DEXIA Group

Mr William McDonough
Chairman of the Basel Committee
Bank for International Settlements
2, Centralbahnplatz
CH - 4002 Basel

Paris, 31 May 2001

Dear Mr Mc Donough,

In January 2001, the Basel Committee on Banking Supervision released a second consultative document on the New Basel Capital Accord. The current proposals of the Basel Committee are perfectly consistent with the strategy implemented by the Dexia group since its creation several years ago. The group thus fully supports the direction which has been taken up to now and which provides a framework we consider very positive for the future of the banking and financial industry. The following remarks and suggestions are, therefore, to be considered in reference to the Committee's proposals.

Dexia has actively participated in the discussions which banks have conducted through their professional organizations in Belgium, France and Luxembourg. In addition, we agree with most of the comments and suggestions made by the Institute of International Finance to the Basel Committee. However, we believe that non-central government public sector entities (PSEs) have not been given sufficient consideration, and it is with regard to this sector that I would like to make a certain number of proposals which are developed in greater detail in the appendix.

As you know, the Sub-sovereign Public Sector plays a key role from an economic (its debt represents 7% of GDP in European Union countries and 19% in the US), social and political point of view. It is an essential factor in economic development. At the financial level, it constitutes a complex system, linked to each country's history and institutions.

For these reasons, it is important that the future regulatory requirements drawn up by the Basel Committee take into account the specific characteristics of this sector. We believe that the general framework described in the consultative document is perfectly applicable to PSEs, but that a certain number of specific provisions should be laid down for them. The key points concern the definition of this sector, the choice of the option applied to PSEs in the standardized approach, the assumptions made for calculating individual capital requirements in the IRB approach, and the calculation of capital requirements for operational risks.

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With total outstanding claims on PSEs of 220 billion euros, the Dexia group is the world leader in this very specific sector. Dexia has a municipal finance practice in most of the countries that have a significant market, both in Europe and in the Americas. The group thus has broad experience and many databases.

I confirm that our risk management teams are at the disposal of the Basel Committee to help it define, in the coming months, specific provisions for public sector entities that are fully consistent with the objectives of the reform.

I hope that the Dexia group will thus be able to contribute to the design of a regulatory framework that will better take into account the specific characteristics of public sector entities.

Yours sincerely,

Rembert von LOWIS
Chief Financial Officer

Dexia Group proposals to include specific provisions for non-central government public sector entities in the new Basel Capital Accord

1. **Standardized approach**

a) What option should be chosen for the standardized approach?

Dexia fully supports the standardized approach on the condition that national regulators adopt Option 1 designed for banks (sovereign risk-weighting plus one category). In our opinion, Option 2 would prove to be inapplicable for PSEs, since the number of Regional and Local Governments with an external rating is exceptionally low, except for the United States.

For the great majority of PSEs with no external rating, a risk weight of 50% - that would apply in Option 2 - would be disproportionate to the actual level of risk. Such a choice would also further incite national regulators to decide to assimilate PSEs to sovereign risk, a step that would be contrary in many cases to the desired objective of better discriminating among risks. The assimilation of PSEs to sovereign risk might also, in some countries, encourage creditors to lend without evaluating the risk while they would rely on a perceived ultimate sovereign guarantee, a risk of moral hazard which is very difficult to prevent due to the great number of financial relations between central States and local or regional governments.

If Option 2 were to be preferred for banks, we believe that an explicit exemption should be included in the Basel Accord so that Option 1 would apply to Public Sector Entities.

b) In which cases could national regulators opt for assimilation of PSEs to sovereign risk? :

Concerning the assimilation of Public Sector Entities to sovereign risk, we suggest to spell out that national regulators may so do only when claims on local governments present the same level of risk as claims on the sovereign entity.

c) Definition of non-central government public sector entities (PSEs)

The non-central government public sector is composed of regional and local governments in the strict sense of the term and of a whole variety of local entities which are more or less directly linked to regional and local governments. Public Sector Entities which are not regional or local governments may, in many cases, be assimilated to regional or local governments by virtue of their protective status in respect of bankruptcy codes and their similar means of financing. However, this should not be the general rule. We think that the best criterion in order to identify entities that should not be considered as PSEs is the competitive nature of the activities exercised by these entities, since this introduces an element of uncertainty in control over revenues. As a positive consequence of this rule, public sector entities that operate in a competitive field, would not benefit from a lower cost of financing than private sector entities.

d) In order to ensure a level playing field, the options left to the discretion of national regulators should apply to the country's entities for all the banks operating in the country (and not to banks governed by the regulations of this country for all the countries in which they operate).

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2. IRB approaches

The risk profile of PSEs is very particular and significantly different from that of banks. It is also quite different from one country to another. Although in some countries, a certain number of local governments have difficulties which may cause them to default on their debt, the actual losses recorded by credit institutions in this sector are generally rather small. In other words, in some countries, the probabilities of default observed empirically are greater than in the banking sector. However, the actual loss given default (LGD) is generally lesser, and somewhat dependent on the borrower's economic sector and legal status. For this reason, and in light of the economic weight of this sector, PSEs should, in our opinion, be considered as a separate sector, different from the sovereign, corporate and banking sectors.

The Dexia group plans to implement the advanced IRB approach as of 2004, primarily in the non-central government sector. It will thus enable banking regulators to benefit from its particular experience in this sector.

Dexia is ready and willing to cooperate with the Basel Committee in order to determine, in the coming months, the assumptions and the definitions that are best suited to the IRB approaches in this sector. We believe that choices specific to the PSEs should be made, for example regarding the definition of default, the assumed average LGD, the reference maturity and the «granularity» adjustment.

a) Distribution of exposures

The consultative document proposes that banks using the IRB approach have "a meaningful distribution of exposures across rating grades, and that no more than 30% of the gross exposures should fall in any one borrower grade." This requirement is generally questioned by banks, for it may encourage actions that are contrary to good risk management practices. In the case of PSEs, this requirement would be even more problematic, since it is probable that some portfolios of claims on local governments will naturally include more than 30% in one of the best rating categories.

b) Minimum requirements for the application of IRB approaches to PSEs

In light of the significant institutional differences and of the unequal degree of development in local sector financing from one country to another, the minimum requirements for the application of IRB approaches should be modulated according to the country, on the basis of available data.

3. Credit Risk Mitigation

The consultative document proposes that there is no additional capital requirement (i.e. w is zero) in the case of a guarantee from a sovereign, central bank or bank. We suggest that the Basel committee consider the extension of such a provision to monoline insurance companies (with external ratings above a minimum), whose guarantees are commonly used in "Government and Municipal Finance".

4. Operational risks

Finally, the specific characteristics of the PSEs lead us to request that the «municipal and government finance» category already detailed in the «investment banking» sector (see appendix 2, page 19 of the consultative document on operational risks) also be created in the «commercial banking» business line for the calculation of operational risk in the standardized approach. The application of a requirement calibrated on a global commercial banking business line would result in a capital requirement disproportionate to the risk observed in municipal and government finance. In this area, the Dexia group is also offering to cooperate with the Basel Committee to define the best way to account for these specific characteristics.