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Research Update:

Societe Generale Outlook Revised To Positive On Plans For Loss Absorption Buildup; 'A/A-1' Ratings Affirmed

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Overview

- We consider that Société Générale (SG) is making rapid progress in the execution of its medium-term financing plan, in particular the buildup of a sizable buffer of bail-in-able debt (TLAC- and MREL-eligible instruments), protecting senior creditors.
- We are affirming our ratings on SG and its rated subsidiaries, and revising the outlook to positive from stable on SG and those group entities that are eligible for additional loss-absorbing capacity (ALAC) uplift.
- The positive outlook reflects our expectations that SG's loss-absorbing buffer will reach 8% of risk-weighted assets (RWAs) by mid-2020 and that the group will enhance profitability in line with 'A+' rated peers.
- We don't expect a change in our stand-alone assessment on SG, hence our issue-level ratings on hybrid debt are likely to be unchanged.

Rating Action

On Oct. 23, 2018, S&P Global Ratings affirmed its 'A/A-1' long- and short-term issuer credit ratings on France-based bank Société Générale and its core banking entities.

We affirmed our 'A+/A-1' long- and short-term resolution counterparty ratings on the group entities operating in countries where there is an effective resolution regime and that would be part of a bank resolution strategy.

We revised to positive from stable the outlooks on all the entities notched from the supported group credit profile (see Ratings List below for full details).

We affirmed all the issue-level ratings on the subordinated and hybrid capital instruments issued by group members.

We also raised our long-term ratings on France-based car leasing and fleet management company ALD S.A. to 'BBB+' from 'BBB', and affirmed our ratings on the France-based insurance company Sogécap and maintained a stable outlook.

Rationale

The outlook revision primarily reflects our expectation that SG will continue to build a sizable buffer of total loss absorption capacity (TLAC) and minimum requirements for own funds and eligible liabilities (MREL) protecting senior creditors while strengthening the bank's intrinsic creditworthiness with a stand-alone credit profile (SACP) we expect to remain at 'a-'. For the stronger buffer of additional loss-absorbing capacity (ALAC) to translate into a stronger rating, we would also have to see SG delivering its strategic targets of improving profitability and efficiency, which today compare unfavorably with most 'A+' rated banks in Europe.

Since year-end 2016, SG has already issued about €13 billion of senior nonpreferred debt. We estimate that the ALAC buffer already represented more than 5% of S&P Global Ratings' RWAs at year-end 2017, which is commensurate with an issuer credit rating one notch above the SACP. We now expect the ALAC ratio will increase steadily to well above 8% in 2020. Our views are informed by SG's announced objective to comply with TLAC requirements and transition toward higher total amounts of required buffers. We incorporate into our forecast the issuance of about €6 billion of senior nonpreferred debt instruments per year, in the lower range of the 6 billion-€7 billion issuance amount communicated by SG. In the meantime, we expect SG will maintain the other layers of its capital structure around their current level.

Given our expectations of a gradual buildup of ALAC, and the existing track record of ALAC buildup, we could include a second notch of ALAC uplift in our ratings on SG and other eligible subsidiaries (see Ratings List below) within the next two years, likely around mid-2020 when our 8% requirement is firmly met.

We use two adjustments for the ALAC threshold, which cancel each other out: we qualitatively adjust down the threshold by 25 basis points (bps) considering the impact in our ALAC calculation of the group's insurance operations and car lease operations, which inflate our RWAs, but would be excluded from a required bail-in process under the French resolution framework, in our view. Conversely, we adjust the threshold up by 25 bps to reflect prepositioning risk.

From a credit perspective, the issuance of loss-absorbing capital is positive as it reinforces the balance sheet and further protects senior creditors in resolution. Still, for an upgrade to 'A+', which would place SG in the top quartile of EMEA banks, the bank would need to close the profitability gap with 'A+' rated peers. The bank's business model is strong and diverse from a geographic and business standpoint, but does not yet deliver returns in line with potential. We note this element is central to the bank's own strategic objectives.

SG's medium-term plan to 2020 also entails a moderate risk asset increase, and a gradual strengthening of core capital ratios and financial performance, on the back of growing intragroup synergies and effective cost control. We will monitor to what extent the evolution of our metrics of core capital adequacy, cost efficiency, and overall financial performance confirm a successful execution of the medium-term strategy.

We expect SG to increase its earnings capacity and keep focusing on improving cost efficiency, not only in its French retail banking division, where low interest rates limit revenue generation and investments to adapt the business model weigh on cost, but also in the Global Banking and Investor Solutions division, which significantly depresses the group average. We will also monitor to what extent the bank can improve the contribution of insurance to earnings and increase cross-selling, which in our view is below the level of French peers'. We note that SG has ambitions to materially improve its cost-to-income ratio to 63% in 2020, from 67% at end-June 2018 (company metrics). We expect to see a similar 3%-4% improvement for our efficiency measure, noninterest expenses to operating revenues, which stood at 70% in 2017.

We forecast that our risk-adjusted capital (RAC) ratio (before diversification) will be in the range 8.5%-9% in the next 18-24 months, supported by stable underlying income and low-single-digit growth in S&P Global Ratings' RWA. At year-end 2017, we estimated the group's RAC ratio at 8.2% (7.9% at end 2016). We estimated the first time application of IFRS9 as of Jan. 1, 2018, represented a 20-bps reduction of the RAC ratio pro forma at year-end 2017, which mostly explains why we do not expect any meaningful strengthening of the ratio in 2018.

We note SG's strategy to rebalance slightly its loan portfolio in favor of lending opportunities that are better-remunerated than mortgage lending in France. Given our more conservative risk weights, we believe that our RWAs are likely to increase by about 3% year on year, with more modest growth of the loan portfolio.

According to its strategic plan, SG expects to generate about 25 bps of core capital annually. We note the group aims to report a common equity tier 1 capital ratio of 12% or more by 2020 (from 11.1% fully loaded at end-June 2018).

We expect consolidated income to be in the €4 billion-€4.5 billion range on average in 2018-2019, reflecting resilient underlying profit, thanks to a resilient group average net interest margin, more synergies developed with specialized subsidiaries like Sogécap and ALD in France and abroad, low cost of risk, and cost containment. We believe that persistent low interest rates will continue to affect SG's net interest margin in its domestic activities, similar to other French banks.

Financial performance has been affected by nonrecurring items in recent years, in particular provisions for litigation. SG has made significant progress in the settlement of legal disputes. At end-September 2018, SG's collective reserve for disputes amounted to a material €1.4 billion. In 2017, the bank posted a charge of €963 million as a result of the settlement signed with the Libyan Investment Authority, and another $1.3 billion of penalties in June 2018 to settle investigations regarding the Libor and Libyan counterparties cases. SG expects that the investigations and proceedings linked to the economic sanctions ordered by the U.S. authorities will be settled in the coming weeks. It considers itself adequately covered by the current provision for disputes. Although the sizable provision built by SG is set to cushion the potential impact of litigation risks on profitability, we do not rule out the possibility of further charges following the repeated allocations to collective provisions for disputes since 2012, but to a lower extent.

We measure SG's return on average common equity at 5.3% on average during the past five years, whereas most of its largest Western European peers display a ratio in the 7%-10% range. As we expect further one-off expenditures to be only small, we expect this measure to converge toward the peer average in the next two years, with return on average common equity standing in the 8%-9% range by 2020. Meeting these strategic objectives will be demanding but achievable in our view.

A second notch of ALAC uplift would leave issue-level ratings on hybrid debt unchanged because we notch them from the 'a-' SACP.

We reviewed the strategic importance of ALD for the group and raised our long-term ratings on the company to 'BBB+' from 'BBB'. The upgrade reflects our views that given ALD's financial contribution and role in SG's Financial Services division, its strategic importance has strengthened despite the IPO launched in 2017. It leads us to expect a stronger likelihood of extraordinary support from SG. The stable outlook reflects our expectation that SG will maintain its commitment and support for ALD through its control of the entity and provision of significant funding and liquidity. The outlook is stable because we consider that ALD as a corporate subsidiary would not be part of bank resolution scenario and is therefore not eligible for ALAC uplift.

We affirmed our ratings and stable outlook on Sogécap as insurance activities are outside the scope of a bank resolution in our view.

Outlook

The positive outlook on SG reflects our expectation that we may raise our long-term ratings on SG to 'A+' in the next two years if the group continues to steadily build a buffer of loss-absorbing instruments protecting senior creditors while delivering on its medium-term strategic objectives. This could occur if SG builds up a sustainable buffer of bail-in-able debt representing an equivalent of at least 8% of our RWAs. We believe SG will likely build such a buffer given its medium-term strategy to comply with TLAC and MREL requirements mainly by issuing a material amount of senior nonpreferred instruments. The strengthening of loss-absorption capacity would lead us to incorporate a second notch of ALAC support in our long-term issuer credit ratings, likely toward the end of our two-year outlook horizon, around mid-2020.

We would also need to observe that profitability and efficiency are improving in line with SG's medium-term strategic targets, therefore closing the gap with 'A+' rated peers in our view. In particular, we expect SG's return on average common equity to converge toward 8%-9% by 2020, while our measure of non-interest expense to operating revenues should reduce toward 65%, and our RAC ratio is likely to be in the 8.5%-9% range over our two-year rating horizon.

The outlook also reflects our view that SG will continue to demonstrate a measured risk appetite, in particular regarding acquisitions.

We could revise our outlook to stable if:

- The gradual buildup of ALAC buffer falls short of our expectations, for instance because of a more rapid growth of S&P Global Ratings' RWAs, or lower core capital generation due to unexpected exceptional items, for instance substantially higher litigation costs compared with current reserves; or
- The bank fails to structurally improve its profitability and cost base, and we expect its performance to compare negatively with that of 'A+' rated peers.

Ratings Score Snapshot

Issuer Credit Rating	A/Positive/A-1
SACP	a-
Anchor	bbb+
Business Position	Strong (+1)
Capital and Earnings	Adequate (0)
Risk Position	Adequate (0)
Funding and Liquidity	Average and Adequate (0)
Support	(+1)
ALAC Support	(+1)
GRE Support	(0)
Group Support	(0)
Sovereign Support	(0)
Additional Factors	(0)

Related Criteria

- Criteria - Financial Institutions - General: Methodology For Assigning Financial Institution Resolution Counterparty Ratings, April 19, 2018
- Criteria - Financial Institutions - General: Risk-Adjusted Capital

Framework Methodology, July 20, 2017

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- General Criteria: Guarantee Criteria, Oct. 21, 2016
- Criteria - Financial Institutions - Banks: Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- Criteria - Financial Institutions - Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- General Criteria: Principles For Rating Debt Issues Based On Imputed Promises, Dec. 19, 2014
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Financial Institutions - Banks: Assessing Bank Branch Creditworthiness, Oct. 14, 2013
- Criteria - Financial Institutions - Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Financial Institutions - Banks: Commercial Paper I: Banks, March 23, 2004

Related Research

- ALD Upgraded To 'BBB+' On Business Growth And Strategic Importance To Societe Generale; Outlook Stable, Oct. 23, 2018

Ratings List

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Ratings Affirmed

Komercni Banka A.S.
Societe Generale Bank & Trust
Societe Generale (New York Branch)
Franfinance
Credit du Nord S.A.
Societe Generale
 Resolution Counterparty Rating         A+/--/A-1

Societe Generale
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Credit du Nord S.A.	
Certificate Of Deposit	
Foreign Currency	A
Local Currency	A/A-1
Franfinance	
Certificate Of Deposit	
Foreign Currency	A
Local Currency	A/NR
SG Americas Securities LLC	
Resolution Counterparty Rating	A/--/A-1
Sogecap S.A.	
Issuer Credit Rating	
Local Currency	A-/Stable/--
Financial Strength Rating	
Local Currency	A-/Stable/--
Societe Generale	
Senior Unsecured	A
Senior Unsecured	Ap
Senior Subordinated	BBB+
Subordinated	BBB
Junior Subordinated	BB+
Junior Subordinated	BBB-
Commercial Paper	A
Commercial Paper	A-1
Credit du Nord S.A.	
Senior Unsecured	A
Commercial Paper	A-1
Franfinance	
Commercial Paper	A-1
SG Issuer	
Resolution Counterparty Liability	A+
Senior Unsecured	A
Senior Unsecured	Ap
SG Structured Products Inc.	
Senior Unsecured	A
Senior Unsecured	Ap
SGA Societe Generale Acceptance N.V.	
Senior Unsecured	A
Commercial Paper	A
Societe Generale (Canada)	

Commercial Paper	A-1	
Commercial Paper	A-1(MID)	
Societe Generale Effekten GmbH		
Senior Unsecured	A	
Societe Generale N.A. Inc.		
Commercial Paper	A-1	
Sogecap S.A.		
Subordinated	BBB	

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Komercni Banka A.S.		
Societe Generale Bank & Trust		
Societe Generale (New York Branch)		
SG Americas Securities LLC		
Franfinance		
Credit du Nord S.A.		
Societe Generale		
Issuer Credit Rating	A/Positive/A-1	A/Stable/A-1

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.