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Mrs Kerstin af Jochnick
Chair
CEBS
Committee of European Banking Supervisors
Floor 18, Tower 42
25, Old Broad Street
London EC2N 1HQ

Brussels, 19 February 2008

By e-mail: cp17@c-eps.org

Dear Mrs af Jochnick,

Draft proposal for a common EU definition of Tier I hybrids (CP17): comment of the Belgian Bankers' and Stockbroking Firms' Association

The Belgian Bankers' and Stockbroking Firms' Association welcomes the opportunity to comment on the consultation paper mentioned above. The following remarks are communicated with reservation for the decision about these matters to be taken by our Board on 22nd February 2008.

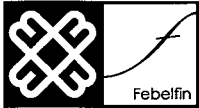
The reform of the hybrid capital instruments is also of considerable importance to the Belgian banks. We intend to support the position paper of the European Banking Federation. We also believe it is appropriate to comment separately on such a matter on behalf of the Belgian banks. You will therefore find herewith our further elaborated views and comments in this respect. In particular we would like to highlight the following items :

Although we support the **principle of loss absorption**, we are of the opinion that the proposals made by CEBS are too prescriptive concerning the write-down mechanism and the conversion into ordinary shares.

We also believe that **ACSM** features do not alter the permanent character of the instrument. Consequently, the use of instruments with ACSM features should in our view not be limited to the 15 % limit.

Although we welcome the **CEBS proposals on grandfathering**, we have reservations on the discrimination between instruments with an incentive to redeem and those without this incentive.

In general, we wonder whether the CEBS proposals could entail possible distortions of competition between EU issuers and non-EU issuers. Therefore we would like to suggest to wait for the outcome of the Basel Committee activities on this matter and for limiting the current



workflow to resolving these differences between Member States, which immediately relate to a proper and competitively functioning market.

We hope our remarks might get be taken into account. We are and remain evidently at your disposition for further questions and comments you may have.

Yours sincerely,

A handwritten signature in black ink, appearing to be "Michel Vermaerke", written over a horizontal line.

Michel Vermaerke
Chief Executive Officer

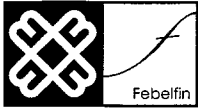
A handwritten signature in black ink, appearing to be "Daniel Mareels", written over a horizontal line.

Daniel Mareels
Head of the Taxation, Accounting Standards
and Prudential Regulations Department

Enc.

cc. David Wright, Deputy Director General, DG Internal Market, European Commission.

J-P. Servais, Chairman of the Banking, Finance and Insurance Commission.



Draft proposal for a common EU definition of Tier I hybrids: Comments of the Belgian Bankers' and Stockbroking Firms' Association (BBA)

Introduction

1. The Belgian Bankers' and Stockbroking Firms' Association welcomes the opportunity to comment on the consultation paper mentioned above ("CEBS draft proposal"). The reform of the hybrid capital instruments is a very important one for Belgian banks and overall we welcome CEBS' work in this regard. Nevertheless, we are of the opinion that the document still has a significant number of flaws as explained further in this position paper. These flaws need to be addressed before envisaging implementing the proposals made by CEBS into the EU legislation.
2. The BBA is of the opinion that it seems appropriate to adopt a staged approach. For the time being, the EU's priority should be limited to resolving only those differences amongst Member States which truly matter from a competitive point of view, while Basel Committee is reviewing its definition of eligible capital in the years to come.
3. To avoid duplication of the feedback to CEBS and EU, the BBA will focus in its Position Paper only on the CEBS draft proposal aspects that are most important from a Belgian perspective.

Besides the comments incorporated in this the BBA Position Paper, there are other concerns for which there is a broad European agreement. For those, the BBA relies on the EBF Position Paper. **The BBA fully endorses and supports the views, opinions and concerns expressed in the entire EBF Position Paper.**

General Observations

1. The BBA supports the objective of levelling the playing field in the acceptance of hybrid instruments for prudential capital purposes. Those instruments are part of the capital management, participating to finance the growth and strategic actions such as mergers and acquisitions. It is therefore clear that differences between regulators in the acceptance of those instruments as Tier I capital can lead to huge competitive distortions for institutions. For this reason a clear and common European approach on these instruments is necessary, in particular a true level playing field on the limits used is urgently needed.

Given the current differences in national tax and legal frameworks, this should not be at odds with the flexibility in the creation of those instruments: once a hybrid instrument has been approved by one regulator, this should automatically be accepted by other European regulators. For these purposes, the BBA supports the creation of a technical working group within CEBS charged with the evaluation of all instruments, enabling it to enhance its knowledge and understanding of hybrid instruments as well as their evolution. The

characteristics of “Tier I labelled” hybrid instruments could then be published on the CEBS-website.

2. The use of hybrid instruments provides an important tool for capital management and an important alternative source of funding for banks. The BBA welcomes the CEBS proposal. **The BBA however wishes to highlight several mechanisms in CEBS proposal which would create competitive distortions for EU issuers vis-à-vis non EU issuers** from an economic point of view by increasing the pricing of future hybrid instruments and limiting the use of tax deductible instruments for some issuers (among which the Belgian ones), and from an execution point of view by ignoring the negative impacts some mechanisms recommended in CEBS proposal will have on the investors community. The investors might indeed theoretically become shareholders (loss absorption by conversion into ordinary shares, ACSM) or be treated pari passu or junior to ordinary shareholders (loss absorption by write-down). Moreover, the BBA wishes to underline that hybrid instruments investors are fixed income investors which distinguish themselves from pure equity or equity linked investors, offering a natural diversification of investors basis for hybrid instruments. **Some mechanisms proposed in CEBS document would potentially decrease the investors basis for hybrid instruments of EU issuers dramatically.**

Belgian Observations

Loss Absorption

1. The BBA fully agrees with CEBS proposal that Tier 1 Capital must be able to absorb losses in case of liquidation, on a going concern basis and in stress situations. The BBA is of the opinion that hybrid instruments fully complete these requirements by their nature as:
 - a. they are contractually undated, hence permanent, and only redeemable subject to prior supervisor approval.
 - b. they provide the issuer with the ability to cancel payments at any time on a non-cumulative basis and for an unlimited period of time without triggering a default and give the issuer thereby full access to the waived payments. Moreover the supervisor can require the issuer to waive payments at their discretion based on the financial situation of the issuer.
 - c. They rank subordinated to all general creditors and subordinated debt of the issuer. In case of liquidation, claims of hybrid instruments will be subordinated to the claims of all depositors, senior and subordinated debt holders.

The BBA believes that hybrid instruments by their nature fulfil the three scenarios envisaged by CEBS in paragraph 107.

2. The BBA is of the opinion that CEBS proposal relative to loss absorption mechanism goes far beyond the guidelines of Basel causing potential competitive distortions, limiting access to existing hybrid instruments investors basis, but more importantly being very

difficult, if not impossible, to apply. The BBA is of advice that the proposed provision does not enhance the issuer's ability to absorb losses on an ongoing basis or in liquidation and it does not facilitate the recapitalization of an issuer under extreme financial stress which would be the result of a full restructuring¹ and not linked to the existence of the write-down mechanism. Therefore, the BBA believes that CEBS proposal should not include a write-down mechanism or a conversion into ordinary shares when a predefined ratio is triggered. However, the BBA being aware of the Belgian insolvency law context, proposes to keep adequate flexibility in the CEBS proposal such that Belgian Hybrid Tier I issuers would keep using the conversion into Preferences Shares ("Parts Bénéficiaires") when the insolvency trigger ratio is touched.

3. Regarding the write-down mechanism, the BBA agrees with CEBS that the permanent write-down mechanism would mean a definitive absorption of losses by hybrid instruments holders but would also mean a more subordinated ranking of hybrid instruments than ordinary shareholders in case of stressed situation. CEBS proposes a temporary write-down mechanism with a write-up of the principal amount under certain conditions. The BBA believes that this mechanism is not necessary or even not feasible:
- From a regulatory point of view, there will be no advantage to pass the write-down into P&L, it would not increase the total Tier 1 capital of the issuer, it does not improve the protection of the more senior debt holders;
 - From a cash flow point of view, there will be no new cash injected at the issuer. Moreover the suspension of cash payments, which gives the issuer access to waived payments can be achieved independently on the basis of the principle of flexibility of payments (and this would more than likely have already happened before reaching the trigger activating the write-down). There is no need of temporary write-down for this purpose;
 - From a legal point of view, there will be no debt write-off as in case of liquidation, the claim of hybrid instruments holders will be for the full original principal amount, there should therefore not be an accounting creation of profit;
 - From an accounting point of view, as far as hybrid instruments are recognized as equity under IFRS, there can not be value adjustments of it through profit and loss;
 - From a tax point of view, the write-down results in a taxable gain. Moreover, there might be divergent tax analysis of issues with write-down mechanism possibly threatening the tax deductibility of coupon payments in Belgium (irrespective of the existence of ACSM).

1. Although it is theoretically possible to redeem hybrid tier 1 instruments at written down amount, hence removing a layer of senior capital to new ordinary shareholders, it is only a hypothetical scenario that is very unlikely to happen from the issuer's management point of view as well as from the supervisor's point of view.

Additionally, and at least even importantly, **the BBA is of the opinion that the write-down and write-up mechanism as proposed by CEBS would have very negative impacts on the financial conditions at which hybrid instruments would be placed because expected negative market reception** for the following reasons:

- As long as the instruments remain written down, coupon payments have to be fully suspended. The BBA is of the opinion that there should not be an automatic full coupon payment suspension as long as hybrid instruments are written down but a partial coupon payment on the remaining outstanding hybrid instrument amount. In time of financial distress, coupon payments will be suspended totally using the flexibility of payments condition, however during write-up period and if appropriate, coupon payments should become payable again on the amortized amount of hybrid instruments.
 - The BBA agrees that the principal of hybrid instruments should be written back up only out of future profits. In CEBS's proposal, the mechanism of write-up provides that it should only be possible pari passu with ordinary shareholders. This condition puts the hybrid investors pari passu with the ordinary shareholders, investors might even be considered as subordinated to ordinary shareholders if write-up is made pari passu with dividends distribution and if coupon payments on hybrid instruments remain suspended at the same time.
4. Regarding the conversion into ordinary shares, the BBA does not agree that this would improve the status of the general depositors and subordinated debt holders as they were already senior to hybrid investors before conversion and the conversion will not improve their situation on an ongoing basis, in important financial distress or in liquidation. It will also not help recapitalisation process as it increases dilution from the new shareholders point of view.

The BBA believes that this mechanism will have several negative consequences:

- From a market point of view: as stated above, hybrid investors are fixed income investors mainly. Selling them an hybrid tier 1 issue which includes a clause for conversion into ordinary shares would not be acceptable for a large part of them. If issuers have to address investors in equity or equity-linked products for sale of their hybrid instruments, there would not be any positive benefit of investors diversification anymore. Additionally, hybrid investors rank senior to ordinary shares as per Basel definition. The equity conversion features will suppress this ranking provision as hybrid investors and ordinary shareholders will rank pari passu in case of liquidation. These consequences will obviously reduce the market size and worsen the economic conditions for future hybrid instruments issues;
- From a legal point of view: it might be very difficult to have the necessary corporate resolutions approving the issue of ordinary shares and this will constitute a heavy process. Moreover, these authorisations are not perpetual, it will have to be repeated on a regular basis;

- From an accounting point of view: Hybrid instruments with conversion in ordinary shares might have a dilutive effect and negatively influence the EPS of the issuer.

Limits and use of ACSM

1. The BBA wonders how the limits proposed are calculated taking into account minority interests and deductible elements such as goodwill. Guidance is also needed concerning the use of International Financial Reporting Standards for the calculation of these limits.
2. Concerning instruments with ACSM features, it needs to be emphasised in particular that they do not alter the equity like nature of the hybrid instrument.

According to CEBS' proposals, "*Alternative Coupon Satisfaction Mechanisms ("ACSM") are acceptable solely if they are put in place for tax reasons and in cases where the issuer has full discretion over the payment of the coupons or dividends at all times. In addition, they are only permitted if (i) they are made out of already authorized and unissued shares, (ii) subscribed by the hybrid holders and (iii) are exercised immediately to avoid the accumulation of debt.*" (Paragraph 57)

- ACSM exist in several jurisdictions to ensure tax deductibility and it is essential to have a level playing field amongst EU Member States in the area of tax deductibility.
- The BBA agrees that ACSM must be used and structured for tax reasons only and that they cannot, therefore, be eligible if used and structured for other purposes (such as an incentive to redeem when mandatory after first call date, ...).
- The BBA acknowledges that ACSM need to be submitted to relevant conditions to ensure compliance with the principles of permanency, loss absorption and flexibility of payments. However, it disagrees with two conditions included in the CEBS draft proposal.

First, it should not be required that the newly issued shares be subscribed by the hybrid holders. The CEBS proposals do not provide any explanation as to why there would be a need whatsoever to restrict the type of investors who are entitled to subscribe to newly issued shares. Such a requirement does not bear any relationship to the principles of permanence, loss absorption and payment flexibility. It was questioned by E.U. representatives if Tier-1 investors, like equity investors, were also exposed to losses. The answer is yes. Tier-1 investors are exposed to losses in case of coupon cancellation. Moreover, Tier-1 instruments are listed. If an investor is not committed to remain an investor of a company in financial difficulties he will be exposed to losses when selling its listed investment.

Secondly, it should not be required ACSM to be exercised immediately to avoid accumulation of debt. Imposing such a constraint unduly restricts the use that can be made of ACSM and reduces the required flexibility and discretion of issuers on payments and capital management. This timing detail concerning the use made of

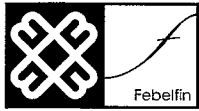
the ACSM should remain a prerogative of the company's management. A timing constraint on the exercise of the ACSM would be a serious limitation of the flexibility of the institution to repair its solvency situation in an optimal way. As deferred coupons will rank *pari passu* with the underlying instruments, it is therefore difficult to imagine how an overhang could be created to the detriment of the solvency position of the institution. Coupons could be postponed indefinitely. Limiting the timing flexibility for the use of the ACSM could interfere with other capital market activities (i.e. capital increase, equity-linked issues, ...) aimed at restoring the capital adequacy position of the institution.

- In a going concern and stressed situation, ACSM leave full flexibility and discretion over the payment to the issuer's management. In stressed situations, ACSM increase the capacity of the instrument to absorb losses, preserving cash without any risk of investors invoking default and triggering liquidation. Moreover, ACSM are non-cumulative from the issuer's perspective as they do not deplete the institution's capital resources.
- In case of liquidation, losses are absorbed in accordance with the degree of liquidation. The subordination of any coupon to be satisfied with the use of ACSM, and for which the ACSM mechanism would not yet have been used remains the same as the subordinated ranking of the instrument ensuring that hybrid holders' claims are not met before all more senior claims are satisfied.
- Most importantly, ACSM do not alter the permanency of the instrument, which is a key feature for hybrid instrument to be eligible as Tier-1 capital and ensure that capital is available in stress situation.

By limiting these Tier-1 instruments to the 15% limit, CEBS proposal introduces an unfair and unsustainable competitive disadvantage between issuers. The BBA, therefore, believes that it would not be appropriate to go beyond the SPR: the 15% limit should apply to true innovative instruments only, i.e. with a principal incentive to redeem which give the instrument a dated nature.

Grandfathering

1. In general the BBA welcomes CEBS' proposals on grandfathering but with several comments. We do not support that instruments with an incentive to redeem remain eligible only until the first call date. CEBS proposes to discriminate between hybrid instruments with incentives to redeem and other hybrid instruments – without providing any explanation as to why such a distinction should be relevant and appropriate from a grandfathering perspective. We question whether such a distinction is indeed relevant on the basis that both types of instruments are all eligible as "original own funds" under the current rules. In addition, once the step-up has occurred, if the instrument is not redeemed (i.e. for example because the it provides the issuer with a funding source substantially more favourable than the then prevailing market conditions), it will turn into an instrument without incentive to redeem.



2. Also, the CEBS draft proposal does not take into account that, in line with the permanency principal, some of the issued Tier-1 are truly perpetual and will inevitably lead to their conversion into ordinary shares at an undefined time in the future (i.e. Fortis FRESH, Monte Dei Paschi Di Siena, ...). Issuers have no control on these instruments to accelerate their conversion and these instruments should be included in a permanent grandfathering.
3. Should the Basel Committee adopt in the future a wider grandfathering clause on existing hybrid instruments, this would create a competitive distortion between European and non-European players. It needs to be reminded in this context that the Sydney Press Release advocated for a total grandfathering.
4. On the basis of the arguments mentioned above, a total grandfathering of existing instruments is strongly required, at least until Basel Committee defines a new framework and gives grandfathering indications. All pre-dated instruments which qualified as Tier 1 capital under the rules that are currently in place in that jurisdiction should continue to qualify.