- BUSINESS
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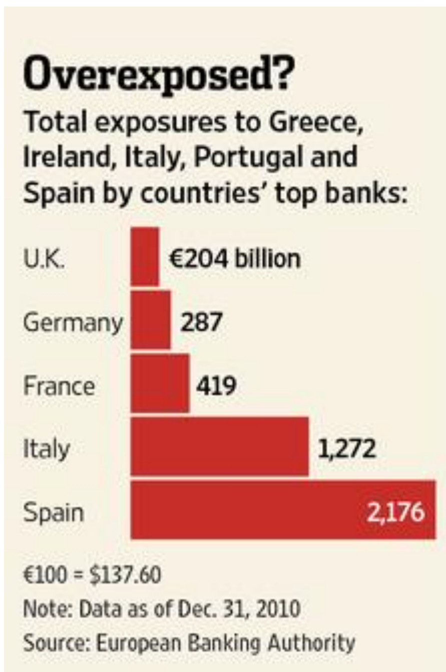
- # Struggling French Banks Fought to Avoid Oversight
- **Article**

By DAVID ENRICH And DAVID GAUTHIER-VILLARS

PARIS—Two years ago, a French banker flew to Washington on an emergency mission: Persuade International Monetary Fund chief Dominique Strauss-Kahn that his concerns about the health of the European banking sector were unfounded.



The trip was a success. Mr. Strauss-Kahn agreed to keep his fears under wraps to avoid causing market panic, according to people familiar with the matter.

Today, that appears to have been a missed opportunity—one of many in the years leading up to Europe's current banking woes. This summer, France's three leading banks—BNP Paribas SA, Société Générale SA, and Crédit Agricole SA—became the focal point of a crisis of confidence that is engulfing European lenders and testing the political and economic underpinnings of Europe. On Thursday, a European push to produce a comprehensive plan to resolve the euro-zone debt crisis was in danger of unraveling amid disagreements between France and Germany.

Among the factors behind today's crisis, experts say, has been the persistent unwillingness of many European banks and their regulators to acknowledge that they had a problem. Instead of making painful decisions years ago to set aside more money to cover unexpected losses,

some of Europe's leading banks and supervisors devoted themselves to fending off tougher international rules and thwarting more-intensive supervision.

Many large banks around the world lobbied aggressively against tough new rules. But the French banks and regulators were at the vanguard, mounting an aggressive campaign of la résistance.

They hopscotched the globe petitioning against onerous banking rules. French banks often helped authorities devise key policies—in contrast to countries like the U.S., U.K., Switzerland and Spain that forced banks to raise tens of billions in new capital and to restructure. Sometimes, French bankers and government officials appeared to be reading from the same script.

French officials scoffed at investors who worried that Greece and other euro-zone countries might default on their debt, heavily held by French banks. In April 2010, Bank of France Governor Christian Noyer argued against excessive capital cushions and insisted that French banks' exposures to Greece were not a cause of "particular concern." By the end of last year, France's top four banks were sitting on a total of €419 billion (about $580 billion) in loans and debt from Greece, Ireland, Italy, Portugal and Spain, according to data gathered in a recent "stress test" of European banks. By comparison, Germany and Britain's top banks were less exposed.

Now the bill is coming due. European political leaders plan in coming days to require European banks to come up with roughly €100 billion in new capital in coming months.

France's major banks aren't at risk of collapsing. But experts say their belated efforts to fortify their balance sheets could drag on the already sluggish French economy—the euro zone's second-largest behind Germany.

Already, BNP, Sociéte Générale and Crédit Agricole are reining in lending to some borrowers in order to improve their capital metrics. If those efforts prove insufficient, the French government could face a painful choice. It could inject taxpayer funds into the banks, which would strain the government's finances and potentially jeopardize its triple-A credit rating. Or it could push the banks to further curtail lending, which would risk strangling the economy.

"French banks failed to learn lessons from the 2007, 2008 crisis and became complacent," said Jézabel Couppey-Soubeyran, an economics professor at the Panthéon-Sorbonne University in Paris. "They refused to put on a small sweater when the weather was still nice; now that climate is ice-cold, it's not even sure that a heavy jacket will suffice."

Investors said they worry the French banks lack enough capital to absorb mounting loan losses and potential government defaults. They fear the banks remain heavily reliant on the sort of short-term funds that tend to evaporate in a crisis. More than 70% of the market funding of BNP and Société Générale matures within a year, making them among the industry's most vulnerable to investor flight, according to a recent report by Barclays Capital.

The banks insist their balance sheets are clean and they need no help.

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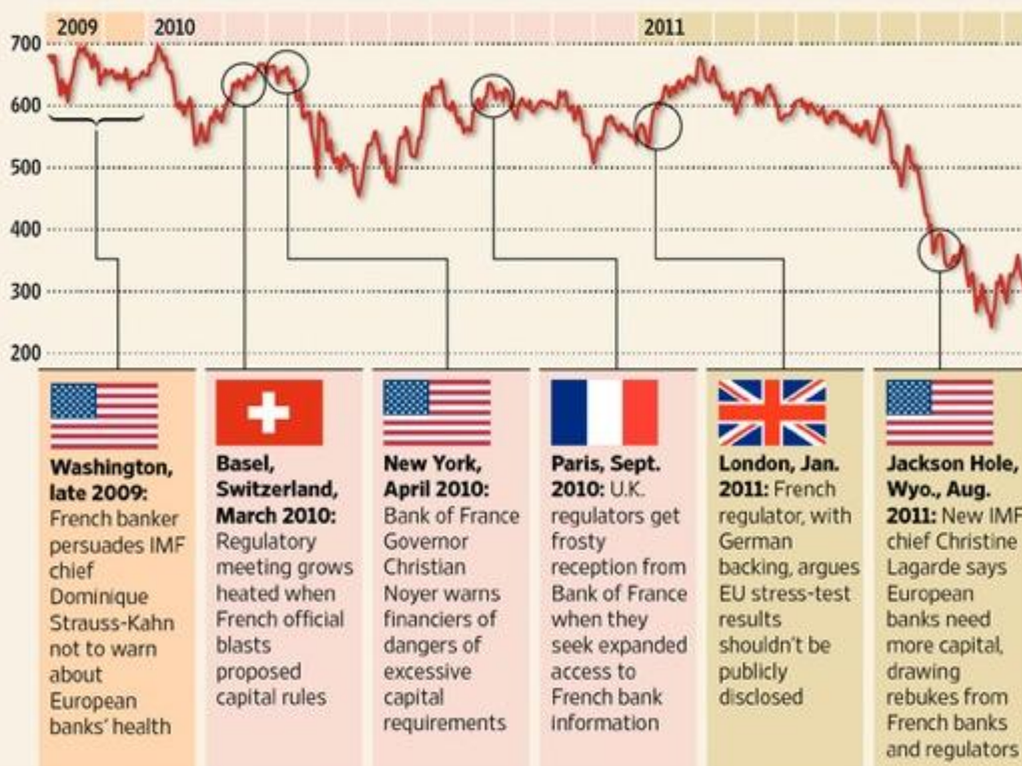

BNP Paribas says it has increased its capital reserves to €57 billion, from €29 billion three years ago. Société Générale notes that it has limited exposure to southern Europe and says it has sliced its reliance on short-term funding by 16% since 2007, while boosting deposits and long-term financing. Crédit Agricole says it has also trimmed its reliance on short-term financing.

The three banks say they are on track to comply with tougher financial-health rules by 2013. The Bank of France said capital ratios are only one among many tools to keep banks in check. "We focus on intrusive controls and rigorous risk management," a spokeswoman for the French central bank said.

The French banks and regulators began their resistance to new rules almost immediately once the global financial crisis kicked into gear in 2007 and 2008. They blamed the U.S., insisted that French banks were strong and repelled suggestions that the banks should beef up capital reserves.

Dow Jones' Terry Roth thinks we will be lucky if there is an agreement next week on proposals to solve the euro-zone crisis. The plans were due Sunday but disagreements between the French and German leaders have led to a second summit being scheduled for Wednesday.

Such a move would amount to "stocking up shareholders' capital in the freezer," BNP Paribas Chief Executive Baudouin Prot said in November 2008. Mr. Prot said his main strategy to keep his bank safe was to carefully select borrowers.

In late 2008 and early 2009, French banks did take a total of €20 billion in government loans to boost their capital reserves. But most of the money was repaid within a year.

Then a new cause for concern emerged: Greece. The small nation of 11 million, about 3% of the European Union total, acknowledged that it had underestimated its budget deficit and called on other Europeans and the IMF to the rescue.

WSJ Berlin bureau chief Matthew Karnitschnig joins Mean Street to discuss German Chancellor Angela Merkel's efforts to broker an agreement among Euro leaders in advance of this weekend's deadline. Photo: REUTERS/Fabrizio Bensch

In the fall of 2009, IMF technocrats started to wonder what would happen if Greece defaulted on its €350 billion debt and other European nations faced hardship. While Mr. Strauss-Kahn agreed not to go public with those concerns, he began using private meetings with European leaders to alert them about the problem. A spokeswoman for Mr. Strauss-Kahn declined to comment.

Following the flurry of bank implosions in 2008 and early 2009, international regulators started working on an overhaul of the global rules governing how much capital and liquidity banks are required to hold.

By the fall of 2009, the Basel Committee on Banking Supervision, named for the Swiss city in which it is based, had hashed out a tentative plan. It called for banks to hold far more capital than before. The types of capital that would count would be much more limited, ruling out certain types of securities and organizational structures that were popular with French banks, among others.

The proposal ignited a firestorm of criticism from banks. The French lenders, backed up by their regulators, were loudest in their protests, according to regulators and industry officials who took part in the discussions.

"Excessive capital and liquidity requirements would bring the economic recovery to a screeching halt," the French Banking Federation wrote in spring 2010 on behalf of the CEOs of France's five biggest banks.

Mr. Prot, the BNP CEO, took to privately badmouthing the Basel Committee's chairman, Nout Wellink, then governor of the Dutch central bank. Mr. Prot questioned whether Mr. Wellink had the credibility to be crafting international banking regulations given the ills of some Dutch lenders.

Such a remark by Mr. Prot "would disqualify him as a prudent banker," Mr. Wellink said in an email.

He also said, "French banks indeed resisted higher capital requirements and were very much against" a proposed liquidity rule.

BNP said it lobbied against higher capital surcharges but simultaneously boosted its reserves. "We did both: try to get a better deal and prepare ourselves for something we knew was in the works," a BNP spokesman said.

In spring 2010, a regular quarterly meeting in Basel escalated into a heated debate. The Bank of France's representative warned that banks would have to raise trillions in new funds,

potentially choking off lending at a time of economic uncertainty, according to people who were there.

A British official retorted that even if France's argument was true, it only underscored the need for the French banks to do more to improve their capital and liquidity, according to someone at the meeting.

French negotiators insisted that the committee commission a fresh "impact study" to assess any economic and financial fallout from the proposed rules, people familiar with the matter said. That led to a recommendation that the rules be phased in gradually—in line with the French banks' demands.

In September 2010, the Basel Committee unveiled its final package. The tough new capital and liquidity requirements were mostly intact. But in a major concession to the industry, the rules would only fully take effect near the end of the decade.

Some U.S. regulators and outside critics warned that allowing so much time meant banks could be vulnerable if another crisis popped up in the meantime. As it turned out, one wasn't far away.

By the beginning of 2011, many investors were growing panicky. After maintaining for months that Greece wouldn't be allowed to default on its debts, euro-zone governments changed tack, saying that private bondholders would have to help shoulder a new bailout for Athens by taking losses on their investments.

Investors immediately started to wonder what would happen if much bigger countries, such as Spain or Italy, couldn't pay their debts. Among the casualties would be banks like France's, which were holding billions of euros worth of government bonds, traditional safe investments that suddenly seemed risky. Investors feared losses on those investments could exhaust banks' capital buffers.

French bankers and regulators dismissed such fears as "irrational." They said that even if banks stored mountains of capital, it wouldn't do much to insulate them from a major European country defaulting. French bankers, government officials and central bankers all made the same argument: "If a big country goes down, we all go down."

Hoping to defuse public fears about banks' solvency, European policy makers started designing a "stress test" of top banks.

At one of the first meetings of the newly created European Banking Authority, however, negotiators from France, together with Germany, argued the results shouldn't be made public, according to people familiar with the matter. They were ultimately outvoted.

The biggest battle surrounded whether the tests should examine how banks would fare if struggling euro-zone countries defaulted on their debts.

French negotiators, along with German and European Central Bank officials, insisted that the tests not contemplate such a scenario, these people said. Sitting around a large oval table in an EBA conference room with panoramic views of central London, they argued that it could undermine already fragile confidence in the continent's financial system.

Regulators from other countries disagreed. "The tests will be worthless" if they don't consider the possibility of a sovereign default, one regulator fumed, according to someone at the meeting.

France and Germany prevailed. When the results were announced in mid-July, only a handful of banks failed, with a total shortfall of €2.5 billion in capital. All the French banks easily passed. Investors and analysts greeted the tests with skepticism.

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In late August, nearly two years after the French banker's mission to IMF headquarters, the agency delivered a stark warning.

European banks "need urgent recapitalization," said the IMF's new managing director Christine Lagarde. "This is key to cutting the chains of contagion."

The message from Ms. Lagarde, who in her previous job as French finance minister had played down such concerns, spooked investors. Mr. Noyer, the Bank of France governor, replied that he didn't understand what Ms. Lagarde meant. "Perhaps she was very badly informed by her staff," he told French radio.

French banks found themselves increasingly locked out of short-term financing markets. Their stock prices plunged.

Yet the banks remained defiant. "I don't see a big problem in terms of capital," Société Générale CEO Frédéric Oudéa said at a New York conference on Sept. 13, after the bank's shares had sunk 23% in the prior two weeks.

Weeks later, Franco-Belgian lender Dexia SA, which had breezed through the stress tests, required a government bailout.

In mid-September, Mr. Strauss-Kahn went on prime-time television in France, offering his first version of the New York sex scandal that cost him his job at the IMF. Turning to financial matters, he said European governments and banks could no longer delay solving the sovereign-debt crisis.

"The problem with Europeans," he said, "is that they often act either too little or too late, or too little and too late."