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-ebs.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

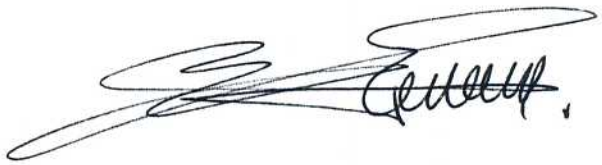
disadvantage vis-à-vis international competitors, in a context where easy access to capital is a key asset.

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[1]

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

[1] 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)[2] and (b)[3] are fully legitimate, information items listed as (c)[4] and (d)[5] 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[6] / SREP[7] 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

---

[2] A well-founded explanation why the credit institution intends to call or redeem the instrument

[3] 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

[4] 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

[5] 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.

[6] Internal Capital Adequacy Assessment Process

[7] 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.

BNP Paribas considers the guidelines related to the definition of loss absorbency in liquidation and in going concern to be broadly sufficiently clear and principles-based, subject to critical comments made in responses 5.2. and 5.3.

In its letter dated 22 February 2008, BNP Paribas strongly disputed the willingness of CEBS to use mechanisms such as write-downs and conversions into ordinary shares to increase the capacity of hybrid capital to prevent insolvency. It was explained in full details why BNP Paribas considered these mechanisms to fail achieving this objective. It is noted that CEBS has taken this argumentation into account and that such mechanisms are no longer mandatory to ensure the loss absorption capacity of hybrid capital both in liquidation and in going concern for what relates to preventing liquidation.

5.2. Do you agree with the definition of loss absorbency in going concern? If not why and what alternative would you propose ?

BNP Paribas agrees with the definition of loss absorbency in liquidation. On the basis of the CRD, an instrument must always rank junior to depositors, general creditors and subordinated debt of the institution, meaning that hybrids collectively are senior only to capital instruments referred to in Article 57(a).

CEBS takes the view in its guidelines that the definition of loss absorbency in going concern is to be assessed both from a capacity (1) to prevent insolvency and (2) to not hinder the recapitalisation / make the capitalisation more likely.

(1) Loss absorbency – Prevent insolvency

BNP Paribas agrees with the definition of loss absorbency in going concern for what relates to the capacity to prevent insolvency as defined in articles 106 to 109.

(a) Permanence
(b) Flexibility of payments
(c) Investors are not in a position to petition for insolvency
(d) Instruments are not taken into account for the purpose of determining insolvency

In some jurisdictions, it is noted that all four preconditions from article 106 can not be met by the instruments issued by banks, in particular the requirements (c) and (d). Only in these circumstances, BNP Paribas agrees that alternative features, other than those of permanence, flexibility and loss absorption to prevent insolvency (as defined in articles 100 to 109), may be required to achieve the criteria of article 106.

This being said, as we agree that such alternative mechanisms like write-downs and conversions do not either increase the loss absorption capacity of hybrids nor improve the situation of the institution or the one of more senior creditors and depositors, it should be confirmed that the use of such mechanisms should be restricted to insolvency purposes exclusively to satisfy the criteria of article 106. There is therefore no need to define a trigger in the terms and conditions as long as the contractual conditions of such mechanism properly address the requirements of article 106.

(2) Loss absorbency – Not hinder the recapitalisation / make the recapitalisation more likely

As hybrids do help to prevent insolvency and not hinder recapitalisation because they meet the four preconditions in paragraph 106, BNP Paribas does not believe that it is any further needed to elaborate on the loss absorption capacity on a going concern basis. In particular BNP Paribas

shares the view with many market participants that it is going beyond CEBS's remit to request that hybrids should contain mechanisms such as permanent / temporary write-down or conversion into equity at a trigger point to demonstrate that they do not hinder recapitalisation and make it more likely. Consequently, BNP Paribas strongly suggests CEBS to remove articles 114 and 115 from the guidelines.

Should CEBS decide to maintain articles 114 and 115, BNP Paribas then counsels against the introduction and definition of a particular trigger point at which the hybrid Tier-1 capital instruments would be automatically written down or converted. Writing down or converting is an approach that BNP Paribas does not agree with but should CEBS choose to keep it BNP Paribas recommends that it be kept at the discretion of the institution and of its competent authority. This will maximise the flexibility to manage exceptional situations such as recapitalisations. BNP Paribas thus strongly recommends the removal of paragraphs 116 and 117.

BNP Paribas believes that hybrid capital satisfying eligibility criteria (other than those 114-117 disputed here) already prevent insolvency. CEBS is concerned, as described in the article 113, that a balance between new shareholders and hybrid holders' rights is likely to be necessary for a recapitalisation. The hybrid instruments' features derived from the CEBS guidelines, excluding articles 114 to 117, already make possible to achieve such balance. Payment of dividends or coupons is at the full discretion of the institution and of the competent authority. As long as required, the equity holders will have full ownership on the value creation while distributions on hybrid capital instruments can be cancelled on a non cumulative basis. This flexibility answers the need for tools allowing to build a balance, or an incentive as the case may be, for a required recapitalisation.

This being said, the idea that new capital coming into the firm and subsequent profits could be used for distribution to ordinary shares while they should not be used "directly or indirectly" to benefit existing hybrid holders, through a write-down or similar mechanism, would effectively subordinate the rights of existing hybrid holders to holders of ordinary shares. BNP Paribas can't see how this would be acceptable, especially as "old" ordinary shareholders will not be able to be distinguished from new ordinary shareholders due to corporate law. As a result, existing hybrid holders would not only be worse off than new ordinary shareholders, but would also effectively be worse off than existing ordinary shareholders, which is absolutely not conceivable.. It would be unacceptable that existing shareholders, having elected the institution's board of Director, the latter having a responsibility on the financial performance and strength of the institution, be treated more favourably than hybrid Tier-1 investors, which have no way to influence the corporate governance of the institution,,.

Should CEBS decide to maintain articles 114 and 115, and the mandatory use of mechanisms such as write-downs, it should be confirmed that such mechanisms would stop to be in effect when the company would resume paying dividends, in order to respect the fundamental seniority of hybrid capital above ordinary shareholders.

Another possible mechanism favoured by CEBS it the conversion of hybrid Tier-1 capital into instruments referred to in Article 57(a) of the CRD. BNP Paribas is convinced that this proposal is counterproductive and fails ensuring the objective of making a recapitalisation more likely.

Mandatory conversion into ordinary shares may achieve a mere desired accounting objective of reducing liabilities for jurisdiction where hybrid Tier-1 capital is considered as liabilities for the purpose of determining insolvency, but are inadequate in many other aspects.

Such conversion mechanism would remove from the institution's balance sheet the hybrid Tier-1 capital component, depraving potential new equity investors from a meaningful leverage. Indeed, hybrid capital that has a fixed remuneration does not benefit from the subsequent recovery and value creation of the company, which remains the ownership of ordinary shareholders. Such conversion mechanism would force potential new equity investors to share all future value creation with a much enlarged group of shareholders. This appears as counterproductive when considering a required recapitalisation.
From a market perspective, fixed income investors are not holders of equity securities and may not be interested in hybrid securities with an automatic conversion feature. Even if they do, they would have to sell the shares in the market in case of effective conversion, triggering a substantial and long lasting selling pressure on the institution's stock price. This could also refrain new equity investors from recapitalising the company.
Other failures of a conversion mechanism are for instance that such provision would result in a massive dilution that could undermine the company's ability to recover and result in potentially new controlling stakeholders. This may stop recapitalisation prospects and lead to new shareholder's resisting recapitalisation plans.

To conclude, BNP Paribas is convinced that write-down or conversion mechanisms are neither necessary nor appropriate to ensure preventing insolvency [8] and to efficiently manage a required recapitalisation. If hybrid Tier-1 capital meets the four preconditions in paragraph 106, amongst others preventing insolvency and not hindering recapitalisation, BNP Paribas is convinced that it is not further needed to elaborate on the loss absorption capacity on a going concern basis.

5.3 Do the guidelines provide sufficient flexibility for institutions to design mechanisms that fulfill the objective of loss absorbency in going concern ? What alternative would you propose ? Does this flexibility raise level playing field issues ?

BNP Paribas considers that the guidance in articles related to loss absorbency in going concern for what related to preventing the liquidation is sufficiently clear and principles-based.

To the contrary, guidance for what relates to making a recapitalisation more likely is over prescriptive and counterproductive, and for reasons presented in answer 5.2, BNP Paribas recommends the removal of articles 114 to 117.

5.4 Do you think that different levels of subordination allow sufficient transparency on the ability of these instruments to cover losses in liquidation ? Alternatively, would you prefer to completely preclude different ranking between hybrids ?

BNP Paribas considers that this flexibility is best left with each individual institution in order to balance transparency, simplicity and efficiency of capital structure with any special requirements such as in the context of a recapitalisation.

Limits

6.1. Are the guidelines relating to the assignment of hybrids instruments to one of the three limits sufficiently clear or are there issues which need to be elaborated further ? Please provide concrete proposals how the text could be amended.

[8] Except in some jurisdictions where instruments are taken into account for the purpose of determining insolvency, where write-down, conversion or similar mechanism might be needed, as discussed earlier in this letter.

BNP Paribas considers that the guidance in articles related to limits is sufficiently clear.

6.2 Do you believe that the conditions imposed to mandatory convertible are proportionate and balanced ? Would you propose any other options ?

BNP Paribas cautions against article 125 requiring the definition of "emergency situation" in the contractual terms of the instrument. To do so might limit the ability of institutions and competent authorities to act with sufficient flexibility and may create unintended consequences which could increase volatility in distressed situations. It should be sufficient that such conversion may occur in case of a breach of capital requirements or regulatory intervention.

Similarly BNP Paribas cautions against the requirement that any higher regulatory limit than the 4% Tier-1 and the 8% total capital ratio must be identified in the terms and conditions. This to avoid disclosing discussions between institutions and regulators that should be treated confidentially as they are on forward looking assessments of profitability and business strategy.

Hybrid instrument issued through an SPV

BNP Paribas considers that the guidance in articles related to SPV's issuances is sufficiently clear.

Appendix 1 :

BNP Paribas' Fixed Income feedback to CEBS on CP 27

The questions posed by CEBS on its Draft Implementation Guidelines are meant to aid the finalisation and implementation of a clear EU-wide standard on hybrid capital. However, in light of recent market and industry developments, it may be appropriate to take a broader look at the banking sector's capital needs, as well as investor demand and market perspective, and whether the proposed guidelines aid in the fulfilment of these needs. We strongly believe that a robust Tier 1 market is integral to the survival and success of European banks.

From a market perspective, in recent months only a handful of "national champions" and the strongest European banks have had access to the Tier 1 capital markets. As the market continues to improve, we expect that second tier banks will also be able to access the market to increase their capital levels. We understand one of CEBS' objectives to be the creation of a level playing field for European banks. However, imposition of more stringent rules such as those set forth in the implementation guidelines would only serve to make it more difficult for all. As a result, many banks would continue to suffer as their access to capital diminishes and cost of capital increases as they are shut out of the hybrid market. This may be especially critical for mutual banks which have limited ability to raise equity.

This widening of the competitive gap may not apply only to banks within the EU. We understand that it is highly unlikely at this point that the Federal Reserve will conduct a regulatory capital overhaul of the same scope as the EU. This may lead investors away from European Tier 1 instruments in favour of more traditional and market-viable Tier 1 instruments in the US. The long term result will be limited access to hybrid capital for European banks compared to their US counterparts. This in turn will force European banks to raise greater levels of equity capital, leading to a higher cost of capital compared with US and international banks and resulting in a serious competitive disadvantage.

We wish to remind CEBS of the widespread market impact of communications from CEBS and the EC. For example, when the EC set out its "burden sharing" guidelines in July, the result was concrete and direct. Fitch Ratings downgraded the hybrid securities of 8 banks (and their related entities) despite the fact that "burden sharing" had already been implicit in EU state aid rules. This highlights that, even when no material change to regulations is made, any communication by regulatory bodies can have a direct and significant impact on the market. S&P and Moodys have also altered their methodology and the Tier 1 securities rated investment grade – which was almost all the market as recently as two years ago – is now a very small subset of the market.

Tier 1 instruments such as those envisaged in the CEBS proposed guidelines may incur even greater notching than traditional Tier 1 instruments currently do. While many investors may be aware of the inherent risks to such instruments, in some cases they may be downgraded to a point where certain investors are no longer permitted to hold them. Under CEBS proposed guidelines, we estimate that a vast segment of Tier 1 instruments would be sub-investment grade. This would reduce even further market demand for the securities.

We would reiterate that many fixed income investors would be unwilling or unable to hold the Tier 1 instruments envisaged in CEBS' proposed implementation guidelines. This is exacerbated by the fact that investors' confidence in the asset class has already been shaken as

hybrid capital instruments have begun to absorb losses through deferral, extension and in some cases write-down and liquidation. If Tier 1 instruments were to adopt the characteristics set out by CEBS, there is a real risk that the fixed income Tier 1 market will cease to exist.

As a last market-based point, we highlight the inherent loss absorption that has occurred in the in the market without the aid of write-downs or conversion clauses. The liability management activity which has been prevalent in the financial sector over recent months has allowed banks to strengthen their capital base while transferring losses to investors through repurchase of hybrid securities below the par amount. By leveraging on existing Tier 2 instruments, banks have demonstrated unequivocally that going concern support can also be practically provided by Tier 2.

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

From a market perspective, principal stock settlement is relatively rare feature amongst existing securities. The cap at 150% would make this a very weak incentive to redeem compared with the permitted level of coupon step-up. Recent market volatility has demonstrated that, even in short periods, stock prices can drop substantially. As a consequence, this feature actually affords very limited protection assuming the incentive to redeem comes into effect after 10 years. The use of this cap probably means that this feature will not be used in practice as investors would deem it useless compared to traditional step-ups.

2.2. CEBS is considering whether buy backs should under certain conditions also be permissible before five years and without replacement...

We believe the five year restriction is not logical. Banks generally do not have blanket restrictions on share buybacks, although of course they have to be discussed with the regulator. We are convinced that a principles-based approach is best and the only requirement for buybacks should be prior regulatory approval. We do not believe that hybrid securities should be subject to stricter regulatory controls than ordinary shares (in essence becoming "more equity-like than equity").

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.

The recent wave of liability management transactions, where banks bought back Tier 1 (and Tier 2) instruments significantly below par, allowed banks to generate Core Tier 1 capital from fixed income investors in substantial sizes. This underlines the key strengths of hybrid instruments even before loss absorption mechanisms are triggered. This was made possible - among other things - because the regulator allowed every bank to act based on its own specific circumstances without any blanket restriction. We believe that imposing such a requirement may limit the benefits of active capital management.

One of the negative impacts of mandatory replacement is that banks often try to "shop" for re-issuance into a cheaper market. This potentially leads to cases where banks issue to (generally domestic retail) investors below the market rate. This is not desirable in the long term. We also find the requirement for replacement into an instrument which is already in existence overly onerous and impractical. In precedent transactions, repurchase of existing securities and issuance of new securities generally take place simultaneously.

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

We find a number of issues with the proposed guidelines:

Tax implications: ACSM was designed to allow directly issued instruments to be tax deductible in the UK, NL and Belgium. Mandatory cancellation if the ACSM cannot occur without delay would likely change the tax analysis of the instrument and disallow tax deduction on the coupons.

Financial issues: While we recognise that accumulation of deferred interest may not be satisfactory, we would point out that immediate settlement has a fundamental drawback: banks may be forced to sell shares when the share price is depressed resulting in excessive dilution. Most structures provide for issuer flexibility to decide when ACSM should be enacted. We see tremendous value in leaving the choice for the issuer to decide when it should be enacted. This was acceptable in various jurisdictions as the unpaid amount would sit pari passu or even junior to the Tier 1 securities.

Practical problems: The requirement that Tier 1 holders subscribe for any shares issued under an ACSM seems counterproductive. Hybrid Tier 1 investors tend to be fixed income investors that prefer not to take possession of equity investments, even if only for a short period of time (many fixed income investors are prohibited by their governing articles from investing in equity instruments). Therefore, many traditional hybrid Tier 1 investors may not be willing, or able, to invest in a Tier 1 instrument with an ACSM that forces the holder to take delivery of shares instead of cash. Nor does the proposed requirement improve the position of depositors and senior creditors because they should be indifferent to the identity of the equity subscriber as long as the ACSM results in the preservation of cash. It is difficult to see the policy objective of Tier 1 holders receiving the shares as they are not bound to hold them. The financial position of the issuer would be the same if it were to (A) deliver shares having a specified value to Hybrid Instrument holders in lieu of payment or (B) sell shares having the same specified value to other investors and deliver the proceeds thereof to Hybrid Instrument holders in lieu of payment.

Fixed income investors cannot in most cases hold equity instruments. As a practical matter, direct delivery of shares would not work and there would need to be an intermediary step where equity instruments are monetised.

As a result of the above, we believe the ACSM will become less attractive for banks and investors alike. This should lead to a marked reduction in direct Tier 1 issuance for the countries which rely on ACSM and a move back to SPV structures.

We believe that CEBS should consider the following ACSM features which have been proven in various countries:

- Settlement timing at the option of the bank. As long as deferred interest is not settled, it should rank pari passu with the Tier 1 instrument (and hence be available to absorb losses)

- Any Tier 1 instrument should be eligible to be used for the purpose of ACSM, not only ordinary shares. This is an important feature in order to provide a level playing field for banks which are not publicly listed.

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

The current guidelines appear to contain some inconsistencies. For example, in respect of conversion for loss absorption purposes, Article 99 restricts conversion to ordinary shares while Article 114 c) suggests any security falling under 57(a) would be eligible.

We believe it would be more appropriate to allow conversion into any security falling under 57(a).

Also we note that the CEBS would leave full flexibility to banks to set the conversion price as appropriate and there would be no restrictions.

5.2. Do you agree with the definition of loss absorbency in going concern? If not why and what alternative would you provide?

We do not believe that a requirement to "not hinder recapitalisation" of a financial institution should be part of the definition of loss absorbency in going concern. This aspect of the requirement is ambiguous and would be difficult to enforce. We believe that "loss absorbency" is not a financial feature but the result of the combination of a number of features in Tier 1 instruments. We maintain our belief that the ability to suspend payment of coupons (or principal) in times of financial stress together with adequate subordination should be sufficient to provide loss absorbency in going concern.

We would stress that there are no case where hybrid holders have "hindered recapitalisation". On the flipside, based on recent experience it is actually ordinary shareholders which may disrupt recapitalisation or bail out (example such as Hypo Real Estate in Germany or Northern Rock in the UK).

A temporary write-down would not aid the restoration of capital to the bank or increase the amount of capital held since, from an IFRS perspective, this does not create accounting profit because the write-up would be automatic. CEBS has not been able to provide any guidance on how such loss absorbency helps banks beyond what is already the norm for existing instruments. This is currently the norm in a number of jurisdictions and has proven acceptable to investors subject to the dividend pushers & stoppers not being disabled.

A permanent write-down would fundamentally expropriate hybrid holders and effectively make them more equity like than equity. In addition, in many European jurisdictions, a permanent write-down would create a taxable profit, which may or may not be offset by tax losses. Recent experiences of German bank structures (IKB, HSH) absorbing losses have highlighted the risks involved in permanent write down for investors. From a market perspective, it is clear that there is no more significant appetite for these structures.

Mandatory conversion into ordinary shares may achieve a desired accounting objective of reducing liabilities, but we perceive several practical constraints. Most companies would be loathe to issue a Hybrid Tier 1 instrument with a mandatory equity conversion feature because, in a financial distress scenario, the provision could result in massive dilution that would undermine the company's ability to recover and result in potentially new controlling stakeholders. Indeed, dilution is highlighted as a concern of CEBS in its comments on principal stock-settlement and ACSM. .This may slightly confuse recapitalisation prospects and lead to new shareholder's resisting recapitalisation plans. Also, as stated, fixed income investors are

not generally holders of equity securities and may not be interested in hybrid securities with an automatic conversion feature.

We have also seen cases Northern Rock and Bradford and Bingley in the UK, in which automatic conversion would have taken place post-nationalisation. We do not see any advantage to this and do not believe it serves to aid recapitalisation o f the bank.

However, we believe that on case-by-case basis, a Tier 1 to ordinary share swap may be a sensible solution. This is illustrated by the Citigroup example where preference shareholders were offered an exchange for ordinary shares. This successful transaction underlines that there is no need for blanket requirements or automatic features and that stakeholders deal efficiently with the issues at hand.

The US institutional hybrid capital market would be particularly vulnerable if hybrid Tier 1 instruments were to include an equity conversion feature because the National Association of Insurance Commissioners (NAIC) could conclude that instruments should be classified as common equity for the purpose of determining the risk-based capital (RBC) charge for insurance company investors. Insurance companies comprise a significant subset of the US institutional hybrid capital market, and a common equity designation implies an RBC charge of 30% of the principal amount of the investment, which is generally prohibitive for many insurance company investors

5.3. Do the guidelines provide sufficient flexibility for institutions to design mechanisms that fulfil the objective of loss absorbency in going concern? What alternative would you propose? Does this flexibility raise level playing field issues?

The requirement that hybrid securities must aid recapitalisation using a write-down or conversion mechanism will severely impede institutions' flexibility to design viable hybrid capital structures. We believe investor demand for these structures would be limited, restricting banks' ability to raise Tier 1 capital.

In addition, some institutions may be unfairly disadvantaged by the requirement to include these mechanisms, for example due to national tax or legal constraints. We strongly believe in a less prescriptive approach to the definition of loss absorbency.

5.4. Do you think that different levels of subordination allow sufficient transparency on the availability of these instruments to cover losses in liquidation? Alternatively, would you prefer to completely preclude different ranking between hybrids?

Generally we are not opposed to flexibility in setting various subordination levels within hybrids. This is the case already in some countries where preference shares are required by law to rank junior to any deeply subordinated security. However, we would expect most capital markets instruments to rank pari passu with the most senior eligible Tier 1 instrument.

However, this flexibility should not be construed as a way to later increase the subordination of hybrid instruments. The idea that new capital coming into the firm should not be used "directly or indirectly" to benefit existing hybrid holders would effectively subordinate the rights of existing hybrid holders to holders of any new capital coming into the firm, even if such capital is in the form of ordinary shares. We can't see how this would be acceptable, especially as "old" ordinary shareholders will not be able to be distinguished from new ordinary shareholders due to corporate law. As a result, existing hybrid holders would not only be worse off than new capital investors, including ordinary shareholders, but would also effectively be worse off than existing ordinary shareholders.

We believe this would be totally unacceptable to Tier 1 investors as it would breach the fundamental feature of Tier 1 hybrids, which is to be better off than ordinary shareholders in a downside scenario. If implemented, this requirement may hinder EU-banks' access to the Tier 1 market.

7. Are the guidelines relating to the indirect issues of hybrid instruments sufficiently clear or are there issues which need to be elaborated further? Please provide concrete proposals on how the text could be amended.

We find the proposals regarding indirect issuance to be sufficiently clear. However, we believe the CEBS should also clarify that SPV structure should be acceptable not only for "solo" capital calculations but also for "consolidated" capital calculations where such notions exists (for example in Germany or Austria). We believe that as CEBS and the CRD make no difference between SPV and direct issues, there should be no penalty for issuing through an SPV. We would suggest that the application guideline provide a specifc waiver for Tier 1 instrument issued through SPV so they can be included not only in consolidated Tier 1 ratios but also on solo basis.