BNP PARIBAS

Comments to the consultation paper on Draft Regulatory Technical Standards on own funds published on 4th April 2012

Executive summary

While our complete answer to the EBA consultation is detailed below, we summarize here the most important points of this answer (by order of appearance in the consultation paper):

- We seek clarification that any "formal" management decision amending the dividend payout policy, while strictly documented, does not have to be made public;

- We feel that Article 6 (direct and indirect funding of capital instruments) should explicitly be directed at regulatory arbitrage situations, with all arm's length transactions conducted in the normal course of business being excluded from its scope;

- We are concerned that Article 15 may not be compliant with the Regulation, as it negates the corresponding deduction approach endorsed by the level 1 text; to address this, we suggest a pragmatic alternative based on subordination to ensure this approach is respected and captures all capital instrument or their equivalents;

- To accommodate the variety of EU company laws and avoid further distortion, the standard should clarify that the requirement that distributions on Additional Tier 1 instruments be paid out of distributable items is of an economic nature (i.e. coupons cannot be paid if they exceed such items), not a strictly legal one;

- We believe the restrictions on the features of Additional Tier 1 instruments imposed by the draft go much beyond what is required for these instruments to exhibit satisfactory loss absorption, in particular with respect to:
    - The proposed prohibition of distributions while the par value of the instrument is temporarily written-down;
    - Other mechanisms which amount to making Additional Tier 1 holders worse off than equity holders (notably the restriction of amounts available for write-ups to profit generation, which ignores other ways of restoring capital ratios)
    - The obligation that write-ups be fully discretionary.

  These features, which are not inscribed in the Regulation, would dry out the market for Additional Tier 1 instruments. This would oblige European banks to comply to Tier 1 capital ratios with Common Equity Tier 1 instruments and would therefore distort competition with US banks as the draft regulation adopted on June 7th, 2012 does not require any compulsory write-down or conversion mechanism to be included in hybrid instruments.

Detailed comments

Q01. Are the provisions on the meaning of foreseeable when determining whether any foreseeable charge or dividend has been deducted sufficiently clear? Are there issues which need to be elaborated further? What would be your definition of foreseeable?

For operational purposes, we would welcome additional clarity on the degree of formality that is required for a management decision to determine the foreseeable dividend. In particular, such decision amending the payout policy would have to be reported to the competent supervisory authority (who shall be entitled to require evidence, such as proceedings from the institution's management), but not necessarily disclosed publicly as it is privileged information.

The expected dividends amount should be reduced, if the application of the dividend payout policy or of the distribution rate actually paid over the last two to three years were to result in the computation of an expected dividend inconsistent with any restrictions on payment (i.e. if the average payout has been at 55 % of the profit and the Maximum Distributable Amount – MDA – calculated in accordance with Article 131 of the Directive is 43% of the profit, then the expected dividends should be capped to this MDA even where the management has not formally decided so).

Additionally, in the "average payout method" it should be clarified whether consolidated profits or statutory profits are to be taken into account (this should depend on the financial communication of the bank, which is generally consistent).

We also wish to make a remark on **Article 7** of the draft RTS (meaning of distributable items for the purposes of determining the amount available to be distributed to the holders of own funds instruments of an institution): we would like clarification that this is to be understood as an economic requirement and that the spirit is more important than the letter. In particular, for Additional Tier 1 instruments that are legally debt (and for which coupons may not be paid "out of" distributable items as these are reserved for shareholders under applicable national company law), we would welcome clarification that EBA would agree with including in these instruments a clause stating that if coupons are higher than statutory distributable items, then the institution will be prohibited from paying the amount of coupons thus exceeding distributable items (with exactly the same effect for the institution as if the coupons were indeed paid out of the distributable items).
We understand from the explanatory text that the EBA is aware of the issue.

Q02. Are the provisions on the applicable forms of indirect funding of capital instruments sufficiently clear? Are there issues which need to be elaborated further?
The scope of restriction could be extended to entities not included in prudential consolidation or in the supplementary supervision in accordance with directive 2002/87/EC, but included in accounting consolidation. Moreover, any entity where the issuer institution directly or indirectly has control, but the entitiy for some reason nevertheless is not included in the consolidation, should be prohibited too, to participate indirect funding, by extending funds to a person in order to purchase the parent institution's share.

The RTS should also clarify that "normal" situations should not be penalized, as the provision in Article 26 is clearly directed at regulatory arbitrage attempts: for instance, if a 100% controlled subsidiary lends its excess cash to its mother company in the normal course of business and not as a consequence of capital transactions, this should not be interpreted as an indirect funding by the subsidiary of the purchase by its mother of capital instruments. Likewise, if a bank lends money to a private customer as part of the normal course of business

and the latter invests part of their wealth into capital instruments issued by the bank, this should be outside the scope of direct / indirect funding, except obviously if the loan is conditional on such investment (either at initiation or through a clause demanding repayment in case the customer sells their investment).

Q03. How do you assess the provisions on related parties in particular the requirement to assess that, on an on going basis, the related party has sufficient revenues?

The definition of "sufficient" revenues to repay interests on funding does not seem specific enough. In addition, it may be very difficult to demonstrate that a related party would have such "sufficient" revenues, and this may raise legal issues (as the institution should not have access to information on the related party's other sources of income, for confidentiality reasons). Requiring that the funding is made fully at arm's length should be a necessary condition and a reasonable assurance that there is no regulatory arbitrage.

Q04. Are the provisions on the limitations on redemption of own funds instruments sufficiently clear? Are there issues which need to be elaborated further?

N/A

Q05. How would you assess the impact of documenting decisions on redemptions?

N/A

Q06. How would you assess the cost impact of including in the provisions of the instruments criteria as listed in paragraphs 2 and 3?

N/A

Q07. Are the provisions on the deductions related to losses for the current financial year, deferred tax assets, defined pension fund assets and foreseeable tax charges sufficiently clear? Are there issues which need to be elaborated further?

We welcome the fact that the netting between Deferred Tax Assets (DTA) and Deferred Tax liabilities (DTL) do not seem dependent on the accounting representation. In other words, in order for the netting between DTA and DTL to be applicable, it seems that there is no need to explicit netting in the balance sheet (i.e. "net" DTA); instead, DTA and DTL can remain represented as "gross " values and be netted for regulatory purposes (provided the other conditions set in Article 12 of RTS are met).

We also recommend to further elaborate EBA stance on Deferred Tax Assets (DTA) and Deferred Tax liabilities (DTL) raised at the consolidated level, since DTAs and DTLs recognised only for consolidation purposes and depending on Purchase Price Allocation (PPA) under IFRS3 rules should not be taken into consideration for the capital calculation.

Regarding pension fund assets that are exempt from deduction, it should be clarified (i) that, in consistence with IFRS standards, this extends to the assets where the surplus can be refunded, used instead of future contributions or used to cover the deficit of another plan; and (ii) that in the case of pension funds managed by a related party and as such being accounted for on a gross basis (showing separately assets and liabilities), only net assets should be deducted.

The immediacy condition should only apply when assets are to be refunded (not used to reduce future contributions or to cover the deficit of another plan, as in these cases a temporal condition makes no sense). In that respect, we draw attention to the clarification adopted by the US consultation paper on Basel 3 transposition, where the access to the assets is deemed to be unrestricted if the institution "is not required to

request and receive specific approval from pension beneficiaries each time it would access excess funds in the plan"; a similar clarification would be welcome.

Finally, we would like further clarification on the condition laid out in paragraph 1 of Article 14 which allows institutions to consider that foreseeable tax charges have been taken into account in accounting own funds: IFRS-based accounts clearly fill that condition, but it is unclear which other GAAP will be deemed equivalent to IFRS in that respect.

Q08. Are the provisions on the types of capital instruments of financial institutions, third country insurance and reinsurance undertakings, and undertakings excluded from the scope of Directive 2009/138/EC in accordance with Article 4 of that Directive that shall be deducted from the following elements of own funds sufficiently clear? Are there issues which need to be elaborated further?

Q09. How would you assess the impact of operating a deduction from Common Equity Tier 1 items?
[Q 8 & 9] We feel that the wording of the Standard could suggest that all "capital" instruments (including dated subordinated instruments) are to be deducted from CET1, except if the issuing financial institution is supervised as under CRR1, which will usually not be the case, even in the EU ("financial institutions" are not subject to CRR, whose scope is limited to "institutions"). As a result, the standard would be **in explicit contradiction** with the level 1 text which clearly stipulates that the deduction approach is to be "corresponding". It would make it extremely costly for EU institutions to invest in subordinated debt from most financial sector entities, and as a result create a clear competitive disadvantage for them – it could even, paradoxically, make it more interesting for EU institutions to invest in (riskier) equity than in (less risky, but less remunerative) debt, as the two will bear the same capital charge.

Furthermore, it would be inconsistent to advocate demanding eligibility criteria for EU institutions (which we do not contest) but to consider that all instruments issued by non-EU institutions or by EU financial institutions which do not meet those criteria carry the same level of risk as Common Equity Tier 1. We suggest to review the wording to make it consistent with the text, which in this respect fully derived from the Basel recommendations.

We understand the EBA may legitimately be concerned that if CRR criteria are kept as a reference (which would be the logical position), almost all subordinated instruments issued by banks outside the EU and financial institutions would be out of the scope of deduction as banks outside the EU will not in general have to respect the strict criteria outlined in CRR and financial institutions are not subject to banking regulation. As a **pragmatic alternative** to the criteria listed by CRR, we therefore suggest that the corresponding deduction approach be based upon **subordination**, with equity being regarded as equivalent to Common Equity Tier 1, deeply subordinated debt to Additional Tier 1 and subordinated debt to Tier 2. This alternative would apply to:
- non-EU institutions;
- non-EU insurance entities (including reinsurance, etc.);
- all other financial sector entities.

For EU institutions and EU insurance entities, the criteria listed in CRR and "Solvency II" would naturally apply.

Q10. Are the provisions related to the requirements for cooperative networks sufficiently clear?
N/A

Q11. Would you agree on the types of incentives to redeem as described in paragraph 2? Should other types of situations be considered as incentives to redeem?
The text seems comprehensive.

Q12. Are the provisions on the procedures and timing surrounding a trigger event and the nature of the write-down sufficiently clear? Are there issues which need to be elaborated further?
We welcome the clarification that the write-down may be either permanent or only temporary. As in other parts of the text, it would be more appropriate to limit the recognition of Additional Tier 1 (AT1) to the "foreseeable" amount of Common Equity Tier 1 to be generated in the event of a write-down.

For operational purposes, the RTS should state that a conservative estimate of the amount of CET1 needed to restore the CET1 ratio to the trigger level should be computed, in order for the write-down to occur as quickly as possible: this could be done by identifying the main sources of decrease in the CET1 and increase in the RWA since the last regulatory reporting (for instance unrealized losses on securities, surge in risk and as a result risk-weighted assets in a particular sector etc.), computing an estimate of the shortfall of CET1 when incorporating these effects to the last solvency ratios computed, and grossing-up the resulting amount by 10% to cover for non-identified variations.

We are puzzled by the prohibition of distribution on Additional Tier 1 while the amount is written down (Article 20 3a), as distributions on shares or CET1 instruments may still be paid during this period. This clause, which made sense for "legacy" hybrid instruments (incorporating dividend pushers and/or stoppers), now amounts to making Additional Tier 1 holders worse off than those shareholders which were present in the institution before the fall of the ratio. At this point, the hierarchy of holders within the capital structure has clearly been reversed as AT1 holders have given up any claim in insolvency for the written-down amount, and for the residual principal, holders have no prospects of payment until the principal amount is fully re-instated. By contrast, equity holders (and any converted AT1 holders) maintain a claim on the residual assets of the institution and, importantly, may also receive payments at the discretion of the institution, subject only to the restrictions of the MDA.

As a reminder, Additional Tier 1 holders have no voting rights to protect their interests. While we recognize that dividend stoppers are prohibited by the Regulation, the interdiction of coupon payments is not required by it in any way (on the contrary, coupons are required to be subject to "full discretion").

We argue that if amounts are available for distribution, the ability to make (partial) T1 coupons should not be excluded. The amount should be subject to the constraints on T1 coupon (i.e. MDA restrictions), but the bank should retain the discretion to pay T1 coupons rather than make distributions to the shareholders once the situation of the institutions allows it (i.e. the principal amount should not need to be written-up in full before coupons are resumed). In practice, if an institution is subject to the MDA restrictions, the institution will be required to prepare a capital conservation plan in close dialogue with the Competent Authority, and therefore in any case, will not have an unfettered ability to use the MDA.

The demand and pricing for AT1 with temporary write down features will be severely impacted if the RTS is not amended, as the vast majority of traditional hybrid investors will find the asset class un-investable, if the hierarchy within the overall capital structure cannot be respected. Such instruments would not only be unduly costly, but also the majority of them will simply find no investors, which would make EU institutions more fragile. Indeed, those instruments would have equity-like features, and the equity investor base is much smaller than the fixed income investors base – too small at any rate to absorb the supply of all EU institutions.

It is imperative that the EBA does not restrict institutions from accessing capital from either the equity or the AT1 investor base to avoid hindering the recapitalisation of the banking industry.

Q13. How would you assess the impact of the provisions to be applied to temporary write-downs and write-ups?

Write-up formulas

The RTS is too restrictive in compelling write-ups to be discretionary. This will not be consistent with the 27 company laws and debt security laws that coexist across the European Union and would necessarily lead to competitive distortions, or to institutions being prohibited from issuing out of their head offices (which is clearly not a goal of the new regulatory framework). This would also be detrimental for the instruments' loss absorbing capacities.[1]

The key objective is to preserve the institution's capacity to proceed to a capital increase once it is in a difficult situation without reversing the hierarchy of investors. As a result, (i) any contractual clause that makes "previous" Additional Tier 1 holders worse off than "new" shareholders and does not hinder recapitalisation should not disqualify the instrument; (ii) notwithstanding the protection of the interests of "new" shareholders and of the bank's solvency, Additional Tier 1 holders should not be subject to inequitable restrictions, i.e. coupon payments and write-ups should be restricted when the buffers are not met, but not if dividend payments to existing shareholders are allowed.

As an example, the simplest version of such a clause could for instance specify that the right to an automatic write-up disappears when and if any capital increase is performed after a write-down. This would ensure that Additional Tier 1 holders are not worse off than "former" shareholders, especially in cases where the bank is able to achieve recovery on its own via for instance disposals of its assets, but may not capture any funds injected by new shareholders where recovery requires external capital.
This would address the EBA's concern to facilitate external capital increase if the 5.125% trigger is breached.

Amounts available for write-ups

We understand the EBA is drawing a parallel between a write-down and a share conversion, but share valuations, as well as distributions, are not fully determined by the profits generated. The goals of the instrument and the write-up should also be commensurate with the metric they are meant to restore, i.e. Common Equity Tier 1 levels. Therefore, with respect to the amounts available for write-ups, these should include all surplus Common Equity Tier 1 generation, without limitation to accounting profits, for instance a reversal of unrealized losses, or disposals that lead to a reduction of risk-weighted assets. This is in full consistence with the fact that the regulatory framework recognizes the effectiveness of such measures by requiring that they be included in the capital conservation plan which the institution must draw if it fails to meet the buffers.

To elaborate on the example provided by EBA, profits (and other sources of surplus Common Equity Tier 1 generation) of preceding years "attributable" to Additional T1 holders should also be available for write-ups.

[1] For instance, the tax regime for additional Tier 1 instruments differs among jurisdictions in Europe. In a number of jurisdictions write-down is considered as a cancellation of debt in absence of return to good fortune provision and generates taxable profit. The existence of a pre-determined write up clause entails that in case of return to "normal", the write up should take place automatically in accordance to certain conditions to be defined and upon approval of the competent authority. This write up automatism makes possible not considering the write down event as a cancellation of debt, which would be taxable and would unduly reduce the instrument's loss absorbing capacity.
As another example, under some jurisdictions contracts that derive from the draft RTS may be deemed leonine and have no legal enforceability.

Indeed, in as much as distributions may be made out of earnings from previous years, in the example provided shareholders essentially keep all of the 100 profit made in year 1 as they are incorporated into retained earnings and will eventually be distributed to them, while Additional Tier 1 holders will never have a claim on the 29 profit attributed to them (in other words, while AT1 coupons are non-cumulative, this is not the case of dividends). As a result, in year 2 the amount available for write-ups before MDA should be 54 (not 25).
Another technical point is the amount available for write-up must be at least the same as would be available for any permanently written-down instruments. The coupons on these instruments are only subject to the discretion of the Issuer and the MDA restrictions when in breach of the capital buffers. Therefore, we reiterate our view that there needs to be greater headroom for the write-up and that the amount available for holders of temporary written down instruments should be at least equivalent to the coupon payment on the written-down amount.

Marketability issues
Finally, here again we wish to draw attention to the US consultation paper transposing Basel 3, which merely applies the common requirements of the BCBS December 2010 text and the associated press release of January 2011, which together require *either* a contractual loss absorption clause *or* a legal loss absorption regime (which will be deemed to exist in the US, thus making the contractual clause unnecessary). By requiring that all instruments issued by EU banks incorporate the clause, even though a loss absorption regime is currently under review, the Regulation is thus already super equivalent to Basel requirements – and the draft RTS make its requirements even harsher.
If the draft RTS are not amended, the gap between the different instruments will widen remarkably, with the obvious result that non-EU banks will capture the majority, if not the entirety, of the market for hybrid instruments, thus putting European institutions at a competitive disadvantage and jeopardizing European growth perspectives.

Q14. Are the provisions on indirect holdings arising from index holdings sufficiently clear? Are there issues which need to be elaborated further?
The text is clear.

Q15. How would you assess the meaning of operationally burdensome and which circumstances would be considered as operationally burdensome?
In general, and to avoid having institutions assume risks on financial sector entities that are not properly monitored, the EBA should further specify the indefinite legal terms such as “low materiality”, “low” (net exposure), “short duration”, “strong liquidity” etc…

Q16. How would you assess the cost of conducting look-through approaches vs structure-based approaches for the treatment of indirect holdings arising from index holdings?
N/A.

Q17. How would you assess the levels of the thresholds for market making purposes (identical for hybrid instruments to the ones provided by CEBS/EBA guidelines on hybrid instruments published in December 2009) for competent authorities to give a prior consent (Article 29)?
The thresholds appear consistent with the current practice.
It would be worth clarifying the circumstances under which competent authorities may lower the limits indicated in points (a) and (b) of Art 29 (3) and Art 32 (2) of the draft RTS.

Q18. How would you assess the impact of the proposed timing of 3 months for the submission of the application (Article 31)?

The timing, though lengthy, is acceptable and welcome insofar as it grants a uniform European perspective and a level playing field.

We do not think necessary to systematically include the over-exhaustive information referred to in Article 30 in the applications (it will probably be time-consuming for all stakeholders and to no use as the supervisor continuously monitors the institution and probably already has the useful information), except obviously if required by the supervisor, who could for that purpose define a materiality threshold.

Q19. How would you assess the levels of the thresholds for the non-materiality of the amounts to be redeemed for mutuals, cooperative societies or similar institutions (Article 32)?
We welcome the alignment between all types of institutions.

Q20. The EBA is considering setting a time limit the waiver shall not exceed. This time limit would be set up at a maximum of 5 years and a lower time limit could also be considered. Which time limit, within a maximum of 5 years, would you find appropriate?
The time limit of five years seems a minimum and thus there seems no reason to reduce it (if anything, an increase would be welcome).

In addition, the authorities that may approve the plan should be defined more broadly (they might include supervisory authorities, resolution authorities, the relevant ministry…). Furthermore, this RTS should not be too restrictive *ex ante* (as is the case in the proposed draft), as during stressed times authorities may want to be able to use this exemption as broadly as possible to make rescue of distressed institutions more attractive and preserve taxpayers' money.

Q21. Would you assess the limit on the amount of assets set at 0.5% of the average total assets of the special purpose entity over the last three years as appropriate?
The limit seems fine; however, to accommodate smaller institutions which are likely to issue small amounts of instruments per SPE, the EBA could consider setting the limit as the maximum between 0.5% of assets and 0.5 M EUR.
We seize the opportunity to seek clarification on the fact that, in consistency with the Basel text, where the conditions are met for instruments issued out of SPEs to be qualifying, they should be treated as if issued directly by the institution (i.e. not subject to the computation described in CRR's article 79).

Q22. How would you assess the impact of setting the limit at 0%, meaning keep only the possibility offered by paragraph (a)?
Again, we draw attention to the variety of corporate and tax laws across the EU and advise against taking radical positions.