



**BNP PARIBAS**

FINANCES-DEVELOPPEMENT GROUPE

3, Rue d'Antin  
75002 PARIS

*Le Directeur*

CEBS Working Group on Own Funds  
Committee of European Banking Supervisors  
[Cp27@c-eps.org](mailto:Cp27@c-eps.org)

Paris, 18 September 2009,

BNP Paribas welcomes the opportunity to respond to the Committee of European Banking Supervisors' (CEBS) Consultation Paper 27 on its proposed implementation guidelines for hybrid Tier-1 capital instruments, dated 22 June 2009. As you will notice, BNP Paribas has participated in many working groups, both at European and French level, and fully supports CEBS's objective of promoting a common understanding and harmonised approach to the treatment of hybrid Tier-1 capital instruments by European supervisors.

BNP Paribas supports the need for greater convergence at both European and international levels and would like to highlight the fact that hybrid Tier 1 is a key constituent of capital, especially as capital management has become increasingly dynamic in recent years and has proven to be of critical importance in the exceptional circumstances of 2008 and 2009. Hybrid capital is an integral part of a bank's own funds as it provides a cost effective source of capital, as well as security and flexibility to stakeholders ; security by providing another layer of capital to protect more senior creditors while retaining the 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 in order "to achieve a common understanding among competent authorities across the EU on the implementation and application of the new provisions adopted in the amended Capital Requirements Directive (CRD)", which will have to be transposed and applied by Member States by the end of 2010.

BNP Paribas is in favour of achieving a level playing field in terms of hybrid Tier-1 capital instruments and fully supports CEBS's objective of promoting a common understanding and harmonised approach to the treatment of hybrid Tier-1 capital instruments. However, BNP Paribas recognizes that this European and international convergence is limited by national legal, insolvency, tax and accounting framework which are far from being harmonized. Consequently, BNP Paribas reminds its view that a principles-based approach is most appropriate. Overly prescriptive EU-wide rules will limit the flexibility for national supervisor to address market innovation and the differences in legal, insolvency, accounting and tax framework in each jurisdiction, as well as exceptional circumstances of individual institutions should they arise.

As a result, and as previously stated, BNP Paribas understands that there must be different phases in the creation of a common European hybrid capital landscape 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, such as limits that substantially differ from one Member State to another ;
- the second phase is to achieve a common definition, interpretation and understanding of eligibility criteria for hybrids Tier-1 capital instruments ;
- the third phase would be to thoroughly monitor and ensure a possible convergence in the application and implementation of the CRD by all Members States.

The objectives of the first phase, and to a large extent of the second phase, have already been substantially achieved. The new provisions of the CRD largely build on the CEBS's advice to the European Commission regarding a common definition of Tier-1 hybrids, published in April 2008. In line with market participants' recommendation, CEBS and the EU have adopted a principles-based approach that may be implemented according to the legal, insolvency, accounting and tax environment of each Member State.

The CEBS' proposed guidelines open for consultation and commented in this letter, also follow this principles-based approach. To a substantial extent, the proposed guidelines successfully provide additional guidance to achieve a common understanding and clear interpretation of the new CRD, while avoiding to become a set of specific rules.

This being said, a non marginal part of the CEBS' proposed guidelines also aim to achieve a common implementation of the new CRD, disregarding the existing differences in the legal, insolvency, tax and accounting environment of each Member State, and disregarding the principles-based approach recommended by market participants and adopted by EU and CEBS so far. Such over prescriptive rules may result in an unsound system, penalizing some issuers more than others, and may limit or even jeopardise the existence of a diversified hybrid capital base.

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 new CRD but is less convinced and concerned by the objective of immediately achieving a common implementation, especially in terms of buybacks and loss absorption in going concern.

As elaborated in this letter, BNP Paribas considers the guidance related to buybacks to be over prescriptive and to unduly restrict both institutions and supervisors from a sound flexibility for capital management purposes.

For the loss absorbency in going concern and to ensure that hybrid Tier-1 capital is making a recapitalisation more likely, CEBS is willing to impose a mandatory and contractual mechanism, such as write downs or conversions. BNP Paribas' view is that this is clearly far too prescriptive, disregarding the principles-based approach and most probably counterproductive. BNP Paribas is convinced that terms embedded in hybrid Tier-1 capital are sufficiently flexible and most appropriate to allow the institution and the supervisor to efficiently consider a required recapitalisation.

BNP Paribas' response will provide answers to the various questions submitted by CEBS. BNP Paribas will also provide additional comments to elaborate and stress that some of the guidelines are over prescriptive rules that may actually put EU banks at competitive

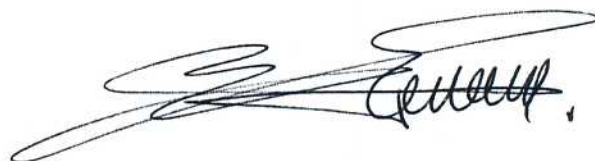
disadvantage vis-à-vis international competitors, in a context where easy access to capital is a key asset.

BNP Paribas would like to also provide in appendix 1 the feedback prepared by its Fixed Income division, which acts as an arranger on hybrid capital instruments issued by a diverse range of financial institution clients in the EU and beyond. This feedback is based on the experience of this department in structuring and placing hybrid Tier-1 capital instruments, as well as on discussions with numerous relevant market participants including issuers, investors, rating agencies, tax and legal advisors.

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 EU level, based on IFRS accounts<sup>1</sup>

To conclude, BNP Paribas thanks the CEBS for having had the opportunity to comment the draft implementation guidelines for hybrid Tier-1 capital instruments.

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



Philippe BORDENAVE

---

<sup>1</sup> To the extent possible and especially for international listed banks which clearly compete in terms of level of capital

**1.1 Are the guidelines in relation to "incentive to redeem" sufficiently clear or are there issues which need to be elaborated further ? Please provide concrete proposals how the text could be amended.**

BNP Paribas considers that the guidance in articles 52 to 57, which describe incentive to redeem, is sufficiently clear and principles-based.

**1.2 Please describe the potential impact of a cap of 150% relating to stock settlement of the conversion ratio. Please provide evidence.**

CEBS takes the view in article 56 that a principal stock settlement in conjunction with a call option must contain a cap limiting the number of shares that may be issued under a principal stock settlement provision to a number of shares that has a value equal to 150% of the principal amount of the hybrid capital instrument on its issue date. BNP Paribas believes that such a cap imposed on the stock settlement mechanism would indeed make it a moderate incentive to redeem in cash, and considers this proposal as a reasonable prudential approach.

**1.3 Other comments on article 49 to 70**

BNP Paribas notes that the existence of an incentive to redeem will be determined exclusively at the issuance date and that such classification as innovative hybrid Tier-1 subject to the 15% limit can not be reversed when such instrument is not called. Although this is debatable, BNP Paribas understands that there is substantial prudential rationale in such guideline.

Regarding the application in view of a prior regulatory approval for a call or redemption, BNP Paribas notes that CEBS has established an extended list of information to be provided to the supervisor. While information items listed as (a)<sup>2</sup> and (b)<sup>3</sup> are fully legitimate, information items listed as (c)<sup>4</sup> and (d)<sup>5</sup> would be a very onerous process, especially in case of multiple and successive calls or redemptions. This information might often become redundant if also presented to the supervisor in other processes. Paribas takes comfort of the words "As far as it is not already available to the competent authority ..." which suggests that there is a prevailing expectation that this information will have been submitted as part of the ICAAP<sup>6</sup> / SREP<sup>7</sup> process where the possibility of a redemption or call will have been addressed.

**2.1 Are the guidelines in relation to "buy back" sufficiently clear or are there issues which need to be elaborated further ? Please provide concrete proposals how the text could be amended.**

BNP Paribas strongly disputes CEBS's assertion that buybacks are analogous to the exercise of call options at par, hence should be treated in the same way with a prohibition to carry on such

---

<sup>2</sup> A well-founded explanation why the credit institution intends to call or redeem the instrument

<sup>3</sup> Current solvency data including the level and composition of original own funds before and after the exercise of the call or redemption and a confirmation that the credit institution continues to comply with all other regulatory requirements after calling or redeeming the hybrid instrument

<sup>4</sup> information on the planned development of the data under item b for the following (e.g. 3-5) years based on its business plan including planned development of the balance sheet and the profit and loss account

<sup>5</sup> The evaluation of the risk to which the credit institution is or might be exposed and whether the level of own funds ensures, or not, the coverage of such risks, including stress tests on main risks showing potential loss under different scenarios.

<sup>6</sup> Internal Capital Adequacy Assessment Process

<sup>7</sup> Supervisory Review and Evaluation Process

transaction in the first five years unless previously replaced by an instrument of at least the same or better quality.

The mechanisms for a call occur contractually and are explained in the documentation. There can be an incentive for the institution to exercise such call. On the contrary, a buyback opportunity is completely at the discretion of the institution's management and the only incentive of a justified buyback is to add economic value to the institution by actively managing its capital structure for reasons, as presented further below in this letter, that differ from a pure right or moral obligation to call or redeem a hybrid capital instrument at a certain point in time.

This being said, BNP Paribas understands the importance of the prudential requirements for a buyback to be at the full discretion of the institution and subject to a prior regulatory approval.

However, as BNP Paribas considers that buybacks are of a materially different nature than calls or redemptions, it strongly recommends removing any reference in article 71 and 72 to a five-year restriction and to a mandatory replacement. Appropriateness of timing and replacement should be left at the discretion of the institution and of its supervisor, depending on the specific situation justifying the economic and prudential rationale of a buyback.

**2.2. CEBS is considering whether buy backs should under certain conditions also be permissible before five years and without replacement. A number of CEBS members would support such a provision under strict conditions and subject to prior supervisory approval, notably if the buy back responds to exceptional circumstances, is acceptable from a prudential point of view and results in a lasting improvement of the institution's solvency situation. A number of other members have concerns regarding such an exemption, in particular as it may compromise the permanence of the hybrid instrument by enhancing investors' pressure on banks to buy back outstanding hybrids and by providing incentives for banks to reduce their overall capital position at times when their own credit quality is decreasing. As a basis for its decision CEBS therefore wishes to gather further evidence on the following points:**

**2.2.1. What would be the impact if buy-backs before five years after the issue of the instrument were only allowed under the conditions described in paragraph 72 ? Please provide evidence.**

A prohibition of buying back hybrid capital instruments in the first five years, which is limitation that is not applied to ordinary shares, would unduly limit the flexibility of an institution to efficiently manage its capital structure and may persuade banks to instead repurchase even higher quality of capital such as ordinary shares, which would be a perverted outcome. Consequently, BNP Paribas strongly recommends removing any reference in article 71 and 72 to a five-year restriction and to a mandatory replacement.

**2.2.2. Please describe circumstances – other than current market conditions - in which a buy-back at an earlier stage without the requirement to replace them with instruments of the same or better quality would be justified from a prudential perspective.**

Such situation, justifying a rationale buyback from a prudential and economical perspective, could for instance occur after a larger than expected profit accumulation, after a merger or take-over to remove legacy transactions with undesired features, for a capital restructuring in view of a recapitalisation, or in case of substantial decrease of

the risk weighted assets. This could also happen to replace excess Tier-1 capital by profits, taking advantage of a buyback at a price below the par amount.

**2.2.3. Which criteria should be provided in order to address the above mentioned concerns, and in particular to avoid setting incentives to deplete the capital base of banks whose credit quality is decreasing ?**

BNP Paribas considers that there is no need to include further criteria and does not understand the concern of CEBS. As BNP Paribas understands the prudential requirement for an institution to submit buyback transactions to a prior regulatory approval, the supervisors will only grant such authorisation if the transaction is deemed rationale and appropriate.

**2.3. What would be the impact of limiting the amount of repurchased instruments held by the institution at any time to 5% of the relevant issuance ? Please provide evidence.**

Institutions issuing hybrid capital are often at the same time issuer and lead manager, whether or not in a syndicate, for placing the hybrid capital into the market. Investors expect the lead manager of a transaction to be able to make a market in these instruments. For this purpose, an overall 5% limit is not practical, especially for transaction of a smaller size. BNP Paribas would like recommending increasing the proposed limit of 5%, which appears to be too low especially for smaller transactions, up to 10% minimum.

**Flexibility of Payments**

**Preliminary comments**

BNP Paribas notes the requirement for dividends and coupons to be cancelled under supervisory request. BNP Paribas perfectly understands the prudential rationale and the type of information, as listed by CEBS in article 81, on which the supervisor could base such decision. But BNP Paribas strongly disputes such requirement to be on a fully discretionary basis. BNP Paribas strongly suggest clarifying the following, in order to avoid such an overwhelming and unfettered discretion impacting too severely the cost of hybrid capital. It is critical to precise in the guidelines that such regulatory intervention would remain an exceptional situation and to refer to a clearly identified risk that the institution will breach its capital requirements set according to Article 75 of the CRD or to refer to the concept of a “MAC clause” allowing regulatory intervention in case of major adverse changes.

**3.1. Are the guidelines in relation to dividend pusher or stopper sufficiently clear or are there issues which need to be elaborated further ? Please provide concrete proposals how the text could be amended ?**

BNP Paribas considers that the guidance in articles related to dividend pusher and stopper is sufficiently clear and principles-based.

**3.2. What would be the impact of the restriction on the use of dividend pusher and stopper ? Please provide evidence.**

Besides the restrictions listed in article 83 of the guidelines, BNP Paribas considers that there should not be any restriction put on the use of dividend pushers and stoppers. Such

mechanisms are a fundamental feature of the hybrid capital instruments. It draws the relationship between equity holders and hybrid holders. Simply, equity holders have ownership of all value creation – through not only dividends but also share appreciation – but cannot receive a distribution while hybrid holders are not paid coupons in full. Fixed income investors, who represent the main available investor base for hybrid capital, relies on this fundamental feature to accept, or to simply be allowed, to invest in hybrid Tier-1 capital instruments.

BNP Paribas is concerned by article 85 of the guidelines stating in a single sentence that such mechanisms should not hinder a required recapitalisation. While BNP Paribas agrees on the principle, it strongly expects that CEBS does not consider the mere application of such mechanism as hindering any recapitalisation.

**4.1 Are the guidelines in relation to ACSM sufficiently clear or are there issues which need to be elaborated further ? Please provide concrete proposals on how the text could be amended.**

BNP Paribas identified a series of issues with guidelines related to ACSM. For what relates to required clarification, article 90 should confirm that banks must have full discretion of payments but subject to dividend pushers and stoppers as applicable.

*“... when the issuer has full discretion over the payment of the coupons or dividend at all times, subject to the application of dividend pushers and stoppers under conditions of articles 82 to 85.”*

**4.2 What would be the impact of implementing these guidelines on ACSM mechanisms ? Would you propose any other options ?**

While BNP Paribas recognises that accumulation of deferred interest may not be satisfactory in some jurisdiction due to insolvency law, it would point out that immediate settlement has a fundamental drawback : banks may be forced to sell shares when the share price is depressed. Also, if there is systemic pressure triggering the immediate use of ACSM by multiple issuers, institutions will have to collectively issue a large number of shares into the market, which could cause the banking system to suffer additional downward price pressure at a time when it might most probably be more appropriate to proceed with new equity raising. Most structures provide for issuer flexibility to decide when ACSM should be enacted and BNP Paribas sees tremendous value in leaving the choice for the issuer to decide when it should be enacted, possibly within an acceptable time period of for instance 3 years.

If immediate use of ACSM is maintained, it is important to understand that it is neither practical nor possible for all banks to have authorised but un-issued ordinary shares. Sufficient timing for submitting and obtaining the shareholders' approval for the use of ACSM and related issuance of ordinary shares should be an exception acceptable to CEBS.

**Loss absorbency**

**5.1. Are the guidelines relating to the definition of loss absorbency in going concern sufficiently clear or are there issues which need to be elaborated further ? Please provide concrete proposals how the text could be amended.**

