Comment letter – April 2010

Dexia's comment letter on Basel Committee "Strengthening the resilience of the banking sector"

Dear Sir/Madam,

Dexia is a European bank, with 35,234 members of staff and core shareholders' equity of EUR 18.5 billion as at 31 December 2009.

The Dexia Group focuses on Retail and Commercial Banking in Europe, mainly Belgium, Luxembourg and Turkey, and on Public and Wholesale Banking, providing local public finance operators with comprehensive banking and financial solutions, notably in France and Belgium. Dexia ranks among the three largest banks in Belgium and Luxembourg. Dexia also holds a strong position in Turkey, through DenizBank. Dexia plays a major role in the financing of local facilities and infrastructures, the health and social housing sectors and the social economy. Thus the Group assists public and semi-public operators in implementing their projects, and participates in the development of local infrastructures and services.

In December 2009, after the financial crisis, the Basel Committee of Banking Supervisors (BCBS) published a document *"Strengthening the resilience of the banking sector"* aiming at improving the system of supervision of the banking sector. This document is open for consultation until April, the 16th, 2010.

Dexia would like to point out certain elements of this new proposal, that may have major impact on the banking business, the primary role of the banks (liquidity transformation) and, there after, the real economy.

As a very general remark, like for the implementation of the Basel II ratio in 2006 (application of *floors*), we strongly believe that these new rules will have a major impact on banks' ratios and businesses. As a consequence, we propose to apply an evolving *cap* to required capital, in order to limit a possible "cliff effect". This is of upmost importance for some specific elements of the resilience paper, detailed here after.

CVA

CVA is an accounting definition (depending on the rating of the counterparty, the spread used, and other parameters which vary over time) used to adjust the market value of a derivative instrument to reflect the counterparty creditworthiness. Indeed, CVA is computed as an economic expected loss for the credit risk
Industry practices are still very different thus we advocate that regulators should take into account the CVA framework and its management (banking or trading) in place for each bank.

The regulatory capital charge should depend on management intent of the CVA position. Especially, in the case of banking book management intent we are of the opinion that counterparty credit risk is already entirely covered by the internal models of the bank which

reflect the management view on this risk type. In this way, the proposed capital add on (= the regulatory view on this risk) would imply a double impact for the banks, indeed the amount of CVA is not recognized as a reduction in the calculation of the counterparty risk capital charge.
If a default occurs the CVA is available to cover the whole or part of the loss so for the part of the loss covered by CVA provision it is unnecessary to have a capital charge.
So, we advocate to the Commission to take into account the CVA provision in its proposal.

The bonds equivalent approach does not properly represent the CVAs sensitivities to market risk factors. The one year market risk capital charge is not consistent with the current market risk framework. With this approach the impact is totally disproportionate with the risk involved, and leads, as mentioned above, to double counting with already existing methodologies to identify counterparty risk.

We advocate that further analysis should be conducted in order to ensure that the approach gives a reasonable reflection of the true risks related to counterparty defaults.

Other Comprehensive Income, Deferred Tax Assets and IFRS 9

In parallel to Basel III consultation where the BCBS develops its new regulation framework, the IASB is drafting a new standard replacing IAS 39. Because of the potential change of the treatment of unrealized gains and losses, a. o., the endorsement and implementation of IFRS 9 will have a paramount impact on Basel III proposals.

When IFRS were put in place, regulators created a series of prudential filters that "managed" the impact of the accounting standards on the solvency ratio and limited the volatility of own funds. While we understand why there is in increasing need to reconcile accounting and supervisory reporting, we are very worried about the removal of the prudential filter on unrealized gains and losses (within Other Comprehensive Income). As a matter of fact, Other Comprehensive Income is a less stable component of accounting own funds and should not be included in the regulatory common equity. In addition, to our understanding, Basel reporting's goal is to catch the risk relating to the assets, independently from the accounting classification used for the assets.

In this context, we propose to allow banks to benefit from a transition period of 5 years, during which no prudential filter would be abolished.

This will also avoid any arbitrage possible with regards to the date of implementation of IFRS 9 by banks (some may want to consider to adopt IFRS9 as soon as possible to eliminate all unrealized losses from their balance sheet, other may want to do the opposite when accounting for unrealized gains). As such, it would smooth the shocks created by the successive implementation of Basel III and IFRS9 in bank's ratios, as well as improving comparability across banks during this transition period. Using IFRS9 instead of IAS39 as the basis of the solvency ratio calculation will carry several benefits:

- Cost efficiency: IAS39 is in any case very likely to be a temporary standard. As a result, the implementation of Basel III under IAS39 will have to be modified when IFRS9 or any IAS39 replacement comes in force. In addition, early adopters of IFRS9 will suffer additional costs due to different references for financial and regulatory reportings (costs of maintaining a dual system as well as costs of disclosing appropriate reconciliations). Such costs will not exist if Basel III is implemented only after IFRS9 or prudential filters are kept in place at least until IFRS9 is implemented.

- Understandability: when IFRS9 comes in force, a shift in Basel III ratios will occur without economic substance.
- Comparability: IFRS9's transition period spreads over four years. Therefore, some companies will choose to adopt IFRS9 as soon as possible while others will continue to apply IAS39 as long as possible. This will impair comparability during the transition period.
- Less accounting arbitrage and better reflection of economic substance: Although IFRS 9 is heavily criticized as a global move toward fair value accounting, it has also advantages. Bonds with basic loan features that are managed on an amortized cost basis may be measured at amortized cost. In addition, unlike IAS39, IFRS9 does not impose a 'tainting rule'. Under IAS 39, sometimes the reason to classify some bonds in AFS (measured at FV through OCI) was just to avoid the tainting rule applicable on the HTM Portfolio.

Let's illustrate the link between solvency and IFRS9/IAS39 further with an example. Presently, without the application of IFRS9, the value at which AFS assets are booked depends on credit spread and liquidity spread environment via movements in the AFS reserve (assuming interest rate hedged). So, under the new Basel III (unchanged) rules before an IFRS9 application, except from the fact that these unrealized gains and losses would imply a high volatility of the own funds of banks having high amount of assets accounted as available for sale, a liquid and low credit risk bond (therefore booked in AFS) would generate a volatility of regulatory own funds above a loan or an illiquid bond booked as « held-to-maturity». For example, an AFS bond "European State" would lead to Core Tier 1 variations due to credit spread or liquidity spread changes whereas an illiquid (and therefore held-to-maturity) General Motors bond would lead to no change in Core tier 1 (as far as no impairment is booked).

In any case, we believe there should be a link between the "impact on solvency capital" and the "impact on RWA" to keep consistency in the rules and avoid double counting or exaggerated impacts. On this matter, if no filter will be retained on the AFS reserves, the AFS reserves deducted from solvency capital as such hit the bank's solvency in respect of the assets classified under AFS. Of course, then the RWA to consider for those assets classified under AFS should account for this impact.

Concerning Deferred Tax Assets (DTA), Dexia understands that supervisors may want to consider deducting some DTA from own funds. However, we remind that these assets are, under IFRS, subject to strict rules in order to be recognized on the balance sheet and under the control of the company's auditors. Hence, in our view, it is legitimate to consider these as own funds. If not, a deduction of these DTA would decrease the own funds more at the moment of a downturn cycle of the economy and would as such increase the pro-cyclicality of the measures, impacting the recovery of real economy.

We consequently also propose not to deduct the DTA booked in relation to these unrealized gains and losses from own funds. Again, if it would not be the case, it would imply a higher volatility in own funds.

Leverage

With regards to the leverage ratio, we have doubts and questions on its current definition. We are of the opinion that such a ratio is a clear step backwards compared to Basel II requirements. If such a ratio would be applicable to banks, we support its inclusion in the Pillar II, certainly not in Pillar I. As matter of fact, where we believe the Solvency ratio is the indicator for Pillar I, we

believe the leverage ratio should remain a supplementary measure and be an indicator for Pillar II.

It is important to note that a too strict regulation on leverage ratio, applied on Pillar I, may have insidious impacts on the real economy and/or the risk level of banks' investments. If a bank has reached its maximum level of leverage ratio but not its solvency ratio limit, this bank will have the following options:

1. Increase its margin on all counterparties, also on "low risk" counterparties (public or local authorities) in order to compensate the impact from the additional cost of the breach of the leverage ratio from low credit risk counterparties with an equal level of leverage consumption as another counterparty with higher profitability, or
2. Increase its investments in "high risk" counterparts in order to increase its return rate (because there is still a margin before breaching the solvency ratio), or
3. Reduce its lending capacity, but it is contrary to the banks' role (macro-economical viewpoint of financing the real economy).

Some may have noticed that in countries where the leverage ratio is applied, its application caused an increase of securitization and off-balance sheet special purposed vehicles.

More broadly, since this ratio does not take into account the risk profile of banks, it will impact banks differently according to their business. Banks active in local credit like Dexia will be, due to their specific type of counterparties, more impacted than others: since public sector counterparts have very low risk, margins are accordingly low and volume of assets on the balance sheet comparatively high. Dexia needs a proportional higher level of nominal exposure, compared to investment banks for instance, to be profitable.

As a consequence, we request regulators not to use, for all components of the exposure value, the accounting value of the balance sheet items but the risk weighted value instead. As leverage ratio guidelines are intended to reduce risk, it may be adequate that measures, taken to reduce risk, such as netting and collateral are taken into account. We believe this is in line with alternative proposals from the Basel Committee. Indeed, with regards to derivatives, we understand that an alternative proposal is based on the regulatory measure and allows for regulatory netting (see paragraph 227, page 64). This could be an adequate means for taking into account the risk profile and the business structure of banks. This should at least be applied for derivatives, repurchase transactions and 0% weighted elements of the solvency ratio.

We do not support the inclusion of off-balance sheet elements in the exposure measure of the ratio at a 100% conversion factor. Off balance sheet elements should be included by using their conversion factor.

In any case, we strongly advocate for the non inclusion of interest rate derivatives and "European portfolio hedge" derivatives since they are never exchanged at the notional amount. The notional amount does not represent a true and fair view of the leverage exposure of the bank on these elements.

In order to respect a minimum of level playing field, rules must be applied identically overseas, especially on netting and consolidation rules. For instance, it would imply for those that are under US GAAP, some necessary adjustments would be made:

- No netting allowed for derivatives,

> Include SPEs that would be consolidated under IFRS but are not under US GAAP,
> etc.

Also, we note that because of interactions between leverage and liquidity ratios, we agree with supervisors' proposal to exclude liquid assets from the exposure measure for leverage ratio (see paragraph 219 of the resilience paper). Accordingly, we believe that assets subject to a 0% risk weight factor under Basel rules should not be taken into account in the exposure value of leverage.

Liquidity

Finally, with regards to liquidity, two indicators will have to be computed: liquidity coverage ratio (LCR) and net stable funding ratio (NSFR). As can be seen in the table below, these indicators are very severe for public sector banks:

	LCR	NFSR
Assets	▪ Loans : inflows within 1 month horizon can be fully considered . ECB eligible loans not included in the buffer. ▪ Bonds : only unencumbered bonds above 1 month issued by public sector entities above A+, with a 0% RWA and for which a repo market exists are included in the liquidity buffer. ▪ Own-name covered bonds not included in liquidity buffer.	▪ Loans : loans above 1 year (regardless of whether ECB eligible or not) need to be backed by 100% stable funding, loans below 1 year don't need to be backed by stable funding. ▪ Bonds : unencumbered bonds above 1 year issued by public sector entities above A+, with a 0% RWA and for which a repo market exists need to be covered by 5% stable funding ; other bonds above 1 year need to be covered by 100% stable funding. Bonds below 1 year don't need to be covered by stable funding. ▪ Own-name covered bonds not included in liquidity buffer.
	=> Public sector banks typically granting long-term loans, very few of their assets are considered as liquid.	
Liabilities	▪ Non-maturing deposits and maturing deposits below 1 month are considered as 0% stable with the exception of operational funds (sight accounts) from clients which have a strong relationship with the bank (25% outflow). ▪ Only maturing deposits above 1 month are considered as stable.	▪ Non-maturing deposits and maturing deposits below 1 year are considered as 0% stable. ▪ Only maturing deposits above 1 year are considered as stable.
	=> Very few of their liabilities are considered as stable.	

Unused lines	▪ 100% draw, potential collateral not considered.	▪ 10% draws, potential collateral not considered.
	=> Unused lines need to be backed by liquid assets.	

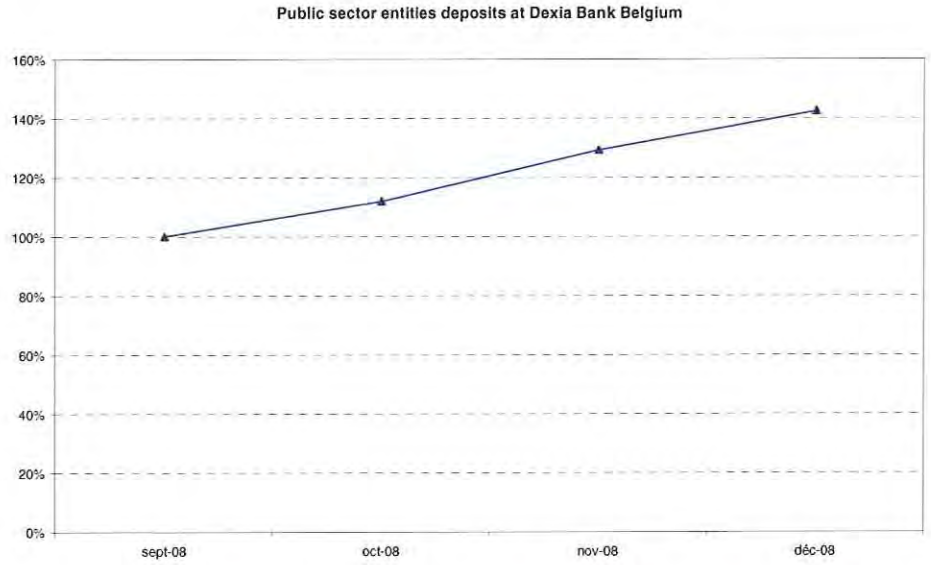
In other terms, the indicators proposed by the Basel Committee suggest a business model in which all long-term loans to public sector entities would need to be funded on a long-term basis, and if to be funded also by deposits, to "allow/promote" doing it – besides with term deposits – with non maturing deposits from retail or corporate clients only. Clearly, a commercial franchise a public sector bank disposes of on the asset side is closely intertwined with a franchise on the liabilities' side, hence it is not at all acceptable that such deposit relation with its public authority is considered more fragile than a retail or corporate deposit relation. This would be very detrimental to the capacity of public sector banks to issue new long-term loans at a decent price. This would probably hurt the small local authorities not issuing bonds even more acutely.

On the assets side, we advocate for a wider definition of the liquidity buffer especially for the NSFR. Although we agree with the Committee's position that the banking sector should be able to resist a liquidity crisis without relying heavily on central banks and that the liquidity buffer should thus be limited to assets convertible into cash outside central banks in times of stress, we question whether this approach should be applied on a 1 year period. Wouldn't this affect the long-term lending capacity of banks and thus harm the economy seriously? Our view is that the liquidity buffer should be derived directly from central bank eligibility rules with an additional provision for the LCR flooring the proportion of the buffer also convertible into cash outside central banks. More specifically:

- We clearly challenge the view that corporate or covered bonds are partly considered as liquid up to A- while public sector entities bonds are considered liquid up to AA- only.
- Also, why would covered bonds be of lesser liquidity value when held by their issuer than by anyone else? Is this restriction not going to be by-passed by banks by swapping their covered bonds?
- In the light of 1) the ECB eligibility of bank loans and 2) of the growing market for repos backed by loans, why exclude loans fully from the liquid assets?
- Eventually, we advocate for a simplification of the assessment of the liquidity of corporate and covered bonds.

Also, this narrow definition of liquid assets may also have an impact on the real economy in times of crisis since all demand will focus on this type of assets. We fear this will create a distortion in markets.

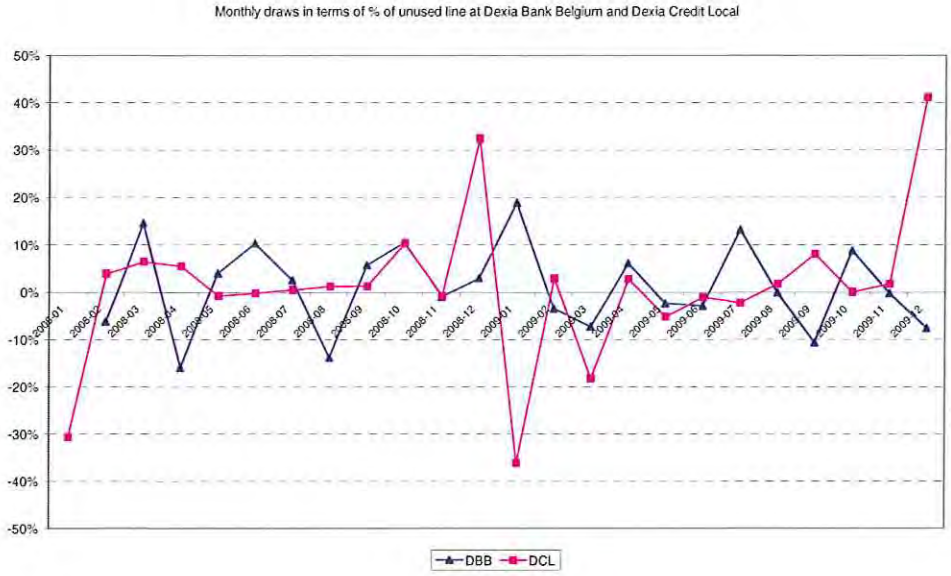
On the liabilities side, the crisis has shown that the deposits from public sector clients were quite stable. The chart below shows the evolution of deposits from public sector entities at Dexia Bank Belgium (where the bulk of those deposits are located) during the most acute phase of the liquidity crisis.



The same trend has been observed on the deposits from public sector entities at Dexia Crédit Local. Of course, the fact that many of those customers are also our shareholders has certainly influenced the stability of those deposits positively but, anyhow, the trend observed is clearly the opposite of what the Committee recommends . Also, worth mentioning is the fact that Dexia's regulator (CBFA) considers 99.8 % of its sub-sovereign public sector clients as retail clients in the context of the Markets in Financial Instruments Directive (MiFID). The trend observed in the above chart on public sector entities deposits is actually less positive on operational funds (increase by 11% on sight accounts vs 42% for all deposits). This contradicts the LCR approach on public sector entities strongly (25% outflow for operational funds vs 100% outflow for other funds). In a bank where the full range of banking services is offered and which has a very strong relation with its public sector customers, like Dexia, we would recommend to apply to public sector entities the same treatment as to small business customers.

Also, repos are considered as stable funding only when the collateral is considered as liquid. As part of its day-to-day monetary policy, the ECB has always injected hundreds of billions of € into the market, with only part of it being backed by liquid assets. Although we acknowledge the desire of the committee to avoid central banks being considered as lenders of first resort, we do not support the view that the deals with the ECB backed by illiquid collateral should be considered as not renewed. Is it reasonable to consider that the ECB will reduce its lending to a bank facing a crisis? Of course "full allotment" tenders will eventually resume but the standing facility still provides a safety net.

As far as off balance-sheet is concerned, the 100% drawing of lines to public sector entities in the LCR is way overstated (and paradoxical with the 10% drawing in the NSFR). The chart below shows the month-by-month evolution of the drawings of lines to public sector entities at Dexia Bank Belgium and Dexia Credit Local.



Clearly, we're far from the 100% assumption (the peaks at year-end at DCL are a normal seasonal effect).

Furthermore, there's no distinction between secured and unsecured lines. At Dexia, a high proportion of those lines are secured with bonds issued by public sector entities and thus part of the narrow liquidity buffer. The final policy should clearly distinguish secured with liquid collateral lines from unsecured or secured with illiquid collateral lines.

In addition, we advocate for globally consistent quantitative regulatory liquidity requirements that would be binding for a short survival period, with a consistent but firm-specific "pillar 2" approach for the longer period, in both cases subject to revisions to achieve more risk-based assumptions and parameters. Liquidity ratios would need to provide for flexibility to take into account an institution's specific situation. In any case, we strongly advocate for a softer constraint on the NSFR via a lower ratio target, a wider definition of liquid assets and a wider definition of stable funding in order not to reduce the capacity of the banking sector to provide long-term loans.

As many international banking groups, Dexia has adopted a central management of its liquidity and wishes to avoid trapped pools of liquidity. As a result, we advocate for an application of those indicators at the highest level of consolidation only.

With regards to disclosures on liquidity topics, we believe that the public disclosure of those figures can be dangerous for the sector and economy and may trigger "self-fulfilling prophecies".

Pillar 3

First of all, we are very reluctant regarding the transformation of Pillar 3 (initially meant as an instrument for banks to communicate to the market) into a regulatory reporting towards the market. Instead we would prefer an enhanced reporting towards the regulators only.

More precisely, Paragraph 80 prescribes required disclosures to improve transparency, e.g. a full reconciliation of regulatory capital elements back to the audited financial statements. We believe

that if market stakeholders do feel the need for this information, it will be proactively requested. A full reconciliation of accounts is extremely difficult to apply in practice because the consolidation scopes are different in accounting and regulatory frameworks (some companies – insurance companies for instance – are equity accounted). This reconciliation would be very costly and very difficult (if not impossible) to put in place. And, due to its complexity, it could lead to undesired side-effects, like misjudgments by the market participants with potential collateral damage.

In addition, we believe that banks have committed themselves to improve their transparency and its effect on the market. As a consequence, since we believe that banks will be self-fulfilling these requirements without any additional regulatory requirements, existing Pillar III requirements should not be altered.

Dexia appreciates the opportunity to share our views and concerns. We are available to discuss any questions you may have regarding this response.

Yours sincerely,

Pierre Mariani
Chief Executive Officer