



BNP PARIBAS

FINANCES-DEVELOPPEMENT GROUPE

3, Rue d'Antin

75002 PARIS

Le Directeur

CEBS Working Group on Own Funds
Committee of European Banking Supervisors
Cp17@c-eps.org

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BNP Paribas welcomes the opportunity to respond to the Committee of European Banking Supervisors' (CEBS) proposal to provide guidelines for a common EU definition of Tier 1 hybrids, dated 7 December 2007. As you will notice, BNP Paribas has participated in many working groups, both at European and French level.

BNP Paribas supports the need for greater convergence at both European and international levels and would like to highlight the fact that hybrid instruments are an important tool for capital management, especially as this discipline has become increasingly dynamic in recent years. Hybrid capital is an integral part of a bank's own funds as it provides flexibility and security to stakeholders; security by providing another layer of capital to protect more senior creditors while retaining the stability of a fixed income instrument and flexibility by diversifying the investor base and the funding mix of a bank (i.e. interest versus dividend, possible foreign currency denominated bonds versus mandatory local currency denominated share).

BNP Paribas understands that the objective of CEBS is "to provide guidelines for a common and clear interpretation and implementation across the EU of the eligibility criteria that hybrids must meet using, as a starting point, the common approach already agreed at international level in the Sydney Press Release ('SPR') of 1998". BNP Paribas is in favour of achieving a level playing field in terms of competition and, to the extent possible, cost of capital. However, BNP Paribas recognizes that this European and international convergence is limited by national legal, tax, regulatory and insolvency framework which are far from being harmonized. As a result, BNP Paribas understands that there must be different phases in the determination of a common European definition of Tier 1 hybrids and would like to stress the importance of each phase:

- the first phase would consist of harmonising the differences that currently truly creates an uneven playing field at the EU level. All EU banks should be authorized to issue hybrids to strengthen their capital base, and the total limit for hybrid inclusion into Tier 1 capital - which currently varies considerably across the EU - should be harmonised;
- the second phase is to thoroughly engage in the process of achieving a common definition (or interpretation) and understanding of hybrids. The CEBS proposal would be the first step of a common EU approach that will be needed at the level of Basel Committee. On this issue, BNP Paribas strongly recommends a principles-based approach that may be implemented according to the regulatory, tax and legal environment of each Member State.

Over prescriptive criteria may result in an unsound system, penalizing some issuers more than others. This is why BNP Paribas believes that the objectives of CEBS are well founded with regard to the need for guidelines for a common and clear interpretation of the eligibility criteria that hybrid must meet but is less convinced by the objective of common implementation.

BNP Paribas would like to take advantage of the CEBS proposal to remind that Core Tier 1 composition is currently not harmonised throughout Europe and that this creates also an important uneven playing field. BNP Paribas strongly advocates for the harmonisation of Core Tier 1 calculation at an EU level, based on IFRS accounts¹ and on strictly harmonised filters without national discretion possibilities. This should be done in connexion with the first phase mentioned above.

Back to the CEBS proposal, BNP Paribas would like to stress that some of its aspects, by imposing requirements beyond the SPR, may actually put EU banks at competitive disadvantage vis-à-vis international competitors, in a context where easy access to capital is a key asset.

BNP Paribas' response will discuss the different phases presented above, first discussing the harmonisation of limits for the inclusion of hybrids into Tier 1 capital and then developing on the definition of hybrid capital and its underlying principles.

I – Harmonising limits at the European level

BNP Paribas believes that the first step of the harmonisation of hybrids at European level would be to set common rules relating to the limits for inclusion of hybrids into Tier 1 capital.

- A. **Principles:** consistent with the objective of the CEBS proposal to achieve a level playing field at European level, BNP Paribas promotes the following principles:
- all European banks should be authorized to issue hybrids to strengthen their capital base,
 - limits to the inclusion for hybrids into Tier 1 capital should be applied on a consistent basis across Europe. Local regulators would not be allowed discretion to impose stricter limits on the banks they regulate.

The Capital Requirement Directive (CRD) currently provides that limits to own funds are calculated before deductions, which are then made half on the Tier 1 and half on the Tier 2². Article 66 of the CRD makes this provision when referring to the limits regulating the amounts of Total Tier 2 and Lower Tier 2.

BNP Paribas expects that the limits applying to inclusion of hybrids into Tier 1 capital will be applied consistently with the CRD and will be calculated on Total Tier 1 (including deductions for own shares, intangibles assets and material losses of the current financial year³) before deductions to be made (half on Tier 1 and half on Tier 2). The rationale for this treatment is that a deduction requires additional own funds to reach the same level of targeted own funds as before deduction and that these additional own funds can be of the same composition as the original own funds before deduction (ie a mix between core Tier 1 and additional own funds) and not only of strict core Tier 1. An example with precise figures is given in the answer to CEBS draft proposal made by the Fédération des Banques Françaises (FBF).

¹ To the extent possible and especially for international listed banks which clearly compete in terms of level of capital.

² Items to be deducted are referred to in article 57 of CRD, items (l) to (r).

³ Items (i) to (k) of article 57 of CRD.

B. General limit: BNP Paribas acknowledges that the SPR provides for limits to the inclusion of hybrids into Tier 1 capital and agrees that low capitalised banks should have a higher proportion of core Tier 1. However, we remain unclear on the exact meaning of the CEBS proposal and would like to confirm our understanding of the general limit as the following: core Tier 1 should be greater than the lower of the two following amounts:

- i. 70% of the minimum Tier 1 requirement (i.e. currently 2.8 % of risk weighted assets, without taking into account any additional Tier 1 requirement under pillar 2)
- ii. 50% of the actual Tier 1 amount.

A dual mechanism, as the CEBS proposal can also be understood, providing for a certain level of core Tier 1 up to a certain limit (ie 70% of Core Tier 1 up to a Tier 1 ratio of 4%) and for another level of core Tier 1 after this limit (ie 50% of Core Tier 1 for the part exceeding 4%), can be contemplated but would need to be clarified.

C. 15% limit for hybrids with incentive to redeem: BNP Paribas recognises that this limit is provided as such, even if at issuance, by the SPR but would like to open a debate on the rationale of such a limit in a context that largely differs from the one of 1998.

BNP Paribas understands that the CEBS requirement to respect the limits at all times would be an issue for some European banks. In any case, BNP Paribas supports the idea of creating a level playing field in Europe, where all issuers apply the same rules in the same way.

A compromise solution should be proposed as we understand, in accordance with CEBS proposal, that respecting a 15% limit at all times would forbid a bank to exceed this limit as a consequence of foreseeable event directly reducing the level of Tier 1, such as share buyback programmes or additional goodwill resulting from an upcoming acquisition. However, losses also have a direct impact on the amount of Tier 1 and the proposed limit would create a cliff effect accelerating the decline of Tier 1 ratio. This would worsen the signal sent to the market in a case where depositors will still benefit from the subordination of the total amount of the hybrid issued. BNP Paribas therefore suggests that the 15% limit could be exceeded, only when this excess would result from a net loss or a reduction of the reserves.

II – Reaching a common definition of hybrid capital and its underlying principles

BNP Paribas supports the objective of CEBS to “provide guidelines for a common and clear interpretation across the EU of the eligibility criteria that hybrids must meet” (cf paragraph 13) but notes that implementation of specific common mechanisms in each Member State can hardly be harmonised as it depends on specific diverging rules in the area of bankruptcy law, company law and tax law.

It has been agreed that a principle-based approach of the eligibility criteria should be developed. Those key economic features, commonly agreed as being permanence, flexibility of payments and loss absorbency, are clearly inter-related and should not be taken and analysed in isolation from each other, being accepted that, in fact, loss absorption is the underlying key objective.

In terms of definition, BNP Paribas mainly agrees with the CEBS definitions of permanence and flexibility of payments but argues strongly against the loss absorption proposal (including the questionable definition of subordination).

BNP Paribas suggests CEBS to adopt a wider approach, recognizing that the eligibility criteria are strictly interwoven and to develop a real “substance-over-form” principle.

- A. **Permanence:** BNP Paribas agrees that hybrids must be available at all times and, consistently with the SPR, that the instrument must be permanent. In addition, BNP Paribas also supports that call options are acceptable under conditions and subject to supervisory approval, as it is a crucial feature both for investors (mainly fixed-income ones) and for the dynamic capital management of the issuer. BNP Paribas also agrees that Tier 1 hybrids must be fully paid-up. However, CEBS definition which states that Tier 1 hybrids must be undated goes beyond the SPR and might prove to be too prescriptive.

A consequence of this feature that needs to be highlighted is that the call option initiative remains solely at the initiative of the issuer and hybrid investors never have enforceable claim to the repayment of the principal and therefore are not in a position to force bankruptcy. Hybrid capital then remains available in time of financial stress.

- B. **Flexibility of payments:** BNP Paribas agrees with the principle that issuers must be able to stop payments on a non-cumulative basis, and that this opportunity becomes an obligation when the issuer is in breach of the minimum capital requirement. In terms of other triggers, BNP Paribas advocates for a less prescriptive approach, avoiding the inclusion of potential national discretion into the regulation, already foreseen by Basel Pillar 2 which ensures an in-depth regulatory supervision.

In addition, BNP Paribas supports the view that payments must be commensurate with the ranking of the instrument and that therefore, in accordance with Member State legislation, dividend pushers have to be allowed.

CEBS proposal states that “distributions can only be paid out of distributable items”. This is already included, as such, in the SPR. In the objective of clear interpretation, which we understand is the purpose of the discussed draft, clarification is required on the exact meaning of this statement, which we understand to mean that coupon payments on hybrids must not cause or increase a loss for the bank.

In conclusion, through the flexibility of payments feature, it has to be noted that the coupon payment decision remains only with the issuer (and its regulator in both cases of optional and mandatory coupon cancellation) and that hybrid investors never have enforceable claim to the payment of the coupon (therefore, they are not in a position to force bankruptcy). The consequence is that the firm is allowed to keep, with undefined term, free financial resources in time of stress, providing financial flexibility until recovery.

- C. **Subordination:** BNP Paribas agrees with the fact that hybrid instruments must always rank junior to depositors, general creditors and subordinated debt of the institution, meaning that hybrids rank senior to ordinary share capital (and does not rank senior only to ordinary share capital as stated by CEBS in its proposal pages 7 and 20⁴).
- D. **Loss absorbency:** BNP Paribas clearly recognizes that this criterion is the key feature and is, therefore, deeply concerned about the lack of precise definition of loss absorption feature.

BNP Paribas would like to clarify what should be understood by loss absorbency. First of all, it is understood that the concept of loss absorbency applies in case of extraordinary loss.

⁴ BNP Paribas however understands that this wording, much stricter than the SPR and excluding potential intermediary instruments that would be junior to Hybrid Tier 1 instruments (such as French “actions de préférence”), was not the intention of CEBS and that the word “only” will be ultimately removed from the document’s wording, thus confirming that it should be sufficient for hybrid instrument to always rank junior to depositors, general creditors and subordinated debt of the institution and senior to ordinary share capital.

Loss appears to be considered mainly as an operational and accounting loss with a direct impact on the profit and loss account. It can also be an accumulation of past and current losses. It can be added that, from a prudential point of view, a loss could also be defined as a negative impact on own funds⁵, that can be for instance a direct record into equity or an additional goodwill to be deducted from own funds.

The loss absorption feature is defined as enabling a bank to continue operations on a going concern basis (cf. paragraph 103). BNP Paribas laments the fact that no further precision is given on this requirement while prescriptive answers are detailed.

BNP Paribas believes that loss absorption is determined through the ability of the instrument:

- to satisfy the claims of all non-subordinated creditors in the event of a bank's insolvency or liquidation,
- to help the bank to continue operations as a going concern – which means that (i) it should help prevent its insolvency and (ii) not hinder its recapitalisation, particularly in stress situations.

BNP Paribas agrees with the principles established in paragraph 105 of CEBS proposal⁶ and with the scenarios of loss absorbency mechanisms detailed in paragraph 107:

- “on a going concern basis, losses can be absorbed by waiving the coupons,
- in case of liquidation, losses are absorbed in accordance with the degree of subordination; and
- in stressed situations, where a bank makes significant losses, especially if it is in breach of its minimum capital requirement and is likely to need new capital either by issuing new capital or through future earnings (or alternatively it could try to reduce its capital requirements), Tier 1 hybrid should not hinder recapitalisation.”

However, BNP Paribas believes that hybrid instruments fulfil these requirements by definition as:

- they rank subordinated to all depositors, general creditors and subordinated debt of the issuer, which enable to satisfy the claims of all non-subordinated creditors in case of bank's insolvency or liquidation (as defined in C.).
- they are permanent (as defined in A.),
- 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 (as defined in B.). Moreover supervisors can require the issuer to waive payments at its discretion based on the financial situation of the issuer.

In addition, BNP Paribas would like to discuss the options of CEBS to address stress situations:

- **coupons are written down on a permanent basis:** from an economic perspective, this reduces the present value of the undated instrument to zero, even if it might be redeemed at par when the institution recovers, at the option of the issuer. This

⁵ For instance, in the IFRS accounting framework, this can be linked to movements in exchange rates, to transactions carried out with minority interests, to changes in the fair value of financial instruments. BNP Paribas acknowledges that, in certain cases, prudential filters minimize the potential impact.

⁶ Ie, regulation of hybrids should not be more onerous than the rules on ordinary share capital and ranking of subordination of different Tier 1 capital instruments should be respected so that the ordinary shareholders should suffer the first losses.

would limit the financial flexibility given to the issuer that can decide when to stop and when to resume those payments. The fact that coupons can be cancelled on a temporary basis is enough to allow the bank to pursue its activity and to avoid hindering a future recapitalisation (in comparison to coupon deferral for instance). Furthermore, in terms of comparison to equity, this would discriminate hybrid instruments as dividends cannot be stopped on a permanent basis.

- **the principal amount of the instrument is written-down but is written back-up:** BNP Paribas does not understand at all why this characteristic would increase the loss absorbency feature of hybrid instruments, or even, to be consistent with the principle applied by CEBS⁷, how it would bring the feature closer to the equity benchmark. Indeed, a temporary write-down of the principal amount does not improve the situation of the bank and the cancellation of coupon payments gives the required flexibility. It is sufficient to ensure that no cash leaves the bank.

BNP Paribas wonders why this write-down feature is required by CEBS as this is not our understanding either of hybrid instrument objective or of loss absorbency feature:

- From a legal point of view, hybrid holders never waive their claim for the full principal amount⁸, as this would effectively result in ranking junior to ordinary shares, which would not be acceptable.

In fact, (i) in liquidation, the investors have the right to claim for the full principal of the instrument and (ii) in going-concern situations, hybrids can never be totally redeemed at an amount different from the full principal amount. This is why we understand the comment made in page 20 of CEBS proposal⁹ as a possibility (quite impracticable from an issuer point of view) of a partial, but not definitive, redemption as total redemption will always be on the full principal amount (coherent with the rank of subordination). As a result of the fact that from economic and legal point of view, hybrid holders never contractually waive their claim, the write-down accounting entry would not be possible (whether hybrid instruments are accounted for as equity or as debt).

- Even if the write-down could be achieved, from a regulatory point of view, there would be no advantage to pass the write-down into the issuer balance sheet as there would be no impact on the total Tier 1 capital of the issuer and as it does not improve the protection of the more senior debt holders.

- Finally, it must be noted that, if the hybrid holders were to waive their claim on a portion of the principle amount, this would give rise to a taxable gain in the hands of the issuer.

In addition, in the event this write-down turns out to be possible (highly improbable in BNP Paribas' view), a necessary write-up out of future profits is likely to severely hinder a potential recapitalisation. Indeed, a potential investor would invest after the write-down (and would not have benefit from its "theoretical" positive impact) and before the write-up and therefore would suffer the reinstatement of the hybrid instrument principal.

- **the principal amount of the instrument is permanently written-down on a mandatory basis:** this would be inconsistent with the ranking of hybrid

⁷ BNP Paribas already indicated that hybrid instruments have advantageous characteristics distinct from equity.

⁸ Unless approved at a Hybrid holders general meeting.

⁹ "If the bank wants to redeem the instrument whilst the principle is written down, it can only redeem it at the written down amount. Redemption at par will not be possible until the principal is completely written up".

instruments which are senior to ordinary shares. Therefore, BNP Paribas agrees with CEBS that it does not constitute an option.

- **the instrument mandatorily converts into ordinary shares:** BNP Paribas agrees that this would make hybrid instruments *pari passu* with ordinary shares and that “the conversion itself does not of itself absorb losses”.
- BNP Paribas disagrees on the fact that the conversion improves the quality of the remaining capital of the bank to absorb future losses, as hybrid instruments are designed for this purpose, as explained before.
 - A conversion into ordinary shares would not improve the status of the general depositors and subordinated debt holders (already senior to hybrid investors before conversion) on an ongoing basis, in financial distress or in liquidation.
 - In addition, BNP Paribas believes that this mechanism will have several negative consequences:
 - * CEBS proposal would introduce rules going beyond established practice applied by companies in difficulty in all sectors of the economy. The write-down and conversion mechanisms proposed by CEBS would actually be less effective than the customary market practice¹⁰ in case of over-indebtedness, in which creditors holding hybrid instruments would agree to waive a portion of their claims (a permanent write-down) because, if the bank succeed in recovering and continuing as a going concern, they would obtain much more of their investment than if the bank would become insolvent (gone concern), where their claim would be deeply subordinated.
 - * from a market point of view, this feature might considerably reduce the hybrid investor base, currently composed mainly of fixed income investors, which is considered as having the advantage to diversify and broaden the investor base of an issuer, which can be crucial to maintaining access to funding and capital in times of economic downturn,
 - * also from a market point of view, the equity conversion might worsen the bank shareholders situation as the fixed-income investors would be required to sell the shares they received, probably creating a market turmoil which would hinder a recapitalisation,
 - * from a legal point of view: it might be very difficult to obtain the necessary approval from ordinary shareholders that might refuse the principle of being (a priori) extremely diluted (principal amount of hybrid instrument to be converted at a conversion ratio based on fair market value¹¹),
 - * from a tax point of view, the conversion into ordinary shares might severely affect the tax deductibility of coupon payments. It should be reminded that this issue is critical to issuers and BNP Paribas supports the creation of a European, and even wider, level playing field in this area and recommends that CEBS proposal does not discriminate Member States, in a context where tax law harmonisation is far from being achieved.

On the principle that hybrid instruments should help prevent the issuer's insolvency, BNP Paribas indicates that, from a French legal point of view, hybrid instruments are not considered as liabilities for insolvency purpose. However, this is mainly within the competence of Member State bankruptcy law, which we understand is far from being harmonised.

¹⁰ This point is also clearly described in the European Banking Federation answer.

¹¹ As a fixed conversion ratio would not be acceptable from the hybrid investors' point of view.

As a conclusion, BNP Paribas does not understand how the CEBS proposal would strengthen the loss absorbency feature of hybrid capital. Indeed, BNP Paribas believes that the features of permanence, flexibility of payments and subordination make hybrid instruments fulfil the objective of what the SPR calls "loss absorption". Any additional requirement would alter the first three features and reduce the issuer's flexibility. In this context, BNP Paribas considers that there is no reason to discuss triggers issues but highlight the fact that making a reference to an absolute threshold (2% for instance) does not seem appropriate for non dated instruments in a context of moving regulations. However, BNP Paribas would be ready to consider a clear and acceptable mechanism that would, in times of financial stress, makes compulsory the reduction in the capital base for interest calculations on hybrid instruments.

To conclude, BNP Paribas thanks the CEBS for having had the opportunity to comment the draft proposal for a common EU definition of Tier 1 hybrids and strongly advocates for associating to this approach a more general one dealing with the strict harmonisation of the definition and calculation of Core Tier 1 throughout Europe.

We would be happy to discuss further the elements detailed in this answer at CEBS convenience,

A handwritten signature in blue ink, appearing to read 'Philippe BORDENAVE', with a large, stylized flourish above the name.

Philippe BORDENAVE