

Pillar 3 of Basel II

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Introduction

The year 2013 was marked by an improvement of the global macro-economic situation compared to the past 3 years although recovery remains fragile. In the Eurozone, despite economic improvement of countries such as Italy, Spain and Portugal, the incomplete recovery of banks, the weak credit (especially in peripheral countries) and the indebtedness of households/businesses and governments are still a concern. Outside the Eurozone, Hungary is quite heavily indebted and is therefore vulnerable to the risk of depreciation of its currency. The U.S. recovery, evidenced by the tapering (reduction in asset purchases by the Fed) from January 2014 and the relief of the U.S. fiscal situation are positive signs for the U.S. and world economies.

Against this background, the Dexia Group continued to implement its orderly resolution plan, approved by the European Commission on 28 December 2012. This decision from the Commission paved the way for a EUR 5.5 billion capital increase of Dexia SA, subscribed by the Belgian and French States, and the granting of a EUR 85 billion liquidity guarantee by the Belgian, French and Luxembourg States.

With this framework in place, the Dexia Group has completed at the beginning of 2014 all required disposals of its most important viable commercial franchises, rolled out the Group's new guaranteed funding programmes, and implemented the "dismantling" of certain activities following the disposal of businesses.

As at 31 December 2013, the Group's asset portfolio is composed of 86% investment grade assets and reflects Dexia Crédit Local's former positioning as a leader in the local public sector in Europe (France, Italy, United States, Germany, Spain and UK) and the United States and more marginally on European sovereigns and project finance. In the current economic environment, Dexia has been especially attentive to developments in the financial situation of local authorities in both Europe and the United States.

In 2013, the Group has also begun implementing a restructuring and integration process of its remaining entities, mainly located in ten countries, aimed at optimising the run-off management of a balance sheet that still totals EUR 223 billion at the end of 2013. To fulfil its mission of safeguarding the financial interests of the shareholders and guarantors, Dexia has identified three strategic objectives: secure the Group's liquidity at all times, ensure business continuity in order to carry out the orderly resolution plan and maintain the Group's solvency.

Within the framework of the implementation of a Single Supervisory Mechanism (SSM) for the main banks in the euro zone by the European Central Bank, the latter announced a review of the accounting valuation methodologies as well as an assessment of the risks and the quality of the assets held by the supervised banks. This Asset Quality Review (AQR) aims at reducing the uncertainty associated with the balance sheets of banks. Dexia makes part of the 130 banks subject to this assessment, which began in November 2013 and whose results will be published in November 2014.

Basel II Framework

Basel II refers to the revision of the 1988 regulatory framework defining the capital requirements for banking institutions.

The main objectives of the capital agreement ("Basel II framework") put in place by the Basel Committee on Banking Supervision are to improve the regulatory framework in order to (i) further strengthen the soundness and stability of the international banking system, (ii) promote the adoption of stronger risk management practices by the banking industry, and (iii) prevent regulatory inequalities that would hinder the competition among internationally active banks.

In order to achieve these objectives, the Basel II framework is based on three pillars:

- The first pillar – minimum capital requirements – defines the way banking institutions calculate their regulatory capital requirements in order to cover credit risk, market risk and operational risk. The framework provides different approaches for calculating credit risk (3 approaches: Standardised, Foundation Internal Rating-Based and Advanced Internal Rating-Based), market risk (2 approaches: Standardised Approach and Internal Model Approach) and operational risk (3 approaches: Basic Indicator Approach, Standardised Approach and Advanced Measurement Approach).
- The second pillar – supervisory review – provides the national regulators with a framework to help them in assessing the adequacy of banks' internal capital to be used to cover credit risk, market risk and operational risk but also other risks not identified in the first pillar such as concentration risk.
- The third pillar – market discipline – encourages market discipline by developing a set of qualitative and quantitative disclosures which will allow market participants to make a better assessment of capital, risk exposure, risk assessment processes, and hence the capital adequacy of the institution.

The requirements of the third pillar are fulfilled by this publication.

Basel II Implementation

Pillar 1

a – Credit Risk – AIRB Approach approval

The Dexia homologation application file was successfully presented for final decision to the Management Board of the Banking, Finance and Insurance Commission on 18 December 2007. Consequently, since 1 January 2008, Dexia has been authorised to use the Advanced Internal Rating-Based Approach (AIRB Approach) for the determination of its regulatory capital requirements under Basel II Pillar 1 for credit risk and for the calculation of its solvency ratios.

This acceptance is applicable to all entities and subsidiaries consolidated within the Dexia Group, which are established in a Member State of the European Union and subject to the Capital Requirement Directive.

Dexia has also decided to maintain a Standardised Approach for some portfolios for which this approach is specifically authorised by the Basel II framework, such as small business units and non-material portfolios.

Consecutively to the disposal of some entities and to the drastic decrease of some portfolios, Dexia presented an official request to the National Bank of Belgium (NBB) Management Board to switch some portfolios from the Advanced to the Standardised Approach. These portfolios have indeed become non material in terms of exposures and/or number of counterparties. The switch from Advanced to Standardised Approach has been implemented as from June 2013 reporting date following the NBB's official acceptance.

b – Market Risk

In terms of market risk, Dexia calculates its capital requirements on the basis of the Internal Model Approach for general interest rate risk and foreign exchange risk and the Standardised Approach for specific interest rate risk (refer to part 4 – Market and Balance Sheet Management risks).

c – Operational Risk

For operational risk, Dexia applies the Standardised Approach. In this regard, an information file was submitted to the regulator in June 2007. Incident collection and reporting are made on a regular basis and the Risk and Control Self-Assessment (RCSA) process covers the entire bank, including foreign subsidiaries and branches (refer to part 5 – Operational risk).

d – COREP

The COREP (COmmon solvency ratio REPorting – European Basel II reporting which includes prudential information on own funds, credit risk, market risk and operational risk quantitative disclosures) is produced by virtue of close collaboration between the various departments and entities of the Dexia Group.

Pillar 2

The second pillar of Basel II requires banks to demonstrate the adequacy between their risk profile and their available capital (Internal Capital Adequacy Assessment Process – ICAAP). Appropriate internal systems should be in place for the assessment and management of all risks and the estimation of capital required for severe downside scenarios.

The Management Board of Dexia SA and the home regulators have been kept closely informed of the developments and principles of the new Risk and Capital Adequacy approach addressing Pillar 2 requirements.

Pillar 3 – Disclosure policy

a – Frequency of Disclosure

The Pillar 3 document has been published since 2008 in line with the Circular PPB-2007-15-CPB-CPA – Titre XIV (Belgian transposition of the Capital Adequacy Directive – Annex XII).

Pillar 3 disclosure is organised on an annual basis together with the publication of the annual report. Nevertheless, a subsequent release may be published if considered relevant by Dexia due to significant changes in its risk profile.

b – Support

Dexia releases the Risk Report – Pillar 3 of Basel II on its website (www.dexia.com).

c – Currency

The figures in the following tables are provided in millions of euro (EUR) unless otherwise stated.

d – Scope of Application

The Pillar 3 disclosure requirements under the new Basel II capital framework are applicable to the upper level of consolidation, the Dexia Group. This consolidation is realised by Dexia SA, located at Tour Bastion, 5 Place du Champ de Mars, B-1050 Brussels, Belgium.

As for 2012 and due to the orderly resolution of the Group, 2013 figures are presented in a similar way as in the 2013 annual report:

- detailed tables and graphs for continuing operations;
- gross figures for the assets and disposal groups held for sale. As at 31 December 2013, mainly Dexia Asset Management Group (closing of the sale on 3 February 2014) makes part of this category.

e – Pillar 3 Contents

Part of the information provided within Pillar 3 is similar to the Annual Report. However, to facilitate the reading of the present document, this information has been duplicated in the Pillar 3 document.

The quality of the provided information is guaranteed by an internal validation process at the level of Dexia. Information is not disclosed if considered non significant or confidential.

From Basel II to Basel III

The recent financial crisis revealed some deficiencies in the Basel II regulation as to measuring appropriately credit risk. Basel III is the response of the Basel Committee on Banking Supervision to the financial crisis, encompassing a comprehensive set of reform measures to strengthen the regulation, supervision and risk management of the banking sector.

Basel III First Time Application – Changes and Impact on Weighted Risks

a – Basel III Credit Value Adjustment (CVA) Capital Charge

The CVA is the expected loss resulting from a credit spread move following the potential default of the counterparty on derivatives.

Banks will be subject to a capital charge for CVA aiming at absorbing potential volatility of CVA associated with the deterioration in the creditworthiness of a derivative counterparty.

b – Basel III Asset Value Correlation (AVC)

During the crisis, credit quality of financial institutions deteriorated in a highly correlated manner and proved to be relatively more sensitive to systemic risk than non-financial companies.

Consequently, Basel III increases the Asset Value Correlation (AVC) used in the weighted risk calculation formula for Large Financial Institutions (LFIs) by 25%.

c – Basel III Definition of Exposure at Default (EAD)

The evolution of the weighted risks will become more volatile following the EAD definition under Basel III. EAD will be directly impacted by interest moves and/or credit spread variations.

Basel III – Changes and Impact on Regulatory Capital

Tier 1 and Tier 2

Narrower definition of regulatory capital: common equity will continue to qualify as core Tier 1 capital, although other hybrid capital instruments (upper Tier 1 and Tier 2) will be replaced by more loss-absorbing instruments without incentives to redeem. Distinctions between upper and lower Tier 2 instruments, and all of Tier 3 instruments, will be abolished. This principle decreases the contribution of the public sector to resolving future banking crises and thereby reduces moral hazard.

Basel III – Changes and Impact on Liquidity Ratio

The Basel Committee proposes a strengthened liquidity framework, which introduces quantitative standards for funding liquidity. The two measures are:

- LCR (Liquidity Coverage Ratio): a 30-day liquidity coverage ratio designed to ensure short-term resilience to liquidity disruptions. It will be adopted as of 2015.
- NSFR (Net Stable Funding Ratio): a longer-term liquidity ratio to address liquidity mismatches and to promote the use of stable funding sources. Applicable date has not been defined yet.

The goal of these new rules under the Basel III regime pushes banks toward holding greater levels of liquid instruments, such as government bonds and more liquid corporate instruments.

Basel III – Leverage Ratio

A simple leverage ratio framework is critical and complementary to the risk-based capital framework that will help to ensure broad and adequate capture of both the on- and off-balance sheet sources of banks' leverage. This simple, non-risk based "backstop" measure will restrict the build-up of excessive leverage in the banking sector to avoid destabilising deleveraging processes that can damage the broader financial system and the economy.

Basel III's leverage ratio is defined as the "capital measure" (the numerator) divided by the "exposure measure" (the denominator) and is expressed as a percentage. The capital measure is currently defined as Tier 1 capital and the minimum leverage ratio is 3%. The Committee will continue to monitor banks' leverage ratio data on a semi-annual basis in order to assess whether the design and calibration of a minimum Tier 1 leverage ratio of 3% is appropriate over a full credit cycle and for different types of business models. It will also continue to collect data to track the impact of using either Common Equity Tier 1 (CET1) or total regulatory capital as the capital measure. The ratio will be tested until 2018 and adopted in 2019.

1. Risk Management Objectives and Policies

1.1. Mission and Objectives

Risk defines and controls the banks' risk appetite while providing an accurate view on the risks that Dexia faces. It ensures that new emerging risks are timely identified through best practice watch-list management.

The task of the Risk support line is to implement independent and integrated risk measures for the various types of risks, to monitor and manage them, to identify risks, to propose corrective measures, to alert the relevant committees proactively and to decide on the amount of necessary provisions.

The main Risk ambitions are to:

- Set up risk policies, guidelines, calculation methodologies and limits to constrain risk generated by the Bank activities.
- Establish a comprehensive and integrated assessment of risks: integrated risk map with appropriate granularity of risk factors demonstrating diversification and major sensitivities/vulnerabilities in order to assess the adequacy of capital to our risk profile.
- Control and monitor credit, market and operational risks.
- Anticipate negative risk evolution so that action can be taken by the Bank to mitigate such risk.
- Pro-actively manage strategic and regulatory projects and evaluate potential impact of regulatory evolutions.
- Set frameworks to better identify areas increasing operational risk so that dedicated mitigating action plans can be implemented by the relevant business lines.
- Maintain appropriate data-warehouses & risk systems ensuring timely and accurate regulatory and internal risk reporting.
- Implement best risk management practices in the whole Group and maintain efficient coordination with subsidiaries and branches' risk units.

1.2. Risk Organisation and Governance

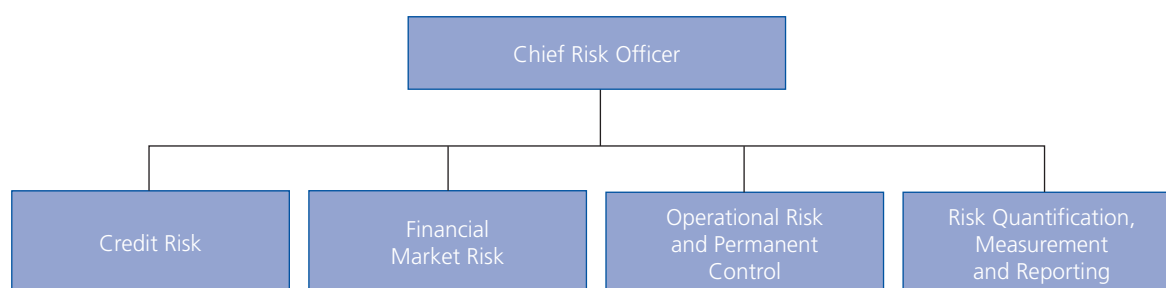
The organisation and the responsibilities of the different teams described below is the organisation in place in 2013. The organisation and governance of the risk department will evolve again in the coming months following the company project launched in 2013. As to governance, the Dexia Company Project aims at optimising the operational structure and processes within an appropriate internal control environment.

1.2.1. Organisation

Governance of the risk department is organised around the Risk Committee (RC), composed of the members of the Management Board. This committee is responsible for deciding on transactions with major impact for Dexia (credit risk, liquidity risk, impact on the results or level of capital). It is also responsible for approving policies and guidelines.

In terms of organisation, the Chief Risk Officer (CRO) may rely on four departments: Credit Risk, Market Risk, Operational Risk and Permanent Control, and finally Risk Quantification, Measurement and Reporting. Risk Quantification Measurement and Reporting includes all support functions to the risk activity line. Since 1 November 2013, the methodological validation function, formerly integrated in the Risk line has been transferred under the responsibility of the General Auditor.

This organisation also relies on the mutualisation of existing risk teams at a Dexia SA and Dexia Credit Local level, organised in competence centres providing services to the local Risk Management teams.



Credit Risk

Credit Risk Management is in charge of:

- defining policies and guidelines on credit risks, determining impairment and calculating cost of risk;
- analysing counterparties and monitoring portfolios. These teams are responsible for assigning internal ratings to Dexia counterparties but also monitoring and reporting on the portfolios;
- developing and maintaining Pillar 1 Internal Rating Systems (IRS);
- also actively restructuring some deals.

Credit risk governance and management of the risk are detailed in part 3.1.

Financial Market Risk

Financial Market Risk Management (FMRM) is responsible for defining policies and guidelines on financial market activities including Balance sheet and liquidity management, identifying, analysing, monitoring (including valuation, model management) and reporting on risks and results with a holistic view.

Financial Market Risk governance and management of the risk are detailed in part 4.1.

Operational Risk and Permanent Control

Operational Risk and Permanent Control is responsible for defining the policies and guidelines on operational risk and permanent control, for monitoring operational risk but also for defining business continuity and recovery plans and managing data and information security.

Operational Risk and Permanent Control governance and management of the risk are detailed in part 5.

Risk Quantification, Measurement and Reporting

Risk Quantification, Measurement and Reporting is in charge of:

- the definition and the development of risk quantification approaches (quantitative risk modelling for credit models, pricing models, mark to model...), of stress testing framework and scenarios;
- the design and production of comprehensive and integrated risk assessments;
- the production of Pillar 1 and Pillar 2 internal and external risk reporting;
- the monitoring of the regulatory framework and overall Basel II coordination;
- the development and the maintenance of all risk systems;
- the overall governance of the Risk Management support line (including the overall organisation, budgets and human resources issues);
- the operational validation of credit models and quality control of internal ratings assigned;
- until November 2013, the internal independent methodological validation of credit and market risk internal models;
- mitigation of operational risks to which Dexia is exposed is also guaranteed by subscription to collective insurance policies, covering professional liability, fraud, theft and business interruption. Insurance Management is in charge of subscribing such policies and following them.

Local Risk Management

Local Risk management, located in each subsidiary and branch, is focused on local risk management activities and is organised through three main functions:

- Local credit risk responsible for analysing and monitoring local counterparties including developing, controlling and maintaining the local Internal Rating Systems (IRS) and for producing local reporting.
- Local financial market risk management responsible for the day-to-day activity i.e. local risk assessment, local risk monitoring (computation of risk indicators, control of limits, triggers and so on), local reporting, reconciliation with local strategic planning and accounting but also with local information systems.
- Local operational risk is responsible for the local risk assessment/monitoring and producing local reporting.

Each operational entity is also responsible for the monitoring and reporting of entities' risks to local supervisory and regulatory bodies. Besides, each entity steers its subsidiaries.

Local chief risk officers put in place a local governance in line with the Dexia Group practices and policies:

- organisation of local committees;
- setting-up of delegation rules;
- production of local reporting;
- detection and monitoring of defaults and watch-list counterparties;
- computation and monitoring of credit risk provisions;
- cartography of local operational risk;
- local management of the data and information security and of the Business Contingency Plan.

1.2.2. Governance

The organisation and governance of the risk management has been streamlined in 2013 in order to adjust to the new scope of Dexia, particularly following the sales of different entities.

The Dexia risk governance model defines currently four types of committees:

- Transversal Committees;
- Credit Risk Committees;
- Market and Balance Sheet Management (BSM) Committees;
- Operational Risk Committees.

Transversal Committees

Risk Committee

The governance revolves around the Risk Committee, composed of the members of the Management Board. This committee has responsibility in particular for ruling on all transactions with a major impact on Dexia as well as various policies and guidelines.

Risk Management Executive Committee

The Risk Management Executive Committee determines the risk management overall strategy, defines and follows up on Risk Management organisation, follows up on major regulatory issues, methodologies and projects, and reviews key risk issues. It is organised on a regular basis and is composed of the Dexia Management Board Member in charge of Risk, the head of Risk and the head of Risk Quantification, Measurement and Reporting.

Credit Risk Committees

The decision-making process applies to transactions and is organised via a series of credit committees organised per entity. All of these committees operate under the delegation of the Dexia Credit Committee. A transaction delegation framework has been set, depending upon the type of counterparty, the rating levels and the credit risk exposure. Subcommittees have been created within the Group (subsidiaries and branches) to deal with credit delegations.

Credit Risk Committees also include the Rating and Operational Validation Committee, the Watch-list Committee, the Impairment Committee and the Default Committee. These committees are detailed in part 3.

Market and Balance Sheet Management (BSM) Committees

Market and BSM Committees include the Dexia Group Assets & Liabilities Committee (Group ALCo), the Funding and Liquidity Committee (FLC) and the Market Risk Committee (MRC). These committees are detailed in part 4.

Operational Risk Committees

Operational Risk Committees include the Operational Risk Acceptance Committee (ORAC) and the Security and Business Continuity Committee (SBCC). These committees are detailed in part 5.

1.3. The Dexia Group Company Project

After having sold the majority of its commercial franchises, Dexia Group has achieved its target scope. The Group manages a portfolio of residual assets in run off. Taking into account the assets' amortisation profile, the resolution process will need to be managed over a long period of time during which Dexia and its main operating entity, Dexia Crédit Local, must maintain operational and funding capacity.

Given the Group's entities' business models, the decentralised organisation and information systems, the adaptation of the governance and operational model suited to the run-off management of legacy assets is necessary; thus Dexia Group launched a "Company Project" in May 2013, aiming at clarifying the Group's strategic objectives, redesigning the governance and operating model to efficiently implement the resolution plan approved by the European Commission.

The transformation process resulting from the Company Project will be conducted in stages over several years given the importance of the objectives and the profound changes made by the Group.

2014, the first stage, aims at laying a solid foundation by defining a clear mission, a target operating model and a simplified governance framework.

Subsequently, activities will be progressively centralised and standardised, particularly by harmonising information systems and, when possible, simplifying legal structures.

This will have consequences on the organisation of the risk management of the Group.

2. Own Funds and Capital Adequacy

Dexia monitors solvency ratios based on rules and ratios issued by the Basel Committee on Banking Supervision and the European Capital Requirements Directive.

The capital adequacy ratio and the Tier 1 ratio, compare the amount of regulatory capital (in total and Tier 1) with total weighted risks.

The Core Tier 1 ratio compares the amount of regulatory capital excluding hybrid capital, with total weighted risks.

The National Bank of Belgium (NBB) requires Dexia to report the calculation of capital necessary to perform its activity, in accordance with the prudential banking regulations on the one hand and with the prudential regulations on financial conglomerates on the other hand.

Dexia did comply with all regulatory capital requirements for all periods reported.

2.1. Own Funds

2.1.1. Accounting and Regulatory Equity Figures

The scope of consolidation of Pillar 3 is the same as the scope of consolidation of the financial statements (as released in the Dexia Group annual report).

In 2012 and 2013, equity figures included in the financial statements are identical to equity figures computed for regulatory purpose.

	31/12/2012	31/12/2013
	Financial statements and Regulatory purposes	Financial statements and Regulatory purposes
Total shareholders' equity	2,852	3,488
of which Core shareholders' equity	10,919	9,959
of which Gains and losses not recognised in the statement of income	8,067	-6,471
Non-controlling interests	458	471
of which Core shareholders' equity	473	470
of which Gains and losses not recognised in the statement of income	-15	1
TOTAL	3,310	3,959

Note: Comments on regulatory requirements are given in the section Information on Capital and Liquidity of the Management Report (see the Annual Report 2013).

The EUR 10 billion Core equity reported in 2013 included the EUR 1.08 billion net loss.

Other comprehensive income (OCI) includes gains and losses not recognised in the statement of income. OCI improved by EUR 1.6 billion to EUR -6.5 billion at year-end 2013 mainly driven by the positive evolution of the sovereign credit spreads.

2.1.2. Regulatory Capital

Regulatory capital consists of:

- Tier 1 capital: share capital, share premiums, retained earnings including current year loss, hybrid capital, actuarial gains and losses on defined benefit plans, foreign currency translation and non-controlling interests, less intangible assets, accrued dividends, net long positions in own shares and goodwill, 50% of the eligible part of subordinated long-term debt, less subordinated debt from and equities in financial institutions;
- Tier 2 capital including 50% of the eligible part of subordinated long-term debt, less subordinated debt from and equities in financial institutions.

According to regulatory requirements:

- AFS reserves on bonds and cash flow hedge reserves are not part of equity;
- AFS reserves on shares are added to Tier 2 equity if positive, with a haircut, or deducted from Tier 1 equity if negative;
- Certain IFRS adjustments on subordinated debts, minority interests and debts must be reversed to reflect the characteristics of absorption of loss of those instruments;
- Other elements (SPV, deferred taxes, etc.) are also adjusted based on requirements from the Belgian regulator, the National Bank of Belgium (NBB).

Moreover, since 1 January 2007, according to the CRD regulation (Capital Requirement Directive), the Belgian regulator adjusted the regulatory capital definition. The most important impact for Dexia is related to deductions from total regulatory capital (banks accounted for by the equity method, participations in financial companies or subordinated loans issued by such a financial company will be deducted for 50% from Tier 1 capital and for 50% from total regulatory capital).

The following table shows Dexia Group regulatory capital calculated under Basel II at year-end.

	31/12/2012	31/12/2013
TOTAL REGULATORY CAPITAL (AFTER PROFIT APPROPRIATION)	11,535	10,617
Tier 1 capital	10,989	10,150
Core shareholders' equity	10,879	9,919
Cumulative translation adjustments (group share)	-31	-55
Actuarial gains and losses on defined benefit plans		-2
Prudential filters	-186	-104
Non-controlling interests eligible in Tier 1	422	418
Dividend pay-out (minority interests)	0	0
Items to be deducted:	-191	-122
Intangible assets and Goodwill	-165	-95
Holdings > 10% in other credit and financial institutions (50%)	-26	-27
Innovative hybrid Tier-1 instruments	96	96
Tier 2 capital	546	467
Subordinated debt	530	410
Available for sale reserve on equities (+)	132	129
IRB provision excess (+); IRB provision shortfall 50% (-)	22	68
Items to be deducted:	-138	-141
Holdings > 10% in other credit and financial institutions (50%)	-138	-141

At year-end 2013, Tier 1 capital amounted to EUR 10,150 million, a 7.64% decrease compared to last year, mainly as a result of the EUR -1 billion net loss reported in 2013.

Innovative hybrid Tier 1 instruments at Dexia (total amount of EUR 96 million) included:

- a) the undated deeply subordinated non-cumulative notes, issued by Dexia Crédit Local and booked for EUR 56 million;
- b) the undated subordinated non-cumulative notes, issued by Dexia Funding Luxembourg (now merged with Dexia SA) and booked for EUR 40 million.

Issuer	Booked amount	Rate	Call date	Rate applicable after the call
Dexia Crédit Local SA	56	4.30%	18-Nov-2015	Euribor 3 m + 173 bp
Dexia Funding Luxembourg SA*	40	4.89%	02-Nov-2016	Euribor 3 m +178 bp

*Now merged with Dexia SA.

Dexia's revised orderly resolution plan includes certain restrictions concerning the payment of coupons and the exercising of early redemption options (calls) on subordinated debt and hybrid capital from the Group's issuers. In this way, Dexia is only required to pay coupons on hybrid capital and subordinated debt instruments if there is a contractual obligation to do so. Dexia cannot exercise any discretionary options for the early redemption of these securities.

In addition, as announced by Dexia on 24 January 2014⁽¹⁾, the European Commission refused to authorise the Group to repurchase the hybrid capital debt issued by Dexia Funding Luxembourg (XS0273230572), noting that the subordinated creditors must share in the financial burden resulting from the restructuring of financial institutions that have been granted State aid. The European Commission has also informed Dexia that it is authorised to communicate this information to the holders of this instrument and to the holders of financial instruments with identical characteristics. Financial instrument FR0010251421 issued by Dexia Crédit Local S.A. has similar characteristics.

The European Commission requested that Dexia communicates that this decision relates to its own situation and does not mean that similar decisions will be taken in respect of such financial instruments issued by other European banks subject to orderly resolution plans under the supervision of the Commission.

(1) Cf. press release from 24 January 2014 published on www.dexia.com

2.2. Capital Requirements by Type of Risk

The following table shows the weighted risks and capital requirements for each type of risk (and exposure class for credit risk) at year-end 2013. The minimum capital requirements correspond to 8% of the weighted risks.

Regarding credit risk, the breakdown by exposure class presented in the following table is more detailed than the advanced regulatory approach, reflecting the presence of Dexia in financing public sector entities and project finance. Details on exposure classes are provided in Appendix 2.

Type of risk	Basel II treatment	Exposure class	Continued activities 31/12/2013		Activities held for sale 31/12/2013	
			Weighted risks	Capital requirements	Weighted risks	Capital requirements
Credit risk	Advanced	Corporate	3,173	254	-	-
		Equities	350	28	-	-
		Financial institutions	5,270	422	3	-
		Monolines	-	-	-	-
		Project finance	4,152	332	-	-
		Public sector entities	2,595	208	-	-
		Mortgage loans	-	-	-	-
		Retail Revolving loans	-	-	-	-
		Other loans	-	-	-	-
		Securitisation	5,811	465	-	-
		Sovereign	7,507	601	3	-
		Others	-	-	-	-
		Total	28,859	2,309	6	1
	Standard	Corporate	678	54	79	6
		Equities	1,037	83	271	22
		Financial institutions	956	76	-	-
		Monolines	1,329	106	-	-
		Project finance	713	57	-	-
		Public sector entities	8,069	645	-	-
		Mortgage loans	-	-	-	-
		Retail Revolving loans	-	-	-	-
		Other loans	2	-	-	-
		Securitisation	12	1	-	-
		Sovereign	128	10	-	-
		Others	-	-	-	-
		Total	12,923	1,034	353	28
Market risk	Internal Model	Interest rate & foreign exchange risk	971	78	-	-
		Position risk on equities	-	-	-	-
		Other market risks	-	-	-	-
		Total	-	-	-	-
	Standard	Interest rate risk	1,523	122	-	-
		Foreign exchange risk	173	14	-	-
		Position risk on equities	-	-	-	-
		Other market risks	-	-	-	-
		Total	1,697	136	-	-
Operational risk	Basic		2,526	202	-	-
TOTAL			46,975	3,759	360	29

Note: the counterparties are the final counterparties, i.e. after taking into account the Basel II eligible guarantee (substitution principle). Monoline exposure is essentially an indirect exposure.

At year-end 2013, the weighted risks of the continued activities of the Dexia Group amounted to EUR 47 billion. The risk weights per type of risk are detailed in the related chapters (credit, market and operational risks).

2.3. Capital Adequacy

Capital adequacy is assessed through the level of capital by type of risk.

2.3.1. Regulatory Solvency Ratios

The adequacy of Dexia's capital is monitored using, among other measures, the rules and ratios established by the Circular PPB-2007-15-CPB-CPA issued by the Belgian Banking, Finance and Insurance Commission (CBFA) and revised by the Circular NBB_2011_04 of 23 August 2011. The solvency ratios compare the amount of eligible capital (in Total and Tier 1) with the total of weighted risks. Dexia monitors and reports its capital ratios and the capital requirements underpinning Dexia's business following the banking prudential rules and the prudential rules of conglomerates of the National Bank of Belgium (NBB).

Dexia complied with all regulatory solvency capital rules for all periods reported.

The following table shows Dexia Group weighted risks and solvency ratios at 2012 and 2013 year-end. Since 1 January 2008, Dexia has used the Basel II framework to calculate the capital requirements for credit, market and operational risks and to publish its solvency ratios. Regulatory floor has no impact on Dexia regulatory capital. As from 2014 Dexia will use the Basel III framework for regulatory reporting.

		31/12/2012	31/12/2013
Tier 1 capital		10,989	10,150
Total regulatory capital		11,535	10,617
Total weighted risks		55,321	47,335
Credit risk	Advanced	32,687	28,865
	Standard	16,227	13,276
Market risk	Advanced	96	971
	Standard	1,180	1,697
Operational risk	Basic	5,131	2,526
Tier 1 Ratio		19.9%	21.4%
Capital Adequacy Ratio		20.9%	22.4%

At EUR 47 billion as at 31 December 2013, weighted risks were down EUR 7.9 billion compared to year-end 2012.

This evolution can be mainly explained by the reduction of weighted credit risks (EUR -6.8 billion) due to the sale of Société de Financement Local (SFIL), parent company of the Caisse Française de Financement Local (CAFFIL – formerly known as Dexia Municipal Agency) (impact of EUR -3.7 billion) as well as the reduction of weighted operational risks (EUR -2.6 billion) as a result of the consolidation scope reduction observed during the last three years'.

2.3.2. Internal Capital Adequacy

Following the approval by its Management Board, Dexia informed its home regulators (ACPR & NBB) in 2012 about developing an internal holistic capacity, integrating all risks and addressing among others Basel II Pillar 2 and related requirements. A planning has been submitted including a joint estimation of capital and liquidity demand according to this new approach applied on 2013 closing figures.

This capacity initially identified as "Risk & Capital Adequacy" (RCA), builds upon key strengths of regular economic capital approaches, stress testing techniques and risk appetite frameworks. It is also devised in order to be fully integrated into the financial planning process, thus demonstrating the capital and liquidity adequacy as required by regulations. The comparison between, on the one hand, the levels of capital and liquidity required for high severity levels and, on the other hand, those required to withstand severe crises is also provided. The articulation of the RCA with more specific stress testing exercises is fully aligned with the one described in the Pillar 2.

Practically, the RCA capacity encompasses three key achievements with dedicated IT tools:

1. An Integrated Risk Map (IRM): this holistic map is Dexia's comprehensive risk taxonomy and cartography allowing among other assessments to measure the sensitivities of the financial and prudential statements to each major identified risk factor (default, rating migration, spread indices, foreign exchange, interest rates...). It covers all qualitative and quantitative risks affecting Dexia beyond the risks of Pillar 1. As an illustration, this IRM provides the sensitivity to a decrease of a major interest rate tenor simultaneously on weighted risks, liquidity reserve, CVA, cash collateral, AFS reserve, hedge accounting, etc. and eventually on available capital and funding sources. This risk map establishes a transparent link between a comprehensive and economic approach of risks and their impact on accounting and prudential measures.

2. Consistent comparison of risk scenarios and assessment of their impact: multiple risk scenarios (expert, historical, market forwards and Monte Carlo) are consolidated in a single format for comparison and benchmarking purposes. Their impact in terms of capital and liquidity requirements is assessed and benchmarked towards base case scenarios. This achievement aims at ensuring the adequacy between available financial and funding resources and the risks facing the bank for a variety of risk scenarios at different severity levels.

3. Reporting: an integrated cascade of reporting is devised ranging from the most synthetic ones submitted to the boards, to more detailed reporting for intermediate Finance and Risk committees. These reports are designed to meet regulatory requirements in terms of ICAAP and ILAAP (Internal Capital/Liquidity Assessment Process) and above all to provide insights on key risks and drivers of the volatilities of key accounting and prudential indicators. Made of an integrated set of dashboards along with key attention points, they will also be used by the departments in charge of optimising Dexia's wind down.

The founding principles of the RCA capacity and its objectives have been presented to the ACPR and the NBB in 2012 and in 2013. This capacity will also be submitted to the ECB in the context of the Comprehensive Assessment in 2014 as the holistic capacity assessing Dexia's intrinsic risk profile by "addressing key risks and embodying quantitative and qualitative analysis based on backward and forward-looking information". Eventually, this internal capacity leads to an internally shared transparency on risk addressing multiple requirements of external stakeholders as the regulators and rating agencies.

2.3.3 Stress Tests

The objective of the stress test framework is to ensure that the Dexia Group's financial position provides sufficient resilience to withstand the impact of severe economic and financial stress. The nature of the stress tests takes into account the Dexia orderly resolution plan of October 2011, approved by the European Commission on 28 December 2012. Stress test exercises are performed in a transversal and integrated way by the Dexia Group's risk management teams.

In 2013, Dexia performed a series of stress tests (sensitivity analysis, scenario analysis, assessment of potential vulnerabilities) particularly based on severe but plausible macroeconomic scenarios reflecting crisis situations.

Main stress tests performed in 2013

- Specific credit stress tests were implemented for the main asset classes. In particular, within the framework of Pillar 1 of Basel II, credit exposures covered by internal rating systems were subject to tests of sensitivity and macro and expert scenarios.
- Market stress tests were conducted by stressing potential events outside the probability framework of VaR measurement techniques and were broken into single risk factor tests, historical scenarios tests and hypothetical scenarios tests.
- Stress tests related to the structural interest rate risk were performed to measure the potential impact on Dexia's own funds of a sudden and expected change in interest rates, meeting regulatory expectations.
- Liquidity stress tests are also regularly performed to estimate the additional liquidity needs under exceptional although plausible scenarios in a certain time horizon.
- In 2013, estimations of credit, market and operational losses were performed on a long-term horizon for the macroeconomic central scenario defined for the Long Term Financial Plan (Resolution plan for the European Commission).
- Regulatory stress tests: given the extent of the Dexia restructuring, a direct consequence of its orderly resolution plan, Dexia was no longer retained by the EBA in 2013 in the sample of banks for the performance of capital exercises. However in the context of the comprehensive assessment conducted by the European Central Bank, Dexia makes part of the 130 banks subject to regulatory stress tests.

2.3.3.1. Stress tests related to credit risk

In the context of Pillar 1 of Basel II, credit exposures covered by the internal rating based approach (IRBA) were regularly subject to sensitivity tests and scenario analyses based on macro-economic and expert scenarios reflecting crisis situations.

The objective is to estimate the impact of adverse although plausible assumptions of economic recession on the main credit risk parameters: Probability of Default (PD) and Loss Given Default (LGD), and risk measures such as weighted risks, Expected Loss (EL) or direct losses.

A quantitative point in time modelling per credit sector was developed to link the evolution of the credit risk parameters to the change of the main macro-economic variables (GDP evolution rate, unemployment rate, interest rate, etc.) under stressed rating migration matrices.

This quantitative modelling is completed by an expert approach to take into account the actual vulnerabilities of each credit sector and the inner limits of historical observations between macro-economic variables and risk parameters (PD, LGD). These expert scenarios are designed and discussed during the credit workshops with credit risk experts involved in the different asset classes.

A stress test report is drafted for each credit sector, including data description, principles of methodology, results and conclusions of different sensitivity and scenarios, as well as possible management actions to face hypothetical and unfavourable situations. At the end of the day, results of the stress test exercise are presented to the Risk Management Executive Committee of Dexia Group. All stress test reports are submitted for validation by the internal methodological validation team in charge of IRBA models.

2.3.3.2. Stress tests related to market risk

The market risk stress tests complete the risk management framework by stressing potential exceptional events outside the probability framework of VaR measurement techniques.

They are performed on a quarterly basis on the Group scope. The stress tests' results are reported to the Market Risk Committee.

A number of scenarios are regularly assessed covering the main market risk factors: interest rate, foreign exchange rate, volatility, credit spread.

Stress tests performed by Dexia can be broken down in three categories:

- Single risk factor (mono-factorial) stress tests, including some stress tests recommended by the banking regulators.
- Historical scenarios stress tests: Equity crash (1987), Monetary crisis (1992), Terrorist attack (2001), Financial crisis scenario (2008) capturing the turmoil triggered by the Lehman default, Sovereign Crisis (2011) simulating the crisis propagation of the recent sovereign debt crisis in the Eurozone.
- Hypothetical scenarios stress tests: scenarios to stress the CVA.

2.3.3.3. Stress tests related to interest rate risk

Dexia applies the supervisory standard shock as defined by EBA, assessing the change in economic value by more than 20% on own funds as a result of a sudden and unexpected change in interest rates. This test is achieved by means of a 200 basis point parallel shift of the yield curve.

The results of this stress are reported to each ALCo Committee.

2.3.3.4. Stress tests related to liquidity risk

Dexia performs liquidity stress tests to estimate the additional liquidity needs under exceptional although plausible scenarios in a certain time horizon such as:

- Market-wide shocks that affect all banks in the system;
- Idiosyncratic shocks, e.g., due to financial deterioration of Dexia;
- Combined scenario.

Stress scenarios are applied on balance-sheet and off-balance-sheet components of the residual gap which is the main liquidity driver.

The residual gap is the difference between:

- Dynamic liquidity gap composed of the static liquidity gap profile adjusted of gap assumptions (new transactions, roll of repo, roll of short term funding,...) defined by Balance Sheet Management (BSM) and Cash and Liquidity Management (CLM) teams;
- Dynamic buffer of reserves composed of the static buffer of eligible reserves adjusted of reserves assumptions defined by BSM and CLM teams.
- Stress tests are mainly performed on wholesale funding, cash collateral and reserves (assets) eligible for pledging to Central Banks, funding deposits and secured funding.

The stress encompasses off balance sheet commitments and downgrade triggers.

2.4. Significant Banking Subsidiary: Dexia Crédit Local

Dexia Crédit Local is Dexia Group's sole significant subsidiary following the orderly resolution plan. Regulatory capital and solvency ratios under Basel II at year-end 2012 and 2013 for Dexia Crédit Local are disclosed in the following table:

	31/12/2012	31/12/2013
Tier 1 capital	8,656	7,974
Total regulatory capital	9,217	8,445
Total weighted risks	50,497	44,445
Tier 1 ratio	17.14%	17.94%
Capital adequacy ratio	18.25%	19.00%

The following table shows the weighted risks and capital requirements for each type of risk (and exposure class for credit risk) for Dexia Crédit Local at year-end 2013. The minimum capital requirements correspond to 8% of the weighted risks.

Dexia Crédit Local figures

Type of risk	Basel II treatment	Exposure class	31/12/2013	
			Continued activities	
			Weighted risks	Capital requirements
Credit risk	Advanced	Corporate	3,068	245
		Equities	83	7
		Financial institutions	5,334	427
		Monolines	-	-
		Project finance	4,152	332
		Public sector entities	2,595	208
		Mortgage loans	-	-
		Retail Revolving loans	-	-
		Other loans	-	-
		Securitisation	5,749	460
		Sovereign	7,507	601
		Others	-	-
		Total	28,489	2,279
	Standard	Corporate	674	54
		Equities	1,037	83
		Financial institutions	955	76
		Monolines	1,329	106
		Project finance	713	57
		Public sector entities	8,069	645
		Mortgage loans	-	-
		Retail Revolving loans	-	-
		Other loans	-	-
		Securitisation	12	1
		Sovereign	128	10
		Others	-	-
		Total	12,917	1,033
Market risk	Internal Model	Interest rate & foreign exchange risk	971	78
		Position risk on equities	-	-
		Other market risks	-	-
		Total	971	78
	Standard	Interest rate risk	1,523	122
		Foreign exchange risk	173	14
		Position risk on equities	-	-
		Other market risks	-	-
		Total	1,697	136
Operational risk	Basic		372	30
TOTAL			44,445	3,556

At year-end 2013, the weighted risks of Dexia Crédit Local's continued activities amounted to EUR 44.4 billion. The risk weights per type of risk are detailed in the related chapters on credit, market and operational risk.

Weighted credit risks were down EUR 7.25 billion year on year, principally due to the sale of SFIL (EUR -3.7 billion), natural run-off of the portfolio (EUR -4.4 billion), the withdrawal from operations with Belfius Bank and Colas (EUR -1.5 billion) and exchange rate movements (EUR -1.1 billion), but this was partly compensated by an increase in loss given default (LGD) in some countries (EUR 3.2 billion).

Weighted market risks are up EUR 1.4 billion. This change is mainly attributable to the opening of a trading portfolio created after the sale of SFIL at the end of January 2013 (see the section "4.1.3.2. Market Risk Exposure" of this risk report).

3. Credit Risk

3.1. Credit Risk Management and Governance

3.1.1. Definition

Credit risk represents the potential loss, materialised by the reduction in value of an asset or by default of payment, which Dexia may suffer as a result of a deterioration of the solvency of a counterparty.

3.1.2. Governance

Within the Risk activity line, the Credit Risk department is responsible for the supervision of the credit risk, under the auspices of the Management Board and specialist committees. It is in charge of defining the Group's policy concerning credit risk, which includes the supervision of the counterparty rating processes, analysing the credit applications and monitoring the exposure of the Group.

Transversal Committees

Credit risk management revolves around the Risk Committee, which approves risk policies for the entire Group and rules on larger transactions from a credit risk perspective. The Risk Committee delegates its decision-making power to credit committees. This delegation is governed by specific rules, by type of counterparty, on the basis of their level of rating and the amount of the exposure.

The Risk Committee remains the decision-making body of last resort for larger credit files or those presenting a level of risk considered sensitive. For each file presented to the credit committee, an independent analysis is performed, presenting the main risk indicators, as well as a qualitative analysis of the transaction.

Specialist Committees per Expertise Centre

Several committees are in charge of supervising specific risks. These committees meet on a quarterly basis and include:

- the Watch-list Committee, which supervises assets considered "sensitive" and placed under watch, and decides on the amount of provisions allocated;
- the Default Committee, which qualifies and monitors counterparties in default applying rules prevailing at Dexia and in compliance with the Basel II regulatory framework;
- the Impairment Committee, which supervises the cost of risk;
- the Rating and Operational Validation Committee, which ensures the correct application of internal rating methodologies and rating systems used as well as the appropriateness of the rating process with respect to the established principles and the homogeneity of those processes within the various entities.

Credit Risk Management in each Dexia Group entity focuses on its own domestic market and is responsible for the analysis and surveillance of local counterparties.

3.1.3. Management of the Risk

Dexia Credit Risk Policy

In order to manage credit risk, Dexia Risk Management has established a general framework of policies and procedures in place. This framework guides credit risk management in its functions of analysis, decision-making and risk surveillance.

Risk Management manages the process of granting credit by delegation to different committees and heads of support lines, within the limits put in place by the bank's management and chairing credit committees. Within the context of its credit risk surveillance function, Risk Management, and more particularly the different teams in charge of credit risk, follow the evolution of the credit risk of portfolios by regularly analysing credit files and reviewing ratings. It defines and also implements provisioning the policy by qualifying files in default and deciding on specific and collective provisions.

Risk Measures

As Dexia applies the IRBA Advanced approach, the assessment of credit risk relies principally on internal rating systems put in place by Dexia within the context of Basel II: in the Advanced approach, each counterparty is attributed an internal rating by credit risk analysts relying on dedicated rating tools. This internal rating corresponds to an assessment of the level of the counterparty's risk of default, expressed through an internal rating scale, constituting a key element in the credit granting process. Ratings are revised at least annually allowing proactive identification of the counterparties. Watch-list committees are organised to monitor sensitive exposures on the basis of objective criteria or expert judgment.

In order to control the Group's overall credit risk profile, and to limit the concentration of risks, credit risk limits are defined for each counterparty, setting the maximum exposure deemed acceptable for each counterparty. Limits per economic sector and per product can also be imposed by Risk Management. The latter proactively monitors limits, and may reduce them at any time depending on the evolution of associated risks.

3.1.4. Fundamental Credit Risks of Dexia in 2013

3.1.4.1. Macroeconomic Environment

In 2013, the global economy continued to grow relatively slowly in a macroeconomic environment characterised by persistent imbalances. The International Monetary Fund cut its growth forecasts from 3.2% in 2012 to 2.9% in 2013 and anticipates an increase to 3.6% in 2014. However, this expected recovery in global growth remains fragile, particularly because of the worsening financial conditions in emerging countries and high levels of public and private debt in many developed countries.

Financial market confidence was gradually restored in the Eurozone in the first half of 2013, illustrated by an easing in sovereign yields in a number of countries and significant rises in some stock market indices. This recovery was underpinned by the European Central Bank President's stated desire to defend the euro, as well as a slight economic upturn observed in some countries. It is also the result of massive injections of capital from Japan, which has softened its monetary policy.

In the United States, the June 2013 announcement that the Federal Reserve might slow down its bond purchase programme was followed by a significant tightening of the long-term interest rates. In December, the Central Bank finally decided to cautiously tighten its monetary policy by gradually tapering its bond purchase programme from January 2014 onwards. However, it indicated that it would keep base rates very low for a period longer than expected.

In the second half of 2013, as signs of a modest recovery appeared in Europe, the United States and Japan, a slowdown in growth was observed in emerging countries.

In the Eurozone, some countries, such as Ireland, Spain and Portugal, made significant progress in relation to fiscal consolidation and competitiveness. Both Spain and Ireland were able to exit their European bailout packages, thus reinforcing market sentiment towards the Eurozone as a whole. The situation in Greece remains delicate with continuing high levels of debt that are likely to require additional support in the future. The incomplete restoration of banks and weak credit, particularly in peripheral countries, as well as the excessive household, corporate and sovereign debts pose continuing risks to the zone.

3.1.4.2. Sovereigns

Dexia's main sovereign exposures are to Italy, Poland and the United States and, to a lesser extent, Portugal, Japan and Hungary.

Maximum Credit Risk Exposure⁽²⁾

	Sovereign	
	31/12/2012	31/12/2013
Italy	16,238	13,855
Poland	2,159	2,046
United States	1,642	1,974
Portugal	1,330	1,420
Japan	1,550	1,197
Hungary	1,191	1,185
France	5,334	624
Others	5,571	4,534
Total	35,016	26,836

Italy

The political situation in Italy stabilised at the end of 2013 thanks to the formation of a new parliamentary majority. This period of stability could enable the country to continue with its efforts on competitiveness and budget consolidation until the next elections, which will take place following Italy's presidency of the European Union in the second half of 2014. The resignation of Prime Minister Enrico Letta on 14 February and his replacement by Matteo Renzi did not change this positive dynamic. During year 2013, Italy left the excessive deficit procedure initiated by the European Union and saw a significant reduction in its structural deficit (-0.5% of expected 2013 GDP). However, while sovereign funding conditions improved significantly, public debt, estimated at 131% of GDP in 2013, remains very high and low economic growth forecasts are hampering the country's ability to reduce its debt.

The Group's sovereign exposure to Italy at 31 December 2013 totalled EUR 13.9 billion, mainly consisting of bonds positions.

⁽²⁾ The Maximum Credit Risk Exposure (MCRE) is one of the metrics used by Dexia for regulatory reporting purposes. Its definition is given in section "3.2. Maximum Credit Risk Exposure" of this Risk Report.

Poland

Poland is a major economic player among the central and eastern European countries, and is the only one of the European Union's 28 countries with continued growth during the crisis that erupted in 2008. After growing by 1.9% in 2012, Polish GDP could, according to the government, grow by 1.5% in 2013 before accelerating to 2.5% in 2014. In 2013, exports grew rapidly and consumer spending picked up slightly. On the fiscal front, however, the sharp economic slowdown in the first half of the year resulted in lower than expected tax receipts and a growing deficit. Consequently, the government decided to suspend the rule under which debt is capped at 50% of GDP. Measures adopted to reduce spending could bring the budget deficit back down from 4.8% of GDP in 2013 to 3.1% in 2015.

Dexia's sovereign exposure to Poland at 31 December 2013 totalled EUR 2 billion, consisting almost entirely of bonds.

United States

GDP growth is estimated at 1.7% for 2013, not as strong as the 2.8% seen in 2012. While private sector demand has remained buoyant, significant budget adjustments made during the year have hampered growth. During the year, political tension over the raising of the debt ceiling adversely affected the country's financial position. Agreement was reached over the budget in December 2013, pushing back the risk of any further budget freezes until September 2015. Finally, the Federal Reserve's decision to taper its bond purchases from January 2014 onwards could also affect the macroeconomic situation.

Dexia's sovereign exposure to the United States at 31 December 2013 totalled EUR 1.9 billion, of which EUR 1 billion in bonds and EUR 0.9 billion in short-term deposits.

Portugal

In spite of a weakening political consensus regarding the austerity measures and a growing resistance to reforms among the population, Portugal continued with measures to cut spending and boost competitiveness in 2013. The country is anticipating a reduction in its public deficit in 2013, and recently reported a significant increase in exports (up to 4% between January and August 2013). Portugal should return to growth in 2014. However its weak growth outlook could threaten the rapid decrease of debt expected as from 2015. Portugal's funding conditions on the financial markets have improved significantly. Its liquidity reserves, estimated at six months, have reassured investors as to the State's ability to honour its financial commitments. However, the exit from the bailout package, scheduled for June 2014, remains uncertain given the high level of public debt and the political difficulties encountered.

Dexia's sovereign exposure to Portugal at 31 December 2013 totalled EUR 1.4 billion, consisting almost entirely of bonds.

Japan

Economic conditions improved considerably in 2013, driven by accommodative monetary policy, fiscal stimulus and reforms aimed at improving competitiveness. Japan also returned to inflation for the first time since October 2008, and manufacturing output reached its highest level since 2006.

However, salaries have not grown in line with prices, resulting in a substantial drop in purchasing power. In addition, the Japanese economy continues to suffer the effects of the country's energy dependence. The return of inflation has largely been driven by a sharp increase in imports of energy products in the second half of 2013.

Dexia's sovereign exposure to Japan at 31 December 2013 totalled EUR 1.2 billion. This exposure consists entirely of yen-denominated bonds whose foreign exchange risk is hedged.

Hungary

Hungary saw a revival in economic activity at the beginning of 2013. However, a tightening in credit, legal uncertainties and certain new taxes continue to hinder private investment. Foreign currency debt remains high; as such, the country's ability to repay that debt is vulnerable to the risk of a depreciation of its currency. The risk of a loss of investor confidence and renewed tension on international markets could trigger capital outflows and accentuate any depreciation of the forint, thus adversely affecting the country's ability to refinance its borrowing.

Dexia's sovereign exposure to Hungary at 31 December 2013 totalled EUR 1.2 billion, consisting almost entirely of bonds.

France

Economic growth remained weak in 2013. The upward trend in unemployment persisted throughout the year as competitiveness continued to decline. Nevertheless, in spite of a challenging economic situation, with large public deficits and limited fiscal room for manoeuvre, France continued to benefit from favourable funding conditions on the financial markets.

The Group's sovereign exposure to France at 31 December 2013 totalled EUR 0.6 billion.

3.1.4.3. Local public sector

Maximum Credit Risk Exposure		
	Local Public Sector	
	31/12/2012	31/12/2013
France	70,033	19,499
Germany	20,007	17,840
Italy	18,059	11,604
United States	10,839	9,858
Spain	11,213	9,281
United Kingdom	9,323	8,825
Portugal	2,009	1,805
Others	18,811	11,749
Total	160,295	90,460

France

Gross savings by local authority declined for the second year in 2013, totalling 18% of operating receipts compared with 18.7% in 2012, as a direct result of an unfavourable margin effect. While growth in tax receipts remained relatively buoyant, overall operating receipts were adversely affected by the freeze of central government transfers and an increasing spending at a sustained pace, mainly driven by personnel costs and the social security expenses, which continued to increase (up 5.6% in 2013). Investments, which totalled EUR 54 billion and represented 70% of public investment, grew by only 1.7% in this pre-election year. Municipalities remained the biggest investors, while departments and regions continued to scale back their programmes. Total outstanding local authority debt was set to reach EUR 167 billion by end 2013. The Caisse des Dépôts played a major role in funding of the local authorities, which will be able to rely on the growing presence in this market of La Banque Postale and the creation of the Agence France Locale in mid-2013.

In 2014, as new municipal and community councils are elected, new constraints will be placed upon local authority receipts, with transfers from central government set to reduce by EUR 1.5 billion in 2014 and 2015 and equalisation mechanisms to be strengthened.

The sale of Société de Financement Local, the parent company of Caisse de Financement Local, in January 2013 led to a significant reduction in the Dexia Group exposure to the local public sector in France, which fell from EUR 70 billion at end 2012 to EUR 19.5 billion at end 2013.

64% of the French local public sector exposure is rated AAA, AA or A. The ratings of almost 70% of counterparties have remained stable. Only 5% of exposure is rated non-investment grade. There are very few counterparties in default, representing only 1% of the total exposure.

During the year, Dexia succeeded in resolving all arrears on short-term facilities granted to the hospital sector, thanks to active support from the Regional Health Agencies, as well as the majority of arrears on short-term facilities granted to local authorities.

Update on the desensitisation of structured loans in France

The first structured loan desensitisation policy within the framework of the production envelope granted by the European Commission also began in 2013.

The definition of structured loans is based on the code of conduct agreed between certain banks and local authorities, known as the "Gissler Charter". This document, which was drawn up at the request of the French government, was signed on 7 December 2009 by a number of associations representing local authorities and by certain banks, including Dexia Crédit Local. It defines structured loans as:

- all loans whose structure falls into categories B to E of the Gissler Charter;
- all loans whose marketing is banned by the Charter due to their structure (e.g. a leverage > 5...), or their underlying index or indices used (e.g. foreign currency or commodities...) or their currency of exposure (e.g. loans denominated in Swiss francs or Japanese yen...);
- with the exception of all loans whose structured phase has ended and whose interest rate for the remainder of their term is either a fixed rate or a simple floating rate.

Under this definition, structured loan exposure on Dexia's balance sheet at end 2013 represented EUR 3.13 billion.

The most highly structured loans under the Gissler classification (categories 3E, 4E and 5E) and those loans whose marketing is banned under the charter may be described as "sensitive". These loans are subject to specific monitoring and a desensitisation policy. Dexia's sensitive loan exposure totalled EUR 1.7 billion at end 2013, compared with EUR 2.3 billion at end 2012⁽³⁾.

(3) The referred outstanding only concerns the local public finance sector in France.

Loans to the French local public sector as at 31 December 2013

	Outstanding ⁽¹⁾	%	Number of clients
Non-structured credits	11.50	78.65%	3,803
Non sensitive structured credits	1.40	9.56%	443
Sensitive credits	1.73	11.80%	1,147

(1) In billions of EUR.

These loans concern the following categories of customers:

Sensitive loans to the French local public sector as at 31 December 2013

	Outstanding ⁽¹⁾	Number of clients
Communes of less than 10,000 inhabitants	0.19	648
Communes of more than 10,000 inhabitants and grouping of communes	0.53	348
Regions and departments	0.09	11
Other clients	0.91	140

(1) In billions of EUR.

The average interest rate paid by the 10% of customers who paid the highest rates in 2013 was 6.98%, while the average rate paid by the 10% of customers who paid the lowest rates in 2013 was 0.28%.

Loans to the French local public sector as at 31 December 2013

	Average rate 2013
1 st decile	6.98
2 th decile	4.91
3 th decile	4.70
4 th decile	4.50
5 th decile	4.29
6 th decile	3.98
7 th decile	3.58
8 th decile	2.96
9 th decile	0.56
10 th decile	0.28

Certain clients summoned Dexia Crédit Local in connection with sensitive loans granted to them. As at 31 December 2013, 219 clients issued summonses against Dexia Crédit Local.

To reduce the risk of litigation in connection with sensitive loans and to enable Dexia to desensitise such loans, the European Commission has authorised the Group to grant new production flows up to a maximum of EUR 600 million, during two specific production windows, from February to July 2013 and from June to November 2014, as part of the Group's orderly resolution plan.

During the first production window, Dexia contacted 222 customers, all of whom received – without any specific ground – an offer to convert their sensitive loan into a fixed-rate loan. 44 clients with sensitive loans have refused to desensitise their credit. Through this campaign, Dexia was able to desensitise 22% of its outstanding structured loan exposure or EUR 0.5 billion.

During the interim phase between the two production windows, the Group continues its desensitisation activities without issuing any new production, in accordance with the undertakings made with the European Commission.

Changes in the regulatory framework for structured loans in France

In 2013, new legislation brought two key changes to the regulatory framework governing structured loans:

- A Validating Law was voted in order to secure the contractual framework for loans extended by credit institutions. Since this Law was subject to a decision from the Constitutional Council (*Conseil constitutionnel*), the government committed itself to propose a new text taking into account the comments of the Constitutional Council.
- A support fund, financed by the State and the financial sector, will be established in order to support local authorities faced with financial difficulties linked to structured loans.

International

Spain

The marked deterioration in economic conditions in Spain has resulted in a reduction in the receipts of the Spanish local authorities since 2012. Local authorities have received support from the State, which has put in place borrowing facilities via support funds, requiring borrowers in return to comply with recovery measures. These measures should allow a gradual reduction of the regions' budget deficits. The regions received a deficit target of -1.3% of GDP for 2013, which appears achievable given the improvement seen in 2012. At the end of 2013, the State announced that it was establishing an assistance fund aimed at helping 536 municipalities in financial difficulty, subject to those municipalities implementing adjustment plans.

Given the financial difficulties encountered by Spanish local authorities, the Dexia Group has lowered its rating for 8 of the country's 17 regions. There has been no arrear or late payment on regional loans and bonds. However, Dexia has noted late payments or arrears on facilities granted to three Spanish municipalities and one public satellite.

Dexia's exposure to the Spanish local public sector at 31 December 2013 totalled EUR 9.3 billion.

Portugal

The overall situation in Portugal remains unchanged, and 2013 data confirm the stability of the country's financial profile. The institutional framework is characterised by a highly centralised structure, allowing State control over local authorities. At the same time, the State control over the two autonomous regions was also reinforced over the year.

In the first half of 2013, the central government put in place a local economy support package worth EUR 1 billion to help Portuguese municipalities optimise their liquidity and reduce their debt. The State also imposed a stringent adjustment plan on the autonomous region of Madeira from January 2012 onwards, in return for financial assistance from the State, which has undertaken to service part of the region's debt.

Given the unfavourable economic climate and Portugal's challenging financial position, (the country is still benefiting from the bailout program from the European Union and the International Monetary Fund), Dexia has lowered its ratings for Portuguese local authorities in spite of these various measures and the efforts made.

Dexia's exposure to the Portuguese local public sector at end 2013 totalled EUR 1.8 billion.

Italy

For the past few years, the Italian government has imposed rules on local authority borrowing. In addition to a cap on debt interest at 8% of current receipts in 2012, reducing to 6% in 2013 and 4% in 2014, debt per capita norms have been put in place and regions' debt servicing costs have been capped at 20% of their own tax receipts.

Since 2011, the country's regions have seen their healthcare costs rise. However, based on 2011 data, data for 2012 and 2013 not yet being available, the regions still have relatively moderate levels of debt. Based on these same data, credit risks on Italy's provinces and municipalities remains relatively low.

Nevertheless, local authorities have not been spared by the economic downturn in Italy. Central government support has been put in place to help them cope with the situation. In particular, this support is provided via a ten-year fund, allowing some sensitive local authorities to avoid declaring insolvency under the "dissesto" trusteeship. Five local authorities to whom Dexia is exposed have received support via this fund: the cities of Naples, Catania, Messina and Foggia and the Province of Chieti. A second mechanism was put in place in 2013, providing a budget of EUR 20 billion a year in 2013 and 2014 to help local authorities and various central ministries settle their supplier debts dating from before 31 December 2012.

Dexia did not note any difficulties or significant payment delays linked to a weak solvency among Italian borrowers. Portfolio credit quality remains acceptable, in spite of the lowering of the ratings of four regions because of a slight worsening of their financial position. Finally, it should be noted that financial regulations governing provinces and municipalities provide protection for creditor banks by giving them preferential ranking in respect of payments and immunising them against "dissesto" procedures.

Dexia's exposure to the Italian local public sector at end 2013 totalled EUR 11.6 billion.

United Kingdom

Measures applied to the British local public sector under the country's austerity policy produced their first effects in 2012 and 2013. In particular, these measures allowed simplifying the debt management of social housing portfolios managed by local authorities. In parallel, transfers from the State to the local authorities have been cut by almost 14% under the three-year programme for the period 2012-2014. However thanks to the efforts made to cut spending, local authorities have managed to improve their financial position over the period. Housing Associations, which represent the second most important force in the social housing sector, have also been asked to contribute to the national economic policy with a reduction of their investment subsidies from the State while the welfare payments, which now consist of a single payment including housing benefit, are no longer paid directly to housing associations. Faced with this reduction in funding, housing associations have scaled back their investment programmes, though they continue to be major players in the construction of social housing.

At 31 December 2013, the exposure of Dexia to the local public sector amounted to EUR 8.8 billion including exposures on local authorities and on the "Housing Associations". The outstanding on the local authorities in the United Kingdom was EUR 4 billion. The United Kingdom's institutional framework allows considering the risk level of this exposure very close to the sovereign risk. On the other hand, Dexia's exposure to the "Housing Associations" totalled EUR 4.8 billion. The Group is not aware of any high-risk situations in its housing associations portfolio.

Germany

The financial position of the German local public sector improved in 2012, 2013 data not yet being available. At EUR 5.6 billion, the budget deficit of the *Länder* has fallen significantly and is better than initially forecast (EUR 14.8 billion). At the same time, borrowing has fallen slightly, though generally remaining at a high level. The Financial Stability Board confirmed these trends in May 2013 and indicated that the five *Länder* that had received the most aid had achieved their consolidation targets. The financial position of municipalities continues to improve, mainly because of an increase in tax receipts. However, regional disparities persist between eastern and western municipalities, with those in the east showing a slight overall deficit for the first time since 2004. The majority of *Länder* have put in place fiscal consolidation programmes for struggling municipalities within their territories under the institutional solidarity mechanism.

Dexia's updated internal rating for the German local public sector illustrates the high quality of its portfolio, which was stable over the year, and the very strong ratings of the *Länder*.

A campaign to desensitise some structured loans granted to municipalities is ongoing. These loans do not represent a significant proportion of the portfolio.

Dexia's exposure to the German local public sector at 31 December 2013 totalled EUR 17.8 billion.

United States

The Federated States continue to be among the largest issuers on the US bond market, with strong demand from creditors, who are protected by the institutional framework. As early as 2011, States were able to benefit from the beginnings of an economic recovery in the United States, managing to increase their overall current receipts by 7% while limiting spending growth to 3%.

However, the Commonwealth of Puerto Rico stands out for its very strained financial position – a result of recent fiscal measures and the termination of benefits available to locally established US companies, which have damaged the island's economic activity and given rise to a structural deficit and an increase in borrowing. The election of a new governor in January 2013 and the launch of a recovery programme aimed at reducing the deficit to zero by 2015 have brought some prospect of an improvement. Dexia's nominal outstanding on Puerto Rico amounted to USD 433 million at the end of December 2013, this exposure being provisioned for an amount of USD 69.2 million (including provisions related to hedging instruments). Dexia nonetheless sold a proportion of the most risky outstanding in January 2014. The residual exposure at the end of January was USD 385 million, of which more than 95% is covered by the highest quality monoliners and provisioned for an amount of USD 33.9 million including the provisions related to the hedging instruments.

In a still strained economic environment, a few local authorities have seen a marked deterioration of their economic and financial situation. They cannot always rely on the benefit of Chapter 9 bankruptcy law. Very difficult cases remain relatively rare but striking, the most obvious example being the city of Detroit in the second half of 2013. In this case, to which Dexia is exposed, the city's emergency manager, appointed by the governor of Michigan, secured a ruling declaring the city bankrupt on the basis of a maximum valuation of its debt. The proposed recovery plan, which places heavy demands on creditors and insurers, has led to what could be a long phase of negotiation and clarification.

At 31 December 2013, the gross booking value of Dexia's commitments on Detroit, concerned by the debt restructuring measures, amounted to USD 330 million, of which only USD 305 million is subject to a risk of value deterioration. The provision made amounted to USD 154.3 million, including provisions with respect to the hedging instruments.

The Group also disposed of other public sector exposures linked to the city of Detroit for an amount of USD 123 million. These exposures were however not concerned by the debt restructuring of Detroit under Chapter 9.

Dexia's exposure to the United States local public sector at 31 December 2013 totalled EUR 9.9 billion.

3.1.4.5. Project Finance and Corporates

Maximum Credit Risk Exposure

	Corporate		Project Finance	
	31/12/2012	31/12/2013	31/12/2012	31/12/2013
France	3,607	2,262	2,651	2,559
United Kingdom	2,280	1,591	3,987	3,935
Spain	238	145	2,677	2,480
Germany	73	17	457	439
Italy	955	903	532	482
United States	520	266	757	701
Portugal	0	0	231	221
Others	897	722	4,665	3,676
Total	8,570	5,906	15,957	14,493

The project and corporate finance portfolio stood at EUR 20.3 billion at 31 December 2013, down 16% relative to 31 December 2012. This portfolio consists for 71% of project finance⁽⁴⁾, with the remainder made up of corporate finance such as acquisition finance, commercial loans and corporate bonds. The portfolio reduction was driven by a number of factors:

- natural amortisation of the portfolio;
- early repayment by borrowers refinancing their debt with lenders other than Dexia ;
- the effects of exchange rate fluctuations over the period, particularly affecting the pound sterling and the Australian dollar, with sterling and AUD assets representing 27% and 8% of the project and corporate finance portfolio respectively.

The project finance portfolio totalled EUR 14.5 billion at 31 December 2013. It consists for 48% of public-private partnerships (PPP), mainly in the United Kingdom and France, for 23% of projects in the energy sector, mostly in the renewable energy field, and 12% of projects with a traffic risk. Geographically, 71% of the portfolio is in Western Europe and 20% in the United States, Canada and Australia. Average portfolio credit quality is high, with 69% of the exposure rated "investment grade".

However, some projects are subject to a special monitoring; this includes, in particular, certain leveraged deals where the restructuring is still in progress. It also applies to Spain, where some problems persist, particularly in the PPP sector, where delays have been seen in some rental payments received from public sector counterparties, and in the renewable energy sector, adversely affected by certain unfavourable fiscal measures.

The corporate finance portfolio stood at approximately EUR 5.9 billion at end 2013. It consists for 42% of loans to infrastructure companies (motorway and car park concession holders and civil engineering companies), for 41% of utilities companies (water, environment, and energy/gas distribution and transmission), for 6% of energy companies (including hydrocarbons) and for 5% of companies in the real estate sector. Geographically, 87% of the portfolio is in Western Europe and 11% in the United States, Canada and Australia. 87% of the exposure is rated "investment grade". The main difficulties encountered relate to pre-crisis acquisition finance too highly leveraged and difficult to refinance under current market conditions.

3.1.4.6. ABS

Maximum Credit Risk Exposure

	ABS/MBS	
	31/12/2012	31/12/2013
United States	4,571	4,714
Spain	1,009	852
United Kingdom	315	269
Italy	199	174
Portugal	152	146
France	109	114
Germany	39	28
Others	6,546	604
Total	12,938	6,901

Dexia's ABS portfolio totalled EUR 6.9 billion at 31 December 2013. The portfolio includes for EUR 3.8 billion US government student loans with a relatively long amortisation profile and high credit quality, backed by a US government guarantee. The remainder of the portfolio mainly consists of EUR 1.5 billion in residential mortgage-backed securities, including EUR 0.6 billion in Spain and EUR 0.2 billion in the Netherlands, and of EUR 0.3 billion in commercial mortgage-backed securities. The quality of the ABS portfolio deteriorated slightly in 2013. Nonetheless, at the end of 2013, 85% of the portfolio was rated "investment grade" given that almost all of the tranches in which Dexia invested are senior tranches.

⁽⁴⁾ Loans without recourse to their sponsors, repaid purely from own cash flow and highly secure for the bank, for example via legal charges over assets and contracts and limits on dividends.

In Spain, the decline in residential property prices, estimated to have fallen by 30% since their 2008 peak, and rising unemployment, which now stands at 26%, continue to hamper the performance of Spanish borrowers. External ratings for mortgage-backed securities have also come under pressure as a result of Spain's "sovereign ceiling". However, Dexia holds senior tranches that continue to be repaid as a priority, the losses being absorbed by the subordinated tranches.

In the Netherlands, in spite of the decline in residential property prices, estimated to have fallen by 20% since their 2008 peak, borrowers continue to perform well, with only 1% of Dutch mortgages in arrears. This is explained partly by the country's relatively low unemployment rate of 6% and partly by the fact that most mortgages in the Netherlands are interest only, with capital not repaid until maturity.

Finally, credit risk on commercial mortgage-backed securities (CMBS) improved in 2013. This was driven by the repayment of some loans underlying CMBS and the priority payment of senior tranches held by Dexia. The repayment of maturing underlying loans will remain a key issue in 2014 for the remainder of the portfolio. However, the level of protection afforded by junior tranches considerably reduces the risk of loss for Dexia.

3.1.4.7. Financial Institutions

Maximum Credit Risk Exposure

	Financial Institutions	
	31/12/2012	31/12/2013
Spain	7,858	6,723
United States	5,581	4,182
Germany	4,471	3,355
France	3,058	3,038
United Kingdom	1,763	1,651
Italy	1,476	748
Portugal	162	149
Others	15,325	5,871
Total	39,694	25,716

Dexia's exposure to financial institutions at 31 December 2013 totalled EUR 25.7 billion. Three quarters of this exposure consists of bonds, covered bonds and loans to financial institutions. The remainder consists of exposure associated with reverse repurchase agreements with financial institutions and derivatives. Exposure to financial institutions decreased by EUR 12.5 billion in 2013 (perimeter of continued activities), mainly driven by the process of separating from Belfius (formerly Dexia Bank Belgium), which continued throughout 2013, as well as natural amortisation of the bond portfolio. The bond portfolio will continue to amortise at a sustained pace over the next few years; one fifth of residual positions are due to be repaid in 2014 and two fifths in the next five years.

90% of the exposure is rated investment grade. No new defaults were seen in the portfolio in 2013. Furthermore, some positions in Lehman Brothers, Kaupthing, Landsbanki and Glitnir, which defaulted in 2008, were sold. Dexia's exposure is concentrated 17% in the United States and 72% in Europe, mainly in Spain (26%), Germany (13%), France (12%), Belgium (6%) and the United Kingdom (6%).

Portfolio credit quality was stable in 2013. However, the situation of southern European banks remains fragile. As well as the bailout of Cyprus' banks in March, on which Dexia had no exposure, 2013 saw Spanish and Portuguese banks experience funding and asset quality problems, in spite of improvements that followed their recapitalisations and the creation of a "bad bank" in Spain (SAREB).

However, Dexia's exposure to Spain's financial sector mainly consists of covered bonds which, given their systemic importance to the Spanish banking system, would very likely receive support from the Spanish and European authorities in the event of major difficulties. Dexia's exposure to the Portuguese financial sector is small and will be almost fully paid off in the second half of 2014.

One of the key events in Europe in 2014 will be the Asset Quality Review to be conducted by the European Central Bank before it takes over the supervision of European banks. This exercise will focus on assessing European banks' asset quality and resilience.

3.1.4.8 Credit Enhancement by Monoline Insurers

As a result of Dexia's activity in the US municipal and ABS sectors, which traditionally use credit enhancement, Dexia's portfolio enhanced by monoline insurers totalled EUR 15 billion at 31 December 2013. Eighty-six percent of the underlying assets are investment grade. The portfolio covered by the guarantee under Basel rating substitution calculations amounts to only EUR 3.1 billion at end 2013.

With the exception of the Assured Guaranty group (AGC and AGM), which continues to operate and enhances more than 50% of the insured portfolio, the other monoline insurers are being managed on a run-off basis, though many are still able to meet their insurance liabilities.

One of the key events in 2013 was the emergence of FGIC from its regulatory restructuring plan. At this stage, if its underlying assets were to default, FGIC would be able to pay the equivalent of 17% of insurance claims. Furthermore, the restructuring of MBIA Inc. has improved not only the company's solvency but also that of its sister company, National Public Finance Guarantee, via the repayment of a substantial intra-group loan.

Generally speaking, monoline insurers have put in place a range of measures – such as commutation arrangements, legal proceedings against US securitisation originators and buybacks of securities – to consolidate their solvency and ensure they are able to meet their obligations as insurers.

3.2. Maximum Credit Risk Exposure

The Maximum credit risk exposure includes:

- the net carrying amount for balance-sheet assets other than derivative contracts (i.e. the accounting value after deduction of specific provisions);
- the market value for derivatives contracts (net of collaterals);
- the total amount of off-balance-sheet commitments: the full commitment is either the undrawn portion of liquidity facilities or the maximum amount Dexia is committed to pay for the guarantees granted to third parties.

When maximum credit risk exposure is guaranteed by a third party with a lower risk weight, the principle of substitution is applied.

As at 31 December 2013, the Dexia Group's maximum credit risk exposure was EUR 173.3 billion.

3.2.1. Exposure by Type of Product and Geographic Area

The table below shows the total exposure with a breakdown by type of product and geographic area at year-end 2012 and 2013.

Exposure at year-end 2012						
	Eurozone ⁽¹⁾	Rest of Europe ⁽²⁾	US & Canada	Rest of the World	Total continued activities	Total activities held for sale
ABS	1,909	419	4,571	1,132	8,031	4,908
Debt securities	45,048	9,309	18,139	9,743	82,240	6,445
Derivatives	3,425	973	1,161	139	5,698	314
Given guarantees	7,302	1,261	3,001	125	11,689	318
Loans and advances	69,465	14,288	2,483	4,032	90,268	55,975
Other assets	400	3	19	552	974	73
Repo	7,107	268	2,136	1,672	11,182	
Retail loans	7	4	2	0	13	
Total continued activities	134,662	26,525	31,513	17,394	210,094	
Total activities held for sale	62,419	4,816	690	108		68,033

(1) Countries using the Euro currency as at 31 December, 2012.

(2) Including Turkey.

As at 31 December 2012, Loans and advances represented 43% of the continued activities exposure as this category mainly included loans to the public sector while Debt securities represented 39.1%.

Exposure at year-end 2013						
	Eurozone ⁽¹⁾	Rest of Europe ⁽²⁾	US & Canada	Rest of the World	Total continued activities	Total activities held for sale
ABS	1,700	348	4,714	139	6,901	
Debt securities	37,423	8,201	14,997	8,122	68,743	
Derivatives	2,697	719	668	66	4,150	
Given guarantees	3,307	603	2,007	113	6,030	
Loans and advances	62,784	13,085	2,599	4,440	82,908	
Other assets	378	1	15	542	936	
Repo	470	670	1,552	969	3,661	
Retail loans	2			0	2	
Total continued activities	108,761	23,627	26,552	14,391	173,331	
Total activities held for sale	23	0	0	102		126

The overall exposure decreased over all countries due to the natural amortisation of the portfolio. As at 31 December 2013, the continued activities exposure amounted to EUR 173.3 billion and remained mainly concentrated in the European Union (63% at year-end 2013).

The continued activities exposure of the other regions remained at the same level compared to December 2012: Rest of Europe (13%), US & Canada (15%) and Rest of the World (8%).

3.2.2. Exposure by Type of Product and Obligor Grade

The following tables show the total exposure and the average exposure with a breakdown by type of product and obligor grade at year-end 2012 and 2013.

For reporting purposes, a rating “master-scale” has been applied. This scale is structured in grades ranging from AAA to CCC and the modifiers plus, flat and minus.

Exposure at year-end 2012							
	AAA+ to AA-	A+ to BBB-	Non investment grade	Default	Non rated	Total continued activities	Total activities held for sale
Debt securities	24,878	44,870	12,398	89	5	82,240	6,445
Retail loans	1	0	0	0	12	13	-
Loans and advances	35,356	42,604	10,823	768	718	90,268	55,975
ABS	5,315	1,770	940	0	5	8,031	4,908
Derivatives	617	4,063	702	292	23	5,698	314
Given guarantees	5,642	4,727	1,066	89	165	11,689	318
Repo	1,224	9,951	0	0	8	11,182	-
Other assets	173	16	3	18	764	974	73
Total continued activities	73,206	108,001	25,932	1,256	1,700	210,094	
Total activities held for sale	23,449	38,666	4,931	500	486		68,033

Exposure at year-end 2013							
	AAA+ to AA-	A+ to BBB-	Non investment grade	Default	Non rated	Total continued activities	Total activities held for sale
Debt securities	22,401	37,719	8,397	222	4	68,743	
Retail loans	1			0	4	4	
Loans and advances	31,474	38,754	11,349	755	574	82,906	
ABS	4,570	1,324	880	101	27	6,901	
Derivatives	787	2,487	682	174	19	4,150	
Given guarantees	2,347	2,786	753	81	63	6,030	
Repo	0	3,661	0		0	3,661	
Other assets	177	4	1	12	742	936	
Total continued activities	61,756	86,736	22,062	1,345	1,433	173,331	
Total activities held for sale	35	12	0	0	79		126

As at 31 December 2013, almost 86% of the exposure relating to the continued activities was Investment Grade. It is to be noted that the non-investment grade exposure is predominantly situated in the ‘BB’ range.

2012 average exposure							
	AAA+ to AA-	A+ to BBB-	Non investment grade	Default	Non rated	Total continued activities	Total activities held for sale
Debt securities	28,214	46,407	10,936	91	114	85,762	
Retail loans	32	0	18	4	4,501	4,556	
Loans and advances	38,937	41,100	11,980	568	2,615	95,200	
ABS	5,960	1,595	900	0	61	8,515	
Derivatives	906	3,934	742	263	53	5,899	
Given guarantees	6,983	5,622	1,380	95	3,953	18,033	
Repo	8,426	5,749	594	0	7	14,777	
Other assets	209	55	1	19	992	1,275	
Total continued activities	89,666	104,463	26,552	1,041	12,296	234,017	
Total activities held for sale	33,913	43,462	8,319	647	1,241		87,582

Note: average exposure is the quarterly average figure.

2013 average exposure

	AAA+ to AA-	A+ to BBB-	Non investment grade	Default	Non rated	Total continued activities	Total activities held for sale
Debt securities	24,618	41,405	9,042	173	8	75,246	
Retail loans	1	0	0	0	5	6	
Loans and advances	33,016	38,960	11,533	730	639	84,878	
ABS	4,791	1,439	895	64	70	7,258	
Derivatives	847	3,037	684	222	21	4,810	
Given guarantees	3,510	3,399	859	87	139	7,995	
Repo	0	5,445	0	0	5	5,449	
Other assets	190	10	1	14	824	1,040	
Total continued activities	66,973	93,694	23,014	1,290	1,711	186,682	
Total activities held for sale	31	80	1	0	88		200

3.2.3. Exposure per Exposure Class and Economic Sector

The following tables show the total exposure with a breakdown by economic sector and exposure class at year-end 2012 and 2013.

Exposure at year-end 2012

Exposure at year end 2012											
Economic sector	Corporate	Financial institutions	Monolines	Project finance	Public sector entities	Retail	Securitisation	Sovereign	Total continued activities	Total activities held for sale	
Industry	3,480	36	0	4,554	4,915	0	102	0	13,086	1,498	
Construction	1,288	0	0	6,446	656	0	0	0	8,390	232	
Trade-Tourism	7	0	0	0	56	0	0	0	63	106	
Services	Transportation and storage	1,304	66	0	767	2,236	0	0	39	4,412	423
	Information and communication	261	0	0	91	151	0	0	503	2	
	Financial and insurance activities	67	36,948	5,652	1	1,750	0	155	1,748	46,320	5,524
	Real estate activities	1,547	173	0	3,701	6,504	0	0	0	11,925	2,147
	Professional, scientific and technical activities	26	0	0	0	125	0	0	0	152	15
	Administrative and support service activities	12	0	0	238	4,933	0	0	0	5,183	12
	Public administration and defence-compulsory social security	0	0	0	27	77,182	0	251	22,710	100,169	46,602
	Human health and social work activities	62	0	0	0	3,920	0	0	0	3,981	6,909
	Arts, entertainment and recreation	0	0	0	0	187	0	0	0	187	147
	Other service activities	1	39	0	0	395	0	0	0	434	91
	Other Services	4	0	0	0	518	0	0	1,647	2,169	87
	Others	339	828		115	16	4	7,524	4,266	13,092	4,235
Total continued activities	8,398	38,091	5,652	15,939	103,542	4	8,031	30,410	210,067		
Total activities held for sale	145	1,603		18	56,753	0	4,908	4,606		68,033	

Exposure at year-end 2013

Economic sector	Corporate	Financial institutions	Monolines	Project finance	Public sector entities	Retail	Securitisation	Sovereign	Total continued activities	Total activities held for sale
Industry	2,617	59		3,844	3,906				10,425	0
Construction	535			6,136	518				7,189	0
Trade-Tourism	5				52				57	0
Services	Transportation and storage	875	64	720	2,023			38	3,720	0
	Information and communication	176		85	76				337	0
	Financial and insurance activities	0	24,763	3,143	0	1,437	42	2,123	31,508	47
	Real estate activities	1,238	5	3,451	6,112				10,806	0
	Professional, scientific and technical activities	20			91				111	0
	Administrative and support service activities	9		218	4,489				4,716	0
	Public administration and defence-compulsory social security	0	0	26	67,197		177	19,780	87,180	0
	Human health and social work activities	55			3,572				3,627	0
	Arts, entertainment and recreation				155				155	0
	Other service activities	0	27		368				395	0
	Other services	0			400			1,374	1,774	0
	Others	296	752	13	64	2	6,683	3,521	11,331	79
	Total continued activities	5,827	25,669	3,143	14,493	90,460	2	6,901	26,836	173,331
	Total activities held for sale	79	47	0	0	0	0	0		126

The exposure of continued activities is mainly concentrated on the Local Public Sector and the Central Governments (68%).

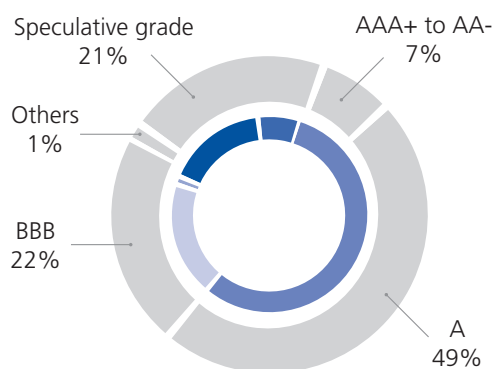
In 2013, the portfolio of Dexia on the local public sector continued to decrease. Also, a securitisation vehicle of Italian local public sector bonds was unwound, and the underlying assets, totalling EUR 2.9 billion, were transferred to SFIL. These two factors explain the bulk of the decrease of the exposure on the local public sector (continued activities), from EUR 103.5 billion at the end of 2012 to EUR 90.4 billion at the end of 2013.

The share of financial institutions decreased by 32%, and now represents 15% of the continued activities, due to the reduction of the refinancing operations between Dexia and Belfius Bank that continued in 2013, as well as the natural amortisation of the bond portfolio.

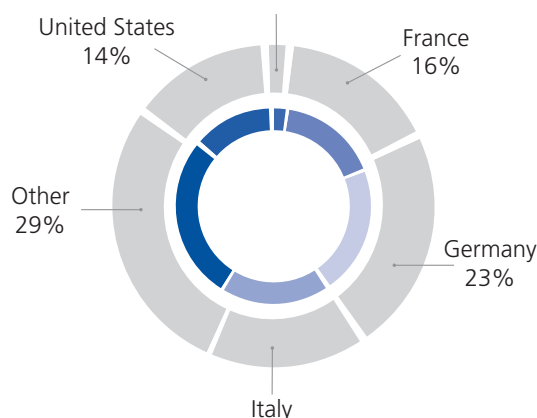
The corporate and project finance segments decreased by 17% due to the natural amortisation of the portfolio and the effect of early repayments. The decrease of the rest of the portfolio is due to natural amortisation.

Exposure in the coloured cells is further detailed in the following diagrams (continued activities of the Dexia Group only).

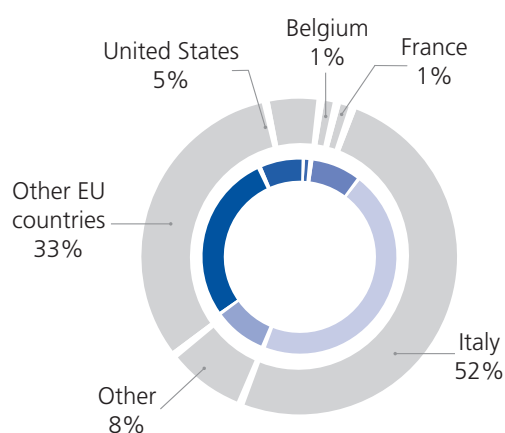
Financial intermediation: split by rating class



PSE: Public administration, social security: split by country



Sovereign: Public administration, social security: split by country



More than half of the exposure of the continued activities of the Dexia Group is related to the public sector (i.e. 52% on public sector entities and 15.4% on sovereign), whereas financial institutions account for 14.8%.

3.3. Impairment, Past-Due and Related Provisions

3.3.1. Concepts and Implementation within Dexia

The concepts "default", "impairment", "non-performing assets/exposures", "Past-Due" and "Provisions" are closely related to each other.

Within Dexia, clear policies and procedures are in place to ensure that these concepts are clear throughout the entire organisation and also uniformly integrated.

3.1.1.1 Principles of Past Due Exposure

A past due is defined as payment that has become due but has not been made according to the terms of the agreement. A past-due is considered by contract. If a counterparty fails to pay the required interests at due date, the entire loan exposure is considered as past-due.

3.1.1.2 Principles of Default (Dexia) and Non-Performing Exposure Definition (EBA)

The concept of default includes counterparties that have (or that are likely to have in the future) difficulties meeting their commitments or counterparties where return to a normal situation seems difficult.

For counterparties that have or are likely to have financial difficulties, Dexia has identified situations described by the different criteria listed below:

- Non observance of any of the contractual obligations that are material in terms of risk.
- Any significant difficulties of the debtor, repeated delay of payments (even if those payments are lower than the threshold) < 90 days (or a different delay decided for a specific market segment), repeated exceeding or incorrect use of line of credit without improvement prospect, justifying a specific follow-up.

- Deterioration of the credit, or important downgrading of the external ratings, or situation which could lead, on a statistical basis, to a non-payment of the obligations.
- Significant devaluation in value (or the probability of devaluation), due to an increase of the risk on an active market, especially where the credit could be threatened, or there is a disappearance of the market including sale of the credit obligation resulting in a material loss due to credit risk.
- Any case of accelerated payment as defined by the law, illegal financial operation, important fraud, misrepresentation, accounting's publishing with reservation of external auditors.
- A cross-default, termination of credits by other banks, "protêt", triggering of an accelerated payment clause, social or tax "past due".
- Total or partial extinction of risk mitigant considered as essential to the credit.
- Legal action against the debtor likely to significantly damage his solvency.
- The debt being classified as "doubtful".
- Any restructuring, including emergency restructuring, triggered by deterioration of the risk and with a disadvantageous character (reduction of the Net Present Value).

These counterparties receive a credit rating of D1 on a case by case analysis.

For counterparties where return to a normal situation seems difficult, Dexia has also identified situations described by the criteria listed below:

- The counterparty is "past due" for more than 90 days on any payment obligation (or a different delay decided for a specific market segment). For authorised overdrafts, the delay starts at the due date of the authorisation and for non-authorised overdrafts, as soon as they appear. Exceptions to this rule are:
 - Past due amounts on banks or sovereigns which are flagged D2 the day after a payment is missed.
 - 180th days of any delay in payment obligation for local French Sector and assimilated counterparties.
 - Technical past dues, defined as the consequence of a mistake of the counterparty, (or by its accountant, or by its bank) that leads to a delayed payment of the debt.
 - Operational past dues, defined as a failure in the process, or in the internal system of Dexia. Operational past due also include the legal risk when the counterparty has the means to afford its payment but refuses to pay for it.
 - Immaterial amounts: Dexia's threshold for past due is a fixed amount established at EUR 2,500. The threshold takes into account nominal past due, past due on interests, penalties and commissions.
- Any case of judicial settlement, unwinding, bankruptcy, concordat, Chapters 7, 9 or 11 or any similar legal status.
- Termination of the loan, due to any type of incident.
- The loan being subject to a legal procedure of "recovery".

For these counterparties, a credit rating of D2 is given.

Non-Performing Exposure (EBA)

The European Banking Authority (EBA) established on October 2013 the EBA Final Draft implementing Technical Standards on supervisory reporting on forbearance and non-performing exposures. The definitions of forbearance and non-performing exposures (NPE) are built on existing accounting and regulatory concepts.

3.1.1.3 Impairments and Specific Provisions

In line with the impairment tests defined by IAS 39, Dexia has defined two types of provisions:

Specific Provisions

The scope of application of specific provisions is determined by an individual impairment tests conducted on the whole portfolio. A specific provision aims at covering assets in default on an individual basis, following IFRS principles and based on the valuation of the net risk of the counterparty. The necessity of a specific provision is assessed on every exposure classified "in default". Individual impairment test is the result of the application of the Special Mention and Watch-list process and default process on individual counterparties.

The amount of provision to be set for the asset is equal to the difference between: the net accounting value⁽⁵⁾, and the net present value of expected free cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (EIR), or EIR at reclassification date for AFS bonds that have been reclassified to Loans and Receivables.

This net present value is determined on a case by case basis by the credit expertise centres. The following indicators are taken into account for proposing the level of specific provisions to the impairment committee:

- the existence of guarantees and credit risk mitigants attached to the facility,
- the use, for some sectors, of external valuations to base its judgment on,
- the use, for ABS, of a free cash flow model to estimate recovery rate at the end of the contract,
- internal estimates, in some other cases, of recovery opportunities (according to objective factor and subjective factors resulting from its knowledge of the counterparty).

⁽⁵⁾ Asset carrying amount.

Collective Provisions

Collective impairment tests are based on objective indicators of impairment on a portfolio basis. These provisions are compliant with IAS 39 allowing banks to assess their provision using a statistical approach *to determine impairment losses in a group of financial assets*". In 2014 Dexia started a full re-engineering of its collective provisioning system covering both the provisioning methodology and the implementation. This review addressed a remark from the Group's external auditors that require to re-allocated the provisions towards the most risky and relevant portfolios of Dexia

Dexia's collective provisions' model is based on two types of provisions:

- Statistical provisions which correspond to the provisioning until maturity of the exposures of a sub-portfolio composed of counterparties which presenting objective evidence of deterioration in terms of risk quality without requiring a specific provision;
- Sector provisions / or asset class provisions based on expert judgment taking into account in-depth knowledge on its portfolio in order to:
 - Adjust its historical loss experiences taking into account the circumstances at the moment of the set-up of the provision if these circumstances were not taken into account in the period during which the historical loss experience has been observed.
 - Cover the risks observed on a segment of counterparties / types of financing / country risk which present advanced deterioration evidence of risk without requiring the constitution of a specific provision (for example, a change in legislation can represent a risk and does not necessary require a specific provision).

3.3.2. Overview of Past-Due Exposure, Impairments and Provisions

A financial asset is past due when the counterparty has failed to make a payment when contractually due. If a counterparty fails to pay the required interest at due date, the entire loan is considered as past due.

The following tables below show the situation of past due and impaired assets at the end of 2012 and 2013.

31/12/2012				
	Past-due but not impaired financial assets			Carrying amount of individually impaired financial assets, before deducting any impairment loss
	Less than 90 days	90 days to 180 days	Over 180 days	
Financial assets available for sale (excluding variable income securities)				160
Loans and advances (at amortised cost)	325	25	251	1,322
Other financial instruments				29
Total continued activities	325	25	251	1,511
Total activities held for sale	135	148	425	354
TOTAL	460	173	676	1,865

31/12/2013				
	Past-due but not impaired financial assets			Carrying amount of individually impaired financial assets, before deducting any impairment loss
	Less than 90 days	90 days to 180 days	Over 180 days	
Financial assets available for sale (excluding variable income securities)	0			69
Loans and advances (at amortized cost)	199	52	478	1,391
Other financial instruments			110	9
Total continued activities	199	52	588	1,469
Total activities held for sale	0	0	0	0
TOTAL	199	52	588	1,469

Within the continued activities, the carrying amount of individually impaired financial assets before deducting any impairment loss overall decreased by EUR 42 million, of which:

- EUR 91 million decrease in the AFS category mainly due to the sale of impaired securities on Icelandic banks (Landsbanki & Kaupthing);
- EUR 69 million increase in the Loans and Advances category. This increase is mainly due to the US local public sector notably related to the default of the City of Detroit and the difficulties of the State of Puerto Rico but is offset by the return to "health" of several counterparties in the French and international local public sector (other than US) and the restructuring and sales of corporate and project files.

	31/12/2012								
	As at 1 Jan.	Additions	Reversals	Utilisation	Transfers in activities held for sale	Other	As at 31 Dec.	Recoveries directly recognised in profit or loss	Charge-offs directly recognised in profit or loss
Specific impairments	(4,512)	(599)	3,603	566	338	35	(568)	78	(3,446)
Interbank loans and advances	(5)	0	0	0	0	5	0	0	0
Customer loans and advances	(1,385)	(254)	393	515	334	2	(395)	29	(367)
Held to maturity securities	(153)	0	141	0	0	12	0	0	0
Available for sale securities ⁽¹⁾	(2,954)	(343)	3,068	51	4	19	(155)	49	(3,079)
Fixed revenue instruments	(2,877)	(335)	3,068	0	4	18	(121)	49	(3,079)
Variable revenue instruments	(78)	(8)	0	51	0	1	(34)	0	0
Other accounts and receivables	(15)	(2)	2	0	0	(3)	(18)	0	0
Collective impairments	(554)	(315)	238	4	203	2	(422)		
Interbank loans and advances	(11)	(4)	6	0	3	0	(6)		
Customer loans and advances	(543)	(311)	232	4	200	2	(416)		
TOTAL	(5,067)	(913)	3,842	570	541	37	(990)	78	(3,446)

(1) The amounts in "Reversals" are mainly related to Greek sovereign bonds.

	31/12/2013							
	As at 1 Jan.	Additions	Reversals	Utilisation	Other adjustments ⁽¹⁾	As at 31 Dec.	Recoveries directly recognised in profit or loss	Charge-offs directly recognised in profit or loss
Specific impairments	(568)	(286)	170	43	16	(624)	12	(130)
Customer loans and advances	(395)	(279)	112	4	13	(545)	9	(55)
Available for sale securities	(155)	(5)	49	39	2	(70)	0	(76)
Fixed revenue instruments	(121)	0	49	37	1	(32)		(76)
Variable revenue instruments	(34)	(5)	0	2	1	(38)	0	0
Other accounts and receivables	(18)	(2)	9	0	2	(9)	3	0
Collective impairments	(422)	(212)	213	0	3	(419)		
Interbank loans and advances	(6)	(5)	7	0	0	(5)		
Customer loans and advances	(416)	(207)	206	0	3	(414)		
TOTAL	(990)	(498)	383	43	19	(1,043)	12	(130)

(1) Other adjustments include notably the impact of changes in exchange rates and in the scope of consolidation during the year.

In 2013, specific impairments rose by 44% to reach EUR 624 million. This evolution is mainly driven by the following elements:

- specific impairments on Loans and advances to customers rose by 38% to reach EUR 545 million, mainly due to the specific provisioning on the American local public sector (EUR 156 million net new provisions, including provisions on securities on the city of Detroit and the State of Puerto Rico).
- specific impairments on AFS securities decreased by 75% to EUR 32 million mainly driven by the litigation settlement on Icelandic Bank securities.

Collective impairments remained stable throughout 2013. Dexia performed a profound re-engineering of the statistical provisioning methodology with the set-up of a new statistical provision based on an Expected Loss at maturity and a full review of the sector provisions. Collective provisions reflect more the current risk structure of the overall credit portfolio.

3.4. Credit Risk Mitigation Techniques

3.4.1. Description of the Main Types of Credit Risk Mitigants (CRM)

Credit Risk Mitigants (CRM) are used by a bank to reduce the credit risk associated with an exposure. CRM are one of the “risk” components used to determine Basel II/Basel III regulatory capital.

CRM can be classified into two main categories:

- Funded credit protection, gathered under the generic name “collaterals”;
- Unfunded credit protection, gathered under the generic name “guarantees and credit derivatives”.

Funded Credit Protection: Collaterals

From a regulatory point of view, funded credit protection represents a technique for mitigating credit risk whereby the credit risk associated with the bank’s exposure is reduced by the institution’s right — in the event of a default by the counterparty or the occurrence of other predetermined events involving the counterparty — to liquidate certain amounts or assets, to have them transferred, to seize or hold them, or to reduce the amount of the exposure by the difference between this exposure and the amount of a claim that would be held on the bank, or to replace it by the balance of this difference.

Funded credit protection can adopt several sub-forms:

Financial collateral (securities portfolio under ratings conditions, cash, gold, precious materials, etc...)

Netting agreements: banks have legally enforceable netting arrangements by which they may calculate capital requirements on the basis of net credit exposures subject to specific regulatory conditions. Types of netting are payment netting, novation netting, close-out netting or multilateral netting.

Physical collaterals:

- Residential or commercial real estate collateral;
- Receivables (eligible only under Advanced Approach);
- Other types of physical collaterals...

Unfunded Credit Protection: Guarantees and Credit Derivatives

From a regulatory point of view, unfunded credit protection represents a technique for mitigating credit risk where the credit risk associated with the bank is reduced by the commitment of a third party to pay an amount in the event of a default by the borrower or in the event that other predetermined events should occur.

They include for example:

- *Guarantees*: guarantees refer to personal guarantees, first demand guarantees, support commitments and “tri-party conventions”
- *Credit derivatives*. The following types of credit derivatives are eligible for recognition:
 - Credit default swaps provide credit protection equivalent to guarantees
 ‘Credit default swap’ means a contract according to which one party to the contract undertakes to make a payment to the other party to the contract on the occurrence of a specified event or events relating to the creditworthiness of a third party. The making of such payment does not in itself give rise to a legal entitlement in the protection provider against the third party.
 - Total return swaps provide credit protection equivalent to guarantees
 ‘Total return swap’ means a contract according to which one party to the contract undertakes to make payments to the other party to the contract of all cash flows arising from a specified asset (or assets) plus any increase in the market value of the asset (or assets) since the last payment date or the commencement date of the contract, whichever is the most recent, and according to which the recipient of these amounts undertakes to pay to the first party an interest rate related flow plus any decrease in the market value of the asset (or assets) since the last payment date or the commencement date, whichever is the most recent.
 - Credit derivatives treated as cash collateral
 ‘Credit linked note’ means a cash funded debt instrument which is redeemable by the issuer in accordance with the terms of the instrument, or the terms of redemption of which are altered, on the occurrence of a specified event or events related to the creditworthiness of a third party.
- *Other credit commitments* received from a third-party.

3.4.2. Policies and Processes

Institutions should use robust procedures and processes to control risks arising from the use of collateral, including in particular strategy, consideration of the underlying credit, valuation, policies and procedures, systems, control of roll-off risks, and management of concentration risk arising from the institution’s use of collateral and its interaction with the institution’s overall credit risk profile.

Collateral and Guarantees/Credit Derivatives

Within Dexia Group, managing the CRMs involves the following tasks:

- Analysis of the eligibility of all CRMs under the Standardised and Advanced approaches.
- To summarise, only financial collaterals, guarantees, credit derivatives, real estate assets and leased real estate assets are eligible under the Standardised approach (providing they respect the related requirements).
- The scope of eligible CRMs is significantly broader under the Advanced approach than under the Standardised approach: in addition to CRMs eligible under the Standardised approach, receivables and other types of collaterals can also be considered as eligible provided they respect the related requirements.
- Collateral valuation in mark-to-market;
 - Description of all CRM characteristics in Dexia Risk Systems, such as:
 - Financial collateral: valuation frequency and holding period;
 - Guarantee/credit derivative: identification of the guarantor, analysis of the legal mandatory conditions, check whether the credit derivative covers restructuring clauses;
 - Security portfolio: description of each security.
 - Periodic review of the descriptive data of its CRM.
 - Detailed procedures for collateral eligibility, valuation and management are documented in line with the regulatory standards.

On and Off-Balance-Sheet Netting

Dexia does not make use of on or off-balance-sheet netting for regulatory purposes, except for over-the-counter (OTC) derivative products.

The following derivative products are eligible to netting agreements: swap, contracts forward, options, etc... covering the following underlying risks:

- Interest rates contracts;
- Exchange rates or gold contracts;
- Contracts on ownership titles;
- Contracts on precious metals except gold;
- Commodities other than precious metals;
- Credit derivatives contracts.

For these products, internal policies document the eligibility criteria and minimum requirements that netting agreements need to fulfil in order to be recognised for regulatory purposes. Eligibility criteria are different for on-balance-sheet netting agreements and off-balance-sheet netting agreements. Adequate documentation should also be put in place. Appropriate internal procedures and minimum requirements have been implemented in the internal risk management process.

Information about Market or Credit Risk Concentrations

Concentration risk is related to a concentration of collateral on one issuer, country, industry or market. As a result, credit deterioration might have a significant impact on the overall value of collateral held by Dexia to mitigate its credit exposure.

3.4.3. Basel II Treatment

For netting agreements (and subject to eligibility conditions), Dexia recognises their impact by applying the netting impact of these agreements on the calculation of its Exposure at Default (EAD) used for calculating its weighted risks.

For guarantees and credit derivatives, Dexia recognises the impact by replacing the PD, LGD and Risk Weight formula of the borrower by those of the guarantor (i.e. the exposure is considered to be directly towards the guarantor) if the Risk Weight of the guarantor is lower than the Risk Weight of the borrower.

For collateral (both financial and physical), the Dexia methodology relating to eligible CRMs depends on the Basel II approach.

AIRB Approach exposures – two methodologies might be applied:

- CRMs are incorporated into the calculation of LGD based on internal loss data and calculated by the AIRB Approach models (the “so called” preliminary LGD).
- CRMs are not incorporated into the LGD computed by the model. The impact of each individual CRM is taken into account in the LGD according to each transaction.

Standardised exposures: eligible CRMs (after regulatory haircuts) are directly taken into account in the EAD.

3.4.4. Exposure Covered by Credit Risk Mitigants by Exposure Class

	Financial and physical collateral	
	31/12/2012	31/12/2013
Sovereign	0	0
Financial institutions	27,278	21,654
Corporate	350	288
Total continued activities	27,628	21,942
Total activities held for sale	8,655	0

Financial institutions represent the overwhelming part of the exposure covered by Basel II eligible credit risk mitigants. The decrease between 2012 and 2013 is driven by the overall exposure decrease.

3.5. AIRB Approaches

3.5.1. Competent Authority's Acceptance of Approach

By letter sent on 21 December 2007 by the former Belgian Regulator (the Banking, Finance and Insurance Commission), Dexia SA was authorised to use the Advanced Internal Rating-Based Approach (AIRB Approach) for the calculation and the reporting of its capital requirements for credit risk starting from 1 January 2008.

This acceptance is applicable to all entities and subsidiaries consolidated within the Dexia Group, which are established in a Member State of the European Union and are subject to the Capital Requirement Directive.

3.5.2. Internal Rating Systems

The internal rating systems developed by Dexia are set up to evaluate the three Basel II parameters: Probability of Default (PD), Loss Given Default (LGD) and Credit Conversion Factor (CCF). For each counterparty type in the advanced method, a set of three models, one for each parameter, has been developed.

The PD models estimate the one-year probability of default. Each model has its own rating scale and each rating on the scale corresponds to a probability of default used for regulatory and reporting purposes. The correspondence between rating and PD for each scale is set during the calibration process, as part of the model development, and is reviewed and adjusted during the yearly backtesting when applicable. The number of ratings on each scale depends on the characteristics of the underlying portfolio (the number of counterparties, their homogeneity, whether it is a low default portfolio or not) and varies between 6 and 17 non-default classes. In addition each scale has been attributed two default classes (named D1 and D2).

LGD models estimate the ultimate loss incurred on a defaulting counterparty before taking the credit risk mitigants into account. The unsecured LGD depends on different factors such as the product type, the level of subordination or the rating of the counterparty. The granularity of the estimate is a function of the quantity and quality of data available.

CCF models estimate the part of off-balance-sheet commitments that would be drawn should a counterparty go into default. The regulation authorises the use of CCF models only when CCF under the Foundation Approach is not equal to 100% (as it is for credit substitutes for instance). CCF granularity also depends on availability of data. In consequence of the orderly resolution plan, internal CCF models are used only on project finance assets; on all other asset classes the foundation parameters are applied.

Internal estimates of Basel II parameters are increasingly used within Dexia in addition to the calculation of the regulatory risk-weighted exposure amounts. They are notably used in the decision-making process, credit risk management and monitoring, internal limit determination, provisioning methodology and pricing.

The control mechanisms for Internal Rating Systems (IRS) are organised in 3 levels:

- Credit IRS Control is defined, in accordance with the regulatory directives, as an internal and independent containment function to ensure that the IRS are being used properly, that they are operationally effective and that the audit trail in the rating process remains clear;
- The validation team is responsible for the independent review of all models used within Dexia, either market risk models, pricing models, Basel II Pillar 1 credit rating models, BSM models, economic capital models;
- Audit is responsible for auditing the general consistency and compliance with the regulation of the IRS. Audit acts then as an additional level of control, included in its Audit plan.

We refer to Appendix 2 for more details regarding Internal Rating Systems.

3.5.3. Average PD, LGD and Risk Weight by Exposure Class and Obligor Grade

The following table shows the total exposure at default, average exposure at default, exposure-weighted average PD, LGD and exposure-weighted average risk weights broken down by exposure class and obligor grade at year-end 2012 and 2013.

Exposure class	Obligor grade	31/12/2012					
		EAD	Average EAD	Average PD	Average LGD	Average RW	Average EL
Corporate	AAA to AA-	0	0	0.00%	0%	0%	0.00%
	A+ to A-	1,142	1,194	0.07%	42%	34%	0.03%
	BBB+ to BBB-	3,735	3,841	0.34%	46%	73%	0.16%
	Others	785	1,439	2.86%	54%	149%	1.64%
	Total	5,662	6,474	0.63%	46%	76%	0.34%
Financial institutions	AAA to AA-	1,982	13,078	0.04%	27%	16%	0.01%
	A+ to A-	19,147	13,024	0.06%	27%	13%	0.02%
	BBB+ to BBB-	6,819	5,816	0.32%	34%	45%	0.11%
	Others	5,087	4,881	2.30%	10%	27%	0.21%
	Total	33,035	36,799	0.44%	26%	21%	0.06%
Monolines	AAA to AA-	4,816	4,929	0.04%	33%	19%	0.01%
	A+ to BBB-	156	157	0.34%	41%	82%	0.14%
	Others	82	110	30.87%	62%	391%	19.03%
	Total	5,055	5,196	0.55%	34%	27%	0.32%
Project finance	AAA to AA-	27	28	0.04%	19%	14%	0.01%
	A+ to A-	2,247	2,046	0.07%	13%	12%	0.01%
	BBB+ to BBB-	8,251	8,415	0.40%	15%	30%	0.07%
	Others	4,053	4,312	2.65%	18%	57%	0.47%
	Total	14,578	14,801	1.00%	16%	35%	0.17%
Public sector entities	AAA	12,451	13,683	0.02%	7%	2%	0.00%
	AA+ to AA-	11,348	14,388	0.03%	9%	5%	0.00%
	A+ to A-	11,912	11,391	0.08%	3%	2%	0.00%
	BBB+ to BBB-	15,971	17,157	0.40%	3%	6%	0.01%
	Others	6,886	5,075	1.49%	3%	8%	0.04%
	Total	58,569	61,695	0.31%	5%	5%	0.01%
Sovereign	AAA	0	53	0.00%	0%	0%	0%
	AA+ to A-	118	37	1%	48%	104%	0%
	BBB+ to BBB-	35	108	1%	69%	195%	1%
	Others	7	9	26%	16%	337%	0%
	Total	160	207	2%	51%	134%	0%
Equities	AAA to AA-	5,022	4,365	0.00%	9%	0%	0.00%
	A+ to A-	18,361	18,703	0.07%	11%	9%	0.01%
	BBB+ to BBB-	1,027	2,487	0.59%	20%	40%	0.11%
	Others	3,338	2,153	0.91%	31%	80%	0.28%
	Total	27,748	27,709	0.18%	13%	17%	0.04%
Default		1,329	1,065				
Total continued activities		146,135	153,945				
Total activities held for sale		58,248	80,638				

Notes:

– The counterparties are the final counterparties, i.e. after taking into account the Basel II eligible guarantee (substitution principle). Monoline exposure is essentially an indirect exposure.

– Average EAD is the quarterly average figure.

		31/12/2013					
Exposure class	Obligor grade	EAD	Average EAD	Average PD	Average LGD	Average RW	Average EL
Corporate	AAA to AA-	9	2	0.03%	35.95%	21.92%	0.01%
	A+ to A-	872	1,030	0.07%	41.33%	28.51%	0.03%
	BBB+ to BBB-	2,896	3,031	0.28%	46.18%	74.94%	0.13%
	Other	483	666	4.25%	52.47%	155.75%	2.50%
	Total:	4,260	4,729	0.68%	45.88%	74.49%	0.38%
Financial institutions	AAA to AA-	1,599	1,281	0.04%	26.36%	14.57%	0.01%
	A+ to A-	11,448	13,385	0.06%	25.89%	14.78%	0.02%
	BBB+ to BBB-	5,577	5,848	0.49%	31.99%	48.03%	0.14%
	Other	4,505	4,566	5.75%	4.95%	14.78%	0.16%
	Total:	23,129	25,081	1.27%	23.32%	22.78%	0.07%
Monolines	AAA to AA-	0	1,235	NA	NA	NA	NA
	BBB+ to BBB-	0	40	NA	NA	NA	NA
	Other	0	21	NA	NA	NA	NA
	Total:	0	1,296	NA	NA	NA	NA
Project finance	AAA to AA-	23	26	0.04%	18.98%	12.17%	0.01%
	A+ to A-	2,698	2,488	0.07%	12.44%	11.26%	0.01%
	BBB+ to BBB-	6,591	7,088	0.38%	15.25%	30.02%	0.06%
	Other	3,478	3,798	1.74%	17.62%	53.68%	0.31%
	Total:	12,789	13,399	0.68%	15.31%	32.47%	0.12%
Public sector entities	AAA	9,858	10,334	0.02%	7.89%	3.04%	0.00%
	AA+ to AA-	8,930	10,155	0.03%	11.21%	6.66%	0.00%
	A+ to A-	10,170	10,775	0.08%	2.30%	2.20%	0.00%
	BBB+ to BBB-	12,469	13,850	0.34%	3.21%	5.66%	0.01%
	Other	8,666	8,999	1.48%	2.94%	8.90%	0.04%
	Total:	50,092	54,114	0.36%	5.33%	5.18%	0.01%
Securitisation	AAA to AA-	14	36	0.00%	5.00%	0.00%	0.00%
	BBB+ to BBB-	57	114	0.57%	3.00%	7.31%	0.02%
	Other	99	106	2.24%	6.21%	26.54%	0.36%
	Total:	171	256	1.50%	5.04%	17.91%	0.21%
Sovereign	AAA	3,744	4,401	0.00%	8.94%	0.00%	0.00%
	A+ to A-	16,763	17,617	0.07%	18.80%	19.14%	0.01%
	BBB+ to BBB-	1,170	1,118	0.56%	34.89%	75.52%	0.20%
	Other	3,165	3,168	0.88%	35.56%	107.92%	0.31%
	Total:	24,842	26,303	0.18%	20.21%	30.22%	0.06%
Equities	A+ to A-	45	73	0.06%	29.07%	25.67%	0.00%
	BBB+ to BBB-	0	10	0.21%	90.00%	134.15%	0.19%
	Other	4	4	27.80%	23.32%	227.53%	0.65%
	Total:	49	87	2.13%	29.21%	41.74%	0.05%
Default		1,460	1,347				
Total continued activities		116,792	126,612				
Total activities held for sale		47	118				

The majority of the continued activities of the Dexia Group exposure (64% of the EAD) is concentrated on the public sector (i.e. public sector entities and sovereign exposure).

A vast majority of average PD levels is situated below 1% (the average PD is 0.56%), reflecting the exposure on highly rated municipal and public related counterparties.

Non-investment grade files represent 14% of total Dexia portfolio. The geographical split indicates a predominance of European assets (80.8%) including 66.1% in GIIPS countries, mostly Spain, Portugal and Italy. Public Sector (52.4%) and Project Finance/Corp (22.6%) are the sectors in which most of the speculative grade files are observed. The majority of the files (85.2%) are in BB category.

Average LGD is very different by exposure class: public sector entities benefit from very low LGD compared to corporate exposures.

3.5.4. Average PD, LGD and Risk Weight by Type of Retail Product

The retail exposure is no longer material following the sale of Banque Internationale à Luxembourg (BIL) and DenizBank.

3.5.5. Back testing

The purpose of the back-test exercises is to assess the performance of the internal rating system ensuring an appropriate balance between capital and risk. As the formulas to calculate the bank's capital are provided by the Basel Committee on Banking Supervision, the internal back-test relating to Pillar 1 rating systems is based on the back-test of the input parameters PD, LGD and EAD in the Basel II credit risk portfolio model.

The back-test is the evaluation of the predictive power of the rating system and the assessment of its time evolution to detect any reduced performance of the rating system. With this purpose three properties are particularly analysed: the model's calibration, its discriminatory power and its stability.

Decreased performance of the rating system decision tool may reduce the bank's profitability and will impact the risk assessments of the defined risk buckets. The performance is tracked by analysing the ability to discriminate between high and low risk and the stability of the data inputs into the rating system.

The back-test procedures include three types of tests:

Calibration

Calibration normally denotes the mapping of the Probability of Default (PD) to the rating grades. A rating system is well calibrated if the estimated PDs (or LGD) deviate only marginally from the actual default rates (or loss).

Discriminatory Power

The discriminatory power of rating systems denotes their ex-ante ability to identify borrowers in danger of defaulting. A rating system with maximum power would be able to precisely identify in advance all borrowers that subsequently default. In practice, however, such perfect rating systems do not exist. A rating system demonstrates a high discriminatory power if the "good" grades subsequently turn out to contain only a small percentage of defaulters and a large percentage of non-defaulters, with the converse applying to the "poor" grades.

Stability

The stability of the population and its data characteristics: the aim is to make sure that the model applied is in line with the reference data sets and with the model where key risk parameters are estimated, or that the population characteristics do not change significantly over time.

The results of the back-testing are assessed using statistical significance tests on the available short-term and long-term data histories. The outcome of the significance tests will drive required action plans. The additional part of the back-test procedure is related to the impact of judgmental aspects i.e. the importance of judgmental qualitative variables in the final rating and the effect of the expert overruling.

3.6. Standardised Approach

3.6.1. Introduction

Dexia applies the Advanced Internal Rating-Based Approach (AIRB) to calculate its capital requirements for credit risk for 70.54% of the credit exposure. The Standardised Approach is applied for:

- Small business units;
- Non-material portfolios;
- Portfolios corresponding to activities in run-off or to be sold.

Consecutively to the disposal of some entities and to the sharp decrease of some portfolios, Dexia presented an official request to the home regulators to move some portfolios from Advanced to Standardised Approach. The portfolios involved have become non material in terms of exposure and number of counterparties.

The switch from Advanced to Standard Approach has been implemented as from June 2013 reporting date, following official acceptance of the proposal by the National Bank of Belgium for the following types of counterparties:

- Insurance companies including monoline insurers;
- Belgian 'other' satellites;
- Belgian Region and Communities expert models and assimilated counterparties;
- Mid-corporate counterparties.

3.6.2. Nominated External Credit Assessment Institutions (ECAI)

The Standardised Approach provides weighted risk figures based on external ratings. In order to apply the Standardised Approach for risk-weighted exposure, Dexia uses the external ratings assigned by the following rating agencies: Standard & Poor's, Moody's and Fitch.

Dexia also plans to use any other eligible ECAI as approved from time to time by the National Bank of Belgium (NBB) and as far as Dexia has implemented these ECAI in its Basel II methodology and IT systems.

The rating used for the regulatory capital calculation is the lower of the two ratings, if two ratings are available, or the lower of the best two ratings, if three ratings are available. If no external rating is available, the Standardised Approach provides specific risk weights (usually 100% or 150% depending on the counterparty type).

Credit rating agencies and credit quality step under Standardised approach			
Standard and Poor's	Moody's	Fitch	NBB credit quality step
AAA to AA-	Aaa to Aa3	AAA to AA-	1
A+ to A-	A1 to A3	A+ to A-	2
BBB+ to BBB-	Baa1 to Baa3	BBB+ to BBB-	3
BB+ to BB-	Ba1 to Ba3	BB+ to BB-	4
B+ to B-	B1 to B3	B+ to B-	5
CCC+ and below	Caa and below	CCC+ and below	6

Risk weights are mainly determined in relation to the credit quality step and the exposure class.

3.6.3. Exposure at Default and Average Risk Weights

The following table shows the total exposure at default and exposure weighted-average risk weights broken down by exposure class and obligor grade at year-end 2012 and 2013.

		31/12/2012	
Exposure class	Obligor grade	EAD	Average RW
Corporate	AAA+ to AA-	465	20%
	A+ to A-		
	BBB+ to BBB-		
	BB+ to B-		
	Below B-	0	150%
	No rating available	1,474	72%
	Total	1,939	60%
Financial institutions	AAA+ to AA-	2,047	1%
	A+ to A-	947	9%
	BBB+ to BBB-	86	100%
	BB+ to B-	333	44%
	Below B-	84	19%
	No rating available	4,291	23%
	Total	7,788	17%
Public sector entities	AAA+ to AA-	40,135	8%
	A+ to A-	1,332	50%
	BBB+ to BBB-	1,000	101%
	BB+ to B-	243	118%
	Below B-		
	No rating available	591	100%
	Total	43,302	19%
Sovereign	AAA+ to AA-	1,359	0%
	A+ to A-	283	20%
	BBB+ to BBB-		
	BB+ to B-	624	11%
	Below B-		
	No rating available		
	Total	2,266	5%
Project finance	AAA+ to AA-		
	A+ to A-		
	BBB+ to BBB-		
	BB+ to B-		
	Below B-		
	No rating available	591	100%
	Total	591	100%
Retail	No rating available	9	100%
Equities	AAA+ to AA-	6	150%
	A+ to A-	88	150%
	BBB+ to BBB-	172	150%
	BB+ to B-	190	150%
	No rating available	295	130%
	Total	750	142%
Others	No rating available	0	-
Total continued activities		56,646	
Total activities held for sale		11,590	

Note: The counterparties are the final counterparties, i.e. after taking into account the Basel II eligible guarantee (substitution principle).

		31/12/2013	
Exposure class	Obligor grade	EAD	Average RW
Corporate	AAA to AA-	0	0%
	A+ to A-	0	0%
	BBB+ to BBB-	212	1%
	BB+ to B-	142	96%
	Below B-	346	100%
	No External Rating	343	41%
		1,043	60%
Equities	No External Rating	763	143%
		763	143%
Financial institutions	AAA to AA-	1,605	0%
	A+ to A-	500	17%
	BBB+ to BBB-	0	0%
	BB+ to B-	133	91%
	Below B-	147	0%
	No External Rating	1,719	44%
		4,104	23%
Monolines	A+ to A-	2,670	50%
		2,670	50%
Project finance	AAA to AA-	68	20%
	A+ to A-	23	50%
	BBB+ to BBB-	19	100%
	No External Rating	673	100%
		782	92%
Public sector entities	AAA to AA-	31,150	6%
	A+ to A-	1,494	51%
	BBB+ to BBB-	1,577	71%
	BB+ to B-	583	107%
	Below B-	5	150%
	No External Rating	4,894	59%
		39,703	18%
Retail	No External Rating	5	100%
		5	100%
Securitisation	AAA to AA-	8	0%
	A+ to A-	25	50%
		33	38%
Sovereign	AAA to AA-	869	0%
	A+ to A-	565	20%
	BBB+ to BBB-	478	0%
	BB+ to B-	72	100%
		1,985	9%
Total continued activities		51,089	
Total activities held for sale		319	

For the continued activities of the Dexia Group, the bulk of the EAD is in the public sector entities class (77%) and is predominantly rated in the AAA/AA/A range.

3.7. Counterparty Risk on Derivatives

3.7.1. Management of the Risk

Dexia enters into derivative contracts primarily to protect cash flows and fair value of financial assets and liabilities from market fluctuations. Derivative transactions are mainly concluded to reduce risk exposure with regard to interest rate risk and foreign exchange risk.

Even though it is the objective of the bank to enter into risk reducing strategies, only part of the derivative transactions can be classified under hedge accounting. In the event a strategy applied by the bank does not fulfil the stringent requirements defined under IAS 39, transactions are classified as derivatives “held for trading” notwithstanding their risk reducing character.

3.7.2. Accounting Treatment

The accounting treatment of Dexia's derivative strategies can be summarised as follows:

Derivatives under hedge accounting

Micro hedge strategies

Micro hedge strategies are categorised as either:

- a hedge of the fair value of a recognised asset (or group of assets) or liability (or a group of liabilities) or a firm commitment (fair value hedge);
- a hedge of a future cash flow attributable to a recognised asset or liability or a forecast transaction (cash flow hedge);
- a hedge of a net investment in a foreign operation.

Dexia designates derivatives as hedging instruments if certain criteria are met:

- formal documentation of the hedging instrument, hedged item, hedging objective, strategy and relationship is available before hedge accounting is applied;
- the hedge is documented in such a way as to show that it is expected to be highly effective (within a range of 80% to 125%) in offsetting changes in the fair value or cash flows attributable to the hedged risk in the hedged item throughout the reporting period; and
- the hedge is effective at inception and on an ongoing basis.

Dexia records changes in the fair value of derivatives qualified as fair value hedges in the statement of income, along with the corresponding change in fair value of the hedged assets or the liabilities that is attributable to that specific hedged risk.

Dexia recognises the effective part of the changes in the fair value of derivatives qualified as cash flow hedges, in “Other comprehensive income” under the heading “Gains and losses not recognised in the statement of income” (see “Consolidated statement of changes in shareholders’ equity”).

Hedge of the interest rate risk exposure of a portfolio (group of assets or liabilities):

Dexia makes use of the provisions in IAS 39 as adopted by the European Union (“IAS 39 carve-out”) because it better reflects the way Dexia manages financial instruments. Hedge accounting is intended to reduce the interest-rate risk exposure stemming from the selected category of assets or liabilities designated as the qualifying hedged items. Dexia performs a global analysis of interest-rate risk exposure. It consists in assessing fixed-rate exposure, taking into account all the exposure coming from balance sheet and off-balance sheet items. This global analysis may exclude certain components of the exposure, such as financial market activities, provided that the risk exposure stemming from the excluded activities is monitored on an activity-by-activity basis. Dexia applies the same methodology to select which assets and/or liabilities will be entered into the hedge of interest rate risk exposure of the portfolio. Assets and liabilities are included in all the time buckets of the portfolio. Dexia may designate as qualifying hedged items different categories of assets or liabilities such as available-for-sale assets or loan portfolios. On the basis of this gap analysis, which is realised on a net basis, Dexia defines, at inception, the risk exposure to be hedged, the length of the time-bucket, the test method and the frequency of the tests. The hedging instruments are a portfolio of derivatives, which may contain offsetting positions. Dexia recognises the hedging items at fair value with adjustments accounted for in the statement of income. Dexia reports hedged interest-rate risk revaluation of elements carried at amortised cost on the balance sheet under the line “Fair value revaluation of portfolio hedges”.

Derivatives held for trading

Not all risk reducing derivative strategies can be documented under hedge accounting (e.g. as a result of rigorous documentation requirements; stringent effectiveness testing requirements...). All changes in fair value are recognised in the statement of income. Dexia reports derivatives as assets when fair value is positive and as liabilities when fair value is negative. Dexia treats certain derivatives embedded in other financial instruments as separate derivatives:

- when their risks and characteristics are not closely related to those of the host contract;
- when the hybrid contract is not carried at fair value with unrealised gains and losses reported in the statement of income.

Detail of derivatives held at fair value through profit or loss

	31/12/2012				31/12/2013			
	Notional amount		Assets	Liabilities	Notional amount		Assets	Liabilities
	To receive	To deliver			To receive	To deliver		
Foreign exchange derivatives	24,424	24,378	1,463	621	34,354	33,752	1,688	545
Foreign exchange forward	1,761	1,755	57	16	1,328	1,330	1	8
Cross currency swap	6,917	6,826	1,406	591	11,958	11,189	1,522	522
Foreign exchange option	413	412	0	1	0	0	0	0
Other foreign exchange derivatives	15,333	15,384	0	13	21,068	21,233	165	15
Interest rate derivatives	176,139	176,251	18,893	23,077	237,223	236,857	14,330	15,823
Option-Cap-Floor-Collar-Swaption	1,017	855	123	29	793	567	93	16
Interest rate swap	175,117	174,392	18,769	23,047	236,430	235,974	14,237	15,807
Interest future	5	1,001	0	1	0	316	0	0
Other interest rate derivatives	0	3	0	0	0	0	0	0
Equity derivatives	111	111	0	0	10	10	0	0
Other equity derivatives	111	111	0	0	10	10	0	0
Credit derivatives	6,302	1,650	798	201	5,438	1,555	528	145
Credit default swap	6,302	1,650	798	201	5,438	1,555	528	145
TOTAL	206,975	202,390	21,155	23,900	277,025	272,174	16,546	16,514

Detail of derivatives designated as fair value hedges

	31/12/2012				31/12/2013			
	Notional amount		Assets	Liabilities	Notional amount		Assets	Liabilities
	To receive	To deliver			To receive	To deliver		
Foreign exchange derivatives	11,047	12,564	375	3,947	9,178	9,350	453	2,269
Cross currency swap	11,047	12,564	375	3,947	9,178	9,350	453	2,269
Interest rate derivatives	123,863	123,671	6,271	24,794	108,407	108,322	4,514	17,359
Option-Cap-Floor-Collar-Swaption	236	142	0	9	85	20	0	7
Interest rate swap	123,626	123,529	6,271	24,785	108,322	108,302	4,514	17,352
Equity derivatives	1,612	1,521	99	2	647	556	78	1
Equity option	91	0	58	0	91	0	61	0
Other equity derivatives ⁽¹⁾	1,521	1,521	41	2	556	556	17	1
TOTAL	136,521	137,756	6,745	28,743	118,232	118,228	5,045	19,629

(1) This position includes hedging derivatives for securities with revenue partly linked to the evolution of a basket of securities.

Detail of derivatives designated as cash flow hedges

	31/12/2012				31/12/2013			
	Notional amount		Assets	Liabilities	Notional amount		Assets	Liabilities
	To receive	To deliver			To receive	To deliver		
Foreign exchange derivatives	1,256	1,397	28	186	422	587	1	260
Cross currency swap	1,256	1,397	28	186	422	587	1	260
Interest rate derivatives	6,611	6,611	290	874	16,560	16,560	145	559
Interest rate swap	6,611	6,611	290	874	13,560	13,560	145	559
Forward rate agreement	0	0	0	0	3,000	3,000	0	0
TOTAL	7,867	8,008	319	1,059	16,982	17,147	146	819

Detail of derivatives designated as portfolio hedges

	31/12/2012				31/12/2013			
	Notional amount		Assets	Liabilities	Notional amount		Assets	Liabilities
	To receive	To deliver			To receive	To deliver		
Interest rate derivatives	115,241	115,241	2,307	5,958	22,714	22,714	754	1,817
TOTAL	115,241	115,241	2,307	5,958	22,714	22,714	754	1,817

3.7.3. Counterparty Credit Risk – Basel II

Counterparty risk is measured and monitored according to the general principles described in the Dexia credit risk policies.

Counterparty exposure arises as a result of positive market valuation of derivative contracts. A positive market value represents Dexia's claim on the counterparty. Since market values fluctuate during the term to maturity, the uncertainty of future market conditions is taken into account by means of an 'add-on' to the current market value reflecting potential market movements for the specific contract. This add-on is function of the complexity, the maturity, and the underlying of the derivative.

The total credit exposure on the counterparty, the credit risk equivalent, is the sum of the market value of the contract and the add-on.

To reduce the counterparty risk, Dexia OTC derivatives are in most cases concluded within the framework of a master agreement (i.e. the International Swap and Derivative Association – ISDA) taking account of the general rules and procedures set out in the Dexia credit risk policies. These framework agreements reduce Dexia's credit exposure through:

- The use of close out netting agreements where all positive and negative market values under the same agreement can be netted on a counterparty level.
- The netting agreement is supplemented with a collateral agreement where the net market value exposure is reduced further by postings of collateral. Collateral postings for derivative contracts are regulated by the terms and rules stipulated in the Credit Support Annex (CSA) negotiated with the counterparty. These terms might depend on the credit rating of the counterparties. The impact of potential downgrades are analysed and managed by a centralised Collateral Management team.

3.8. Focus on Equity Exposure

3.8.1. Accounting Rules

Available-for-sale quoted equities are measured at fair value through "Gains and losses on securities not recognised in the statement of income" or within the statement of income in the case of impairment. For equities quoted in an active market, any significant decline in their price (more than 50% at reporting date) or a prolonged decline (5 years) compared to the acquisition price is considered as an objective evidence of impairment. In addition, management can decide to recognise impairment losses should other objective evidence be available.

Impairments on equity securities cannot be reversed in the statement of income in the case of later recovery of quoted prices.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's-length transaction. Quoted prices on an active market (such as a recognised stock exchange) are used as fair value, as it is the best evidence of the fair value of a financial instrument. Quoted prices are not, however, available for a significant number of financial assets and liabilities held or issued by Dexia. Therefore, for financial instruments where no such quoted prices are available, the fair values have been estimated using the bank's proper valuation model and market assumptions, i.e. present value or other estimation and valuation models or techniques (hereafter called models) based on market conditions existing at balance-sheet date.

3.8.2. Equity Exposure

The following tables show the amount of exposure to equities included in the banking book broken down by type of asset and by calculation process at year-end 2012 and 2013.

Exposure at year-end 2012		
Type of asset	Accounting value	Fair value
Financial assets designated at fair value	0	0
Available-for-sale financial assets	490	490
Total continued activities	490	490
Financial assets designated at fair value	0	0
Available-for-sale financial assets	182	182
Total activities held for sale	182	182
TOTAL	672	672

Exposure at year-end 2013		
Type of asset	Accounting value	Fair value
Financial assets designated at fair value	1	1
Available-for-sale financial assets	368	368
Total continued activities	369	369
Financial assets designated at fair value	0	0
Available-for-sale financial assets	193	193
Total activities held for sale	193	193
TOTAL	562	562

The equity portfolio of the continued activities decreased by EUR -121 million, of which EUR -54 million as a result of the sale of Dexia Sofaxis.

The majority of equity exposures is classified as Available for Sale financial assets and is assessed via pricing models as some key market data are not 'observable'.

3.9. Focus on Securitisation Activities

Dexia is managing in run off mode a portfolio of senior ABS bonds.

No more securitisation transactions have been originated since 2011. The same goes for new investments or acting as sponsor for providing liquidity facilities in Dexia securitisation transactions or third parties.

4. Market and Balance Sheet Management Risks

4.1. Market Risk

In order to ensure integrated market risk management, Dexia has developed a framework based on the following elements:

- A complete risk measurement approach which is an important part of the process of surveillance and control of the Dexia Group risk profile;
- A structure of limits and procedures governing the taking of risks, consistent with the entire process for measuring and managing risk.

4.1.1. Market Risk Definition

Market risk represents the Group's exposure to variations of market parameters, such as interest rates and exchange rates. Interest rate risk consists of a general interest rate risk (Euribor, Libor...) and a specific interest rate risk associated with the issuer. The latter arises from variations of the credit spread of a specific signature within a rating class. Exchange risk represents the potential fall in value due to the fluctuation of exchange rates of currencies against the euro.

4.1.2. Market Risk Governance

Financial Market Risk Management (FMRM) supervises market risk under the aegis of the Management Board and specialist risk committees. Relying on its global risk management approach, it is responsible for identifying, analysing, monitoring and reporting risks and results (including the valuation of financial instruments) associated with market activities.

Policies, directives and procedures documenting and framing each of the market activities are applied to the entire Dexia Group. Central teams within the competence centres have the task of defining methods of calculation of the income statement and measuring risks, as well as guaranteeing the consolidated measurement, reporting and monitoring of the risks and results of each of the activities for which they are responsible.

Established in the operating entities, local FMRM teams are in charge of monitoring daily activity, i.e. inter alia the implementation of policies and directives defined at a Group level, the assessment and monitoring of risks at a local level (calculating risk indicators, controlling limits and triggers, framing new activities / new products, etc.), as well as reporting, reconciliation with local management control, accounts and information systems. Each operating entity is also responsible for monitoring and reporting to local management committees as well as to local supervisory and regulatory bodies.

Committees

The Market Risk Committee (MRC) meets each month and deals with the following matters: definition and revision of limits, analysis of ratios in relation to risks and result triggers⁽¹⁾ and decisions relating to them, discussion of directives, governance and norms with regard to risks, risk concepts and methods for measuring risks, and the quality of the valuation process.

A Valuation and Collateral Market Risk Committee (V&C MRC) meets each quarter to analyse indicators relating to the management of collateral and to examine the quality of valuations of structured products.

The Risk Committee (RC) and the Risk Management Executive Committee validate all major changes to be made to the risk profile or risk governance.

4.1.3. Market Risk Measures

4.1.3.1. Market Risk Measures

VaR

Dexia Group adopted the VaR (Value at Risk) measurement methodology as one of the leading risk indicators. The VaR is a measure of the potential loss that can be experienced with a 99% confidence level and for a holding period of 10 days. Dexia applies multiple VaR approaches according to their performance to measure market risk accurately in different market activities and portfolios.

⁽¹⁾ Result triggers warn of a deterioration of results and are expressed as a percentage of VaR limits, i.e. generally 50%, 75% and 100% for triggers 1, 2 and 3 and cease activity at 300% of VaR.

- General interest-rate risk and exchange rate (FX) risk are measured through a parametric VaR approach. This methodology relies on the assumption that the returns of the risk factors follow a normal distribution and consists in computing variances and correlations for all risk factors. Dexia uses an internal parametric VaR model for the calculations of regulatory capital requirements for the general interest rate risk and for FX risk in trading activities.
- The specific interest rate risk (spread risk) and other risks in trading books are measured through a historical VaR. The distribution of the historical VaR is constructed by applying the historical changes of credit spreads on the current portfolio. On each position, 250 historical scenarios are applied based on the observed credit spread variations for the same bond or for a bond with similar characteristics.

As a complement to VaR approach and result trigger, Dexia applies a wide range of additional measures to assess the risks related to the different activities and portfolios (limits in terms of maturity, market and authorised products, sensitivity limits to various risk factors...).

The bond portfolio is not subjected to VaR limits given its different investment horizon but is subjected to regular stress tests (see 2.3.3.)

Stressed VaR

The Stressed VaR (SVaR) is an additional regulatory requirement for the calculation of the Market Risk Regulatory Capital with first application on 31 December 2011.

The Stressed VaR intends to replicate a value-at-risk calculation calibrated to a period of significant and relevant financial stress specific for the bank, based on a 10-day, one tailed 99% percentile confidence interval.

Dexia implemented the Stressed VaR based on a historical VaR methodology in order to allow diversification between the risk factors and to fit with the target methodology required by regulators.

4.1.3.2. Market Risk Exposure

VaR

The table below shows the details of VaR used for market activities, not including the bond portfolio. At end December 2013, total VaR consumption stood at EUR 12.2 million, compared with EUR 10.4 million at end 2012.

31/12/2012						
VaR (10 days, 99%)	By risk factors				Globally	
	Interest and FX (Banking and Trading)	Shares (Trading)	Spread (Trading)	Other risks ⁽¹⁾	Activities held for sale	Continued activities
Average	4.7	0.1	6.5	0.4	2.0	9.7
End period	1.8	0.0	8.2	0.4	0.0	10.4
Maximum	11.9	0.6	9.6	0.4	4.7	18.3
Minimum	1.1	0.0	2.6	0.4	0.7	4.7
31/12/2013						
VaR (10 days, 99%)	By risk factors				Globally	
	Interest and FX (Banking and Trading)	Shares (Trading)	Spread (Trading)	Other risks ⁽¹⁾	Activities held for sale	Continued activities
Average	2.6	0.0	7.2	0.4	0.0	10.2
End period	6.4	0.0	5.6	0.3	0.0	12.2
Maximum	7.8	0.0	8.4	0.7	0.0	14.9
Minimum	0.7	0.0	5.6	0.2	0.0	8.2

(1) Other risks (of which inflation, commodities, CO₂).

(2) Take into account DMA positions. In fact, no VaR specific to this sub-perimeter was calculated. These positions only contributed very slightly to the total amount of DCL VaR throughout 2012.

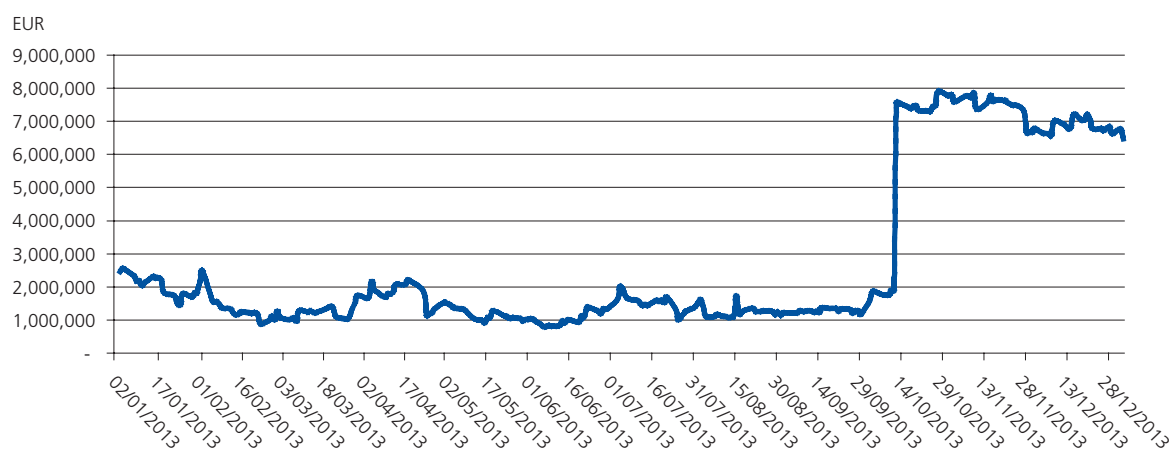
The unwinding of positions held by Caisse Française de Financement Local (formerly Dexia Municipal Agency) and their transfer to SFIL in mid-January 2013 made it necessary to create a trading portfolio to manage risks arising from hedges that continued to be housed within the Dexia Group. The creation of this trading portfolio led to the appearance of new risk factors, including in particular the following:

- basis risk on currency swaps;
- interest rate basis risk between the swap index considered and the BOR benchmark used to value swaps.

Consequently VaR consumption arising from this trading portfolio totalled EUR 5.9 million at end 2013, compared with zero at end 2012.

Consequently, at its meeting of 17 December 2013, the Management Board signed off an increase in the aggregate VaR limit for activities from EUR 22 million to EUR 40 million with an aim to take into account the existing risk factors and of which the calculation methodology will be refined as from 2014.

Impact of the two new risk factors on the VaR framework (FX and IR risks).



Bond Portfolio

Dexia bond portfolios represented EUR 75.2 billion as at 31 December 2013. The sensitivity in economic value of these bond portfolios to interest rate variations is limited, as interest rate risk has been systematically hedged.

A major part of the bond portfolio is classified as Loans & Receivables and is consequently not sensitive to credit spread variations.

As to the bond portfolios classified as Available for Sale (AFS), the AFS reserve is sensitive to an increase in credit spreads. The sensitivity of the AFS reserve to a "one basis point" increase in credit spreads is monitored carefully. This sensitivity amounted to EUR -23.4 million at the end of 2013.

Please note that considering the limited liquidity of the markets and the lower visibility of prices/spreads in the valuation process, mark-to-model valuations have been applied to the "illiquid" part of the AFS portfolio.

4.1.3.3. Regulatory Internal Model and Back testing

Basel Treatment

Internal Model

Dexia applies the internal VaR model for the regulatory capital requirement calculation of foreign exchange risk and general interest rate risk within the trading scope.

The Stressed VaR is calculated on a weekly basis using parameters from the period May 2008 – June 2009. The regulatory capital is calculated as the sum of both a multiple of VaR and a multiple of Stressed VaR. Nevertheless, the National Bank of Belgium (NBB) requires Dexia to apply a floor of 2.5 times the VaR while calculating the SVaR.

Standardised Approach

The other market risks (spread, equity) are treated under the Basel II standardised approach.

Back testing

A back testing is performed on a daily basis on the trading scope.

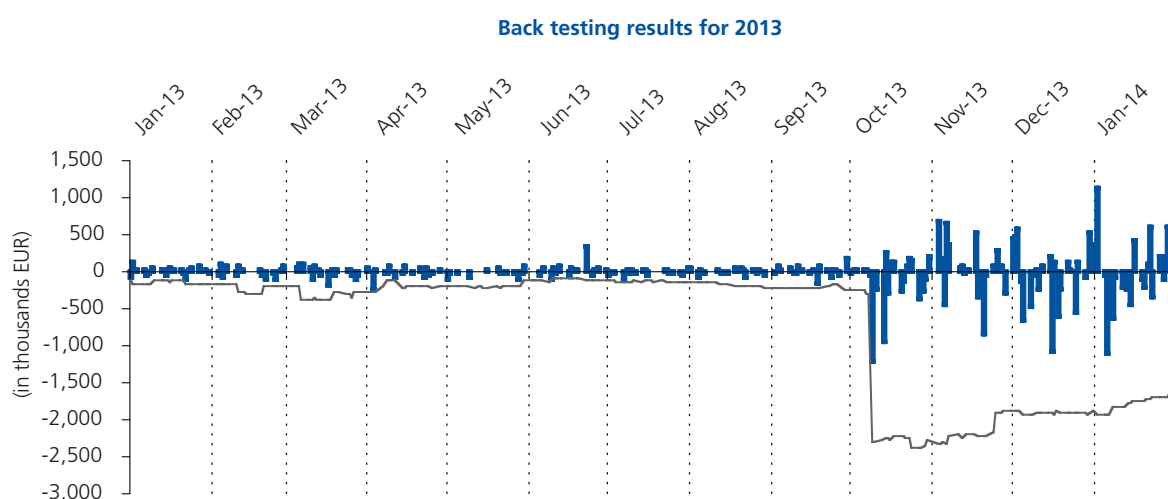
The result of the back testing is the number of losses exceeding their corresponding VaR figures (i.e. "the number of exceptions"). For back testing purposes, the VaR amounts need to be recalculated using a 1-day holding period. For VaR figures calculated under a parametric approach, rescaling is achieved through the application of a square root of 10 conversions. For any other VaR approach, a 1-day VaR figure is calculated.

Risk reports are based on end-of-day positions meaning that risk figures refer to the maximum loss at the chosen confidence interval over the holding period of the portfolio that is held at the end of the business day. With a 1-day holding period, this figure is compared with the variation of the statement of income of the following business day.

Intraday trading tends to increase the volatility of trading results and consequently might result in rejecting a theoretically sound model although this volatility falls outside the purpose of VaR measurement. For this reason, Dexia considers hypothetical back testing as the main indicator. The hypothetical statement of income is calculated under the assumption that the portfolio breakdown remains stable and is only impacted by the change of the corresponding risk factors.

Hypothetical back testing runs under the scenarios of change in interest rate alone, in change in exchange rate alone and change in both market data together. The back testing process provides the Market Risk Management department with a view of the number of exceptions. This number is taken into account to adjust the multiplier used for calculating the bank's risk capital requirements for market risk under the regulatory internal model.

In 2013, Dexia noticed 0 "downward" exceptions on its IR perimeter on internal models (as compared with 8 exceptions in 2012).



4.1.3.4. Validation

Validation is responsible for the overall assessment of the market risk models. The process set up to endorse the validation of models deployed within Dexia Group is multi-layered, ensuring total compliance with regulations and local regulatory requirements through the work-out of proposals by the Validation Department: an approval of these proposals by the Markets VAC and a final endorsement by the Risk Policy Committee, composed of members of the Dexia Management Board.

4.1.3.5. Systems and Controls

On a daily basis, Financial Market Risk (FMR) calculates analyses and reports the risks and results on entity and consolidated level. On a monthly basis, the Market Risk Committee meets to analyse the risk and results, to propose the market limits, to present procedures, guidelines and policies and to approve or amend new valuation methodologies.

All market activities are backed by specific guidelines describing the objectives, the authorised products, sensitivity, VaR and/or outstanding limits. The systems and controls established inside the Dexia Group are described in various procedures to ensure a complete and formal framework established to support all the market risk responsibilities.

As an example, the New Product Approval Procedure (NPAP) describes the approval process for requests to trade new products from the Front Office until the formal approval of each new product by the Executive Operational Market Committee (EOMC). During this formal process, FMR analyses and proposes a valuation strategy for each product and presents its validation to the MRC prior to its formal validation by the EOMC. Dexia has put forward two ratios to conduct a self-assessment on its capacity to deliver correct valuations. The results are discussed in the Valuation & Collateral Market Risk and Guidelines Committee (V&C MRC) and if necessary, this committee will put in place an action plan to improve the valuation strategies.

4.2. Balance Sheet Management Risk

The main aim of Dexia balance sheet management is to minimise the volatility of the statement of income, immunising the commercial margin and preserving the creation of the Group's global value. It does not aim to create additional income by deliberately taking interest rate risk, and attention is paid to the overall stabilisation of bank revenues.

4.2.1. BSM Risk Definition

Balance Sheet Management (BSM) is in charge of managing all structural risks associated with the banking book, i.e. rate risks, exchange risks, liquidity risks and result risks.

Cash and Liability Management (CLM) is in charge of managing cash and covering short-term rate risks.

The definitions of structural and specific interest rate risk and exchange risk are detailed in the chapter on market risk.

Liquidity risk measures the Group's ability to deal with its current and future cash requirements, both discounted and in the case of a deterioration of the situation, with the Group working on various stress scenarios.

4.2.2. BSM Risk Governance

Balance Sheet Management (BSM) is under the responsibility of the Finance activity line and has the task of managing the structural risks of the entire Group.

Within Risk Management, a dedicated team, called BSM Risks, is in charge of defining the risk framework (risk factors, limits, investment universes, parameters), validating models used in the effective management of this risk, monitoring exposures and checking the compliance in relation of Group standards, defining stresses to be applied to different risk factors and validating risk management by the Finance support line and ensuring the compliance of the framework with external regulations in force.

Committees

ALM risks (Balance Sheet Management – BSM) are managed within the Dexia ALCo committee (Group Assets & Liabilities Committee) which meets on a quarterly basis. The Dexia ALCo committee decides on the global risk framework, fixes limits, guarantees the consistency of strategy and delegates operational implementation to local ALCo. The Dexia ALCo committee decides globally on the level of exposures, consistent with the decisions of the Management Board. Local ALCo committees manage the risks specific to their balance sheet within the framework defined by and under the responsibility of the Group ALCo committee.

The Funding and Liquidity Committee (FLC), by delegation from the Dexia ALCo committee, centralises and coordinates the decision-making process regarding liquidity matters. The FLC is responsible for surveillance of the Group's liquidity position, its evolution and its cover by short, medium and long-term resources. It monitors the achievement of liquidity targets set by the Management Board and contributes to elaborating strategies for funding and the disposal of assets which will enable the Group to overcome deteriorating stress scenarios realised internally or on the request of the regulators. It validates the price mechanisms for internal disposals within the Dexia Group. The FLC, which meets on a weekly basis, is doing everything to improve the Group's liquidity profile.

4.2.3. BSM Risk Management

4.2.3.1. BSM Risk Measures

Interest Rate

The measurement of balance-sheet risks is harmonised among the Group's various entities. The risk sensitivity measures reflect balance sheet exposure to a parallel movement of 1% on the rate curve. Sensitivity of the net current value of BSM positions to an interest-rate trend is the main indicator for fixing limits and monitoring risks.

Global and partial sensitivities per interval of time are still the main risk indicators on which asset-liability risk committees (ALCo) manage risks.

The structural rate risk of the Dexia Group is concentrated principally on European long-term interest rates and results from the structural imbalance between Dexia's assets and liabilities after hedging the interest rate risk.

(Structural) Foreign Exchange

Dexia's reporting currency is the euro, but its assets, liabilities, income and expenses are also denominated in other currencies. The Group ALCo decides on hedging the risk associated with the evolution of these results in foreign currencies. As it happens, a systematic and ongoing hedge was applied to these exposures.

The structural risks associated with the funding of holdings with equity in foreign currencies (limited to the US dollar) as well as the volatility of the Group's solvency ratio are also monitored regularly.

4.2.3.2. BSM Risk Exposure

BSM Interest Rate Risk Exposure (Sensitivity)

Interest rate risk is measured via sensitivity. Risk sensitivity measures reflect the balance sheet's exposure to a 1% movement in the yield curve. The main indicator used to determine limits and to measure and monitor risk is the sensitivity of the net present value of accrued interest positions to interest rate fluctuations.

The main risk indicators used by asset and liability risk committees (ALCos) to manage risk are overall and partial sensitivities by time period. The Dexia Group's structural interest rate risk is mainly concentrated in European long-term interest rates, and arises from the imbalance between Dexia's assets and liabilities after hedging for interest rate risk.

The sensitivity of long-term ALM was +EUR 8.5 million at 31 December 2013 for the entire Group scope, compared with -EUR 6 million at 31 December 2012 (continued activities scope). This is in line with the ALM strategy, which aims at minimising volatility in the results.

	31/12/2012	31/12/2013
Sensitivity	+4.0	+8.5
Limit	+266.0	+96.0

4.2.4. Liquidity Risk

Dexia Policy

Dexia measures and manages liquidity risk by an internal management process redefined in 2011. The cornerstone of this management process is the Funding and Liquidity Committee (FLC), a central committee composed of all parties concerned by liquidity as well as funding and coordinating their actions.

In 2013, the Funding and Liquidity Committee met almost every week basis to monitor the evolution of Group liquidity and, mandated by the Management Board, to take structural decisions aimed at its improvement. Collateralised long-term funding transactions, securities swaps, guaranteed issues and non-covered funding as well as the surveillance of funding sources and production are some of the levers used by Dexia on the initiative of this committee to remedy the Group's liquidity situation.

The liquidity management process aims at covering the Group's funding requirements. Funding requirements are assessed prudently, dynamically and exhaustively taking into consideration existing and planned on and off-balance sheet transactions; reserves are formed of assets eligible to the refinancing facilities of central banks to which Dexia has access.

Regular information channels have been put in place for the management bodies:

- Frequent meetings of the FLC during which the evolution of the liquidity situation is studied and analysed in detail;
- Regular meetings of the audit committee and the board of directors.

Considering the pressures suffered by the liquidity situation over the past years, specific and regular modes of information have been introduced:

- Daily, weekly (including weekly Warning report to States) and monthly reporting to members of the Management Board, to the shareholders and guarantor States and to the regulators. This information is also used by all parties involved in managing Dexia Group's liquidity position, namely BSM, BSM Risk Management and TFM;
- Monthly dissemination to the shareholder and guarantor States, central banks and regulators of the 12-month liquidity forecasts and funding plan;
- A bi-monthly call with the French and Belgian regulators and central banks (NBB, BoF, ACPR).

Risk Measures

Liquidity indicators have evolved to take into account the constraints affecting Dexia's liquidity position. The four-week liquidity ratio, comparing the liquidity reserves with the Group's liquidity requirements under various scenarios, is supplemented by the maximum limit set by Banque de France on its emergency liquidity assistance (ELA) and the maximum authorised amount of guaranteed issues.

Dexia's liquidity risk is also managed via the liquidity ratios monitored by its various regulators – the Belgian National Bank (BNB) for Dexia SA and France's Prudential Supervision and Resolution Authority (ACPR) for Dexia Crédit Local:

- The BNB ratio to which Dexia SA is subject, establishes an institution's liquidity position by comparing required liquidity with available liquidity at one week and one month. It must be lower than 100% over each of these periods (CBFA circular 2009_18-1 of 8 May 2009). This ratio will be replaced as from 2015 by the "Liquidity Coverage Ratio" which will have to amount to a minimum of 100% as from 1 January 2015.
- The ACPR ratio to which Dexia Crédit Local is subject is defined as the ratio of cash to liabilities over a forecast one-month period; the ratio thus calculated must always be above 100 (Instruction 2009-05 of 29 June 2009 on the standard approach to liquidity risk).

These ratios are submitted to the BNB and the ACPR on a monthly basis.

Liquidity Management

2013 was marked by a decrease in the Group's liquidity need, combined with an improvement of the liquidity situation, illustrated by the following elements:

- Compliance with the regulatory thresholds defined for calculating the liquidity ratios for Dexia SA and Dexia Crédit Local (cf. "Risk management" section on page 33);
- The reduction in the level of refinancing from the central banks, down from EUR 50.1 billion at end-2012 (or 24.5 % of the total funding) to EUR 34 billion at end 2013 (or 20% of the total funding);
- A greater capacity for guaranteed market-based refinancing. The Group increased the proportion of long-term guaranteed financing (longer than 12 months), with an outstanding of EUR 9 billion placed at 31 December 2013, compared with less than EUR 3 billion one year earlier⁽¹⁾.

⁽¹⁾ Numbers excluding the State guaranteed debt held by Belfius Bank.

This results from the combination of two positive developments. The first is the consequence of the efforts made by Dexia to stabilise and optimise its liquidity situation. The main lines of work related to:

- The disposal of the entities consuming the highest levels of liquidity, in particular CAFFIL (formerly Dexia Municipal Agency);
- The sustained marketing of the debt issued with a guarantee from the Belgian, French and Luxembourg States. The road shows organised during the year made it possible to expand the investor base for guaranteed debt, from a geographical perspective, with increased levels of issues placed in the United States and Asia in particular, while also diversifying the categories of investors, including a stronger presence of central banks. The signing of the definitive issue agreement in January 2013 made it possible to renew the Certificate of Deposit programmes and launch the Commercial Paper, Euro Medium Term Note (EMTN) and US Medium Term Note (USMTN) programmes, giving access to refinancing in US Dollars (USD 9 billion outstanding at end-2013) and increasing the maturity of issues to five years;
- The renewal of collateralised financing reaching maturity and above all the new operations carried out to replace Belfius Bank (formerly Dexia Bank Belgium) as counterparty for the least liquid assets.

The second aspect is linked to a series of positive developments concerning the financial markets and macroeconomic conditions, primarily:

- The gradual normalisation of the European financial situation allowing the first issue by Dexia with the State guarantee to achieve a favourable welcome from investors for larger volumes, for a longer maturities and at a lower cost than anticipated in the context of the revised business plan;
- The gradual increase of interest rates and the evolution of the main exchange rate parities reduced continuously the amount of net cash collateral paid by the Group to its derivatives counterparties. This amount is EUR 20.7 billion at year-end 2013 against EUR 29.8 billion at year-end 2012;
- The stability of the asset quality (in terms of eligibility as well as in terms of collateral value) pledged as collateral for secured funding.

Despite this improvement in its liquidity situation, the balance sheet structure of the Group continues to be structurally imbalanced. It remains very sensitive to changes in external parameters, which will also have to be monitored closely. It cannot be excluded that, in the future, the Group will have to request access to the emergency liquidity lines (Emergency Liquidity Assistance – ELA), notably in the event of significant funding agreements coming to maturity during the first quarter of 2015.

In 2014, Dexia will continue with its marketing efforts for its guaranteed debt. Two new public issues – seven years in Euros and five years in US Dollars – were carried out in January, which confirms the placement quality of the guaranteed bonds and which makes it possible to significantly extend the maturity of Dexia Crédit Local's guaranteed reference curves. In particular, this dynamic approach has enabled the Group to cope with the maturing of EUR 9.7 billion of guaranteed debt issued in 2008 at a high cost.

In addition, the Group will continue to develop its access to the repo market, another one of Dexia's preferred sources of financing in the context of its orderly resolution process.

5. Operational Risk

5.1. Definition

Operational risk represents the risk of financial or non-financial impacts arising from a shortcoming or failure in internal processes, personnel, systems and external factors. This definition includes IT, legal and compliance risk.

Permanent Control (excluding compliance) has the task of checking that the risk control mechanism in place is robust and effective, and of ensuring the quality of accounting and financial information and the quality of information systems.

5.2. Governance

The operational risk management framework within Dexia relies on governance including clearly defined responsibilities and roles.

- The Management Board regularly examines the evolution of the risk profile of the various Group activities.
- The Risk Committee approves policy for the entire Group.
- The Operational Risk Acceptance Committee (ORAC), meeting on a quarterly basis, examines the main risks identified, decides on whether they are acceptable or not, and the corrective actions possibly to be taken. It also validates proposals for assessing prevention or improvement in relation to the various elements of the mechanism (permanent control, IT security, insurance programmes and so on). It is chaired by the member of the Management Board in charge of Risk analysis, shared services and international subsidiaries.
- Middle management remains the principal guarantor of operational risk management. In each field of activity, it appoints a correspondent for operational risks whose role is to coordinate the collection of data and to assess risks, with support from the local operational risk management function.
- The IT systems security committee examines and decides on actions to be taken to ensure business continuity and the implementation of IT systems security policy.

Permanent Control excluding compliance in the Dexia Group is run by the Head of operational risks. In order to ensure consolidated surveillance, permanent control relies on risk measurement and surveillance teams, on decentralised means within departments, subsidiaries and branches, and on consulting mechanisms within the framework of permanent control committees.

5.3. Management of the Risk

5.3.1. Operational Risk Framework

Dexia policy regarding operational risk and permanent control

Dexia's policy regarding operational risk management consists of regularly identifying and assessing the various risks and existing controls to check that the predefined level of tolerance for each activity is respected. If predetermined limits are exceeded, the governance in place must ensure that corrective action is quickly taken or that improvements are put in place to bring the situation back within acceptable parameters. This system is supplemented by a prevention policy covering in particular information security, business continuity and, when necessary, the transfer of certain risks via insurance.

In terms of permanent control, Dexia's policy aims to ensure that the areas of risk laid down in the French CRBF Regulation 97-02 relating to the internal control are covered by a system of first and second level controls. Heads of operational departments and members of staff in those departments are responsible for adapting first level permanent controls and ensuring that they are properly implemented within their business areas. Second level controls are carried out by specialist functions. The execution of permanent controls is audited quarterly via the report on the permanent control plan, and corrective action plans are drawn up and implemented if necessary.

Risk measures and management

The follow-up of the operational risk is done within the framework of the standard approach determined by the regulatory methodology of Basel II. Under this methodology, information relating to the operational risk must be transferred by the operational actors to the managers in charge of the follow up of this risk, and a follow-up of the tasks identified as critical must be done.

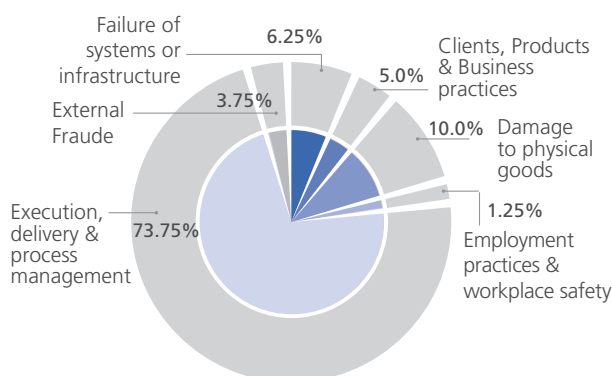
The Company Project identifies the operational risk management as one of the pillars of Dexia's strategy in the context of its orderly resolution.

The operational risk management mechanism relies on the following elements.

Operational risk database

The systematic capture and monitoring of operational incidents is one of the most important requirements of the Basel Committee. By capturing data on its operational incidents, Dexia not only complies with regulatory requirements but also obtains information that it can use to improve the quality of its internal control system.

The breakdown of total losses among standard event types over the past three years is as follows:



The classification of the various categories of operational incidents has been modified as a result of the reduction of the scope of the Dexia Group. For example, internal fraud, which is typical for retail and private banking activities, has almost disappeared following the disposal of the Group's retail banking businesses. "Execution, delivery and process management" remains the most dominant category, though there have been very few major events since 2010. The other categories account for few events and represent low loss levels. The "damage to physical assets" category comes in second place. The most important incidents are subject to corrective actions approved by the Group's management bodies.

Self-assessment of risks and associated controls

As well as building a history of losses, Dexia's exposure to key risks is determined via an annual risk mapping exercise. All Dexia Group entities conduct risk self-assessment exercises that take into account existing controls, thus providing senior management with an overall view of most areas of risk within the Group's various entities and businesses. Actions to limit risk may be defined where applicable.

Definition and monitoring action plans

Corrective actions are defined in response to major incidents, deficient controls or important risks identified. In this respect, the operational risk management function does a regular monitoring. By virtue of this process, the internal control system is continuously improved and key risks are appropriately mitigated over time.

Permanent control

The permanent control system is aimed at ensuring that all business areas have high-quality key controls covering all major risks, whatever their nature. This includes both first level controls performed by operational staff and second level controls performed by non-operational support functions.

On the basis of a control plan that is updated each year, quarterly campaigns are run to check that controls are properly executed, with detailed reports presented to the various governing bodies. Corrective actions are always defined whenever shortcomings are identified.

Information security and business continuity management

The information security policy and associated instructions, standards and practices are intended to ensure that Dexia's information assets are secure. Security programmes and defined responsibilities ensure that all activities take place in a secure environment. As required by Group policy on business continuity, the different activity lines must draw up impact analyses for any interruption in vital activities. They must define substantiated recovery plans and ensure that business continuity plans are tested and updated at least once a year. On the basis of regular reporting, the Management Board signs off recovery strategies, residual risks, and action plans with the aim of delivering continuous improvement.

Management of insurance policies

Dexia also ensures that operational risk is kept to a minimum by taking out Group insurance policies covering professional liability, fraud, theft and interruptions in activity. The Group's overall policy on insurance lays down the principles governing insurance cover for the various risks incurred, to be implemented at both Group and subsidiary level.

5.3.2. Calculation of Regulatory Capital Requirements

Dexia applies the Basel II Standardised Approach to calculate regulatory capital for operational risk.

This approach consists in applying a percentage (called the beta factor ranging from 12% to 18%) to an appropriate activity indicator, calculated for each of the eight business lines defined by the Basel Committee.

Capital requirement for operational risk was EUR 202 million at year-end 2013, down from EUR 410 million at year-end 2012.

The substantial decrease compared to the year 2012 is due to the calculation method based on the 3 year average of net banking income reprocessed.

5.3.3. Operational Risk Management in the Transition Period

Both 2012 and 2013 were key years in the implementation of the Dexia Group's orderly resolution plan, including in particular the disposal of a number of operating entities. Such transition phases are by nature liable to give rise to operational risks, particularly as a result of factors such as the departure of key personnel, potential staff demotivation, and process changes when operational applications need to be replaced or duplicated.

The key components of the management system described above continue to be applied during this period. Specifically with regard to self-assessment of risks and controls, the bank's management was called upon several times during the year to assess the risk of discontinuity associated with the factors referred to above. A map of critical tasks was drawn up and action plans were put in place whenever incidents occurred. The results of these analyses and action plan updates were regularly presented to the Management Board for approval.

Furthermore, the separation of Dexia from SFIL is subject to specific analysis and monitoring, particularly concerning the continuity of critical tasks.

Finally, under its ongoing reorganisation plan, Dexia has taken action to prevent psycho-social risks and provide staff with support in connection with such risks.

6. Remuneration policies and practice

Information about remuneration policies and practice is available in the annual report of 2013 published on the website of Dexia (www.dexia.com).

Appendix 1

Glossary

ABS	Asset-Backed Security	Securities issues by a vehicle created for the purpose of buying assets from a bank, a company or a state, like trade receivables or inventories, and to provide the seller with cash and the buyer with a financial product characterised by a certain risk profile and a rate of return.
ABCP	Asset-Backed Commercial Paper	A programme of securitisations the securities issued by which predominantly take the form of commercial paper with an original maturity of one year or less.
AFS	Available For Sale	Non-derivative financial assets designated on initial recognition as available for sale or any other instruments that are not classified as (a) loans and receivables, (b) held-to-maturity investments or (c) financial assets at fair value through profit or loss.
AIRBA	Advanced Internal Rating-Based Approach	Institutions using the IRB approach are allowed to determine borrowers' probabilities of default and to rely on own estimates of loss given default and exposure at default on an exposure-by-exposure basis. These risk measures are converted into risk weights and regulatory capital requirements by means of risk weight formulas specified by the Basel Committee.
ALM (BSM)	Asset and Liability Management	Action – for instance in a financial institution or a corporate – of managing the net risk position between assets and liabilities, particularly with respect to imbalances generated by the evolutions of interest rates, currencies and inflation, but also maturity mismatch, liquidity mismatch, market risk and credit risk.
AVC	Asset Value Correlation	The AVC parameter is a means by which the framework captures the extent to which defaults across firms will cluster together. A multiplier of 1.25 is applied to the correlation parameter of all exposures to financial institutions meeting defined criteria (see LFI/UFI)"
CCF	Credit Conversion Factor	The ratio of the currently undrawn amount of a commitment that will be drawn and outstanding at default to the currently undrawn amount of the commitment. The extent of the commitment will be determined by the advised limit, unless the unadvised limit is higher.
CDO	Collateralised Debt Obligation	Type of structured asset-backed security (ABS) the value of and payments for which are derived from a portfolio of fixed-income underlying assets. CDO securities are split into different risk classes, or tranches, whereby "senior" tranches are considered the safest securities. Interest and principal payments are made in order of seniority, so that junior tranches offer higher coupon payments (and interest rates) or lower prices to compensate for additional default risk.
CDS	Credit Default Swap	Swap contract in which the buyer of the CDS makes a series of payments to the seller and, in exchange, receives a pay-off if a credit instrument (typically a bond or loan) undergoes a defined "Credit Event", often described as a default (fails to pay).
CLN	Credit Linked Note	A credit linked note (CLN) is a form of funded credit derivative. It is structured as a security with an embedded credit default swap allowing the issuer to transfer a specific credit risk to credit investors. The issuer is not obligated to repay the debt if a specified event occurs. This eliminates a third-party insurance provider.
CRD	Capital Requirements Directive	The Capital Requirements Directive (CRD) for the financial services industry introduces a supervisory framework in the EU which reflects the Basel II rules on capital measurement and capital standards.
CRM	Credit Risk Mitigant	Range of techniques whereby a bank can partially protect itself against counterparty default, for example by taking guarantees or collateral, or buying a hedging instrument.

CVA	Credit Value Adjustment	The Credit Value Adjustment (CVA) is one of the components of the fair value (FV) of the derivatives. CVA adjusts FV in order to take into account the counterparty risks. CVA has been implemented by banks 10 years ago and is included in the IFRS 13 accounting framework. The CVA applied to OTC derivatives corresponds to the difference between the risk-free valuation and the valuation that takes into account the possibility of a counterparty's default (reflects the expected losses due to a counterparty's default). Under the Basel III the banks are subject to a "CVA" capital charge for potential mark to market losses associated with a deterioration in the creditworthiness of a counterparty. The CVA capital charge corresponds to a Value At Risk (VaR) applied to CVA.
DVA	Debit Value Adjustment	The Debit Value Adjustment (DVA) is the measure of a bank's probability of not fulfilling its own obligations based on its probability of default.
EAD	Exposure At Default	EAD is used to calculate regulatory capital requirement under the Basel III framework. EAD of an on balance sheet exposure corresponds to the accounting value of the financial asset without taking into account any credit risk adjustments made. EAD for off balance sheet commitments is equal to the undrawn commitment multiplied by a Credit Conversion Factor (CCF).
ECAI	External Credit Assessment Institutions	Under the Basel II agreement of the Basel Committee on Banking Supervision, banking regulators can allow banks to use credit ratings from certain approved Credit Rating Agencies when calculating the risk weight of an exposure. Competent authorities will recognise an ECAI as eligible only if they are satisfied that its assessment methodology complies with the requirements of objectivity, independence, ongoing review and transparency, and that the resulting credit assessments meet the requirements of credibility and transparency.
EL	Expected Loss	The amount expected to be lost on an exposure from a potential default of a counterparty or dilution over a one-year period.
FX	Foreign eXchange	Transaction of international monetary business, as between governments or businesses of different countries.
IAS	International Accounting Standards	IAS stands for International Accounting Standards. IAS standards are used outside the US, predominantly in continental Europe.
ICAAP	Internal Capital Adequacy Assessment Process	The main objective of the Pillar 2 requirements is to implement procedures which will be more sensitive to an institution's individual risk profile. This is to be achieved by introducing implementation of internal processes (ICAAP).
IFRS	International Financial Reporting Standards	International Financial Reporting Standards published by the IASB and adopted by most countries but the USA. They have been designed to ensure globally transparent and comparable accounting and disclosure.
IR	Interest Rate	Interest expressed as an annual percentage rate.
ISDA	International Swap and Derivative Association	Trade organisation of participants in the market for over-the-counter derivatives. Its headquarters are in New York, and it has created a standardised contract (the ISDA Master Agreement) to enter into derivatives transactions.
IT	Information Technology	Study, design, development, implementation, support or management of computer-based information systems, particularly software applications and computer hardware IT deals with the use of electronic computers and computer software to convert, store, protect, process, transmit, and securely retrieve information.
LFI	Large Financial Institution	A Large Financial Institution is a regulated financial institution (defined as an institution that provides financial services to its clients or acts as an intermediary in providing such services) whose total assets, on the level of that individual firm or on the consolidated level of the Group, are greater than or equal to EUR 70 billion.
LGD	Loss Given Default	The ratio of the loss on an exposure due to the default of a counterparty to the amount outstanding at default.
L&R	Loans & Receivables	Non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than held for trading or designated on initial recognition as assets at fair value through profit or loss or as available for sale.
MBS	Mortgage-Backed Securities	Asset-backed security or debt obligation representing a claim on the cash flows from mortgage loans.

MCRE		MCRE is one of the 2 credit risk metrics (with EAD) used for official reporting to regulatory authorities. MCRE is quarterly reconciled with accounting figures.
NBB	National Bank of Belgium	The National Bank of Belgium is the Belgian Financial Institutions regulator.
PD	Probability of Default	The probability of default of a counterparty over a one-year period.
P&L	Profit and Loss	The statement of income is a document showing all wealth-creating revenues and wealth-destroying charges. There are two major statement of income formats: the by-nature statement of income format and the by-function statement of income format. Also called profit and loss account (or P&L).
RAROC	Risk Adjusted Return On Capital	Risk-based profitability measurement framework for analysing risk-adjusted financial performance and providing a consistent view of profitability across businesses.
RMBS	Residential Mortgage-Backed Securities	RMBS are securities where the primary source of payments is a mortgage loan or a pool of mortgage loans secured mostly on residential real property. Investors receive payments of interest and principal that are derived from payments received on the underlying mortgage loans.
SIFI	Systemically Important Financial Institution	A SIFI is a bank, insurance company, or other financial institution whose failure might trigger a financial crisis. A domestic SIFI represents a risk at a national level. A global SIFI represents a risk at an international level.
SPV	Special Purpose Vehicle	Separate legal entity created specially to handle a venture on behalf of a company. In many cases, the SPV belongs from a legal standpoint to banks or to investors rather than to the company. The IASB has however stipulated that the company should consolidate the SPV if it enjoys the majority of the benefits or if it incurs the residual risks arising from the SPV even if it does not own a single share of the SPV.
UFI	Unregulated Financial Institution	From a regulatory standpoint, unregulated financial institutions are defined as non regulated financial entities that perform, as their main business, one or more of the activities performed by regulated financial entities. The followings entities can be included in the UFI list: unregulated non Equity funds (may include funds involved in credit intermediation and operating with some degree of maturity and/or liquidity transformation) and unregulated structured finance vehicles (securitisation vehicles created for the purpose of warehousing assets and issuing ABS).
VaR	Value at Risk	(VaR) represents an investor's maximum potential loss on the value of an asset or a portfolio of financial assets and liabilities, based on the investment timeframe and a confidence interval. This potential loss is calculated on the basis of historical data or deduced from normal statistical laws.
WR	Weighted Risks	Used in the calculation of risk-based capital ratios. They are the total assets calculated by applying risk-weights to the amount of exposure.

Appendix 2

Internal Rating Systems

1. Structure of Internal Rating Systems

The internal rating systems developed by Dexia are set up to evaluate the three Basel II parameters: Probability of Default (PD), Loss Given Default (LGD) and Credit Conversion Factor (CCF). For each counterparty type in the advanced method, a set of three models, one for each parameter, has been developed.

The PD models estimate the one-year probability of default. Each model has its own rating scale and each rating on the scale corresponds to a probability of default used for regulatory and reporting purposes. The correspondence between rating and PD for each scale is set during the calibration process, as part of the model development, and is reviewed and adjusted during the yearly back testing when applicable. The number of ratings on each scale depends on the characteristics of the underlying portfolio (the number of counterparties, their homogeneity, whether it is a low default portfolio or not) and varies between 6 and 17 non-default classes. In addition each scale has been attributed two default classes (named D1 and D2).

For reporting purposes, a “master scale” has been set up. This master scale is structured in grades ranging from AAA to CCC and the modifiers plus, flat and minus (except for both extremes of the scale). The two default classes D1 and D2 are also reported. Each rating corresponds to a bucket of PD set up according to the one-year average default rate of rating agencies. This rating is obtained by mapping its probability of default as estimated by the relevant IRS (Internal Rating System) into the master scale bucket. Rating classes provided in the present document stem from the master scale.

LGD models estimate the ultimate loss incurred on a defaulting counterparty before taking the credit risk mitigants into account. The unsecured LGD depends on different factors such as the product type, the level of subordination or the rating of the counterparty. The granularity of the estimate is a function of the quantity and quality of data available.

CCF models estimate the part of off-balance-sheet commitments that would be drawn should a counterparty go into default. The regulation authorises the use of CCF models only when CCF under the Foundation Approach is not equal to 100% (as it is for credit substitutes for instance). CCF granularity also depends on the availability of data.

The relation between the outcome of internal rating systems and external agency ratings is at two levels.

- While designing the models: some internal rating systems have been designed and calibrated on the basis of external ratings. This is typically the case when internal default data are scarce.
- While establishing reporting: information on the portfolio is reported using the master scale which is representative for the external agency probability of default.

2. Description of the Internal Rating Process

General Organisation of the Internal Rating Process

The internal rating process is organised in three stages: the model development, the maintenance and the control of the internal rating. The model manager is responsible for the entire process of developing and maintaining a model whereas the control of the internal rating is dispatched through several control functions within the Dexia Group (validation, audit, quality control...).

Development of the Models

The different steps of models development are:

- Defining the scope of the counterparties concerned;
- Identifying and gathering the most relevant available data (financial data, data on defaults of the segment concerned, institutional framework);

- Building a database if needed;
- Defining a broad list of financial ratios and qualitative criteria;
- Testing these ratios (repetitive processes between statisticians and analysts);
- Building the score function. A score function is the mathematical function that allows determination of the counterparty (or exposure) PD, LGD or CCF based on its characteristics. Score function is established by the modelling team on the basis of statistical analysis and modelling techniques; after the score function is constructed, it is segmented into homogeneous risk classes and rating respecting optimal discrimination and stable through-the-cycle rating migration behaviour. The risk classes are conservatively calibrated taking into account the data size and macro-economic volatility of risk parameters to limit frequent model revisions on low default portfolios.
- Testing the score function;
- Developing IT tools;
- Validating and implementing the model;
- Adjusting risk policies to take internal risk systems into account;
- Documentation (user guide, documentation for the regulator, notes concerning the building of the model).

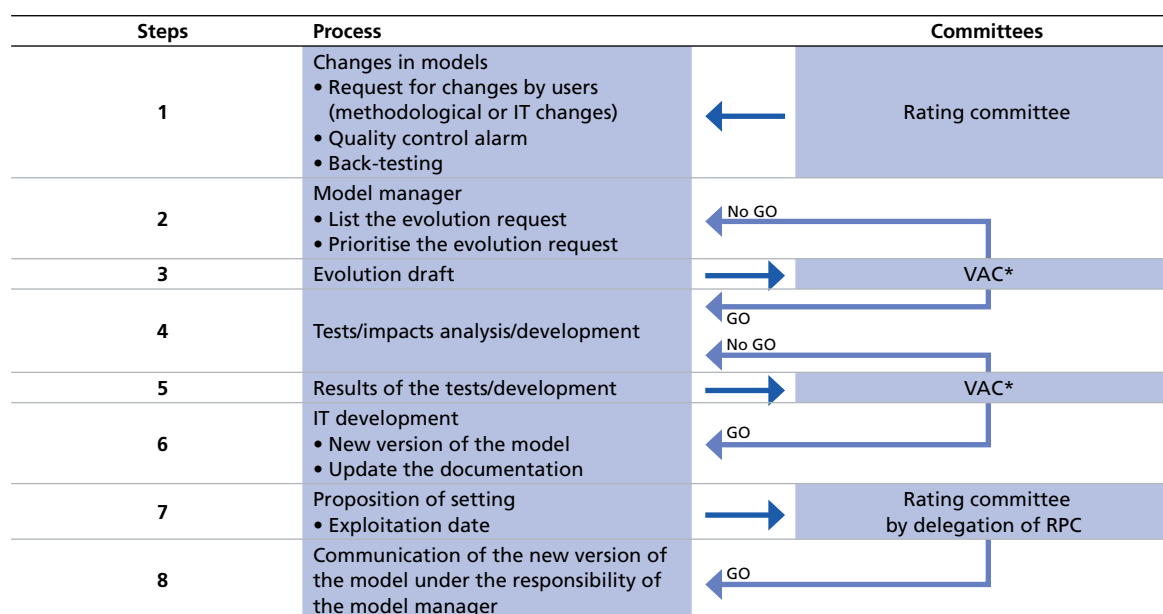
Nevertheless, some steps in the development process detailed above (such as building the score function, testing the function, etc.) are not applied for some specific models:

- Models based on an expert approach (such as the LGD model used for US municipalities) do not include a score function. They are based on internal experience and qualitative knowledge and not on statistical data (which may not be available due to the very low number of defaults for instance).
- Models based on a derivation approach are derived from an existing model.
- Models based on an assimilation approach are not *stricto sensu* models due to the fact that counterparties treated by assimilation simply inherit the rating of their “master” counterparty.
- Assimilations and derivations are applied when it is neither financially intuitive nor statistically relevant to develop, adapt or use an existing model. Such cases occur typically for low default portfolios with a low number of observations, limited data availability (both for design and for model use) and for portfolios where strong relations exist between the “master” counterparty and the “assimilated” or “derived” counterparty. These relations can be legally bound or based upon long-term past experience and practice.

Maintenance of the Models

As mentioned above, the model manager is responsible for the entire process linked to the model developed, including the maintenance of the model.

The model maintenance process is detailed in the diagram hereafter.



*VAC = Validation Advisory Committee.

Internal Rating Process by Broad Exposure Class

Type of Exposure Included in Each Exposure Class

Dexia has developed a wide range of models to estimate PD, LGD and CCF of the following types of counterparties.

Sovereigns

Sovereigns

The scope of the model encompasses sovereign counterparties, defined as central governments, central banks and embassies (which are an offshoot of the central state), and all debtors of which liabilities are guaranteed irrevocably and unconditionally by central governments or central banks.

Assimilations to Sovereigns

The in-depth analysis of some public sector counterparties (such as public hospitals in France or communities in Germany) shows that they share the same credit risk as the “master” counterparties to whom they are assimilated (usually local authorities or sovereigns). They are consequently assimilated to these “master” counterparties and benefit from the same PD and LGD as their “master” counterparties.

Project Finance (Specialised Lending)

This model encompasses the project financing activity of Dexia on all segments of activity in which Dexia intervenes (which are actually mainly Energy and Infrastructure). The specialised lending portfolio is a subgroup of the corporate portfolio which has the following characteristics: the economic objective is to finance or acquire an asset; the flows generated by this asset are the sole or practically the sole source of repayment; this financing represents a significant debt in respect of the liabilities of the borrower; the main distinguishing criterion of risk is essentially the variability in flows generated by the financed asset, much more than the borrower's ability to repay.

Banks

The scope of the model encompasses worldwide bank counterparties, defined as legal entities which have banking activities as their usual profession. Banking activities consist of the receipt of funds from the public, credit operations and putting these funds at customers' disposal, or managing means of payment. Bank status is gained by the delivery of a banking license given by the supervisory authority.

Corporates

The scope of the model encompasses worldwide corporate counterparties. Dexia defines a corporate as a private or a publicly quoted company with total annual sales higher than EUR 50 million or belonging to a Group with total annual sales higher than EUR 50 million which is not a bank, a financial institution, an insurer or a satellite.

Public Sector Entities

Public sector entities represent a large part of the Dexia portfolio. Some differences between counterparties have been noticed inside this portfolio, and this explains the number of models.

West European Local Authorities

This model encompasses local authorities from France, Belgium, Spain, Italy and Portugal. From this model, the models applicable for German Länder and French “Groupements à fiscalité propre” have been inferred.

Dexia defines local authorities as sub-sovereign governmental elected bodies empowered by the legislation of the country in which they are located with specific responsibilities in providing public services and with certain resources and capacity to decide their own practical organisation in terms of administrative procedures, personnel, buildings, equipment, etc.

US States

The scope of application of the US State model encompasses the 50 States of the United States of America and the Commonwealth of Puerto Rico. The model only rates US State general funds or general obligations.

Every US State or local government has a general fund and generally issues general obligation or general fund debt. The general fund of a public entity is the main revenue coming from direct or indirect taxes and is used for common and general purposes. For instance, a general fund usually backs general obligation bonds, lease or certificate of participation bonds.

US Local Governments

The scope of the US local government model encompasses cities, counties and school districts. The internal rating system only rates US local government general funds or general obligations.

Other Counterparties from the US Municipal Sector (Expert Model)

The scope of application of these expert models covers only the counterparties related to the special revenue funds, i.e. the following categories for Dexia: Special Tax, Utilities (including water and sewer, gas and electricity), Higher Education, General Airport, Toll Facilities, Mass Transportation, Housing, Healthcare, Public Facility Lease.

Every local government or public authority generally has one or several special revenue funds, the financial characteristics of which differ from one sector to another. The special revenue funds of a public entity are usually used for a special purpose and they receive either utility revenues (water, public power, toll...) or special taxes (sales tax, allocation tax, excise tax...).

Social Housing

This model encompasses social housing companies in France and the United Kingdom. The social housing sector encompasses dedicated entities with public, private or non-profit entity status which have a social lessor's mission within the regulated field of social housing activity in France and in the United Kingdom. This field is notably strongly regulated by the "Code de la Construction et de l'Habitat" in France and by the Housing Corporation in the United Kingdom.

Assimilations to Public Sector Entities

The in-depth analysis of some public sector counterparties shows that they share the same credit risk as the "master" counterparties to which they are assimilated (usually local authorities or sovereigns). They are consequently assimilated to these "master" counterparties and benefit from the same PD/LGD as their "master" counterparties.

Equity and Securitisation Transactions

No internal models have been developed specifically for equity or securitisation transactions which follow a different regulatory approach under Basel II: securitisation risk weighting is based on external and not internal ratings (Rating-Based Approach – refer to part 7); equities do not require the development of specific models (refer to part 8).

Default Definition Used in the Models

The "default" notion is uniform throughout the entire Dexia Group covering all business segments with some minor exceptions due to special characteristics.

The notion of default has been harmonised from the beginning of the Basel II project with the impairment notion used in IFRS. All credits in default and only those flagged as in default give rise to an impairment test (that can or cannot eventually lead to a provision).

The notion of default is not automatically related to the notion of potential loss (for instance, a loan may present unpaid terms but may be totally collateralised and consequently present a nil expected loss) or to the notion of denunciation (which is decided on the basis of the interest Dexia may have to do so).

Definition, Methods and Data for Estimating PD, LGD and CCF

Main Principles Used for Estimating the PD

Types of Counterparties	Through the Cycle Models	Default Definition	Time Series Used	Internal/ External Data
Sovereigns	Models are forward looking and through the cycle. They are designated to be optimally discriminative over the long term. The through the cycle aspect of the rating is also addressed in a conservative calibration of the PD.	Default at first day	> 10 years	External
Banks		Default at first day	> 10 years	External
Local Public Sector		Default at 180th day		Cf. following table
Corporates		Transverse	> 10 years	External
Specialised Lending		Transverse	> 10years	Internal
Equity	Specific approach: PD/LGD Approach.	N/A	N/A	N/A
Securitisation	Specific approach: Rating-Based Approach.	Default if related ABS is classified as impairment 1 (loss probability >50%) or impairment 2 (loss probability =100%).	N/A	N/A

Overview of the Local Public Sector

Types of Counterparties	Time Series Used	Internal/External Data
Western Europe Local Authorities	From 5 years (e.g. Italy) to over 10 years (e.g. French Municipalities,).	Internal + External
US Municipalities	> 10 years	External
Groupements à fiscalité propre	> 10 years	Internal
Social Housing	> 10 years	Internal

Main Principles Used for Estimating the LGD

Types of Counterparties	Main Hypotheses	Time Series Used	Internal/ External Data
Sovereigns	Expert score function based upon Fitch country loss risk methodology and internal expert knowledge to discriminate between high and low loss risk.	> 10 years	Internal + External
Banks	Statistical integrating I risk factors adapted to banking counterparties (country of residence, business profile, etc).	> 10 years	Internal + External
Corporates	Statistical model based on external rating agencies loss data. The LGD depends on counterparty rating, exposure seniority level, geographic region and macro-economic factors.(calibrated to define the downturn LGD)	> 10 years	Internal + External
Local Public Sector	Cf. next table.		
Specialised Lending	This model belongs to the 'Workout LGD' type: the LGD computation was developed according to the workout of the bank during a 10-year period concerning internal Project Finance default facilities. Cash flows are estimated on the basis of the observed historical recovery process, and LGD is computed by means of discounted cash flows.	10 years	Internal
Equity	Specific approach: PD/LGD Approach.	N/A	N/A
Securitisation	Specific approach: Rating-Based Approach.	N/A	N/A

Overview of the Local Public Sector

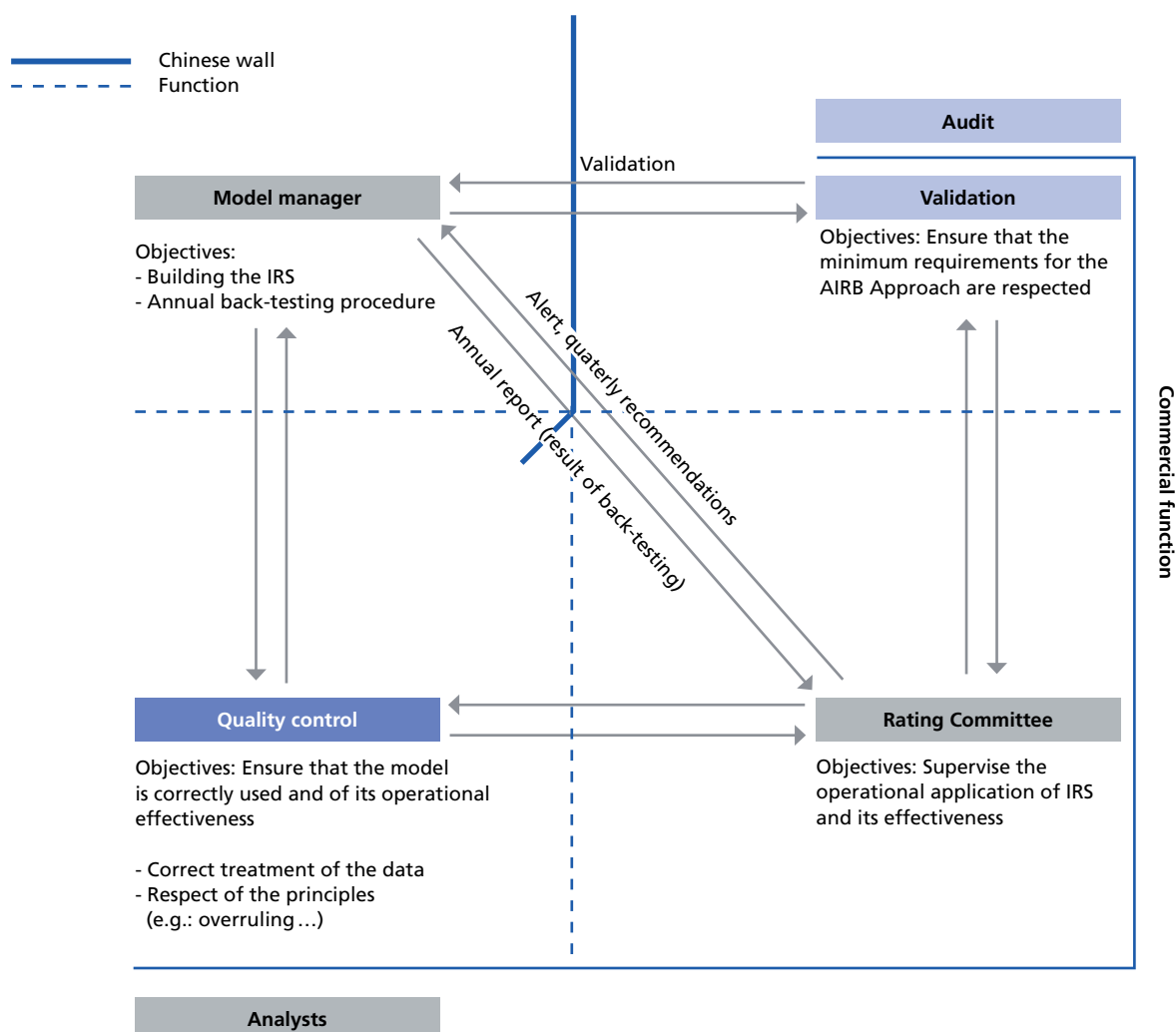
Types of Counterparties	Main Hypotheses	Time Series Used	Internal/ External Data
Western Europe Local Authorities	Statistical model based on the internal existing default cases observed which were related to French municipalities. Final LGD are segmented on the basis of the number of inhabitants and on an economic parameter reflecting the financial flexibility.	>10 years	Internal
Municipalities US	The Muni US LGD model is an expert model guided by external recovery rate factors and estimates. The final segmentation is based on business sectors.	N/A	External
Groupements à fiscalité propre	A mixed analytical - expert model was chosen and constructed based on the indicative available observations to determine indicative LGD and quantify potential loss related to a default in this sector.	9 years	Internal
Social Housing	Expert model based on a global evaluation of security/ credit risk mitigant. Segmentation is based on the number of houses and on a performance ratio.	9 years	Internal + External

Main Principles Used for Estimating CCF

At present Dexia does not use CCF models for regulatory purposes except for Specialised Lending CCF model. Otherwise, Foundation Approach is applied.

3. Control Mechanisms for Rating Systems

The Basel II regulation requires internal control of the internal rating systems and processes. The following graph provides an overview of the different control functions.



The control mechanisms for Internal Rating Systems (IRS) are organised in 3 levels:

- Operational Validation & Quality Control (OV QC) is responsible for the monitoring of the models' use and environment review, pertaining to the permanent control of IRS (models' scope, model's inputs quality, overruling, audit trail);
- Market and Credit Validation are responsible for the overall assessment of the IRS (models' set up, models' reviews, back testing and stress testing);
- Audit is responsible for auditing the general consistency and compliance with the regulation of the IRS, operational validation being carried out by the OV QC Department.

The Operational Validation & Quality Control (OV QC) is integrated in the Validation department.

Chinese walls between Model manager and Validation & QC, Model manager and Rating and Operational Validation Committee (ROVC) and Credit Validation & QC and Audit ensure the control system independence.

Operational Validation & Quality Control

Purpose

Operational Validation and Quality control is defined, in accordance with the regulatory directives, as an internal and independent control unit aimed at ensuring that the IRS are used properly and in an operationally effective manner and that an audit trail of the rating process is maintained.

In practice, the controls and the organisation are established to meet a number of requirements:

- Ensuring that the assumptions on which the models are founded are respected;
- Ensuring the reactivity of IRS supervision procedures and the maintenance of the audit trail in the rating process.
- Facilitating the IRS containment procedures. When malfunctions or anomalies in the use of or in the results produced by the model are evidenced, swift and effective remedial action should follow. To this end, controls should not only concentrate on anomalies but also help explaining their cause. Moreover, a regular and constructive relationship with the back-testing functions is put in place.

Global and specific key controls are applied for the monitoring of the models' use and environment review. The global controls are applied without distinction of the model reviewed and the specific ones (i.e. dependent of the model) reflect the monitoring of existing issues related to the model in question. These controls encompass the review of:

- the rating scope exhaustiveness,
- the quality of the audit trail,
- the quality of the models' inputs and their accuracy/relevance,
- human overruling of the models,
- the correct application of rating guidelines & procedures (mother support/BE, country ceilings, re-rating, piercing of LCCC & FCCC, country/mother company downgrade impacts, rating inheritances on counterparties etc.)

Scope

The scope of the quality control process covers:

- All Advanced Basel II models;
- All entities within Dexia; and
- All geographical locations.

Process: Parties Involved

Key Stakeholders and Functions

The organisation follows that of the Credit Risk teams: the principle is that IRS that are specific to an entity are used and controlled with the help of local correspondents while "transversal" IRS are treated at Dexia Group level. Annual visits are carried out to ensure of the coordination and steering of the global quality control process.

To enhance the efficiency and increase the uniformity of the control procedures, Operational Validation & Quality Control monitoring tasks have been permanently united in 2012.

Rating and Operational Validation Committee (ROVC)

The key role of the ROVC is to monitor the appropriate use of internal rating systems within the Group as a whole and to ensure that these IRS are effective. For these reasons, the ROVC:

- Validates overrides, above tolerance threshold, proposed by analysts;
- Reviews quality control reports about the utilisation and performance of IRS;
- Monitors the homogeneous application within the Group of the rating and derogation principles;
- Validates operational establishment of the models once they are validated by the VAC.

Processes and Guarantee of Independence

Fully aware of the importance of preserving the neutrality of the control process, a Chinese wall have been set between the development departments, model managers, sales functions, analysis functions and the Operational Validation & Quality Control function. These walls ensure a high credibility of the final quality control outcomes. This way any potential conflict of interest is fully avoided:

- The operational validation & quality control function is independent;
- The operational validation & quality control function submit their proposals to the ROVC and to the Validation Advisory Committee that can deliberate on any subject concerning IRS or modes of applying the IRS within the Group.

Market and Credit Validation

The Market and Credit Validation Departments

All the models used within Dexia, either market risk models, pricing models, Basel II Pillar 1 credit rating models, BSM models, economic capital models have to be validated by an independent entity. The Validation departments ensure that the models used within the Bank:

- provide reliable outcomes that are in line with the objectives assigned by the management;
- are correctly implemented and adequately used;
- meet the regulatory requirements.

The main objectives of the Validation departments are:

- To define the procedures and guidelines of model validation;
- To identify all models waiting for validation;
- On this basis to elaborate a validation schedule, taking account of a firewall between Validation and Modelling;
- To exercise the validation work on the models;
- To bring and defend their works before the Validation Advisory Committee (VAC) in order to obtain a pre-approval;
- To present these pre-approvals for final approval to the Risk Committee (RC).

Validation Approval Process

The process set up to endorse the validation of models deployed within Dexia Group is multi-layered, ensuring total compliance with regulations and local regulation requirements through the work-out of proposals by the Validation department, an approval of these proposals by the VAC and a final endorsement by the RC, composed of members of the Dexia Management Board. The validation approval process is formalised in a set of policies and guidelines. The output of the validation is formalised in a validation report also including an executive summary, strengths and weaknesses and a list of recommendations. These reports are presented to the VAC, the RC and are sent to the Regulators upon request.

The Validation Advisory Committee

As mentioned above, in order to develop an efficient and transparent validation process, the Validation Advisory Committee (VAC) has been set up. The VAC is responsible for:

- Establishing and following up the overall validation framework including procedures and subcommittees terms of reference;
- Defining priorities in the validation of the various risk models;
- Reviewing each validation step of the guidelines and model life cycle validations;
- Preparing proposals for decisional committees to facilitate the decision-making process.

Two Validation Advisory Committees have been processing the Validation outcomes:

- The Markets VAC covering market risk and pricing models;
- The Credit and Transversal VAC covering Basel II Pillar 1 credit rating models, operational risk models as well as transversal Pillar II models (such as economic capital and BSM models).

The VAC are composed of the representatives from the Validation departments, the Model Management, the head of Risk Governance and Regulatory Watch, the heads of Risk, Market Risk and Risk Analytics, as well as representatives of the business lines and/or Modelling teams for the validation of their respective business lines/models, this in line with the type of models they cover. Internal Audit is also present as it constitutes an additional level of control on the validation process.

Validation Scope

The global scope of the generic validation process within Dexia Group applies to:

- All models requested by regulators (e.g. Basel II, IFRS II) or for business purposes;
- All risks deployed in the company, such as credit, market, operational and BSM related risk...;
- All Dexia Group entities (cross-entity dimensions);
- All geographical locations (cross-border dimensions).

Audit

According to the CRD minimal requirement 131, Annex VII Part 4, "Internal Audit has to include in its plan, at least once a year, a review of the IRS and its functioning, including credit scoring and estimation of PD, LGD, EL and CCF. Also compliance with all the minimal requirements has to be verified".

At Dexia, this annual verification has been delegated to the Operational Validation & Quality Control department. Audit acts as an additional level of control, included in its audit plan.

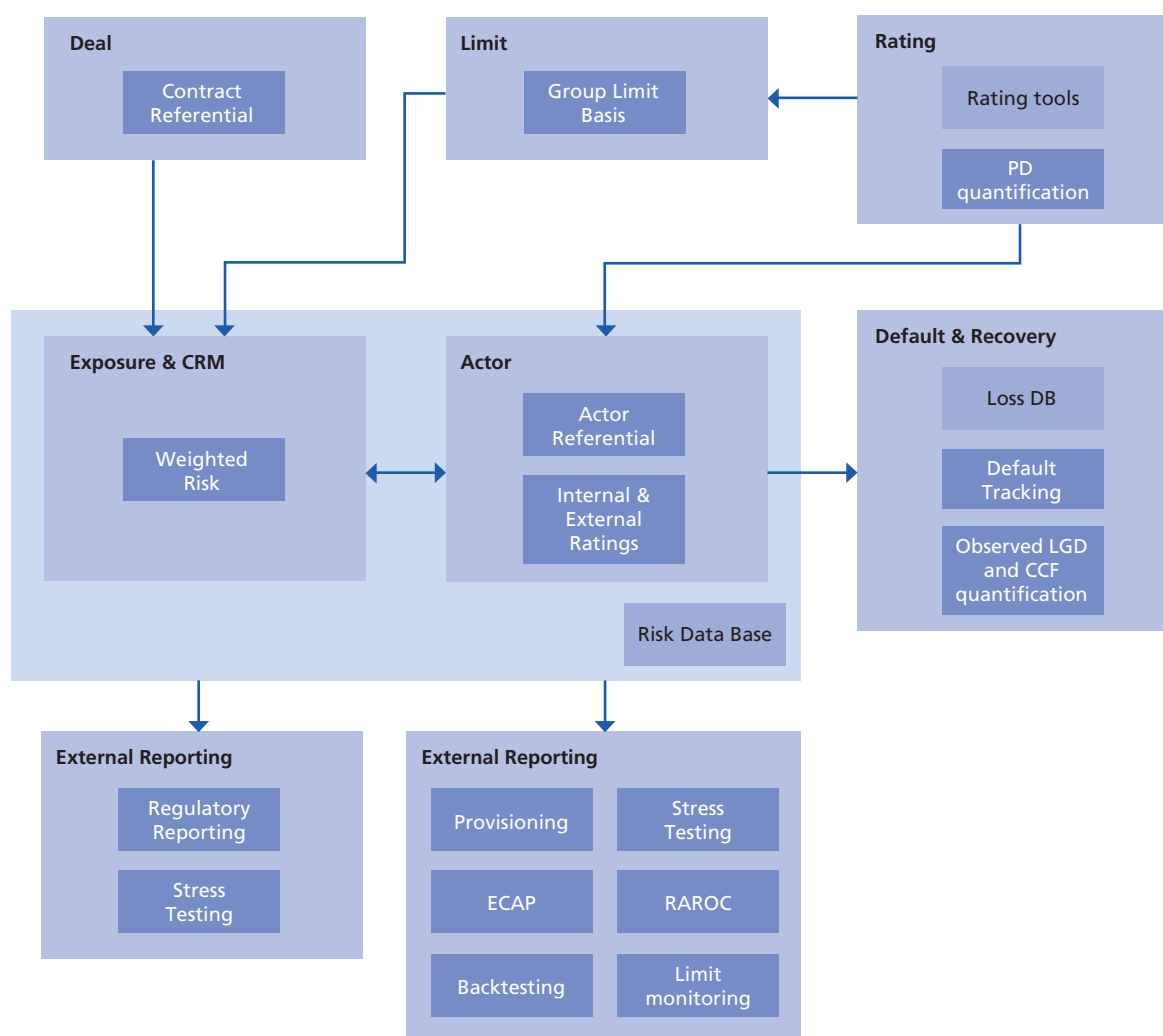
The Risk Committee can delegate application modalities for their decisions to other specialised Risk Committees (within the limits and rules defined by the RC).

4. Credit Risk IT Systems

Since the implementation of Basel II Dexia reinforced the integration of its risk management IT systems and promoted close cooperation between Dexia entities.

In order to foster best practices in its IT systems and to ensure state-of-the-art solutions to Basel II requirements, Dexia completely redesigned its Credit Risk IT Systems. The risk IT architecture was partially reviewed in order to meet to the integrate Dexia unwinding process.

The following chart provides a global view of the functional architecture of the credit risk information system within Dexia Group as at 31 December 2013.



The core of credit risk IT systems is built around the actor and exposure information. Both concepts are united in the central risk data base system which gathers information on all Dexia credit counterparties (identified by a unique internal identification number) and their corresponding exposures and credit risk mitigants.

The actor universe consists of referential information and rating information:

- Type of counterparty (bank, corporate, local authority, and so on);
- Descriptive data;
- External ratings from rating agencies (S&P, Moody's and Fitch);
- The internal rating before and after the Sovereign ceiling impact;
- The internal rating system;
- Available internal credit analyses;
- Relations between different counterparties such as capital or commercial ties.

The individual rating analysis is made within different rating tools, either individually or in batch, by the credit risk expertise centres. This internal rating data together with the external ratings are collected and linked in the actor data base.

The second component of the central risk data base is the exposure and CRM universe. A precise view on the exposure with significant amounts valuations (nominal, outstanding, mark-to-market, accrued interests, and so on) are joined with the credit risk mitigants (collateral and guarantees) to have an integrated risk view on the positions taken by the group.

Around the central risk three other data situate for different purposes.

- The contract referential data bases containing (product type, seniority level, maturity...).
- In limit data bases current limits on any credit counterparty (limit database) are defined using the counterparty rating information. Comparisons are made of current exposure towards the limits in order to take appropriate actions when needed.
- Dexia's default database is used to collect the default and recovery information. This serves to calibrate and back test Dexia internal rating systems.

Dexia's centralised IT systems are linked to a centralised by a reporting infrastructure allowing to produce credit risk reports based on the information gathered on different levels. All these IT and reporting systems support the general risk monitoring for both internal and external purposes as there are:

- External Reporting
 - Regulatory Reporting
 - Pillar 3
 - Regulatory Stress Testing
- Internal Risk Reporting
 - Cost of risk calculations and provisioning
 - Life time loss calculations (ECAP)
 - AIRB model back testing
 - Stress Testing
 - Limit Monitoring

Process Used to Transfer the Issuers and Issue Credit Assessments onto Items not Included in the Trading Book

Issuers and issue credit assessments onto items not included in the trading book are automatically collected by Dexia credit risk IT systems and then attributed to the relevant issuers or issues on the basis of a unique identification number for issuers (Dexia internal "ID" numbers) and for issues (ISIN codes).

