



RESPONSE BY SGCIB TO CEBS'S CP27

Implementing guidelines regarding hybrid capital instruments

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Executive Summary

Société Générale Corporate and Investment Banking ("SGCIB"), the investment banking arm of Société Générale¹, welcomes the opportunity to comment on the implementation guidelines regarding hybrid capital instruments released by the Committee of European Banking Supervisors ("CEBS"), further to the European Parliament's vote of the amendments to the Capital Requirements Directive ("CRD")

We support the process followed by the CEBS and consider it is useful and important that there exists a public consultation on this topic with interested stakeholders to ensure convergence and stability of the framework.

We highlight below the key areas where we feel that Consultation Paper 27 ("CP27") from CEBS could propose further notions in order to facilitate this convergence:

- on **incentive to redeem**, SGCIB believes that these should be qualified as such ex ante and that the limit proposed on stock settlement incentives are shareholder friendly more than they are regulator friendly
- regarding **buybacks**, the firm understands the market is already regulated minimum synthetic maturities to manage time horizons, and no further regulation should be needed ; given the many reasons why an issuer would repurchase such securities, SGCIB believes that a larger array of options should be open for issuers to manage their hybrid securities in the secondary market
- in relation to **flexibility of payment**, an hybrid distribution should not be triggered through a "dividend pusher" given a payment on a junior or pari passu security in shares exclusively ; also, given the nature of the current investor base, a payment in shares directly to holders may be negatively perceived by these fixed income investors. ACSM will be a welcome addition to the techniques available to structure instruments in most EU countries.
- **loss absorption** harmonisation is complex given different use of accounting standards and bankruptcy law across the EU ; we do not believe that CEBS should concentrate on any other aspects than regulatory but should welcome an array of loss absorption and return to financial health mechanisms
- regarding **limits**, SGCIB believes the following categories of hybrids could be set:

Category	Limit to Tier 1	Typical characteristics
Core Tier 1	None	Share capital Short dated mandatory convertibles, Perpetual deeply subordinated convertibles without call, non-cumulative, conversion in shares difficult times
Tier 1 hybrid	50%	Perpetual deeply subordinated instruments with call after 5 years minimum, non-cumulative, conversion in shares in difficult times
Tier 1 hybrid	35%	Perpetual deeply subordinated instruments with call after 5 years minimum, non-cumulative
Tier 1 hybrid	15%	Perpetual deeply subordinated instruments with call after 5 years minimum, non-cash cumulative, moderate step-up from year 10 Minimum 30 year deeply subordinated instruments with call after 5 years minimum, non-cash cumulative,

Of course, SGCIB would be pleased to have further consultations with CEBS on this topic, and will participate in the public hearing on 8 September.

¹ Société Générale Corporate and Investment Banking highlights here its views as an arranger of Tier 1 hybrid instruments and does not convey the views of Société Générale as an issuer.

1. Permanence / incentive to redeem

1.1. Are the guidelines in relation to incentive to redeem sufficiently clear or are there issues which need to be elaborated further?

In order to avoid confusion, the proposed wording on step-up calculation should be clarified for the case where it is 50% of the initial margin: "50% of the initial credit spread, less the swap spread between..." should be replaced by "50% of : the initial credit spread corrected by the swap spread between...".

Guidelines are otherwise clear and well in line with the definitions set by the Sydney Press Release from 1998, which is used as a bellwether by the whole market. One should state that incentives to redeem, whether a coupon step-up or any other mechanism, are evaluated at issue date: SGCIB does not believe that random changes to the cost of a benchmark should be seen as an incentive to redeem for the purpose of this principle.

For example, given a Tier 1 hybrid security offering a possible fixed rate remuneration of 6.50% from issue date until the first call date, and a 3M Euribor + 2.50% coupon thereafter (with no step-up in remuneration), floored at 6.50%, we look at the following alternatives should the instrument not be called:

3M Euribor rate fixing	2.50%	7.50%
Fixing + margin	5.00%	10.00%
Floor application	Yes	No
Remuneration for the fixing	6.50%	10.00%

In this example, we do not believe that either of the cases (especially when coupon is 10.00%) point to an incentive to redeem that could be qualified from the outset, as in many other cases involving activating options. Instruments with "a posteriori" incentives should not be falling in the category limited to 15% of Tier 1.

1.2. Please describe the potential impact of a cap of 150% relating to stock settlement of the conversion ratio. Please provide evidence.

The cap to the dilution proposed is well understood. SGCIB does not believe however that it is appropriate for CEBS to introduce this concept in the framework of the principles, or to fix such a precise limit to conversion ratio.

We are aware of the current events on instruments using such incentives to redeem and the lack of a cap to the dilution of the instrument. We do believe, however, that this general proposition to cap mainly creates a disincentive to exercise the call option by matching the interests of the shareholders, when the previous agreement from the competent authorities should be sufficient to avoid cash consumption and decrease in capital ratios.

SGCIB believes that banking regulator should not have to incentivize shareholders by giving them a protection of their position.

2. Permanence / buybacks

2.1. Are the guidelines in relation to "buy back" sufficiently clear or are there issues which need to be elaborated further? Please provide concrete proposals how the text could be amended.

The proposals are clear but stringent. SGCIB understands that, in addition to the constraints on buy-backs already imposed by necessary regulatory approval, the market already offers the level of comfort required by the proposals through self regulations: the largest segment of investors are fixed income oriented and are therefore looking for fixed time horizons for the investment that they are making for valuation purposes as well as for annuity management.

A buy-back exercise being by nature motivated by exceptional factors that are not forecasted at the issue date (as opposed to a fixed call date), a restriction such as the 5-year minimum threshold should not be imposed by CEBS guidelines.

2.2. Buyback cases

2.2.1 What would be the impact if buy-backs before five years after the issue of the instrument were only allowed under the conditions described in paragraph 72? Please provide evidence.

2 notions would be required to amend paragraph 72:

- Tier 1 hybrids, as per common equity, may be bought back at anytime;
- Institutions may replace instrument which they want to buy back with capital of at least the same or better quality before 5 years after the issuance date provided that the instrument has already been issued or is being issued through an exchange offer.

2.2.2 Please describe circumstances – other than current market conditions - in which a buy-back at an earlier stage without the requirement to replace them with instruments of the same or better quality would be justified from a prudential perspective.

Tier 1 hybrids are issued for a number of complementary reasons:

- Cost of capital
- Regulatory recognition
- Rating agencies recognition
- Accounting, e.g. capital becomes split in the same currencies as assets
- Tax
- Merger financing, etc.

Should any of these reasons become obsolete, the issuer has a case to redeem the instrument early, which it cannot propose to do in the market under the current circumstances.

2.2.3 Which criteria should be provided in order to address the above mentioned concerns, and in particular to avoid setting incentives to deplete the capital base of banks whose credit quality is decreasing?

Calls for early redemption may be approved for most of the above, from the initial documentation of the instrument. These may be additionally covered with substitution clauses which will ensure that documentation can be amended to allow the capital instrument to keep its original qualities

Unforeseen cases may not be discounted and regulators should be ready to discuss on a case by case basis.

2.3. What would be the impact of limiting the amount of repurchased instruments held by the institution at any time to 5% of the relevant issuance? Please provide evidence.

Our databases on positions held by SGCIB in certain subordinated lines for market making purposes went to a superior share of the total sizes. We believe 10% is the right mark.

3. Flexibility of payments

3.1. Are the guidelines in relation to dividend pusher or stopper sufficiently clear or are there issues which need to be elaborated further? Please provide concrete proposals how the text could be amended?

The proposals are clear. We would strongly recommend that the dividend pusher is not activated when a dividend payment is made exclusively in shares only (83, last paragraph).

3.2. What would be the impact of the restriction on the use of dividend pusher and stopper? Please provide evidence.

SGCIB accepts the rest of the proposal regarding dividend pushers, although we do not believe that a dividend pusher or a dividend stopper could hinder recapitalisation.

4. Flexibility of payments / ACSM

4.1. Are the guidelines in relation to ACSM sufficiently clear or are there issues which need to be elaborated further? Please provide concrete proposals on how the text could be amended.

The proposal suggests that ACSM does not necessarily require the issuer to find investors for the exercise of the ACSM and may deliver shares directly to the investors, for a fair value equal to the deferred coupon. While we are sympathetic of the idea, the reaction from investors is unlikely to be positive as fixed income investors are not able to hold onto equity (in ACSM, ordinary shares are often distributed to a representative of the securityholders, in a number sufficient for it to obtain the required amount by selling the shares into the market).

4.2. What would be the impact of implementing these guidelines on ACSM mechanisms? Would you propose any other options?

Such mechanism, if provided broadly across the EU, will allow further confidence from investors of the participation of shareholders in the solvency of banks, hence attract confidence and demand.

European laws are highly differentiated with regard to the issuance of shares underlying the use of ACSM, and SGCIB believes that the wording supports principles which are applicable in all European countries, bearing in mind:

- Length of board authorisations to issue shares;
- Equal treatment of investors;
- Ability to use trustees.

5. Loss absorbency

5.1. Are the guidelines relating to the definition of loss absorbency in going concern sufficiently clear or are there issues which need to be elaborated further? Please provide concrete proposals how the text could be amended.

The text is clear.

5.2. Do you agree with the definition of loss absorbency in going concern? If not why and what alternative would you propose?

Agreed.

5.3. Do the guidelines provide sufficient flexibility for institutions to design mechanisms that fulfil the objective of loss absorbency in going concern? What alternative would you propose? Does this flexibility raise level playing field issues?

The premises of paragraph 109 suggest that debt instrument should have a mechanism that qualifies them as equity under stress scenario from an accounting perspective (to determine an insolvency situation). The guideline may lead to improper accounting mechanisms whereby a dated Tier 1 hybrid instrument (considered as debt under IFRS, and limited to 15% of total Tier 1 under CRD rules) may become more subordinated than other less limited Tier 1 hybrid instruments (if converted in equity for example).

Concerning the fact that hybrid instruments should not hinder recapitalisation, paragraph 112 clearly states that “the new capital provided to recapitalise the institution should not be used directly or indirectly to benefit existing hybrid holders”. Some existing instruments currently have a provision whereby once the “principal write-down” trigger is breached, the issuer is required to propose a share capital increase – to the extent legally and economically possible – before writing down the principal of the notes. We understand that such a feature is a way to ensure that the capital increase is realised soon enough (which avoids, together with complementary provisions, using funds from a recapitalisation to serve payments to hybrid holders), and does not contravene with CEBS guidelines.

This can be combined with the trigger for write-down or conversion mechanism to be applied (paragraphs 115 and 116): we agree on the fact that it may happen before a breach of the required solvency levels, in the case where the competent authority has determined that the deteriorating financial condition of the issuer may lead to a breach of the required solvency ratios in the short term.

Concerning write-up, we agree that a pari-passu mechanism with common dividend payment is an adequate trigger. We understand that the proposed guidelines do not prevent the existence of other triggers, not directly linked to payments made to ordinary shareholders or other subordinated instruments holders, under the condition that these triggers reflect a sufficiently strong solvency and accounting situation of the institution (consecutive periods of profits, etc.).

5.4. Do you think that different levels of subordination allow sufficient transparency on the ability of these instruments to cover losses in liquidation? Alternatively, would you prefer to completely preclude different ranking between hybrids?

Different levels of subordination are sufficient to demonstrate hybrid instruments' ability to cover losses in winding up.

In addition, different layers of hybrids, given standard definitions of subordination for a class of given instruments (Shares, Core Tier 1 non-share instruments, Tier 1 hybrids, Tier 2 subordinated) are most suitable, and it is not our recommendation to completely preclude any order of priority among hybrid instruments themselves.

6. Limits

6.1. Are the guidelines relating to the assignment of hybrids instruments to one of the three limits sufficiently clear or are there issues which need to be elaborated further? Please provide concrete proposals how the text could be amended.

The proposed wording is clear.

6.2. Do you believe that the conditions imposed to mandatory convertible are proportionate and balanced? Would you propose any other options?

Our views differ substantially from the proposed guidelines in the sense that instruments which should convert into shares with certainty (i.e. that have no possibility to be redeemed in cash through a call option) should be classified as Core Tier 1 rather than Tier 1 hybrids. One of the reasons is that there is no fixed income market for such instruments not repayable in cash, and that only equity investors would be able to buy such securities.

SGCIB therefore believes that the initial approach from CRD on instruments which could qualify beyond 35% and up to 50% of total Tier 1 should have the ability to:

- have a call option date after 5 years,
- convert into ordinary shares in “emergency situation” or at the discretion of the competent authority.

We also believe that the features proposed by CEBS in paragraph 131 (“an issuer should have the flexibility to convert at any time”) are not market practice, and that such characteristics should not be imposed to instruments qualifying within CRD’s “50% limit”.

As it imposes “equity-like” features, the proposed wording of CEBS guidelines for instruments falling into the category beyond 35% of total Tier 1, should instead allow these to be accounted for as Core Tier 1 (such as preferred shares), and hence not be subject to quantitative limits.

Likewise, shorter-dated mandatory convertibles instruments, which will convert mandatorily into ordinary shares at a pre-determined date at the latest and at a pre-defined price should be accounted for as Core Tier 1, and introduced into the Capital Requirements Directive environment through appropriate CEBS guidelines.

7. Indirect hybrids

- 7.1. Are the guidelines relating to the indirect issues of hybrids instruments sufficiently clear or are there issues which need to be elaborated further? Please provide concrete proposals how the text could be amended.**

SGCIB do not have comments on this.