BNP PARIBAS
CORPORATE & INVESTMENT BANKING

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CONFIDENTIAL

Feedback to CEBS on its Draft Proposal for a Common EU Definition of Tier 1 Hybrids (the "DP")

This feedback has been prepared by BNP Paribas' Fixed Income department and follows our experience in structuring and placing bank hybrid capital transactions. Our feedback is based on our own experience and discussions with issuers, investors and regulators as well as rating agencies, tax and legal advisors. This content of this memo does not constitute official feedback from BNP Paribas SA as a regulated bank and issuer of capital markets securities. We have formally discussed the issues and questions raised by the DP with various other market participants and issuers.

Executive Summary

- A complex and comprehensive prescriptive set of rules defining capital is not appropriate because of differences in tax and national company law between Member States. Instead a commonly agreed set of design principles (based around permanence, loss absorption and flexibility) could be applied by local regulators on a case-by-case basis. In any case, when a financial institution is below its minimum required capital, a regulator has the ability to retain full control of the bank and hence hard-wired mechanisms may not be appropriate

- EC should not legislate and define capital before Basle's review on the definition of capital or EFRAG's review on classifying debt or equity instruments is completed as it may leave European financial institutions disadvantaged relative to the rest of the world.

- Although we understand the starting point was to harmonise limits, and especially limits applicable to "non-innovative" Tier 1 beyond 15%, this is not achieved by the current paper. On the contrary, the proposal actually increase the differences among EU countries based on their legal, tax and regulatory framework as the proposal has too specific instrument requirements

- Loss Absorption: CEBS guidelines do not achieve the desired outcomes and more importantly have a number of undesirable consequences.
  - Write-down is not effective, does not increase the capital base of an issuer, and creates a taxable profit in many Member States
  - Mandatory conversion into ordinary shares may prove counter-productive forcing financial institutions into a cul-de-sac, at a time when flexibility is most needed and when decisions should be made on a case-by-case basis
  - Results in a shift in issuance trend from simple, easily understandable directly-issued hybrid instruments to complex, cumbersome documented transactions that rely on SPV based technology featuring potential operational and cross-border risk

- Flexibility of Payments: 1) Limited rationale for limiting ACSM to 15% of Tier 1 capital. 2) Immediate ACSM is highly undesirable for issuers and existing shareholders. The issue of accumulation of deferred interest may be solved in other ways

- Limits: should be applied at issuance as stated by the SPR and applied before 50/50 Tier 1/Tier 2 deductions are taken into account.

- Grandfathering: Current guidelines are likely to lead to the re-pricing of instruments in the secondary market. Such grandfathering options might also reduce the flexibility that firms have over their capital management and may put firms under strong pressure to redeem non-qualifying instruments

Should you wish to discuss any aspects of our commentary with us in more detail, we would be happy to arrange a meeting or conference call to speak in person.

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GENERAL APPROACH ON CAPITAL AND EU CONVERGENCE

In general, BNP Paribas agrees with the objective of determining a uniform set of principles across the European Union (EU), but we believe CEBS' initial guidelines may be overly prescriptive and may have negative implications for the European banking sector.

We understand the European Commission's (EC) objective is to achieve convergence as much as possible between Member States. Such convergence may be helpful in achieving a level playing-field in terms of competition and, to the extent possible, cost of capital but should not bring undue tension to the European banking sector. However, tax, accounting and national company law are in practice far more important factors in achieving a level playing-field and have not all been achieved yet.

Because of these differences, a prescriptive rules based approach that restricts innovation may not be appropriate, especially where such innovation has no impact on the quality of capital for prudential purposes. Generally, principles-based regulation should enable the market to evolve and also provide a sound capital base for regulated institutions. Policy should be flexible enough to apply to newly-developed instruments. A rules based approach would lead to an unintended outcome of: (1) new instruments being developed in the market (in order to work around existing legislation) without such legislation matching its pace, (2) continuing structural divergence rather than convergence across Member States resulting in the risk of an unlevel playing field being created. Rules should also not restrict financial institutions from an existing wide, diverse and deep funding base for capital. It is important to ensure this diversity of this investor base is maintained as during a downturn, this diversification can be crucial to maintain access to funding and capital. In times of stress this enhances the chances to raise significant amounts of hybrids when the equity markets are closed, and can be an important part of any solvency restoration plan.

CEBS' proposed guidelines have gone far beyond the EC's original stated objective of integrating the Sydney press release into EU legislation. The Sydney Press Release (SPR) was based on the notion of replicating a "preference share" through innovative hybrid instruments. It appears CEBS has gone beyond this by interpreting SPR's key principles (permanence, loss absorbency and flexibility of payments) and in many cases gone beyond the Basle Committee's requirements. In effect, CEBS most comparisons are made with ordinary shares, not preference shares, as a reference point. It seems CEBS is overly focused on core Tier 1 without recognising that different capital instruments are appropriate in an issuer's capital mix.

The EC should not go too far (for now) in defining capital as this is currently being reviewed by the Basle Committee (now that Basle II has been (or will shortly be) mostly integrated), and hence the EC should wait to see Basle's recommendations on the definition of capital before legislating within the EU. Although we recognise the tangible benefits of harmonisation throughout the EU, we believe it is more relevant to ensure that current regulations of leading EU countries are not restricted to the lowest common denominator and where possible should be "Basle-friendly" to not result in European banks being at a significant disadvantage compared to North America and Asia.

Lastly, the current proposal has been drawn with the last five year's perspective during which issuers have enjoyed attractive conditions for issuers. In that context, investors were willing to purchase instruments which provided regulatory friendly features at limited cost. The market may have turned and investors may become increasingly discerning about the features they are willing to accept. In that context, some features from a strictly rules-based approach may not be practically saleable to the market at a time where banks badly need capital.

1. CEBS PROPOSAL FOR A COMMON EU DEFINITION OF "PERMANENCE"

a) Contractually Undated

CEBS has stated that they will require all Tier 1 instruments to be "contractually undated". This goes beyond the notion of "permanent" as stated in the SPR. It can be argued that a contractually undated maturity may not necessarily be required if the capital instrument has strong enough features to ensure that the capital is fully paid up and available when needed. We do not believe there is any formal need to be contractually undated. In a number of jurisdictions globally, in the case of existing dated Tier 1 instruments, a lock-in feature is provided which means the capital can not be repaid at maturity if to do so would breach the financial institution's capital resources requirement. Repayment is permitted once the firm's capital resources have been restored and replacement with similar equity-like capital has been arranged.

Technically, directly issued Italian Tier 1 instruments are dated securities. Furthermore, US banks can raise Tier 1 through dated instruments which can prove a strategic advantage when market conditions deteriorate markedly.

b) Callable Subject to Prior Supervisory Approval

Currently in many Member States only prior notification is required. Additionally, in some Member States redemption can occur automatically as long as the instruments are replaced with similar instruments. Such methods facilitate efficiency and are consistent with the general Basle ethos of moving from prescription to principles based regulation.

c) Step-ups

We agree with CEBS guidelines and believe all Member States should adopt an either / or approach on: (i) 100bp step-up or (ii) 50% of the initial credit spread. The flexibility to chose the 50% of initial spread is particularly important given recent market conditions and for lower rated financial institutions within Member States.

We do not believe there should be legislation that states a <u>one</u> time *only* step-up is permitted but instead CEBS should be focused on the aggregate step-up amount over the call period being no larger than (i) or (ii) above.

d) Principal Stock Settlement Mechanisms

We agree with CEBS that such a clause creates an Incentive to Redeem. However, we don't think it is necessary to specify a cap. Although we believe a cap may be appropriate, this should be decided on a case by case basis by regulators with issuers based on their specific circumstances.

We would stress that in current market conditions, this may be supportive of capital transactions.

A contractually undated maturity may not be required for the capital to be available when required. A potential alternative would be dated securities with a "lock-in" provision.

BNP Paribas supports regulatory oversight on call provisions, but this may not be necessary if the instruments are replaced with similar instruments

The limits on step-up provisions are acceptable, but there is no need to require a one-time only step-up.

In terms of principal stock settlement, in order for a cap to be effective, it should be decided in conjunction with regulators on a case-by-case basis.

2. CEBS PROPOSAL FOR A COMMON EU DEFINITION OF "LOSS ABSORPTION"

CEBS' recommendation for loss absorption to be achieved does not have the required outcome via either (i) a write-down/up mechanism or (ii) a conversion into ordinary shares.

We find it surprising the CEBS is pushing to hard-wire such mechanisms into capital instruments: if a bank's Tier 1 ratio falls below 2%, it's likely that it would have already been placed under regulatory control and in that case, the relevant regulator would be in position to decide what action would be preferable, crucially on a case by case basis resulting in a remedy that's appropriate for the financial institution's unique problem at the time. Over-prescriptive regulation may inadvertently drive banks into problematic cul-de-sacs exactly at the point when flexibility is most needed.

Such clauses may also adversely affect the depth and/or pricing of the capital markets for hybrid Tier 1 securities as many fixed income funds are prevented from purchasing securities with equity-linked features. In addition, a write-down/up mechanism may result in "equity" classification by the National Association of Insurance Commissioners (NAIC) in the United States which represents probably over 40% of the US buyer base for hybrid securities. European financial institutions will therefore be negatively impacted from raising cost-efficient regulatory Tier 1 capital (see page 2, paragraph 3 for further information on this point).

(i) Write down/up Mechanism

Firstly, we would like to stress that by definition Tier 1 instruments protect the cash position of the issuer at time of stress because payments are suspended (on a non-cash cumulative basis) and there is no maturity while the call option is subject to prior regulatory consent. During such times, hybrid holders are already similar to equity holders (except that they do not have voting rights).

Conceptually we do not believe such a mechanism achieves the desired outcome and instead results in some undesirable consequences for European financial institutions. We understand that CEBS has considered permanent write-down and temporary write-down. We would strongly oppose a permanent write-down as it would fundamentally expropriate hybrid holders while equity holders still have exposure to all potential upside. Any permanent write-down may hurt hybrid capital raising significantly.

Looking at the proposal of temporary write-down, where the claim is re-instated in liquidation, we fail to see the actual benefits from a regulatory perspective. CEBS has not explained what the tangible regulatory benefits of a temporary write-down mechanism are. We would like to highlight a few facts that the CEBS should consider:

- The write-down feature does not aid in the restoration of capital to the bank, or does not increase the amount of capital that a financial institution holds.
- There may be a perception that this feature may help the capital position of the firm by changing the ratio of equity to hybrid instruments. But we believe this perception is wrong:
    - from an IFRS perspective it does not achieve the desired outcome of creating "profit" if implemented as proposed by CEBS because the write-up is automatic. In that case, the effect of the write-down is simply ignored for accounting purposes because it is temporary and the write-up is beyond the issuer's control.
    - If the proposal was adjusted to be accounted appropriately under IFRS (such as the write-down being made permanent and/or subject to issuer's discretion only), in many European jurisdictions it would create a taxable profit for the issuer which may not be offset by tax

losses (because they are in a foreign jurisdiction for example). It is not appropriate for a capital instrument to create an economic liability, representing a cash drain from the institution when cash preservation is most needed

Furthermore, a write-down of a hybrid instrument:

(a) is not consistent with tax-deductibility of direct-issue hybrid instruments in many Member States (e.g. UK, Netherlands, Belgium)

(b) is merely optical in nature representing only a book-keeping entry (which as explained above may not even work under IFRS)

(c) in some Member States (e.g. UK, France), the insolvency analysis is such that a hybrid Tier 1 instrument (even if the legal or accounting form is debt) is not used to determine whether a financial institution is insolvent and hence a write-down feature provides no tangible benefits

Loss Absorption may lead to Resurgence in SPV Issuance

Because of the above-mentioned issues, issuance within some Member States will result in a shift in issuance trend from a direct template to SPV-based technology for the issuance of Tier 1-qualifying capital. The SPV would be incorporated in jurisdictions where the tax implications of the write-down are less severe.

Many regulators over the last five years have expressed their preference for direct-issuance as the documentation is simple to understand from all perspectives (regulator, issuer and investors). SPV based technology has been quoted as featuring operational based risks arising from cross-border risk and less transparency. Consequently, such a shift as a result of CEBS guidelines may be undesirable and result in overly complicated structures.

SPV issuance may also cause potential problems with respect to Article 70 of the CRD on solo-consolidation. For example, in some countries like Austria, there is no possibility to solo consolidate an SPV. Furthermore, this may lead to "backdoor" restrictions, where specific loss absorption requirements are also required on the on-lending instrument between the SPV and the regulated Bank. Such requirements may cause tension from a tax perspective and solo Tier 1 capital may not be tax-deductible in certain Member States creating more arbitrage.

Loss absorption and Preference Shares

Preference shares have traditionally been the first types of hybrid instruments and hence provided the benchmark for the SPR. As they are legally equity, they were assumed by definition to meet all requirements for hybrid Tier 1. Countries like Spain or France have in the past few years modified their corporate law and tax law for hybrid Tier 1.

Based on discussions with legal advisers, we believe that the currently contemplated loss absorption mechanism may not be compatible with Corporate Law in most jurisdictions. This would mean that what is currently the best form of issuing hybrid capital will have to be abandoned.

Although this is not explained in the CEBS DP, we understand that the key issue the regulator wants to address is ensuring that existing hybrids are not seen as a liability if a bank is being recapitalised.

We understand the regulator's concern and offer some thoughts:

- By nature, all situations are different. In case of recapitalisation, there can be an ad-hoc meeting organised with existing hybrid holders which would be asked to accept specific sacrifices in exchange for an infusion of equity. This does not

need to be documented in the instrument itself and would be led in conjunction with the regulatory authorities at the time of such restructuring.

- If a write-down/up mechanism is incorporated it is essential to ensure that relative subordination of hybrid and equity holders is maintained. Hybrid holders should not be penalised before resources provided by existing shareholders have been fully and permanently depleted. We believe the Danish and Swedish models of write-down/up provide good precedents for this. Under these templates, shareholders have the ability to write-down the principal only if the share capital and reserves have been reduced to zero, and either sufficient new capital is subscribed, or the Issuer ceases to carry on its business without a loss for its non-subordinated creditors.

- A potential enhancement could be to disable any dividend pusher or stopper until the Bank is deemed to be fit again. This can enable dividend payments to the new shareholders while existing hybrids still fully support the Bank. As a reminder, the Dividend Pusher and Stopper is generally required in hybrid instruments to maintain payment discipline on hybrids (in the absence of voting rights).

In summary, an even better solution is the Italian direct issue Tier 1 template. These structures feature a "suspension" clause following a breach of regulatory requirements. This provides for the suspension of: the principal amount, rights to any coupons and redemption, while a breach of regulatory requirements is occurring.

We do not believe that investors would be willing to be redeemed below par at time of financial stress. The likely scenario is that the regulator will not be giving the approval for call and hence the security would be extended.

(ii) Conversion to Ordinary Shares

The automatic conversion of hybrids into ordinary shares may prove counter-productive in a stress scenario. We believe this would generate a number of issues which may simply compromise any attempt to restructure the financial institution:

- Fixed income investors are not holders of equity securities (in some cases they are prevented from doing so). They will sell the shares, or require that someone sells on the behalf, in order to get repayment. This would create massive supply at a time at which the share price would likely be very depressed and may prevent any third party investor to subscribe for new shares

- Limiting the maximum dilution is possible but then it would expose investor to potential capital loss while they are only subordinated credit. This would technically qualify as "common equity" under NAIC's definition hence increasing the cost of US$ capital raising for EU financial institutions

- If the conversion is into an unlimited number of shares, it may result in new controlling shareholders

- Mutual financial institutions do not have ordinary shares. Even if they have equivalent securities, these securities are not sold to institutional third party investors. As a result, the conversion will simply not work for mutual banks

We find no tangible benefit to a write-down clause in terms of recapitalisation of the bank or creation of "profit" for IFRS purposes. A "suspension clause", in which principal and coupon payments are suspended while a breach of regulatory minima is occurring, would be a more effective alternative.

Conversion into ordinary shares is, at best, counterproductive as fixed income investors will sell immediately the shares which will hurt the stock price and, at worst, unfeasible (i.e. for

mutual banks). Also the conversion raises technical issues from a legal and financial perspective (is it a convertible bond ? where to put the cap ?).

3. CEBS PROPOSAL FOR A COMMON EU DEFINITION OF "FLEXIBILITY OF PAYMENTS"

While CEBS recognises the value of an Alternative Coupon Settlement Mechanism (ACSM) from a tax perspective, it proposes to limit to 15% all instruments featuring ACSM as well as providing strict rules for such payment settlement:

- Only through authorised and un-issued ordinary shares.
- ACSM to take place immediately as CEBS believes accumulation is undesirable. However, this would force issuance of shares during time periods of financial distress which may not be beneficial or even feasible for financial institutions during such periods. On the contrary, the best option is to provide full flexibility to the Issuer to decide when the shares should be sold.

We believe the solution to the concern of the CEBS is not the immediate settlement which may compound the problem but actually to avoid the "accumulation" effect. In some EU jurisdictions, there are accepted ways to deal with this by, for example, making the deferred interest ranking junior to the hybrid securities. This is accepted by Moody's as sufficient to avoid accumulation.

We do not believe it's appropriate to limit the ACSM clause to only 15% of an issuer's Tier 1 capital. ACSM clauses do not result in any economic cash outlay of existing financial resources either during financial distress or even when a financial institution has restored its financial resources. We do not understand CEBS rationale for its objections with an ACSM clause and why it is being limited to only 15%. Furthermore, settlement securities should not be limited to just ordinary shares but to any Tier 1-qualifying securities.

Inclusion of an ACSM clause should not automatically result in a 15% limit as ACSM does not result in any economic outlay during or after periods of financial stress.

Immediate ACSM should not be required, as this actually decreases an Issuer's financial flexibility in times of stress. We believe the key point is avoiding accumulation which can sometime be feasible (by getting deferred interest ranking pari passu with shares until they are paid).

4. CEBS PROPOSAL FOR EU LIMITS ON THE INCLUSION OF HYBRID INSTRUMENTS IN TIER 1 CAPITAL

In general, we believe fixed limits are inevitably arbitrary and not principles-based. Limits also act as a disincentive to issuing capital above the prescribed limits because it is not counted as eligible capital even if it meets the characteristics of (either going or gone concern) capital and improve the capital base of an entity.

We believe the current proposal implies three substantial draw backs:

- The application of limits "at any time" as opposed to "at time of issuance" as prescribed in the SPR, will lead to a double negative impact on Tier 1 when a bank starts to report losses affecting its core Tier 1. We do not see the benefit of

such measures as the hybrids that may be disqualified will still be providing the financial institution with the required payment flexibility and the ability to absorb losses.

- The proposed guidelines of 50 / 50 for Core Tier 1 / Hybrids Tier 1 switching to 70 / 30 when the minimum capital requirement or the target requirement is breached are also counterproductive. It would create a "cliff" effect during distress situations and increases the volatility of capital ratios. We can not see any regulatory benefit in such approach that will hurt the financial institution even further while the amount of Tier 1 capital remains the same.

- Our understanding is that the current rule for calculation of the 15% limit (after goodwill but pre-deductions which impact 50% Tier 1 and 50% Tier 2) may change so that all deductions are taken into account before the limits are calculated. We do not see how this is justified and what the logic is when on the asset side the CRD has moved deductions into RWA.

We propose a financial institution should always hold a minimum level of capital purely in equity form. Hybrids for the minimum required capital should be limited to 30%. However, the amount of hybrids in excess of regulatory minima should not be limited and should be decided issuer by issuer based on the deemed risks of the financial institution.

There should be no super-equivalence that permits more favourably limits in certain Member States versus others.

The key purpose of limits should be to reduce the volatility at capital ratios at time of stress. As a consequence, limits should be enforced at the time of issuance rather than at any time. Limits being enforced at any time will lead to a double negative effect as the bank begins to encounter Core Tier 1 losses.

As an alternative to outright limits, there should be a minimum amount of core capital required. Hybrid capital could then be issued to the extent desired by each institution. We understand the FSA has made such a proposal in CP 07/9 "Definition of Capital" published in December 2007.

5. CEBS PROPOSAL FOR GRANDFATHERING RULES

In general grandfathering provisions, where instruments no longer qualify as regulatory capital either after a pre-set period of time or after the first call date, have a number of adverse consequences. Both options effectively date tier 1 instruments. This is likely to lead to the re-pricing of instruments in the secondary market. Such grandfathering options might also reduce the flexibility that firms have over their capital management and may put firms under strong pressure to redeem non-qualifying instruments.

Grandfathering provisions should be unqualified and unrestricted such that all currently qualifying instruments should remain qualified (as Basle normally does), especially until the Basle Committee concludes their thoughts on the definition of capital.

Grandfathering provisions should allow all currently qualifying instruments to remain as such, at least until the Basle Committee releases their final conclusions on the definition of capital.

CONCLUSION

The CEBS proposal could be so much better. It is not self-evident that the desired "level playing field" is best achieved through a complex, comprehensive and prescriptive set of rules and limits. Surely, a commonly agreed set of design principles (probably based around permanence, loss absorption and flexibility) could be applied by local regulators on a case-by-case basis.

On the sticky principle of loss absorption, the answer does not need to be complex: so long as regulators are able to prevent coupons being paid when a bank breaches its minimum capital requirement, capital is preserved in a stressed situation.

And as for limits, why not cap hybrid usage at 30% of minimum required capital but remove limits on its contribution to excess capital? Likewise with grandfathering: why not grandfather all existing issues and allow business growth to naturally and gradually erode their importance -- after all, after 30 years of 5% compound growth, a bank will have grown to 430% of its previous size.

Most importantly, the FSA's discussion paper on the strategic redefinition of capital reminds us that any harmonisation of current rules by the European Commission will be a stop-gap. It may take a few years for Basel to deliver its fundamental rethink of capital, but the anticipated paradigm shift will supercede the CEBS and render it redundant. With this in mind, CEBS should prioritise its work and aim for a hybrid framework that is -- as much as possible -- common, simple and based on principles.