



RESPONSE BY SGCIB TO CEBS'S CP17

Common EU definition of Tier 1 hybrids

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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 draft proposal for a common definition of Tier 1 hybrids presented by the Committee of European Banking Supervisors ("CEBS")

We support the proposal issued by the CEBS and consider it useful and important that there exists a public consultation on this topic with interested stakeholders on the development of the own funds framework. This will ensure that the desired convergence of financial supervision in the European Union will not trigger any side effect arising from the inconsistencies of the legal, fiscal and accounting frameworks, mainly.

In SGCIB's view, it is indispensable to monitor and to re-consider the appropriateness of these tools and structures on an ongoing basis, in order to ensure that these allow supervised institutions to benefit from a level playing field vis-à-vis own funds instrument.

We highlight below the key areas where we feel that Consultation Paper 17 ("CP17") from CEBS could propose further notions in order to facilitate this convergence:

- Disclosure regarding capital adequacy and capital instrument mechanisms need to be made more widely and on a detailed level,
- Mandatory Convertible Securities should be recognised as Tier 1 hybrids,
- Permanence of Tier 1 hybrids, in line with shares, need to be managed based on the economic benefit of these securities, possibly under the supervision of regulators,
- Loss absorption mechanisms need to retain conversion into non-cumulative preference shares (rather than ordinary shares) in order to avoid accounting and tax issues raised by write-up and write-down mechanisms as well as investors concerns with pure equity instruments,
- ACSM rules proposed by CP17 could be relaxed to ensure that the level playing field ensured by this mechanism on the fiscal front is preserved between European banks,
- Limits could be set as to minimise "sliding effect" of a loss on the regulatory capital.

Of course, SGCIB would be pleased to have further consultations on a bilateral basis with CEBS on this topic, and would make itself available as was done on previous occasions.

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. General principles

1.1. Easy access to Tier 1 information and mechanisms

We agree with paragraph 33 of CP17, regarding the notions of public disclosure and easy understanding of the mechanisms of the instrument, which we believe is strongly in the interest of investors and will ensure that the mechanisms for the day-to-day functions of the instrument or those which may be required in time of stress are well-known and will limit any speculation from market participants.

The proposed principle will require that banks add regulatory calculations (i.e. figures retreated through prudential filters) in annual / interim reports, which we believe will be of key importance to market analysts and/or investors. However, based on the evolution of the capital requirement under Basel 2's Pillar 2, we are not certain that the publication of "*the proportion of Tier 1 it accounts for and the Tier 1 requirements it effectively meets*" will provide the necessary element of regulatory discretion.

Also, we believe that the mechanism under which the instrument will work will need to be detailed, yet it may not be "easily understood". We have observed that qualified investors were often turning to investment banks to explain the mechanisms of certain detailed clauses. In any case, Tier 1 hybrid instruments falling in either of the category of with or without incentive to redeem could state so on the first page of their prospectus.

1.2. Mandatory Convertible Securities specifics

CEBS makes mentions of Mandatory Convertible Securities in paragraph 89. We add that these instruments are short-dated, and due to mandatory conversion will provide Core Tier 1 capital upon the maturity date. CEBS rightly mentions that such products allow investors to receive shares solely.

SGCIB proposes mandatory convertible securities to be eligible for Tier 1 treatment. Given the strong equity content of such instruments, SGCIB proposes that such structures are treated similar to Tier 1 hybrids with no incentive to redeem for as long as they are not converted. This may be subject to complementary rules.

1.3. Permanence

In paragraph 41, CEBS suggests that "*principal stock settlement mechanisms must contain a cap on the conversion ratio in order to limit potential dilution*". Despite the strong economic background to this statement, we do not believe that CEBS needs to limit the structure of Tier 1 to take dilution into account. Such considerations are new to the principles set out in previous regulatory texts and add shareholders' considerations to the constraints regarding Hybrid Tier 1 instruments. We do believe that CEBS' members will be in a position to limit this dilution on a case by case basis, should this type of event be detrimental to the member's policy.

As mentioned under paragraph 72, early redemption is generally accepted by most CEBS members under conditions of changes in tax leading to a lost benefit from the instrument or changes in the regulatory recognition of the instrument. We believe that CEBS acknowledges therefore the necessity for banks to manage their Tier 1 instruments in relation to their economic value and should therefore open cases of buying back such securities to a larger number of events, e.g. including changes in the rating agencies recognition, accounting recognition, etc.

1.4. Loss absorbency

On a more general note, and as we testified to CEBS in a session on 22 October 2007, we face rules, codes and general obligations that require that fixed income hybrid capital investors are barred from receiving equities. As a result, we do expect largely diminished demand for Tier 1 hybrids bearing loss absorption through conversion in ordinary shares. As mentioned in CP17 (paragraph 101 and 102), only 1% of instruments are structured to convert in ordinary shares in this case, while 18% can convert in perpetual non-cumulative preference shares, showing the usual practice of the market where the fixed income nature of the instrument is preserved in loss absorption. We strongly reiterate our comment from October 2007 that loss absorption remains in preference shares rather than ordinary shares.

We suggest that paragraph 43, in line with previous publication from European Supervisors, should allow hybrid capital to rank senior to all forms of share capital, both ordinary or extra-ordinary (e.g. savings shares, preference shares, etc. available in most jurisdictions).

On the mechanism of write-up and write-down, CEBS may want to clarify its position between paragraph 110 and the final sentence of the conclusion on loss absorption: will CEBS accept that payment are made while the instrument is written down (at the lower principal amount for calculation of interest) or will CEBS prefer that no distribution is made for as long as the instrument is written down?

SGCIB observes that this write-up and write-down mechanism are creating some concerns on the accounting and fiscal front, which may therefore limit the benefit of CP17 for issuers in creating a regulatory level playing field for Tier 1 hybrid instrument.

On the basis of the question as to conversion in ordinary shares and this last issue, we recommend that CEBS offers the ability for issuers to use conversion into perpetual non-cumulative preference shares or write-up/ write-down as the sole accepted methods to achieve loss absorption.

1.5. Flexibility of payments

CEBS wisely introduces ACSM as an accepted form of non-cumulation from an issuer's perspective. SGCIB strongly backs this view and would like to add some comments for practicalities.

Paragraph 57 of the proposal is laying out that ACSM will function with:

- Authorised and unissued shares, which we agree with as it replicates the standard methodology available for existing Tier 1 instruments bearing this feature, although poses some corporate law issues and hinders issuers to place treasury stock, which would also allow to free Tier 1.
- Subscribed by the instrument holders, which, as per our preamble on loss absorption is likely to be severely punished by fixed income investors, who are not allowed to hold shares.
- Exercised immediately, which we feel puts more pressure on the share price, dilution aspects and moreover puts pressure on the issuer amid difficult conditions. Leaving timing issues in the hand of the issuer may allow better market management, with the strong possibility that such an ACSM could be activated immediately to preserve investor's interest.

Under paragraph 54, CEBS suggests that ACSM may be blocked under supervisory event which has strong implications from a tax perspective for a number of jurisdictions.

Finally, we do not believe that the inclusion of an ACSM within the mechanisms of payment for an issuer will create an incentive to redeem and would suggest that such instrument count within limits depending on the presence of this incentive (e.g. step-up or principal share settlement).

2. Convergence on quantitative limits

2.1. Mathematical challenge of the proposed implementation

In previous discussions with CEBS, we have regularly acknowledged the potential slide which may affect capital ratios under a stress scenario and we feel that the proposed limits may need to be slightly amended:

Given the following example, where a bank regulated under the proposed limits has maximised its usage of hybrid and subordinated capital:

	Issued	Limit
Required Tier 1 capital	100.0	
Core Tier 1 capital	100.0	
Hybrid Tier 1 with incentive to redeem capital	30.0	15% Total Tier 1 = 30.0
Hybrid Tier 1 without incentive to redeem capital	70.0	50% Total Tier 1 – HT1 with incentive = 70.0
Total Tier 1 capital	200.0	
Total Tier 2 capital	200.0	100% Total Tier 1 = 200.0
Total capital	400.0	

Given a loss of 10 taken by the company, the following cascade would result in a decrease of the total capital available of 30 as per the usually known vicious effect of regulatory limits calculation.

	Issued	Limit	Recognised
Required Tier 1 capital	100.0		
Core Tier 1 capital	90.0		90.0
Hybrid Tier 1 with incentive to redeem capital	30.0	27.0	27.0
Hybrid Tier 1 without incentive to redeem capital	70.0	63.0	63.0
Total Tier 1 capital	190.0		180.0
Total Tier 2 capital	200.0	180.0	180.0
Total capital	390.0		360.0

Moreover, as an added constraint, should the company fall at or below its regulatory limits as in the example below, the limits available for Hybrid Tier 1 would fall to 30% of Total Tier 1, as in the example below, with a hit of 55 on the initial example.

The result here is a depletion of the capital from (i) the sliding effect above and (ii) the change in limit of 216.6 on the regulatory capital of the company. The capital of the company has however been really impacted in cash terms by 55 only.

	Issued	Limit	Recognised
Required Tier 1 capital	100.0		
Core Tier 1 capital	45.0		45.0
Hybrid Tier 1 with incentive to redeem capital	30.0	9.6	9.6
Hybrid Tier 1 without incentive to redeem capital	70.0	9.6	9.6
Total Tier 1 capital	145.0		64.2
Total Tier 2 capital	200.0	64.2	64.2
Total capital	345.0		128.4

2.2. Alternative approaches

2.2.1 Unique limit for “required” and “above limit” Tier 1

We believe that the method for setting a unique limit for the Total Tier 1 Hybrid as a part of the Total Tier 1 capital provides the best results. In recent years, we have had several discussions with regulators on this topic and witnessed that convergence seems to appear to increase the share of so-called “non-innovative Tier 1” in the total Tier 1 structure of supervised entities.

- A limit set at 50% from the outset would allow all banks to benefit from a level playing field from the inception of the new Tier 1 rules
- A limit set below 50% will negatively impact banks in jurisdictions such as Germany, Ireland, the Netherlands, the United Kingdom and would have to become a limit to be gradually implemented to allow the Issuer with Hybrid Tier 1 above the chosen limit to gradually increase their Core Tier 1

2.2.2 50% limit to be available only for excess capital

Alternatively, CEBS may implement a method where the capital built in excess of the required position will benefit from the 50% limit whereas the capital below the mark will remain constrained to the 70%/30% limit.

This approach will allow the supervisor to better limit sliding effects.

It will however create other issues which will be related to disclosure:

- Required Tier 1 capital will not be disclosed by the regulator, in particular under Basel 2
- Capacity calculations which are transparent to market participants (e.g. for their internal risk, capital markets, equity modelling) will be more difficult to define

Our preference is to set a unique limit for Tier 1 hybrids, leaving banks to define the adequate proportion within this limit to avoid any “sliding” impact resulting from a difficult exercise.

3. Grandfathering features

Based on our internal discussions as well as recent conversations with regulated clients, the proposed functionalities of the grandfathering for the purpose of this discussion paper is in line with expectations.

The expected implementation calendar gives further confidence to most market participants that they will be able to start adjusting the documentation of their future Tier 1 hybrid transactions shortly after the local legislations are put in place.