamping) by the MoF. ACP does not have such power. Finally, the authorization of exchanges remains in the hands of MoF, based on a recommendation of AMF.

134. **Both regulatory authorities operate under a framework of accountability and transparency.** Authorization requirements are established by law and developed via regulations and are all available on websites. AMF follows a consultation process to develop regulations. Individual decisions must be motivated and are subject to judicial review. AMF and ACP prepare annual reports that provide a detailed account of their activities and budget. Their budgets are subject to oversight by the audit of the *Cour des Comptes*.

135. **Several mechanisms are in place to foster cooperation.** Regular meetings are organized on a monthly basis between AMF and ACP and there is cooperation at an operational level on a day-to-day basis regarding the ongoing supervision of regulated entities. An institutional cooperation mechanism (the *Pôle Commun*) was created by law in

2010 to address (i) the need for coordinated monitoring of all investment vehicles (particularly unit-linked life insurance policies); and (ii) the rise of firms distributing a complete range of banking and insurance products, such as bancassurance networks and wealth management advisors. AMF and ACP have also signed bilateral MoU with H3C. Finally, Corefris, composed by the MoF, AMF, ACP, ANC, and BdF, was introduced in 2010 with the aim of identifying and addressing possible systemic risks.

136. **There are no self regulatory organizations (SROs).** Mandatory membership in an association is required for all ISPs and FIAs. However, they do not have a material role in self-regulation, as they do not have real supervisory or enforcement powers; and therefore are not considered SROs for purposes of the assessment. As in many other countries in Europe, AMF is the front line supervisor for purposes of ensuring compliance of issuers with their disclosure obligations as well in market surveillance for the purpose of detecting market abuse. The regulated markets and organized multilateral trading facilities (OMTFs) have a complementary role in both areas. Given their limited role, market operators are not considered SROs for purposes of this assessment (although they are subject to AMF oversight).

D. General Preconditions for Effective Securities Regulation

137. **General preconditions necessary for the effective regulation of securities markets appear to be mainly in place in France.** There are no significant barriers to entry and exit for market participants. Competition is encouraged and foreign participation is welcomed. The legal and accounting system supports the implementation of requirements and effective regulation of market participants. The commercial law is up-to-date, and so are corporate governance standards. The framework for insolvency was updated in 2006. The *Loi de Sauvegarde des Entreprises*, effective in 2006, introduced restructuring procedures in the French legal system. Managers now have the opportunity to restructure their business before the company declares the inability to pay its current debts with its available assets (the state of suspension of payments). This procedure is an adapted version of the U.S. Chapter 11, which relates to reorganizations, through the introduction of safeguard proceedings. This Insolvency Act also codified the practice of *mandat ad hoc* procedures (whereby a company's legal representative confidentially requests assistance from a receiver appointed by the court) and improved corporate voluntary arrangements through conciliation proceedings. Therefore, with the new conciliation and safeguard proceedings, French insolvency law now provides strong incentives for debtors to anticipate their difficulties, and for creditors to help businesses in difficulty and to participate in their financial recovery. The regulators have legally enforceable powers of decision and action.

138. **Tax incentives on certain insurance products might be creating distortions that in turn can affect the goal of the IOSCO Principles of efficient markets, as the**

distribution and placement of products is largely based on these tax incentives rather than on the specific risk characteristics of the products.

139. **There are also a number of level-playing field issues at the European level, which, however, can impact French companies and thus the French financial market.** Participants commented on the existence of stricter standards in France in connection with the asset management industry (safeguard of assets, rules on diversification, approval of marketing material for highly complex products); facilitation; and the definition of investment advice vis-à-vis suitability requirements. There are also concerns regarding differences in supervisory practices among regulators in Europe. It remains to be seen whether the appeal procedure of ESMA can serve as an effective procedure to mitigate some these issues. Probably it would make sense for France as well as the other European countries to promote at the European level a process to harmonize to some extent the supervisory approaches across the EU.

E. Main Findings

140. **Principles for the regulator.** The mandate of AMF and ACP are clear and stem from the law and sufficient cooperation arrangements exist between these authorities and between them and H3C. Through the *Pôle Commun*, French authorities are seeking to address challenges arising from the different regulatory treatment of investment-like products and distributors of financial products; although its work is still at an early stage. The current governance structure of their Boards and enforcement committees poses threats to independence. In addition, current legislative initiatives have imposed caps on the level of resources of all independent agencies, which include both institutions. Resources at AMF appear limited in light of the state of development of the market and the number of entities under supervision, in particular in the inspection area. AMF has developed processes to identify and monitor emerging and systemic risks that are also supportive of a review of the perimeter of regulation. These processes are still evolving. Through Corefris, AMF, ACP, and BdF exchange views and cooperate on financial stability issues. There is a strong framework of accountability and transparency that applies to all of the institutions.

141. **Principles for enforcement.** AMF and ACP have extensive powers to supervise regulated entities within the areas of their competencies. They both have broad investigatory and enforcement powers. At AMF, the number of onsite inspections and sanctions aimed at ISPs, and especially FIAs, is relatively low. This seems not to be the result of lack of quality or willingness to pursue a sanction, but of capacity available to perform inspections. ACP has also made very limited use of its formal enforcement powers. Criminal enforcement faces challenges.

142. **Principles for cooperation.** There are several arrangements in place to foster domestic cooperation. At the international level, most of the cooperation takes place through AMF. AMF has responded to requests for information that is in its file in a timely manner,

and has also proactively worked to obtain information that was not in its files through the opening of investigations. AMF has also taken testimony and obtained court orders on behalf of foreign regulators.

143. **Principles for issuers.** Issuers of public offering and/or admitted to trading on a regulated market are subject to a prospectus requirement. Extensive periodic and ongoing disclosure obligations apply to issuers admitted to trading on a regulated market. Requirements for OMTFs are in line with the IOSCO Principles but lower than for regulated markets, in line with European legislation. AMF has established robust arrangements for the supervision of issuers' compliance with such obligations. Mandatory tender offer provisions and rules for the notification of substantial holdings and transactions by "insiders" apply to issuers admitted to trading in a regulated market and in an OMTF (although the thresholds differ). Such disclosure requirements and minority protections provisions do not apply to issuers admitted to trading only in MTFs, but those MTFs operate in practice as markets for institutional and professional investors.

144. **Principles for auditors, credit rating agencies and other information service providers.** Auditors are subject to oversight by H3C. The supervisory approach established by H3C is reasonable but resources appear to be a challenge. Of more concern is the fact that H3C lacks enforcement powers. Credit rating agencies (CRAs) were subject to a thorough registration process by colleges of European supervisors and are now subject to ongoing supervision by ESMA, which is defining its supervisory approach. Research by sell side analysts is subject to a robust framework of disclosure, which was extended to "independent analysts". Other evaluative services have also been subject to disclosure obligations.

145. **Principles for collective investment schemes.** Authorization requirements for PMCs are robust and include capital, fit and proper, and organizational requirements. Disclosure requirements for CIS are robust, and include both a prospectus and periodic information. AMF has an active supervisory approach and is applying the law stringently. The current framework requires that assets be properly segregated and be held by a depositary, whose liability framework is very strict. There are clear rules on valuation, and AMF has provided guidance in connection with illiquid assets. Suspensions of redemptions must be notified.

146. **Principles for securities intermediaries.** Authorization requirements are robust and include capital, fit-and-proper, and organizational requirements; however, fit-and-proper requirements apply only to the two senior managers in line with EU Directives. The supervisory program includes both offsite reporting as well as onsite inspections. AMF has made significant progress in putting the investor and consumer protection topics on the agenda, and is achieving commendable results with some of its actions. The introduction of the highly complex products doctrine has delivered good results and is a good example of how AMF is giving priority to investor protection. There is reason to increase the scope of the approach created by this doctrine. However, AMF should increase its capacity to

supervise appropriately the large groups of FIAs and ISPs. ACP has developed a risk scoring system for the supervision of prudential requirements by ISPs. Such system is supported by a series of reporting obligations, including on capital adequacy. However, the frequency of capital adequacy reporting is limited, and there is no obligation for ISPs to notify when their capital falls below defined thresholds. ACP conducts full scale onsite inspections on ISPs.

147. **Principles for secondary markets.** Requirements for the authorization of regulated markets and MTFs are robust. Both AMF and ACP have established arrangements for ongoing supervision of operators of regulated markets and MTFs. Currently the bulk of the resources are dedicated to the supervision of Euronext. AMF has established a robust automated system for market surveillance. AMF conducts an important number of investigations every year, and administrative sanctions have been imposed for market abuse infractions. Criminal enforcement has been limited. LCH Clearnet monitors positions daily, and a comprehensive system of intraday margin applies. Default procedures are in place. The college of LCH Clearnet has developed a framework for crisis management, which includes periodic simulations. A system of mandatory reporting of short-selling is in place.

Annex Table 5. France: Summary Implementation of the IOSCO Objectives and Principles of Securities Regulation

Principle	Findings
Principle 1. The responsibilities of the Regulator should be clear and objectively stated.	The responsibilities of AMF and ACP are clearly defined by law. There are robust arrangements for cooperation. The authorities are seeking to achieve a consistent approach in connection to investment-like products and their distribution through the *Pôle Commun*. The *Pôle Commun* has delivered positive results, but it is still at an early stage.
Principle 2. The Regulator should be operationally independent and accountable in the exercise of its functions and powers.	The current governance structure of the Boards of AMF and ACP raises concerns due to (i) the participation of a representative of the MoF at the meetings who, while not being a member and not having a voting right, can ask for second deliberation, i.e., second discussion, except on matters concerning sanctions, and (ii) the participation of industry representatives, while at the same time there is limited retail investors' representation. In addition, on some Boards a number of industry members are still active in industry. However, AMF and ACP work under a strong framework of accountability and transparency. While these entities are self-funded, recent legislative initiatives have put a cap on the number of human resources. Governance issues in connection with H3C are described in Principle 19.
Principle 3. The Regulator should have adequate powers, proper resources and the capacity to perform its functions and	Especially AMF has made considerable progress with its objective of boosting investor protection. It also has made some noticeable steps in creating a risk culture within the

exercise its powers.	organization. AMF has a hands-on culture willing to apply sanctions where necessary; however, the inspection capacity of AMF is limited in relation to the large population it supervises. At ACP, there is sufficient capacity, yet the mindset could benefit from a change towards a willingness to enforce where appropriate. Issues related to powers and resources of the H3C are described in Principle 19.
Principle	**Findings**
Principle 4. The Regulator should adopt clear and consistent regulatory processes.	The AMF has established a consultation process for the development of regulations. Requirements for the authorization of regulated entities are set up in laws and regulations, which are publicly available. Administrative decisions must be motivated. Individuals affected by decisions of AMF and ACP must be afforded a due process prior to taking such decisions. Administrative decisions that affect third parties are subject to judicial review.
Principle 5. The staff of the Regulator should observe the highest professional standards, including appropriate standards of confidentiality.	Staffs of AMF and ACP are subject to robust ethics conduct obligations, which include provisions on conflict of interest, restrictions on trading of securities, cool-off periods, and confidentiality rules.
Principle 6. The Regulator should have or contribute to a process to monitor, mitigate, and manage systemic risk, appropriate to its mandate.	Through the Risk Committee, AMF has established a structure for the identification and monitoring of systemic risk. This is complemented by work of ACP. Corefris provides a framework for all the authorities to cooperate and exchange views on financial stability. The structures are of recent creation and therefore evolving.
Principle 7. The Regulator should have or contribute to a process to review the perimeter of regulation regularly.	The structures identified above also serve the purpose of supporting risk identification at a more general level, and therefore they provide the foundation for reviews of the perimeter of regulation.
Principle 8. The Regulator should seek to ensure that conflicts of interest and misalignment of incentives are avoided, eliminated, disclosed, or otherwise managed.	The supervisory processes in place for different types of intermediaries have helped AMF to identify and address conflicts of interest. There are a number of risk areas, mentioned by respondents during the assessment that could benefit from further exploration.
Principle 9. Regulatory Organizations (SROs)	There are no SROs.
Principle 10. The Regulator should have comprehensive inspection, investigation and surveillance powers.	AMF and ACP have been given broad powers to supervise regulated entities.
Principle 11. The Regulator should have comprehensive enforcement powers.	AMF and ACP have been given broad powers to investigate and impose enforcement actions, including money penalties.
Principle 12. The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance, and	AMF has supervisory programs in place for the supervision of all types of regulated entities, which include offsite reviews as well as onsite inspections. However, onsite

enforcement powers as well as implementation of an effective compliance program.	inspections of ISPs and FIAs appear limited and, as a result, so are enforcement actions. ACP relies on a combination of both off and onsite inspections for the prudential supervision of ISPs. On the enforcement side, the ACP culture still relies on "informal" measures. Criminal enforcement faces challenges. Issues related to the supervisory program of H3C are described in Principle 19.
Principle 13. The Regulator should have authority to share both public and nonpublic information with domestic and foreign counterparts.	AMF, ACP, and BdF are required to cooperate with each other. AMF, ACP, and H3C are authorized to provide information to each other. AMF and ACP are authorized to cooperate with foreign authorities. There are no limits to the type of information that can be provided.
Principle 14. Regulators should establish information sharing mechanisms that set out when and how they will share both public and nonpublic information with their domestic and foreign counterparts.	Several formal arrangements have been put in place to foster domestic cooperation. AMF is signatory of the IOSCO MoU. The bulk of cooperation at the international level takes place through AMF. AMF cooperates extensively with foreign regulators, and their response time is reasonable.
Principle 15. The regulatory system should allow for assistance to be provided to foreign Regulators who need to make inquiries in the discharge of their functions and exercise of their powers.	AMF and ACP can provide assistance to foreign regulators to obtain information that is not in their files. AMF has opened investigations, taken testimony, and received court orders on behalf of foreign regulators.
Principle 16. There should be full, accurate, and timely disclosure of financial results, risks, and other information that is material to investors' decisions.	Issuers of public offering are required to submit a prospectus. There are extensive periodic and ongoing reporting requirements for issuers admitted to regulated markets. An adapted regime applies to issuers admitted in an OMTF. AMF has put in place a robust system to review compliance by issuers with reporting obligations. Disclosure requirements do not apply to securities listed on MTFs only, in line with EU legislation. However, the latter MTFs operate in practice as markets for institutional and professional investors.
Principle 17. Holders of securities in a company should be treated in a fair and equitable manner.	Company Law establishes a basic framework for investor protection. Additional protections for minority shareholders exist in connection with issuers admitted to trading in regulated markets and to a large extent for OMTFs. In particular, tender obligations and notification of substantial holdings and transactions by insiders apply. Such additional framework does not apply to securities listed on MTFs only, in line with EU legislation. However, the latter MTFs operate in practice as markets for institutional or professional investors.
Principle 18. Accounting standards used by issuers to prepare financial statements should be of a high and internationally acceptable quality.	IFRS apply to issuers admitted to a regulated market. Issuers admitted to an OMTF can choose between French Generally Accepted Accounting Principles (GAAP) and IFRS. Few differences remain between French GAAP and IFRS, the main one in connection with financial instruments.

Principle 19. Auditors should be subject to adequate levels of oversight.	The H3C conducts onsite reviews of audit firms with public interest entity engagements (except those with one PIE engagement which have been delegated to the *Compagnie Nationale des Commissaires aux Comptes*, under the supervision of H3C). The supervisory program developed by
	the H3C is reasonable; however, additional resources would be key for the implementation of such program. The H3C lacks direct enforcement powers as it has to go through the prosecutor. Finally, the current governance structure of the H3C raises concerns, in particular due to the participation of active auditors in the Board (albeit a minority). The current legislative limits to headcount are also a source of concern.
Principle 20. Auditors should be independent of the issuing entity that they audit.	Auditors are subject to strict rules on independence, which are overseen by a combination of mechanisms, including oversight by H3C and by the audit committees of the issuers, in the case of issuers admitted to trading in a regulated market.
Principle 21. Audit standards should be of a high and internationally acceptable quality.	French auditing standards apply and are broadly consistent with ISA. H3C oversees compliance with them.
Principle 22. Credit rating agencies should be subject to adequate levels of oversight. The regulatory system should ensure that credit rating agencies whose ratings are used for regulatory purposes are subject to registration and ongoing supervision.	CRAs registered in France were subject to registration by a college of European supervisors. Under the EU regulatory framework supervisory powers over CRAs have been transferred to ESMA. ESMA has conducted initial onsite inspections on the larger CRAs. Individual reports were delivered to them and a report with general findings was recently released. Obtaining the remaining human resources planned is key to effective on-going supervision.
Principle 23. Other entities that offer investors analytical or evaluative services should be subject to oversight and regulation appropriate to the impact their activities have on the market or to the degree to which the regulatory system relies on them.	Disclosure requirements are in place in connection with research produced by sell side analysts. AMF has extended such framework to “independent analysts”, i.e., investment analysts not associated with an ISP. In addition, disclosure requirements aimed to address potential conflicts of interest have been developed for other types of evaluative services.
Principle 24. The regulatory system should set standards for the eligibility, governance, organization, and operational conduct of those who wish to market or operate a collective investment scheme.	Authorization requirements for PMCs are robust, and include capital, fit and proper, and organizational requirements. AMF has an active supervisory program, which includes both offsite and onsite monitoring.

Principle 25. The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and for the segregation and protection of client assets.	There are robust rules on segregation of assets. Assets of CIS must be held by a depositary whose liability regime is very strict. Depositaries can be related entities, but additional safeguards are in place including special reports from the statutory auditor of the depositary and robust supervision. The segregation and protection of clients' assets have received and are receiving extra attention because of the crisis as well as in the wake of the Lehman, Madoff failures. In the events following these failures, French investors did not suffer any losses from incorrect segregation or protection by French regulated entities.
Principle 26. Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.	Disclosure requirements for CIS are robust and include a prospectus and periodic reporting. The doctrine of high-complex products is an example of the priority given by AMF to investor protection issues.
Principle 27. Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a CIS.	There are clear provisions for valuation of assets, including on valuation of illiquid assets. Rules on subscriptions and redemptions must be included in the prospectus. Suspensions of redemptions must be notified to AMF.
Principle 28. Regulation should ensure that hedge funds and/or hedge fund managers/advisers are subject to appropriate oversight.	Hedge funds are regulated like other CIS in France and are subject to registration or authorization requirements. Hedge fund managers are subject to requirements and regulatory supervision as stringent as those of other CIS managers.
Principle 29. Regulation should provide for minimum entry standards for market intermediaries.	There are robust authorization requirements for ISPs, which include capital, fit and proper, and organizational requirements. However, fit and proper requirements apply only to the two senior managers, in line with EU Directives.
Principle 30. There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.	ISPs are subject to minimum capital requirements as well as requirements adjusted by risks. ISPs are subject to periodic reporting of their financial situation, including annual audited financial statements and semi-annual results. More frequent reporting applies to larger ISPs. Capital adequacy is generally reported on a semiannual basis, and occasionally on a quarterly basis for only a segment of the larger ISPs. However, more frequent reporting can be demanded on an ad-hoc basis. ACP conducts onsite inspections of ISPs.
Principle 31. Market intermediaries should be required to establish an internal function that delivers compliance with standards for internal organization and operational conduct, with the aim of protecting the interests of clients and their assets and ensuring proper management of risk, through which management of the	ISPs must have robust internal controls and risk management processes; such processes must be evaluated periodically by an independent unit of the ISP. There is a robust framework of business conduct obligations applicable to ISPs. AMF has in place a supervisory program for ISPs that include both offsite reviews and onsite inspections. However, onsite inspections for ISPs and FIAs are limited.

intermediary accepts primary responsibility for these matters.	
Principle 32. There should be procedures for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.	ACP does not have in place plans to deal with the failure of ISP; however, its risk scoring system also functions as an early warning tool. In addition, ACP has powers to deal with the failure of an intermediary, including transferring of clients' assets, and there is an investor compensation scheme in place. ACP is currently engaged in the development in recovery and resolution plans for systemically important institutions. AMF is in the process of developing a toolkit to deal with the failure of a PMC.
Principle 33. The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight.	There are robust requirements for the authorization of regulated markets and MTFs, including capital requirements, fit and proper, and organizational requirements.
Principle 34.There should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.	AMF and ACP have established arrangements for the ongoing supervision of operators of both regulated markets and MTFs. The bulk of resources are dedicated to the supervision of Euronext, given the importance of this market. The college of regulators established for the joint supervision of Euronext by all the relevant authorities appears to be working well.
Principle 35. Regulation should promote transparency of trading.	As in other countries in Europe, market fragmentation has had an effect on pre-trade and post- trade transparency since the implementation of MiFID.
Principle 36. Regulation should be designed to detect and deter manipulation, and other unfair trading practices.	AMF has established an automated system for market surveillance. It has a good record of investigation. A reasonable number of administrative sanctions in connection with market abuse are imposed every year, although processes are lengthy. For dealing with financial offences, criminal enforcement faces additional challenges, and very few convictions have been secured.
Principle 37. Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.	LCH Clearnet S.A. conducts monitoring of large exposures by clearing members. Positions are monitored on a daily basis and a comprehensive regime of intraday margin has been in place since 2008. Default procedures are clear. The college of LCH Clearnet has developed a crisis management framework that includes periodic simulations. A system of disclosure of short selling is in place.
Principle 38. Securities settlement systems and central counterparties should be subject to regulatory and supervisory requirements that are designed to ensure that they are fair, effective and efficient and that they reduce systemic risk.	Not assessed.

Annex Table 6. France: Recommended Action Plan to Improve Implementation of the IOSCO Principles

Principle	Recommended Action
1	French authorities should continue to work toward harmonizing approaches to (a) common institutions engaging in business across sectors; and to (b) commonly offered financial products. The authorities could consider whether the single Ombudsperson used for securities could be extended to financial services more generally.
2	French authorities could consider a number of possible changes to their current governance structure: (i) increase the formal distance between the representative of the Ministry of Finance (MoF) while creating more informal mechanisms to ensure the MoF can continue to gather first-hand experience on how the markets function; (ii) restrict membership of Board and sanctions committee to former members of industry who no longer have a vested interest; (iii) ensure Boards and sanctions committee become more balanced by including more members representing retail investors and consumers; and (iv) increase the limitations on the type of topics in which former industry members can participate.
3	AMF could benefit from increasing the capacity of its inspection unit so as to step up supervision and enforcement at ISP as well as FIAs. H3C is already planning to increase its capacity in the next two years. If it were possible to speed up this process, the H3C should take the opportunity. ACP could think of setting up a program redefining its supervisory philosophy and changing the supervisory mindset of the organization to enhance its enforcement orientation.
6	AMF should continue on its path of contributing to an effective systemic-risk framework and risk culture for the financial services oversight authorities.
7	AMF could determine how the risk processes can be adapted so as to increase their capacity to review sufficiently and systematically the perimeter of regulation.
8	AMF could consider whether a further exploration of the risk areas mentioned by the respondents in the assessment would be beneficial.
12	In addition to the recommendations on Principle 3, AMF and ACP could think whether and how a lighter version of the sanctions procedure could be designed that includes sufficient safeguards yet requires less manhours to operate and takes less time to complete. Such a procedure ought to be designed with the smaller/objective infringements in mind and with the full respect of the rights of defence. It could usefully be based on examples observed in practice in certain countries that have proven to develop effective models.
14	ACP should establish mechanisms to monitor that cooperation with foreign regulators is provided diligently.
16–17	The assessors encourage the authorities to determine whether additional safeguards are necessary in connection with *Marche Libre* and Alternativa, for example, by more directly prohibiting access of retail investors to these markets.

Principle	Recommended Action
19	H3C should follow through with its plan to expand its inspection team, accelerating it if possible. All auditors who audit listed companies, whether on a regulated market or an MTF, should be included in the PIE concept. H3C should seek to establish cooperation arrangements with the Public Prosecutor in order to ensure that cases are brought diligently to the regional chambers. H3C should be given more direct enforcement powers
20	The assessors encourage the authorities to find mechanisms to ensure a similar level of oversight in relation to auditors' selection and independence for issuers admitted to trading in OMTFs as that required for issuers admitted to trading in a regulated market.
21	The authorities should consider adoption of the quality control standard of the International Standards on Auditing as part of the French auditing standards.
23	AMF should consider including remuneration of sell side analysts as part of its supervisory efforts in connection with compensation.
30	ACP should consider implementing capital adequacy reporting on a more frequent basis, as well as consider whether its onsite inspection program can be made more risk based.
31	See recommendation on principle 3.
32	ACP should determine specific triggers at which additional reporting (in terms of scope and frequency) to ACP has to be commenced. In addition, to its current work on recovery and resolution plans for systemically important institutions, ACP could consider conducting crisis management exercises. AMF should finalize the development of its crisis management toolkit in connection with PMCs.
33	AMF and ACP should continue to take all necessary actions to ensure the information technology reliability of Euronext.
34	AMF should continue to monitor that Euronext keeps sufficient resources dedicated to market integrity issues. AMF should request that Euronext implements a disclosure policy in connection with enforcement actions. AMF should re-evaluate arrangements and resources dedicated to the oversight of the operators of MTF that are not managed by Euronext in tandem with the increase in activities in such platforms.
35	AMF is encouraged to continue to work with other European regulators, in particular via ESMA, with the objective of (i) limiting the negative impact of waivers on pre-trade transparency, and addressing potential imprecisions in definitions to avoid diverging interpretations amongst national regulators; (ii) achieving a single and exhaustive European consolidated tape in the equity markets; and (iii) consolidating audit trails on orders in the EU allowing national regulators to monitor equity markets.
36	Market abuse provisions should be extended to all MTFs. AMF is encouraged to work through ESMA in implementing order reporting requirements across Europe. A unique client identification number can also be pursued in the context of the implementation of MiFID II. AMF and the Public Prosecutors are encouraged to work in addressing challenges to criminal enforcement, as described in this report.

Principle	Recommended Action
37	A large trades report (“commitments of traders”), which includes information on clients’ positions, should be implemented in connection with the derivatives markets.

F. Authorities’ Response to the Assessment

148. **The French Authorities would like to express their appreciation to the IMF and its staff for their thorough analysis of the French financial sector and the very informative exchanges of views within the context of the IOSCO assessment.** The FSAP remains the key vehicle for an effective implementation of IOSCO international regulatory standards and confirms the added value of the robust IOSCO assessment Methodology as reinforced in the aftermath of the financial crisis.

149. **The Authorities welcome the IMF’s judgement stating that France exhibits a high level of compliance with the IOSCO standards.** Since the last FSAP in 2004, France has reinforced its system in several aspects as identified by the IMF. The conclusions of this second FSAP will be beneficial in order to further improve the French regulatory and supervisory approach. The French Authorities also trust that the conclusions will help inform the future development of the European legislative and regulatory framework as the IMF will certainly extend its recommendations to other European countries in the areas where weaknesses have been found which relate to the European legislative or regulatory framework.

150. **It should be noted that France has been among the first jurisdictions to be subject to a more thorough FSAP, assessing not only the regulatory framework but also effective supervision**. In addition, this evaluation is already based on the revised IOSCO standards which were largely reinforced since France’s first assessment in 2004. This explains why certain grades may now be set at a lower level than at the time of the first assessment. This should not in any case be interpreted as a decrease in the level of regulation or supervision in France.

151. **However, French Authorities wish to raise one important concern in relation to the IOSCO assessment, which relates to the independence of the AMF.** The Authorities believe that the French governance system brings valuable benefits and provides for robust guarantees for the independence of the regulators also in comparison to other examples at the international level. The AMF disposes of full regulatory and supervisory powers and its statutory independence is ensured through its statute as “*autorité publique indépendante*” defining, among others, also a budgetary independence. Many other market authorities do not benefit from the same safeguards, some of them being placed under the direct supervision of the Ministry of Finance. In addition, the AMF Chairman has a non revocable and non renewable mandate of five years. There have been no failures identified with the current system that has been place for several years. AMF’s decisions are taken in a collegial manner

within the AMF Board as well as in the distinct Enforcement Committee. These bodies need specific expertise to fulfil their missions efficiently given the increasing complexity of market activities and the speed of market developments and innovation. This is why, in addition to representatives nominated by institutions that are themselves independent from the executive power, the Board and the Enforcement Committee also benefit from the participation of representatives of the private sector—issuers, investors and intermediaries—nominated by the Minister of Finance on the basis of their expertise and experience. The composition of the Board and the Enforcement Committee is defined to bring together the views of the public sector (represented by judges, public authorities such as the *Banque de France* or the *Autorité des normes comptables*) as well as those of market intermediaries, investors and issuers who very often have competing interests, in order to reach a balanced outcome. The role and powers of the representative of the Ministry of Finance are fully set in the law, which gives no membership status in the AMF Board and Enforcement Committee. The only right attributed by law is to ask for a second deliberation in the Board for matters other than sanctions. The request for a second round of deliberations has no effect on the eventual content of the decision but gives the Board an opportunity to review its decision, within a very short space of time, so as to consider all its consequences and to ensure it is reasonably undisputable.

152. **Efficient financial regulation requires that all parties involved work together and have efficient exchanges.** To that aim, the French authorities believe that this relationship and dialogue need to be clearly defined. To our knowledge it is rarely the case that the relationships between regulators and the Ministries are framed in this formal way and set by the law. It is the preference of France to have clear and formal ways of exchange of views. This provides for transparency about the position of the Ministry of Finance, to the full knowledge of all stakeholders. Finally, the participation of the representative of the Ministry in the Board is a way to ensure good coordination and efficient information sharing between authorities on issues related to financial stability, financing of the economy as well as on European and international negotiations. These exchanges undoubtedly allow improving the quality and reactivity of the process of elaboration of financial regulations.

153. **The AMF will monitor with great interest future FSAPs so as to learn from other countries' experiences within the context of consistent implementation of international standards.**

ANNEX IV. IMPLEMENTATION OF THE CPSS-IOSCO RECOMMENDATIONS FOR CENTRAL COUNTERPARTIES

A. Information and Methodology Used for Assessment

154. **This assessment of LCH.Clearnet SA against the CPSS/IOSCO Recommendation for Central Counterparties was undertaken as part of the FSAP for France.** Information used in the assessment includes relevant laws, bylaws, regulations, rules and procedures governing the systems. The assessment relied also on the LCH.Clearnet SA self-assessment against the European System of Central Banks and the Committee of European Securities Regulators Recommendations conducted by BdF. Extensive discussions were held with ACP, AMF, BdF, LCH.Clearnet SA senior management and staff, and representatives for the participants in the system.

155. **LCH.Clearnet SA provides clearing services to several European markets.** For this reason, BdF, as a 'lead overseer', invited other competent authorities in France, Belgium, the Netherlands, and Portugal to cooperate in the preparation of the assessment of LCH.Clearnet SA aspects that are of common interest. In addition, information was exchanged between the French and Italian authorities within the context of the self assessment, on the link between LCH.Clearnet SA and the Italian CCP, Cassa di Compensazione e Garanzia (CC&G). The French authorities and the management of LCH.Clearnet SA have been cooperative in providing supplemental information and organizing additional meetings to fulfill the assessment.

B. Institutional and Market Structure

156. **Since December 2003, LCH.Clearnet SA is fully owned by the holding company LCH.Clearnet Group Ltd., which is a private company registered in the United Kingdom.** The holding company was created as part of a merger in December 2003 to oversee the two wholly-owned subsidiaries of the Group: (i) LCH.Clearnet Limited (formerly London Clearing House Limited); and (ii) LCH.Clearnet SA (officially "Banque Centrale de Compensation SA"). The latter became an independent legal entity at the time of the merger, having previously been part of the Euronext Group. The shareholders of the holding company are mainly its users with 83 percent of total shares, and the remaining part is owned by NYSE Euronext, and London Metal Exchange.

157. **LCH.Clearnet SA is a company incorporated in France, licensed as a credit institution and, therefore, governed by French law.** It has branches in Amsterdam and Brussels and a representative office in Portugal. It has developed cross-border activities in Italy, Luxembourg, Germany, and Spain. LCH.Clearnet SA operates a link with CC&G, which is part of the London Stock Exchange group.

158. **LCH.Clearnet SA clears a broad range of products traded on stock exchanges, electronic trading platforms, and over-the-counter (OTC) markets.** These products include: listed cash products (cash equities, convertible equities, and bonds listed on the NYSE Euronext markets); listed derivatives products (equity and commodity derivatives listed on the NYSE Euronext markets); fixed-income products (government debt securities traded on electronic trading platforms); and OTC product (credit derivative swaps-CDS).

159. **Two major developments took place recently.** The Board of the group initiated a "Transformation Plan" aimed at creating "One Firm" by consolidating and rationalizing some of the operations of both the French and U.K. subsidiaries. The transformation plan would lead to promoting the horizontal multi-asset class clearing model and enhancing the risk and collateral management capability within LCH.Clearnet Group Ltd. Also, in March 2012, the LSE Group offered a bid to acquire at least 50 percent and up to 60 percent of LCH.Clearnet Group Ltd share capital. The transaction is expected to be completed by the fourth quarter of 2012, subject to regulatory approvals, including competition clearance.

C. Regulatory Structure

160. **LCH.Clearnet SA is incorporated in France and operates under French law.** By law, a clearing house in France must have a credit institution statute and be licensed and supervised by the banking supervisory authority, ACP. It is a credit institution within the meaning of the European Banking Directive. As a clearing entity, it is regulated by the securities regulator, AMF, which approves its operating rules. As a clearing and settlement system for financial instruments, LCH.Clearnet SA is overseen by BdF.

161. **LCH.Clearnet SA is subject to the regulation and oversight of the Dutch, Belgian, and Portuguese competent authorities.** It provides clearing services for NYSE Euronext Amsterdam, NYSE Euronext Brussels and NYSE Euronext Lisbon. To coordinate the regulation and oversight of LCH.Clearnet SA, MoUs have been signed between the National Bank of Belgium and Financial Services Market Authority; De Nederlandsche Bank and Nederlandsche Autoriteit Financiële Markten; and Banco de Portugal and the Comissão do Mercado de Valores Mobiliários. A college has been set up for this purpose.

162. **LCH.Clearnet SA is also licensed as a Recognized Overseas Clearing House (ROCH) by the U.K. Financial Service Authority.** An MoU is signed between all involved authorities (France, Belgium, the Netherlands, Portugal, and United Kingdom) for exchange of information at the level of the LCH.Clearnet Group Ltd.

D. Main Findings

Legal Framework (Rec. 1)

163. **LCH.Clearnet SA activities are governed by a consistent and solid set of laws, regulations, and rules.** In particular, the legal framework supports the enforcement of transactions, netting procedures, and protection of customer assets. There are adequate rules for addressing the event of a participant default, including the effective use of collateral. The implementation of the settlement finality and collateral directives provide a solid protection both in France and other European Economic Area (EEA) countries.

Participation requirements (Rec. 2)

164. **LCH.Clearnet SA access and exit criteria are well defined and publicly disclosed.** LCH.Clearnet SA's participation requirements are objective and clearly stated in its website. They do not limit access on grounds other than risks. Only regulated credit institutions and investment firms are eligible to become clearing members. Furthermore, participants should meet financial resources and operational reliability. LCH.Clearnet SA monitors participants' compliance on a regular basis.

Financial risk management (Rec. 3–6)

165. **LCH.Clearnet SA has a comprehensive risk management framework.** It monitors its participants' exposures at least once a day and conducts intraday margin calls. It employs several tools to limit its exposures to potential losses from defaulting participants, including a high level of required capital, margin requirements, and contributions to the clearing fund. LCH.Clearnet SA can also require additional financial resources from participants in situations where unusual prices levels are detected. Recently, LCH.Clearnet SA developed dedicated risk-management procedures to handle sovereign debt. Nevertheless, LCH.Clearnet SA should measure its exposure continuously throughout the business day; i.e., an exposure is calculated continuously intraday once the positions, the participants, or the prices of the products have changed.

Custody and investment risks (Rec. 7)

166. **Cash and securities are kept safe in central bank account and national and international central securities depositories.** LCH.Clearnet SA has an account in TARGET-2.LCH.Clearnet SA investment policy is conservative by investing in highly rated government instruments. It ensures that its overall credit exposure to any individual issuer remains within acceptable concentration limits by the daily monitoring procedures.

Operational risk (Rec. 8)

167. **LCH.Clearnet SA business continuity arrangements are well developed and cover all aspects of its operation and communication networks.** As a credit institution, LCH.Clearnet SA has implemented the Basel II Operational Risk Framework. Operational risk management is an ongoing process based on a formalized methodology. The monitoring of operational risks and loss events is performed through a dedicated tool. Contingency plans and back-up facilities are regularly tested and maintained to ensure the resilience of LCH.Clearnet SA. A simulation exercise with market participants should be carried out annually. The relevant authorities should also formalize the assessment of the operational risk, including onsite inspections, of the insourcing company that develops and manages the largest part of LCH.Clearnet SA activities.

Money settlements (Rec. 9)

168. **LCH.Clearnet SA uses both central bank money and a private settlement bank for cash processing (margin and settlement).** Central bank money is used for most euro payments, about 85 percent for the cash equity segment and 100 percent for other asset segments. Euroclear Bank is used for about 10 percent of the volume of NYSE Euronext markets and Clearstream Luxembourg is used for the settlement of transactions on Bourse de Luxembourg, although the amount is very low. Commercial bank money is also used for the settlement of margins in British pound and U.S. dollars, which are very negligible.

Physical deliveries (Rec. 10)

169. **LCH.Clearnet SA clearly identifies and manages its obligation for physical delivery.** The deliveries of securities are carried out in book-entry form (dematerialized and immobilized), and delivery obligations are fulfilled via book transfer. LCH.Clearnet SA has developed comprehensive rules and instructions for the delivery of commodity contracts.

Risks in links between central counterparties (Rec. 11)

170. **LCH.Clearnet SA has a link to CC&G for clearing Italian government bonds.** LCH.Clearnet SA has specific rules and risk methodology aimed at minimizing its risk exposures to CC&G. Both CCPs collect margins from each other based on a methodology that is applied on their members, but they do not contribute to the other's clearing fund to minimize contagion risk that may result from members' default. The link is subject to the regulation and oversight of relevant French and Italian competent authorities. Both CCPs are designated payment systems according to Article 10 of the Settlement Finality Directive, which provides legal protection to finality and collaterals.

Efficiency (Rec. 12)

171. **LCH.Clearnet SA reviews its pricing and service levels, as well as capacity levels regularly.** It performs periodic benchmarking studies with comparable European CCPs to assess its costs and fees. An ongoing profit-and-loss analysis is conducted.

Governance (Rec. 13)

172. **LCH.Clearnet SA is a wholly owned subsidiary of LCH.Clearnet Group Ltd.** LCH.Clearnet SA governance arrangements and composition of the Boards are clear and publicly available on its website. The Board, which includes four independent Board members, is accountable to the shareholders. However, there is no formal selection criteria or procedure used to choose the "user representative" on the Board, so as to ensure the Board has appropriate skills and incentives. Procedures to identify and mitigate conflicts of interests should be further enhanced. A transformation plan is currently being implemented, aimed at streamlining the operations of both subsidiaries based on product lines, and some of the functionalities will be concentrated at the group level. In this context, it is crucial that the new organization does not compromise that LCH.Clearnet SA retains the necessary level of independence to meet its regulatory obligations as a distinct legal entity.

Transparency (Rec. 14)

173. **LCH.Clearnet SA discloses to its clearing members and other market participants its rules, procedures, and policies on its website.** These rules cover, among other things, governance issues, the rights and obligations of participants, procedures and tools for handling risks, and fees for using its services. Also important notices and information are posted on the website. LCH.Clearnet SA has not completed and disclosed a comprehensive self-assessment following the RCCPs assessment methodology.

Regulation and oversight (Rec. 15)

174. **The objectives and responsibilities of the regulators of LCH.Clearnet SA are well defined and transparent.** The supervision and oversight of LCH.Clearnet SA are comprehensive and effective. LCH.Clearnet SA is regulated and supervised by several domestic and foreign authorities. Cooperation and coordination between these authorities are governed by French law and, where necessary, formalized in several MoUs.

175. **A general discussion with the system operator and the regulators indicates that LCH.Clearnet SA will be, in principle, able to meet the newly revised CPSS/IOSCO principles.** In particular, the new principles would not have any significant impact on LCH.Clearnet SA, and it will be able to adjust to the new requirements as far as needed.

Annex Table 7. France: Recommended Action Plan to Improve Implementation of the CPSS-IOSCO Recommendations for Central Counterparties

Recommendation	Recommended Action
Recommendation 2: *Participation requirements*	Due to the unique position of LCH.Clearnet SA, as a single CCP serving the French financial markets, an applicant should have the possibility to appeal to a third party (cf. competent authority) rather than addressing a court, which is a lengthy process, to solve litigation linked to the refusal of a membership.
Recommendation 3: *Risk management*	LCH.Clearnet SA should measure its exposure continuously throughout the business day, i.e., exposure is calculated continuously intraday once the positions, the participants, or the prices of the products have changed. For fixed income instruments, LCH.Clearnet SA should use intraday prices for the calculation of its exposures. The triggers for additional intraday margin calls for exchange traded equities should be formalized with specific procedures and policies. LCH.Clearnet SA should develop a mechanism that allows the calculation of margin call for CDS on the same day prices rather than the prices of previous day.
Recommendation 4: *Margin requirements*	Improvements are still needed in automation, trailing and accuracy in parameters' calculation. To enhance transparency and reduce uncertainty, LCH.Clearnet SA should formalize its policy to address wrong way risk. LCH.Clearnet SA should commission an independent review of its risk models for all its products and not only for CDS. Intraday margin call should also be applied on cash equity.
Recommendation 6: *Default procedures*	LCH.Clearnet SA should introduce a mechanism to allow the segregation between the clearing member's proprietary assets and its clients' assets when the segment is developed for CDS contracts. LCH.Clearnet SA should introduce an operational segregation mechanism for all fixed income products.
Recommendation 8: *Operational risk*	An external audit of the business continuity plan should be carried out annually. LCH.Clearnet SA should formalize the external audit of the operational risk of the outsourced activities. The relevant authorities should formalize the assessment of the operational risk of the insourcing companies, including onsite inspection. The business continuity plan should be tested regularly with participants. A feasibility study, including cost assessment, should be undertaken by LCH.Clearnet SA to reduce the recovery time objective from four hours to preferably less than one hour.
Recommendation 9: *Money settlements*	Once the volume of non-euro payments in commercial bank money increases, LCH.Clearnet SA should carry out an assessment of the finality of these payments.
Recommendation 11: *Risk in links*	LCH.Clearnet should collect adequate level of additional margin from CC&G as contribution to the default fund is not made. LCH.Clearnet SA should ensure that the collateral provided to CC&G is safely invested by minimizing credit and liquidity risks.

Recommendation	Recommended Action
Recommendation 13: *Governance*	LCH.Clearnet Group should adjust its criteria for the independence of the non-executive Board to be in line with the U.K. Code on Corporate Governance. In particular, criteria 2 on "no material business relationship with the company" and criteria 5 on no "cross-directorships were omitted from the articles." At the level of LCH.Clearnet SA and at the Group Ltd qualification and criteria to select Board members should be disclosed to ensure the Board has appropriate skills and right incentives. LCH.Clearnet should formalize the selection criteria used to choose the "user representative" on the Board. LCH.Clearnet SA should provide clarity on its remuneration policy. LCH.Clearnet at the level of the Group and LCH.Clearnet SA should review their structure, identify possible conflict of interests, and enable prompt actions from independent directors and the chairman of each Board. LCH.Clearnet Group Ltd is aware of some of the shortcomings mentioned above and is undertaking initiatives to address them. It is important to ensure that the transformation plan that will lead to further integration of the clearing activities within the Group would not erode the decision making process at the level of LCH.Clearnet SA with an adverse impact on managing the risks and meeting the needs of the local market.
Recommendation 14: *Transparency*	LCH.Clearnet SA should complete and disclose the answers to the key questions set out in the CPSS/IOSCO report on RCCP. It should also review the answers at least once a year or when major changes occur.
Recommendation 15 *Regulation and oversight*	BdF should be empowered to issue regulation and undertake measures to effectively enforce its oversight responsibility. ACP and AMF should produce a policy note clearly defining and publicly disclosing their respective objectives, roles and responsibilities with regard to the soundness and efficiency of LCH.Clearnet SA. To increase transparency and accountability, the three involved competent authorities—BdF, AMF, and ACP—should produce a joint policy note clearly defining and publicly disclosing their respective objectives, roles and responsibilities with regard to the soundness and efficiency of LCH.Clearnet SA.

E. Authorities' Response to the Assessment

The authorities had no comments.