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FRANCE IN THE CAPITAL MARKETS

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Hollande provides unlikely impetus to crucial French reforms

France's fate is inextricably linked to that of Europe as a whole. With the eurozone enjoying a period of stability and new president, François Hollande, pressing ahead with reforms, the outlook for the French economy looks markedly better than it did 12 months ago. **Solomon Teague** reports.

WHILE NOBODY is prepared to call the end of the European debt crisis just yet, there is no doubt the continent experienced a turning point in September 2012.

When ECB president Mario Draghi assured markets he would do whatever it took to save the euro and eurozone sovereign debt, including potentially unlimited purchases of bonds, his words had a profound impact on the continent as a whole, and the outlooks for all the eurozone states individually too.

"The European debt crisis has changed dimensions now," says Michala Marcussen, global head of economics at Société Générale. The issue of where sovereigns — and the banks to which they have become so interdependent — would get emergency funding if needed, was essentially resolved in the summer of 2012, when the ECB pledged to buy unlimited one to three year paper, she says. While funding is now solved, solvency requires growth, adds Marcussen.

The ECB's move stabilised markets but its promises are contingent on beneficiary countries sticking to the conditions laid out in the European Stability Mechanism, namely austerity and structural reform. More than ever before, stability in France, and elsewhere in Europe, is dependent on the country being seen to deliver on austerity and structural reform.

In one sense the resolution has only changed the complexion of the problem, not solved it entirely. France's challenge now is principally political as it weighs up the need for sweeping structural reform against the difficulty the socialist president will have in selling such measures to his electorate.

France can at least be grateful it has its election behind it, and will not now elect a leader that rejects reform, as Italy may do at the end of February. However, such is the integration of European states, and their problems, that such events in Italy could themselves trigger a fresh round of panic that could spill across borders into France and elsewhere.

A hunger for change: Socialist PM François Hollande might well deliver the structural reforms that evaded his right wing predecessors

Vote left, get right

There is some irony in the fact that it looks as though it will be a socialist who finally delivers the structural reform that his right wing predecessors have for so long failed to deliver. France needs to cut red tape and simplify regulations, which make it very expensive to form companies, and introduce considerably more flexibility into the labour market.

In France there is insufficient dialogue between the unions and the owners, says Jean-Paul Betbeze, chief economist at Crédit Agricole in Paris. All attempts at reform — of pensions, the labour market or anything else — are therefore far harder than necessary. This is in sharp contrast to Germany, at least partly accounting for the relatively greater appeal of Bunds versus French government bonds.

The National Pact for Growth, Competitiveness and Employment, unveiled on November 5 last year by prime minister Jean-Marc Ayrault, is a step in the right direction. A measure designed to increase competitiveness in France, its headline clause is a tax credit spread over three years, thereby cutting production costs.

The pact was announced just one day after Louis Gallois, the former chief executive of aerospace group EADS and corporate troubleshooter, published his government-commissioned report on competitiveness, in which he wrote of an "emergency situation" and called for a "competitiveness shock". The report's 22 proposals included cutting the social contributions paid by employers by €20bn as well as those paid by employees by €10bn.

On the same day the International Monetary Fund weighed in with its own report, urging France to act or risk falling further behind its European peers, employing measures such as loosening employment laws to make it easier to both hire and fire workers, as well as cut payroll taxes to encourage employers to

Louis Gallois: shocking

hire more staff.

However, arguably more significant is the agreement on labour market reform reached in January, giving employers greater freedom to cut salaries and wages, in return for greater protection of jobs. “The recent agreement signed in Paris between the unions and the owners is a very big change in this respect,” says Betbeze. “Let us hope it will open a new social relationship in the country.”

However, in exchange unions are calling for increased costs for the use of temporary workers, which looks like a step in the wrong direction. And it will be hard for a socialist president to resist such union demands.

But François Hollande appears to understand the nature of the country’s problems. After a nervy start to his presidency, the markets have settled, clearly believing he has shelved his socialist rhetoric and will chart a pragmatic course forward. And while some see his ill-fated 75% top rate of tax, or his reduction of the retirement age policies as indicative of his left wing leanings, others see clever manoeuvres to win the political capital needed to push through his other reforms.

His aggressive tax policies play well with his support base, politically, and will have less of a detrimental impact in France than they would in the US or UK. There are fewer ultra-rich individuals in France, and wages are more moderate. “The level of inequality is stable in France, unlike in the US where it is growing rapidly,” says Betbeze. “The resentment caused by massive banker bonuses is an American story, not a French one.”

With the approval of the mid-year corrective budget last year aimed at meeting the 4.5% deficit target in 2012, and a 2013 budget that is designed to achieve the 3.0% deficit target this year, the government has shown the seriousness of its commitment to fiscal discipline, says Olivier Bizimana, an economist at Morgan Stanley.

“The government seems to be moving faster on reform implementation than we, and most observers, were expecting,” he adds. While these steps are quite small in the context of the overall changes required, he has still won admiration for sidelining the more extreme elements of his party.

Resisting change

The big question now is how the French electorate will respond to contentious reforms, particularly of pensions and the labour market. Some will doubt Hollande’s appetite or ability to push through sufficiently far-reaching reforms, particularly on pensions, lifting the retirement age as others in Europe have begun to do, and securing a sufficient increase in contributions to ensure plans are fully funded. If presidents from the right wing did not have the stomach for it, the logic goes, what hope is there for a socialist to stay the course? On labour market reform, too, there is recognition that he has made some progress, but economists argue more is needed to put France on a similar footing to Germany.

Yet many are surprisingly optimistic France will eventually get there, even if it is more likely to do so via a series of small, seemingly insufficient steps, with its slight progress on labour market reform providing the model.

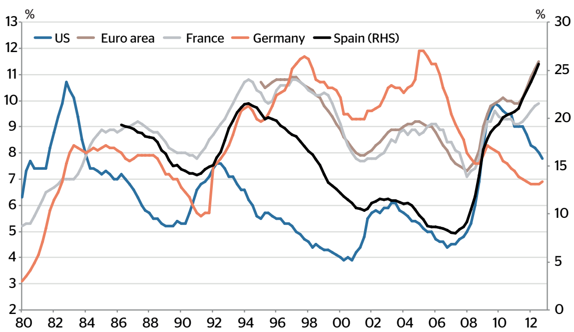
In fact, says Michel Martinez, chief France economist at SG, this will be the first time in 30-40 years that the two sides have reached any agreement at all, and as such it could set a useful precedent on which further advances can be built. “This does not get us to where Germany or Denmark are overnight, but it is a step and the first step is always the hardest,” he says. “It is a small step economically but a huge step politically.”

If France’s challenge is now more political than economic, perhaps investors in French debt are right to be sanguine. Economically it has time on its side, and while sooner is always better than later, to some extent it makes little difference whether the reforms come this year or next, as long as it increases its long term growth potential.

“Yes, growth is likely to disappoint, but this shouldn’t be a big problem,” says Marcussen. “Several aspects separate France from some of the peripherals that have found themselves in trouble. It does not have to worry about unruly regions or its ability to pass budgets, it has no problem collecting taxes, unlike somewhere like Greece where tax evasion is a really major problem. Moreover, France did not suffer a housing bust.”

With a small manufacturing sector, France has seen a greater level of economic stability, says Dominique Barbet, BNP Paribas economist for France, with services tending to be more resilient during periods of recession. France also benefits from its

Unemployment rates



Source: Société Générale

large public sector, which tends to be slower to cut jobs than the private sector, meaning unemployment has been slower to rise. And unlike Italy and Spain, where wages are decreasing, in France wages are stable — at least before tax.

Like Italy, France sees moderate net negative international investment flows of -20%, but when you compare that to Spain's -90%, France's moderate reliance on international investors does not look much of a problem.

Factors well beyond France's control also seem to be easing. China's slowdown appears to be moderate, while indicators in the US suggest it could bounce back this year.

While GDP growth is clearly disappointing, hovering around the zero mark, unemployment looks resilient and shows no sign of spiking as it has in the periphery.

Despite these positives, many investors and market observers maintain a negative view on France, believing its deteriorating economic fundamentals eclipse those of its neighbours. The key economic measures — structural unemployment, external balance, performance of the industrial sector, tax burden, public debt — have reached a critical point of deterioration, says Bizimana, in large part as a result of the financial crisis. "The government cannot afford to delay structural economic reforms," he adds.

Under siege

The feeling is widespread enough that both French sovereign debt, and the country's banks, have been targeted by short sellers throughout the crisis. Traders were betting there would be no money left after saving Italy and Spain, and that contagion would ensure the crisis spread north into France. So far, this has not proved to be the case.

"The government cannot afford to delay structural economic reforms"

Olivier Bizimana, Morgan Stanley

No doubt, French banks must learn to adapt to a new macroeconomic reality. Traditionally very large banks, they have been profitable despite low margins, with Crédit Agricole generating around €5bn of pre-provision income on €2tr of assets over the last 12 months.

By contrast, BBVA, the Spanish bank, generated €4.5bn (7%) of net revenues and €2.4bn (3.8%) of oper-

Goldilocks debt

Not too expensive and not too risky, but just right: why investors have been flocking to French sovereign bonds.

FRANCE IS still considered a stable, core European state, as evidenced by its success in recent bond issues. French sovereign debt have been stable at around 60bp-65bp over Germany, demonstrating investors still have confidence, for whatever reason, in France's ability to navigate the financial storm. French CDS spreads have tightened by around 150bp since the summer of 2012.

Several factors explain the historically low French interest rates and resulting lower spreads against German interest rates versus peripheral credits in recent months.

The general mood of economic uncertainty has reinforced investors' desire for high quality credits with good liquidity, but also the desire for yield, says Philippe Mills, until recently CEO at Agence France Trésor in Paris. This particularly benefits the core issuers at the expense of peripherals.

The impact on France has been particularly beneficial, says Mills, reflecting investor confidence in the government commitment to deficit reduction. In addition, "the low rates environment set by ECB has pushed short term government securities rates close to zero or even in negative territory, leading investors to extend the duration of their investments to longer maturities in a search for yield," explains Mills. Historically low rates, and thus spreads, are not confined to France, but are also evident in the other strongest eurozone states, including Germany, Austria, Finland and Benelux.

"In a world of uncertainty, It is attractive to have part of your portfolio in something that is pretty stable"

Dominique Barbet, BNP Paribas

With the available stock of double and triple-A assets dwindling all the time, France remains part of an exclusive club, ensuring its debt remains in demand. "We may well see further downgrades in the coming months, but we can be confident France will not drop below double-A in the foreseeable future," says Dominique Barbet, BNP Paribas economist for France.

In some ways French debt has emerged as the most desirable paper to hold. With German Bunds offering precious little return, investors seeking safe assets but higher returns have turned to French bonds, judging the additional yield to be greater than the additional risk.

French debt has also displayed considerably less volatility than either peripheral debt or Bunds, says Barbet. "In a world of uncertainty, it is attractive to have part of your portfolio in something that is pretty stable," he says.

Despite a lot of speculation about France being dragged into full blown crisis, in fact it has always looked a very strong credit, says Michel Martinez, chief France economist at SG. "The usual triggers for crisis were just not present in France." In particular the French banking sector looks sound, while unemployment, though high, has not spiked to dangerous levels.

In terms of sovereign debt, "France is less expensive than Germany and less risky than the peripherals," says Martinez. ▲

ating income from €63.4bn of assets in South America (ex-Mexico), and €6.4bn (2.1%) of net revenues and €3.6bn (1.2%) of operating profits on €310bn of assets in Spain and Portugal.

As French banks' balance sheets shrink, with borrowers remaining more cautious than before the crisis, more profit will need to be generated from smaller revenues.

At 5%, non-performing loans are low in France, relative to the more troubled economies of Europe, like Spain (11%) and Italy (17%), although they are higher than Germany. For the large banks they are lower still, though the figures will rise across the board if unemployment rises. Finally, bond markets are a third of corporate credit, versus only 5%-10% in the periphery.

French banks are coping well with the extra burdens brought about by Basel III regulations. On the capital side, French banks are well capitalised, with around three or four times more capital than they had pre-crisis, well above required levels. The liquidity requirements were more problematic, but have been modified and now look more feasible, says Betbeze.

France also escaped a housing market crash, unlike some of its European neighbours, which stands its economy — and its banks — in good stead. France remains a country with a shortage of housing, and steady, natural population growth, ensuring demand remains healthy. Houses tend not to be viewed as wealth assets in France, but places to live.

Having experienced heavy losses following a housing bubble in the 1980s, France did not see big home equity lending, as in the US, and mortgage lending was quite conservative, even before the crisis. With a prevalence of fixed rate mortgages, French households have not come under the same kind of pressure that threatens banks with a spike in NPLs.

Credit conditions in France have held up well compared with some of its neighbours. Loan costs in France are still affordable and comparable to those in Germany, even as the cost of loans in Spain and Italy have soared. This has made life considerably easier for SMEs in France than their peers across either of its borders to the south.

Credit supply has held up well, while demand is also firm, though naturally it has declined as borrowers wait for growth to pick up before further indebting themselves, says Marcussen. "We are not seeing a credit crunch in France, we are seeing reduced demand, but nothing like what we see in the periphery," he says.

Good access

Access to capital is very good, even by long term historic standards, for the larger corporates. As elsewhere in Europe, they have started to rely less on the bank market, and drift to the debt capital markets, where demand is outstripping supply.

Many are also diversifying into the US dollar market, giving them another, potentially cheaper option. Some are even looking further afield at renminbi issues, while maturities are being lengthened. In all, French bond issuance levels in 2012 were close to 2009 levels, making it one of the busiest years in French corporate DCM history.

French corporate bonds have seen a spike in liquidity as both equity and sovereign bond investors have come into the market. The private placement market has also swollen in response to investor demand for assets, with €3.5bn raised in the euro market via PPs in 2012. It is the smaller SMEs that are struggling to find capital, a picture that is repeated across Europe.

With a dearth of other attractive looking assets in the market, and some banks buying back their debt in the market, further limiting supply, there are plenty of yield-hungry investors happy to lend to the French government and banks.

"Investors who are short France are right on one level, but this is a story that will take three years to play out," says Alberto Gallo, head of European macro credit research at RBS. "We have taken the opposite view and have been long French banks since last year. If you look at the specifics, France looks very different from the periphery."

While French banks are very large at over 400%, of GDP, they have been swift to act in the deleveraging process and committed to their strategies to navigate the crisis. Crédit Agricole, for example, has been scaling back its activities in Greece, selling Emporiki, its Greek subsidiary, to Alpha Bank last year for €1.

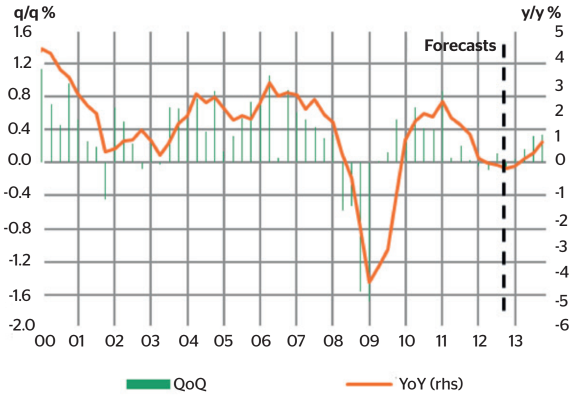
Crédit Agricole had already provided funding to the subsidiary, to the tune of €2.1bn by the end of September 2012, demonstrating its eagerness to retreat following its six-year foray into Greece. But "the recapitalisation of Emporiki and subscription for the convertible bonds to be issued by Alpha Bank [as part of the terms of the deal] will immediately reduce this funding by approximately €0.7bn," Crédit Agricole said in a statement announcing the sale.

And while it took a big loss on the sale, its share price jumped 5% on the announcement, illustrating investor relief it would be able to focus on core businesses from now on. ▲

"The agreement between the unions and the owners is a very big change"

Jean-Paul Betbèze, Crédit Agricole

A modest rebound in French growth



Source: Insee, Crédit Agricole

Demoted France attempts to regain the European initiative

France was until recently seen as co-CEO of Europe. But the crisis has elevated the status of its one-time partner, Germany, eroding France's influence. Yet this has provided the pretext for the French government to push through reforms previous administrations have struggled to deliver, as it strives to regain its former leadership role. **Solomon Teague** reports.

Reflecting on its position: France wants its European CEO job back

SINCE the outbreak of the financial crisis, France has seen its influence in Europe diminish, with the former "Paris-Berlin Axis" increasingly dominated by Berlin, with one country struggling with structural imbalances while the other gets ever more powerful.

"France needs to tackle its structural problems to regain credibility with Germany and be in a position to negotiate and have influence at the eurozone level," says Olivier Bizimana, an economist at Morgan Stanley with a focus on France.

Until France can resolve its internal struggles with structural reform it will not command its former of influence over others wrestling with the same problems. Germany, by contrast, is able to point to its own experiences implementing structural reforms when calling on others to do the same.

In style and temperament, François Hollande is very different from former president, Nicolas Sarkozy. Many in France had the impression their former president took orders from Germany's Angela Merkel, and there was also considerable resentment at his ostentatious wealth when the country was in deep recession and unemployment was rising. All that has changed under Hollande.

Politically the two men are very different. Yet their attitudes to Europe, and to France's role within it, are strikingly similar, reflecting broad consensus within France on these questions. The recent Fiscal Compact was approved by over 85% of parliament. Two-thirds of French voters back pro-European parties at the last general election, and by extension parties that advocated a rebalancing of the public finances and structural reforms. France is more relaxed about Europe than many of its fellow members — including Germany, where the cost to the German taxpayer has made the issue increasingly contentious.

One big difference between Hollande and his predecessor has been his insistence on a rebalancing away from austerity, towards measures to promote growth. When Hollande was elected and first made such comments, it was a big departure from what Europe's other politicians were saying. But it has come to be accepted as mainstream wisdom, says Gilles Moec, co-head of European economic research at Deutsche Bank. It might be a stretch to say it was pressure from France that changed the thinking in Germany and elsewhere in Europe, with the IMF also pushing such arguments, but France certainly started the conversation, he adds.

Crucially, there are issues of national self-interest to France that explain policy continuity, relating to agriculture and the budget in particular. It also has a strong desire not to split up its leading banks.

At the same time France is looking to improve convergence among the eurozone member states, and to enhance the political legitimacy of eurozone institutions.

"Our main goal is eurozone consolidation, and that is the way Europe is heading," says Dominique Barbet, BNP Paribas economist for France.

The feeling in France is that those countries pushing for further eurozone integration should be free to get on with it, without being held back by the sceptics.

Europe is evolving in other ways that makes it feel more French. One is the role of its central bank, which has come to resemble the Banque de France far more than the Bundesbank, says Paul Donovan, global economist at UBS. "The ECB is more willing to accept its role as a political player in a broader economic realm, beyond the strict criteria of a monetary policy," he explains. "The Bundesbank was far more purist in approach, in a monetarist sense."

Elusive growth

Europe needs growth. But with the periphery locked in recession and economies as large as Spain also struggling to pay the bills, that growth looks as elusive as ever. The rating agencies' patience looks to be wearing thin, with France itself downgraded in November precisely because of its lack of growth — and growth prospects.

Europeans look set to conclude that they need to slow down the pace of austerity to give growth a chance, but there is a delicate balancing act required: if they move too far from austerity they will jeopardise their access to funding; too zealous in pursuit of austerity and they risk choking off growth, prolonging recession.

Europe may use this crisis as the opportunity to rebuild a stronger banking system, with a full banking union and fully harmonised regulation. Yet some worry the moment may have passed. European politicians have shown they will kick the can down the road given the opportunity, and have only acted decisively when there was a real risk of economic collapse.

Now that danger looks to have been averted, they fear the politicians will revert to their old habits and avoid serious discussion.

Despite the criticism levelled at Europe's politicians for their lack of decisiveness, a lot has been achieved since 2009: the first tentative steps towards banking union, the possible harmonisation of fiscal rules and peer reviews have been debated, a €700bn rescue fund has been set up and unlimited market intervention promised.

"If all that had been envisaged back at the start of the crisis it would not have seemed possible, so that is a credit to the politicians, but at the same time it took too long to get there," says Michala Marcussen, global head of economics at Société Générale. There is no room for complacency now, and yet there is every possibility of politicians becoming complacent, especially with Italian and German elections looming.

Since European Central Bank president Mario Draghi promised to stand behind troubled eurozone economies with unlimited bond purchases in September, there has been a shift in mood within Europe, says Jean-Paul Betbeze, chief economist at Crédit Agricole in Paris. There is a renewed sense of optimism that the continent will come through the crisis stronger.

There is an understanding in France that saving the European project will continue to prove expensive. According to the European Commission's own estimates France puts more money into the EU budget than it gets out. It 2011 it made a net contribution of €6.455bn, compared to €7.255bn for the UK and €10.994bn for Germany. Yet this is not a big political issue in France, says Barbet. But there is a sense of perspective about this cost that prevents it becoming a defining political debate: "The cost of Europe is not a big political issue in France," he says.

"The cost of the rescue programmes now in place is around 1% of GDP for each European nation."

While this is clearly a significant cost at a time when the public will have to endure difficult adjustments, the French are keenly aware of the benefits they get from European membership, for example the support afforded to its farmers via the Common Agricultural Policy. And it is also clearly understood that the costs associated with European failure are far higher than those of propping up struggling peripheral countries.

Integration nation

While the French were initially sceptical about banking union, the concept has been accepted and even welcomed as a step towards greater European federalism, says Barbet.

France will end up with a large proportion of its banks overseen by the centralised authorities. A higher proportion than Germany, for example, which has fought to keep its Landesbanks and other smaller banks under national control, despite the experiences of Spain clearly demonstrating that the seeds of crisis can originate at smaller banks. Consequently, Germany will only cede control of around half of its banks to Europe, against an estimated 90%-95% in France. Hollande agrees with this arrangement, says Betbeze, though it is envisaged that later steps will see the smaller European banks eventually come into the banking union as well, he adds.

France will push for Europe to continue towards greater political integration as the solution to the crisis. "Our will to resolve the crisis is stronger than the problems we face," says Betbeze. "We need a stronger and more unified Europe, one that is simpler, with more democratic accountability."

France's pursuit of structural reform is more urgent from a poltical perspective than an economic one

Michel Martinez, Société Générale

Tax policy is an important item for the agenda, says Betbeze. In the US, while states set their own tax rates, there are limits to their freedom to ensure competition between states does not get too fierce. Europe needs similar safeguards, he adds, to ensure the playing field remains even.

A world order where production is confined to Asia and Europe is merely a market that is not sustainable, says Betbeze, and France, along with others in Europe, will ultimately repatriate some manufacturing that has been outsourced. "With around 40% of young people unemployed in Italy and Spain, we are close to the point at which you will see social breakdown," he says. "We need a new industrial and social fabric."

While France cannot afford to be complacent in its pursuit of structural reform, the matter is probably more urgent from a political perspective than an economic one, says Michel Martinez, economist at SG. It is important for Europe to see France lead by example, and for France to demonstrate its ability to reform itself.

France's efforts to recapture its former leadership role in Europe are probably responsible for its progress in pushing through the reforms that Sarkozy and others have found so difficult to deliver in France. While the market continues to believe Hollande's commitment to delivering such reforms, it seems sanguine about the French economy and debt levels. Any suggestion of a diminished appetite for such reform may cause a quick rethink in the markets. For now Hollande seems to understand this, and to be keen to reassure the markets that he will deliver the reforms Sarkozy promised to deliver when he was elected in 2007. ▲

Net contribution to EU budget, including own resources collected

Country	Total Expend. €m	Total Rev €m	€m	Pop.	NET cont/cap €
Denmark	1,473.1	2,488.3	975.2	5,580,516	174.7
Germany	12,133.0	23,127.1	10,994.1	81,843,743	134.3
France	13,162.3	19,617.2	6,454.9	65,397,912	98.7
Italy	9,585.9	16,078.0	6,492.1	60,820,764	106.7
Cyprus	183.6	184.8	1.2	862,011	1.39
Netherlands	2,064.3	5,868.9	3,804.6	16,730,348	227.4
Austria	1,875.8	2,688.7	812.9	8,443,018	96.3
Finland	1,293.0	1,955.2	662.2	5,401,267	122.6
Sweden	1,757	3,333.6	1,576.6	9,482,855	115.2
UK	6,570.0	13,825.2	7,255.2	62,989,550	115.2

Source: European Commission

Paris proves financial life exists outside of London

Although London is clearly Europe's number one financial centre, Paris has a fine pedigree of its own and can boast the world's third largest bond market, behind the US and Japan and ahead of Germany and the UK in terms of primary issuance by French issuers. **Philip Moore** reports.

FRANCE MUST be doing something right to attract foreign investment, although it would probably be well advised to let the data, rather than some of its politicians, do the talking. Those numbers show that in the second quarter of 2012, France attracted FDI flows of €18.6bn — more than any country bar the US and China. By the end of October 2012, FDI inflows had reached €42.5bn, compared with €29.5bn in the whole of 2011.

Granted, those figures refer to a period before President Hollande announced his proposal to tax high earners at 75%. They also track inflows before his administration's attack on ArcelorMittal, the French operations of which were threatened with nationalisation in response to its plans to shut the Florange steelworks.

The government insists, however, that the rise in FDI in 2012 is just the beginning. The Ministry of Economy has released details of its National Pact for Growth, Competitiveness, and Employment, which aims to cut labour costs by €20bn and to slash payroll taxes by 6% for workers earning below 2.5 times the minimum wage.

France's drive to boost employment and competitiveness includes the provision of research tax credits, the simplification of administrative formalities for businesses and the establishment of a state investment bank (BPI) jointly owned by the government and Caisse des Depots with funding resources of €42bn.

The plan includes a pledge to launch a new stock exchange that will "make it easier for state and mid-sized companies to access the capital markets".

That France means business seems to have been underscored in January, when, after three months of negotiations, the government agreed a new labour law with the unions, giving employers more leeway for cutting salaries and axing unproductive staff.

The government hopes this will lead to at least 300 new companies setting up shop in France by 2017, although it is unlikely that a large share of these new investments (if any) will be in financial services. Investment banks, insurance companies and hedge funds are not obvious candidates for preferential tax treatment or support from the new state investment bank.

Far from dwelling on former glories, Paris has ambitious plans for its standing as a global financial centre

But it's not as though Paris has no pedigree as a financial centre. It has an impressive one. In the 1970s it was far from clear that London would become the centre of gravity for fast-expanding Eurobond market. Morgan Stanley, for example, built on the longstanding presence that the House of Morgan had had in France since 1916 when it chose Paris as the nerve centre for its Eurobond operations in the late 1960s.

It was not until 1976 that it set up Morgan Stanley International in London. By then, according to Ron Chernow's exhaustive history of the Morgan dynasty, Morgan Stanley had made a "spectacular success of Paris, financing Standard Oil of New Jersey, US Steel, Eastman Kodak, Texaco, American Tobacco, Amoco, Procter & Gamble and so on. As the lugubrious atmosphere [of the early 1970s] waned, the Paris venture surpassed all rivals. By 1975, it would issue $5bn in yearly offerings."

Eugene Burghardt, head of sales and trading at Morgan Stanley in Paris, says that it has maintained a consistent commitment to its French operation ever since, and that Paris itself remains a leading financial centre. "I would argue that as a bond, equity and derivative centre and an exporter of financial expertise, Paris is maybe even a more important financial centre than it was in the 1970s," he says.

Second chance

Perhaps. But the far-reaching nationalisation programme under President Mitterand in the early 1980s, which brought more than 30 banks and about 90% of the system's deposits into state ownership, hardly helped to strengthen France's credentials as a financial centre. Paris was, however, given a second chance with the emergence in 1981 of the Ecu bond market, around which a very substantial infrastructure was built in Paris. By the early 1990s, the Ecu market was one of the largest and most liquid international bond markets in the world, while on the Matif, futures contracts on French government bonds were among the most traded derivatives products in Europe.

As late as the mid-1990s, France's futures exchange was accounting for about 30% of all European futures trading. While this may not have made Paris a serious competitor to London, it certainly helped it to steal a march on Frankfurt.

While the collapse of the Ecu market dealt a blow to Paris's ambitions as a financial centre, today it is "the leading bond market in Europe," according to Paris Europlace, which aims to "promote and develop the Paris financial market". Quoting the latest BIS data, Paris Europlace says that totals outstanding in the French bond market are $5.8tr, compared with $5.5tr in Germany and $5tr in the UK. That, says the Paris Europlace, makes it the third largest market in the world, behind the US (with $33tr) and Japan ($14.5tr).

Arnaud de Bresson, managing director of Paris Europlace, says that these numbers refer to the primary issuance of French issuers, reflecting the size of sectors such as the French government debt market and its corporate bond market. France, he says, is the leader in Europe with 33% of all international issuance in the European corporate bond market. De Bresson concedes that London accounts for a larger share of bond trading, although he says that the Cassiopeia Committee is exploring ways of enhancing secondary market activity in Paris.

For the time being, however, London continues to dominate euro bond market origination, syndication, trading and research. The CityUK estimates that London accounts for about half of all European investment banking activity. "So it is very likely that it is a much larger centre than France in terms of research, syndication, trading and all other skills-based activity conducted by investment banks," says a spokesman for The CityUK.

In foreign exchange trading, London's lead over Paris is more pronounced. According to the latest BIS survey, published in 2010, even though daily volumes traded in Paris rose from $127bn in 2007 to $152bn in 2010, this still left the French city as the eighth largest FX centre in the world, with a global share of just 3%. London, by comparison, accounted for 37% and the US for 18%. Switzerland, meanwhile, was ahead of France, with 5%.

"As a bond, equity and derivative centre and an exporter of financial expertise, Paris is a more important financial centre than it was in the 1970s"

Eugene Burghardt, Morgan Stanley

Financial services continue to make a big contribution to France's economy. De Bresson says that the sector accounts for about 5% of national GDP, while in the Greater Paris region, it accounts for closer to 15% of GDP and 6% of total employment. He insists, however, that the role played by financial services in Paris is essential for the health of the broader French and, by extension, European economy.

Co-operating with London

This, he says, is why Paris Europlace emphasises co-operation rather than competition with financial centres such as London. "Our core philosophy is that the most important function of the financial centre is to serve the economy," he says. "We recognise that more so than ever, we need to explain to the government and to the general public the importance of financial services to support economic recovery. We view financial services as an ecosystem in which issuers, investors and intermediaries across Europe need to work with the common objective of supporting economic recovery. We recognise the need to develop initiatives such as Euronext, pooling the resources of centres such as Amsterdam and Brussels with those of Paris."

Bankers say that Paris has plenty of strengths to fortify its credentials as a leader in eurozone financial services. Martine Boutinet, regional head of sales for France, Belgium and Luxembourg at Crédit Agricole CIB in Paris, points to the asset management industry as one clear area where Paris enjoys a competitive edge *(see separate chapter on France's asset management industry)*.

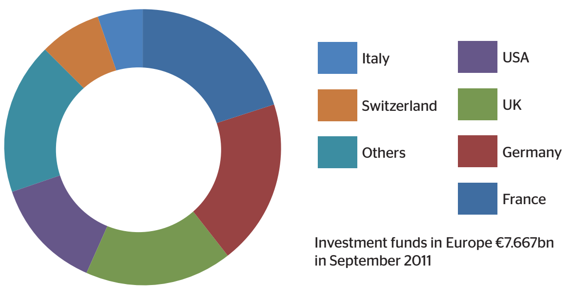
According to the Association Française de la Gestion Financieres (AFG), at the end of 2011, assets under management in France were €2.65tr. That, says the AGF, makes Paris the largest fund management centre in Europe and the second largest in the world (after the US); in terms of fund domiciliation, says the AGF, Paris is the second largest centre in Europe and the third largest worldwide.

Over the last 10 years, the number of asset management companies in France almost doubled, from 350 to over 600, with four of these ranking among the 20 largest in the world.

It's easy to see why France is an attractive location for asset managers. "The way the savings market is organised in France, with a number of tax incentives offered to retail investors through life insurance contracts and the mutual fund market, has been very important in supporting the growth of the asset management business in France," says Boutinet.

One area of the French asset management industry that has created a modest but important niche is the hedge fund sector. Significantly, a number of large new funds have established themselves in Paris in recent years: one notable entrant in 2012, for example, was Verrazzano Capital, which was set up by the former Gartmore long/short equity manager, Guillaume Rambourg. In one of the most successful fund launches of 2012, Verrazzano raised $400m for two long-short equity funds. By the start of January 2013, total assets under management at Verrazzano had reached $566m.

France is Europe's biggest investor



Source: Paris Europlace

De Bresson says a clear indication of Paris Europlace's commitment to supporting the expansion of the French asset management industry was its creation in January 2012, in a joint venture with the AFG, of Emergence, France's first seed-capital fund for young asset management companies.

One reason why the Paris asset management and hedge fund community has continued to thrive is the abundance of highly qualified quant and other derivatives experts in France. This is the product the country's education system, and more specifically of its Grandes Ecoles, which exist alongside French universities and have strong links with banking and industry. Today, some 60% of the managing directors and chief executives of France's 100 largest companies are graduates of the Grande Ecoles system.

Many of these star graduates have traditionally made their way into the banking industry, which is why it is close to impossible to scroll through the roll-call of investment banks' derivatives technicians without coming across several French names *(see separate chapter on equity derivatives)*. For example, Morgan Stanley's head of global equity structuring, Selim Mehrez, came from Société Générale in 2010. But as Burghardt explains, the quality of the young people emerging from France's education system means that it is also essential for banks like Morgan Stanley to maintain close contacts with noted academics like Nicole El Karoui, who is a renowned authority on areas such as stochastic calculus. Demand among banks for graduates from her Probability and Finance course remains as strong as ever, even if the reputation of financial engineering is not quite as unsullied as it once was.

It is the quality of the talent available in France, says Burghardt, which prompted Morgan Stanley to invest in building a new retail structured products desk in Paris in 2011 and 2012, which was a time when most of its competitors were cutting. The Morgan Stanley initiative may, however, be an exception which proves the rule, because so many of the best young French structurers, traders and analysts in the derivatives world have chosen to work in London and New York rather than Paris. As Boutinet points out, as measured by its headcount of French nationals, London would now rank as the sixth largest French city in the world. Only a small fraction of those nationals are employed in the financial services sector. Nevertheless, if Paris is to fully realise its potential as a financial centre, tempting some of them back across the English Channel would be a good starting point.

Universal and proud of it

Another reason why France retains strong credentials as a financial centre is the commitment of the leading French banks to their local franchises across retail and investment banking. France's universal banks are resolutely and irreversibly French, single-mindedly committed to maintaining strong domestic retail and corporate banking operations. In the investment banking area, meanwhile, most have chosen to divide their capital market operations between London and Paris.

It is not just the banks that have committed themselves to promoting Paris as a financial centre. The Agence France Trésor (AFT), widely acclaimed for being among the most innovative debt management offices in Europe, has never been shy about emphasising its role in championing Paris. As it commented when it launched its first inflation-linked OAT, in 1998, "this inflation-indexed bond issue… also paves the way for other issuers which will benefit from the emergence of this new asset class. These actors will enhance the role of Paris as a financial centre, which will ultimately foster economic growth and higher employment in France."

"Financial services is an eco-system in which issuers, investors and intermediaries across Europe need to work with a common objective"

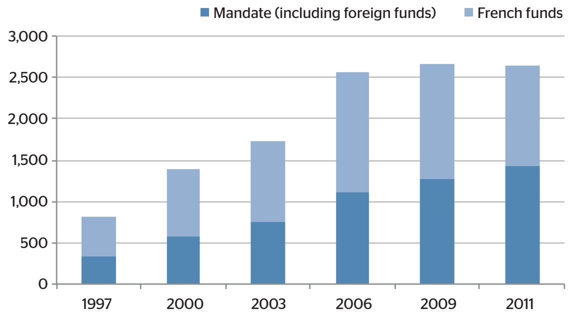
Arnaud de Bresson, Paris Europlace

The same, say bankers, could be said of the pioneering work that the AFT has done at the long end of the curve. "Paris is Europe's major liquidity centre at the long end and in the inflation-linked market," says Burghardt at Morgan Stanley. "If you want to be part of the dialogue on innovation in either of those areas, you need to be in Paris, talking to the AFT."

Similarly, a relationship with the AFT is essential for building a dialogue with the French corporate sector and other borrowers. "This is a testimony of a strong commitment and can be used as a springboard, so if you're not part of the local financial community you risk being side-lined in terms of corporate relationships," he says.

The other principal driver of Paris as a financial centre is Paris Europlace, which, for example, has been energetically promoting France's credentials as a European hub for the fast-expanding Chinese RMB market. Again, de Bresson insists that the primary objective here is to complement London, rather than to compete with the UK, given that the Chinese potential is large enough to ensure that there is more than enough business to go round between the two centres. "Our first priority is to help large companies and SMEs develop their RMB capabilities, so we are very focused on trade finance and the use of RMB by French companies in building their operations in China," says de Bresson. "We are also focusing on the issuance by European companies in the dim sum market, where French companies have been very active." To date, he says, there has been more issuance from France than from any other European country in the RMB market, with five corporate borrowers (Air Liquide, Lafarge, Alstom, Veolia and Renault) and one bank (Société Générale). ▲

The French asset management industry (AUM €bn)



Source: AFG 2012

Noyer heralds new era for eurozone and for France

Appointed as governor of the Banque de France in November 2003, and reappointed in October 2009, **Christian Noyer** is one of the longest standing and most highly regarded central bank chiefs in the eurozone. Before taking up his present position, Noyer served as advisor to a number of French finance ministers and as head of the national Treasury.

Beyond the pivotal role he has played in shaping and implementing French economic policy over the last 20 years, Noyer has also been a key architect of the European single currency project. He was appointed vice-president of the European Central Bank (ECB) when it was set up in 1998, a position he held until 2002. Noyer's European and international experience also includes several years serving on the European Monetary Committee, senior positions at the OECD, the G7, the G10 and the IMF, and the chairmanship between 1993 and 1997 of the Paris Club.

He is a member of the Governing Council and General Council of the European Central Bank, and was re-elected last year as chairman of the Bank for International Settlements (BIS).

In this exclusive interview with *EuroWeek*, held in Paris in February, Noyer shared his views on the challenges and opportunities that lie ahead for the French economy and for the broader eurozone. Interview by **Phil Moore**.

EUROWEEK: **You were frequently quoted in 2012 as saying that the eurozone was moving in the right direction. Do you feel vindicated by the recent strength of the euro and the performance of the eurozone's financial markets?**

Noyer: Things have clearly improved, but this should not come as a surprise. It's clear that markets lagged a bit before taking stock of what has happened, but looking back, enormous progress has already been made on all levels. This is true in terms of policies aimed at the restoration of sound public finances in many, if not all, eurozone countries as well as in the field of structural reforms.

For example, we have seen very extensive progress in areas like pension reforms in France and Italy, banking reform in Spain and labour market reforms across much of southern Europe and France.

We have also seen great progress in terms of surveillance — not just surveillance of fiscal policies, which is a must in the context of the European monetary union, but also surveillance of competitiveness which is the basis for structural reforms. This is essential if we are to avoid distortions in the convergence of competitiveness and therefore prevent a re-emergence of the problem of growth moving towards certain parts of the eurozone to the detriment of others.

In structural terms a decisive move in this direction was the agreement on banking union which will break the negative feedback loop between banks and sovereigns and will ensure the efficiency of the single monetary policy. Last but not least there was the new concept developed by the ECB saying it was determined to do whatever it took to ensure the stability of the euro. The concept of the OMT has the merit of making it difficult for the market to fight the central bank once it has expressed a determination to do whatever it takes to achieve a certain goal.

On the other hand, the OMT is also credible because of the conditionality. It's not a case of simply endlessly signing cheque after cheque. It is framed within the context policies which are geared towards sustainability.

Finally, of course there is the permanent backstop of the ESM. So I think that when we look at all these decisions they amount to a very comprehensive package which addresses all the doubts and questions which have been raised since the start of the sovereign debt crisis. Therefore it is quite natural that 2012 is considered by market participants to have been a landmark in the creation of a new era for the eurozone.

Noyer: "Enormous progess has already been made on all levels... in many, if not all, eurozone countries"

EUROWEEK: **You have often expressed frustration that markets aren't ready enough to acknowledge the longer term sustainability of monetary union. Are views changing, especially beyond the eurozone itself?**

Noyer: Although it is of course clearly understood in Europe, it is starting to become relatively well understood in the US and in Asia. It is taking more time outside Europe to develop this comprehensive view, because markets in the US and Asia don't have as much information at their disposal about Europe. But given how globalised markets now are, the fact that they have been so positive in recent weeks is to me a clear sign that it has started to be understood relatively well all around the globe.

EUROWEEK: **You've been speaking with your eurozone hat on, rather than specifically about France. Some of the data that has come out recently about European**

growth in general and French growth in particular have been very depressing, haven't they? Is there a concern that the so-called *modèle Français* is defunct?

Noyer: It is absolutely true that the figures have been disappointing in 2012. But what has to be taken into account is that France has been facing the same very strong headwinds that have been blowing across certain parts of Europe. Apart from Germany, the major markets for French exports are the southern European countries and the UK, all of which have been in recession in 2012.

The consequence was that the French economy was more or less stagnant. At a time when so many other parts of Europe were stagnant or in recession, this should not come as a surprise.

Additionally, French consumption, which had been very resilient during the crisis, was weakened by the fact that to restore credibility in the consolidation of public finances the government decided to implement a number of tax increases. These inevitably have had an impact on consumers' behaviour.

I do not believe that this will necessarily last, because the savings ratio in France is high compared to the average elsewhere in Europe. We can therefore expect the savings ratio to decrease somewhat, leading to a more sustained recovery in consumption.

That is hopefully one positive factor for the future. Another is that France is definitely moving towards reversing the trends in terms of competitiveness. The country is now demonstrating that there is a clear understanding of the need to pay close attention to firms' production costs, which is illustrated by the government's so-called Competiveness Pact. It is also illustrated through a number of structural reforms that have started to be introduced to increase the flexibility of the economy and make job creation more resilient.

From that standpoint the first move which is very significant is the so-called National Pact between business and unions which will be vetted by law. This is a complete reversal of the previous trend. So in a sense, yes, the *modèle Français* is adapting.

But I also think the model is retaining some features which are strong cultural characteristics. It relies on positive demographic trends, high educational standards and the quality of infrastructure. So it is not true to say that the French economic model has been characterised exclusively by the excessive inflexibility of its welfare system.

I would add finally that France has started taking measures to correct the excessive costs in the welfare system while not by changing radically the way it is constructed. Instead, we will probably move more towards what the Scandinavian countries have been able to do by introducing pension reforms to contain the costs of the system for corporates and containing healthcare expenditures. The Nordic countries have proved that you can have an efficient welfare system without damaging competitiveness.

EUROWEEK: **But countries like Portugal are seeing their exports surging, underpinned by lower unit labour costs, while France's exports continue to fall. Does it concern you that the IMF has openly suggested that France is in danger if being overtaken by southern Europe?**

Noyer: My understanding of what is behind the IMF's comment is the idea that these countries are addressing their competitiveness problems in a very strong manner, knowing that their problems were much more severe than those we had in France. Their relative productivity was lower and they also had relatively inflexible labour markets, which they are now reforming, notably in Spain and Italy.

So the IMF has simply observed that France can't afford to stand still when Germany began to reform some years ago, and given that the southern European countries are also moving to address the problems of cost competitiveness and rigidities. This is clearly why the economic reforms announced in France are so important. I'm delighted that the government has made this such a high priority.

EUROWEEK: **Let's move on to France's relationship with the financial markets and with the developments in its banking system. Are you concerned about what the ratings agencies have been saying about France? Or are ratings agencies irrelevant these days? They don't seem to have had much of an impact on France's borrowing costs.**

Noyer: No. I don't worry about ratings agencies. The crisis led to a weakening in public finances in most countries, so in relative terms there have been few changes in their ratings. No agency is denying that France still has one of the strongest risk profiles in Europe.

The second reason why I don't worry is that worldwide authorities such as the G20 and the FASB have said very clearly that they want market players to rely less on credit ratings agencies and to make their own judgments. This can be done by banks' internal models or other types of analysis by investment managers which are more sophisticated than they used to be a few years ago. For all those reasons I don't think the agencies are as influential as they used to be.

The agencies themselves have always claimed that they are just one of the resources available in the market. They have always insisted quite rightly that they are not the final arbitrators of investment decisions.

EUROWEEK: **What about the French banking system? Are you comfortable that the French banks are adequately prepared for Basel III?**

Noyer: I have always considered each of the five major groups within the French banking system to be basically resilient. The universal banking model is playing an important role in that respect because it creates a large base of diversified revenues which means that when one business line of the banks has been hit by a shock they can rely on the variety of their other revenues and preserve their earning capacity.

But this being said, with the benefit of hindsight, it's clear that like many others the French banks weren't sufficiently resilient to withstand major external shocks and tail risks during the crisis.

So the French banking sector had to increase its capital base and reduce its leverage. I have to say that in my view the French banks have done so quite successfully and rapidly. Between the end of 2011 and June 2012 they increased their capital base by €20bn through retained profits or fresh fundraising in the market or from their shareholders.

They have also managed to achieve a very well controlled process of deleveraging by reducing their exposure to non-core businesses, in general at good prices. So their overall balance sheet situation has been substantially improved and they are now in the process of meeting in full the requirements of Basel III with core tier one ratios of 9% before the end of 2013. This is several years ahead of the schedule that was originally stipulated.

By the way, I always felt that the time frame determined by the supervisors in Basel for compliance by the beginning of 2019 was always a little bit theoretical, because markets were likely to ask for more rapid implementation, which is what the French banks have done.

So when I compare the French banking system with other major banking systems, be it in North America or in Europe, I have the clear conviction that the French banks are on track and are among the best performers in terms of their capital ratios.

EUROWEEK: Has this deleveraging process been at all damaging to the economy, as some people say it has been in the UK and in southern Europe, by reducing their lending to the corporate sector? Or is the universal banking system such that this is much less of a threat in France than elsewhere?

Noyer: The deleveraging of the French banks has been partly done through the reduction of their exposure to sovereign debt markets globally. The remainder has been in areas such as project and trade finance.

The French banks haven't exited from these businesses altogether, because they have very strong franchises in these areas which are a good source of revenue. But they have managed to liquidate a number of operations that were weighing down their balance sheets. That has helped them to reduce their financing needs.

They did not reduce their leverage through imposing some kind of credit crunch — absolutely not.

Actually, the change in the volume of bank lending in France has been less rapid than in almost all other eurozone countries — or almost all other European countries, including the UK.

I don't believe there has been any constraint on the supply of credit to the economy. If there has been a decline in lending volumes this has been a reflection of reduced demand, rather than any decline in supply.

Possibly in the future there may be a relative decline in the importance of bank lending, because we have worked a lot on developing simple and transparent alternative financing instruments such as securitisation.

These may attract more attention from institutional investors and would therefore be a way of providing more credit to the economy without putting as much pressure as there may have been in the past on the balance sheets of the banks. This will be positive as long as we can avoid the defaults we saw at the beginning of the crisis, which were created by vehicles that were opaque and complex and impossible for investors to understand.

Noyer: "I have been reticent about the idea of separating investment banking and retail operations. I don't think that is an appropriate concept"

EUROWEEK: At the same time, presumably French banks should not be discouraged from using the skills of their derivatives technicians, which are recognised throughout the world?

Noyer: I agree completely. That is why I have been reticent about the idea of separating investment banking and retail operations. I don't think that is an appropriate concept.

We live in a world where medium-sized and large corporates require access to bank lending for a large number of banking activities but also for market operations. Exporters, for example, also use the markets to hedge their risks — so they're re-shaping the risk on their balance sheet by changing the structure of their liabilities or their assets if they have claims arising from trade.

For all these activities and risks, giving corporates access to banks which are able to respond to their entire commercial and investment banking needs is crucial for the development of the economy.

On the other hand, what we don't want to see is banks embarking on proprietary trading which is totally disconnected from their banking activities. The ideal approach is to have a clear separation between what we in France call "purely speculative activities" — in America they would call it "prop trading" — and what is useful for the financing of the economy.

Admittedly, it is not always simple to know exactly where the line should be drawn between these two purposes. But if the guidelines are clear enough it should be up to the supervisors in each country to make sure that this line is respected, and if need be to oblige banks to reorganize their activities. This is the philosophy which was the basis of the Liikanen Report and hopefully it will prevail.

EUROWEEK: And if things do go wrong is it fair to have a bail-in regime where debt investors bear their share of the losses?

Noyer: Bail-in is an important concept. We discovered during the crisis that if all stakeholders are not eventually obliged to take part in the cost of restructuring a bank if necessary, the consequence might be that the taxpayer has to foot the bill, which is not fair , although it can be necessary in extreme circumstances.

The other consequence is that banks are forced into fire sales of assets, which means the prices they command are very low and their losses are maximised. The result is either that the bank is pushed towards bankruptcy if the state allows it, or has to be supported using taxpayers' money and possibly having them bearing the losses, which as I said before is not right.

So the concept of bail-in after all the equity holders and the subordinated debt holders have been wiped out, could involve the transformation of senior debt into equity or semi-equity in a going concern bank. In such a case, it is a very good and important concept.

To my mind, bail-in should be part of the extra powers given to the supervisor. That is the only way we can reassure investors that it will be used only when it is absolutely needed to avoid a bankruptcy. That means that ultimately it is in the interests of senior bondholders to know that they won't be penalised just because it's beneficial for other stakeholders, but because it can't be avoided. This is why it is essential that this power should be in the hands of the supervisor.

But bail-in needs to apply to the whole of the senior debt. I'm not completely convinced that there is merit in having specific bail-inable instruments like CoCos. This is because either it makes the basis of the bail-in very restricted and may not be sufficient in many instances so that in the end you may need recourse to a second layer. Or, if it is a big amount, it can be extremely costly because of the specific risk, and therefore it may be better in that event to move directly to equity.

In any case, the fact that bail-in is now on the table and can be used by the supervisor will probably be one of the reasons why the banks will be tempted to increase their capital base regularly over time, to demonstrate to the buyers of senior debt that they are sufficiently protected. It will also be a strong incentive for banks to limit and control their risks and clearly communicate to the market how they do so.

EUROWEEK: **Has all this done enough to break the pernicious and highly damaging loop between sovereign and bank risk that was so central to the crisis? Or is that loop one that is simply impossible to break?**

Noyer: I think we have reduced that risk. The work is not totally finished. We need to continue in the direction we have taken. But to my mind there were three decisive moves that have addressed the problem of this feedback loop. One was the action that was taken on the consolidation of public finances, because if you have stronger government finances then of course the risk for banks is reduced.

The second was moving decisively on the banks' capital bases, because clearly if you have stronger banks then the risk for governments is lower.

And finally, the decision to move to a banking union starts with supervision and then allows us to advance to the second and third steps which will have to be a resolution scheme and a resolution authority and finally a euro area deposit guarantee scheme.

There is also the possibility in the euro area to ask for refinancing by the ESM. Those developments are key for providing a comprehensive response. We still have some work to do to finalise the consolidation of public finances and establish them on a stronger footing. But clearly we are well advanced in the process of doing so, and the same is true of the banks' capital base, although we may have to finish that with the SIFIs' capital surcharge as from next year or thereafter, and with banking union which is in the process of being negotiated.

EUROWEEK: **You've made some very strong comments about London. But what role does Paris see itself playing as a financial centre in the European context?**

Noyer: First, it's clear that London is and will remain a major financial hub which brings a lot of advantages to the global economy, given its skills base and the capacity of its infrastructure.

The comment I made was not a suggestion that Paris should replace London but simply that I do not believe in the trend of financial services concentrating more and more in London. This is something that should not be acceptable from a financial stability perspective by the euro area authorities.

Why? Because, in the event of any problems, the central bank needs to be able to provide liquidity without any time lag where and if it is needed, and in a strictly controlled way. To do so, central banks need to exercise very close oversight not only on the banks themselves but all the major financial players and infrastructure providers.

So I think it's normal that within a given monetary area the bulk of banking and financial activities should take place within the area itself and not overseas. Clearly there are many US dollar operations that take place outside the US, but the bulk is still concentrated in the US, and the same is true of activities in pound sterling, Japanese yen, Canadian dollar... The same must apply in the eurozone because it is a complex area and its activities should therefore be shared between Paris, Frankfurt and other financial centres within the zone.

To answer your question about the specificities of Paris, we have several assets to play an important role. First, the Paris marketplace has a very strong position in equity markets within the euro area. Second, in the fixed income sector, Paris is by far the most important centre in two areas — the market for short term paper, where it has a share of about 36% of the euro market, and the corporate bond market, where its share is about the same.

Finally, we have in Paris the world's second largest asset management industry after New York. We may not have the entire panoply of banking strengths, but we have a number of very strong niches which will continue to make Paris a strong hub, which can and should continue to play an important role in the European financial services sector.

EUROWEEK: **At the same time, would you like to see the big French banks continue to be active on the global stage, where their experience has been mixed? They didn't do very well in southern Europe, did they?**

Noyer: There was a time when there was a feeling in the market that we were going to move towards a return to more national banking system, which meant that international diversification was basically a weakness.

Things have changed quite a lot and I don't think anyone would argue that the move by BNP Paribas to acquire Fortis during the crisis was not a clever one.

The French banks weren't alone in believing that because we were supposed to have a single market in Europe, it was natural for banks to expand to neighbouring countries — just as it is natural for banks originally set up in Scotland to expand to England. So it was natural for French banks to see the eurozone and future euro area members in central and eastern Europe as their backyard.

Yes, we had the Greek problem, which was painful and costly for Crédit Agricole. But this was really an extreme case and hopefully we'll never see similar accidents again in our banking industry.

As we move out of the financial crisis, I believe that having activities in several countries across the eurozone will soon re-establish itself as a normal diversified business model that is regarded as a strength rather than a weakness. ▲

AFT emerges from crisis in stronger condition

Transparency, regularity, liquidity and innovation have long been the hallmarks of the Agence France Trésor, the institution that manages France's debt. But recently, in the face of the euro crisis, it has added adaptability to its qualities. **Philip Moore** reports.

THE MARKET for French OATs (Obligations Assimilables de Tresor) has a tough act to follow after an outstanding couple of years. As Citi commented in its preview of European government bond markets in 2013: "The performance has been stunning, especially against the background of the tremendous volatility experienced in Q4 2011."

Specifically, the French sub-index of the World Government Bond Index (WGBI) returned almost 22% between January 2009 and December 2012. That, according to Citi, is 3% above the performance of EMU government bonds as a whole, 4.8% above Italy and 10.1% more than Spain. Overlay that performance on what Citi describes as "phenomenal liquidity" and it forms a formidable picture.

"The strong performance of the OAT market has been especially impressive in 2011 because it came against the backdrop of probably the worst economic environment that France has been confronted with in the last 20 years," says Pierre Blandin, head of SSA origination at Crédit Agricole CIB in London. "At the end of 2011, 10 year spreads had reached almost 200bp over Germany, but France continued to generate a very strong bid for its bonds."

Citi's research attributes this strong performance to a number of factors, including rotation by Asian investors away from Italy, Treasuries and MBS into Bunds and OATs. Domestically, meanwhile, Citi points to the "continuous investment into OATs financed by large cash balance, resulting from de-risking of peripheral portfolios during the second half of 2011."

Laurence Mutkin, European interest rate strategist at Morgan Stanley, agrees that in 2013 it will be difficult for OATs to sustain the strong performance they have posted over the last year or so. "Like all non-German credits, France cheapened up in sympathy with the peripherals," he says. "That turned around partly because of what has happened in the peripherals, but mainly because of the decline in sovereign systemic risk in the eurozone, supported by initiatives such as the OMT."

More specific to the OAT market, says Mutkin, has been its appeal to investors — especially to Asian institutions — in spite of the rating downgrade risk that hung over France throughout 2012. "Among those who invested in France during 2012, and benefited as a result, were Asian investors, such as official institutions and banks," he says. "OATs tend to trade at a small beta to the peripherals and at a larger beta to Germany. That means that when the peripherals are widening out and Bunds are rallying, France will be caught between the two and remain very stable. So from a Sharpe Ratio, risk-reward perspective, OATs look like one of the most stable bond markets in Europe."

At the same time, adds Mutkin, investors in Asia and elsewhere have become increasingly relaxed about the ratings question. "The experience from the US and Japan suggests that when ratings agencies decide a sovereign is no longer AAA, investors generally choose to abandon their rating criteria rather than the sovereign as an issuer," he says. "The interest we have had in our Euro-Strongest benchmark, which will include France even without its AAA rating, shows that investors see it as too big a market to overlook regardless of the rating."

That, says Mutkin, was precisely the message that Morgan Stanley put across to clients in a research note it released just before the Moody's downgrade. Entitled "Une Certaine Idée de la France", this included an intriguing analysis of the ownership of French debt, which concluded that in theory €217bn, or 18% of the total, held by foreign real money investors, might be vulnerable to index-based selling. In practice, however, the Morgan Stanley report concluded that this selling pressure would be "close to zero" based on the way indices are constructed.

"OATs look like one of the most stable bond markets in Europe"

Laurence Mutkin, Morgan Stanley

AFT fêted

Beyond these technical influences, much of the credit for the performance of the OAT market in recent years must go to the tireless work and consistent innovation that has been dedicated to the promotion of the market by the Agence France Trésor (AFT), which was set up in February 2001 "as part of the government reforms to modernise its public debt and treasury management".

Before then, however, the team responsible for managing France's debt had always been at the cutting edge of innovation. "First as the Bureau A1, and then as the France Trésor in the Ministry of Finance, France was at the forefront of innovation," says Eugene Burghardt, head of sales and trading at Morgan Stanley in Paris. "In 1986 it was one

"The AFT guarantees regularity and transparency by following a non-opportunistic approach to funding"

Benito Babini, BNP Paribas

of the first European governments to implement a primary dealership system based on the US model, and the fact that the system has remained almost unchanged since then shows how robust it is. It was also the first European sovereign to issue a 30 year bond, in 1989, and the first to launch a strips market, in 1991."

Since the establishment of the AFT, meanwhile, France has built on its reputation as one of the ablest — if not the best — debt management office in Europe. That is an accolade that can be extended to the track record of French borrowers and regulators in other areas of the fixed income market. French corporate issuers, for example, have probably been fêted more enthusiastically than their counterparts in any other European country for their shrewd asset-management liability strategies.

Pioneering spirit

Bankers are virtually uniform in saying that no individual transaction epitomised the AFT's pioneering spirit better than the groundbreaking €6bn 50 year benchmark it launched in February 2005. Led by Barclays Capital, BNP Paribas, Deutsche Bank and HSBC, the first ever 50 year bond issue from a European sovereign was a hands-down winner of the *EuroWeek* bond of the year in 2005, with orders worth more than €19bn cascading in from 200 investors from 22 countries.

Perhaps more important than the size of the order book, however, had been the diligent preparation that the AFT put into its first ultra-long bond. As Benito Babini, managing director at BNP Paribas and chairman of ICMA France, says, the transaction was launched only after exhaustive dialogue with investors via the AFT's panel of 21 primary dealers.

Before its pioneering work at the long end of the curve, the AFT had also established its credentials as a standard-bearer for continental European sovereigns in the inflation-linked market. The UK had been the first European government issuer in the asset class, in 1981, and Canada and the US had both launched inflation-linked markets in the 1990s. It was France, however, that led the way among eurozone countries, with the then finance minister, Dominique Strauss-Kahn, announcing the issuance of the first inflation-linked OAT in December 1997. That paved the way for the first OAT linked to French inflation excluding tobacco in September 1998, and to the first issue linked to European inflation (OAT€i) in October 2001.

As with the precedent established by the AFT in the 50 year market, these issues put down a benchmark for other sovereigns. Italy, Greece and Germany all followed suit, and by 2007 all G-7 sovereigns had issued in the inflation-linked market.

These innovations, as well as a number of others such as the launch of the strips market in May 1991 and the Tec-10 bond in 1996, all pre-dated the arrival at the AFT of its last CEO, Philippe Mills, who stood down at the beginning of February after just over five years in the post. Before then, the AFT's CEOs were Sylvain de Forges (now at the insurance company, La Mondiale), Bertrand de Mazières (now at the EIB) and Benoit Coeuré (now at the ECB). All were very well regarded, but as bankers say, Mills faced very different challenges from his predecessors, in two notable ways.

"The difference between Philippe and his predecessors is that he took up the job just as the global financial crisis was taking hold, in January 2008," says Zeina Bignier, global head of DCM public sector origination at Société Générale in Paris, who has worked with the French government in the primary market for 27 years.

"Between 2000 and 2007 the market had been driven much more by issuers, which probably made it much easier for debt management issuers to influence and shape the market than it was after 2008. The AFT was able to adapt to the crisis and became flexible."

"The AFT was able to adapt to the crisis and became flexible"

Zeina Bignier, Société Générale

Mills: adaptability

"There have always been four key drivers to the AFT's issuance strategy, which are transparency, regularity, liquidity and innovation," she adds. "Philippe Mills added a fifth, which is increased adaptability in response to a more difficult market environment."

This view is echoed by Babini at BNP Paribas. "The AFT guarantees regularity and transparency by following a non-opportunistic approach to funding which means there are never any surprises in terms of timing," he says. "The AFT's issuance calendar is released a year in advance and meetings are held with primary dealers before each auction. Its relationship with the primary dealer community is very open and based on an interactive, two-way dialogue."

Another challenge Mills confronted which his predecessors did not need to worry too much about was the pressure he was under to promote the broader single European currency project, which was the subject of increasingly intense scrutiny during his tenure. This is not just because France itself is so pivotal to the longer term prospects of the euro. It is also because Mills chaired the EFC's sub-committee on EU sovereign debt markets.

Others agree that Mills has been one of the most tireless evangelists of the single European currency. "He has been a relentless advocate of the eurozone over the last two years," says Blandin at Crédit Agricole CIB.

Amaury d'Orsay, global head of

long term rates at Société Générale in Paris, agrees that adaptability in the face of unprecedented challenges in the global debt market was a key hallmark of Mills's tenure at the AFT. "Since the start of the crisis, the AFT has reacted much more quickly to the changes in the market environment than many other European sovereign borrowers," he says. "For example, the constraints on banks' balance sheets led to a number of requests from financial institutions and from primary dealers for more flexibility in the management of the AFT's issuance calendar. The AFT responded positively by agreeing to issue more off-the-run paper to meet bank demand for less rigid benchmark issuance."

Another example of the AFT's increased adaptability, says d'Orsay, was its introduction of fungible coupons into the strips market at the end of 2009.

"Fungibility, which was requested by the primary dealers, added dynamism to the market," he says. "France has always had the most active and innovative strips market in Europe, which has helped support liquidity in the OAT market."

Bankers add that while liquidity may be bolstered by the recent launch of OAT futures contracts on

"The AFT has reacted much more quickly to the changes in the market than many other European sovereign borrowers"

Amaury d'Orsay, Société Générale

Euronext, the French market has always compared well with Bunds in terms of liquidity. "The AFT has always been careful to ensure that any liquidity premium in the Bund market is kept to a minimum," says Mutkin at Morgan Stanley. "Although there are two, five and 10 year German government bond futures contracts, I'd say that in shorter dated, on-the-run paper France is as liquid a market as Germany."

Dollar dreams

Superficially, one way in which the AFT could save some taxpayers' euros might be through the opportunistic issuance of a dollar benchmark. After all, when Germany launched its dollar benchmark in September 2009, the Finanzagentur reckoned it saved the German taxpayer some €25m. There are a number of reasons why France is unlikely to follow in the footsteps of Germany or Holland. One is political, given France's strong and consistent support for the single European currency. "There has always been a worry at the AFT that issuing dollars would suggest it has no faith in the euro," says one banker.

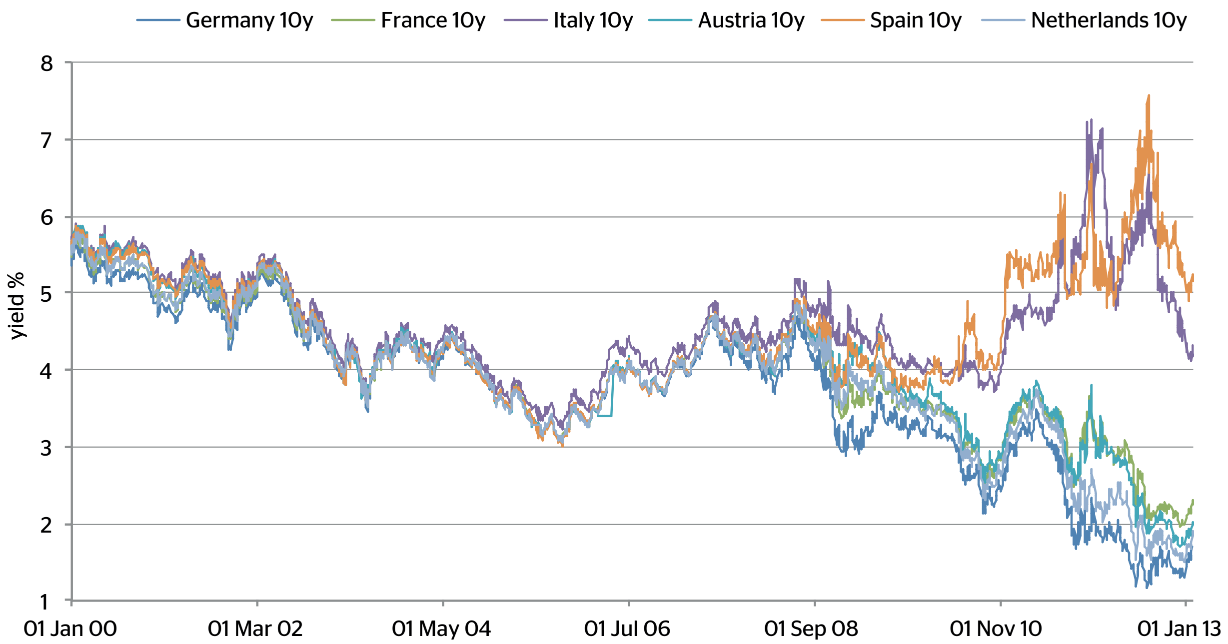
The second reason why the AFT is unlikely to issue in dollars, say bankers, is that it would be inconsistent with the philosophy that is at the heart of its funding strategy.

"Issuing in dollars would by definition be opportunistic," says one Paris banker.

"That would not fit with the AFT's commitment to regularity and transparency. The AFT believes that the short term cost gains of an opportunistic dollar trade would be insignificant compared with the long term benefits of transparency and regularity."

It is for precisely the same reason, says another Paris banker, that the AFT has also chosen not to issue in the private placements market. "Any cost savings that the AFT could generate through private placements would probably be marginal in any case," he says. ▲

French 10 year government bond yields versus eurozone peers



Source: Société Générale

AFT helps France plot safe course through euro crisis

THE FRENCH government bond market is a mainstay of European capital markets and lies at the heart of the eurozone. Two years ago, it suffered a wobble after Standard & Poor's downgraded the country's sovereign debt, but it is once again back among the safest of safe havens.

EuroWeek met the then head of the Agence France Trésor and four of its primary dealers in Paris early in 2013 to discuss how France batted away the doubters to maintain one of the biggest, most liquid and perhaps most innovative of government debt markets, and to consider what the future holds for investors in French sovereign debt.

Participants in the roundtable were (left to right):

Benito Babini, senior relationship manager, European sovereigns, BNP Paribas

Amaury d'Orsay, global head of rates, Société Générale

Philippe Mills, CEO, Agence France Trésor and chairman of the European Sovereign Debt Market sub-committee*

Panos Yiasoumi, managing director of European government bond and agency trading, Morgan Stanley

Pierre Blandin, head of SSA origination, Crédit Agricole CIB

Ralph Sinclair, SSAMarkets editor, *EuroWeek*

* Mills left the AFT to take over as the head of new French regional lender Société de Financement Local (SFiL) on February 1, after this discussion took place.

EUROWEEK: It has been a very robust start to SSA markets in general this year and I wonder if the panel feel the OAT market has reflected that sentiment, especially compared to the start of last year when the entire market was a lot more strained for everybody.

Philippe Mills, AFT: I would not qualify the start of last year as strained. You had some stress before, at the end of 2011, especially in October and November 2011. But already, in January last year, the starting point was much quieter and French debt trading levels were back to normal.

We are part of the core European rates markets and we are considered — in terms of market stress — a safe haven.

What is true is that, since a year ago, a series of events have occurred. First of these was the decisions taken by the ECB on top of the two LTROs to continue to enshrine the financial stability of the euro area — especially, of course, the decision taken in September with the announcement of the Outright Monetary Transactions (OMT) scheme.

There were also the ECB's rate cuts, with the creation of the deposit facility at 0% in July, which had an impact on the debt curve for all euro area sovereign issuers.

Then there were the efforts made by European governments to increase the co-ordination and convergence of all euro area economies at the European level with the treaty on fiscal stability. We have also seen the beginning of banking union integration, which was agreed in principle last June.

We have all the enforcement at national level to continue the reduction of public deficits and reforms to increase the growth potential of each country.

All this has created a much more benign environment for the overall sovereign rate market and we are benefiting from this more benign environment.

So, if we compare now to a year ago, we started our auctions in 2012 with a 10 year with a yield of 3.29%. This year, we auctioned at 2.07%, 122bp less.

And we have tightened to Germany, which was at that time around 130bp tighter than us but which is now around 60bp tighter.

Definitely you have an improvement in the overall European context and we benefit, as any other issuer in the euro area, from this more benign environment.

EUROWEEK: Amaury, does the OAT market feel much stronger now than it was this time last year?

Amaury d'Orsay,
Société Générale

Amaury d'Orsay, Société Générale: The market is now very robust because the overall outlook is very positive for the various reasons that Philippe outlined — LTRO, euro crisis fading away and evolution of European financial system and so on.

Overall, after a very stressed market from September to December 2011, right from the beginning of 2012 the OAT market behaved very well. It decoupled from the eurozone crisis situation and especially from the Spanish and Italian markets.

Investors, especially Asian investors, were searching for the right investment vehicle away from the distressed sovereigns. Clearly they chose France for the liquidity and yield.

That explains why in the spring of 2012 when the overall market was very stressed regarding Italy and Spain, the OAT market was immune from the perceptions surrounding the European crisis.

Today, on top of this and on top of all the European evolution there is a clear change in investor sentiment about financial systemic risk. In the last three months we have switched from an environment where people were in survival mode to a situation where people are looking for revenue. The psychology of the market has completely changed.

It is beneficial to the OAT market but as we said it was already quite a robust market in 2012.

The main beneficiaries now are the Italian and Spanish markets.

Panos Yiasoumi, Morgan Stanley: As described, the French market has been very robust in the last 12 months and there are several factors behind that. The issues that Europe and the peripherals experienced last year actually benefited France to a certain extent as a safe haven asset. Many investors, both international and also within Europe, moved a lot of their portfolio into interest rate products, into bonds, and there was, in terms of supply, strong demand for triple-A and double-A rated, high quality assets.

Meanwhile, rates were going lower, driven by conventional and unconventional policies from central banks. All those things were positive for French and similar yielding paper.

At the same time the French market, as more investors were involved, became very liquid and OATs became one of the least volatile assets in Europe from an interest rate volatility point of view, which attracted even more investment from people looking for a stable vehicle in which to put their money.

French debt trades like a bond rather than like a credit instrument. France provided the core benchmark instrument, which gave superior yield to investors' portfolios.

We saw many clients, as rates and returns got lower towards the end of the year and people were looking for more return in a still uncertain environment, move money out of underlying core markets and into France. France has outperformed its peers in Europe, with the yield spread over Germany trading at the tightest level over Germany that we have seen in quite some time. The increased interest in French debt has made the French market a lot more liquid. The investor base is a lot wider than it used to be and we continue to see decent interest for French debt, whether it's for a safe haven asset or a yield-enhancing asset.

Pierre Blandin, Crédit Agricole CIB: It's clear that if you look, since the start of the year, the focus has been more on the peripheral sovereigns. That's where we've see a lot of tightening.

But France has already performed, thanks to all the reasons that have been mentioned before, during the course of 2012.

What is interesting is that even if you have that strong performance of the peripherals, the French government bond markets continue to attract very, very solid buying, in particular from the central bank community — investors that are not necessarily going to be able to go back to the periphery in the very near future. So whatever happens on the peripheral side, we remain very optimistic on the potential performance of France.

Benito Babini, BNP Paribas: The environment in general for all markets, and in particular for OATs, will remain partially clouded by some factors, such as weak growth and the capacity to reduce deficit to GDP ratios as planned by the government. So probably economic reforms will, depending on how they are implemented and when, prevent rating agencies from arguments of downgrade.

As long as the OAT maintains its rating, the demand for OATs will remain elevated, as investors will keep triple and double-A rating investment policies.

The good news is that the eurozone crisis is gradually fading.

The ECB decision to conduct the OMTs if necessary was key to curbing risk factors. From that perspective, the environment is more favourable for eurozone sovereign debt this year than at the start of 2012.

EUROWEEK: So do you feel that the contagion risk from countries like Spain and Italy has diminished to a negligible level, or do you think that it could come back?

Babini, BNP Paribas: The level of contagion risk is much lower now than it was in the past. Directly, as the ESM and the OMTs offer direct protection to vulnerable countries. Indirectly, as banks reduced significantly their exposure to sovereign risk over the last two years.

In addition, you have good reforms and economic policies being conducted in Italy and Spain and other countries that have been very well received by the market. This is contributing to lower pressures on these markets and therefore contagion risks.

Blandin, CA CIB: On top of that, in a period of very significant stress in the periphery, France has demonstrated that, thanks to the liquidity of the OAT market and its safe haven status, it was able to sustain the pressure surrounding the periphery.

There was some widening but not comparable to what happened in Italy and Spain.

Contagion risk was somewhat subdued. The environment has completely changed now.

The OMT is a game-changer. Market participants realise that even if some pressure was to return they've got an umbrella. It has not been used but it's there. That has completely changed the psychology of market participants. We see it with investors slowly returning to the peripherals.

Mills, AFT: Just to follow up on what both Benito and Pierre have said, I think you want to take a broader view. You have three periods.

There was the peak of the tensions — starting either in September or October, up to the beginning of December 2011 when European sovereigns except Germany had tensions in their markets, and, at the end, even Germany did too.

That was before anything started at the European level regarding either any specific measure taken by the ECB, by the governments increasing their co-operation with the ESM treaty and the fiscal treaty, and by the countries dealing with themselves such as with prime minister Monti's arrival in Italy.

From, I would say, the beginning of last year up to the OMT announcement was the period of polarisation when you had, effectively, two groups of countries and the split was somewhere in between Belgium and Italy.

Germany, Finland, the Netherlands, France, Austria and Belgium were all together, and behaving more collectively. For instance, the degree of correlation in performance between French debt and German debt was very high. The potential for contagion was reduced at this time as banks used the LTRO cash to reduce their exposure to the periphery. Investors also made that distinction between the two groups.

Since the OMT started, there has been a more general reconvergence of the overall rates market. Also, Italy and Spain, together with Ireland, even Portugal, have started to converge slowly but surely to trade at more sustainable levels.

During the second phase, I would say the contagion effect was inverted — we benefited from it.

And now the contagion has also disappeared because of all the European-level decisions we have mentioned. There is no longer any redenomination risk or exit risk for the single currency.

The ESM provides a real backstop. There is convergence with the fiscal treaty on the long term sustainability of public finances organised at the European level and at the national level, and you have this measure to improve the growth potential within the different parts of the euro area. If you combine all this we are becoming duller.

EUROWEEK: Duller?

Mills, AFT: Duller, yes. It's the normal way of the rates market to be dull — with less volatility around. France has always been among the top liquid and less volatile credits with a very high quality rating and strong economic fundamentals.

Philippe Mills, Agence France Trésor, European Sovereign Debt Market sub-committee.

Yiasoumi, Morgan Stanley: The question specifically mentions contagion with respect to France. I don't think you can say that a situation where the market is pricing the break-up of the euro is something specific to France. It is going to affect all eurozone countries. And it's not going to be specific to an asset class. It will affect all assets, whether they're interest rate assets, or equity, from inside or outside of Europe.

I don't think you can really say Italian and Spanish contagion is going to affect solely French products or bonds. Rather, being a safe haven benefits French debt.

But with all of the measures in place that we've talked about, in terms of going back to a period like that which we've experienced over the last couple of years, I don't think we'll see moves as fast as those again. I think the risks have definitely been reduced.

D'Orsay, Société Générale: There are two questions here. One is whether or not there is a risk of tension again in the market. The risks are obviously much smaller than they were before but there's still some risk — Italian elections, growth outlook and a German election coming up.

The second question is if tension does arise again, how would the OAT market react? In 2012 it reacted very well because it was a safe haven offering great liquidity and so on. That will not change. For instance if tension grows in the Italian and Spanish markets we should still see the OAT market perform pretty well. As Panos said, I think for the OAT market to really perform badly we have to be very close to the break-up of the euro. It's that simple and that big.

In 2012 we saw some leveraged money trying to bet against French spreads. And they suffered a lot for doing so because they were very wrong — especially around the time of the French presidential election.

They have suffered so many times in the last few years as a result of trying to bet against France that I think they are more or less out of that market now.

We could see some people try it again. But I think it's going to be very limited. So, overall, is the OAT market immune from the tension? I would say, overall, yes.

Yiasoumi, Morgan Stanley: Many of the investors who were selling French debt as a bet on French debt trading wider were trading it as a relative value trade — so as a tail hedge, or as a hedge to some long exposure in another credit product.

Those types of players got it wrong, but they are also not in the market like they used to be. They're really not playing any more.

That indicates that they don't view France as really having any credit risk or moving like a credit product any more. It doesn't really work in the kind of world that they take risk in. An OAT is purely an interest rate product.

Mills, AFT: As the head of the French team, what was very interesting in this period, especially in the first four or five months of 2012, was to see, if I may say, the imperfect connection between the noise around a specific bond market and the reality of the price mechanism in that market. Because France — as a result of its high quality credit, very liquid global trading activity — always sees strong buying from central banks, sovereign wealth funds, pension funds and insurance companies.

Quite a number of them are large, regular investors who do not change their investment policies quickly. Neither are a great number of them very talkative. They do not express their view in a regular manner to any sort of channel of information distribution.

The noise around France at the beginning of 2012 was quite at odds with the reality of the French government bond market. The noise was not always positive but investors' behaviour was quite stable. Then there came an improvement in the market sentiment because of the mechanisms we mentioned on both the ECB policy side and our progress on the European political side.

But at the beginning of the year what I was reading in some headlines was sometimes very different from the reality of the market. I have seen that before and had the intuition that the reality in the market would not bear out the headlines but never was that intuition so ratified as between January up to April or May of 2012.

Some of the leveraged money became automatically intoxicated by the negative noise around at the time and they forgot what the real forces of supply and demand are of a large, liquid, high quality debt market like the French OAT market.

EUROWEEK: We've talked a lot about what's happened at the European level in particular to reassure bond investors about government bond markets. I was going to ask what the AFT has done to instil investor confidence. But from what you tell me, I'm beginning to wonder if the question should be whether or not it has had to do anything at all.

Mills, AFT: Yes, we try to work with investors and we do so with the help of all the gentlemen and institutions on this panel.

The Agence France Trésor has always been a DMO, which has a very active investor relations policy. We hold a great number of meetings with investors and we hold them regularly.

In 2012 we had a lot of interest from investors not only because of the European situation but also because of the presidential election contest — every five years we have the mother of all elections.

If we take into account the meetings we held, the roadshows and the so-called reverse roadshows — the people who have come to Paris to see us — we were able to meet more than 180 investors in face-to-face meetings.

They were not all one-on-one meetings because sometimes there were several investors around the table but all the meetings were face-to-face.

By comparison, during an average year since the beginning of the crisis, we usually see more like 100-110 investors.

There were 70 more direct interactions with investors in 2012 than in a typical year.

We have been very active on that front and we have provided investors with a lot of information. We have a little booklet of 130 pages, for example. It covers all dimensions — the European side, the French side, the macroeconomic outlook, the fiscal policy outlook, the structural reforms, the sovereign debt crisis, central bank policies and our issuance policy in different segments of the debt market.

We also — for credibility as a DMO — always use public information. It comes from international institutions such as the OECD or the European Commission. It gives investors the opportunity to compare, and to have as precise feedback as possible on all the European or French policies they could be interested in.

With all this material and the regularity of our meetings, we are able to provide very good information to investors. Our investors know us very well. Quite a number of them are used to seeing us on a regular basis.

Blandin, Crédit Agricole: To a large extent, I think communication has been critically important and the French government bond market has benefitted from what the AFT has done for many, many years.

That work over a long period of time has contributed to the extent of liquidity in the market. It is a market that is also very diversified in terms of the products on offer, which means that the AFT is able to tap into different pockets of demand. There is the linker market, the strip market, and the 50 year OAT. All of that work over many, many years has made the French government bond market one of the most, if not the most, sophisticated in the eurozone. That certainly helped in the difficult times that we have been through.

D'Orsay, Société Générale: Going back to what Philippe was talking about when he said he met 180 investors versus 110, I would say that 110 is already a huge number compared to the average sovereign debt management office that markets to investors. It has always been a strength of the AFT and investors around the world appreciate it.

The AFT has another strength which is the link to its primary dealers. These links are much stronger than the ones than most sovereign borrowers have.

Overall, it means that AFT has been able to listen very well to the market through its primary dealers and through its face-to-face contacts with investors.

Two good examples of this are how the AFT reacted quickly to the constraints that were placed upon the primary dealers' balance sheets from 2008 onwards.

The AFT quickly re-opened and issued off-the-run bonds because it met investors' demands and met constraints on primary dealers who had an increasingly hard time being long on-the-run OATs and short off-the-run bonds.

The second example has been the strip market. The strip market has always been a strength of the French government bond market but it consumes primary dealers' balance sheets. Creating fungibility in the strip market and therefore releasing primary dealer balance sheets from their constraints had a very positive effect on market liquidity.

Benito Babini,
BNP Paribas

Babini, BNP Paribas: The OAT market is one of the most liquid markets in the triple-A and double-A rated zone.

The AFT has always been transparent and keen to innovate to drive liquidity.

It is one of the sovereign markets that offers that many classes of assets and that level of diversification and innovation. There are inflation linkers — offering exposure to both European and French inflation — not to mention the strip market and fungibility of coupons and so on.

The AFT only initiates deals that it can continue to tap on a long run basis. It is very open for discussions with its primary dealers. Sometimes we don't agree but it is still an open discussion.

Yiasoumi, Morgan Stanley: Speaking as a primary dealer, a treasury or DMO, much like the AFT, that is very clear in its communication and predictable and transparent in the way it works is the best sort. It encourages a stable market. Whether it's in primary issuance, or whether it's in secondary trading, I think that's key.

There is a big difference between the AFT and the liquidity of the French government bond market and the markets in many other countries. The close links with investors and the primary dealers, the regular formal and informal meetings make a big difference in terms of the liquidity and even the investor bases for some of these assets.

Mills, AFT: The AFT has a complete commitment to the curve. May I give you a precise example of what it means for us to be committed? I will take one segment of the market which is one of the strongest assets of the AFT, which is our stance towards the linker market.

Just after the Lehman Brothers failure, the debate among the vast majority of investors was about deflation, predicting a deflationary environment everywhere, or at least in the OECD countries. And of course back in 2008 and 2009 in that kind of environment, demand was sometimes very poor for inflation linkers because of the perceived inflation risk.

However, we always issued linkers every month, as scheduled. Even if it was only €600m which I think was the case once in January 2009, if I am not mistaken.

A €600m bond is very small for us. But we issue every month to make it crystal clear that when we have a commitment to a segment of the market it is a long term commitment.

Of course, we introduce the necessary degree of flexibility when required. As Amaury mentioned, we did this with our policy of issuing off-the-run bonds for example, which effectively accounted for some 29% of the nominal bond issuance we did last year.

That degree of commitment is really one of the strengths we have towards investors — the regularity of the policy and also the regularity of contact with investors.

For me — and I have been the head of the Agence France Trésor for five years — whenever I meet an investor, I always believe that I will meet him again and probably quite soon. So whatever I tell him about the background context, whatever I tell him about the European and French interaction, whatever I tell him about specific market segments, he will remind me about it in six months' time, nine months' time, one year's time when I see him next. So I need to be consistent and transparent in what I am saying to investors, and also to have a degree of crystal clear commitment over the long term.

EUROWEEK: What overall effect has that had on the OAT investor base? What changes has the AFT seen in the constituency of the OAT investors?

Mills, AFT: Effectively, we haven't seen a lot of change because, for quite a long time, the investor base for French debt has been very diversified. For quite a number of years it has been made up of three parts — one third being French investors, one third other euro area investors and one third investors from outside the euro area. It is pretty stable.

If you look at what we publish on our website, which is the split between non-residents and residents, the distribution has been very stable since May 2011, at around 64%-65% in favour of non-residents. The split is very stable.

And of course, depending on the circumstances, sometimes parts of the overall investor base are stronger than others. During 2012 the strength of the Asian investor base was a feature. Looking at the flow analysis, with the help of the primary dealers who give us this feedback every month, almost half of the net buyers of French debt were from Asian or Middle Eastern countries. The exact number was 46%. Before, it was typically between a fifth and a third.

It demonstrates that investors see the quality of French debt, the liquidity, the low volatility, the quality of the credit in this environment and the good comparison to be made between Germany and us on that front. Those investors, be they central banks or real money funds, commercial banks or asset managers, were interested in investing with us on a large scale because of all these elements, when comparing us with other potential choices.

EUROWEEK: And what have the dealers noticed in terms of the change either in the consistency of the investor base or how that investor base has behaved over the last year or so?

Panos Yiasoumi,
Morgan Stanley

Yiasoumi, Morgan Stanley: There has not been a huge shift in terms of splitting everyone out by overall volumes.

In a more volatile period for the market, some of these investors have been more active for certain periods.

In terms of the volume of investment it has been a little bit less consistent with these investors. Maybe Asian and Middle Eastern investors were very, very active at the beginning of last year but, in general, sovereign wealth funds, official institutions and the domestic investor base has a very large presence in the French market as well. They were all very, very active as were banks as well, to a certain extent. And not just in the French market but also in the highly liquid, top-rated asset markets, in terms of dealing with liquidity buffer regulations.

But there hasn't been a huge change in the investor base. Timing and impact, the size of investment might change, but that's to be expected when you have a changing rates environment where you go from very high rates to low rates. Maybe if the economy turns round in the next few years as well you will have further periods of reallocation. That won't necessarily be out of France or into France. It could be across the curve and across products, whether they be inflation linkers or nominals.

Blandin, CA CIB: It's very clear that France's safe haven status, liquidity and a pick-up versus Germany has been a big driver for central banks. The AFT has been very successful in selling its debt to central banks during the crisis period.

The introduction of the Liquidity Coverage Ratio is also beginning to be an important factor in demand for OATs. Panos mentioned the banks buying OATs. They are becoming more active players when building their reserves. Again, the yield pick-up over Germany, for instance, could be a big incentive for them here.

D'Orsay, Société Générale: There has been some evolution in the strength of certain types of investors mainly coming from Asia.

The investors that I would say were least active, if you had to name some, were the Nordics. But that is pretty much it.

EUROWEEK: Across a number of sovereign markets, primary dealers have complained over the last year about the cost of being involved, given the costs of capital and the perceived lack of ancillary business to be won away from auctions. Is being an SVT [Spécialiste en valeurs du Trésor] profitable? Does the AFT think it should be profitable? And what would the dealers on this panel suggest the AFT does to improve the primary dealer system that it runs?

Yiasoumi, Morgan Stanley: For Morgan Stanley, being a French primary dealer is an essential part of a client-focused European fixed income platform, and is a key part in us having a strong and credible presence in Europe. The French government is a major debt issuer, it is a big, liquid market and it is an essential market for us to be involved in.

For banks that are fully committed to that market, it is a profitable, standalone business, but also one that contributes to the whole with respect to our European operation. I don't really see that there's an issue.

EUROWEEK: And is there anything that you would like the AFT to do differently? Are there improvements that could be made to the system?

Yiasoumi, Morgan Stanley: The AFT seems like it is doing a good job to fully address all the issues effectively, whatever they may be.

Mills, AFT: Just before we publish our detailed financing programme, we always have a session with all 20 of our primary dealers about our issuance methods — should we change them or not.

The last time we changed them was at the end of 2011 when we changed how we conducted bills auctions, so that we now give a range of yields and shortened the timing between the announcement and the auction itself.

We are always keen to listen and to adjust and to fine-tune our issuance system whenever we have feedback and some consensus among primary dealers.

Pierre Blandin,
Crédit Agricole CIB

Blandin, Crédit Agricole: I think you can take a narrow perspective to the question and we all know that there is some overbidding at the auctions. But that's not specific to France.

Or you can take a broader more strategic perspective, which is that being a primary dealer in France is key to our strategy. It is key to engage with a number of investors, so you have to look at it from a much broader angle. And from that perspective, yes, it is a good business.

Yiasoumi, Morgan Stanley: I have to add as well, around the auction, people talk about premiums, but you have to look at it from the side of the banks that are quite active in French debt. Whether it's the primary dealers themselves, or them acting on behalf of a client, when they have large risk that they're looking to invest within the French market and transfer that risk then that's not necessarily a premium. It's the price for liquidity.

If you look at the larger context of price action, whether it is a 24 hour period or a one week period, it can be argued that there is no premium there.

Babini, BNP Paribas: It is not specific to one country but every business has got its required investment and its return on that investment. It depends what you do with it.

See how many primary dealers there are on the French primary dealership system and how long they have been there and you will have the answer as to how worthwhile it is.

EUROWEEK: Are you beating off new applicants for primary dealerships with a stick, Philippe?

Mills, AFT: Yes. And just to follow on from Benito and Panos, we always have discussions to improve the process. But in the end, as Benito mentioned, the proof of the pudding is in the eating.

We run a selection process every three years to become a primary dealer. One just took place last autumn with all 20 primary dealers. All 20 without exception applied again to be primary dealers of French debt for the next three years.

Other banks knock on the door and ask if the AFT is interested in having them in the group and are looking for the AFT's blessing.

But as is said sometimes in US-style Westerns, we are not in the blessing business.

D'Orsay, Société Générale: We have a profitable European fixed income business and being a primary dealer in France is part of it.

There is overbidding. But you have to look at all aspects of your business and servicing your customers is the most important thing.

EUROWEEK: You mentioned, Philippe, the change you'd made to the way you run bills auctions recently. Does the AFT have any other changes in the amount or methods of its issuance that we can look forward to?

Mills, AFT: We listed some in 2013's detailed financing programme. They were mainly linked to the introduction of collective action clauses — CACs. Article 12.3 of the European Stability Mechanism treaty says that all euro area governments should introduce, starting January 1 2013, CACs in their new bonds — bonds meaning all securities issued with a maturity longer than one year.

So, of course, like any other euro area government, we have introduced them, something that was agreed upon at the European level.

Because of that, and to take advantage of it, we have done two things. We have simplified the denominations we offer so you will now only have bills and bonds with bills meaning BTFs and bonds meaning OATs. You have no more BTANs [Bon à Taux Annuel Normalisé].

A long time ago, when the BTAN was created, it was considered a part of the money market and so received different treatment from the Banque de France, but that treatment disappeared more than 15 years ago.

Effectively, as there was no limit to what an OAT could be, we were only issuing BTANs out of habit so we dropped just that denomination.

We also changed the dates of maturities to May and November, to help us achieve as soon as possible a liquid strip market for bonds with CACs.

Our German friends and our other friends have also made similar moves in order to make sure that the strip market with CAC bonds is as liquid as possible, as soon as possible.

Ralph Sinclair,
EuroWeek

EUROWEEK: The proposed changes to the way rating agencies will be allowed to change sovereign credit ratings is something that may affect France in the future. What does the panel think of restricting credit rating agencies like that? Is it a good thing for the market as a whole or a bad thing?

D'Orsay, Société Générale: Overall I see that as a positive evolution. Sometimes a downgrade pours oil on the fire and comes at the worst time. These changes increase transparency because, on top of the restricted timing, there will be also more explanation about the methodology that the agency used to arrive at its conclusions. It is good for the market.

Yiasoumi, Morgan Stanley: I think it's good for the market for all the things Amaury has mentioned. The only risk is further measures that might hinder the independence or the autonomy of the rating agencies. That would be my only worry.

Blandin, Crédit Agricole: It's a positive because it will prevent some behaviour that was not necessarily beneficial to the markets and increased volatility. Investors have also learned to take ratings with a pinch of salt, and we've seen a complete lack of reaction, or even a positive reaction after recent downgrades, which shows that it is more a technical measure to facilitate an orderly market and prevent ratings being published before an auction and so on — things which are from a short term perspective, really unhelpful.

EUROWEEK: But given the wave of indifference that tends to greet ratings downgrades nowadays, are we not at the stage where ratings actions aren't disruptive anymore? They lag investor opinion rather than leading, don't they?

Blandin, Crédit Agricole: Yes, I think they were clearly lagging the consensus, but they can still, from a very short-term perspective, be disruptive. A rating announcement a couple of hours before an auction is not welcomed by the issuer and it is not good for the market.

D'Orsay, Société Générale: Or a few hours after the auction.

Blandin, Crédit Agricole: Yes.

D'Orsay, Société Générale: We saw last year with Spain that although ratings agencies may lag the general opinion, if the momentum behind that credit is negative then ratings agencies can be very disruptive if investors and issuers have no guidelines to go by.

In the end there has been little reaction this year but last year it was different.

Yiasoumi, Morgan Stanley: If the ratings agencies primarily — or hopefully — are working to inform the investor, then changing the ratings just after an auction when the investor has just gone and invested his money, is bad timing — especially when it has probably taken quite a long time to arrive at that rating decision, so the agency probably knew about its decision in advance. It is clearly an area where some more work is needed.

Also, a lot of the bigger investors within Europe have actually started to put together some of their own internal ratings with respect to sovereigns, to help them more precisely with their investment decisions. That would imply there is still more work to be done for the rating agencies. There is demand out there for something else.

D'Orsay, Société Générale: Rating agencies very often have a tendency to follow the market action. These regulations won't prevent that entirely, but at least they will temper it because rating agencies will have to act at a certain time and therefore react a little less to the market action.

Babini, BNP Paribas: It's good if it is a transparent, economical and financial study.

Mills, AFT: I completely agree. It surprises me that there is even a debate because what has been decided is quite common sense. It is common sense that you publish a rating decision after the market closes or at least one hour before it opens.

There is unanimity among DMOs regarding the fact that the ratings agencies should only be doing the evaluation two or three times a year, and that they have to announce that calendar.

I am strongly in favour. I have pushed for this evolution as the chairman of the European Sovereign Debt Managers Group. I honestly think that you should have rating agencies which are completely independent and who are transparent with their methodology.

You should take into account the fact that when you rate a sovereign you rate something specific.

And the role of the rating agency is, as much as possible, to rate the part of the sovereign which is linked to long term quality of credit, and to try to isolate that. It is complicated to do so but the real quality of sovereign credit doesn't change every week or every day. It changes from time to time with large events.

It's not a constraint for a ratings agency to be able to evaluate a sovereign twice a year. In the case of major events they can say they are going to do so and so and it all becomes completely manageable.

It will also become more difficult for some people to try to launch unhelpful rumours. The DMOs agree that this is a good thing.

EUROWEEK: The original concluding question I had planned was to ask what the biggest worry you all had for the French government debt market for the next 12 months. But perhaps worry is a bit too strong a word, given what you have all said today. So what are your hopes, fears, dreams and aspirations for this market over the next 12 months?

Blandin, Crédit Agricole: The question is where can risk come from. We talked a lot at the beginning of the discussion about the resilience of the French government bond market in the face of massive volatility in 2011 and again at the beginning of 2012. So the risks are limited.

Benito mentioned the word earlier on — growth. We need to look for some growth. And not only growth in France but we need growth to pick up globally, so it is good news to hear that China is progressing. There are some indicators that the US is pointing in the right direction too.

Growth will make the continuing process in the eurozone much easier, not only for France but for the entire zone. So there will obviously be some surprises on that front.

Babini, BNP Paribas: There is no particular worry ahead for the OAT market in my mind, but the OAT, like other EMU best-rated sovereign debt, will probably face a challenge in 2013.

The low level of yields and the lack of potential further easing mean that the performance of triple-A and double-A rated paper might be quite limited.

D'Orsay, Société Générale: The risks are very limited. It's going to be the perception of a real break-up of the eurozone that will trigger something. But I see that as having a very, very, very low probability of occurring over the next 12 months. So I don't think that it is the issue.

The market will be more volatile around the time of the Italian election and again around the time of the German election. But I don't think that should be the worry either.

The worry, if there is any, could come more from the lack of economic performance of the world overall and of France specifically. It is clear for all the Western countries, and it's not specific to France, that a very poor outlook for growth will be difficult to handle in terms of fiscal rules and for France to stick to its fiscal targets.

Too much relaxation by governments as the European sovereign debt crisis fades is a longer term concern but I don't think that's a 12 month worry.

The economic outlook being bad is the main concern. It's not my central concern but it is something that has to be watched.

Yiasoumi, Morgan Stanley: We'll be focused on whether the government is going to address the body of long term fiscal issues. There are a lot of structural issues to tackle — labour market reform, supply side reforms, competitiveness. These are types of things the market is going to focus on. But I don't think these issues will really have an impact on the debt market.

The reforms are slowly being made in France.

It's going to be more global concerns in terms of what could have an impact on the market. One thing to take note of that nobody is really talking about is the upside to the economy. A lot of investors have come into this year overweight fixed income, overweight rates, underweight credit and I think the bull and bear case is actually more finely balanced than people suggest.

I think there's definitely upside. If you look at, say, credit conditions, we've already seen with Basel III the relaxation of liquidity requirements. That's quite bullish.

Talking about where global growth is going to come from, will it just be emerging markets? You could have better newsflow out of the US. Japan is changing its inflation targeting and asset purchases could have a big impact on fixed income assets.

This could affect levels and volatility within foreign exchange and equity markets. If you look at peripheral debt, peripheral yields in the context of fixed income and in the context of equity, trade at quite cheap levels. There are quite a few potentially positive developments.

The risks to French debt are more about interest rate risks. There is already a grab for yield under way, with new investors coming in looking for yield. In terms of looking at the French debt purely as a yield product, I think we could have either trade around current yield levels or we could have a moderate increase in yield levels in general, due to a more positive economic outlook.

I don't think there's going to be any large change because the growth outlook is still uncertain. I don't think underlying and key interest rates in Europe are going to move aggressively any time soon, so there's definitely an anchor there in the carry and in the interest you can earn on a fixed income portfolio.

Mills, AFT: I have no specific worry for 2013. I think you have two kinds of concerns or possible shocks, one of which is a background shock and one of which is more linked to the working of the debt market itself.

The background shocks will be interesting because for the first time in a long time, since 2010, the worry will probably come more from outside Europe than from inside Europe. Nobody has yet mentioned the US fiscal cliff, but it has not been really resolved.

Will Chinese growth be a growth that benefits other countries in the world or will it be more domestically oriented?

That the risks will probably come more from outside Europe than from within Europe is a very strong element of the stability of overall European markets and, of course, of the French market. If there is a moderate increase in yield levels then this is something that I think will be manageable.

With regard to French fiscal targets, the budget bill is built in on both parts of the curve — the short end and the long end. We have made provisions for that potential risk. ▲

Agencies set to shine

New French public sector borrowers will hit the market in 2013 — and they look assured of a strong reception from investors. **Tessa Wilkie** reports.

THIS YEAR will mark the beginning of a new era of public sector issuance in France. The state has set up a new agency — the Société de Financement Local (SFiL) — to provide funding to local authorities. Meanwhile, the planned merger of Société Nationale des Chemins de Fer Français and Réseau Ferré de France is expected to produce another new state-backed borrower.

Conditions have rarely been better for French agencies mulling a debut bond. Investors are ready to chew the arm off any borrower that is backed by a core European sovereign but offers bonds with a pick-up over their state.

"It's clear from investor enquiries that there is appetite for new names," says David Villedieu, head of French corporate fixed income capital markets at Morgan Stanley in Paris.

Morgan Stanley has had a lot of requests from investors in Asia, the Middle East and South America for paper that is France plus a premium, says Villedieu. "These are investors with huge liquidity that are searching for yield," he says. "Agence France Trésor has done a very good job of marketing to investors and explaining the economic situation."

Agency paper is also becoming attractive versus covered bonds, which have become more and more expensive. Lucette Yvernault, global credit portfolio manager at Schroders in London was recently offered a switch from Obligations Foncières to agency paper and found it tempting. "There's a lot to be said for taking state backing over having to monitor a cover pool on a regular basis and spreads of agencies are attractive compared with Obligations Foncières," she says.

"From a credit investor's perspective, as long as it's public issuance and comes with a bit of a spread, it can be used in portfolios instead of covered bonds, which credit investors use to barbell. There isn't much spread difference between covered bonds and agencies now, and agencies offer some diversification. Yield depletion in covered bonds has been huge — you'd have to look to Cédulas to pick up yield."

"There isn't much spread difference between covered bonds and agencies now, and agencies offer some difersification"

Lucette Yvernault, Schroders

SFiLing the funding gap

The French government announced the creation of SFiL in January. Its aim will be to fill a hole left in local government funding left by the reduction of Dexia's municipal financing activities.

SFiL is expected to print Obligations Foncières via a refinancing entity, but it is government backed with 75% owned by the state, 20% by Caisse des Dépôts and 5% by La Banque Postale. It is to be headed by the ex-CEO of Agence France Trésor, Philippe Mills.

SFiL's refinancing entity will fund an annual €5bn of newly originated French local authority assets from the balance sheets of CDC and LBP.

Covered bond bankers expect the new issuer to trade towards Caisse de Refinancement de l'Habitat's levels.

Do it yourself

While the issuer should make financing for France's local authorities and hospitals more available, increasingly bond market financing is something that local authorities have looked to find for themselves.

Departement du Val d'Oise was one of the six French regions to print bonds for the first time in 2012. These issuers are the vanguard of a growing market as local authorities look to diversify their funding sources.

"At the end of 2012, around 40 French local authorities were rated," says Audrey Sebban, director in debt capital markets origination at Crédit Agricole CIB in Paris. "More and more are considering coming to the market."

Val d'Oise has around €100m to raise this year and is looking at opportunities in bank financing but also in the MTN market.

"In 2013 Val d'Oise wants to print bonds but also fund through bank loans. The split will be based on how competitive the costs of funding is in each market," says Florent Horta, head of debt management at the Departement du Val d'Oise. "Bank financing is usually more flexible but also more costly than bond financing."

SFiL is also an option, if the pricing and terms are attractive, says Horta.

Val d'Oise set up a euro medium term note programme last year, as it saw bank liquidity become more costly.

The issuer raised nearly €30m via private placements in November, split into a €15m 10 year piece and a €14m 11 year, both placed via Société Générale.

The local authority bond market is one set for growth, albeit at a stately pace, as issuers have a lot of preparation to work through if they want to issue.

"It's potentially an important market but growth will be gradual," says Zeina Bignier, global head of DCM public sector origination for Société Générale in Paris. "These issuers have to prepare ratings and MTN documentation before being regular issuers. They also have a legal requirement to only fund for investments, such as in infrastructure and real estate.

"I expect the market to increase rapidly, but from a low level. For example in 2012, issuance totalled about €4bn. It will probably be €5bn next year and could double in five years."

Another possible new issuer that could emerge this year is an amalgamated Société Nationale de Chemins des Fers and Réseau Ferré de France. The government is merging the two as part of its plans to reform and streamline the railway system in France.

"The French government is preparing a reform that will be submitted to parliament in the coming weeks," says Villedieu at Morgan Stanley. "While the exact reorganisation of SNCF and RFF is not known yet, it is clear that achieving a good standing with the markets to ensure fluid access to capital is definitely an objective taken into account."

The issuers mainly print long-dated funding through private placements, and market participants do not expect the issuers' investors to be put off by a merger.

"If SNCF and RFF merge, they will still be government backed names, so I can't see investors being too concerned," says Bignier at SG.

For any new issuers marketing will be key, however.

"Any agency has to explain to investors how they are attached to the state," says Yvernault at Schroders. "I'd really encourage new issuers to roadshow and explain their structures to investors. Investors are still wary around language and are scared of being burnt if state backing turns out not to be as strong as they had thought. It helps if the agency supports public projects, for example."

Canny Cades

But it's not just the new issuers which can catch investors' eyes. Caisse d'Amortissement de la Dette Sociale surprised many when it opted for a dollar deal, instead of its more usual euro trade, to kick off its 2013 funding. But the deal — a $3.5bn five year sold in January — showed how popular French agency paper has become.

"We're in good shape to do deals — our paper should be in demand"

Philippe Noël, Cades

This bond, with a book of around $4bn, was the issuer's largest ever dollar deal — its previous largest being a pair of $3bn three years sold last year.

The deal was also $1bn clear of Cades's largest previous attempts in the longer, and often more difficult, five year maturity.

As the Cades deal shows, French agencies have benefitted as investors step up their hunt for yield. France's 10 year yields are around 50bp higher than Germany's, which is not to be sniffed at in this ultra-low yield environment.

State-backed issuers such as Unédic or Société Anonyme de Géstion des Stocks de Securité (Sagess) should be popular alongside Cades, as investors look for France plus a spread. Sagess's last trade, a €700m 2019 deal priced in October, came at 33.4bp over France — and received €1.9bn of orders.

"I expect investors to see value in France as a whole and as a result in other public sector issuers backed by the sovereign," says Pierre Blandin, global head of SSA debt capital markets at Crédit Agricole CIB in London. "France performed extremely well in the course of last year, it offered an attractive pick-up over the core as well as supranational institutions."

Demand will be further boosted by low supply from agencies in France and across Europe.

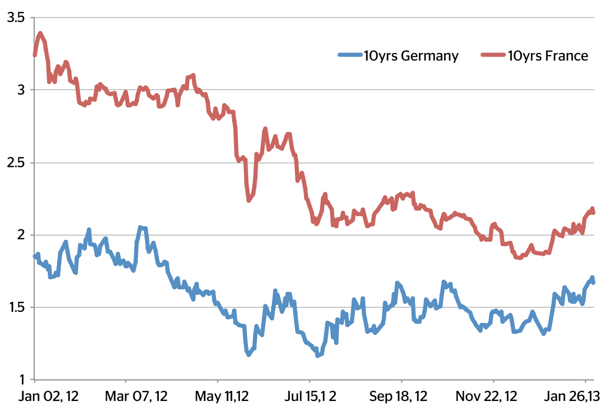
French agencies are expected to raise a similar amount of cash this year, but higher redemptions mean that net supply will be lower, says Benjamin de Forton, in charge of French agency coverage at BNP Paribas in London.

This will help insulate borrowers from any wobbles in the European periphery.

"Investor demand for top quality assets — especially those coming from France — is strong across the curve," says de Forton. "We expect this demand to remain high throughout the year as we are in a period where European SSA net supply across all currencies is expected to reach its lowest level since 2009. It is expected to be down 20% on last year, at €159bn."

The low yield environment should also help issuers push out their maturities. "International investors are looking at mid-to-long term maturities to pick up yield, as well as rarer issuers such as the local authorities in France," says Bernard du Boislouveau, managing director in debt capital markets origination at Crédit Agricole CIB.

Getting closer: 10 year government bond yields



Source: Markit

Long dated demand is something that Cades could well capitalise on later in the year. It hopes to print a 10 year dollar deal if the opportunity presents itself.

"We love the idea of doing a 10 year dollar deal if conditions are right," Philippe Noël, head of capital markets at Cades in Paris, tells *EuroWeek*. "We have a small programme compared with previous years [€30bn for 2013, compared with €40bn the year before] so we're in good shape to do deals — our paper should be in demand." ▲

French banks catch up in capital stakes

French banks are shaking off their reputation as laggards to their European peers with a sharp push on capital and solvency. Now that common equity ratios have improved, **Katie Llanos-Small** asks if it is time for the focus to switch back to total capital.

IN THE STICKY heat of the summer of 2011 — the time of year when most sensible Europeans are lounging on a beach — markets hammered French banks. In the space of a month, CDS spreads referencing the three big French lenders virtually doubled. Société Générale was worst hit. Its CDS moved from 141bp to 334bp between July 7 and August 10. Combined with its share price closing down 15% on August 10, the bank was prompted to respond. It "categorically and vigorously" denied "all the market rumours which have affected its share price" that day.

A short selling ban followed the turmoil, but the longest lasting result was a firm commitment to change. SG pledged to "accelerate the transformation", announcing plans to cut leverage and increase its Basel III capital ratio by 100bp. Crédit Agricole's adjustment plans involved slashing funding requirements by €50bn and cutting risk-weighted assets by €35bn. And BNP moved ahead with an adaptation plan, cutting dollar funding needs by $65bn and risk-weighted assets by €45bn in the corporate and investment bank.

The 2011 volatility was generalised across Europe, but it was a particular wake-up call for France's banks, says Alain Branchey, French banks analyst at Fitch Ratings in Paris.

"The shortcoming in the past was that French banks were not at the top of the class in terms of capital ratios," he says. "When there was a crisis in 2011, the major French banks all responded quite actively by introducing deleveraging plans. They all strengthened their capital ratios, and continue to strengthen them through deleveraging, reducing RWAs, selling assets and retaining earnings."

The banks are now well capitalised. Crédit Agricole boasted an 11.3% Basel 2.5 core tier one ratio at the end of September 2012, having increased the ratio by 110bp over the course of the year.

Similarly, SG added 125bp to its Basel 2.5 ratio in the first nine months of 2012, reporting a 10.3% ratio in its third quarter results. And BNP Paribas was up 180bp to 11.4% in September.

Those efforts have paid off.

"Since before 2011 we have been explaining our strategy," says Stéphane Landon, head of group treasury and ALM at SG. "We have demonstrated our capacity to improve our situation — through the right level of deleveraging, resilient earnings, and the ability to strengthen our capital."

He adds: "Since June 2011, the bank has reduced more than €32bn of assets. We've been delivering on our promises in a market that's been improving. The reception to our deals is a combination of market conditions and our capacity to deliver, to increase our capital ratio significantly quarter after quarter, and to improve our liquidity position and dispose of assets."

"We've improved our situation through deleveraging, resilient earnings, and the ability to strengthen our capital"

Stéphane Landon, Société Générale

Economic worries manageable

France's banks still have plenty of work ahead of them, however. Questions over the country's economic outlook continue, while across Europe banks are preparing for incoming rules to haircut senior unsecured bondholders.

As investors have divided Europe into core and non-core jurisdictions, France has flirted with the boundaries between the two. It has maintained its core Europe title, but worries about the economic outlook remain. Deutsche Bank analysts, for example, expect the country's GDP to shrink by 0.3% this year.

Happily for the institutions concerned, a poor economic showing this year is unlikely to cause big problems for the credit quality of France's banks, however.

"If the economy were to slow down, that would take a toll on SME portfolios," says Ivan Zubo, European banks credit analyst at BNP Paribas. "If non-performance on those portfolios were to go up, then the risk weights would increase, and there would be a negative impact on capital. But, one thing to keep in mind — and French banks are unique in this sense — is that they have a very profitable, very predictable, solid home market."

Mortgage lending forms part of that predictable home market. French banks base their mortgage underwriting decisions partly on the borrower's salary, with repayments — and therefore the principal amount — limited to a proportion of the borrowers' income. Combining that with typically fixed rate mortgages means defaults should remain under control.

"If borrowers have a job, no matter what interest rates do, their ability to repay is the same," says Branchey. "The risk is from unemployment. The French unemployment rate is about average for Europe, although higher than what the government would like it to be. The real risk to the mortgage market is from people who have loans today who lose their jobs. There will be some of that. But I think the housing market should not be a problem for the French banks."

Potentially a bigger focus for France's banks is preparing for the capital and funding regulations coming into force across Europe.

Total capital focus

The largest lenders have done their homework on their equity ratios. But total capital ratios have taken a second priority — evidenced by big liability management exercises by BNP Paribas and Société Générale in late 2011 that took out hybrid capital to boost equity ratios.

Delays on rules governing hybrid capital structures have constrained French banks' ability to issue fresh instruments to boost total capital.

The need for a thick layer of subordinated debt and hybrids is increasing as new rules on bailing in senior unsecured creditors loom on the horizon. The European Commission's draft resolution and recovery directive proposes senior bondholders face haircuts if a bank becomes non-viable.

"In an environment moving towards bail-in, the investors are comparing capital ratios and the cushions protecting senior unsecured creditors of banks," says Khalid Krim, head of European capital solutions at Morgan Stanley. "French banks will need to address that and where needed raise total capital to be in line with their peers and major banks around Europe."

Basel III was due to take effect from January 1. Yet Europe's policymakers have continued debating rules on the structure of new tier two subordinated debt and tier one hybrid instruments well into the new year. Without finalised regulations, issuance has been constrained.

SG is the only French bank to have sold a regulatory capital instrument in the public markets over the last year.

It put the regulatory uncertainties aside on November 29, when it sold an unusually structured $1.5bn tier two bond. Rather than selling a dated instrument — as is the norm for tier two bonds — SG's issue carries a perpetual maturity. It is callable after 5-1/2 years.

The perpetual maturity makes the bond count towards Standard & Poor's risk-adjusted capital ratio, the ratings agency's proprietary score.

"We don't have the regulations completely defined," says Landon. "The hybrid tier two capital we issued at the end of last year enabled us to increase our total capital base, and had several innovative features, including the added bonus of being given equity credit by Standard & Poor's. Once again the market appetite was there. And it is still there. We were specifically trying to address European and Asian markets."

Coco no-go

SG jumped in before the rules were completely finalised. Yet already the banks have an understanding of some of the limitations ahead for issuing hybrid capital.

First up, it is clear that banks are unlikely to find regulatory credit for contingent capital bonds in the near future. The Swiss regulator has mandated its national champion lenders to hold a swathe of such instruments. And the UK's bank regulator has hinted at its interest in the securities — it is widely expected that Barclays will have received some credit for the Coco it sold in 2012.

Across most of the rest of Europe, though, regulators have been wary of the novel structures, and France is in that group, hybrid structurers tell *EuroWeek*.

On a more positive note, however, the tax treatment of Basel III-compliant hybrids looks rather more straightforward. In some European jurisdictions, it remains to be seen whether additional tier one hybrids, as the instruments will officially be named, will count as debt or equity for tax purposes. The difference can change quite sharply the cost profile of issuing such paper. In France, the issue is unlikely to be a problem.

"Compared to other countries, new-style tier one will be much easier for French banks to sell internally and externally," says Krim.

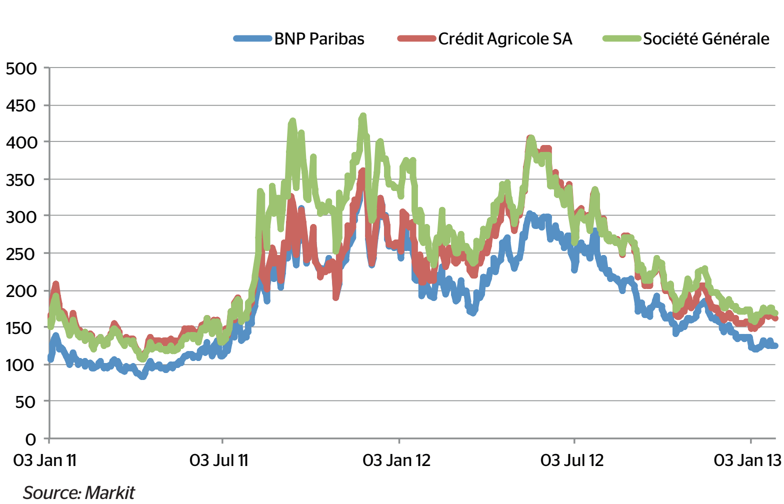
"It's tax deductible — there's no doubt or concerns about that. The tier one that will come from French banks under CRD IV/CRR 1 will come with a write-down/write-up structure. If you look at the previous generation of tier one that French banks have issued since 2003, they had write-down/write-up already. Issuers are very familiar with the structure, they know it well."

The other positive for France's banks when it comes to looking at new hybrid capital and subordinated debt issuance is that the work they have already done to strengthen their balance sheets is paying off. That will make market access easier.

The fact the big three have sold dollar denominated senior unsecured bonds recently shows credit investors' confidence in French banks, says Morgan Stanley's Krim.

"Moving from there to capital instruments is quite important," he says. "SocGen's tier two was issued in US dollars. It was primarily targeted at private banks in Asia and was well received there, but also generated strong interest from European and US investors. And US investors are saying they would be interested in buying tier one or tier two paper from French banks. That's positive and very encouraging for 2013." ▲

French banks' CDS since 2011



Source: Markit

Lenders *sans frontières* — banks recover their swagger

France's lenders have made much progress in cutting their balance sheets and reducing their reliance on wholesale funding since the crisis. As they push out into pastures new, such as the Samurai and securitisation markets, the challenge now is taking care of these new investor bases. **Will Caiger-Smith** reports.

FRENCH banks took a hammering in the equity and debt markets in 2011, when worries about their sovereign's economy, and about their own exposures to peripheral European economies such as Greece, pushed investors to examine their funding structures.

An over-reliance on short term funding in banks with very large balance sheets was identified as a key problem — one that US money market investors in particular took it upon themselves to regulate, as they pulled out of French lenders for several weeks running.

Since then, France's financial institutions have made a big effort to streamline their business models, and in particular, the ways they fund themselves. They have deleveraged heavily over the past two years and are weaning themselves off very short term funding, pushing out their average maturity in those markets, and looking to the longer part of the curve in senior unsecured and covered bonds.

The International Monetary Fund published a report on French banking in December 2012, in which it recognised the system's resilience to market pressures and praised the progress banks had made in bolstering their capital reserves and diversifying their funding sources. But it cautioned that more needed to be done.

"They remain… vulnerable to sustained disruptions in funding markets and reduced profitability, which would cause delays in meeting capital-raising plans," said the report.

Over-reliance is over

When mortgage market stalwart 3CIF ran into trouble with Moody's in 2012, one of the main concerns was its over-reliance on the covered bond market and wholesale funding in general.

The largest French banks differ from 3CIF in that they can source a

"[Securitisation] deals were oversubscribed last year — they ticked all the boxes, so now French banks have to bring more."

Laurent Mitaty,
Société Générale

portion of their funding from customer deposits, alongside their capital markets activities. But they still have a lot of diversification to do.

Banks such as Société Générale have made their debut in the Samurai market, and the securitisation market has also become of greater importance as French lenders seek greater funding autonomy for their consumer finance subsidiaries.

Maxime Stevignon, head of French, Belgian and Swiss FIG fixed income capital markets at Morgan Stanley, says this overhaul of banks' funding structures will continue, as issuers adapt to changes in investor appetite and look to diversify wherever possible.

"We've seen diversification of funding products, with the increase of securitisation in particular, which is very much a nascent market — we've seen banks securitising consumer loans and other assets," he says.

"In covered bonds, investor appetite is high, but issuance is decreasing. That's partly because banks are wary of encumbering their assets to raise funding, which favours senior unsecured, especially when markets are strong."

French banks were also active in the Samurai market in 2012, as lenders increasingly sought to source their funding from a wider range of markets, terming out their maturities where possible.

Much of French banks' recent issuance in the senior unsecured market has been opportunistic rather than strategic. While few have publicly stated that the short term debt they issued at the end of 2012 and at the start of 2013 was expressly for the purpose of paying back the funds they took in the European Central Bank's three year longer term refinancing operation (LTRO), many market participants have drawn that conclusion.

"Given the rally we have seen since September, most banks in core Europe can get two year funding at cheaper levels than the LTRO," says Ivan Zubo, a credit analyst at BNP Paribas who specialises in European banks. "And they can do that in the senior unsecured market, without having to provide the collateral they have to pledge to the ECB.

"It's an economic decision. If you can fund at a cheaper level and with a better structure, it's a no-brainer."

A €2bn two year that SG sold in January, for example, pays 48bp over three month Euribor — well inside the 75bp cost of the LTRO.

Samurai arrives at last

By contrast, Samurai issuance from French banks has been a long time in the making. BPCE and SG both tapped the Japanese market in late 2012, the culmination of months, or in SG's case, years of planning.

Its trade was initially slated to launch on September 15, 2008 — the day when Lehman Brothers collapsed. The transaction was postponed until a second try in the summer of 2011, but SG was again forced to step back from the market after Moody's downgraded it along with other French banks in June that year.

The third attempt, in November 2012, was luckier, netting the bank ¥70bn ($848m) across three fixed rate tranches. SG now aims to be a regular issuer in the Samurai format.

But while diversification of currency and investor base is important, it must come in conjunction with prudent redemption management, says Stephane Landon, head of ALM and treasury at SG.

"We try to manage our funding profile so we can spread our redemptions appropriately," he says. "We're careful to make sure we don't have a wall of redemptions in one year, so we spread them across the curve.

"The other point in terms of maturity is that it also depends on investor appetite. Covered bonds are generally bought by insurance companies, and they're a more long term instrument, but we don't intend to issue more than 20%-30% in covered bonds, which is what we issue on average every year. In September the average length of our funding was six years, and we don't intend to lengthen that much more."

Like most financial institutions, French banks have made progress in lengthening the average maturity of the capital markets funding, in accordance with new regulations, such as Basel III's net stable funding ratio (NSFR).

BNP Paribas this year printed a €1bn 10 year senior clip at 105bp over mid-swaps, while Crédit Agricole and BPCE have been active in five and six year tenors, respectively.

"What they will need to go for is a combination of price and duration and they will try to optimise that balance — finding longer tenors at the right price," says Pierre Yves Bonnet, global head of FIG at SG.

"They'll focus more on the seven year part of the curve, as well as the tier two market."

The Yankee market was tapped by borrowers such as BNP Paribas ($1bn five year sold in April) and offers the opportunity to push out even longer, into the 30 year part of the curve, for example. However, that might not make sense in terms of price, says Stevignon at Morgan Stanley.

"The first move in 2010 and 2011 was to replace short term funding with long term funding," he says. "This trend will accelerate, and banks will focus on the long term portion going forward.

"However, the key focus is now shifting to return on equity, as banks concentrate on profitability again. So while markets are open for longer term debt, particularly the Yankee market, banks are unlikely to push out too far because they don't want to lock in spreads for too long. Three to five years is the issuers' sweet spot for senior unsecured, while covered bonds can cater for longer maturities, up to 10 years."

Securitisation comes of age

So while French banks are pushing their profile in global markets, it could take a while before US investors can rely on them being repeat issuers.

Meanwhile, securitisation specialists are wary of French issuers going quiet in their market. After a spate of deals in 2011 and 2012, their challenge is to ensure that the investors that bought in the first time around do not go hungry in the coming months.

Post-crisis securitisation is still a developing market in France, and it makes up a small portion of French banks' funding. But it carries the advantage of giving their finance subsidiaries a greater level of autonomy from their parents.

"Following 2007, securitisation deals were used by the French banks, like in many other European institutions, in a fairly defensive way to constitute ECB repo-eligible collateral," says Laurent Mitaty, head of European securitisation at SG. "But over the past 18 months, these deals have become a proper funding tool for French banks."

"[Issuers] will need to go for a combination of price and duration and they will try to optimise that balance"

Pierre Yves Bonnet, Société Générale

Specialised lending divisions of French banks, in areas like auto lending, equipment finance and consumer finance, are now getting their funding from the securitisation market.

BNP Paribas Personal Finance launched Autonoria, an auto-loan securitisation, in 2012, while SG intends to tap its own auto-loan ABS, Red & Black, again this year. And Crédit Agricole securitised consumer finance assets in its Ginkgo deal, sold in October 2012.

But the securitisation investor base is a small community, and investors expect their portfolios to be kept full, says Mitaty.

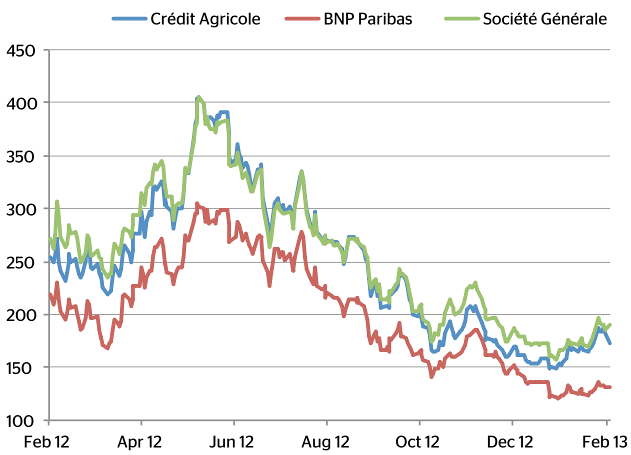
"Once banks launch the public placement of their securitisation programmes, the market expects them to be regular issuers," he says. "They really have to maintain supply if they want to maintain some proper liquidity of their securitisation funding programme. These deals were oversubscribed last year — they ticked all the boxes, so now French banks have to bring more.

"Banks also need sufficient origination to be active as recurrent issuers the same way they are in the senior and covered bonds markets. It's a challenge, but it's a positive one."

Whether or not they can continue originating enough assets to fill investors' boots with new paper will be down, to a large extent, to the performance of the French economy and the depth of consumer demand.

But after the battering the banks took just over a year ago, it is heartening to know that for now, the problem is too much demand, rather than too little. ▲

French banks' five year senior CDS, 2012-2013 ytd



Source: Markit

An embarrassment of solvency riches for French insurers

Faced with tax uncertainties for life products and stiff competition in non-life, France's insurers have plenty to keep them busy over the coming years. From monetising intangibles to eyeing new investments, the borrowers are exploring their options to build solvency, writes **Katie Llanos-Small**.

FRENCH life insurers' solvency ratios are at their lowest levels in recent history — and a poor economic outlook is set to constrain their profitability. Debt capital markets bankers are hoping for a raise this year on the €800m of French insurance hybrid issuance sold in 2012. But for insurers themselves, the possibilities are much wider. They are looking at more profitable investment options among ways of boosting solvency ratios.

French life insurers' risk-adjusted capital adequacy levels are well below pre-crisis levels, according to ratings agencies. And they are likely to see their profits squeezed. Low interest rates will hinder their investment returns, and bank deposit accounts offer competition. Property and casualty insurers have a better profit outlook for 2013 — but competition from mutuals and bancassurers will be strong, Standard & Poor's expects.

French life insurance products are frequently used for tax-efficient savings, particularly for retirement. But their market share in that area may be eroding. Low interest rates make it difficult for the insurers to generate strong returns. And since the crisis policyholders have been increasingly dipping into their insurance savings, says Benjamin Serra, insurance analyst at Moody's in Paris. "That's linked to the economic crisis and the need for households to deleverage," he says.

"It's also linked to structural reasons. Policyholders are getting older — some have retired — and so instead of saving, they're withdrawing their money. The reduction of inflows and the increase in outflows led to negative net flows in France for the first time in 2012. We expect some continuation of that pattern this year."

At the same time, it is increasingly unclear how long the tax advantages that have driven savers into life insurance products, in favour of bank deposits, will remain.

"There is a political willingness to change the fiscal rules related to savings," says Serra. "Life insurance products benefit from fiscal advantages, and they may be changed this year. That may have an impact on the life insurance industry. One of the reasons why life insurance products have been so popular is because they benefit from fiscal advantages. If these benefits are reduced, this could have an impact on sales of insurance products."

Not everyone is worried, however. In January, Barclays analysts said they expected volumes to stabilise in 2013. Worries about tax on life insurance were easing, they said, and that was likely to drive increased consumer interest in such products.

Moving to Solvency II

In the words of one insurance banker, it is the "elephant in the corridor". Another questions whether it will ever come into force, given it has lurked in the draft stages for so long. But the preparations for Solvency II are real. French insurers are already focussing on what the pan-European insurance rules will mean for their businesses.

It is tough to calculate French insurers' need for capital. Their regulatory ratios have decreased a small amount since 2009, mainly because unrealised gains have decreased, says Moody's Serra. But they still look set to comply with the forthcoming rules.

"It's difficult to have a final opinion on the impact of Solvency II," says Serra. "The QIS5 numbers didn't show any specific need for recapitalisation in France, both in life and non-life. So the new framework is not expected to trigger a recapitalisation of insurance companies."

Many in the banking world are relaxed about the move to Solvency II.

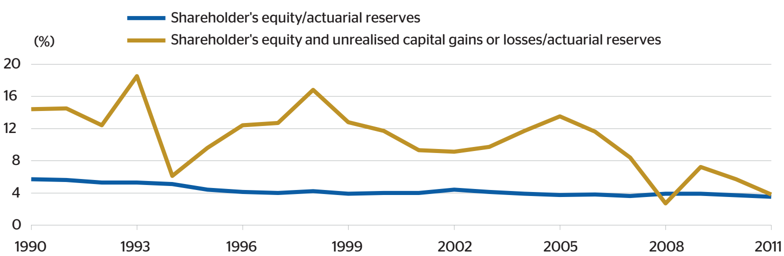
"The volume of contracts in force with long term guarantees on the liability side is small compared to the bulk of contracts, mainly savings contracts, with guarantees that are very limited in time if any," says Ludovic Antony, continental European insurance advisor at Société Générale.

"So Solvency II is not really a big concern for insurance in France. Typical life insurance companies need approximately the same amount of capital under Solvency II as under as Solvency I, although the ratio increases because the value in force is part of tier one capital."

Insurers have several options for increasing their capital ratios. French insurers are expected to increase their sales of subordinated debt and hybrid capital year on year *(see box)*, and creative investments will help profitability.

Meanwhile, reinsurance agreements could offer another avenue for French insurers to increase their capi-

Changes in solvency margins



Source: Source: FFSA, Fitch

tal. Deutsche Bank subsidiary Abbey Life Assurance agreed in July 2012 to reinsure Banco Santander's individual life risk portfolio in Spain and Portugal, for example. The deal plonked €490m, before tax, on to Santander's capital pile. So far such deals have been scarce in France.

"Monetisation of intangibles, and the release of capital in the form of reinsurance are both aspects that have been used in the UK but only to a very limited amount in France," says Michele Bareggi, head of European insurance capital management group at Morgan Stanley.

"People are spending more and more time understanding how that can be done. Insurance companies are working with ourselves, market participants, regulators, on these goals."

Another avenue for stocking up on capital is to invest in better yielding products. That is easier said than done, in a market full of cheap central bank liquidity. Europe indicated in late 2012 that it was rethinking Solvency II's very high capital charges for holding asset backed securities. That could prompt more insurers to buy RMBS.

Whole loan investments

But at the same time, insurers across Europe are tipped to increase investments of loan portfolios, taking higher yielding assets as banks delever. Investing directly in loans requires intense credit analysis. Yet, the equation works for some. Axa was reported to have started lending to mid-cap companies last year.

"Given the low rates, relatively high corporate bond prices, and equities being penalised by Solvency II, there is a search for diversification and yield in fixed income investments," says Olivier Aubertin, senior banker at Crédit Agricole CIB.

"Some French insurance companies have started investing in medium sized corporate loans, local authority loans, real estate mortgage loans. While French insurers may already have a general understanding of some of the underlying assets, they appreciate our philosophy to work in partnership mode and to usually keep a share in the loans to ensure alignment of interests. However, the investment decision is definitely theirs." ▲

Hybrid hopes on the rise

AFTER A quiet 2012 for French insurers in the bond market, Axa set the tone for the sector in 2013. In the first weeks of the year the insurer hit the bond market twice, selling a perpetual instrument in dollars and then a few days later bringing a tier two note in euros.

The bond issues were the first of what debt capital markets bankers expect to be a number of transactions this year from France's insurers. The borrowers will refinance issues that are getting close to their first call and step-up dates, says Charlie Morin, head of FIG origination for France and Belgium at HSBC.

Investors are unlikely to be overwhelmed with new deals, but there are a number of projects in the pipeline, says Antoine Loudenot, head of capital structuring group at Société Générale.

"CNP is well in advance on its replacement instruments so it may not have to come to market," he says. "Groupama is restructuring, so issuance would be from the new Groupama. But aside from that, there are a few projects which we are lining up. Issuance will hopefully be above the €800m issued in all of 2012 by French insurers."

The conditions are right for issuance. For a start, investor appetite is keen. Markit's iTraxx Europe Europe subordinated financial's index crunched continually tighter last year. It closed 2011 at 509bp, moving progressively downwards to close at 238bp on December 31, 2012. The compression slowed in January, but continued broadly in the same direction.

"That's a considerable amount [to have tightened in 2011], and it shows the appetite for the financial sub debt asset class," says Jean-Yves Bourbonne, co-head of corporate and institutional sales for France in HSBC Global Markets.

"There's a strong preference for fixed income risk, notably credit, versus equity risk. Particularly among the private banking community there's a preference for hybrid debt of insurance companies, rather than equity. Dated sub debt of the top tier European insurers is returning between 4%-6% in euros, maybe slightly more on US dollars perpetual bonds. That's really compelling for private banks."

At the same time, the structuring outlook is favourable for insurers to tap markets for hybrid capital instruments. Europe's insurance regulation project, Solvency II, is a long way from being finalised. But it looks like the rules will stipulate tougher conditions for subordinated instruments.

"One thing we know about the forthcoming regime is that regulatory criteria for certain forms of capital will be more stringent, resulting in less investor-friendly instruments," says Gabriel Moulinier, director, FIG, France, at HSBC. "While there continues to be some uncertainty in terms of the exact timing of Solvency II implementation, insurance companies are able to issue certain structures that are cost-effective and should continue to be eligible under the new framework."

"There's a preference for hybrid debt of insurance companies, rather than equity"

Antoine Loudenot, Société Générale

Indeed, tier one and tier two securities should be grandfathered at least as tier two for 10 years, with no amortisation of regulatory capital content, says Charles de La Rochefoucauld, global head of insurance coverage at Crédit Agricole CIB.

"If you combine these expectations with the currently red hot market conditions for issuers, it explains why insurers are actively issuing, even if they may not have immediate capital needs," he says. ▲

Buyside shows off Gallic flair for innovation

Viewed through northern European lenses, the French institutional asset management market looks distinctly odd. Occupational pension schemes are rare, but the savings rate is high and asset management firms are thriving. **Andrew Capon** reports.

THE FRENCH asset management industry is rather formidable. Amundi and Axa Investment Managers, with $855bn and $665bn in assets under management respectively, are 10th and 14th respectively in terms of the biggest money managers in the world. Three fund managers, Amundi, BNP Paribas Investment Partners and Natixis Global Asset Management, are among the top 10 managers of European institutional assets.

The French also have a flair for innovation. Lyxor Asset Management, part of Société Générale, launched Europe's first ETFs (exchanged traded funds) and introduced many investors to the once mysterious world of hedge funds via its managed account platform. All manner of quantitative strategies have been promulgated and popularised with a French accent.

The industry is not standing still. BNP Paribas' head of institutional sales, David Bouchoucha, says it is investing further in a financial engineering team, "to build on our expertise in asset-liability management".

The firm is also keen to promote the benefits of risk-managed, or minimum variance, equities. Axa, says Laurent Seyer, global head of multi-asset class client solutions, is developing dynamic asset allocation strategies.

Says Seyer: "The crisis has shown how difficult it is to manage money effectively. When markets are volatile a manager has to be able to switch between asset classes. You need to be flexible as expected returns and correlations change. We are designing solutions that hedge tail-risks and optimise the solvency ratio for insurance companies and pensions funds, while continuing to be invested in risky assets. This can be achieved via derivatives and overlays."

Inès de Dinechin, who replaced Seyer as CEO of Lyxor in February 2012, is building on her firm's long established structuring capabilities and is also looking to add to the firm's cross-asset class expertise. This makes up €4bn of Lyxor's €75bn in assets under management but it is an area that de Dinechin is keen to develop alongside its €30bn in ETFs, €17bn in alternative investments and €23bn in structured investment products. "As markets evolve so will asset managers, but the goals are the same," says de Dinechin. "To deliver the performance, to listen to what clients need and adapt accordingly."

A fixed fixation

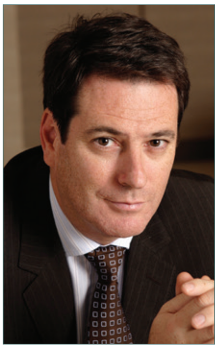
In spite of the sophistication and élan of the French asset management industry, their domestic clients are resolutely cautious and conservative. Fixed income is the asset class of choice. That is good news for the French government and other European issuers. Domestic investors own 45% of the long term sovereign bond market (OATs) and 85% of French asset managers' total fixed income portfolios (€1.7tr) are invested in bonds issued in the eurozone.

The institutional framework of long term savings in France is an even greater influence than investor preferences. Ranked by nominal GDP, France is the fifth richest country in the world according to the International Monetary Fund. However, only one French pension fund makes it into a ranking of the world's biggest 300 asset pools. Australia, ranked outside the top 10 nations by wealth, has 14 funds in the same listing. The UK has more than 20.

To say the French pension system is complicated is a bit like saying Jacques Derrida's deconstruction of metaphysical oppositions is slightly wordy. One report, from the European Social Observatory in 2010, describes, "extreme systemic fragmentation and complexity".

"We think not being tied to a bank is an advantage as it enables us to originate loans in an open architecture format. I think that is what clients want"

François Hullo, BNP Paribas



The defining characteristic that sets France apart from its northern European neighbours is the role played by the state beyond the first pillar.

Pay As You Go (PAYG) unfunded first pillar schemes, the social security safety net, are common throughout developed countries. But there is a general recognition that rising life expectancy has rendered proper state provision unaffordable and insufficient. Employers have stepped in, creating occupational pension schemes (traditionally defined benefit and now defined contribution) and individuals have topped up their retirement income in a variety of ways.

In France, overlaid on the first pillar there are mandatory supplementary schemes. Private sector employees pay into ARRCO (Association des Regimes de Retraite Complémentaire). For senior executives there is AGRIC (Association Générale des Institutions de Retraite des Cadres). Public sector employees, which account for 20% of the workforce, have very generous schemes known as régime spéciaux.

Even in the voluntary, privately managed second pillar the state is present. Public sector employees can make voluntary additional contributions to the Caisse Nationale de Prévoyance de la Fonction Publique managed by insurance companies. In the private sector, the Fabius Act of 2001 created the regulatory framework for financial institutions to develop standardised employee savings plans.

An electrifying issue

Some 260,230 companies operated an occupational scheme in 2011, compared to 140,000 in 2005. But in spite of this growth pension funds make up just 10% of institutional funds and only 20% of companies have introduced a second pillar scheme. Even this modest progress is under threat.

In addition to the controversial financial transaction tax, President François Hollande's left-wing coalition is pushing ahead with plans to more than double employers' tax on profit sharing and employee savings (forfait social) from 8% to 20%. This will represent an explicit tax on private sector pensions. It seems all the more wrongheaded given that France's state pensions deficit continues to widen.

A recent report by the Conseil d'Orientation des Retraites, whose job it is to monitor the state of the French retirement system and make policy recommendations, projected the deficit will reach more than €20bn by 2020. As things currently stand, the annual cost of state pension payments are equal to 14% of GDP.

The appetite of the Hollande government for reform seems limited. For politicians, pensions are a third-rail issue. Since prime minister Jean-Pierre Raffarin began the stop-start process of pensions reform in 2003, the response from the unions has been the same: strikes and mass protests.

Former President Sarkozy's modest proposal to raise the retirement age from 60 to 62 caused a wave of civil unrest. Somewhat bizarrely Hollande has promised to reverse this change. Not that Sarkozy ever really got to grips with the fundamental issues. One of the more positive steps forward on pensions reform was the establishment Fonds de réserve pour les retraites (FRR) in July 2001. Like other pension reserve systems the idea was that funds from privatisations and other state revenues would be used to top up any deficit in the PAYG system.

Instead, on Sarkozy's watch it was decided that the FRR should pay €2.1bn a year to Caisse

"As an investment manager we want to encourage long term investing and would welcome any regulation that encourages that"

Joseph Pinto, Axa

d'Amortissement de la Dette Sociale (Cades). In effect, the coffers of FRR have been raided to help fund the deficit, robbing Pierre to pay Paul. The goal of FRR of accumulating assets of €150bn by 2020 has receded well into the future. Its current assets are €37bn.

The assurance of insurance

Faced with a chronically underfunded state system and stunted employer-sponsored provision of occupational pensions, French savers have used the third pillar. Life insurance has been the by far the most important savings vehicle, largely because of tax incentives. After holding a policy for eight years any capital gains and accrued interest are free of income tax. Says Axa's Seyer: "This tax advantage has been in place for many decades. Life insurance has become entrenched in the investment culture."

But not even insurers can escape regulation and state interference. The European Union's Solvency II directive, due to be enforced in 2014 (though likely to be subject to amendments and delays), has already made insurers across the continent rethink their asset allocation policies. Most have cut equity allocations in favour of more fixed income.

Credit markets have been the main beneficiaries. Most managers acknowledge that with core European sovereign bonds (OATs and German Bunds) at historically low yields, asymmetric risk is writ large. Though a further fall in yields is possible, especially if there is another bout of risk aversion, it is far more likely the next significant move will be up. "There has been a change in mentality. Investors are diversifying portfolios more widely across rates and credit," says Eric Brard, global head of fixed income at Amundi, which manages €430bn in the asset class.

The game changer was European Central Bank president Mario Draghi's "whatever it takes" speech last summer. But even at the peak of the eurozone crisis, there was little panic among French investors, according to François Hullo, head of fixed income at BNP Paribas Investment Partners. "Clients have lived through various stages of the eurozone crisis over the past four years and are well used to volatility," says Hullo. "Of course, we have actively managed country, duration and credit exposure, but a buy and hold strategy would also have worked well."

The investment constraints of Solvency II may yet damage the ability of insurers to produce sufficient returns for their products to be competitive. But so long as French investors remain heavily biased toward fixed income assets this effect is likely to be muted. In the short term the heavy hand of state interference has already been felt as a result of a different influence.

In 2012 insurance assets did not grow overall. Instead, investors sought safety and liquidity in the Livret A. These are state-guaranteed time deposits. In 2012 these deposits offered 2.25% net of tax, a decent yield pick-up over government bonds and a real return over inflation. The Livret A is used to fund social housing. In 2013 the rate paid has been reduced to 1.75%.

Returns from fixed income were spectacular in 2012, with investment grade indices returning 14%. Joseph Pinto, global head of markets and investment strategy at Axa Investment Managers, says, "it will de difficult to deliver similar returns." But adds: "Clients who are willing to diversify across geography, into high yield and different parts of the capital structure continue to do well, especially if they appoint skilled active managers."

Warming to risk

At Lyxor de Dinechin thinks credit is also now too well bid. "Yields are too low in supposedly safe areas of the fixed income market and where there are pockets of higher yields remaining the risk-return profile does not look attractive. If clients want to balance risk and return, other asset classes, including equities, now look more attractive."

Across Lyxor's global client base de Dinechin has already detected this shift, though she admits French sentiment is lagging behind. "In France the process of adding risk has barely begun." At BNP Paribas, Bouchoucha says their low volatility minimum variance equity products offer naturally cautious investors — scarred by two vicious bear markets and negative returns over the last decade — a way to dip their toe in the water.

But BNP Paribas' Hullo points out for many investors constrained by Solvency II, other regulations, or their own strategic asset allocation decisions, equity markets remain off limits.

One product that has proved popular in the search for yield has been loans. For insurers such as Axa with its own balance sheet, and tolerance for illiquidity, corporate loans have played a part in portfolios for more than a decade.

Five years ago Axa Investment Managers, helped by Axa Insurance Group, launched a commercial real estate lending capability, says global head of markets and investment strategy Pinto. Last year Axa Insurance announced its intention to invest in loans for mid-cap companies in partnership with Société Générale. The bank will act as an originator of loans in the French small and mid-sized enterprises (SME) sector. Axa is looking for further origination relationships around Europe.

Fund managers are also getting into the loans market. Hullo at BNP Paribas Investment Partners says: "Our loans team covers both the US and Europe and we were very active in 2012. We now have a five year track-record in the asset class on both sides of the Atlantic. In the second half of the year we raised €700m and we continue to raise more. We think not being tied to a bank is an advantage as it enables us to originate loans in an open architecture format. I think that is what clients want."

The first close of a mid-cap corporate loan fund by Amundi last year raised €475m according to head of fixed income Eric Brard. He expects to raise more on a second close between the end of February and mid-March. These firms believe the yield pick-up is attractive and the risk is somewhere between mainstream fixed income and equities.

The need is clear. BNP Paribas' Hullo says that because of banks having to rebuild their balance sheets only €2bn of new loans were written in France during 2012. That is less than 10% of the European total. He adds: "Before the crisis loan issuance in France was €30bn which represented 20% of the European total. That was far more typical than the issuance we saw in 2012."

The dark side of caution

The way French asset managers have stepped into the gap in the loan market left by deleveraging banks and their flair for applying cutting edge theory to investment management problems, shows flexibility and a willingness to embrace the new. But it could be argued that the foray into loans also reveals a weakness endemic to France. It is the bad side of the French exception.

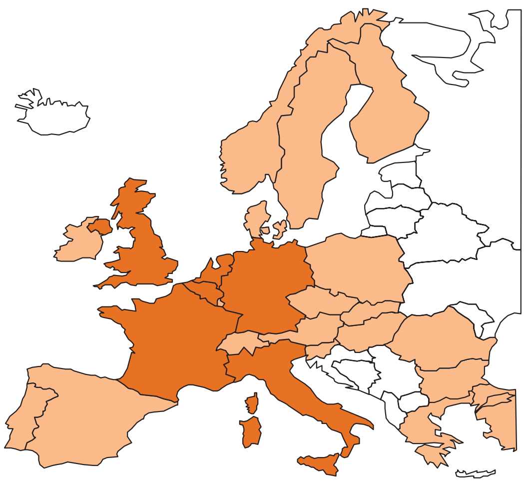
French SMEs that are not large or established enough to tap bond markets have few other sources of capital. Raising equity is more difficult than is the case in the UK or US. It is a flaw recognised by the Association Française de la Gestion Financière (AFG), the French asset management industry body. In July last year it published 12 proposals to make pension funds more "socially useful and encourage the financing of SMEs".

The AFG stepped into the debate in response to the proposal to increase the forfait social. It is currently unclear whether this tax hike will hit pension funds and the lobbying comes ahead of the 2013 Finance Act. The other controversial proposal of President Hollande's government is the introduction of a financial transaction tax on French shares. The socialists raise the spectre of speculators, but in reality this is yet another tax on saving.

AFG's 12 proposals include the acceleration of payroll savings in SMEs. The broader goal is to enable, "savers to mobilise their investments to benefit the real economy". The AFG also points out that the potential tax changes run the "risk of undermining the industry at a time when it will be making a vital contribution to business financing, which in the future will rely less on bank lending".

"As an investment manager we obviously want to encourage long term investing and would welcome any regulation that encourages that," says Axa's Pinto. "Solvency II, for example, does little to encourage equity investment. More broadly there is clearly room for progress in France. The lack of a properly funded occupational pensions system means that equity markets probably suffer from a lack of committed investors with deep pockets and long time-horizons that can cope with short term volatility." ▲

European assets under management (end 2010)



UK €4,599bn	**Netherlands** €492bn
France €2,904bn	**Belgium** €227bn
Germany €1,496bn	**Other** €3,647bn
Italy €670bn	

Source: European Fund and Asset Management Association

A taste for adventure pays off for French corporates

Over the last couple of years whenever there has been a market to be opened, a record to be broken or a structure to be developed, more often than not it has been a French investment grade corporate doing it. The result is that blue chip firms from France have truly diversified their financing, establishing their name in a wide range of international markets. **Nina Flitman** reports.

French blue chip borrowers have become prominent in the US dollar market

FROM JACQUES Cousteau to Jules Verne, France is known for producing people with a taste for adventure and exploration. This national custom for venturing into new and promising places has been inherited by the country's blue chip corporate borrowers, who are grabbing funding opportunities wherever they are available.

From Hong Kong to New York, there are few international markets where French investment grade companies have not made their mark, highlighting their flexibility and their almost universal investor appeal.

"The French blue chips are among the most prudent and yet experimental of issuers," says Félix Orsini, co-global head of corporate debt capital markets at Société Générale in Paris. "They are very experienced borrowers, and have been through many crises, many bursts of volatility, and have learned how to use the most effective market tools to get through the evolution of the markets."

French borrowers are some of the most innovative in Europe, and perhaps globally. As well as considering structured and inflation-linked transactions, blue chip borrowers have looked at bespoke funding, such as Air Liquide's €500m nine year SRI (socially responsible investing) bond last October.

"This was the first socially responsible investment from a corporate in Europe, we believe, and a real illustration of a French borrower being innovative," says Hugues Delafon, head of European corporate debt capital markets at Crédit Agricole CIB in Paris. "There are plenty of socially responsible investment funds that need to invest into specific types of products."

The deal led by Crédit Agricole, Citi, HSBC and SG attracted €3.2bn of appetite. But deals such as this, and the presence of French borrowers in markets and products across the world, has not simply been driven by a desire to innovate for the sake of it, but rather, in the wake of a several years of market volatility, a prudent desire to diversify funding as much as possible.

"French issuers are quite cautious about the future," says Pierre Palmieri, head of global finance at SG in Paris. "The turnover among French treasurers is on average very low, and as a result they have accumulated a lot of experience in volatile or difficult markets. Because of that, they are quite proactive establishing tools that allow them to diversify and manage their debt."

Certainly French borrowers have quickly established themselves in international bond markets as they look to end their reliance on bank financing through syndicated lending.

"Corporate borrowers still go to the loan markets for their back-up facilities — those undrawn lines remain important to their discussions with the rating agencies and are necessary," says Jean-Francois Balay, global head of debt optimisation and distribution at Crédit Agricole CIB in Paris. "But most large companies will have most of the term facilities in the capital markets, while the bank market will be used to support M&A and for back-up lines."

But while European borrowers have been cutting their reliance on bank financing, the experience of French corporate borrowing teams has pushed them to become some of Europe's most well diversified issuers.

"On an historical basis, French corporate blue chips are some of the most frequent issuers," says Laurent Attali, head of corporate DCM, France, at BNP Paribas in Paris. "The treasury teams of these corporates are well experienced. They know how to analyse the markets and the funding opportunities that are available."

Yankee dandies

This understanding of the importance of diversifying, to take full advantage of investor appetite globally, has seen French blue chips become prominent in the US dollar bond market. French issuance in the Yankee market has grown substantially: from six deals for $3.938bn in 2008 to 19 deals for $17.624bn in 2012.

Alongside the well established names that have returned to US dollars such as Pernod Ricard, Total and (after a long absence) Vivendi, many debut dollar deals have been completed for the likes of Schneider, GDF Suez and Danone.

"Many of these issuers do not have a direct need in dollars, but the rationale for them is maintaining or developing their name in the dollar market," says SG's Orsini. "For some of them this will allow them to get access to longer maturities (you can easily issue 30 year dollar bonds, which are rare and tricky in the euro market), but most importantly it's about being established in a market that is the biggest in the world and a market that never closes."

Since the start of last year, the most successful borrowers in US dollars have been those nimble enough to take advantage of the sweet spots in maturities as and when they have emerged. In January 2012, France Télécom (at the time rated A3/A-/A-) found a window at the longer end of the market, issuing a $900m 30 year transaction with a coupon of 5.375% and priced at 240bp over Treasuries. Almost exactly a year later, oil firm Total (rated Aa1/-/AA) saw an opportunity at the other end of the maturity scale, pricing a $250m three year deal at 48bp over Treasuries and with a coupon of 0.75% through its subsidiary Total Capital International. Alongside three $1bn tranches issued through the funding entity Total Capital Canada, this was one of the largest Yankee transactions ever from a European corporate borrower.

While a borrower such as Total has a global presence that makes the dollar market a natural choice, other issuers are tempted by the prospects of arbitrage, or by the opportunity to diversify their investor base.

"When you think about the buyers in the Yankee market, it's not just the money managers, the insurance firms and the pension funds," says Marcus Hiseman, head of European corporate fixed income capital markets at Morgan Stanley. "Corporate borrowers are recycling cash into the bond markets — tech companies that are sitting on billions on their balance sheets are investing in paper to pick up yield. Also we're increasingly seeing central banks investing in corporate paper in the Yankee market."

French borrowers have also found success tapping into new investors on the other side of the world, as the presence of French blue chips in the offshore Chinese offshore renminbi markets slowly but steadily grows.

French borrowers that enjoy name recognition among investors in the region and that have needs for the currency have found success issuing in dim sum. Names such as Lafarge and Alstom have found traction in the region, while in last October car maker Renault, in an effort to diversify its funding sources, completed its debut Rmb750m two year transaction in the offshore renminbi market.

Last June, Veolia Environnement also made its dim sum debut, placing Rmb500m of five year notes after generating orders of over Rmb1bn.

Hybrid trailblazer

The Baa1/BBB+/BBB+ rated borrower, which provides environmental services, returned to the capital markets in January 2013, trailblazing a very different deal. Its €1bn and £400m perpetual non-call 5.25 year bonds, led by global co-ordinators Deutsche Bank and SG, attracted investor interest of around €9bn, illustrating that the hybrid product in the euro and sterling markets was no longer a niche investment. The euro and sterling notes were priced with coupons of 4.5% and 4.875% respectively.

"Veolia coming at such a low coupon, below 5%, shows how interesting these deals can be for borrowers," says Palmieri at SG. "This is a great tool for diversification: diversifying in terms of investors but also in terms of the financing itself. It's another layer of funding that banks have always used but that corporates are new to. It's going to be a major theme in 2013."

But while Veolia's deal may have opened the hybrid market for 2013 with a bang, this was soon drowned out by another French borrower. Electricité de France raised €6.2bn of hybrid bonds, 3-1/2 times bigger than the largest previous corporate transaction. Global co-ordinators HSBC, BNP Paribas and Citi tapped the three largest currency markets, breaking records in each, with the $3bn dollar transaction marking the first time that a European issue had offered dollar hybrid capital to US investors using 144A documentation.

With French borrowers already having chalking up successes in 2013, it is no surprise that many market participants are already predicting more to come this year while rates remain low.

Certainly borrowers can see the appeal of strengthening their balance sheets and defending their ratings. For Veolia, the hybrid transaction came as part of a strategy to build up its capital and cut senior debt through divestment. As long as low rates mean that hybrid capital will pique investors' appetites, the product could become more mainstream, especially for borrowers from the utilities and telecoms sectors.

"It is being considered in a context not just around ratings defence and the strengthening of the balance sheet, but as a core part of funding strategy," says Morgan Stanley's Hiseman. "The product has proved itself to be stable enough that people can think about it as a core part of their balance sheet. French corporates will be front and centre of the next hybrid market development."

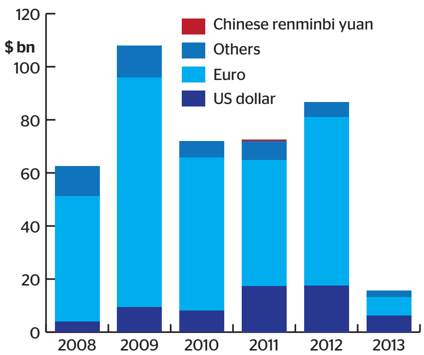
"The hybrid product is now part of borrowers' financing strategy. It is one of the tools in the box and not just a trend that will pass"

David Villedieu, Morgan Stanley

His colleague David Villedieu, head of French corporate fixed income capital markets, agrees: "The hybrid product is now part of borrowers' financing strategy," he says. "It is one of the tools in the box and not just a trend that will pass."

Certainly, the willingness of French borrowers to adopt new financing products, to venture into new funding markets is not something that is likely to ease. Their innovative approach has seen them prosper with new and established investors alike, and they are likely to keep adventuring. After all, it's in their blood. ▲

French corporate IG bond issuance by selected currencies



Source: Dealogic

France SA reveals post-crisis zeal to expand bond funding

France has long been one of the most active hotspots of Europe's corporate bond market, but that trend is accelerating. The jolt of seeing the banking system wobble in 2008 and 2009 was a *mauvais quart d'heure* that French corporate treasurers will not soon forget.

Banks have stuck with their corporate clients, but both sides agree that big companies need to do much of their funding in the capital markets, so that they can continue to call on bank support when they really need it, such as for an acquisition.

In *EuroWeek*'s roundtable, held in Paris in January, four leading corporate borrowers and three debt capital markets specialists discussed how companies can best secure market access and manage bank relationships – and whether the crisis is really over.

Participants in the roundtable were (l to r):

Laurent Attali, head of French corporate debt capital markets, BNP Paribas

Sergio Val, head of corporate finance, treasury and insurance, GDF Suez

Hugues Delafon, head of European corporate origination, Crédit Agricole CIB

Emmanuel Rapin, head of treasury and finance, Lagardère

Yann Passeron, head of debt capital markets, RCI Banque

Jean-François Deiss, head of financing, treasury and insurance, Rexel

Jon Hay, *EuroWeek* (moderator)

Félix Orsini, co-head of global corporate debt capital markets, Société Générale CIB

EUROWEEK: How are French corporate borrowers perceived by international investors?

Hugues Delafon, Crédit Agricole CIB: One of the major themes of the markets in the last few years has been the impact of the sovereign on corporates. There used to be quite a correlation between the spread of corporates and the country where they were located.

Very clearly in 2012 there was a decoupling of corporates from sovereigns. Investors wanted to buy more corporate paper, to some extent regardless of its place of incorporation. Of course in France it's more difficult to see because the sovereign has not been under as much pressure as Italy or Spain.

Félix Orsini, Société Générale CIB: We had one quarter at the end of 2011 when there was pressure on the OAT spread versus Bunds. French banks were under pressure at that time, too. A lot of French issuers came to the market at that time, both to have a cautious approach, saying 'volatility is increasing again, let's secure our financing', but also to send a signal to investors that they still had very good access to the market.

From time to time there has been selling pressure on some French government-linked bonds from hedge funds or other investors, but every time these flows have been absorbed quite quickly and I think one of the strengths of the French market is the strong demand from local investors.

Clearly today it's no longer an issue; French names are trading extremely well, including in other currencies, such as dollars.

French issuers have done a very good job in trying to be prudent and anticipate problems and volatility. For the time being everything is looking very good.

EUROWEEK: Is that sort of volatility now in the past?

Jean-François Deiss, Rexel: No, it's not in the past.

We wanted to increase our investor base by going to the US market after issuing in Europe. Two months ago I went to a US high yield bond conference and the issue for US investors was not with French corporates, or Spanish or Italian, but European corporates and what is going to happen in Europe, with the euro crisis and the economic recovery.

Now things have settled a bit, but in the mind of the US investor at least, being a European corporate is still a drag on credit quality versus somebody from the States or the UK or Asia.

Jean-François Deiss,
REXEL

Things are improving. The Anglo-Saxon world is seeing that there won't be a euro break-up, which was very much a theme at the end of 2011 and the first half of 2012. But it's still on their mind and they are very cautious about investing in Europe, even though they are looking for yields. But economically, France itself was not a major issue.

Laurent Attali, BNP Paribas: Yes, the case of France has always been very different from Italy or Spain. At the time we had some pressure in the last quarter of 2011, there were a lot of headlines saying French corporates would now be impacted.

But, in fact, with high flows of issuance, it was not the case. Even in November and December 2011 we were still issuing large deals. And afterwards, since Mario Draghi's decision at the end of 2011, it has been another picture. The French situation has been quite resilient, from the state point of view and the corporate point of view.

Yann Passeron, RCI Banque: I have a slightly different perception. My view is that the French market has been under pressure because of the banks, because of their exposure to southern Europe, and corporates have suffered directly from this.

As soon as Draghi solved the situation of the banks with the LTRO plus the OMT, then the situation came back to normal.

But corporates had access to the markets all the time; they suffered a little bit during the peak time of the sovereign crisis as we said, with volatility, but we have never seen corporates out of the market as in 2008. That was not the case for financials.

Sergio Val, GDF Suez: We issued a Yankee bond in September, when the euro crisis was still an important theme, and indeed from US investors there were recurring questions about it.

My sense is that today, all those questions are — not completely but substantially — over. Investors are looking back to Europe to pick up good yields.

There was a time when the spread between OATs and Bunds became a bit wider and there was some press about the potential difficulties of European and French corporates accessing the market.

But one of the key competitive advantages of the French market is the pool of investors; they are able to generate demand and make good deals happen.

EUROWEEK: Looking back over the last five years, what do you think corporate borrowers can learn from the crisis?

Rapin, Lagardère: You need to be agile and ready at all times to issue, because if you suddenly realise there is a window opening it could be too late to prepare.

The second thing we learnt, especially for a less frequent and unrated issuer, is you need to build much more confidence with your investor base, which means keeping them updated in a way that goes beyond the non-deal roadshow. We have to give them the information and comfort they need to follow our company and be ready to invest when we are ready to go to the market.

EUROWEEK: They need more than just the ordinary financial statements?

Rapin, Lagardère: Absolutely. If you want to build a true disintermediation, it needs to be built on differentiating your credit. Investors need to know what they are buying for, and that is not only your financial statements — it's a story about what they should expect from you in terms of your growth pattern, your regional themes.

So it's a question of being transparent on your strategy, in a way that is not just readable through numbers and a financial presentation.

EUROWEEK: Does that mean travelling every year to visit every group of investors?

Rapin, Lagardère: It means being selective. You need to tap who could really be interested in your investment sector, in our case the media, and in your profile and size of company. You need to identify maybe 10-15 top investors that you keep informed with what you believe are the reasons that make sense for them to be receptive when you come to the market.

Deiss, Rexel: I totally agree. We have realised through the crisis that banks won't always be there to finance your operations. So you need to broaden your investor base. You need to improve your communication through these kinds of events or non-deal roadshows, participating in conferences, and having one-on-one discussions with bond investors, just like equity investors.

At Rexel we have exactly the same kind of communication for bond investors as for equity investors. And I do feel that investors appreciate the openness of the discussion we have with them, because at least for high yield issuers they are as big a part of the capital structure as equity investors.

Unlike Lagardère, we are rated, but on top of that we really want three or four times a year to participate in global events to make sure that everybody understands the business of Rexel, our strategy, our accounts, and they are able to ask any questions they want.

EUROWEEK: But perhaps we've just got here the companies that are good at communicating, and others are less good. Are French companies generally getting this message?

Félix Orsini,
SOCIETE GENERALE

Orsini, SG: Yes, I think French issuers and investors have both made tremendous progress. Several years ago when we did roadshows in Paris, all the investors wanted to be at the lunch and then there would be no questions afterwards. They didn't like to be in front of an issuer one-on-one, because they couldn't be sure that they were capable of asking the right questions.

EUROWEEK: It was all about whether you gave them good enough food…

Orsini, SG: Well, in France that's always important. But that has completely changed now.

And on the issuer side we have seen the same trend. You have to go back many years to find issuers that didn't understand the importance of communicating with bond investors.

Today they not only all understand it, they all do it, and regular issuers at least once a year. In some instances it's at very high level, with CEOs attending bond investor meetings.

Another lesson French companies have learnt from the financial crisis is that they shouldn't rely only on the domestic market, no matter how solid domestic demand is.

They saw that the euro market stopped in 2008 for several months, and in the following years it stopped for shorter periods. Now there's a growing trend for issuers to establish their names in various markets.

The dollar market is an important target because it almost never closes, it's very deep, it offers long maturities, so many issuers have come to that market for the first time in the last few years. RCI Banque did it a couple of years ago, GDF Suez last year.

Among the inaugural transactions in dollars last year from European issuers, most of them were French: LVMH, Schneider, Danone. So, yes, the importance of communication is well understood and it's not only done on a domestic basis; now it's becoming global.

EUROWEEK: Of course, communication with investors is carefully regulated now, and one aspect is that it's much more difficult to take soundings with investors before a deal. This presumably means the signals you get about market appetite from the secondary market are much more important. Yet investors complain that liquidity is terrible now. Is this something issuers should worry about?

Passeron, RCI Banque: Yes, because when we want to price a new issue we discuss the new issue premium with the banks, but then we have to agree on the secondary curve and then we've got big differences between the banks. So for us it is a problem that we don't have a unique price on our secondary curve.

EUROWEEK: And you've noticed those prices becoming less precise over the last few years?

Passeron, RCI Banque: Yes, because when you have a syndicate of three banks, for instance, you get three different prices. If you have three different prices, there is no market. Perhaps it's a kind of market, you've got three traders who have a view on the bond, but they don't really trade it, so that's a problem, yes.

EUROWEEK: Do you think there's a need for some effort to improve liquidity?

Val, GDF Suez: There have been efforts already. As for equity, in France we can now put in place a liquidity contract on our bonds, with a bank or a few banks. It has been allowed by the AMF last year. So that is a step in the right direction.

On the other hand, Basel III obliges banks to put less liquidity in the market. So there are contradictory forces.

Attali, BNP Paribas: Before the crisis the trading efficiency in credit markets was quite different. Things have changed. I wouldn't say they have worsened recently — I think it has been quite stable, though not completely satisfactory.

There are some initiatives like the Euronext trading platform on which the banks have worked a lot. It's not perfect yet, obviously it is complicated to construct something to accommodate the different kind of players that can want to trade — banks, brokers, corporates themselves and investors, which includes large and small investors, whose behaviour vis-à-vis such a platform is not the same.

But I believe something will develop which may not work for every corporate, but more for the regular, large and liquid issuers.

EUROWEEK: We talked about the crisis, which hopefully is abating now. Are you able to say to investors that French corporate balance sheets are strong now, that they have been delevered and refreshed?

Delafon, CA CIB: I don't think there have been any major changes to the French corporate 'offering' to fixed income investors in the last few years.

The corporate structure in France is skewed to very large multinationals which are active all over the world,

Hugues Delafon,
CREDIT AGRICOLE

like the groups represented at this table.

In terms of addressing the balance sheet, French corporates like most in Europe were very quick to go to the market in early 2009 and put as much cash on the balance sheet as needed. That was done a long time ago.

That costs these companies a lot of money, but they continue to do it, so it's a very safe posture.

Then you've got a second layer of mid-cap companies. Some of them are world leaders too, some are more domestic, and in the past didn't have access to capital markets.

They've been pushed into the market recently, through the crisis, and seem to be doing pretty well accessing the private placement markets in the US, Japan and now Europe as well.

EUROWEEK: Is that sort of very safe position with high cash now going to be permanent?

Passeron, RCI Banque: We've changed our funding policies and activities. We have tried to get longer cash than before, we are funded longer than before.

Before 2008 we relied on banks, securitisation and capital markets, mainly in Europe. Since the crisis, we have diversified our currencies — dollars, Swiss francs and others. As we have banking status, we also started to collect deposits directly from French citizens.

This doesn't mean that if the market collapses we won't have any problems, but we have a stronger and healthier position than before 2008.

We are sticking with this strategy. We applied it in 2009 and every year we try to make a further step. This year we will begin collecting deposits in Germany.

Deiss, Rexel: For us, a more conservative posture means diversifying into bond funding.

Before 2009 we relied only on bank funding and securitisation. Then we decided at the end of 2009 to move away from bank towards bond funding and we are going to continue with this strategy in the next couple of years.

We still need the banks to help us develop, to accompany us in our acquisition strategy, but it's only liquidity lines. The core, basic funding is through capital markets, be it securitisation of trade receivables, high yield bonds or possibly at some stage investment grade bonds.

We do not want to rely on bank funding because we do not see any increase in it in the coming years, and also the spread between bond and bank lending rates is narrowing.

Loans are still cheaper, but now the gap is much more manageable. You can explain much more easily to your top management why you want to go to the bond market when you see falling yields in the bond market and still-increasing yields on bank funding.

And you really have stable funding with bonds, because the banks can always step out, can always find ways not to give you funds when you need them. Once you get the money from a bond issue in your bank accounts, you have it and you can operate.

Rapin, Lagardère: Companies are at different stages of this transformation. Disintermediation is certainly a focus, but for companies that are already in the safe haven of disintermediation, there are two areas to work on.

The first is trying to minimise the cost of this disintermediation, which is intended as insurance of your longevity.

So you have to either diversify your funding sources, or find windows where suddenly there is a small blip in the market that enables you to tap funding for the right cost.

The second is, how do you reduce the significant cost of carrying a lot of cash? Gradually, you have to make a trade-off and either limit the volume of cash or find clever ways of making returns on it.

An obvious one is that maybe corporate bonds are going to be bought not only by investors but also by corporates themselves.

EUROWEEK: Sergio, do you put any of your cash in corporate bonds?

Val, GDF Suez No. We have less cash now, as we are working on optimising our cost of carry. But we have quite a conservative policy in managing cash. We only allow a marginal part to be invested in corporate debt, meaning commercial paper of very highly rated companies. We try to diversify, but not buying corporate debt, as you can have mark-to-market risks and unfortunately it can't be treated as cash for accounting purposes.

Orsini, SG: We see it in Germany, with a lot of corporates investing in the corporate bond market, and a bit in France, but it's true that it's quite marginal.

EUROWEEK: Now that companies have been, for a few years, running with a lot of cash, do you think shareholders have got used to it and still want companies to reassure them at the AGM that they are prefunded for the next year ahead?

Orsini, SG: Nothing is permanent, but this conservatism is going to stay for a very long time, for two reasons. First of all, the structural trend is there — Europe is getting in line with the US in terms of using the capital markets.

The second reason is the human memory. In September 2008, when the market collapsed, two issuers came back to the market quite quickly — GDF Suez and France Télécom.

It was a very brave decision because the cost of funding was much higher than several months earlier and a lot of issuers were asking, what are they doing, coming to the market when it's so expensive? In the US it was seen as completely natural to adapt to the cost of funding, but in Europe it was quite innovative.

I asked the treasurers of France Télécom and GDF Suez at the time, what made you do this? The common answer was, we've been through tough times — they had experienced difficult funding conditions earlier in their careers.

In treasury departments people are often very long-serving, so they gain a lot of power internally, and even more since the financial crisis. They remember what volatility is like, and when they see risk, they take strong decisions very quickly.

That's one way that I think French issuers differentiate themselves from others. They're very cautious in their approach, very prudent. They have very often re-opened the market after difficult times. They've been the first ones to use tools like liability management, which is another way to get some insurance on your future cost of funding. They are now the leaders in developing hybrid capital.

I think it has a lot to do with their personal histories and the histories of the companies. They don't take risks with the markets.

Deiss, Rexel: Yes, as corporate treasurers we always want to optimise our financial cost, but at some stage since 2008 both we and the top management have realised that ultimately, liquidity is priceless.

You need liquidity to be able to operate. When you've got a crisis you need to give your management peace of mind, so that they can concentrate on the operation and not on the financing. So at some stage you pay the price you have to.

There is always a balance, but right now it is more on the side of maintaining liquidity, even though it costs a lot of money.

Passeron, RCI Banque: Yes, it's difficult to say that the crisis is over because in Europe it's still very shaky. You could have a problem one day or another. So being on the safe side is better than leaving things till the last moment.

Delafon, CA CIB: The rating agencies have raised their expectations on liquidity, so higher rated companies need to maintain a very conservative level of liquidity. And then it's a question of comparing costs.

Nobody knows exactly how Basel III is going to impact the banks in providing undrawn facilities, but there will be an adaptation in cost. So companies will have to decide whether it's going to be cheaper to rely on good banks to provide undrawn lines or just to do their own cash management.

Val, GDF Suez: Nevertheless, we make a strong difference between cash and liquidity. Cash and therefore the cost of carry is quite important. Liquidity lines from a pool of good banks, as in our case, provides liquidity at a much more reasonable price. It's the balance between the two which we, and I guess other companies, focus on.

Deiss, Rexel: You have to make sure you manage your bank pool well to make sure that the banks are always going to be with you in case of bad times, because otherwise there is no alternative to cash on balance sheet.

So the relationship with our core banks is key for Rexel. We prefer to rely on a smaller group of banks which we know really trust our credit than to fight for the best pricing on a liquidity line or open our credit facility to 20 or 30 banks to get 25bp less on the pricing.

EUROWEEK: Isn't there a paradox, though, because everyone is saying 'we want to be safe, so we're going to have more of our funding in bonds, because one day the banks may not be there'. But actually, in the last few years, the bond market sometimes closed, but there was never a time when the banks weren't there. Corporate treasurers always say, 'the banks have always supported us; we've had a good relationship'. So aren't you starting to trust the market that is in fact less trustworthy?

Deiss, Rexel: But with the bond market, once you've got the cash, you've got it. The bank market can evolve.

EUROWEEK: If you borrow the money from a bank you also have the cash.

Deiss, Rexel: But you never know if you can borrow the money because it's a revolving facility.

Attali, BNP Paribas: The difference is between cash and liquidity. The relationship with banks is maintaining undrawn revolving credit facilities, whereas drawn loans will be tapped less and less often, or refinanced quickly in the bond market. Bigger needs such as acquisition finance are being met with bridge loans to bonds, or equity, or a disposal.

Val, GDF Suez: There is also the maturity of debt. Before the Lehman crisis, like all corporates, we used to have quite short dated debt. In our case it was around five years; today our average is nearly 10 years.

And if you want to increase the maturity of your debt, you have to go to the bond markets. We issued even a 100 year bond.

At the same time, if the bond market dislocates, you can rely on your bank credit lines.

Deiss, Rexel: It really depends on your bank pool. Your core banks will always be there. But if you have a very wide group of banks from 2006 and 2007, and a lot of them were just asset-takers, then when you renew your credit facility, a whole bunch of them will have disappeared.

So you really have to make sure that for your stable funding you go to the bond market, to get longer terms of five to 10 years. And for liquidity you have your core banks.

Rapin, Lagardère: Yes, during the crisis some banks had difficult discussions with us, saying, we would like to be part of your syndicated line but we are in deep trouble and our credit committee declines the idea, even though we are supposed to be long term partners. When you have this kind of thing happen, it reminds you that you need to have a second, safe side for your funding.

EUROWEEK: And that's when you have to go to the friendly banks and say, can we have a bit more than we asked for before?

Rapin, Lagardère: There is no free lunch, so if we want to overweight some relationship, we know we will have to pay for it in one form or another.

A bank relationship has many angles. It can play out through a discussion, through corporate activity, M&A, flows of side business. You will always have this relationship and negotiations with your banks, but it cannot be all. At least the bond market is another animal — when it's there it gives you the money.

Emmanuel Rapin,
LAGARDERE

EUROWEEK: This is a very important issue, because most treasurers are shifting more of their drawn debt into the bond market. But what is the right balance to aim for? Is 90% too far — that can mean a big issuer easily having to refinance several billions a year in the bond market?

Deiss, Rexel: For us, stable funding should be through the bond market. We went from 100% bank debt to 90% capital market. Then you've got your liquidity lines to manage ample liquidity. There is a price to pay for it, but that's our insurance policy — as long as the insurance is working.

Then we need to manage the price of this policy through diversification — going to the bond market, securitisation, commercial paper. Comparing 2009 when we were only bank-funded with 2012 when we are only in the capital markets, we are paying the same spread, with a more stable and longer term maturity.

Orsini, SG: You asked earlier, shouldn't issuers focus on banks, because in the case of a crisis, bank support is going to be critical, and I totally agree with that.

But it's important to underline that the more you issue bonds, the easier you will get access to bank support. If most of your permanent funding is done in the bond market, the banks have more capacity when you need them to step in, because they only have undrawn lines.

It works both ways, too. An issuer needs strong liquidity support from its bank to go to the bond market. Bond investors want to know that in case of crisis, you have strong relationships, and they ask a lot of questions on roadshows about this.

So in theory, you should have all your drawn funding in the bond market, which is what more and more issuers are doing.

Attali, BNP Paribas: And this has clearly been understood by the rating agencies. There are several examples of issuers feeling pressure in discussion with the rating agencies about the weakness of having too much bank funding. And when an issuer does a major bond issue, it's celebrated by the rating agencies, and the market, as very good news.

EUROWEEK: How do you think French corporates are in relation to this issue, compared with those elsewhere in Europe?

Delafon, CA CIB: Across Europe it's been extremely similar. The crisis of the winter of 2008-09 has proved definitely that the insurance policy is the banks, reinsured by the central banks.

This has worked to a certain extent, but the capital markets have been much quicker to support corporates, so that has only pushed us further to the current way of structuring a resilient way of funding, with a big part in bonds.

Earlier you said that the bank market never closed. But the bank market, to my knowledge, was closed.

Rapin, Lagardère: Yes, it was closed.

Delafon, CA CIB: And Félix talked about the elephant-style memory of treasurers... well this was a shock, and they remember it. The bank market had never closed. It did close.

The bond market did close, too, for a few months, but everybody knows it closes from time to time and we get used to it, so you do five, 10, 30, 100 year bonds to mitigate your refinancing risk.

Deiss, Rexel: And in the US the bond market is never closed. We have to pay a price for it, but you will get some investors, even if the market is very difficult. When the bank market is closed, nobody does anything.

EUROWEEK: Another thing I hear from banks a lot is, we want to make corporate relationships work better for us, we've thinned out our book of corporate clients, we've said goodbye to the ones that weren't making us any money, and we want to do more with the ones we have kept. What has that felt like for issuers? Are the banks really demanding different things of you now?

Deiss, Rexel: They are always complaining that they are not doing enough business, but it's the name of the game.

We do recognise that they need to have a return on the money that they want to allocate to Rexel. So we make sure that all the banks in our pool get enough operations to make quite a similar return on their commitments. That's why we have a very limited pool of banks — if we had 20 or 30 we wouldn't be able to do this.

Passeron, RCI Banque: The dialogue with banks has not changed for us recently — it's a long process. Ten or 15 years ago banks could lend to a corporate and make sufficient margin just from lending.

Then the spreads of corporates went down. The spreads of banks were volatile as well so they were looking for cross-selling. And with regulations like Basel II, Basel III, the banks wanted more and more cross-selling as they analysed the profitability of their lending relationships more carefully.

Over the years the relationship between banks and corporates has changed, and now we give side business only to banks which have a lending relationship with us.

All the banks now have senior bankers overseeing their relationships, which was not obviously the case 10 or 15 years ago.

Yann Passeron,
RCI BANQUE

Orsini, SG: Banks should be cautious about this approach which, pushing it to the extreme, means looking every year at what each issuer has generated in fees, at how much of the balance sheet it is taking, and saying OK, it's under the average so we cut the relationship and allocate the capital to another issuer.

That's extremely dangerous and destructive to the relationship. Some banks have been doing it to some extent and I think treasurers remember those banks extremely well.

From our point of view, some issuers don't seem to generate a lot of side business but may do so one or two years later, perhaps because they have been making acquisitions.

The added value we try to develop is building a relationship through the long term. You have to be patient. You have to be there in difficult times.

What we expect from corporates is also not just a return, it's an attitude. When they have the opportunity to play ball with us, they do it. They will be transparent on their plans and have a decision process we can anticipate, so that people at the bank who are fighting to get the credit through are not taken by surprise. Banking is credit — it's about trust on both sides.

Deiss, Rexel: We look at numbers in our dialogue with our relationship banks, but on a cycle. It's not about a return on a yearly basis; it's through the life of a three to five year commitment.

It's become easier and easier to have an open dialogue about profitability, because both sides understand that there needs to be some profitability on both sides — even though it's still a bit of a black box.

Rapin, Lagardère: We are also a little bit cautious because through this crisis some of our banking partners have sold some of their divisions.

They sold us their franchise, saying, please come with us because we can help you with so and so, and suddenly that capability has disappeared.

EUROWEEK: Sergio, have you noticed some of your bank group behaving differently towards you from others?

Val, GDF Suez: No. In recent quarters, no, I wouldn't say we have seen the reshaping or refocusing that you were mentioning at all.

EUROWEEK: And given some of the constraints on banks' capital for different things, liquidity facilities, credit facilities and derivatives, are you changing the way you use your relationships and the capital available?

Val, GDF Suez: No. In a banking relationship the key point for us is to make sure we have one of the strongest pools in the market, in terms of the robustness of the banks. So today, more than 50% of our undrawn credit lines are with non-eurozone banks.

That is also related to our strategy — we are becoming more and more international. We are refocusing and growing, so we are adapting our banking to the business reality.

EUROWEEK: The question of the capital cost of derivatives is important to many treasurers, though. Is it clear yet what effect Basel III will have?

Delafon, CA CIB: No, I don't think we know. It's still ongoing. There's a major debate in the French association of corporate treasurers and intense lobbying going on. There are very different views on how it's going to affect companies.

But the basic truth is that counterparty risk has become a major feature and, as much as they can, corporates try to avoid swaps. Banks have equipped themselves to be able to value this counterparty risk and are charging their clients, so it does create some extra pricing. As they try to diversify their funding into new currencies, corporates are therefore trying to actually source the currencies they need for their operations.

Passeron, RCI Banque: I don't know if currency swaps are becoming more expensive, but they may change our liquidity management when EMIR [the European Market Infrastructure Regulation] comes into force.

We issue bonds in currencies we don't have a natural fit with, so we swap them back to euros. When the new regulation is in place, we will have to sign collateral agreements with our counterparties, and as a consequence may face margin calls. Therefore, we will need to put aside part of the proceeds of the bonds in order to face these potential margin calls.

This could be a brake to currency diversification, particularly where you don't have a natural fit with the currency.

We have to price this. It's not going to stop funding diversification, because otherwise you would get back to square one, facing the risk of a market disruption. But you have to know what the cost is and what the risks are.

EUROWEEK: What is the best way to approach the market in terms of using large benchmarks — Sergio, you did one of the biggest deals in euros last year — versus the more opportunistic €200m-€300m trades that are perhaps underwritten at tight levels?

Val, GDF Suez: Our approach is to have a full toolkit, with many different currencies and products. The toolkit has become extremely large for corporate treasurers, with plain vanilla products, and more

Sergio Val,
GDF SUEZ

structured and focused ones. We try to be opportunistic every time and optimise cost of funding and size. That drives the different kinds of issues we have performed. But I wouldn't say there's a formal policy. We adapt every time according to pricing, liquidity and what the market requires.

EUROWEEK: One way to be opportunistic is through the MTN market, but apart from a very few top names, corporates are still not a very strong segment of issuers. Is that changing?

Delafon, CA CIB: Yes and no. What we usually call the MTN market is by definition opportunistic, with deals driven by reverse enquiry and investor interest. This is generally a position on interest rates or the credit curve or inflation, leading to a structured investment. Investors don't necessarily want to add credit risk on top of that.

So MTNs obviously appeal to some of the stronger corporate issuers, but not to everybody.

At the same time, now that the credit market has become more diverse, some investors are ready to compromise on liquidity. So there is a developing private market of purely credit investment. An investor may say, I want to buy this credit because I think it's going to improve and I'm happy to buy a €100m clip rather than go into the secondary market and buy a liquid bond.

And most corporates have MTN programmes, so there is a wider private MTN market developing. But it's marginal in terms of the funding programme of larger issuers.

Passeron, RCI Banque: Another problem is the new directive released last year on EuroMTN programmes. Now if you want to do structured EMTNs, you have to have all the structures you want to issue explained in your programme documentation beforehand. That's a big hurdle for structured private placements now.

Orsini, SG: Defined on the basis of deals led by one bank, MTN volume has grown. It's still marginal, but there was a shift in 2012. Some of the most established issuers have become more active, like Saint-Gobain, Vallourec, ASF Vinci.

It comes back to the diversification and opportunism which are leading corporate funding. Issuers want to target different pockets of investors. They don't have large needs, so doing small things fits them well, and they are opportunistic so they like to answer reverse enquiry a bit more.

Val, GDF Suez We only do this quite marginally. The size is quite limited.

Attali, BNP Paribas: Other products are developing, too, for a range of French issuers, from large ones to mid-caps.

The Schuldschein, for example, is growing in French capital markets, and not only with German investors but more widely. There are US private placements and now euro private placements, which are opening the way to mid-caps, which have no EMTN programme or are debut issuers.

The issuers that appeal to investors in these different formats are often fresh names, which bring diversity to their portfolios, rather than frequent issuers like GDF Suez, which supply a lot of public bonds. Investors are interested in these products for getting more yield, which a top quality issuer does not provide, especially in the low rate environment.

Orsini, SG: Just to support what Laurent is saying, I have the figures. Euro PPs in the broad sense, including a lot of EMTNs, were €9bn in 2010, and €17bn in 2012 — for corporates in euros.

Schuldscheine were €5bn in 2010. We are now at €13bn in 2012, with many French issuers going in that market. And USPPs were $42bn in 2010, $52bn in 2012, with European issuers' share increasing from less than 35% to over 40%. The dim sum market has also been tapped by a number of issuers.

Deiss, Rexel We have thought about Schuldscheine but we would need to improve our rating to get a good base of investors. It's a good market, but deals are still small. We still want to establish our signature with benchmark issues. Even though the documentation for Schuldscheine is a bit lighter than a normal bond issue, with the size and the rating of Rexel, we would not consider it right now.

Passeron, RCI Banque We used to be rather active in the Schuldschein market, but then when the German banks had their difficulties the market didn't close but reduced. We did some Schuldscheine last year, but on a very small basis. I imagine the investors in RCI's Schuldscheine invest in our bonds as well. They don't see the interest to invest in Schuldscheine today.

Delafon, CA CIB: I'm sceptical about the Schuldschein market for French corporates. By definition it's a bank market, so at some stage it will also be impacted by Basel III. It's interesting for corporates who want to tap this specific investor base.

Schuldscheine have been a very good tool for institutional investors because there was an offer of corporate paper there.

But now we've got all the instruments to be able to serve those investors in other formats which are much more international, so I don't see the Schuldschein as a meaningful funding tool for corporates.

Passeron, RCI Banque: My perception is that today it's more newcomers to the capital markets that are coming to the Schuldschein market as a first step, rather than regular issuers.

Delafon, CA CIB: That's because to some extent it is a bank market. You can go in on a private basis, you don't need to list.

Orsini, SG: It's mainly non-rated and smaller issuers that have come to this market — Orpéa, Sonepar, Plastic Omnium, Neopost.

EUROWEEK: The euro PP market grew tremendously in 2012, and in many ways it's a very French market at the moment. Is it going to develop into something more international, with a continent-wide base of investors and issuers?

Orsini, SG: Yes, but there are reasons why it developed specifically in France. First, we have a very strong investor base, and we didn't have a tool for investors and issuers to meet, like the Schuldschein in Germany.

We also don't have in France direct access for corporates to retail investors, which is often used by Belgian and Italian companies. So there was a special need to be filled.

But the investors coming into the euro PP market are very large funds. They may be French, but most of them have operations internationally. And German insurers are also very interested.

So I'm thinking along the same lines as Hugues. There was the Schuldschein format. Now there's a simpler format, a bond format — although some issuers can also use loan format PPs — that is being developed.

Once this format is there, people will take the format they think is most efficient and probably the PP format may be easier to internationalise than the Schuldschein, but we'll see with time.

Laurent Attali,
BNP PARIBAS

Attali, BNP Paribas: I think it will, and sooner than we think. Some other countries will provide good issuers in terms of credit profile, and yield as well.

EUROWEEK: Is there any challenge for corporate finance in France that you really hope will be addressed in the next couple of years?

Deiss, Rexel: I'm puzzled by the bubble that is starting in the bond market. It's the kind of thing we saw in the loan market in 2005 to 2007. When I see coupons for high yield bonds below 3%, like Fresenius, I start to get nervous.

Of course, we can benefit from it right now. The all-in cost we're paying, even as a high yield company, is what the French state was paying six or seven years ago.

My issue is that more and more issuers are going to the European bond market, but if there is some hiccup it will be the first market to close, and for quite some time. I'm not sure the bank market is still as wide open as it used to be.

So, for corporate treasurers, relying on the bond market is better than relying only on the bank market, but it's not wise to depend only on Europe. Companies should diversify as much as they can in the US and Asia, because the European bond market, at least for high yield, is still at an early stage. If we see some nervousness, it can shut quite quickly.

Orsini, SG: It's a bit like the housing bubble in France that people keep talking about. But what does a bubble mean? If it means speculative demand, which shouldn't be there, then there's no bubble in French housing and I'm not sure there's a bubble in corporate bonds either.

Today if an investor wants a safe haven, there's nothing that can match what corporates can offer, as long as the sovereign crisis is there. Hopefully one day things will go back into order and sovereigns will become the best credits and then banks and then corporates, but that's probably not going to happen in the near future.

And until it does, liquidity has to go to safe and strong balance sheets. So I think the demand is genuine.

Deiss, Rexel: Demand is genuine, but it's volatile as well. The market can shut down.

Orsini, SG: It's fuelled by very strong liquidity. Quantitative easing has meant that there's huge liquidity. As long as this liquidity is there I think a very important portion will stay and will remain focused on the corporate market.

Passeron, RCI Banque: Well, markets have stabilised today, but we are still in the European crisis. We don't know if markets will be stable at the end of the year or next year.

Unless and until we have more federalism in Europe, we may face another crisis. That's the big challenge we have to be ready for.

EUROWEEK: And you're looking for Europe to take a more federal path, more fully integrated?

Passeron, RCI Banque: We have one single currency, so I imagine some time or other, people expect more federalism.

Delafon, CA CIB: We need European capital markets to be a good citizen again. Since the euro was introduced the development of the European capital market has been fantastic, but I'm ambivalent about some of the successes we've seen recently, because most of them are actually retrenchments into domestic capital markets.

We've talked about the French private placement market, which is great, but it is a retrenchment. And we've talked about the support French investors are giving to corporates and the French banks to the corporates.

These are good news, but we need them on a European basis. ▲

Confidence key for corporate capital-raising

2012 wasn't a vintage year for French ECM but with global macroeconomic concerns waning and the country's multinationals in good shape, there could be more to celebrate in 2013, writes **Nick Jacob**.

FRANCE WAS put under the economic spotlight in 2012, spending much of the year facing down critics that claimed it would be the eurozone's next flashpoint. Its blue-chip corporates hunkered down — and without investment or M&A, ECM activity withered. But bankers unanimously reject any suggestion that France is, or will be, the sick man of Europe — and have the figures to prove it.

They point to the low yields of the sovereign's bonds and the tight spreads on corporate debt. Closer to home for the ECM world, the performance of the CAC 40 (a total return of 23% in 2012) is encouraging: it by and large underperformed the DAX (with a total return of 32%) by a small-ish margin and what gap there was is seen as more of a positive for future performance than a reflection on fundamental weakness.

Investment figures bear out the claim that France has been and will continue to be seen on the right side of the core/periphery dividing line.

"Overseas holdings of French stocks are a good barometer — and although in 2008 there was dip consistent with what was happening in other European countries, since 2008 they have been relatively stable," explains Luis Vaz Pinto, global head of ECM at Société Générale in Paris. "It shows that the crisis in Europe hasn't led to overseas investors not wanting to hold French equities."

Now, the hope is that as US funds rediscover European equities and correct a long-term underweight, the CAC along with other European indices will be lifted on the rising tide.

Alain Dib, head of EMEA equity capital markets at BNP Paribas says that deals from French issuers in the last year or so have been unaffected by the perceived split across Europe, though Germany has benefited from a positive tag, and Iberia and Italy negative. Like many French bankers, he was non-plussed by the splashy cover story of *The Economist* in November that singled out the country as a ticking bomb at the heart of Europe.

"There are a lot more reasons to be optimistic for 2013 and I think some companies will really go for it"

Alain Dib,
BNP Paribas

"There were a lot of concerns surrounding France last year but from a market standpoint — whether our equity investors or the fixed income investors — there was not the same concern," says Dib. "You can see that in the fact that French interest rates have never been so low for corporates or the sovereign."

France though still has a lot to prove, as the nine-month old government of Francois Hollande gets to grips with the economy and introduces supply-side reforms and more austerity. But even though that could have a big impact on the domestic business environment, the effect on France's corporate sector will be limited, says Xavier Larnaudie, head of equity syndicate at Crédit Agricole CIB in Paris.

"Most large corporates in the CAC 40 have become truly international and have significant proportions of revenues from outside France so even if the domestic economy suffers a slowdown, they are to a large extent protected from adverse conditions," he explains. "There's a push from French companies to focus more and more on activity outside of France and outside of Europe — it's clear from their investments that they are focusing on growth abroad.

"In terms of macro reforms, investors still have a wait-and-see attitude — they hope that government will move in the right direction. Investors are pragmatic and want to see a move towards a more business-friendly climate. One key test will be the labour market reform and its implementation by parliament."

Waiting for clarity

Sentiment then is reasonable, even strong, but French companies haven't regularly featured in the European ECM market. While the country was ranked fourth in EMEA by volume in 2012, according to Dealogic, better than its seventh position in 2011, there is clearly plenty of room for growth. Volume was only 40% of that from German issuers last year, while over the last three years it has been running at between one-third and one-half of pre-crisis levels.

Secondary sales through accelerated bookbuilds are opportunistic — and there has been decent supply, such as with a block of Eutelsat in January 2012 and Pernod and Arkema in February — but the other drivers of ECM activity should respond more to macro market conditions.

So, when will listed French firms start raising fresh equity, what can we expect from the IPO pipeline, and will the equity-linked market return to lead Europe again?

The restrained ECM showing can be partly attributed to a year of uncertainty, in eurozone economics and domestic politics. *The Economist* cover story, while seen as an exaggeration, clearly touched a nerve — perhaps because the French multinationals simply have not been showing the élan they once had for international expansion, while domestic industries have been operating amid a stagnating retail market.

"There was certainly a bit of soulsearching by French companies — indecisiveness stemming from uncertainty about the elections and the new government and about the whole eurozone situation," says Dib. "For French CEOs and CFOs it was not an easy time to make big decisions."

Most of the ECM moves that were seen could be called defensive, such as the €1bn Peugeot rights issue that brought in General Motors as a strategic partner and investor and bolstered the struggling firm's balance sheet.

"We saw a lot of defensive moves in 2012, and activity was limited and muted as a result," says Dib. He points to the €414m rights issue in October and €360m convertible bond in November from CGG-Veritas, a geophysics firm that was buying a competitor, as the exception that proved the rule. "There was fantastic execution as it was a constructive issue, building and expanding a business. But rebuilding a balance sheet doesn't make anybody dream. My view is that because a lot of companies waited for clarity last year, there are a lot more reasons to be optimistic about 2013 and I think some companies will really go for it."

Emmanuel Gueroult, co-head of EMEA equity capital markets at Morgan Stanley in London, agrees and points to the price that boards and executives pay if deals don't work as planned.

"One of the reasons why there has been so little M&A in Europe is because boards are afraid of the execution risk," he says. "There is a lot of timidity despite the fact that financing terms have never been so good. One or two large deals could change that."

The view at Société Générale is similar and bankers there, as with others around La Défense, say that the CAC 40 is ready to look for growth again — and will look far afield.

"M&A moves from large corporates could drive ECM volumes higher," says Michael Maringe, head of ECM for France at SG in Paris. "Most of the CAC 40 is well-financed and highly rated and they are redeploying assets and activities globally to capture emerging markets growth. Given lower volatility, higher valuations and solid balance sheets, they could look to M&A to compensate for the low

"There is a lot of timidity despite the fact that financing terms have never been so good. One or two large deals could change that"

Emmanuel Gueroult, Morgan Stanley

growth that is expected in the eurozone for some time to come."

Vaz Pinto puts it succinctly: "French companies are going to be able to move aggressively in the coming years — and to do so from a position of strength."

Accelerating dealflow

But when French companies want to access the ECM market they might not do so in the same ways that they have in the past, say bankers.

Right across Europe there has been a shift over the last year towards accelerated transactions that are in and out of the market in less than a day, and away from fully-marketed offerings that take weeks. In 2012, over 60% of EMEA equity capital markets volume was accelerated in some form or another, whether blocks, cash placings or equity-linked. But France has had little experience of the accelerated placement of primary equity, particularly at the CAC 40 end of the market.

The cultural norm has been for boards to opt for rights issues despite companies having the flexibility to go for the same accelerated option as other European firms by getting shareholder authorisation to issue relatively small capital increases.

That, though, has been changing and late 2012 saw the first accelerated bookbuild of new shares for a CAC 40 company since 2006, a €350m deal in October that engineering firm Alstom used to strengthen its balance sheet with the sale of shares representing 4.3% of its share capital. Crédit Agricole, BNP Paribas, Natixis and Société Générale were joint bookrunners.

"After four years in a tough environment there is a clear view among CFOs and CEOs that when the market is there you should raise the money," says Maringe. "French issuers are becoming more opportunistic in the way that they access the capital markets and it is leading to a different mix of quick-to-market deals versus rights issues such as last year [with Alstom]."

"The feedback from other issuers shows us that others see this now as part of the toolbox and using this type of technique to access the market."

The deal caused some angst on launch — the share price fell below the issue price as several brokers immediately responded with notes questioning the rationale for a capital increase that came without a strong use of funds rationale. However, the shares soon recovered — and investors in the next company to take the accelerated route won't be so surprised.

"It was very much an innovation — the first time it's been done without retail and without a prospectus," says Vaz Pinto. "There was some domestic surprise and questions about the innovation but looking back, I think everyone would agree that it was the right thing to do."

Larnaudie at Crédit Agricole also thinks that it could entice others.

"The Alstom accelerated bookbuilt capital increase could pave the way to other similar transactions: it's an ideal way to raise capital by taking advantage of a positive market momentum while limiting shareholder dilution and without going through a cumbersome process."

Mainstream mandatories

It's not just in straight equity that accelerated execution may become more prevalent in France. Mandatory convertible bonds are also tipped to make a comeback in the country as they are across Europe.

The product, which lapsed into obscurity as the post-Lehman financial crisis removed the mainstay of demand — hedge funds using lots of leverage — has found a new lease of life. First with Volkswagen in November 2012, and then with almost-French though Luxembourg-headquartered, ArcelorMittal, in January 2013, mandatory convertibles are back on the agenda as a funding option.

Tight pricing — driven by dedicated US funds — is drawing the attention of corporates to a product that provides 100% equity credit from the rating agencies and is seen by accountants as 80% debt, making it increasingly attractive relative to hybrid bonds and straight equity.

For large companies, which can offer a €500m-€1bn minimum-sized deal, it can make the execution of a capital raise in accelerated form — perhaps in conjunction with a primary ABB — much more palatable.

In essence, ECM bankers are now saying that dilutive rights issues are no longer necessary for any company that wants to raise even as much as 20% or more of its market capitalisation.

"The Volkswagen and ArcelorMittal mandatories have increased the spectrum of possibilities for companies to tap the market in an accelerated fashion and that is tempting for French companies," says Bruno Magnouat, head of equity-linked at Société Générale. "Whether or not we see a wave of mandatories across Europe is an open question but there's a lot of excitement and we are certainly having discussions with issuers on the topic."

Pierre-Alexis Renaudin, head of equity-linked at Morgan Stanley, says that mandatories might become more common for large companies. "It is a chicken-and-egg story," he says. "Long-only investors will buy it if they see liquidity for the product and the product will get more liquid and more efficient if they buy it. It is not as reliant, as in the past, on hedged investors and leverage."

Chateau Equity-Linked

Standard fare in the equity-linked market, convertible bonds, should also enjoy a better year than 2012. In the latter part of last year, and the early part of this, there has been a big revival in issuance across EMEA amid big inflows to outrights funds.

In a reflation scenario, investors like the combination of the equity-like potential for upside and tightening credit spreads but with a bond floor in case of renewed macro worries.

"There is an incredible window in equity-linked with investors having a lot of money to put to work and French and other European companies need to be sensitive to that," says Magnouat. "There have been so many successful deals that we have great confidence that French companies will also benefit."

And although French issuers didn't have a prominent 2012 in league table terms — volume was flat to 2011 at $2.6bn — in a year dominated by German issuers (with $9.7bn), the country has long been seen as the home of European equity-linked. Indeed, it's almost a national industry in its own right: many of the big investors are based in Paris, its corporate executives are well-versed in the product, and French nationals make up a high proportion of investment bank origination and trading teams.

"French companies haven't fallen out of love with equity-linked and there should be some catch-up," says Dib, with high hopes for 2013.

"French companies are going to be able to move aggressively and to do so from a position of strength"

Luis Vaz Pinto,
Société Générale

Privatisation: never say never

ANOTHER player also has debt problems to cure: interest rates on OATs might be at record lows, but the government still has a record amount of debt to finance. It also owns stakes in some of Europe's biggest and most valuable companies. But the obvious answer — privatisations, including block sales of some parts of those stakes — isn't yet on the public agenda.

While some bankers look back with fondness at the Mitterand era of the early and mid-1980s — selling off the assets that had been nationalised only a couple of years earlier — or even at the privatising record of the more recent socialist government of Lionel Jospin in the 1990s, they don't yet see the François Hollande government becoming much of a seller. Partly that is political, and partly it recognises that set against a national debt of €1.8tr, a few multi-billion euro blocks are inconsequential.

Michael Maringe, head of ECM for France at SG in Paris, however, says never say never. "We haven't had a block from the state since EDF in December 2007. It has to start again at some point and we feel that 2013 could be the year that we might see some transactions."

FSI gives hope

The French state isn't only an ECM participant through its large holdings of the big liquid stocks, such as EDF, where it owns 84% (with a market value of €22bn) and France Télécom where it owns 27% (€6bn).

It also participates through the Fonds Stratégique d'Investissement — part fund manager, part strategic investor, part private equity fund.

Since its creation in October 2008 when it took over many of the stakes held by CDC — it is part owned by the treasury and part by CDC — it has been involved in a score of capital raisings by French companies.

And even though the structure of the FSI is changing — it has become the equity arm of the new Banque Publique d'Investissement, a Hollande creation that is also an umbrella for a debt financing vehicle and a small and medium sized enterprises bank — bankers think that it will continue to operate in much the same way. However, the reorganisation might include changes in how the portfolio of FSI and CDC stakes are managed and owned — and that could lead to block sales, say some bankers.

The management of the BPI will be led by Nicolas Dufourcq a former senior executive at Cap Gemini, and its market and investor-friendly approach is seen as a positive.

Indeed, when the short-termist nature of public market equity investors is under great scrutiny by regulators even in the UK, the existence of a potential long-term investor is enticing for many smaller French companies, say bankers.

"It can be useful for companies that are looking for a core shareholder with a medium-term perspective to have the FSI come on board and we certainly know corporates that are interested," says

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Renaudin points to the importance of the local investor base, which he says naturally tends to overweight French deals.

"France had a decent year and, although it was overshadowed by Germany which was on fire, there was still an interesting diversity of issuance," he says.

"The French long-only investors are still there — there is still a premium for French deals while lower-rated French issuers get the benefits of a better credit spread assumption."

Missing the Mittelstand

ECM wouldn't be ECM without IPOs. Except in France. Since care homes operator Medica France went public in February 2010 there hasn't been a deal of over €100m in the country. Is that a function of the malaise gripping European markets or does it say something more profound about France?

Some bankers bemoan the lack of privately-owned mid-caps, which some observers blame on the sclerotic labour market, the tax structure and regulatory burden.

"France has got some very large international companies in the CAC 40, but in terms of mid-caps, France lags behind Germany or even Italy, and that's one of the reasons why we don't have the same level of IPO activity," says Larnaudie.

That lack of a German-style Mittelstand is important, says Gueroult. "France has never been a big IPO market because, although it has many worldwide champions, it doesn't have the Mittelstand of Germany. Mid-caps are underrepresented for structural reasons. The other component of IPOs is the technology sector and while France does have those high-tech firms, they tend to go to the US to list."

But bankers aren't all pessimistic about the chances of deals this year, however, as macroeconomic conditions improve with the hoped-for fading of the eurozone debt crisis, resolution of the US fiscal cliff and an upbeat mood about China-led growth.

"The first half of 2013 looks promising," claims Dib. "We've had a pipeline building up in France and we think it's ripe to come to the market this year. We can see maybe 10 potential French IPOs — there is no certainty but improving sentiment has removed one of the stumbling blocks and should help deals come to fruition."

What has been missing is the type of sponsor-backed IPOs that provide many of the listings in other European jurisdictions. There are potential French deals — such as online travel firm Odigeo or aluminium packaging firm Constellium — but they appear to be the exception to the rule.

"The lack of French IPOs is not because of conditions in the French economy but rather it is linked to the fact that we don't at the moment have good quality companies coming out of private equity funds, as with the likes of Ziggo, Kabel Deutschland, Brenntag or Amadeus" says Maringe. "There could be a huge pipeline of sponsor-backed IPOs but the companies in portfolios are too leveraged, having been acquired in 2006 and 2007. The financial structures are too difficult to present these companies to the market."

Vaz Pinto puts the situation in France in the context of the European market and says that the same factors are at play.

"The IPOs that took place in Europe last year were all high quality companies — the market was not ready to look at anything else — and they all had a big yield factor to them," he says. "Growth has also been important — investors haven't been prepared to put money into a company just so that the sponsors could restructure — they want to put money into companies to see growth." ▲

Largest French ECM deals, 2012

Pricing Date	Issuer Name	Size $m	Deal Type
13 Jan 12	Eutelsat	1,253	Block
11 Sep 12	Unibail-Rodamco	959	Convertible
27 Mar 12	PSA Peugeot Citroen	916	Rights Issue
06 Feb 12	LVMH	733	Block
15 Mar 12	Pernod Ricard	652	Block
01 Mar 12	Rexel	634	Block
14 Mar 12	Arkema	569	Block
19 Oct 12	CGG-Veritas	507	Rights Issue
13 Nov 12	CGG-Veritas	458	Convertible
05 Mar 12	Legrand	452	Block

Source: Dealogic

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Xavier Larnaudie, head of equity syndicate at Crédit Agricole CIB in Paris. "It's doing a good job so far. It is viewed as a pragmatic shareholder that will have a say in the management but is business orientated."

Where the FSI has participated in equity capital markets deals – the CGG-Veritas rights issue for instance, or on the IPO of DBV Technologies, a small biotech firm – it is seen by and large as neutral at worst and positive at best. Some investors, particularly French ones, might welcome state support as a potential backstop in times of trouble. Others are just happy for the incremental demand. And bankers are pleased to have a large lead order in the book, just as they would be with any other anchor or cornerstone investor.

It is in the technology sector that the FSI has been most active – and coincidentally or not, that is the sector that has stood out as a bright spot while larger companies have been absent from the IPO market.

There were 10 IPOs of healthcare and technology companies in France in 2012 (though only one of just over $100m equivalent, and only two of more than $50m), a decent if not stellar return, and the country continues to produce high tech small caps.

"Med-tech and biotech have been very active in France," says Christophe Alleman, co-head of global capital markets for SG MCIB, the bank's specialist mid-cap investment bank. "It's a sector where the French state has been very supportive, for example providing finance for R&D, and a consequence of that is that there are interesting start-ups regularly emerging. After two or three private equity or venture capital rounds, an IPO is a good way for these companies to finance themselves."

Investors include retail buyers, with French small and mid-cap funds taking 50%-60% and UK, German and Swiss biotech specialists also active.

"From an investor point of view, it's one of the few sectors where you can expect significant returns," says Alleman. "We have a pipeline of around 10-12 companies in these sectors that could come to market in the short or mid-term." ▲

Who's afraid of François Hollande? Levfin aims to thrive

France has a rough reputation in European leveraged finance. The insolvency regime is unfriendly to creditors, while specific laws make it hard to raise debt on an acquisition target. The new socialist government has tightened the tax regime and changed employment law. But it's not all bad news for levfin. Some of Hollande's changes could help the market, and above all, debt is available and private equity funds have an appetite for deals. **Stefanie Linhardt** reports.

"OPTIMISTIC" MAY be too strong a word to describe French leveraged finance practitioners. They have come through a grinding few years of meagre dealflow, capped in 2012 by the election as president of François Hollande, a socialist who has already introduced several reforms that made the captains of French private equity splutter into their Beaujolais.

Yet market participants are convinced 2013 will be a busier, more exciting year for the buy-out market in France. The country may never be every private equity investor's fantasy destination, but workarounds have been found for some of the local legal problems. Most importantly, Europe's private equity funds, armed with ultra-cheap funding, are hunting for targets, and deals are afoot.

"2012 wasn't very active at all for leveraged finance," says Romain Cattet, partner at debt advisory practice Marlborough Partners in London. "You had bad GDP figures, the French elections and a new socialist president introducing new tax laws in a market that was overall very bad. That explains why France was one of the least active markets for M&A overall in Europe, excluding Italy and Spain."

Dealogic recorded just $6.1bn of French LBO loans last year, out of Europe's $35bn total. This was more than in 2009 and 2010, but a step down from 2011.

Apart from midcap deals below €200m, the last sponsor to close a French acquisition was Axa Private Equity with its takeover of industrial engineering group Fives in July, Dealogic's loan database shows. The deal was financed with a €450m term loan.

Meanwhile, the only high yield bond issue in 2012 tied to a French LBO actually supported a deal signed in 2011. Spie, the technical services provider, sold €375m of 2019 notes in March to pay for its buy-out by Clayton Dubilier & Rice, Axa PE and Caisse de dépôt et placement du Québec the previous August.

"Potential vendors of good assets had price expectations which were often not met by potential buyers"

Patrick Sandray, Société Générale

"There was also the issue that potential vendors of good assets had price expectations which were often not met by potential buyers," says Patrick Sandray, head of leveraged finance for France, Italy and Switzerland at Société Générale in Paris. "As a result, the French buy-out market lost ground."

However, the French buy-out market has its own peculiarities, some of which derive from the insolvency regime.

Legal labyrinth

A French company can file for safeguard proceedings in the bankruptcy courts without the consent of its lenders. This triggers a stay of the security enforcement — proceedings some French companies have used to get around looming covenant breaches and other contractual obligations.

"The structures we had before the financial crisis in France have in many cases been tested and were not necessarily deemed creditor-friendly," says Thibery Gleizes, head of leverage finance, France, at Crédit Agricole CIB in Paris. "That led to the creation of a more effective security package in France."

Lawyers have introduced a new structure for French LBOs: the Double LuxCo. This involves inserting two Luxembourg companies into a buy-out target's chain of holding companies. One grants security over the shares of the other, enabling lenders to benefit from Luxembourg's creditor-friendly enforcement procedures and EU insolvency directive provisions, even if the French borrower becomes insolvent.

"The aim," explains Arnaud Fromion, partner in Shearman & Sterling's finance group in Paris, "is also to convey a message to the [equity] investors that seeking judicial protection — mainly under safeguard proceedings — rather than triggering an open discussion with the lenders, would not prevent the latter from enforcing their security over the shares of the second Luxembourg company. In essence, it is a way to reach a lost equilibrium in the relationship between the lenders and the [equity] investors."

This is possible so long as a Luxembourg court decides that the centre of main interests of the Luxembourg companies does indeed lie there. This requires including a particular set of contractual provisions in the finance documentation.

Today, almost all large cap French leveraged buy-outs feature a Double LuxCo structure, and it is finding its way into midcap transactions more often. Other French quirks are the financial assistance and corporate benefit rules. The financial assistance concept forbids an acquisition target to secure debt a buyer raises to finance the acquisition — a practice central to leveraged finance in most countries.

After the transaction, the target can, however, pay dividends to the new owner or make a loan to it, which the shareholder can use to service the debt.

"A company in a group can only provide guarantees to another member of the group if it is of corporate benefit for the company, making it difficult for a French company to give upstream guarantees under the corpo-

"International private equity firms might be a bit more cautious in France, but they are still willing to do deals"

Romain Cattet, Marlborough Partners

rate benefit rules," says Fromion.

France's new government, elected in May 2012, has brought fresh challenges for leveraged finance, especially in taxation. The tax on capital gains from selling shares in a company has been raised and the ability of a company to deduct interest from taxable earnings has been limited in several ways, according to Fromion.

"Still, although these changes have been in play for a few months now, there are a number of financings in the pipeline and funds have adapted by bringing leverage down and injecting more equity," he says. "It's just a new way of doing business. Today you often see leverage of three or four times Ebitda, which could easily have been around 10 times in the past."

More change coming

Apart from the changes already made, two further Hollandeisms are awaited.

While implementation guidelines are not yet clear, companies will be able to claim a payroll cost rebate against the salaries of low-paid staff — those earning up to 2.5 times the minimum wage, says Gleizes at Crédit Agricole.

"This will have a positive impact on the labour-intensive companies in France and will positively counterbalance the partial loss of deductibility of interest," he says.

There were also national labour negotiations towards the end of 2012 to promote "flexi-security" in employment law.

"In exchange for increased flexibility for companies to reorganise, relocate or downsize," Gleizes says, "employees will be eligible for additional benefits such as mandatory healthcare insurance coverage, which will have some additional cost for companies."

With all these stumbling blocks in the way of LBOs and given 2012's slow activity, one might not expect 2013 to be a better year. Nevertheless, the buy-out pipeline is swelling.

Dealmaking to accelerate

"International private equity firms might be a bit more cautious in France, but they are still willing to do deals," says Cattet at Marlborough. "We are indeed seeing international sponsors participating in current French sale processes."

Labco and Elior are two private equity-owned companies that are, or could be, on the block.

A consortium led by 3i is auctioning Labco, the laboratories group, and has received broad interest. Private equity firms like Blackstone, EQT, KKR and Bain are all thought to be interested.

Meanwhile, bankers are working on the planned sale of caterer Elior by its sponsor Charterhouse, which could include buy-out packages of over €2bn.

"If Elior is put on the market and successfully completed, it would underline my view that 2013 could start with a more positive mood and with more impressive transactions than in 2012," says Sandray at Société Générale. "It would be the largest LBO transaction put to the market in France since Spie was signed in 2011."

Charterhouse paid €2.5bn for Elior in 2006.

Smaller scale activity is also flowing through the market. L Capital, the private equity fund sponsored by LVMH, is looking to sell its stake in Groupe SMCP, the luxury apparel group including the brands Sandro, Maje and Claudie Pierlot, for around €600m.

Two retailers are also expected to come to market soon. Fragrance and cosmetics seller Nocibé may be sold by Charterhouse, which invested €490m in the business in 2005, while Apax Partners and LBO France are mulling a sale of furniture retailer Maisons du Monde, of which they bought a majority for €435m in 2008.

"On almost every occasion, private equity houses ask us to pitch loan solutions with senior debt or the classic construction of senior plus mezzanine, but we are also asked to provide bond solutions," says Sandray. "We need to think as an integrated financing solutions platform, mixing loan and capital markets approaches."

Direct from fund to borrower

Many market participants also expect direct, private lending by institutions to play a larger role. Tikehau Investment Management has a specialist private debt practice and launched a direct lending fund for retail investors, that is open for investments from February to July this year.

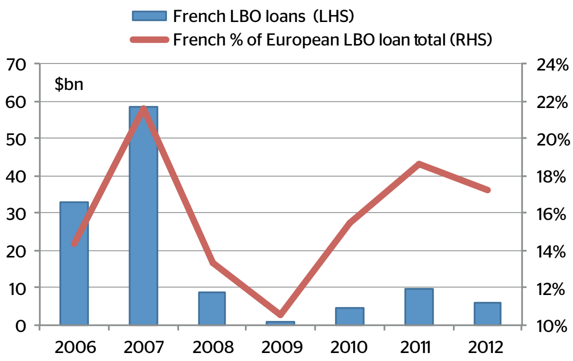
"Private debt strategies have existed for a while in the US and the UK but are more of an innovation in France," says Maxime Laurent-Bellue, fund manager at Tikehau in Paris. "We anticipate a growing pipeline of companies in the mid-market looking for direct lending options."

Some opt for lending, but others are still moving in the opposite direction.

"The general trend of [funding] diversification will carry on in France as it does throughout Europe," says Youssef Khlat, global head of high yield capital markets at Crédit Agricole in London. "We will see a number of sponsor portfolio companies refinancing their bank debt in the high yield market this year, like Cerba."

Cerba European Lab, the operator of clinical pathology laboratories, has been through several buy-outs and is now owned by PAI Partners. The private equity firm took advantage of the strong demand in the high yield market in January and sold €365m of bonds to refinance all of Cerba's senior and mezzanine loans. ▲

French LBO loan volumes 2006-2012



Source: Dealogic

Breakthrough for mid-caps as new PP market takes root in France

For years, Europe's big investors took no interest in private placements — despite banks' efforts to pitch them. Then came the sovereign debt crisis, which flattened yields on safe credit, including corporate bonds. As **Jon Hay** discovers, this opportunity came at the perfect time for France's mid-cap companies — just when the banks started to nudge them towards the capital markets.

FROMAGERIES Bel's products are known worldwide: BabyBel, Laughing Cow, Leerdammer, Kiri — popular brands of processed, packaged cheeses. Still controlled by the founding family, the company has a minority listing in Paris, with annual sales of €2.5bn.

Until 2012, it had never raised debt in the capital markets. "In the past the banks pitched us [a variety of debt products], and we said no," says Benoît Rousseau, director of financing and treasury at Fromageries Bel in Paris.

Yet last year, Bel set up a *billets de trésorerie* (commercial paper) programme, through which it borrows about €100m without a rating, and raised €160m with a privately placed bond.

This change of heart is not a one-off. It's a story echoed at several dozen French mid-caps which turned to the capital markets in 2012 — and at a quickening rate as the year passed.

Between January and June, at least six French companies raised US private placement debt, says Clémence Berroeta, executive director in debt capital markets corporate origination at Crédit Agricole CIB in Paris — as many as had done so in all the previous five years.

Then between July and December, Société Générale estimates that about 40 French companies borrowed a combined €2.7bn through a completely new market — so-called Euro-private placements, sold largely to French insurance companies and asset managers.

Why this sudden migration? Like most firms that took this step, Bel had previously relied on banks for funding, and was still loyally supported by its core French relationship banks.

Nevertheless, Rousseau says: "It is true that we feel pressure from the banks regarding the possibility to diversify our sources of funding. We have not been very affected by the crisis, we have no liquidity problem. The only thing is that the banks say, if you make a big acquisition and have a bridge financing, it will be very important to be able to refinance it with diversified sources of funding. You need to be prepared for this diversification and need to be able to show your bankers the ability to diversify."

Bel and its fellow new issuers are the cream of the French mid-cap world. One or two are very large companies, like electrical wholesaler Sonepar, with sales of €15bn, and Lactalis, the world's largest dairy group. Their absence from the debt markets hitherto is no accident: many of them have little debt.

"These companies are not reducing their bank facilities because the banks are not willing to lend as much — most of these are very well known companies and the top notch credits in the unrated world," says Fabien Calixte, a French corporates origination specialist in debt capital markets at BNP Paribas in Paris. "They are switching their drawn financing needs into disintermediated options and keeping revolving credit facilities with the bank. It's nothing to do with banks' liquidity issues. They need to diversify their funding, and maybe have half and half."

Yet ever so gently, the banks are encouraging them to look elsewhere for some of their debt.

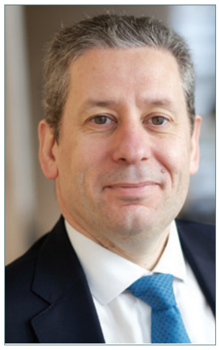
New model banking

"The catalyst was Basel III," says Patrick Guivarch, head of investment solutions for insurance companies in euro fixed income and credit at Amundi, the asset manager owned by Crédit Agricole and SG. "The investment banks wanted to adopt a new model — they call it 'originate to distribute'. They want to keep the relationship but not fund the debt."

It is no accident that French banks have become cheerleaders for a style of banking that since the crisis has become a dirty word in the UK, for example.

"We are definitely trying to push up the margins on corporate facilities when we renew them"

Vincent Tricon, Société Générale



French banks had a nasty shock in mid-2011, when US money market funds took fright at the eurozone crisis and shunned their debt. This stung, because the banks rely more on wholesale funding than others in Europe, since insurance products siphon off a good part of French savings.

SG's domestic banking network, for example, has 23% more loans than deposits. In the UK, banks can fund pretty well all their corporate lending from corporate deposits.

"We are definitely trying to push up the margins on corporate facilities when we renew them," says Vincent Tricon of SG mid-cap investment banking in Paris. "Since 2007, the banks' cost of funding has exploded."

Rousseau at Fromageries Bel has felt it. "The margin on our bank facilities used to be around 20bp; today it can be 75bp-80bp or higher," he says. Even that may only be half what banks pay to borrow. Hence the attraction for Bel, now, of issuing CP at 15bp-20bp over, all-in.

None of this amounts to a credit crunch. Tricon says the banks have become more prudent about risk and tried to restrict their financing to struggling, loss-making firms. "But I've been visiting a lot of companies, and in no situation have I heard them say their banks are not supporting them," he says. In fact, SG has increased its lending to French industry by 3% or 4% a year, faster than the rate of economic growth.

France is above the European average, and higher than Germany, on the European Commission's SME Access to Finance Index, though its surveys show strains here, as elsewhere.

Tailored finance

Nevertheless, the banks know which way they want to shepherd their clients: the debt capital markets. The speed with which this long-closed door opened to French mid-caps in 2012 was astonishing.

Some entered the public bond market, like Bureau Veritas, the certification and testing group that raised €500m of five year debt in May at 250bp over mid-swaps, amid rough market conditions.

But among unrated companies, Veritas's public debut is unusual. Most have avoided the public market, partly because they only want to borrow €100m-€250m, a size too illiquid for many public investors. Many firms are also shy of the financial disclosure a mainstream bond would require.

Guivarch at Amundi describes a "community of interest" among banks, companies and investors that made the Euro-PP market happen. "With the backdrop of low yields, insurance companies wanted to increase their exposure to corporate debt, but with public bonds there are two drawbacks," he says.

"Spreads are really tight, and there is a great imbalance between demand and supply. You ask for €100m of public bonds, and you get €10m or €20m. So we jumped into this new market and started to meet the issuers."

Those same low yields that drove investors to consider private placements brought companies running to issue. PPs remain more expensive for borrowers than bank loans, but the difference is smaller than before.

With banks advising companies to create undrawn headroom in loan facilities in case they need it for an acquisition — rather than assuming the banks will cough up more when asked — the reduced cost of bonds, combined with other attractions, has been enough to convince issuers.

"Banks are limited in maturity to five year loans," says Clémence Berroeta at CA CIB. "As the natural need of asset managers and life assurance companies is six to seven years, companies can get a longer, more spread-out repayment schedule by doing a private bond."

The cultural change demanded of investors has been if anything greater than that for issuers. "Of course we already have some credit analysts, but they just look at credit quality," says Guivarch. "Now we have got to consider covenants and negotiate directly with the issuer. We can have some really bespoke bonds, which is very interesting for us."

Amundi has hired loan specialists from banks, partly for their expertise in this area, and partly to take on the compliance burden of handling private information.

Degrees of privacy

So far, the Euro-PP market has two strands. First came the loan format, represented by two deals for Sonepar and franking machine maker Neopost, and placed with Axa under origination partnerships it has struck with SG and Agricole.

But since Axa requires the banks to co-invest, the deals are limited to five years. For that reason, and because French regulation makes it complicated for insurers to buy loans, most of the other deals have been bonds.

The market soon broadened from Axa to take in Amundi and 10-15 other insurance companies and asset managers, including one or two outside France such as Allianz — though not yet the big Dutch pension funds.

Many investors can only buy listed bonds. Some companies, such as tinned foods producer Bonduelle, care homes group Orpéa and Plastic Omnium, which makes car parts and rubbish bins, have therefore listed their notes on NYSE Euronext Paris.

This requires regular publication of financial results, however — something Lactalis and Groupe Soufflet, a family-owned food producer, were unhappy with. Their deals in December were listed on Luxembourg's lightly regulated MTF market, which requires disclosure at listing, but not thereafter. The companies will update their PP investors in future, but privately, as if they were banks.

Such innovations are likely to continue in a market evolving fast, amid intense competition between the three leading French investment banks. "These are not going to be regular issuers, so if you miss their first deal, you may have missed your chance for three or four years," says Berroeta.

Banks are keen to speed up execution by making the market more organised and standardised — though without spoiling its ability to cope with issuers' unique needs.

"This market is going to grow and extend to smaller companies than last year, with turnover in the €500m-€1bn range," says Tricon. "It needs to be companies with a fair amount of debt, because the institutions do not want to provide more than about 10%-20% of a company's debt. They don't want to have to take on hard negotiations with a borrower."

Even US PP investors, whose supply of French deals has dried up, now want to know if they can get involved.

Once the race through their French Rolodexes eases, the banks will start bringing issuers from other countries.

"This is not going to stay a French market," says Calixte at BNP Paribas. "All institutional investors are thinking about what they should do in this market, and there are lots that have not participated yet. The market will probably develop down the credit spectrum and across Europe as their skills increase." ▲

Selected Euro-PP deals in 2012

Sonepar	**Electrical wholesaler**	**Unlisted, family-owned, €15bn turnover**
July	Loan format deal placed by SG with itself and Axa. Capital markets debut	
Neopost	**Mail handling machines**	**Listed, €1bn turnover**
Sept	€150m loan placed by CA with Axa, other insurers. Also done US PP, Schuldschein	
Bonduelle	**Tinned foods**	**Listed, €2bn turnover, has issued US PP before**
Sept	€145m 6.5yr 3.83% placed by CA as Paris-listed bond with <5 investors	
Plastic Omnium	**Plastic car parts**	**Listed, €5bn turnover**
Oct	€250m 6.2yr 3.875% placed by BNPP as Paris-listed bond, no covenants, as on loans	
Lactalis	**Dairy products**	**Unlisted, family-owned, €15bn turnover**
Dec	€507m via SG <10 invrs: €128.5m 5yr 3.15%, €22m 6yr 3.45%, €356.6m 7yr 3.75%	

Source: banks, EuroWeek research

Attention au fossé — the search for infrastructure finance steps up

As France's infrastructure industry awaits the outcome of an enquiry into the feasibility of spending plans devised by the Sarkozy government, banks are exploring the possibility of attracting new investors into the sector. **Lucy Fitzgeorge-Parker** reports.

FEW THINGS ARE as susceptible to changes of administration as public sector infrastructure projects. In opposition, politicians frequently find that such programmes make a handy stick to beat the government with — on the grounds of extravagance, ecological insensitivity or inappropriate financing structures — and once in power they come under pressure to make good on their rhetoric.

That is the situation being played out in France. Before winning last year's presidential election, François Hollande — along with other senior members his Socialist party — had been harshly critical of incumbent Nicolas Sarkozy's plans to revitalise the French economy via lavish spending on infrastructure.

It therefore came as little surprise when, with the election in the bag and attention increasingly focused on France's failure to bring its budget deficit — estimated at 4.5% for end-2012 — into line with eurozone requirements, incoming ministers announced that the previous government's pet infrastructure projects would be subject to renewed scrutiny.

For the key players in the infrastructure sector, the most important question concerns the fate of the Schéma national des infrastructures de transport. Launched in 2009, the SNIT was a cornerstone of Sarkozy's stimulus programme for France in the wake of the global financial crisis and laid out plans for a 25 year programme of transport infrastructure development at a total cost of €245bn.

As early as July, budget minister Jérôme Cahuzac had commented publicly that some projects under the SNIT umbrella would have to be abandoned and in October his colleague at the transport ministry, Frédéric Cuvillier, announced the creation of a commission to review the programme as a whole.

Comprised of politicians and experts, the commission has been charged with "prioritising and putting in perspective" the largest infrastructure projects and developing "a sustainable vision of transportation" with the emphasis on "everyday transport", "the renovation of existing networks" and "short-term improvements to the service provided to users".

"The benefit for the government from guaranteeing part of the revenues in PPP projects is that it gives a lower margin"

Hervé Le Corre, Société Générale

The results of the six month study are due to be published in April and speculation has been increasing that some of the bigger projects will be shelved. Topping the list of likely casualties is the controversial Canal Seine Nord Europe, a 106km waterway that would link Le Havre to northern France, Benelux and the Rhine and whose price has already risen from an initial estimate of €4.3bn to as high as €6bn.

Other candidates for postponement include some of the pricier high-speed rail and motorway projects, especially those in ecologically or politically sensitive regions, with the proposed A381 autoroute link from Rochefort to the south Vendée region cited as one of the most likely to be scrapped.

Some of these projects are already in the advanced stages of development but that is not seen as a bar to abandonment after the Hollande government's cancellation last summer of the €750m Strasbourg bypass after the concession had been awarded to a consortium led by Vinci. Similarly, the controversial Grand Paris project, an €80bn plan to upgrade the capital's transport and accommodation infrastructure that was launched by Sarkozy in 2007, appears to have ground to a halt under the new administration.

While they wait for the results of the SNIT review, however, market

Negative publicity around the Centre Hospitalier Sud Francilien profect that went severely over budget has not helped the PPP cause in France participants remain optimistic about the infrastructure pipeline in France. Some high profile rail projects have already received implicit backing from the government, including the new €25bn Lyon-Turin rail link, the €8bn high-speed line from Tours to the Pyrenees via Bordeaux and the A45 autoroute between Lyon and Saint-Etienne.

The need to upgrade France's existing infrastructure should also offer opportunities. The country's traditional rail network, for example, has long been neglected in favour of new high-speed projects, to the point where trains on some sections of the original line are limited to speeds of under 60kmph. To address this, Hollande pledged in January to ensure the renovation of 1,000km of secondary rail lines a year.

Similarly, in January tenders closed for a €250m 30 year concession to renovate and maintain nearly 30 dams on rivers in the east of France, while a plethora of projects are also still outstanding in the prison, hospital and university sectors.

Whatever the final shape of the new government's infrastructure plan, however, the key question will be how to fund it while simultaneously reducing the budget deficit. One obvious solution is via PPP, a financing model that was introduced to France in 1993 under the Sapin law and has been increasingly dominant since the 2004 implementation of private finance initiative legislation that allows public authorities to fix returns to private sector partners.

As Hervé Le Corre, head of infrastructure project finance for France at Société Générale, points out, this helped both by providing certainty for private sector operators and lowering costs for the public sector. "The benefit for the government from guaranteeing part of the revenues in PPP projects is that it gives a lower margin than on a traditional PPP scheme," he says.

The Sarkozy government showed strong support for the PPP model — indeed, a €10bn state PPP guarantee to facilitate the financing of "priority projects" signed before the end of 2010 was a key plank of the administration's infrastructure stimulus package, and helped secure the financing for the Tours-Bordeaux high-speed rail line.

Socialist politicians have, perhaps unsurprisingly, proved more resistant to the concept. Justice minister Christiane Taubira, for example, told reporters soon after taking office that PPP was "not acceptable" as a means of financing for prison construction.

Two prison PPPs, both won by consortia led by Spie Batignolles, were closed in January after protracted delays but the model is likely to meet with resistance in future — particularly since Taubira reduced the target for the number of extra prison places to be built in the next six years from the 23,000 set by the previous government in March 2012 to 6,000.

A key objection is that the cost of PFI projects has gone up because of changes in spreads on public authority-backed tranches of debt. Under these arrangements, a "Daily tranche" under which public authorities guarantee project payments used to cost around 8bp before the financial crisis but now spreads have widened to as much as 200bp — as for example on the Spie Batignolles prison concessions.

"Institutional investors are showing strong interest in providing long-term financing for infrastructure, and they still see France as a very good risk"

Olivier Jaunet,
Crédit Agricole

The PPP cause was also not helped by negative publicity around the Centre Hospitalier Sud Francilien, a hospital project to the south of Paris that went severely over-budget after the local authority ordered Eiffage to delay construction for nine months pending the outcome of a design review.

Hollande had positioned himself in the run-up to the election as an opponent of PPP, describing it as "a tool that encouraged life on credit and over-indebtedness". In a speech in January, however, he appeared to have changed his mind, saying his approach to private finance would be "pragmatic" and that the PPP model could be a useful mechanism for funding five areas of "essential investment" — accommodation, energy, digital technology, transport and aviation.

What about the money?

If this does mark a fundamental shift in attitude to the PPP concept, the next question will be over the availability of private sector funding. Thus far, even in the wave of the financial crisis, French banks have strongly supported the infrastructure markets, and the sector has also attracted considerable interest from Spanish, Japanese and German lenders.

With new capital regulations on the horizon, however, European banks in particular are becoming more reluctant to provide long term financing, according to Olivier Jaunet, head of Crédit Agricole CIB's infrastructure team in Paris — with the result that French infrastructure players, like their counterparts elsewhere in Europe, are urgently looking for alternative funding sources.

The obvious answer, for both the French and broader European markets, lies with the institutional buyer base. Pension funds and insurance firms in particularly have seen returns on traditional longer dated investments dwindle in recent years and are at the same time under increasing pressure to match long term liabilities with assets of similar duration.

"Institutional investors are showing strong interest in providing long term financing for infrastructure, and they still see France as a very good risk," says Jaunet.

There have been encouraging signs over the past 12 months that the two sides are coming together. In July, fund manager Allianz Global Investors revealed that it had hired a team from MBIA subsidiary Trifinium Advisors to oversee a strategy of investment in infrastructure debt, while November saw both BlackRock and Macquarie announce the creation of infrastructure debt platforms.

BlackRock's infrastructure division is due to focus on Germany, France, the UK and Benelux, while Macquarie's platform will also cover the UK and northern Europe. The Australian house received a rapid validation of its strategy in the form of an announcement in December by reinsurer Swiss Re of plans to invest $500m in its Midis platform.

"A lot of insurers are interested in the infrastructure loan market because it matches their liabilities and has a relatively low correlation with the wider economy," says Le Corre.

Indeed, bankers report a high level of interest in infrastructure, along with other alternative asset classes such as real estate and aircraft financing, from across the institutional investor base — and Jaunet at least is confident that this represents the start of a shift in approach rather than a short term hunt for yield.

"The type of institutional investors that are now showing an interest in infrastructure financing would not be looking at new sectors for short term, opportunistic investments," he says. "They are exploring various options to diversify away from their traditional asset classes and I believe this is something that will have a long term impact."

There are, however, still several hurdles to be cleared before institutional investors can become fully engaged in the infrastructure sector. In a broader European context, the biggest of these is the proposed Solvency II capital adequacy legislation for insurers, which as currently envisaged would treat infrastructure debt as corporate rather than public sector risk.

Pierre Nicoli, head of energy and infrastructure at BNP Paribas, confirms that this would likely restrict the appeal of infrastructure assets for insurers but is confident that lobbying efforts from the sector will have an effect. "I would say the [European] authorities should and probably will ease the interpretation of the rules to make it easier for insurers to buy infrastructure assets," he says.

In France, a more specific issue concerns the lack of provision in current PPP legislation for make-wholes, whereby investors are compensated for loss of income and margin in the event of early termination of the contract. Make-wholes would, inevitably, increase the potential cost of projects — something that is unlikely to appeal to the government while bank funding is readily available.

"The fact is that in France so far every project has been financed without institutional money," says Jaunet. "As a result, we are not convinced that the French authorities are ready yet to change the contractual provisions [to their disadvantage], since no project has failed to date."

"There will be less liquidity than before the financial crisis but because the volume of deals has also reduced there's a balance between supply and demand"

Pierre Nicoli, BNP Paribas

Christian Jabre, head of structured finance at KPMG Corporate Finance, takes a more optimistic view, noting that banks in France are showing more interest in ensuring that financing structures are suitable for subsequent distribution to institutional investors. "Public authorities are gradually also becoming familiar with the peculiarities of fixed rate financing and are mindful of the flexibility that needs to get in the tender documents to let these new players in," he says.

The French government may also look for infrastructure funding from more traditional sources such as the European Union, particularly for larger scale projects with cross-border implications — indeed, the authorities have already appealed to the EU for help with Canal Seine Nord Europe. With the EU itself under increasing pressure to cut costs, however, this may not be as reliable a support as in past decades.

For smaller projects, on the other hand, it looks likely that more funding responsibility will in future be farmed out to France's regional authorities — something that Jabre says could in itself create challenges. "There is a growing sensitivity among banks to the quality of local authorities with non-French banks preferring to focus on state or quasi-state level counterparties," he adds.

Refinancing fears

Jaunet also points to a swathe of upcoming refinancings of projects put together in the early 2000s as a potential source of problems for the French authorities.

"France is one of the countries where revenues for motorways are most resilient but unfortunately the revenue anticipations for traffic projects initiated in pre-crisis years have often turned out to be optimistic, so some of the refinancings required may not be easy," he says.

By contrast, he takes a relatively sanguine view of the slowdown in the greenfield sector. "Total project finance activity in the public infrastructure sector doesn't add up to much over the past months but it's more a time of big question marks than a time when we can draw final conclusions," he says.

Nicoli agrees, pointing out that so far activity has declined in line with banks' funding abilities. "The new regulatory environment for banks does mean there will be less liquidity in future than there was before the financial crisis but because the volume of deals has also reduced there's a relatively good balance between supply and demand for now."

For him, as for other bankers, the more exciting infrastructure prospects are in the private sector, where the sale by Total of its gas transport business, valued at €2bn-€3bn, has raised hopes of a long-awaited wave of M&A activity in the French energy and utility sectors.

"If the government starts to cut infrastructure spending it will obviously have a major negative impact on the overall market for greenfield projects but that could be more than offset by an increase in divestitures and privatisations as the large utilities in France follow the example of their German, UK and Spanish counterparts," says Nicoli.

Market participants are also tipping renewables as a promising sector for the coming years, given the need to meet EU targets for energy from alternative sources by 2020 and the requirement to strengthen the existing grid to cope with the new input. Last May funding for a €100m solar energy project near Nancy was completed, while the concession granted to an Iberdrola-led consortium for an offshore wind plant in Brittany in April is due to be the first of many.

Whatever the state of the market in France, however, the country's infrastructure bankers are unlikely to be short of work given the international reach of key clients such as Bouygues, Vinci, GDF Suez, Veolia and Eiffage. "We are still very active in a number of external markets, so while it would be better for us to have a strong home market we can live with a slowdown in the French market for the moment," says Jaunet. ▲

French banks spearhead drive to raise liquidity in VStoxx

The VStoxx, Europe's volatility index, has played second fiddle to the US's Vix in recent years, as a hedge for eurozone risk or as an alpha-generating strategy. Investors and bankers bemoan the lack of liquidity in the index. But the game is changing. France's biggest banks — leaders in this, as in other areas of equity derivatives — say the VStoxx is ready to support more products and strategies. As **Rob McGlinchey** reports, the time is ripe for busier flow from European investors.

THE VSTOXX, the index that tracks the volatility of the Euro Stoxx 50 index of Europe's ultra-blue chip companies, has experienced a surge of interest in recent months, as institutional investors increasingly come to regard volatility as an asset class in its own right.

Société Générale and BNP Paribas have been setting the trend, with VStoxx activity widely recognised as being driven by French volatility traders and structurers.

Those leading the charge at other firms are typically French or have worked at French banks. At Barclays, for example, VStoxx trader Gabriel Manceau is a graduate of the Ecole Polytechnique, while Anice Lajnef, a director on the index options desk, is a former trader at Société Générale.

Such desks have supported the increase in two-way VStoxx options flow in the last year. This has helped facilitate the growth in liquidity, with substantial flows in strategies such as out-of-the-money calls or call spreads, especially from US investors wanting to hedge their portfolios. On the flipside, there has been a steady increase in alpha-generating strategies, such as risk reversals, to play the normalisation of the index.

"The Vix term structure has become a key focus and is now fairly efficient"

Kokou Agbo-Bloua, BNP Paribas

"In 2012, the volumes on the VStoxx tripled," says David Escoffier, head of global equity flow at Société Générale in London, which has the largest volume of all market-makers in VStoxx options, according to Deutsche Börse, where the contracts are traded on the Eurex derivatives market. "What we are thinking is that, come the end of 2013, US interest will continue to be very strong and European interest from asset managers and institutions will be in full swing — and therefore you will see a big increase in the VStoxx volumes."

A product in embryo

Two years ago, it was a different story, as most US and European investors opted instead for the US volatility index — the Vix — even when they wanted to hedge against volatility in the eurozone as the sovereign debt crisis escalated.

"Up until recently, people were saying, 'the VStoxx isn't liquid enough, there aren't enough prints on the screen and that's why we are reluctant to do anything and we prefer to do the Vix'— the old fashioned way of thinking. But, volumes have increased massively, and now they are starting to dip their toes in," says Richard Quessette, head of cross-asset solutions at Société Générale in Paris.

According to traders and structurers, investors started paying more attention to the VStoxx during the eurozone debt crisis 18 months ago. Although trading was still slight, many tail funds and global macro hedge funds became focused on buying convexity in Europe. "VStoxx and options on VStoxx became very attractive products, as the futures provided investors with directional and liquid exposure to volatility," says Kokou Agbo-Bloua, head of equity and derivatives strategy for Europe at BNP Paribas in London. "There was also a lot of interest in Vix and VStoxx options, which effectively gave investors exposure to volatility of volatility."

Monthly trading volume in VStoxx options averaged just 46,000 in 2011, though interest from hedge funds produced a peak of 64,000 in May. Since then, volume has risen sharply, particularly since mid-2012, with an average of 120,000 contracts over the last year and a high of 233,000 in December.

Volumes in VStoxx mini-futures also rose in 2012, from 159,000 in January to 445,000 in December.

Seeing advantage in options

So what has set off this wave of interest? The main factor is that investors have gradually begun to understand it is easier and more efficient to buy a call option on the VStoxx to express a view on tail risks than to take the mark-to-market volatility of an outright VStoxx futures position.

Call options on the VStoxx have also typically been cheaper than Vix call options, leading to relative value strategies between Vix and VStoxx options, which have consequently helped increase the liquidity of VStoxx futures. Volatility arbitrage hedge funds have also profited from strategies focused on the VStoxx term structure, a strategy that has previously been popular on the Vix.

"Typically, the traditional volatility arbitrage hedge funds who traded the Vix to capture the term structure roll-down have performed very well in 2012. The Vix term structure has become a key focus and is now fairly efficient," says Agbo-Bloua. "The trading opportunity in the VStoxx started with the business day count convention of VStoxx contracts versus listed options."

The argument is that for Vix and VStoxx term structures, December futures should *a priori* trade at a discount to January futures as December is the month with the lowest number of business days.

Agbo-Bloua explains: "Given the day count convention of the VStoxx [which is 30 calendar days], there

“There is no concern over the index itself; it’s just a question of liquidity. Once the VStoxx becomes liquid, European investors will trade on it”

Selim Mehrez, Morgan Stanley

was an opportunity to sell December futures against January futures to take advantage of the lower expected realised volatility in the month of December relative to January. This was eventually corrected towards the end of the year.”

Most flow in such strategies has come from US investors, especially on the back of regulatory approval of the VStoxx there. In July, the US Commodity Futures Trading Commission approved VStoxx mini-futures to be sold to investors domiciled in the US through Eurex’s direct access terminals.

“Most investors have been disappointed with the Vix and the eurozone crisis,” says Escoffier. “People thought initially that the Vix was the good global risk management tool, but actually during the eurozone crisis, which some may consider as still ongoing, the Vix did not react as one expected to eurozone news — the VStoxx did. That’s why we have seen a lot of flows on the Vstoxx, coming firstly from our US clients. European investors remained mostly on the sidelines but are starting now to invest.”

Liquidity headwinds

An expectation that European investors will flock in greater numbers to the VStoxx in 2013 is widely held among market-makers but not among all sell-siders.

Some maintain that liquidity is still the biggest challenge to the development of the VStoxx. Others also cite the short-selling bans in Europe and the complexity of hedging the VStoxx as challenges to expanding liquidity in it.

Such claims are, however, rebuffed by market-makers and Stoxx, the sponsor of the VStoxx. “We think the VStoxx is a good index — it is based on the most liquid index in Europe, the Euro Stoxx, and is not as complex as the Vix in terms of the way it has been devised,” says Escoffier.

“Yes, the hedging is complex, but it’s about having the proper IT, the proper trading infrastructure and the proper methodology.”

Morgan Stanley provides liquidity and pricing to clients and to the broker market on request in VStoxx mini-futures and options.

Selim Mehrez, the bank’s global head of financial engineering – equities in London, says he has no concerns with the index itself. He observes, however, that questions remain about its liquidity and therefore its usefulness as a hedge — so that European investors still prefer to trade the Vix.

Mehrez argues that an asset manager investing in French equities with up to €10bn in assets under management, for example, would want to hedge the entire portfolio, but can only do this with the Vix.

Even if the asset manager applied a VStoxx hedge to half the portfolio, the bid-offer on the VStoxx would be so wide that performance would suffer. And if the asset manager rolled it out each month in a year, it wouldn’t just have the costs for one month, but for 12 months.

“Liquidity helps drive liquidity,” says Mehrez. “You need to compare it on the order book, where the majority of the trading takes place. If you look at the Vix, prices on the futures are 5bp wide in terms of volatility points and they are 10 times the size of the VStoxx, where prices will probably be around 20bp-25bp wide. Until we achieve more liquidity on the general order book, it is very difficult for trading desks to provide the kind of liquidity that big asset managers require. Trying to hedge yourself out of that trade becomes far too difficult in the current demand.”

Mehrez adds that one firm’s attempt two years ago to create liquidity in the VStoxx by replicating a Vix strategy, despite attracting significant investor interest, also found such challenges when hedging or unwinding during the life of the product.

New products on the way

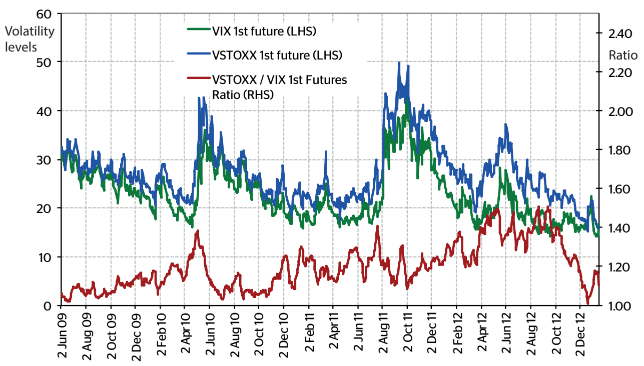
Despite these concerns, market-makers and liquidity providers are examining either replicating Vix strategies on the VStoxx, or stepping up their efforts to expand interest in current VStoxx offerings.

Barclays, for example, is set to market a VSXX exchange-traded fund, based on the VStoxx short term futures total return index, to US investors. The firm also recently attended an investor roadshow in the US to promote the VStoxx as an alternative to the Vix.

Konrad Sippel, head of global product development at Stoxx in Frankfurt, says the VStoxx and Vix are very similar in their methodologies, meaning there is no reason why the offerings that are available on the Vix — or even more innovative products or strategies — should not be developed for the VStoxx.

“VStoxx is hard to replicate in a delta one tracking product, but a rolling futures index using the respective Eurex futures is more transparent for the end investor, since there is an independent and transparent index that underlies that strategy,” he says. “Investors can also check the performance of the product against an index. There are a couple of these products already available and more in the pipeline, around creating tradable products. I think the next step is going to be strate-

VStoxx and Vix futures and ratio



Source: BNP Paribas

gies to optimise the volatility in various ways."

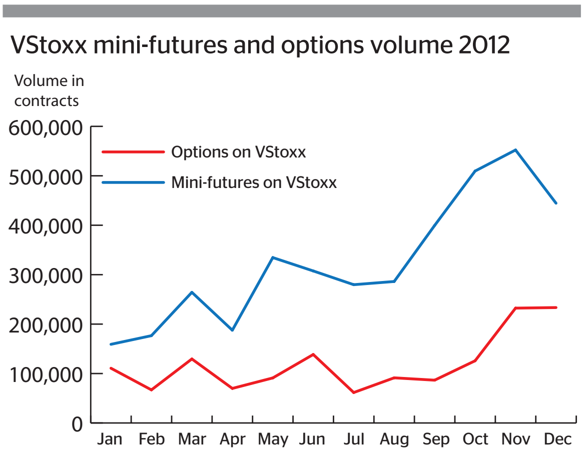
For Morgan Stanley, however, the current low liquidity is preventing it from launching one of its most successful and popular Vix strategies on the VStoxx.

The firm's Vix carry strategy involves being long the three month term structure and short the two month, to play the carry. The strategy will be at capacity in two months.

"If we had exactly the same liquidity on the VStoxx, we would launch it right away," says Mehrez. "But looking at the actual liquidity and the actual bid-offer on the VStoxx, the performance of the carry strategy would have a Sharpe ratio of 0.5, instead of the 2 that it has on the Vix now."

A matter of time

Once liquidity improves, there will be no reason why the VStoxx should not become the volatility benchmark of choice for investors in European equities, Mehrez believes.



Source: Société Générale

"There is no concern over the index itself; it's just a question of liquidity. European investors are trading the Vix today because they are convinced it is a liquid index. Once the VStoxx becomes liquid, they will for sure trade on it, especially because their benchmarks are generally more than 50% European equities," he concludes. "It's especially attractive to European investors because they would like to hedge themselves with the VStoxx and not with the Vix. What they are doing now is like bespoke hedging on European equities with the Vix."

Stoxx, along with its mini-futures and options market-makers — French banks in particular — won't be letting up in the push to increase liquidity in the VStoxx and promote product expansion.

Sippel cites the large interested client base, among other reasons, as to why it is worthwhile to quote instruments on the VStoxx. "The value of the VStoxx to the end investor is very clear — there is clearly demand for this type of product and demand for flow in this type of product," he says.

For many VStoxx market-makers, raising liquidity is little more than a formality, as volumes continue to surge in the underlying and interest from investors increases.

"Quite simply, we want to take the VStoxx from a product that we see as marginal, to one that is an essential volatility player product, like the Vix is," says Dan Fields, head of global markets at SG in Paris. "That is a realistic goal." ▲

Why the French dominate equity derivatives

THE PARTNERSHIPS between French banks and the country's *grandes écoles* have produced financial market professionals that have pioneered many of the most innovative flow and structured derivative products in recent years.

Those alumni have risen to senior positions at leading dealers globally, and are now at the forefront of steering the derivative markets during a period of increased regulation, low interest rates and a growing shift to electronic trading and clearing.

The *grandes écoles* — the rank of French higher education establishments that sit outside the country's university framework — have become the first step in producing today's derivative professionals, among others, with their quantitative economics, public policy and mathematical modelling programmes widely praised among financial market professionals.

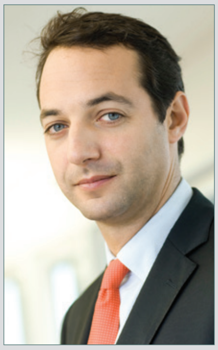
French banks, such as Société Générale and BNP Paribas, provide the second part of the graduate's development.

"One of the big advantages is that we have close links to polytechniques and other engineering schools, which are links that we have been developing over the last 20 years when developing the European derivatives markets. We work very closely with the schools and make sure we have a regular influx of students," says Dan Fields, head of global markets at Société Générale.

It is because of this structure that the desks of the major equity derivative dealers globally possess a vast number of ex-French bank and *grandes écoles* alumni across trading, sales, structuring and strategy. Benoit Savoret, a former SG trader who studied at the Ecole Centrale de Paris and is joint head of global equities at Nomura, is one example of a senior derivatives official who has benefited from the structure.

"We work very closely with the schools and make sure we have a regular influx of students"

Dan Fields,
Société Générale



"The reality is that French engineers, and quants in general, are throughout the industry and a lot of them start with us, as we make a certified effort to work with the engineering schools through our different hiring processes. We give those students a cutting edge platform that gives them access to product development and pricing issues," adds Fields. ▲

Insurers muscle in on French CRE funding

Stifled bank lending levels and a bleak macroeconomic outlook have left a French real estate market bifurcated into prime and non-prime sectors. Cash is, however, pouring into the prime sector, driven by lending interest from French insurance companies. **Joe McDevitt** reports.

FRENCH COMMERCIAL real estate is facing the same challenges as the rest of the European CRE market. Lending is down as banks deleverage and avoid incurring high costs of capital against their loan books. Investors are, for the most part, looking for prime assets.

As a result, refinancing outcomes have become very binary. High quality assets in good locations and with strong tenancy agreements tend to attract healthy lending interest, while financing for less desirable underlying assets is harder to come by.

Also in keeping with other European countries, the providers of real estate funding in France have diversified in the last few years.

Insurance companies and specialised real estate debt funds are participating in the space with greater intent than ever. And as bank lending shrinks, the market will become increasingly reliant on those new non-bank players.

Centralised, liquid market

The French real estate market is focused predominantly on Paris and the surrounding Île de France region.

Jean-Philippe Guillerault, head of international real estate financing at Crédit Agricole CIB, says: "Paris and Île de France represent 85% of the real estate investment market in France, which means you have a high volume of transactions every year. This gives the market a minimum of liquidity."

This level of liquidity gives the French market an advantage over other countries in Europe. Germany, for instance, has a larger commercial real estate market overall, but it is also spread out among several regions and cities. This decentralised characteristic means no single German city has the concentration of liquidity that Paris can offer to investors and lenders.

"For logistics or shopping centres prime locations are spread all over the country"

Nadine Glicenstein, BNP Paribas

This is not to say that all prime assets are located in Paris. The type of real estate involved is as important as the region or city.

"If you are talking about logistics or shopping centres, the discriminating criteria to assess the value is not location," says Nadine Glicenstein, real estate practice co-ordinator at BNP Paribas. "There's no difference between Paris-Île de France and other areas in France because prime locations for those types of assets are spread all over the country. But for offices it's different. Because the liquidity in office markets in regions is far less deep, those assets are considered less prime as a whole. Those markets require more selectivity."

While offices outside Paris may suffer because of their location, the same cannot be said of shopping centres. Strict French planning regulations make it notoriously difficult to receive approval to construct new shopping real estate. Those that have already been built therefore benefit from better liquidity than other asset types outside Paris.

France's real estate challenges lie less in the lingering effects of the price peak in 2006 and 2007 and more in the knock-on effect of an economic downturn.

"The real estate market is less volatile than in the UK or London. Market values have fallen since the last peak but less than in the UK," says Glicenstein. "The distinction between prime assets and medium quality assets is especially strong in France because the macroeconomic trends are perceived to be quite sluggish today. If there is no job creation, it is hard to imagine that rents in offices will stay where they are."

Unlike the UK and Germany, the French market is certainly helped by the country's reticence towards securitising commercial real estate loans before the financial crisis. French CMBS constitutes only 5% of the European market.

There is only one wholly French CMBS outstanding, Windermere XII, which is backed by the Coeur Défense building in Paris. Other assets were put into pan-European transactions. The Lumière office in Paris, the largest privately owned building in the city, for instance, was one of the loans in Quirinus EuroLoan 23 CMBS.

French banks are still important players in the real estate market. They have continued to extend loans from their own balance sheets, albeit in smaller size than before, and arrange lending for non-bank players looking for investment opportunities.

The tradition of banks working alongside development companies to underwrite construction projects, guaranteeing their completion, has also continued.

"Some of the foreign banks, from the UK or US, are not active in France anymore, but the number of players hasn't been impacted as it has in other markets," says BNP Paribas's Glicenstein. "There remain around five or six French banks that are really active in this type of financing, and we have two or three German banks that are still there."

BNP Paribas last year put together a €245m refinancing of a mixture of retail and office units, FOSCA 1 SCA, with five banks in total extending credit.

The global financial crisis has, however, taken a toll on banks' ability to lend in size. Large-scale financing solely through the bank market remains tricky, even in club deal format. Basel regulations have made the cost of commercial real estate lending much more expensive, reducing appetite for lending. Banks simply cannot match the volume of loans they provided in previous years, creating a refinancing gap.

Insurers step up

This has, however, presented an opportunity for non-banks, especially cash-rich insurance companies, to plug the hole. And they have grasped it with both hands.

Unlike in the US or UK, regulations in France stipulate that only banks can arrange lending for borrowers. But non-banks can still act as the underlying credit provider, as long as a registered bank arranges the loan.

"Historically, French insurance companies have been equity investors in French real estate assets: they started in purchasing office and residential assets, then also invested in purchasing shares in the largest Reits and recently have also started to fund mortgage loans arranged by banks," says Crédit Agricole's Guillerault.

Bankers say nearly all of the leading insurance companies in France and Germany are looking intently at the sector for investment opportunities as they are cash-rich and the real estate market can provide high returns to help them match their liabilities.

There are also several local debt funds that have entered the market, providing another source of funding. BNP Paribas, for instance, arranged a deal last year to refinance a €115m logistics portfolio for Blackstone which involved a handful of banks and a real estate debt fund.

"The new financing actors will increasingly be insurance firms. Borrowers may find it easier to refinance in the bond market"

Hubert du Vignaux, Gide Loyrette Nouel

Hubert du Vignaux, partner at law firm Gide Loyrette Nouel, says: "As a result of Basel III regulations the banks will not stop lending, but will reduce their lending capacity. Secondly, the new proposed insurance regulations reduce significantly their investment in shares to the benefit of bonds. It is highly likely that in France and the rest of Europe the new financing actors in the economy will increasingly be insurance companies. That's probably why as a borrower you may find it easier to refinance in the bond market."

According to BNPP, insurance companies prefer lending in bond format for their own management and accounting purposes, though they are still allowed to lend through whole loans.

Last year saw the completion of two large mortgage bonds, both involving insurance companies.

The first was a €472m refinancing of the Lumière office building. French insurance companies Cardif, CNP and Predica bought 90% of the deal, while the other 10% was allocated to BNP Paribas, which acted as arranger.

The five year bullet bond will pay the bondholders directly from rents from the buildings' tenants, which include Natixis and the French Ministry of the Interior.

There is no amortising feature to the bonds. If principal payment is not possible at maturity, the bondholders will be able to foreclose and sell the building.

This was followed by a €255m mortgage bond issued by Foncière des Murs, a real estate investment trust that belongs to Foncière des Regions.

Unlike the Lumière bond, the notes are not secured by a single asset but by a portfolio of hotels, and the deal was listed on the EuroNext Paris exchange.

Lawyers at Gide Loyrette Nouel, the law firm hired on both transactions, say the mortgage bonds have paved the way for more.

"[The mortgage bond market] is new, so investors and issuers will take time to see how it works, but the amount of issuance should increase"

Kamel Ben Salah, Gide Loyrette Nouel

"We've already been asked for several mortgage bond estimates, and at least two or three of them should be ready by the first half of this year," says Kamel Ben Salah, partner at Gide Loyrette Nouel. "These estimates are for deals that range between €70m and €700m. It is a new market, so investors and issuers will probably take time to see how it works, but the amount of issuance should increase."

If the performance of listed property companies in the capital markets is a bellwether of investor sentiment towards the sector, then the signs are promising.

The cost of funding for Unibail-Rodamco, the European real estate giant headquartered in France, fell consistently from the end of 2011 to the end of 2012. It paid 3.875% for six year funding in December 2011, 2.25% for six year funding in July 2012, and 1.625% for four year funding in October.

"Financing costs for listed French property companies fell last year, which is one reason why we will see a significant increase of cashflow for those companies in 2013 and 2014," says Michel Varaldo, head of European real estate research for Société Générale. "We anticipate a growth of cashflow on the continent of 3% in 2013 and 6% in 2014."

"The European property market outperformed last year with a total return of 28.7%, compared with average returns in the equity market last year of 16.9%," he added. "The main driver has been very low, long-term interest rates across Europe. In addition, investors are more confident in real estate companies because they have assets and it's tangible, so investors are willing to put up with a lower spread than before. It's a sort of flight to quality." ▲

France in figures: an economic snapshot

Over the following pages *EuroWeek* provides a snapshot of France's macro-economic, bond market and bank sector data, from a range of official sources, including the Agence France Trésor, the Ministry of the Economy and Finance, Banque de France, the European Central Bank, Eurostat and the rating agencies. For more detailed information, please refer to the websites of these institutions.

Standard & Poor's: AA+ • Moody's: Aa1 • Fitch: AAA • Outlooks negative

SELECTED KEY OFFICIALS

MINISTRY OF THE ECONOMY AND FINANCE

Pierre Moscovici
Minister of finance

Jérôme Cahuzac
Budget minister

Benoît Hamon
Minister for social economy

AUTORITÉ DES MARCHÉS FINANCIERS (FINANCIAL MARKETS AUTHORITY)

Gérard Rameix
Chairman

Benoît de Juvigny
Secretary-general

BANQUE DE FRANCE

Christian Noyer
Governor

Anne Le Lorier
First deputy governor

Robert Ophèle
Second deputy governor

AGENCE FRANCE TRÉSOR

Ambroise Fayolle
to be new CEO at AFT*
**unconfirmed*

Maya Atig
Deputy chief executive

STANDARD & POOR'S LATEST RATING UPDATE ON FRANCE - NOVEMBER 23, 2012

Ratings On France Affirmed At 'AA+/A-1+' On Commitment To Budgetary And Structural Reforms; Outlook Negative

Overview

- In our opinion, the French government remains committed to budgetary and structural reforms that would build on measures it has proposed so far to improve the country's growth potential.
- We are therefore affirming our unsolicited long- and short-term sovereign credit ratings on the Republic of France at 'AA+/A-1+'.
- The outlook on France is negative, indicating that we believe that there is at least a one-in-three chance that we could lower the ratings during 2013.

Rating Action

On Nov. 23, 2012, Standard & Poor's Ratings Services affirmed its unsolicited long- and short-term sovereign credit ratings on the Republic of France at 'AA+/A-1+'. The outlook is negative. Our transfer and convertibility (T&C) assessment for France, as for all European Economic and Monetary Union (eurozone) members, is 'AAA'.

Rationale

The affirmation reflects our opinion that the French government remains committed to budgetary and structural reforms that would build on the measures it has proposed so far and improve the country's growth potential. In particular, in the face of uncertain economic growth prospects, the government has already taken steps toward restoring competitiveness, by announcing the National Compact for Growth, Competitiveness and Employment this month, and toward compliance with its medium-term budgetary targets.

Source: Standard & Poor's, Nov 23, 2012

FITCH'S KEY RATING DRIVERS FOR FRANCE – DECEMBER 20, 2012

Long term issuer default rating AAA

AAA Status: underpinned by a wealthy and diversified economy with moderate levels of private sector debt as well as strong institutions and political stability.

Fiscal Policy on Track: France is set to meet or better its budget deficit target for the fourth consecutive year. The new administration is committed to deficit reduction, in particular meeting the 3% of GDP deficit target in 2013. Recently announced reforms, and in particular, transposing the fiscal compact into national law and the creation of the High Council of Public Finances is expected to strengthen the fiscal policy framework.
Years of Consolidation Ahead: The government plans to close the structural deficit by 2016 and bring the headline budget close to balance by 2017. Discretionary measures on the income side are front loaded while expenditure measures will be more constant over the next five years. If growth is below projections, greater consolidation on spending is likely to be needed.
Medium-Term Challenge: Placing public debt on a sustainable decline from 2014 implies multi-annual fiscal consolidation that the Fifth Republic has never previously achieved. Public spending and the tax burden is amongst the highest in the OECD and securing a drop in government debt over the medium term and enhancing competitiveness will be challenging without substantive fiscal and economic reform.
Debt Peaks Below 100%: The fiscal adjustment will be sufficient to start reducing the public debt to GDP ratio after a peak at about 94% in 2014. This is high among AAA peers but not inconsistent with the current rating. Under a stress scenario where the crisis in the eurozone intensifies, government debt could exceed 100% of GDP.
Slow Loss of Competitiveness: The trade and current account deficits have gradually widened with rising foreign liabilities and debt, underscoring concerns about the international competitiveness of the French economy and medium-term growth prospects. A national compact for competitiveness was recently announced by the government and reforms to the labour market are expected to be announced early in 2013.
Diminished Bank Risk: the risk of contingent liabilities arising from the exposure of French banks to troubled eurozone economies has diminished. Nonetheless, France's substantial trade and financial linkages to the rest of the eurozone render it vulnerable to a worsening of the crisis, including its commitments to the EFSF/ESM.
What Could Trigger a Rating Action
Failure to reform France's economy would undermine medium-term prospects for the country and increase the fiscal challenge.

Deficit reduction against a backdrop of weak growth and rising unemployment will be challenging. Worse deficit or growth outturns would be rating negatives.

A worsening of the debt crisis or crystallisation of French contingent liabilities through the eurozone crisis management system would also put the rating under pressure.

Good Progress: Meeting deficit targets and substantial progress on reform would support the affirmation of France's AAA rating with a Stable Outlook.

Source: Fitch Ratings, December 20, 2012

MOODY'S LATEST FRANCE CREDIT OPINION – FEBRUARY 18, 2013

Aa1 (negative outlook)

Credit Strengths
- A large, wealthy and diversified economy
- Robust institutions and competent administration
- Strong social cohesion
- Sound and innovative debt management

Credit Challenges
- Structural challenges, including a gradual, sustained loss of competitiveness
- Rigidities of labour, goods and service markets
- Relatively large government deficit and debt in relation to GDP
- Exposure to contingent liabilities arising from the support of non-core euro area countries

Rating Rationale
France's government bond rating is Aa1 with a negative outlook. The rating reflects the country's 'very high'/`high' Economic Strength, the robustness and transparency of its institutions which informs our assessment of `very high' Institutional Strength, the `very high'/`high' Government Financial Strength, and the `low' Susceptibility to Event Risk.

France's Economic Strength is supported by the economy's large size, its broad diversification, significant wealth as represented by GDP per capita, high private-sector savings, and an only moderate build-up of household and corporate liabilities. These features provide a capacity to absorb shocks, although risk factors like subdued growth prospects, a loss in competitiveness relative to trading partners, a gradual erosion of its export-oriented industrial base, and rigidities in labour, goods and service markets continue to constrain the country's medium-term economic performance.

The rise in France's real effective exchange rate reflects this erosion of competitiveness, in particular relative to Germany, the UK and the US. The challenge of restoring price-competitiveness through wage moderation and cost containment is exacerbated by France's membership of the European monetary union, which removes the adjustment mechanism that the ability to devalue its own currency would provide.

France's robust institutional framework is based on the government institutions' very high competence and depth. Moreover, the government's commitment to structural reforms and fiscal consolidation supports our assessment of `very high' Institutional Strength.

The French government is working on a reform programme to address the country's competitiveness issues, and the key measures are outlined in the National Pact for Growth, Competitiveness and Employment. Moreover, on the fiscal side, the European Treaty on the Stability, Coordination and Governance of the Economic and Monetary Union (TSCG) has been implemented through the Organic Law on Public Finance Planning and Governance, which envisages multi-annual planning laws that are binding for budget and social security financing.

However, France's Government Financial Strength has weakened as the global financial and economic crisis has led to a significant deterioration in government debt metrics - which are now weaker than those of France's Aaa-rated euro area peers. Moreover, we consider France's fiscal outlook to be uncertain as a result of its weakening economic prospects, both in the short term due to subdued domestic and external demand, and in the longer term due to the structural rigidities. As a result, Moody's sees a continued risk of fiscal slippage and of additional consolidation measures. However, in our view, Government Financial Strength is still `very high'/`high', particularly on the basis of debt affordability (interest burden in relation to government revenues) which remained comfortable at 5.0% in 2012. That said, this high debt finance-ability in an uncertain financial and economic environment rests on investors' confidence in the government's ability and willingness to tackle unforeseen challenges.

We assess France's Susceptibility to Event Risk to be `low'. On the one hand, the country's economic, financial and political situation points to a low risk of a sudden and sharp rating migration away from the Aa1 level. On the other, over 60% of outstanding French public debt is held by non-residents, and this internationally diversified investor base could turn into a source of potential vulnerability in times of stress. Moreover, the balance sheets of the sovereign and French banks could be negatively affected by the fragile confidence in the European financial markets, which could lead to episodes of market disruption, as well as by fears of contagion from the peripheral sovereigns. The increased contingent liabilities stemming from the support mechanisms for non-core euro area countries as well as from the French banks' sizeable exposures to stressed euro area countries, particularly to Italy, make France relatively more vulnerable than its peers to a potential deepening of the euro area debt crisis.

Rating Outlook The negative outlook on France's government bond rating reflects the weak macroeconomic environment, and our view that the risks to the implementation of the government's planned reforms remain material. Moreover, together with the remaining Aaa-rated euro area sovereigns, France's balance sheet is likely to bear the main financial burden of support via the operations of the European Financial Stability Facility (EFSF), the European Stability Mechanism (ESM) and the European Central Bank (ECB). Apart from France, these countries comprise Germany (Aaa negative), the Netherlands (Aaa negative) and Austria (Aaa negative).

What Could Change the Rating - Up
Given the current negative outlook on France's sovereign rating, an upgrade is unlikely over the medium term. However, we would consider changing the outlook on France's sovereign rating to stable in the event of a successful implementation of economic reforms and fiscal measures that effectively strengthen the growth prospects of the French economy and the government's balance sheet. Upward pressure on France's rating could also result from a significant improvement in the government's public finances, accompanied by a reversal in the upward trajectory in public debt.

What Could Change the Rating - Down
We would downgrade France's government debt rating further in the event of additional material deterioration in the country's economic prospects or difficulties in implementing reform. Substantial economic and financial shocks stemming from the euro area debt crisis would also exert further downward pressure on France's rating.

Source: Moody's Investors Service, February 18, 2013

MACRO-ECONOMIC FORECAST REAL GROWTH RATE (%)

	2011	2012	2013
French GDP	1.7	0.3	0.8
Euro zone GDP	0.8	-2.1	0.4
Household consumption	0.3	0.2	0.3
Business investment	5.1	0.1	1.5
Exports	5.3	2.7	4.8
Imports	4.9	1.3	3.8
Consumer prices (on an annual average basis)	2.1	2.0	1.8

Source: Ministry of the Economy and Finance

GOVERNMENT BUDGET MONTHLY POSITION (€bn)

			end of Nov level		
	2010	**2011**	**2010**	**2011**	**2012**
General budget balance	-150.80	-90.09	-141.10	-88.29	-96.87
revenue	274.89	275.23	241.57	246.97	250.78
expenditure	425.69	365.32	382.67	335.26	347.65
Balance of special Treasury accounts	2.00	-0.63	0.45	-8.86	-6.50
General budget outturn	-148.80	-90.72	-140.66	-97.15	-103.37

Source: Ministry of the Economy and Finance

RECENT ECONOMIC INDICATORS

Industrial output*, year-on-year	-3.2%	11/2012
Household consumption, year-on-year	-1.3%	11/2012
Unemployment rate (ILO)	10.3%	9/2012
Consumer prices, year-on-year		
all items	1.3%	12/2012
all items excluding tobacco	1.2%	12/2012
Trade balance, fob-fob, sa (€bn)	-4.3	11/2012
	-4.7	11/2012
Current account balance, sa (€bn)	-2.9	11/2012
	-2.9	10/2012
10-year constant maturity rate (TEC10)	2.27%	20/2/2013
3-month interest rate (Euribor)	0.221%	20/2/2013
€/$	1.3356	20/2/2013
€/¥	125.05	20/2/2013

**manufactured goods / Sources: Insee, Ministry of the Economy and Finance, Banque de France*

OVERALL RANKING: THE MOST ACTIVE SVTS IN 2012

Each year, since 1999, Agence France Trésor (AFT) publishes the league table of the most active primary dealers (SVTs) in French government securities. The assessment of SVT activity takes into account all aspects of their role: participation in auctions, presence in the secondary market, as well as the qualitative characteristics of their commercial relationship with AFT.

100 points are allocated among all 20 SVTs, with a weighting of 40 for participation in auctions, 30 for presence in the secondary market and 30 for qualitative characteristics. On this basis, the institutions that have obtained a score above the theoretical average of 5 points (i.e. 100 points divided by 20 primary dealers) for 2012 are as follows:

1 BNP Paribas
2 Société Générale
3 Morgan Stanley
4 Barclays Bank
5 HSBC
6 Natixis
7 Crédit Agricole
8 Royal Bank of Scotland
9 UBS

Primary, secondary and qualitative rankings

Primary market: For the participation in auctions and buybacks, the institutions which have a market share above 5 % are:

1 Morgan Stanley
2 BNP Paribas
3 HSBC
4 Barclays Bank
5 Société Générale
6 Natixis
7 Crédit Agricole
8 Royal Bank of Scotland
9 UBS

Secondary market: For activity in the secondary market, the institutions which have a market share above 5 % are:

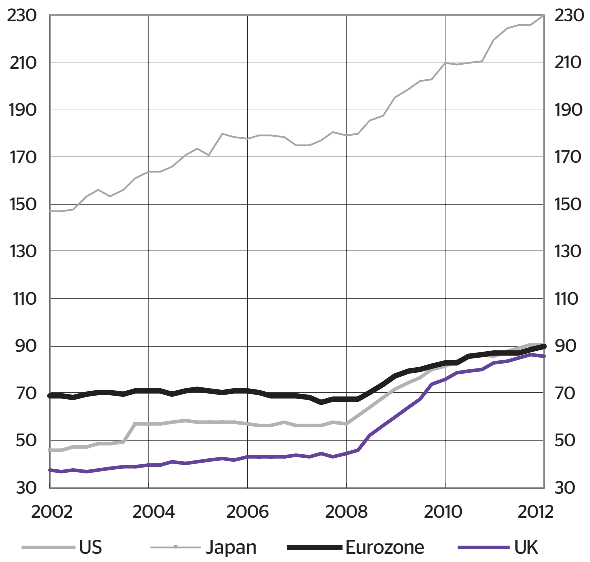
1 Société Générale
2 Barclays Bank
3 BNP Paribas
4 HSBC
5 Royal Bank of Scotland
6 Natixis
7 Crédit Agricole
8 Citigroup
9 Morgan Stanley
10 UBS

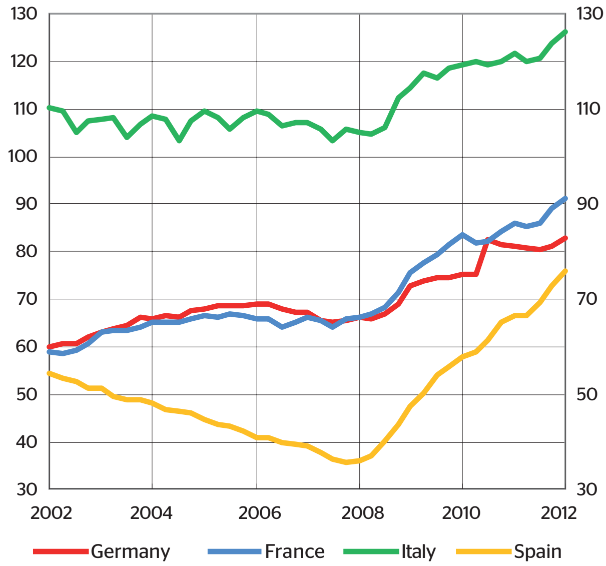
Finally, for the **quality of services** provided as primary dealers, the institutions which obtain an above-average score are:

1 Société Générale
2 BNP Paribas
3 Barclays Bank
4 Natixis
5 HSBC
6= Crédit Agricole
6= Deutsche Bank
8 Morgan Stanley
9= Crédit Suisse
9= UBS

Source: Agence France Trésor

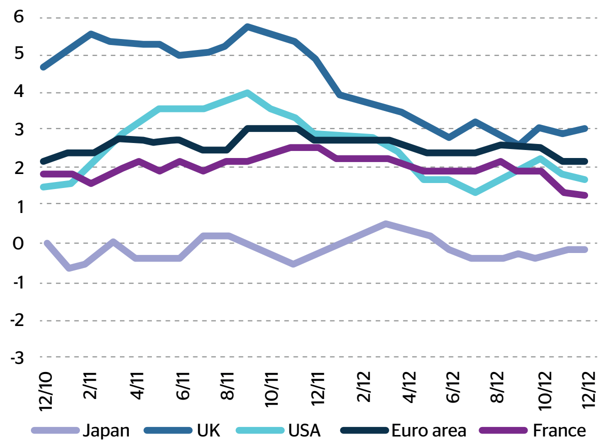
DEBT RATIOS (%) 2002-12





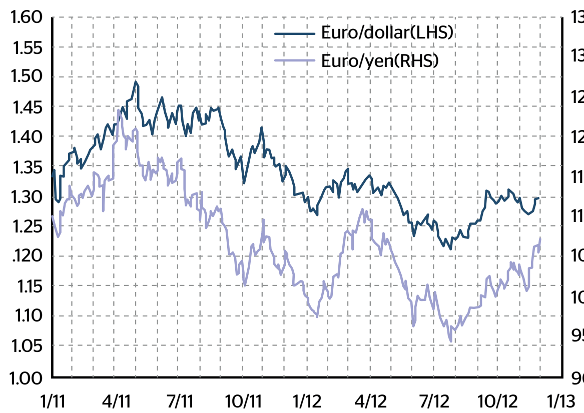
Source: Eurostat, directed by General Directorate of Statistics

CONSUMER PRICE INDEX: YEAR-ON-YEAR % CHANGE



Source: Statistical institutes

EURO EXCHANGE RATE: DAILY QUOTES



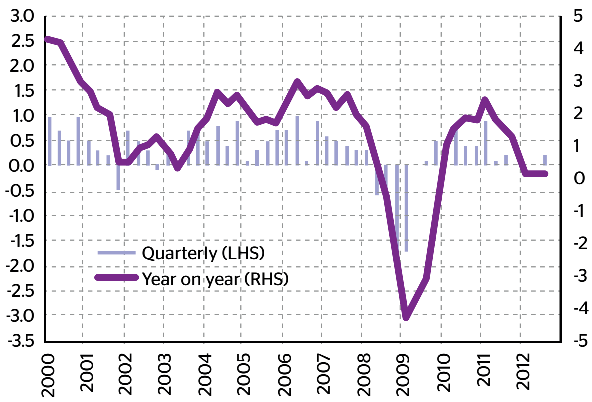
Source: European Central Bank

GOVERNMENT BOND PRIMARY DEALERS

Barclays
BNP Paribas
Crédit Agricole CIB
Citigroup
Commerzbank
Credit Suisse
Deutsche Bank
Goldman Sachs
HSBC
JP Morgan
Bank of America Merrill Lynch
Morgan Stanley
Natixis
Nomura
Royal Bank of Canada Capital Markets
Royal Bank of Scotland
Santander
Scotiabank Europe
Société Générale
UBS

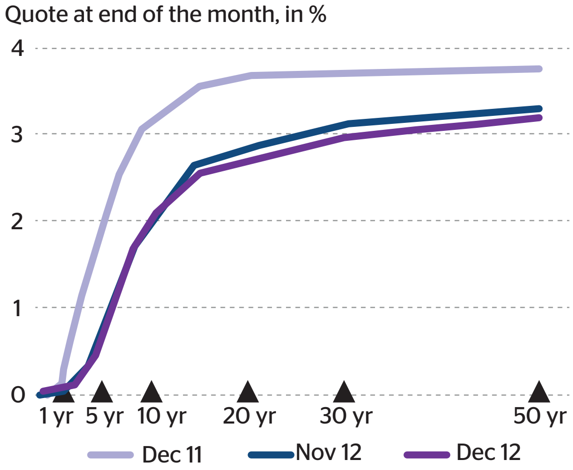
Source: Agence France Trésor

FRENCH GROSS DOMESTIC PRODUCT AT CHAIN-LINKED PREVIOUS YEAR PRICES: VARIATION IN %



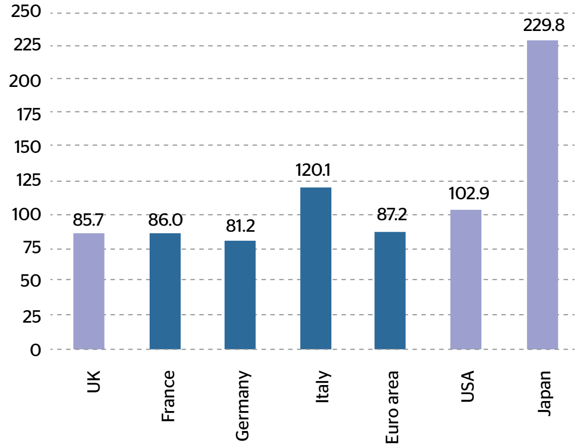
Source: National Institute of Statistics and Economic Studies, quarterly national accounts

FRENCH GOVERNMENT YIELD CURVE



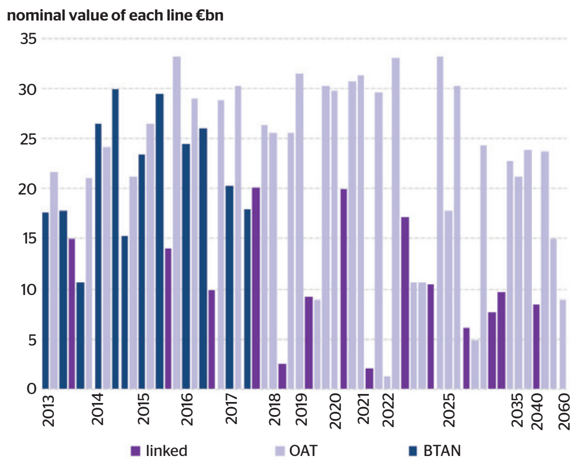
Source: Bloomberg

GENERAL GOVERNMENT DEBT IN 2011 AS A % OF GDP



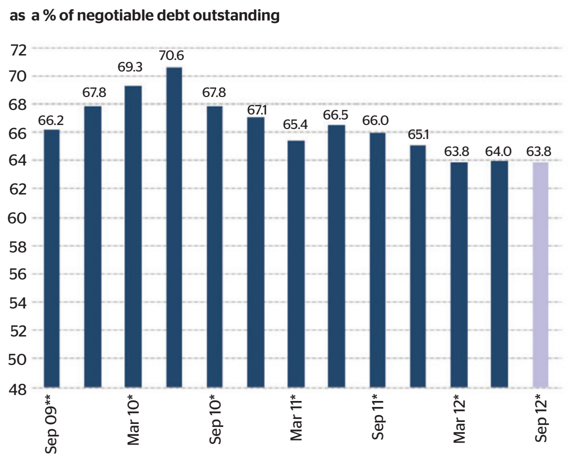
Sources: Eurostat (04/12), Insee (05/12), IMF(04/12)

FRENCH GOVERNMENT LONG AND MEDIUM TERM NEGOTIABLE DEBT ON DECEMBER 31, 2012



Source: Agence France Trésor

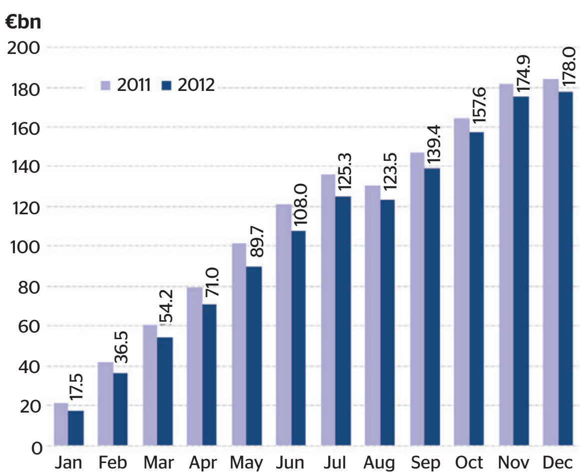
NON-RESIDENT HOLDINGS OF FRENCH GOVERNMENT NEGOTIABLE DEBT SECURITIES



(*) figures revised quarterly (**) figures revised annually

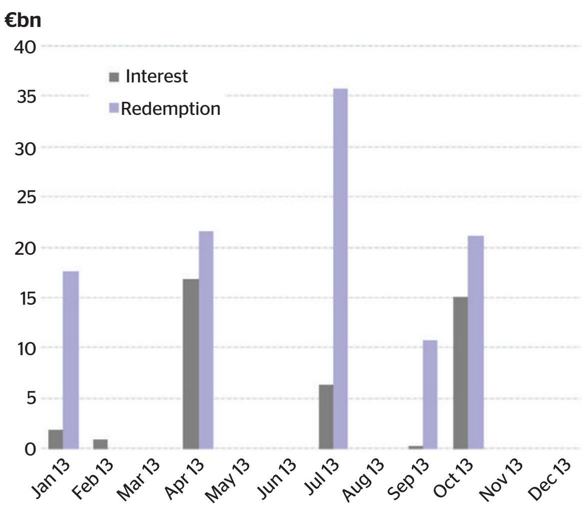
Source: Banque de France

LONG AND MEDIUM-TERM FINANCING OVER THE YEAR ON DECEMBER 31, 2012



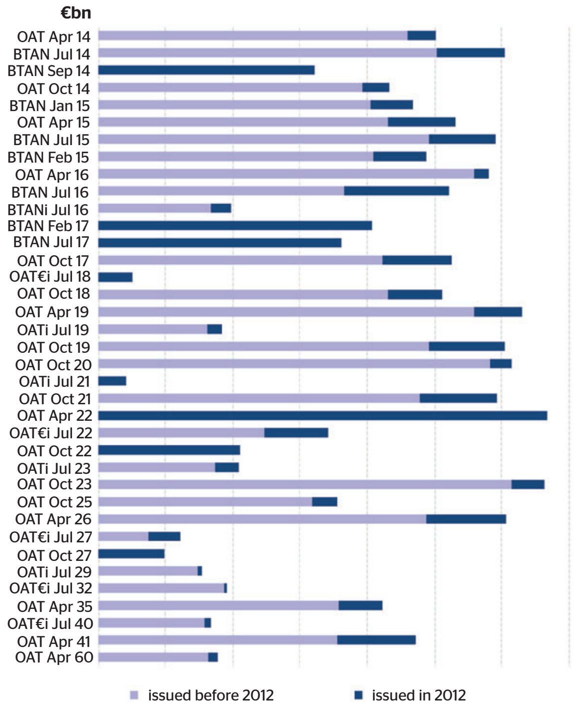
Source: Agence France Trésor

OATS AND BTANS: INDICATIVE REPAYMENT SCHEDULE ON DECEMBER 31, 2012



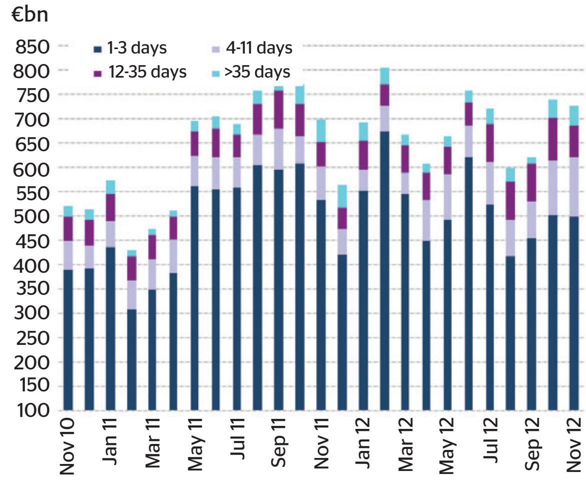
Source: Agence France Trésor

OATS AND BTAN ISSUES AND CUMULATIVE TOTAL ON DECEMBER 31, 2012



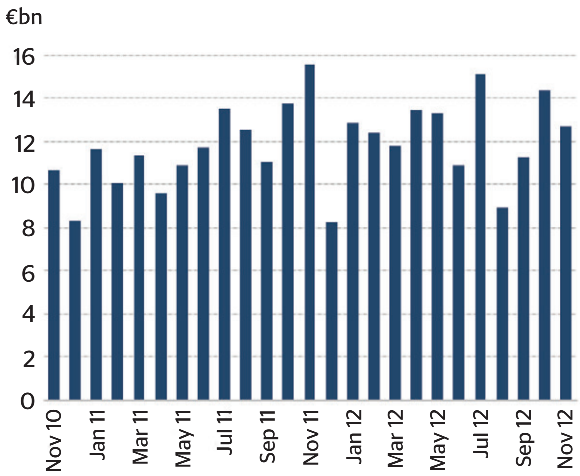
Source: Agence France Trésor

PRIMARY DEALERS, MONTHLY FIXED-RATE REPO TRANSACTIONS



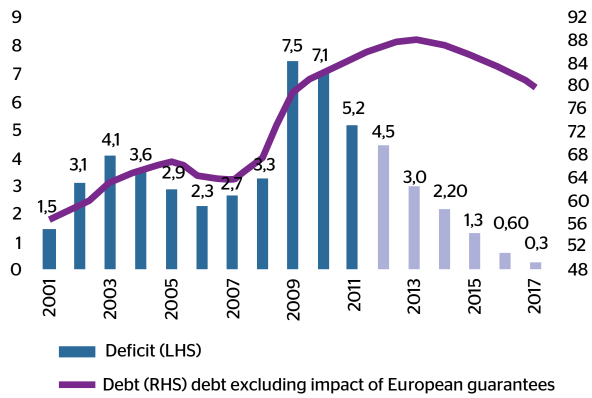
Source: primary dealers

AVERAGE DAILY TURNOVER ON OATS AND BTANS



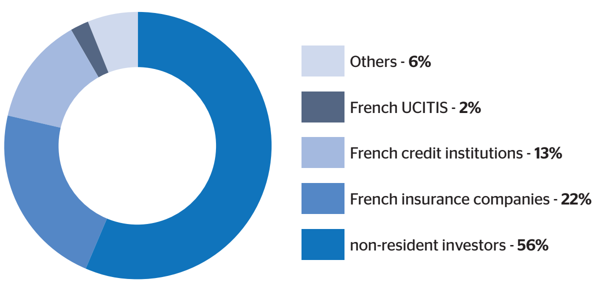
Source: primary dealers

PUBLIC FINANCE: GENERAL GOVERNMENT DEFICIT AND DEBT AS A % OF GDP



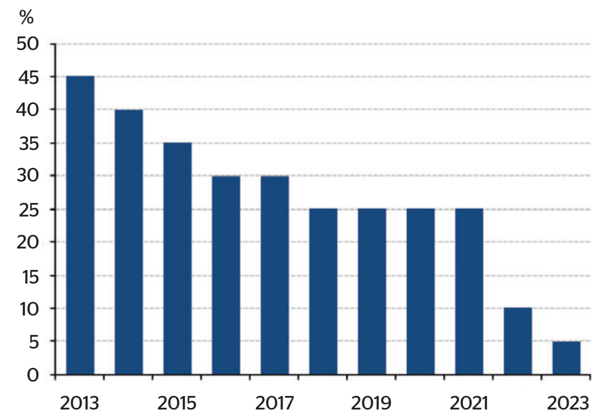
Source: Ministry of the Economy and Finance

OAT OWNERSHIP BY TYPE OF HOLDER: THIRD QUARTER 2012



Source: Banque de France

SHARE OF FRENCH DEBT ISSUANCES WITHOUT COLLECTIVE ACTION CLAUSES (IN %)



Source: Agence France Trésor