ESRB
European Systemic Risk Board
European System of Financial Supervision

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

Introduction

On 23 April 2020, the Haut Conseil de stabilité financière (High Council for Financial Stability - HCSF) notified the European Systemic Risk Board (ESRB) of its intention to extend the period of application of its current macroprudential measure based on Article 458(2)(d)(ii) of the Capital Requirements Regulation (CRR)[1], which aims to limit concentration risk with regard to highly indebted large French non-financial corporations (NFCs). The HCSF is designated as the authority in charge of the application of Article 458 of the CRR in France[2].

Pursuant to Article 458(4) of the CRR, the ESRB must provide the Council, the European Commission and France with an opinion within one month of receiving the notification. The opinion must be accompanied by an assessment of the national measure in terms of the points mentioned under Article 458(2) of the CRR. The procedural framework for providing opinions under Article 458 of the CRR is clarified in Decision ESRB/2015/4[3].

The ESRB's assessment focuses on the net benefits of the national measure for maintaining financial stability. In particular, the ESRB has assessed the rationale and merit of the measure against the following criteria:

- **Justification:** Has there been a change in the intensity of systemic risk and does it pose a threat to financial stability at the national level? Can alternative instruments provided for under the Capital Requirements Directive (CRD IV)[4] and the CRR adequately and appropriately address the risk, taking into account their relative effectiveness?
- **Effectiveness:** Is the measure likely to achieve its intended objective?

1 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27 June 2013, p. 1).

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

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

4 Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27 June 2013, p. 338).

- **Efficiency and suitability:** Will the measure achieve its objective in a cost-efficient way, i.e. have the appropriate instruments and calibration been used?
- **Proportionality and impact on the Internal Market:** Is there an appropriate balance between the costs resulting from the measure and the problem it aims to address, taking into account any potential cross-border spillover effects?

The ESRB's assessment draws on the information provided by the HCSF in addition to discussions with the Banque de France, the Autorité de Contrôle Prudentiel et de Résolution (ACPR) and their staff.

Section 1: Description of and background to the existing measure and its extension

1.1 Description of the existing measure and its proposed extension

The existing measure consists of a tightening of limits for large exposures of French systemically important credit institutions to highly indebted large NFCs that have their registered office in France. The tightened limit requires systemically important French credit institutions to ensure that exposures to highly indebted large NFCs are no greater than 5% of eligible capital. An NFC is to be classified as highly indebted if its ultimate parent company has both a net leverage ratio[5] greater than 100% and its interest coverage ratio[6] is below three. A credit institution applies the measure to those of its exposures, where it has an original exposure to the highly indebted NFC, or to the group of connected clients to which the highly indebted NFC belongs, equal to or larger than EUR 300 million.[7]

The primary objective of the existing measure is to increase the resilience of the systemically important French credit institutions in the event of default of large and highly indebted NFCs. This is achieved by limiting concentration and hence the impact that the default of a large debtor could have on the lender's solvency. Furthermore, as a secondary objective, the measure aims to send a signal to financial institutions and investors of the risks associated with the high leverage of large French NFCs.

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[5] Defined as total financial debt less outstanding liquid assets over total equity.

[6] Defined as earnings before interest and taxes over interest expenses.

[7] Exposures as defined in Articles 389 and 390 of the CRR that are larger than or equal to EUR 300 million before taking into account the effect of credit risk mitigation techniques and exemptions in line with Article 9 of the Commission Implementing Regulation (EU) No 680/2014. For NFCs that belong to a group resident in France, the sum of the net exposures towards the group at the highest level of consolidation applies. For NFCs resident in France belonging to a foreign group, the large exposure limit applies to the sum of the exposures towards the part of the group resident in France. The term "group" also includes interconnected clients based on the conditions outlined in the CRR large exposure framework other than ownership.

For a more detailed description of the existing measure, please refer to the ESRB's original assessment.[8]

The extension of the measure is scheduled to apply from 1 July 2020, the date the current measure in force would expire. A decision on the extension is expected to be taken in June 2020 and communicated to the market by an HCSF press release and publication of the related legal text on the HCSF website and in the Journal Officiel de la République Française (Official Journal of the French Republic - JORF). If extended, the measure would continue to be fully applicable for another year until 30 June 2021. No change in calibration, thresholds or other modalities of the measure is proposed by the HCSF. The HCSF intends to review the calibration and appropriateness of the measure annually. This annual review will also make it possible to assess any potential profound changes in underlying fundamentals, triggered for example by the coronavirus (COVID-19) pandemic.

The HCSF requested reciprocation of the existing measure by other Member States under Article 458(8) of the CRR; the ESRB General Board decided to recommend reciprocation,[9] **and its recommendation will also apply to the measure in its extended form.** The HCSF emphasised that reciprocity remains relevant for the extended measure, since banking sectors of some Member States may be exposed directly or through their branches to the risk of NFCs' indebtedness in France. While the market share of significant institutions other than the six French systemically important institutions targeted by the measure is very small, the HCSF points out that in addition to the positive impact on the financial stability of the reciprocating jurisdictions, the reciprocation reduces the risk of leakages and ensures a level playing field in the EU.

1.2 Background

The proposed extension of the measure comes at a time of severe economic crisis triggered by the impact of the COVID-19 pandemic. While the exact duration and severity of the economic shock is still uncertain at the current juncture, it is already clear that the pandemic is having a profound negative impact on corporates worldwide and will lead to an increased level of indebtedness at global level and among French NFCs.

Member States, EU institutions and national authorities have taken a number of policy measures to mitigate the impact of the COVID-19 pandemic.[10] Supervisory and macroprudential authorities have notably encouraged credit institutions to use their capital buffers to ensure they can continue lending to the real economy. In this regard, the HCSF decided on 18 March 2020 to lower the countercyclical capital buffer (CCyB) to 0%. The

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[8] **Assessment of the French notification in accordance with Article 458 of Regulation (EU) No 575/2013 concerning the application of a stricter national measure as regards requirements for large exposures**, ECB, 9 March 2018

[9] **ESRB recommendation of 5 December 2018**

[10] For an overview of policy measures in response to the COVID-19 pandemic see **https://www.esrb.europa.eu/home/coronavirus/html/index.en.html**

CCyB had previously been set at 0.25% and was scheduled to increase to 0.5% as of 2 April 2020. Moreover, France adopted substantial State aid measures to support the French economy which partially took the form of State guarantees for corporate loans.[11] These measures were introduced in addition to the economic measures taken as part of the common European response to the COVID-19 outbreak coordinated by the European Commission.[12]

The HCSF is of the view that in the current economic situation, which has seen a significant deterioration, large exposures to highly indebted French NFCs remain a macroprudential concern. Although it considers the targeted risks to be of a cyclical nature, the diagnosis that warranted the activation of the measure remains valid. According to the HCSF, the design of the measure is appropriate even in the current economic situation. The HCSF noted the measure will not capture the portion of a loan guaranteed by the State, since said portion qualifies as an eligible credit risk mitigation technique.[13] The HCSF does not expect the measure to restrict NFCs' access to credit. It stands ready to take appropriate action to ensure the flow of credit, should the limit become excessively constraining. The ESRB points out that in the current economic situation, the diversification of NFCs' lender base could be more difficult than when the measure was introduced, even for large companies.

Section 2: Analysis of the underlying systemic risks

The underlying systemic risk which the HCSF aims to address with the extension of the measure is the same as for the existing measure, namely a too high concentration risk which could result in an idiosyncratic corporate default having a substantial negative impact on the solvency of a systemically important institution (SII), which in turn could spill over to the financial system. The measure can hence be described as a backstop to ensure resilience by limiting individual exposures to a maximum of 5% of eligible capital compared to the general 25% limit provided for in Article 395 (1) of the CRR. The HCSF points out that in light of the high debt levels reached by some large NFCs and the high concentration of the French banking sector, the measure ensures that NFCs properly diversify their lender base, particularly against a background of increased risk aversion on the bond markets that might lead large corporates to increase their share of bank funding.

The ESRB points out that this underlying systemic risk has intensified in light of the economic impact of the COVID-19 pandemic. This impact is likely to trigger a significant increase in NFC debt levels combined with a decline in income and an overall negative impact on the capital levels of credit institutions. This will have an

[11] See for example 3 State guarantee schemes expected to mobilise more than €300 billion of liquidity support for companies affected by the economic impact of the Coronavirus outbreak: **https://ec.europa.eu/commission/presscorner/detail/en/IP_20_503**

[12] See **https://ec.europa.eu/info/live-work-travel-eu/health/coronavirus-response/overview-commissions-response_en**

[13] As per Article 395 CRR, exposures are taken after credit risk mitigation techniques.

impact on all of the measure's parameters, i.e. increases in NFC leverage ratios, making it more likely that the net leverage ratio of 100% is reached; earnings will be reduced while interest expenses will increase, in spite of loose monetary policy, making it more likely that the interest coverage ratio will be breached; and the eligible capital of credit institutions is likely to shrink, making it more likely that the 5% threshold will be breached.

The HCSF conducted a scenario analysis to assess the potential impact of the COVID-19 pandemic on the different parameters of relevance for the measure. The first scenario assumes that debt ratios in all large French NFCs increase, qualifying all of them as highly indebted. As a result, any lending to them by French SIIs is limited by the 5% threshold. The second scenario assumes that the crisis leads to a depletion of French SIIs' capital levels by 30%, leading to a greater likelihood of the 5% threshold being reached. The third scenario combines these two effects and assumes all NFCs are classified as highly indebted *and* that French SII capital levels are depleted by 30%. On top of these scenarios, the HCSF analysed by how much French NFCs could *increase* their current debt levels with the six French SIIs, which would allow them to react to re-intermediation needs in case of a freeze in debt markets, or to increased financing needs.

According to the HCSF's analysis, there is still substantial margin for any large, highly indebted NFC to obtain further funding from different French SIIs. In the first scenario (deterioration of NFCs' debt ratios), the 5% threshold would be reached for two NFCs vis-à-vis one French SII in each case. Financing could therefore be obtained from other SIIs, which would lead to the intended diversification effect. In the second scenario (capital depletion by 30% in all French SIIs), the 5% threshold would still not be reached in any case. In the third scenario (combining scenarios 1 and 2), four NFCs would breach the 5% threshold each vis-à-vis one SII, also allowing for financing from other SIIs. The HCSF also analysed how much additional lending (compared to the current debt levels) NFCs could obtain. Even in the third scenario, the additional borrowing capacity for the most severely constrained NFC amounts to an increase in total borrowing of 10%. According to the HCSF, the nature of the measure as a backstop is therefore maintained.

2.1 Developments in French NFCs' debt

According to the HCSF, there was an upward trend in the debt of large and highly indebted NFCs, underlying the macroprudential risk facing the French financial system. Overall NFC debt growth has continued at a fast pace following the announcement of the measure in December 2017 and its implementation in July 2018. The increase in corporate debt was particularly strong up to the end of 2019, with the total annualised NFC debt growth rate amounting to 5.6% between December 2017 and December 2019. Exposures in the form of debt securities, which constitute the bulk of large corporates' debt portfolios, rose even faster (at an annualised rate of 6.6%). Debt-to-GDP ratios of French NFCs increased from 2017 levels by 3.6 percentage points to 73.5% in the second quarter of 2019. Information provided by the HCSF shows the entire distribution of large NFCs' net leverage ratios (defined as debt net of liquid assets relative to equity) shifted upwards in 2018. This is not a counter-factual analysis, i.e. it does not indicate by how much the leverage would have increased in the absence of the French measure.

Due to the economic impact of the COVID-19 pandemic, the ESRB expects a sharp rise in NFCs' debt levels. The scenario analysis conducted by the HCSF takes this effect into account.

The ability of French NFCs to service the increased debt levels did not improve materially in recent years, as reflected in the interest coverage ratio and the debt service ratio. Large NFCs' interest coverage ratios saw only a small decrease in 2018 relative to 2017. A more comprehensive debt service ratio comprising both interest and principal payments increased in recent years for French NFCs. Data for 2019 and the first quarter of 2020 were not provided in the notification.

The HCSF points to the sensitivity of outstanding debt to an increase in interest rates. The concerns raised by the ESRB in its assessment of the original measure in this respect remain valid.[14] This is particularly relevant in light of the high share of French corporate debt carrying a floating interest rate or maturing within one year that is likely to need renewing, possibly under less favourable conditions due to the COVID-19 pandemic.[15]

Section 3: Effectiveness and efficiency of the measure

3.1 How the measure addresses the identified risk

As stated in Section 1, the measure's primary objective is to safeguard the resilience of the French banking system by limiting concentration risk. Its secondary objective is to serve as a preventive warning signal. The effectiveness of the measure is therefore assessed according to: (i) its capacity to prevent the excessive concentration of exposures to highly indebted NFCs in French systemically important credit institutions; and (ii) signal to all investors the risk inherent in the accumulation of debt by large and highly indebted NFCs.

As regards the primary objective, the concentration in systemically important credit institutions of large exposures to highly indebted NFCs did not increase further. The measure was taken to prevent a possible further increase in this concentration. According to the HCSF, the concentration of exposures to NFCs breaching both thresholds remained stable and considerably below the 5% threshold considered risky by the French authorities. Although it cannot be proven this was achieved as a direct consequence of the measure, the primary objective of resilience therefore appears to be fulfilled.

As regards the secondary objective, it is difficult to provide evidence of increased investor awareness as a result of the measure, but at least no obvious leakages were observed. The indebtedness of large NFCs is still high and rising despite the measure having been implemented. As shown in Section 2.1, French NFC debt

[14] See point 2.2, **https://www.esrb.europa.eu/pub/pdf/reports/esrb.opinion180309_large_exposures.en.pdf**

[15] See also **https://blocnotesdeleco.banque-france.fr/en/blog-entry/do-highly-indebted-large-corporations-pose-systemic-risk**

growth has continued at a fast pace, even after the measure was announced in December 2017 and implemented in July 2018. To assess possible leakages, i.e. increased non-bank or foreign-bank financing by large French NFCs, the HCSF analysed the borrowing behaviour of large NFCs and observed that those most affected by the measure experienced slower debt securities growth compared to a control group; it also found that foreign bank lending only increased very modestly from 6% at end-2017 to 7% at end-2019.

Overall, the specific conditions that led to the activation of the existing measure still prevail and hence the extension of the measure as a backstop against a potential further increase in concentration risk seems warranted. The ESRB's assessment of the unchanged calibration and design of the existing measure remains valid in this respect.[16]

3.2 How the measure relates to possible alternatives

As required under Article 458 of the CRR, the ESRB's assessment of the original measure already analysed whether other available macroprudential instruments under the CRD IV and CRR could adequately address the systemic risk identified, taking into account their relative effectiveness.[17] The main arguments as to why these measures are not considered to be appropriate alternatives to the envisaged extension of the measure under Article 458 of the CRR remain the same and are repeated below.

a) Article 124 (risk weights under the standardised approach) and Article 164 (higher loss given default (LGD) minimum under the internal approach) of the CRR

According to Article 124 of the CRR, competent authorities can impose higher risk weights for exposures secured by mortgages on credit institutions that apply the standardised approach on the basis of financial stability considerations.

According to Article 164 of the CRR, competent authorities can set higher minimum values of exposure weighted average LGD for retail exposures secured by residential property on the basis of financial stability considerations for credit institutions that apply the internal approach. LGD is one of the parameters used in the risk weight function, and hence increasing the LGD indirectly increases the risk weight and resulting capital requirements.

[16] See **Section 3.1** of the ESRB's Assessment of the French notification in accordance with Article 458 of Regulation (EU) No 575/2013 concerning the application of a stricter national measure as regards requirements for large exposures, ECB, 9 March 2018.

[17] ibid., **Section 3.2**.

Given that the measure pertains to exposures to the NFC sector and intends to limit the risk deriving from the growing indebtedness of these corporates, Articles 124 and 164 of the CRR are not relevant or able to safeguard the resilience of the French financial system with respect to this risk.

b) Articles 101 (ongoing review of permission to use internal models), 103 and 104 (supervisory powers) of the CRD IV

Article 101 of the CRD IV establishes requirements for competent authorities to review permission to use internal approaches. The competent authority shall review on a regular basis, and at least every three years, institutions' compliance with the requirements regarding approaches that require permission by the competent authorities before using such approaches for the calculation of own fund requirements.

Competent authorities can apply supervisory measures to address risks that are not sufficiently covered by Pillar 1, including systemic risks. These powers can be applied under the Supervisory Review and Evaluation Process (SREP), one of the components of Pillar 2.

The HCSF believes that acting on the basis of these articles would not be as effective as the proposed measure, notably because they do not capture macroprudential concerns. The HCSF highlights in particular that the lack of disclosure underlying the Pillar 2 requirements would not make it possible to raise public awareness through a signalling effect of the issue related to the growing debt of French NFCs.

The ESRB agrees with the HCSF that the aim of the proposed measure is intrinsically macroprudential, while Articles 101, 103, and 104 are microprudential in nature. The measure aims to mitigate an increase in the systemic risk related to the increase in NFC indebtedness and is not aimed at issues on a microprudential level. While the measure applies to six SIIs, their market share among French banks in the non-financial private sector in France is 94%.

The ESRB believes that a clear distinction between microprudential and macroprudential measures improves transparency and strengthens accountability. Macroprudential objectives should therefore be primarily underpinned by macroprudential tools. At the same time, microprudential initiatives, such as the enforcement of sound risk management practices in individual credit institutions, can be used to enhance the overall resilience of the financial system.

c) Article 105 of the CRD IV (liquidity requirements)

Article 105 of the CRD IV concerns specific liquidity requirements. The systemic risk that the proposed measure aims to address is not linked to banks' liquidity risk but to credit risk, given that it relates to banks' exposures to increasingly indebted French companies.

d) Article 133 of the CRD IV (systemic risk buffer)

Under Article 133 of the CRD IV, Member States may introduce a systemic risk buffer (SyRB) to address long-term, non-cyclical systemic or macroprudential risks not covered by the CRR. The SyRB can be applied to all banks or to a subset of banks. In addition, the SyRB can be applied to domestic exposures, exposures in third countries and exposures in other Member States.

Currently, the SyRB is not designed to be applied to specific sectoral exposures. If the SyRB were to be used and applied to all exposures in France, this would affect all credit, including other exposures to small and medium-sized enterprises (SMEs) and corporates with low indebtedness, which would not be desirable as these other exposures have a different risk profile.

The HCSF should nevertheless reassess the need for the current Article 458 measure when Directive (EU) 2019/878[18] becomes applicable and allows for the application of a sectoral SyRB, which may be designed in a way that it targets the exposures of large, highly indebted NFCs. Setting a sectoral SyRB does not directly limit exposures and can be seen as a softer measure than a large exposure limit. Although a sectoral SyRB might not be a full substitute for a large exposure limit, it could complement such a limit by providing a capital incentive to limit exposures towards highly indebted NFCs and bolster resilience of the banking sector. The announcement of a positive sectoral SyRB rate could provide the signalling effect identified by the HCSF as the current measure's secondary objective. However, the ESRB acknowledges that a sectoral SyRB would not directly address the risk of concentration, which is the primary objective of the present measure and remains particularly relevant in the current situation. The ESRB also acknowledges that increasing capital requirements during the COVID-19 pandemic could potentially hinder the provision of credit to the real economy. These potential adverse effects, however, would likely be limited as a targeted sectoral SyRB would increase overall capital requirements only modestly.

e) Article 136 of the CRD IV (countercyclical capital buffer)

The CCyB can be used to address some of the procyclicality in the financial system. The CCyB addresses cyclical risks and is a requirement applied to all banks with the same buffer rate applied to all domestic risk-weighted exposures.

The CCyB is not an appropriate tool for addressing systemic risks linked to a subset of exposures in a subset of institutions. It is not possible to apply the CCyB requirement to specific subsets of exposures, such as loans to large, highly indebted NFCs, and hence setting a higher CCyB rate would have the unintended effect of also increasing the capital requirements for other exposures located in France. Moreover, calibration of the CCyB to a specific risk would prevent the CCyB from meeting its primary objective of building resilience in the upward

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[18] Directive 2019/878 of the European Parliament and of the Council of 20 May 2019 amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures (OJ L 150, 7 June .2019, p. 287).

phase of the financial cycle. The ESRB has also identified an important structural dimension of the risk targeted by the present measure, which should not be covered with a cyclical instrument.

f) Using other measures

In its assessment of the existing measure, the ESRB encouraged the French authorities to take the necessary initiatives to further expand their toolkit to address financial stability concerns, exploring in particular the introduction of borrower-based measures for large NFCs. The ESRB reiterates its view that borrower-based measures for NFCs might be effective in increasing the banking sector's resilience and might help prevent over-indebtedness of French NFCs. Borrower-based measures could target the specific segment of NFCs and be applicable only to corporations fulfilling certain criteria, such as the level of indebtedness or interest expenses. Borrower-based measures could also provide the desired signalling effect.

The ESRB is aware of the challenge of implementing borrower-based measures of this kind. Its stance reflects the absence of such measures in the EU regulatory framework, little experience in their implementation and challenges that their reciprocation could entail. While the ESRB is in favour of working on an EU-wide approach to borrower-based measures, Member States should in the meantime examine national solutions. They should nevertheless take into consideration that borrower-based measures usually only apply at the time of loan origination, while the large exposure limit applies at any time. In addition, the ESRB is mindful that the introduction of borrower-based measures would need to be considered very carefully in a situation of economic crisis, where the provision of credit to the affected NFCs may be impaired.

Section 4: Analysis of the measure's net benefits

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

The proposed extension of the measure contributes to the resilience of the French banking system, and thus to potentially enhancing the resilience of the economy as a whole. Tightening the limit on the exposures of SIIs in France to highly indebted, large corporates would help to maintain the resilience of the financial system to any sudden failure of those NFCs. The impact on the banks' balance sheets would be mitigated, reducing the possibility of a negative knock-on effect on the remainder of the domestic and European financial system.

The targeted nature of the measure contributes to its proportionality by aiming to avoid negative spillover effects on the overall extension of credit and the real economy. The measure applies only to highly indebted large NFCs and therefore does not constrain lending to other sectors such as SMEs or less indebted large corporates. Its sole application to systemically important credit institutions dominant in lending to large NFCs helps to reduce the administrative burden on smaller institutions, thereby respecting the principle of proportionality.

The measure does not seem to unduly restrict large French NFCs' current access to financing, and hence the potential negative impact of the measure on economic growth seems to be small. Given that this is designed as a pre-emptive, backstop measure, the expected impact, if any, on growth in other Member States is expected to be minimal. According to the scenario analysis conducted by the HCSF and described above in Section 2, the measure maintains its nature as a backstop measure, even in light of the negative economic impact of the COVID-19 pandemic. The HCSF also emphasised that even in the event of a breach of the 5% threshold, the supervisory response to the breach and the approach taken will take into consideration the specific situation, including the effects of the COVID-19 pandemic, and will allow for the necessary flexibility to avoid disproportionate effects. Moreover, the measure will not capture the portion of a loan guaranteed by the State, and State guarantees have been significantly extended in response to the COVID19-pandemic.

4.2 Cross-border effects and impact on the Internal Market

The HCSF does not expect the measure to have a significant negative impact on the EU Internal Market. On the contrary, it believes that the measure strengthens the resilience of the French banking sector against shocks from the large French NFC sector and reduces the risk of contagion from France to other EU Member States.

The measure does not apply to NFCs outside France, except for foreign subsidiaries if their parent company has its registered office in France. The HCSF applies the measure to these foreign subsidiaries to avoid excessive leakages and regulatory arbitrage from the French NFCs, because otherwise, the French parent company could use its foreign subsidiary to contract debt and channel it to France via intragroup lending. The HCSF states that there is no indication that the measure could have any direct impact on NFCs outside France not covered by the measure.

The HCSF did not observe a shift in highly indebted NFCs' demand for credit away from large French banks toward foreign banks. It stated that the role of foreign banks in the loan market for French NFCs remained small and increased only very modestly from 6% of total financing of loans to French NFCs at end-2017 to 7% at end-2019.

4.3 Domestic cross-sector effects and regulatory arbitrage

The HCSF has not detected any substantial leakage to the financial markets, non-bank sector or to non-systemic banks as a result of the current measure. As of Q2 2019, 35% of French NFC financing was provided by the financial market. The HCSF did not observe any increase in market borrowing by firms most affected by the measure, and even observed the opposite: highly indebted firms tended to increase the relative size of their loan borrowing. NFC loans granted by non-bank institutions remained flat and represented 4% of total NFC loan borrowing in Q2 2019. On the banking side, the share of systemic banks in total non-financial private sector financing is 94%. Since they usually focus on the SME segment, smaller French banks could only take on a small portion of this lending. They are also bound by the general large exposure limits and must comply with their internal risk management practices.

The ESRB welcomes the HCSF's and ACPR's intention to regularly monitor possible leakages or regulatory arbitrage in the future. From a financial stability perspective, it is important to ensure that stricter measures in one part of the financial system are not circumvented by the transfer of exposures to other financial intermediaries that may have a lower risk-bearing capacity or where concentration risk may arise.

Conclusion

The ESRB is of the view that the extension of the proposed measure serves as a helpful backstop to ensure risk diversification and safeguard the resilience of the French banking system. The measure aims to enhance the resilience of French systemically important credit institutions by limiting their individual exposure to highly indebted large NFCs. As such, it serves as a backstop against concentration risk.

The ESRB is of the view that the current economic crisis triggered by the COVID19 pandemic intensifies risks in the corporate sector across the EU and globally. Given these circumstances, the debt levels of French NFCs are likely to increase further over the coming quarters. Use of the French measure as a macroprudential backstop to ensure diversification and avoid the concentration of risk towards individual, highly indebted large NFCs therefore remains justified.

The ESRB is of the view that the proposed extension of the measure does not contradict the overall aim of guaranteeing lending to the real economy throughout the aforementioned economic crisis. Clear communication in this respect is important, explaining to the public that the extension of the measure is consistent with other measures taken in response to the COVID-19 pandemic. The extension of the measure does not per se set a limit to the overall borrowing of highly indebted large NFCs, but ensures that individual systemic credit institutions cannot have too large a concentration of their exposures towards any one individual NFC. Importantly, the portion of the exposures which have State-backed guarantees - granted in response to the COVID-19 crisis - do not count towards this large exposure limit. This is because the portion guaranteed by the State qualifies as an eligible credit risk mitigation technique.

The ESRB therefore supports the HCSF's intention to extend the period of application of its stricter national measure. At the same time, the ESRB reiterates that the issues raised in its assessment of the original measure require continued follow-up by the French authorities to ensure the effectiveness of the measure and avoid unwarranted consequences.

First, close monitoring of the impact of the measure and the evolution of the risk must continue, particularly if the 5% threshold for large exposures were to be frequently breached as a consequence of the COVID-19 pandemic. The severe negative impact of the COVID-19 pandemic will trigger a potentially large increase in NFC debt levels combined with a decline in income and an overall negative impact on credit institutions' capital levels. Therefore, all parameters of the existing measure will be negatively affected. Enhanced monitoring of the change in NFC financing vis-à-vis the six targeted institutions, and the corporate debt market more generally, is therefore required. The HCSF's scenario analysis is helpful in this respect, and the ESRB welcomes the HCSF's constant monitoring of the situation and its readiness to reassess the measure in light of the evolving circumstances. In addition to constant monitoring, the ESRB welcomes the HCSF's emphasis on a balanced and flexible approach in the event of a breach of the 5% threshold, taking into consideration the specific characteristics of each case, including the effects of the COVID-19 pandemic.

Second, the ESRB continues to encourage the French authorities to explore alternative options for addressing financial stability concerns, in particular if risks continue to develop unfavourably. These options include, but are not limited to, borrower-based measures and the SyRB after its sectoral use is permitted. The risks targeted are likely to persist over an extended period of time and permanent tools with less onerous administrative procedures should be explored. These alternatives could be used to substitute or to complement the current measure. In this context, the ESRB also believes that it would be helpful if the French authorities would be more specific in clarifying the criteria they would apply or indicators they would use for the extension or deactivation of the measure, particularly in light of the need to reassess and renew the measure on an annual basis.