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Conference Call Transcript

DEXB.BR - Dexia - Strategic Review and 2Q 2008 Earnings of FSA

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PRESENTATION

Operator

Good evening, ladies and gentlemen, and welcome to today's conference call regarding the strategic review and 2Q 2008 earnings of FSA. For your information, this conference is being recorded. At this time I would like to turn the call over to your host for today, Mr. Axel Miller, CEO of Dexia. Please go ahead, sir.

Axel Miller *- Dexia - CEO*

Thank you. Good afternoon and welcome, ladies and gentlemen. First of all I would like to apologize for the very short notice of this conference call and for the early disclosure of a number of important announcements which were initially planned to take place next week.

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The fact is that rating agencies do not always take the same kind of consideration that we do of our shareholders and we had to align the timing of our communication to the timing set by Standard & Poor's and Fitch.

You may have seen in the meantime that both S&P and Fitch have released their announcement and, in the case of Fitch, have confirmed the AAA rating of FSA with a stable outlook. In the case S&P, have confirmed and maintained the AAA rating of FSA, but which has been put on negative outlook. And obviously these announcements take into account the development that we will comment with you tonight.

We actually wanted to update you today on two key recent developments. First of all the strategic review of FSA's business has been concluded and results in a number of important decisions.

Secondly, expectations for the U.S. housing market deteriorated in the second quarter, as you know, and this evolution, along with FSA's strategic review, have led us to significantly strengthen FSA's reserves. We wanted to update you on FSA's second quarter results and also give you a sense of Dexia's overall performance in the period.

I have here with me Alain Delouis, our newly appointed head of our Wholesale division, Public Financial and Credit Enhancement, and Rembert von Lowis, head of Strategy and Development. We also have on the call Claude Piret who is, as you may know, the Chief Risk Manager of Dexia, and we also have Bob Cochran the CEO of FSA.

Alain and Rembert will respectively address the commercial situation of FSA and Dexia, and the numbers we'll walk through in more detail. And Claude Piret and Bob Cochran will be available for any questions you might have at the end of this presentation.

We have put on our website the full details for FSA's Q2 numbers, as well as the presentation that I will review with you now. So any reference to slides will be slides of the document called Strategic Review and 2Q 2008 Earnings of FSA. And I will try to mention the comments that I am giving on the various slides. I will be commenting slide one to 11, I think, and then my colleagues will take over from then.

If we start with slide number three, it's important to put today's announcement in their context. As you may remember, on the 14th of May we have announced that we would engage in a strategic review of FSA. At the time we had already announced that we would discontinue activity in the HELOC and Closed-End Second Lien sectors, as well as all forms of unsecured consumer credit.

Since then we have done quite a lot of work to assess a wide range of strategic options based on an in-depth analysis of the various businesses of FSA, including analyzing the global and U.S. economic and financial environment. We've had closing directions with rating agencies and we've assessed the prospects of the U.S. municipal finance market as a whole.

We do believe, as a result of this examination, that the decisions we've taken for FSA are based on a recent, thorough and thoughtful analysis. And these decisions have been taken bearing in mind two important principals. One, whatever we did had to conform to Dexia's fundamental risk appetite. Second, whatever we do should make use of and should not endanger our position of financial strength.

Let me give you now the highlights of our decisions, which is set forth on slide number four. I will then let Alain and Rembert walk you through the details of FSA's commercial positioning and results and the consequences of its strategic realignment.

To summarize in very simple terms the outcome of our review, we have decided to reposition FSA on the insurance of municipal bonds and associated services to municipal clients. This results in FSA exiting the Asset-Backed and Structured Finance business and downsizing the Financial Products, the FP business. To facilitate this exit and if I may say start with a clean slate, we have essentially taken three steps.

First of all, we have significantly strengthened FSA's reserves. Secondly, Dexia will reinject $300 million into FSA, this is money that was actually dividends previously paid by FSA to Dexia.

Thirdly, Dexia will continue to support the Financial Products business. As you well know, the situation of the U.S. financial market is uncertain these days. We nevertheless believe, and we believe strongly, that FSA has a quite valuable value proposition and today's announcement really demonstrates our belief in that.

However, we also acknowledge the high levels of uncertainty that are currently prevailing and we will of course continue to closely monitor developments in the U.S. market and assess any further actions that Dexia and FSA will want to take in that framework.

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Finally, I wanted to point out to you as well that Dexia as a whole has shown, I think, remarkable resilience and has ended the second quarter of 2008 with a very strong level of capital and very good liquidity situation.

Let me now give you a bit more detail on our thinking in our decisions. In turning to slide five, one of the driving factors of our thinking has been the deterioration of the housing market in the second quarter. As you can see on the left side of this slide, U.S. house prices have declined faster and more than expected in the quarter and anticipations have generally been worse.

We have now assumed that the decrease in house prices should not stabilize before well into 2009 and that house prices may only start appreciating again in early 2011. The difference between the blue curve and the red curve of this slide may not seem much at first glance, but it has huge significance for the computation of expected losses for FSA's mortgage market exposures, as you will see on the next slide.

If we look at slide six, as you probably will recall, we make a distinction between what we believe to be true economic losses, which we account for in our underlying earnings, and temporary fluctuations in value, which we only report within our reported earnings. And the market can make its own judgment about the classification that we use.

In the second quarter we have increased our loss estimates and accordingly strengthened our reserves for both our Financial Products business and for our insured portfolio. With respect to Financial Products, we have for the first time booked economic losses on certain ABS assets to the amount $316 million. The assets on which we booked economic losses were all already in negative mark-to-market through other comprehensive income, OCI.

As required by our accountants, the whole of the negative mark-to-market in excess of the $316 million figure was recycled through P&L. This is the $726 million non-economic impairment that you can see on this slide. It is important to note here that these losses did not impact FSA's equity as they were compensated by a reversal of prior negative mark-to-market taken into accumulated OCI.

We have also decided to increase our reserves for our insured portfolio by $671 million in the quarter, taking into account a more severe U.S. mortgage market scenario. This is essentially valid for our HELOCs and Closed-End Second books for an amount of $525 million out of the total $671 million.

We have also booked a further $68 million reserve on two CDS transactions, $39 million on our option ARMs exposure and $51 million reserves on a specific situation within our municipal finance book, the Jefferson County Sewer Transaction. Alain and perhaps Bob will walk you through these numbers in more detail in a minute.

All these amounts are in dollar pretax. You would need to convert them in Euro post tax to calculate the effect on Dexia's numbers and essentially divide them by 2.4 to get the after tax Euro number. This means that after taking these provisionings, which assume a very deteriorated housing environment and level of losses which goes well into the middle of 2009 and with a progressive recovery to a sort of more normal historical level up to the middle of 2010, that these losses, we believe, should amply cover a very deteriorated scenario.

As of this day, if you add those numbers to the provisions that we have already taken during the first quarter, that would be a global amount of economic provisions which would be more or less equal to $1.4 billion. That's the first point.

Second point, the ABS business on slide number seven, we've looked at the deterioration of the U.S. mortgage market and the inherent cyclicality this market has. One of the three decisions we made was that FSA would exit the asset-backed and structured finance sector and from now on focus exclusively on U.S. municipal and Global Public Finance markets.

This decision really has been taken for two reasons. One, we want FSA to refocus on one of Dexia's primary and strategic goals, which is to maintain and develop its position as a world leader in Public Finance. Second, we have noted the cyclicality, the level of risk and the relative lack of predictability of the ABS and structured finance, which we just didn't like in light of our risk appetite.

For these two reasons we will stop the ABS business all together. And clearly, as a result of the decision, FSA will align its human resources and expense levels to the new volume of activity that we will have, which should translate into a 10% headcount reduction and about $30 million of annual cost savings.

We expect the ABS book, which will be put into run off, to run off relatively quickly and it should represent about less than 5% of net par insured by 2012. This run off would also result in about $1 billion of capital release over the next five years, as well as $700 million of revenue yet to be earned over the remaining life of the policies.

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Point one, take the necessary levels of provisions. Point two, terminate with immediate effect the ABS business. Point three, downsize the Financial Product business. On slide eight: In line with refocusing on its core Public Finance customers and businesses, FSA will from now on restrict the issuance of GICs, Guaranteed Investment Contracts, to Public Finance players only. As a result, we expect the portfolio to quickly decrease to a much smaller size. These measures should greatly reduce the FP business risk profile in line with Dexia's general risk appetite.

On slide nine we also underline the reasoning that we have followed to continue supporting the FP business. As you know, we believe that current mark-to-market values of FP assets are well below their true economic value as hold-to-maturity assets.

It's worth noting that this view of ours is in line with what several rating agencies have reported and also with different stress scenarios that we have run independently from FSA and also at FSA. We see significant benefits for our shareholders in providing FSA with the liquidity required to enable it to hold these assets until market conditions are more in line with economic values and essentially to avoid crystallization of losses because of forced sales in a distressed market.

The numbers are self explanatory, we believe. We have now taken provisions of about $316 million on this portfolio. If we were to liquidate these assets because of an acceleration of the liabilities in a distressed market there would be a gap of about $4 billion to potentially $5 billion. This is something that we don't believe reflects the economic value of the underlying assets. So it's a sound business decision to try and protect the value that is out there.

This is the reasoning that was behind the provision of the liquidity line a number of weeks ago to the FP activity. Note that this line is not available generally for FSA's activities as a whole but is restricted to liquidity needs that would be arising in the circumvented FP parameter, and as such is then not available to the whole of FSA.

This is the reasoning that a provisioning of a liquidity line in June. We will continue in the future to support that business, both its liquidity and its credit risk. This is essentially a credit spread business, which is well within our competencies at Dexia. We have more than ample liquidity to meet potentially accelerated repayment of liabilities and so it's a sound decision to assess all possible ways to preserve the value in this portfolio for our shareholders.

This will be, in the coming weeks and months, structured appropriately and will be perfectly manageable within the scope of our own capital requirements and policy. On top of that, this will provide for further capital relief for FSA, which further strengthen their capital position as part of the general realignment that we are explaining to you today.

Let me remind you that the U.S. Public Finance market is probably one of the largest, if not the largest Public Finance market in the world and has on top of this, we believe, strong growth prospects, certainly on the medium to long term. As the Global Public Finance leader, this is clearly a market we need and want to be in.

Basically our decision to inject additional capital into FSA stems from our view that, despite that the uncertainties that are currently existing, the municipal bond insurance market is likely to remain a very attractive place for FSA to be in, provided confidence is restored. Let me explain briefly our thoughts around this.

In the first six months of 2008 we had about 24% of total municipal bond insurances which were insured by monolines, which clearly is lower than what we've seen in 2007 where the levels of insurance were more in the range from 40% to 50%.

Globally the volumes of financing were also down compared to 2007 for a number of obvious reasons, one of them being that the market has been pretty dislocated in terms of instruments with dislocation of the ARS and other structures, which clearly have limited the supply on the market.

In the same period you have to know that FSA had a remarkably strong performance. It grew its U.S. Public Finance growth by originations by about 51% year on year, achieved on that difficult market a 62% market share and doubled its prices at the same time.

For the first six months of the year 2008 the U.S. municipal finance business originated present value premiums, the PV premiums originated were $466 million. This is up more than three times the amount of PV premiums which FSA originated in the same period last year.

Additionally, we originated about $44 million of PV premiums in the international Public Finance markets, which we see are slowly regaining some momentum. In contrast to the $510 million of PV premiums generated by the Public Finance business, the ABS business in the same period

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originated about $80 million for the first half of 2008, which is actually 43% less than from the comparable period in 2008. And this was with virtually none done during the second quarter of this year. On top of that, on Public Finance the return on the equity deployed for these transactions in the muni sector is now significantly in excess of 20%.

Now it may appear that these two factors, lower volumes and much better numbers and profitability for FSA, would be to a certain extent contradictory. However, we believe that there are two main reasons for this pattern to have emerged. The first one is clearly a sharp drop in the supply of bond insurance.

There were over the period only two significant players, FSA and another competitor, who were still able to offer a credible bond insurance in that period. Less supply therefore resulted in a smaller market. The dislocation of other financing instruments also may provide part of the answer.

The second reason flows from first, clearly confidence in the long-term stability of bond insurers dropped sharply. And let's be fair, FSA has not totally dodged that bullet for industry related reasons but also for FSA-specific reasons. Hence the decision that we take today. We believe FSA's very strong performance points to potential for the municipal bond insurance market to bounce back strongly once capacity is restored and confidence returns to the market.

We do not buy into the argument that the municipal market could do, on the long term, totally without insurance. There are about 30,000 issuers in that market, each of which has unique credit characteristics. The ability of smaller, less well known municipalities to attract debt investors without the benefit of insurance is likely to be limited in our mind. The financial benefits of insurance, lower coupons for issuers, security and liquidity for investors will also persist, particularly for the lower rated issuers.

The characteristics of this market may change or adapt, but we believe that the market will stay on the long term. If anything, financial strains of local U.S. authorities and potentially increased losses in the future, whilst they may be addressed by sound and conservative underwriting policies and certainly better economic terms on the insured transactions, should underline the existence and the reasons for the existence of a reliable and long-term credit enhancement market.

For all these reasons and others that we'll be happy to comment with you later, we believe that municipal bond insurance will remain and that FSA can benefit from it, provided that we are able to tell FSA's prospective policyholders that we will be around to pay claims if and when they arise.

These are the reasons that we are focusing today on FSA on Public Finance and are taking all these steps to bolster its capital strength, including injection of additional equity or quasi-equity to FSA. This decision is more than simply strengthening FSA's balance sheet to compensate for losses, it is very much a mark of our confidence in the potential of FSA at this juncture.

And with these measures, FSA now exceeds the AAA corporate capital requirements for all three rating agencies, as we have seen from the announcement of S&P and Fitch and as will be confirmed by Moody's. And we will continue to work closely with each of these agencies to address the qualitative and systemic issues which they raised in recent reports.

Our RMBS reserves now anticipate the long and stressful economic environment and therefore we expect these reserves to be sufficient over time. Equally important, the strategic realignment is expected to reduce FSA's future financial statement volatility and significantly strengthen its capital position as its asset-backed exposure is amortized over time.

Now the full details of FSA will be presented later by Rembert. Before leaving over to Alain and Rembert, let me update you briefly with the help of slide 11 on Dexia's second quarter performance. These are preliminary unaudited numbers, the full details will be given to you on 29th of August. But I think there are three major messages we want to give you here.

Obviously as a whole Dexia has been affected by FSA's losses, difficult to be otherwise. Our second quarter reported profit was EUR539 million, which is 32% lower than the same quarter last year. This drop is entirely due to FSA. If we exclude FSA, our reported net income in the quarter would have been EUR755 million, which is up 3% compared to the same quarter last year.

As you know, our reported net income is affected by mark-to-market movements, which we consider to be transitory in nature. We believe our true performance is best represented by our underlying earnings.

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On an underlying basis and excluding FSA, our net income would have been EUR760 million in the second quarter, which is 24% higher than last year. This is I think a very good and solid performance in a very disturbed market environment in general and it's really a reflection of the specific nature of Dexia's activity excluding FSA.

We will give you more details on how this performance was achieved at our second quarter earnings presentation on August 29. But what's also important to note, and that's the second element, is that over the quarter Dexia's core shareholder equity amounted to EUR15.6 billion. Within this total, negative OCI reserves remained at roughly EUR7 billion, which is a pretty similar level than the level that we had at the end of March when we reported on our Q1 numbers.

Finally, our solvency remains one of the best in the sector with a Tier 1 ratio of 11.3% at quarter end, with a very healthy liquidity position. All of this means that the strategic realignment of FSA that we have decided to implement and that is translated into the various decisions that I've just outlined to you, has no detrimental effect on our capital position or policy.

Now just to finish briefly on slide 12, let me give you a bit more details on how we achieved this 24% growth in underlying profit excluding FSA. If you focus on the right hand side of the slide, on Dexia excluding FSA, you will note that our income grew by 10%. This is stemming for about 50% from the sound commercial development of the group across most of its business lines.

Half of this growth is due to positive mark-to-market effects on the trading portfolios that we have in our financial markets divisions and some credit defaults related to two synthetic securitizations. I think we have mentioned these elements when they were negative in previous quarters, we are mentioning them as well when they have a positive effect on underlying numbers in succeeding quarters.

In the same period, as you see on the table, our costs grew by 4%, which is really a cost evolution driven by our further developments in Turkey and our growth in our international Public Finance business where we continue the trends that we have observed in previous quarters. Gross operating income goes up 16%, cost of risk remained at a very moderate level with 38 million of provisioning taken during this quarter.

And this all has resulted in a 24% underlying net income growth for Dexia excluding FSA. If FSA is included, you go to the left hand side of the slide, the growth becomes a 37% decrease in underlying earnings, as you can see with the breakdown of the various lines of the P&L.

Now let me hand over to Alain to walk you through the commercial positioning of Public Finance and FSA in that story, and to Rembert to go over more details for the results of FSA and the provisioning levels before concluding and opening the floor to questions.

Alain Delouis *- Dexia - Member of the Management Board*

Thank you, Axel. Let's start this part of the presentation with a quick reminder of Dexia's strategy in Global Public Finance. We already have a worldwide leadership and want to strengthen it through a multi-product offer, through the diversification of our client base in our current markets, for example through satellites of local authorities and geographical development.

As you can see, on the pie chart on slide 14, out Public Finance operations are already well diversified with historic countries, mainly France and Belgium, representing 35% of the 2007 net income of the business line. America represented 32%, mainly two thirds FSA and one third for our banking activities run mainly through our New York branch.

The key messages for the first half of 2008 are the following. One, the buoyant commercial activity with originations up to 48% compared to the first half of 2007. Two, increased commercial margins despite the slight increase of our long-term funding costs. Three, strict credit underwriting criteria applied for this production. And four, all in all a confirmed return on equity in excess of 20%.

On slide 15 you can see commercial figures for the first half of 2008. Originations have grown by 48% year on year and even by 58% on a constant exchange rate. We have reached the record figure of EUR43.6 billion with the second quarter even more dynamic than the first one.

In terms of geography, historic markets have decreased slightly, minus 2%, mainly due to the electoral cycle in France, demand tends to be reduced just after local elections and comes back afterwards once the new teams launch their programs.

What we call growth markets, mainly USA and the rest of Western Europe, have been very active, plus 89%. And in the third cycle, tomorrow growth markets continue to increase rapidly with notably very good results in Japan. Looking at the right part of the slide, long-term commitments, which are the basis of our future revenues, have grown by 17% and even 21% on a constant exchange rate to EUR342 billion.

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Let's focus now on the United States. The U.S., the big finance market, as Axel said, is the second largest in the world, just after the Japanese one. The debt outstanding is enormous, more than $2.6 trillion and the annual production is in the region of $400 billion. As you know, this market used to be almost entirely desintermediated with municipalities issuing bonds partially funded by tax exempt investors.

Credit enhancements grew up to 50% of this market during the most recent years, the rest being done directly without financial guaranty. We at Dexia are present on this market with two complementary offers. One is FSA, two credit enhancement products, the second is our banking branch based in New York which provides municipalities and related bodies with liquidity lines, interest swaps and more recently direct loans or bonds.

This U.S. market has been facing a major disruption since the end of last year, mainly due to the fact that a significant portion of it was refinanced on a short-term basis. The drop in market confidence in the short-term papers relate to a bridge between supply and demand, pushing credit spreads up for many municipalities.

This bridge has been worsened by worries related to the monoline industry, with some key players being no longer in a position to provide credit enhancement. Therefore, market share of credit enhancement declined to 24% during the first half of 2008. Even though demand for credit enhancement in the U.S. market has decreased recently, we believe that this product will continue to be attractive, both for insurance and investors.

Taking the insurance point of view, spreads on AAA insured bonds are clearly much lower than spreads on unwrapped bond. As you can see on slide 18, the gap is currently around 20 to 30 basis points for A issues and around 80 to 90 basis points for BBB issuers. There is therefore a clear opportunity for those issuers to pay an interest premium to benefit partially from these gaps.

On the other hand, we should take the investors point of view. It's very difficult to fully assess the credit risk of 30,000 varied issuers, each of them presenting credit specificities. That's why we believe that even with a potential shift to a global rating scale for U.S. municipalities, credit enhancement provided by monoline insurers with very high ratings should, once the market stabilizes, keep penetration in the range of 20% to 30%, which will be clearly below highest figures reached last year but still left enough room for focused player.

The first half of 2008 has been very successful for the muni business at FSA. You can see on slide 19, despite the reduction of credit enhancement penetration, two positive factors explained the record level of PV Premium originations which reached $466 million on the U.S. muni business compared to $151 million last year. FSA market share was 62%, a huge increase explained by the fact that historic players almost disappeared in 2008. Two, premium rates are doubled compared to last year.

It is clear that during the last two weeks, after Moody's decision to put FSA and Assured AAA ratings under negative credit watch, the commercial activity of FSA has been almost nil because market participants wanted to hear from other rating agencies. But we believe once dust will have settled, which should be the case in the coming weeks, that the potential market for highly rated monolines focused on public finance will be there.

To conclude this commercial part of our presentation, I would like to illustrate the synergies and complementarities that exist between credit enhancement and banking approach in the U.S. muni market. A very good example of these synergies is the so-called SBPA, Standby Bond Purchase Agreements, provided by Dexia New York on bonds enhanced by monolines including FSA.

We have been by far the market leader with the prediction of $15 billion with very interesting margins during the first half of this year. And the banking activity of Dexia in the U.S. muni market has been very successful with a production of $22 billion, including the SBPAs. I would like to draw your attention to what we call direct lending, which consists in loans or bonds closed in the B2C approach with municipalities.

For the first half of this year this activity has reached $2.2 million. This activity did not exist before the crisis. It has been developed successfully because it brings an alternative solution for clients to pure disintermediation. We believe that having two irons in the fire to answer to the U.S. muni needs is the best way for Dexia to develop its franchise in the west market.

That's why Axel told you earlier we have decided to inject $300 million in FSA to consolidate their financial strengths and let then both rating agencies consider the requirements for AAA ratings. This financial strength is illustrated by the Claim Paying Resources of FSA on slide 21, which present funds available to pay future claims from policyholders. At the end of Q2 those claim paying resources amounted to $7.9 billion. I'll give now the floor to Rembert for the third part of our presentation.

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Rembert von Lowis *- Dexia - Member of the Management Board*

Thank you, Alain. So we'll take you rather rapidly through the financials of FSA during Q2. Axel has already summarized the main elements of the P&L in the second quarter. On page 23, is the P&L of the second quarter with the net premiums earned excluding refunding up 5.3%.

I would just like to draw your attention to the fact that revenues from financial derivatives are no longer recorded as earned premiums and they are reported in a separate line called Now Realized Gains From Credit Derivatives Contracts.

If you sum up the first four lines, which represent more or less the total of the financial revenues during the first quarter, you will find an increase of 12.3%, which illustrates the successes of the commercial developments, in particular on the Public Finance side, of FSA during the first half of this year and the end of last year.

FP segment's net interest margin is down for the reason that we have been willing to increase the liquidity of this division, resulting into a placements that are less profitable than the previous one. Then the Financial Products economic OTTI, which already was mentioned by Axel, amounts to $316 million.

The rest of the OTTI is recorded in the non-operating items. The losses on the insured portfolio amount to EUR603 and $78 million as also mentioned by Axel earlier in the presentation. I will provide you with more details about these losses.

Finally, the other operating expenses and amortization of deferred acquisition costs decreased by 70%, mainly due to reductions in variable employee compensation linked to growth in operating earnings and adjusted book value. The total operating earnings sum up to a negative number of a little more than $500 billion. This is included in the underlying net income of Dexia.

The rest of the P&L concerns the non-operating items. The three most important ones are a positive number of after tax $184 million resulting from the tightening of the spreads on the CDS portfolio. Then a $500 million positive number which reflects the spread widening on the owned debt recorded by FSA.

I would like to draw your attention to the fact that this number, given the magnitude of revenue, has been included in non-operating items, both at FSA and also at Dexia. Until the first quarter of this year this was not considered as a non-operating item at Dexia, but given, again, the magnitude of this number, we will consider this as a non-operating item in Q2. And of course we will restate the previous quarters so as to make the numbers comparable from one quarter to the other.

And finally, the last number, $472 million, represents the portion of charges on Financial Products which we deem non-economic, so that the reported net income of FSA in Q2 amounts to minus $330 million, a little more than EUR200 million.

The following slides describe the provisions, the reserves that have been established on the different portions of the business of FSA. From left to the right, on Public Finance, one major provision which has to do with our exposure Jefferson County.

Then on the insured portfolio $620 million with the breakdown, which is represented on this slide, which shows that the bulk of it is due to our exposure to the HELOC sector. And then on the right hand side of the slide, the Financial Products portfolio with a total economic impairment of $316 million, of which the bulk, $200 million approximately has to do with assets in the first-lien Alt-a sector.

Details on these different sectors on the following slide, with notably HELOCs, show actually that the performance of the problematic transactions were very close to the expectations that we had taken into account in our Q1 scenarios.

Still we have decided to increase significantly the reserves established on this exposure because the underlying assumption is that the peak delinquencies will last longer than we expected. And we have increased the duration of these peak delinquencies by six months until the middle of 2009.

The other parameters have also been adjusted by the main parameter, which explains the reason why we have increased substantially the provisions. It has to do with this lengthening of the peak of 6 months. Also in the second quarter we considered that eight of our transactions were problematic and we now consider that 10 of them are problematic with an aggregate net par of $4.5 billion.

On the following slide, the Alt-A Second Lien, here also we have adjusted the parameters, the main one again being the period of the plateau which has been extended by six months, consistent with the decision we've taken at the HELOC level, until mid 2009 and with the adjustment of

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the other parameters and also the fact that an additional transaction is considered as problematic we have raised the provisions from $87 million in the first quarter to $168 million in the second quarter.

For the rest of our exposure on the RMBS sector, that is to say the subprime the first lien Alt-As, Option ARMs we have also established the provisions based on scenarios that have been strengthened as opposed to the first quarter of this year, with a peak default rate that was assumed to extend to March 2010, and also with loss severity that have been significantly increased to 50% for the Option ARMs and to in 60% subprime. This new scenario, this more stressed scenario, results into a $39 million provision insured portfolio loss reserve and 277 in the FP portfolio.

The following slide which I will not detail has to do with the $51 million provision that we have established as a consequence of our exposure to Jefferson County Sewer debt. The total debt amounts to $151 million. Jefferson County is facing a very difficult situation mainly due to the importance and the nature of its debt. And given the uncertainties surrounding the capability of Jefferson County to repay its debt, we have established again a $52 million pretax provision.

On the insured CDS portfolio here also we have established provisions based on more conservative assumptions than in the past. Basically two transactions are considered problematic. The first one is a pooled corporate transaction, a very atypical one, and so far its maturity is much longer than the typical maturity of these products, it was 12 years at the beginning. It's a season transaction actually with a good maturity and we have established a $50 million provision against that exposure.

The rest of the portfolio of pooled corporate CDS is of very strong quality, mainly AAA or super AAA. And we have currently no word of the performance of the rest of this portfolio. Also one other CDS transaction that was wrapped by XLCA has been considered as problematic and an $18 million provision has been established against that provision.

Page 31, a few comments on the financial consequences of our decision to discontinue the ABS business. As you can see on this slide, the ABS portfolio is expected to pay down very rapidly, actually by half in about 3 years.

The average maturity of this ABS is much shorter than the average maturity of the Public Finance portfolio. This, as Axel said earlier, will result into a release of approximately $1 billion economic capital in the coming three to five years and an accumulated revenue stream of approximately $700 million.

Finally, and this will be my last slide, on page 33 we have updated the stress scenarios related to the liquidity of the Financial Products portfolio. As you can see, the high stress scenario, which is the most stressed one, would still result into an excess of liquidity of approximately $2 billion, of course taking into consideration the $5 billion credit line that has been granted by Dexia. This very high stress scenario assumes that no additional GIC is sold in the market from now on.

So this, ladies and gentlemen, concludes my part of my presentation. I think if you have any questions my colleagues and myself will be very happy to take them.

Axel Miller *- Dexia - CEO*

Thank you, Rembert. So we can go over to Q&A. I know it has been a long call so we'll keep it -- maybe come back on some of the issues that may be of particular interest for you.

QUESTION AND ANSWER

Operator

Thank you, ladies and gentlemen. (OPERATOR INSTRUCTIONS). The first question we have comes from the line of JP Lambert of KBW. Please go ahead with your question.

JP Lambert *- Keefe, Bruyette & Woods - Analyst*

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Yes good evening to all, I have two fast questions. The first one is regarding the stress test and the additional six months you have taken. Could you indicate what would be the additional need for provisions if that six months were to become 12 months?

The second question is regarding the $300 million you're injecting. Have you internally decided some form of limit on the capital injections you would be prepared to provide to FSA? Or have you considered other options? Thank you very much.

Axel Miller *- Dexia - CEO*

Okay, thank you, Jean-Pierre. Can I ask Claude to give a first shot at the first question and I will take the second one.

Claude Piret *- Dexia - Member of the Management Board*

Yes naturally the extension of the crisis has an impact from the stress depending on the evolution of the different sectors of the structure of the credits. But all in one it should be around $100 million per month of extension, pretax dollar.

JP Lambert *- Keefe, Bruyette & Woods - Analyst*

For which portfolio, sorry?

Claude Piret *- Dexia - Member of the Management Board*

For both portfolios, Insured and Financial Products.

JP Lambert *- Keefe, Bruyette & Woods - Analyst*

Thank you very much.

Axel Miller *- Dexia - CEO*

On the second question, Jean-Pierre, I can tell you the world in the summer of 2008 is very different from the world we knew in the summer 2007. I don't know what it would look like, but clearly the world in the summer of 2009 will be again very different from the world that we know today. These have been long, intensive and quite interesting discussions I can guarantee you, and yes we have reviewed all strategic options with respect to FSA.

We have just come to the conclusion that what really needed to guide us was not a desperate will to cling onto something but really to seek and weigh each and every option and see where the most value could be created for our shareholders.

And we do believe that what we're doing here is essentially dealing with legacy issues on ABS, reducing the size of the FP and limiting that to municipal GIC issuances, taking that over in a framework which really is perfectly feasible for Dexia from a solvency perspective and make sure that we keep the option value that we have in a market which, whether we like it or not, is going to remain very important.

And is just that important that it won't be able to work all under one set of rules and procedures. There may be adjustments made in the market. But my view at least, and our collective view, is that there is a market that will be remaining on the long term for credit enhancement. And there is just no business case today to throw the baby with the bath water, it's a simple as that. And I can tell you that we have weighed very carefully any and all options.

Now to your first question, which is a conceptual question, is there a limit to the amount of capital that Dexia would put into FSA ultimately, yes of course. There are limits to everything in this world. But we haven't reached that limit yet and by far. We believe that with the provisions that we have taken on ABS we have adequately covered the legacy issue that we have there for the foreseeable future, even in a very stressful environment.

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The FP is actually not that much of a problem because of the liquidity situation we are having and because of our view on the underlying quality of the assets. It would just be, I think, silly to today let it go and crystallize this economic value that we still have in that portfolio. And again, we have run pretty stressful scenarios that we are comfortable with. So we think that we have adequately dealt with that.

Remaining in the industry, being clearly one of the leading actors in this industry, is something that we can put back into a larger context. And granted, there are uncertainties. What's going to happen with the ratings scale of municipal issuers is something where your bet is probably as good as mine, what is going to happen with volumes in the short term, what is going to happen with the market as such.

But I think we've been sufficiently long active in this market. We have sufficient experience collectively at Dexia and, as I say, to believe in some manner that there will remain for a long period of time attractive business to be done. And this will done probably in a changed environment, probably we'll have a bit more risk in the future that will have to be counterbalanced by conservative underwriting discipline and also by changed economic terms and pricing, which we see happening in the market at this point in time.

So we continue, as we said, to monitor developments in the market and to adapt our strategy to those changing environments. But we do believe that a refocused and centered FSA on muni, we have a winning value proposal, which is the best one to protect and develop value for our shareholders and beyond that, all other relevant stakeholders.

JP Lambert - ***Keefe, Bruyette & Woods - Analyst***

Thank you very much.

Operator

Thank you. The next question we have comes through from the line of Guillaume Tiberghien of Credit Suisse. Please go ahead with your question.

Guillaume Tiberghien - ***Credit Suisse - Analyst***

Hi it's Guillaume Tiberghien, Credit Suisse, I've got two questions which actually do not relate to the problems currently but more trying to monitor and to have a vision of Dexia a little bit in the future. The first one relates to the underlying revenues that you published for Q2 of 1888, excluding FSA. Could you just clarify again what is sort of a bit extraordinary in that line what you would qualify one-off figures? There's quite a few restatements in the various documents that you've provided.

And secondly, if I project myself in five years, FSA, will it be a bank with the same amount of capital because some will have been released on the asset-backed securities doing 20% return on equity? Is that a fair way to look at it? Or what is your vision of FSA in five years?

Rembert von Lowis – ***Dexia - Member of the Management Board***

For the first question, I'm not totally sure I understand the question, but what I understand is that you ask what is the contribution of the volatile items in the revenues of the second quarter.

The volatile items being the reflection of the changes in the spread environment, which all will sum up to zero. So the contribution was positive in the second quarter and the order of magnitude, I will just give you an order of magnitude of this contribution, it is EUR80 million pretax in the second quarter.

Guillaume Tiberghien - ***Credit Suisse - Analyst***

Thank you. Thanks.

Axel Miller - ***Dexia - CEO***

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Your second question is a fair question, Guillaume, projecting our self in the future. Clearly we are comfortable with FSA being a specialized player on the municipal finance market. It's not only the United States, by the way, on top of the rest of the world.

And as we've seen over the last years, the international expansion of the business has been quite strong. And as Alain mentioned, there are a number of combinations where a bank execution combined with a debt execution, possibly insured by FSA, has been proving to be winning in a number of transactions.

Clearly we want to have ultimately the same level of return on equity invested in FSA as we have in other parts of the group. So we will be, sorry Bob for that, but we will be as demanding for FSA as we are for our other activities.

And clearly we would not be satisfied with a situation where over time there would be a combination of factors which would make the level of capital that would need to be deployed to support the activities in the market, having certain characteristics, would sort of be in the very low teens or the high single-digits. This is something that we would not be comfortable with at this time over the long term.

If that were to happen, you would have a difficulty finding fresh capital to invest in that industry for the long term. That's also what we mean by monitoring development, but that's more sort of a medium- to long-term issue. We'll need to see how the market adapts to do that. And we'll then take the necessary consequences. But again that is for the medium to long term.

It seems to me that if there is a value proposal, as we believe is something which is attractively priced from a return on capital perspective. And I said it already but I'll repeat, will be as demanding for the level of return on the capital deployed at FSA on the long term as we are with other parts of the banking business at Dexia, as we should.

At this point in time, clearly the level of ROEs that we get on transactions, we are effectively working. And I don't see that happening in the short term, for sure. It's a level, which is way in excess of 20%. This is actually the very good time to be out there, like under current circumstances. So we'll see, rendez-vous in the summer of 2009.

Guillaume Tiberghien - ***Credit Suisse - Analyst***

Over time, should we expect the capital to remain stable at FSA with less, obviously, capital allocated to ABS and more to muni? Or should we actually expect FSA to run with lower capital as ABS mature?

Axel Miller - ***Dexia - CEO***

Well, clearly, at this point in time, the intended purpose of all the actions we take is to be able to redeploy capital towards the muni activity. The FP decisions would be capital relief. That is to say, the ABS run off will, over time, as we mentioned, allow, over time, about 1 billion of capital to be deployed to muni.

So two things, can happen there. Either that capital can be put to good use, and in a way that structurally allows FSA to continue to be active in the market, or for the remainder, we'll see what we can do with that capital. If there is excess capital, then the answer is in the definition of excess capital.

Guillaume Tiberghien - ***Credit Suisse - Analyst***

Okay. Thanks.

Operator

Okay. Thanks. The next question we have is from the line of Manus Costello of Merrill Lynch. Please go ahead with your question.

Manus Costello - ***Merrill Lynch - Analyst***

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Hello. I have a couple of questions please, based around the other and temporary disclosure, which you've given. First of all, I think probably to Bob. If I look at the marks you've taken through the P&L, the majority of it seems to be coming on the Alt-A RMBS portfolio. I just wondered why has the Alt-A portion of that been recognized through the P&L more than the rest?

And why have you not, if you're seeing significant impairments in that area of Alt-A, not taken reserve built against your insured Alt-A portfolio where you've specified that you've actually seen internal downgrades?

And then secondly, to Dexia management more generally, this category of other than temporary impairment, I wondered how you're going to treat it at a Dexia group level, both specifically the charge, which FSA has taken. Will you be ignoring that for IFRS purposes?

And more generally, you've got $7 billion of temporary gains against equity of $8.6 billion at the moment and the market is understandably concerned that some of that might be regarded as other than temporary. So I wondered if you could update us about your thinking on that.

Axel Miller *- Dexia - CEO*

Okay, Bob, do you want to take the first question?

Bob Cochran *- FSA - CEO*

Yes. I'd be happy to. So the first question is the Alt-A first lien exposure. We have about $1.7 billion of that in the insured portfolio and haven't taken significant reserves there. We have about 2.1 billion in the FP portfolio.

Those are securities.All those were structured or bought at AAA levels, those that were bought in the open market for the FP portfolio, and we structured and ensured transactions at the AAA level in the financial guarantee portfolio.

We've applied exactly the same metrics and assumptions in evaluating all of these transactions.Perhaps the answer is that the transactions where we were in full control of the whole transaction and did the underwriting in advance, were stronger than the transactions than the transactions that we were buying at AAA levels, uninsured in the open market.

Alt-A transactions generally were structured with 10 to 12 points of expected break-even loss protection over time,. As pre-payment speeds have slowed down, that's adverse in one respect, in terms of potential future cumulative loss, but it's positive in the sense that the transactions have 1.5 points of average spread margin, which is the first line of defense in terms of absorbing loss. And so as the deals get longer, the amount of what we call break-even protection moves up closer to, say, 20%.

The problem, of course, that we're seeing, with the Alt-A product across the entire market is that the "Alt-A borrower," turns out to be more like a subprime borrower than a true closer-to-A borrower and the transactions were structured with less protection than a true subprime transaction.

So we are, as I said, running exactly the same stress assumptions, with actually the peak defaults continuing into 2010, because of the longer time period that it takes for delinquencies to evolve all the way through the foreclosure process. So actually, with our first lien product, we're assuming the market remains negative and foreclosure rates remain high into mid-2010 and that we don't sort of return to a more normal market environment and default realization environment until 2011.

It's a quite serious, strong assumption. It just turns out that the transactions that we we structured internally can withstand that assumption, and some of the Alt-A transactions, not by any means all, are performing at a level where some amount of loss was found in each of those transactions and then, of course, we have to take the full mark-to-market on those securities to the income statement.

Manus Costello *- Merrill Lynch - Analyst*

But just to understand, you've taken and accumulated OCI of $768 million, or have you taken $768 million on the Alt-As and you've now recognized half of that through the P&L. And I just want to understand why that is 50%?

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Whereas, if I look at the subprime RMBS, for example, you've only taken 15% of that as other than temporary. It's a pretty big discrepancy and it comes through as a pretty big number if you were to adopt the same other than temporary approach to the subprime as you have to the Alt-A. I'm looking at slide 179 of the FSA presentation here.

Bob Cochran *- FSA - CEO*

Okay. Well the subprime transactions have really almost no ultimate loss exposure. A few transactions that are sort of the weak stragglers have demonstrated some level of exposure and we've taken charges for those.

The Alt-A transactions end up having a higher severity of loss, in the cases where impairment is found, than the subprime do. Because they,the subprimes, have dramatically more protection and spread.

Manus Costello *- Merrill Lynch - Analyst*

Okay. I'm just trying to get comfort that we're not going to come back in Q3 and find that you've decided actually to recognize 50% of the subprime through the P&L because obviously that has a material impact on capital.

Bob Cochran *- FSA - CEO*

50% of the subprime? No -- well, I don't think so. Of course, none of us know exactly what the future holds, but the subprime transactions generally started with 25 to 27 points of protection from a combination of hard overcollateralization and excess spread. And as they season over time, that amount of protection generally grows.

So we're really finding that other than the occasional straggler transaction in the FP portfolio, and really in none of our insured portfolio, are we seeing subprime difficulties that would challenge those levels of protection.

Manus Costello *- Merrill Lynch - Analyst*

Okay. Thanks. And then the more general question on how Dexia's thinking about other than temporary?

Rembert von Lowis - *Dexia - Member of the Management Board*

First, there has been no restatements between the impairments that have been made at FSA level and their inclusion in Dexia's consolidated accounts. In other words, the assets that have been impaired at FSA are also impaired at the consolidated level and the amount of impairment is the same, with the same breakdown between operating and non-operating revenues, of course, at Dexia and FSA. So the shift there is no difference.

As you know, excuse me, there is nothing like OTTI under IFRS and the fact is that the assets that have been impaired at FSA during the second quarter are assets that we consider will incur losses, economic losses, over the lifetime and therefore the same assets would also have been impaired under IFRS.

Now your question, if I understood it well is, is there going to be such kind of OTTI impairments at Dexia? And the answer is, no, there haven't been, during Q2. I don't expect such impairments to take place in Q3 at least because the quality of the portfolio, both the credit spread portfolio and more generally the bonds that have been acquired in the framework of the public finance business, are of very high quality and we have not identified assets for which we believe that there are going to be economic losses. So no OTTI or no impairments of any kind in Q2. And hopefully, but we don't believe it, no impairments at least in Q3 and more probably the rest of the year.

Manus Costello *- Merrill Lynch - Analyst*

So sorry, just to understand this. $678 million of OTTI, which FSA is taking through its P&L will not be taken through the P&L at Dexia. Is that what you're saying?

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Axel Miller *- Dexia - CEO*

No, no, no. No, no. The impairments that have been taken by FSA have also been taken by Dexia.

Manus Costello *- Merrill Lynch - Analyst*

Okay. Okay. That's clear. Thank you.

Operator

Thank you. The next question we have is from the line of Christophe Ricetti of Natixis. Please go ahead with your question.

Christophe Ricetti *- Natixis - Analyst*

Hi, everyone. I have several questions. The first one to follow-up on what Bob had just mentioned on the U.S. subprime exposure. If I understand correctly, you consider that in the FP portfolio you will see $68 million economic losses on the portfolio, which is around $7.6 billion. So that means that today, you consider that the protections are fully covering the losses? So this is my first point.

The second point, more general question regarding what is considered as counterparty risk for the monolines by all the European and also some U.S. banks. I don't see in your statements something that could be treated as counterparty risk. Is it considered in the FP impairments?

And the last questions are regarding what S&P has just released. It seems that their test on the Helocs and the closed-end seconds portfolio is much higher than yours. Do you have an idea of why? Thank you.

Axel Miller *- Dexia - CEO*

Bob you get the first shot?

Bob Cochran *- FSA - CEO*

Yes. Let me start with the subprime. The answer to your question is essentially, yes, that's correct. It is a large number in the FP portfolio, but as I mentioned, the transactions were all bought at AAA levels, they all had substantial amounts of protection to the AAA level and most of those losses that we're showing as impairment are generated by three specific transactions that were bought in the FP portfolio, that were guaranteed by FIGIC and unfortunately FIGIC was insuring subprime transactions at the BBB level. So the underlying transactions didn't have as much protection.

And we're looking through the FIGIC insurance to see the underlying risk and taking a charge in relation to that. The rest of the transactions seem to be quite resilient. Of course delinquencies are high. Losses are high. But they're not exceeding the 25 or 30 points of cumulative expected loss in many cases. The third question related to HELOC losses and the comment made by S&P on their expected, and I think they were clear.

But those are AAA stress losses. And, if you recall, Moody's did the same thing in their statement a week or so ago. Their methodology is always to have an expected case and then a AAA stress. A AAA stress is obviously, marked in an environment like this, the expected stress is getting closer to the AAA stress. But the number that S&P cites is what they've put into the model essentially to support a AAA level of comfort with the loss potential in that portfolio.

Christophe Ricetti *- Natixis - Analyst*

And can the monolines can support the risk?

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Bob Cochran - ***FSA - CEO***

So the question there, I'm sorry, is what sort of impairment or assumptions do we make involving other monolines where we have counterparty risk in the FP portfolio?

Christophe Ricetti - ***Natixis - Analyst***

Yes.

Bob Cochran - ***FSA - CEO***

We have essentially evaluated every underlying transaction, using the same assumptions that we've used to evaluate the direct and uninsured exposures. Where we've found that there is potential loss by that measure, then we take a haircut on that amount based on the rating and probability of repayment by the insurer.

So if the insurer is still A-rated or better, we assume that they are going to be capable of making the payments. And for the non-investment grade insurers, we discount that probability in order to reach an impairment number.

Christophe Ricetti - ***Natixis - Analyst***

Speaking of figures given by all of the banks, it seems that for all the non-investment grade insurers, loss rate could be around 90% for counterparty risk. Are you taking that kind of figure, making your calculations?

Bob Cochran - ***FSA - CEO***

No, we're not taking that big a haircut and I think the reason the banks are doing that is that the exposures they have are counterparty on ABS CDOs, which have two structural characteristics that probably justify that discount.

One is that the final claim payment is not due for 20 to 30 years. So there's a present value in effect. And secondly, there has been already several, in part because of the long present value effect, there have been some settlements that have been at relatively low percentages on the claim. Although, on saying that, I note that yesterday, Ambac apparently settled a claim at 850 versus $1 billion negative mark. Is that right

Unidentified Company Representative

Yes, $1.4 billion.

Bob Cochran - ***FSA - CEO***

There was a total of $1.4 billion of notional exposure. We don't know exactly what the true loss severity might have been or was viewed as, but we know that Ambac, I think, had that exposure on its books at $1 billion and they settled for $850 million. So in that case, the exposure couldn't have been greater than $1.4 billion and therefore the settlement amount was actually greater than 50%.

But nonetheless, the ABS CDOs that was, I believe, for CDO-squared transactions. So it shows you that there can be a fairly significant and wide range of potential recovery, depending upon the underlying structure. And if you have a claim that's not realizable for 20 years or more, from a bank's perspective, getting something today, even if it's only 10% of the perceived risk, might be a fair settlement.

Christophe Ricetti - ***Natixis - Analyst***

Just a very quick follow-up, if I may, you are making this stress test on the HELOC insured portfolio on the $4.5 billion, which is around 50% of the total, if I am not wrong. Why are you considering that the rest is okay in terms of risk?

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Bob Cochran - ***FSA - CEO***

The other transactions are performing, well not exactly, as we had anticipated. But they are showing themselves to be the kind of mortgage product that we expected. They are essentially bank-originated transactions. The current delinquency levels are not even sufficient to exceed the current available spread.

So those transactions are continuing to build credit protection at a time when others are exceeding available spread and actually suffering current losses. Those are seasoned transactions that are looking quite good at the moment. There's no reason why that would change.

Christophe Ricetti - ***Natixis - Analyst***

Thank you very much.

Bob Cochran - ***FSA - CEO***

Yes.

Operator

Thank you. The next question is from the line of Francesca Tondi of JPMorgan. Please go ahead with your question.

Francesca Tondi - ***JPMorgan - Analyst***

Hi. Good afternoon. I also have a couple of questions. And if you don't mind going back to the HELOC portfolio again. Referring particularly to some of the underlying assumptions that you've made, with not just the default rate, but also how the transaction is structured, going to slide 199. I see the actually, what is happening in the FSA portion of the future losses is increasing.

If I'm looking at the Q1 percentage it was 15%. It’s gone up to 30%. To what extend is this a risk of increasing further even on the existing transactions? What kind of scenario are you running here as in the portion covered by the transaction, going down further, which we have seen already, from 65% to 50%, referring to that?

Also, again, you've just commented on S&P. Moody’s also seems to be running higher stress scenarios. Can you clarify what is the difference between what have you taken in the stress scenario and what Moody's have been taking for a stress scenario?

In particular, you mentioned that Moody's, and I think, in Dexia slide number nine, talks of $600 million stress test losses on the financial product portfolio. How come you're actually only taking $316 million? What is the difference between the two?

I also wanted to clarify your statement, just earlier, that increasing the default rate by another, each month, would cost $100 million more in pre-tax provisions. To what exactly are you refering here? Are these just HELOC or Alt-A as well and is it just insured portfolio or for the FP portfolio?

And then broadly, what is the situation with the remainder of some of the other asset classes, NIMs, the Option ARMs, also the U.S. Autos portfolio. Can you give us visibility on how these portfolios are performing in wrapping up this quarter again? Thank you.

Bob Cochran - ***FSA - CEO***

Okay. I may need your help to keep me on track….

Francesca Tondi - ***JPMorgan - Analyst***

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… yes…

Bob Cochran - ***FSA - CEO***

… in answering all of those questions. We really have tried to address all of these -- all of those questions in the slide program that we've posted, but I will try to address them as we go along.

First, the slide 199, which is the one you referred to, where we show how the structure helps to withstand the gross losses that go through a HELOC transaction. And it's important to note that the first line of defense is the available spread of about 400 basis points per annum and month-by-month, quarter-by-quarter, that spread is still there and essentially withstands or mitigates the first 4% of charge-offs that occur in that month. And then charge offs in excess of that are taken by the remaining sources that we described here.

So as you get to higher and higher loss assumption modeling, then the amount of loss that exceeds the spread and exceeds the draw rate from additional draws made by, generally Countrywide or the lender, the amount of losses that spill over and are then the responsibility of FSA increase, just as the total losses have increased. Now the percentage of those losses increased for FSA.

So that's the primary reason. The critical assumptions are the constant default rate, or CDR. We essentially have five to six months of that pipeline already in view because the loan can't be charged off 180 days from now unless it goes into delinquency today.

Actually, current observations since the end of the first quarter has been level to down, in terms of new delinquencies. Up a little in June, but down significantly in July. So, overall, consistent with our assumptions at the end of the first quarter.

But we've essentially reevaluated our reserves based on a view that the negative market environment is going to continue for a longer period of time. The other thing that we did in structuring these reserves, but is ultimately an important variable, is the percentage of draws that will be funded by Countrywide. If we reduce those and assume that they will run down to, I think, a 1% level over the next six months.

So there's really not much wobble left in that assumption because we're pretty near zero as it stands. And at some point, there are some loans that Countrywide is absolutely going to have to fund. So I hope that answers the first part of your questions. The second would be --

Francesca Tondi - ***JPMorgan - Analyst***

Yes. What is the likelihood then that the proportion or the portion of the losses covered by the transaction may be going down even lower, to the 50% of the pie that it is now?

Bob Cochran - ***FSA - CEO***

Well, to the extent that default rates were to increase to a higher rate than currently observed, which can't really happen for next six months. But if incoming delinquencies were to start to get worse and the CDR got higher, then our percentage would go up.

Francesca Tondi - ***JPMorgan - Analyst***

Yes.

Bob Cochran - ***FSA - CEO***

Interestingly, if the default period extends, that would have a less dramatic adverse effect because we would just simply be having a longer period when we're relying on the available spread. But there is also a certain amount of recovery from future spread embedded in our assumptions.

It'll be six to nine months before we could get to a point where we would have additional information that could be materially adverse to the reserves that we're taking now. That would be our expectation.

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Francesca Tondi - ***JPMorgan - Analyst***

Yes. I was actually looking also within that. Of the portion that is covered by the present value set of reinsurance, which could that instead seem to have gone up. How is that, that the value of reinsurance has actually gone up?

Bob Cochran - ***FSA - CEO***

The reinsurance is quota share reinsurance with the FSA exposure. So, as our percentage of the loss goes up, the reinsurer percentage goes up in exact proportion.

Francesca Tondi - ***JPMorgan - Analyst***

As part of the contract?

Bob Cochran - ***FSA - CEO***

Yes. Exactly.

Francesca Tondi - ***JPMorgan - Analyst***

Okay. And this is not obviously with critical monoliners and difficulties?

Bob Cochran - ***FSA - CEO***

Yes. Well, actually we don't have too much exposure to the monolines that are downgraded in this HELOC division.

Unidentified Company Representative

We have one FGIC.

Bob Cochran - ***FSA - CEO***

One FGIC reinsured transaction. Okay. So it's a fairly small exposure.

I did want to respond to a second element of your question, now --

Francesca Tondi - ***JPMorgan - Analyst***

Yes?

Bob Cochran - ***FSA - CEO***

You had questioned earlier to Claude was what would be the impact of extending six months? In the HELOC and closed-end second category alone, the answer to that question would be a little less than what Claude said, but it's the biggest component thereof.

And beginning with the extension six months from now, that incremental loss would be around $60 million per month of the extension of the exposure. But the exposure will be going down, so a constant default rate against the declining exposure would be expected to decline. So the six-month extension would be, andthese are really rough estimates, in the range of $300 to $360 million …

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Francesca Tondi - ***JPMorgan - Analyst***

…Okay…

Bob Cochran - ***FSA - CEO***

… pre-tax from the evolution.

Just to emphasize the nature of our underlying assumption here, that would then mean that -- well let me just say, the current reserves, if you think about it, we're saying that mortgage obligors who have paid these mortgage rates, these mortgage obligations constantly for three to four years, would be the new defaulting parties beyond the end of our current stress scenario.

So we believe, pretty strongly that, at some point, the people who are able to pay and willing to pay, have demonstrated their capability and the weak obligors have been sorted out of this pool.

Francesca Tondi - ***JPMorgan - Analyst***

And I just want to make sure that I understand this correctly. So with your current assumptions, you're already eating into a lot of the most recent vintages? Is that what you're saying?

Bob Cochran - ***FSA - CEO***

Yes.

Francesca Tondi - ***JPMorgan - Analyst***

Okay.

Bob Cochran - ***FSA - CEO***

But further our assumptions assume that we'll return to essentially a normal rate of default for this product by the summer of 2010. And these loans were generally originated in 2006 and 2007.

So they will have by then --

Francesca Tondi - ***JPMorgan - Analyst***

… Right …

Bob Cochran - ***FSA - CEO***

… already have been paying for somewhere between four and five years.

Francesca Tondi - ***JPMorgan - Analyst***

Yes. I understand.

Bob Cochran - ***FSA - CEO***

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Okay? Now I know there was another element to your question.

Francesca Tondi - ***JPMorgan - Analyst***

Was the comparison with the Moody's stress test ..

Bob Cochran - ***FSA - CEO***

Yes,

Francesca Tondi - ***JPMorgan - Analyst***

… for the HELOC because I remember recent comments saying Moody's had actually come up with higher potential projected losses? And also the Moody's stress test on the financial product portfolio of a potential $600 million loss versus the $316 million that you've taken?

Bob Cochran - ***FSA - CEO***

Well I think the answer to both of those is the same as the answer I gave earlier. Moody's doesn't necessarily share with us their input assumptions and their modeling. But when they produce a number like that, that's their AAA stress number.

We're not really permitted or expected, under U.S. GAAP, to set our reserves at a AAA certainty. We're setting our reserves at a reasonable expectation. We hope we've made that expectation conservatively. But a AAA stress number is clearly a different number and that's the reason for that difference.

Francesca Tondi - ***JPMorgan - Analyst***

Okay. I am -- I think those were all my own -- yes, I was lastly asking also on the option ARMs and the NIMs on the U.S. autos, how are the projected losses behaving there versus your expectation? What are you seeing there in the recent months?

Bob Cochran - ***FSA - CEO***

Okay. Well, first of all, the U.S. autos, are performing well. Delinquencies are up a bit, but those transactions can withstand quite a bit of deterioration and they have a very short average life. The average life on the remaining portfolio is now less than a year.

A substantial part of it is cross-collateralized, so that any weak transaction would be supported by stronger and more seasoned transactions. We would expect that portfolio to really rapidly disappear from our risk profile.

And then option ARMs, the mortgage portfolio is basically made up of, primarily, subprime being the big one. You really don't see any evolution there that's causing us any concern. We have talked a lot about the HELOCs and closed-end seconds. Then we have Alt-As and option ARMs.

The Alt-As and option ARMs we're subjecting to the same analysis we have described and the difference with the option ARMs, of course, is that they can negatively amortize and then at a certain point, the loan has to be recast so that the negative amortization becomes a part of the principle repayment and it has to start to amortize, which can cause payment shock.

And that's what has people concerned about that product and its future performance. The important thing to note is that all of our transactions, again, were structured originally at AAA levels and the re-amortization points for those transactions won't come until 2010 through 2012.

So there's quite a bit of time yet before the reset and it's just too early to tell. We won't really know what the mortgage shock or payment shock effect of that will be until three or four years from now, by which time we'll be in a very different economy.

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There will be significant pay down of the portfolio. Also we would reasonably anticipate that these are exactly the kind of borrowers who the various federal programs that are being set up, would be targeted for. People who can afford to make reasonable payments on their homes, but can't really handle a payment shock.

Francesca Tondi *- JPMorgan - Analyst*

Thank you.

Bob Cochran *- FSA - CEO*

Yes.

Operator

Okay. Thank you. The next question we have is from the line of Sabrina Blanc of Societe Generale. Please go ahead with your question.

Sabrina Blanc *- Societe Generale Securities - Analyst*

Hello. Good evening. I have three questions. The first one is regarding the margin that you mentioned recently, on the municipals. It showed that we are in a very specific environment today. What do you expect in a more normal environment? And the second question concerning also the ABS products. If we could have a contribution in the past of this product for FSA?

And the last question is more a strategic question. I know that you don't share this idea, but nevertheless, this year, if the U.S. government changes its mind and says that we should have a AAA rating on municipals, what could be the business model of FSA? What could be the strategy of the group in this context? And what could be your answer to this move?

Axel Miller *- Dexia - CEO*

Bob, do you want to take the first two ones?

Bob Cochran *- FSA - CEO*

Okay. I'll take that. Actually, the first one and the third question sort of work together. Because we have to think about what the future environment will be. And while I talk about this, I would ask you to take a look again at slide 18 that Alain spoke of. And while I look at this slide, I wonder myself, and with my colleagues, what is the expected future normal margin environment?

The environment we operated in from 2000 through early 2008 was a relatively narrow spread environment with five to sometimes as many as six or seven AAA financial guarantors competing in the U.S. municipal space. In general credit spreads were tight. I think the competition among the insurers made municipal spreads even tighter than they might have been naturally in the absence of financial guarantee insurance.

So what will be normal as we go forward, we certainly plan for FSA to be at least one participant in that AAA market. And how many others there will be, it's hard to know at this moment. But I am pretty confident there won't be more than three or four.

The rating agencies are very attuned to the destructive aspects of the potential impact of high levels of competition. I think they're going to be very careful about the number of AAAs that they think qualify in this market.

So if you look at those margins that you see today, we think, based on our own internal return on deployed equity model, we think we've been averaging well over 20% in return on equity, I'd say well over, 23%. But that's over for us.

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In the long term, I would think natural economics would suggest to me that a business of this nature with low risk and, we think, fairly high attractiveness, maybe is more naturally a 16% to 20% ROE business. But we're certainly going to do everything we can to optimize the economic equation for the shareholder and I think that something at least in the high teens should be sustainable.

Regarding AAA, the creep toward AAA ratings: I guess I'm just not a believer that that's going to happen any more than it already has. For general obligation credits of states and counties and perhaps some large cities, most are already rated AA, a few that aren't may become AA.

But there is still an enormous world of much more complex revenue generated and revenue secured transactions, various types of tax revenues or user fee revenues that the individual investor is not very well equipped to evaluate. I think there's a real value to our service there.

And secondly, we're entering a period where there is going to be considerable economic stress on U.S. municipal issuers. We're already beginning to hear about budgets that don't balance. Cities and other issuers having to make hard choices between providing the services that their taxpayers want and increasing taxes or lowering those services. So I think there will be, if anything, downward pressure on ratings and upward pressure on spreads in the environment, at least for the next several years.

Sabrina Blanc - ***Societe Generale Securities - Analyst***

And would the contribution --

Axel Miller - *Dexia - CEO*
On the ABS contribution?

Sabrina Blanc - ***Societe Generale Securities - Analyst***

Yes, please.

Axel Miller - ***Dexia - CEO***
On the results? Bob?

Bob Cochran - ***FSA - CEO***

Yes. Shall I respond to that? I believe it was -- the question, just to be sure, because you were breaking up a bit. The question is what has been the contribution of ABS to our earnings and what impact will the run off have over time?

Sabrina Blanc - ***Societe Generale Securities - Analyst***

Yes. Please.

Bob Cochran - ***FSA - CEO***

Earned premium from asset backs over the last couple of years has been roughly 50% of our earned premium. Pretty close to exactly, plus or minus a little bit. It's not 50% though of our total economics.

Because one of the wonderful things about thethe U.S. municipal finance business is that we collect 100% of the premiums upfront. So we build up an unearned premium reserve, which you'll see on our balance sheet, which is real cash. It's not a receivable.

And so the components of earning on the public finance side are a little bit taking one-thirtieth or so each year of the UPR against the long life of the municipal portfolio, but it's also the investment earnings on the unearned, and untaxed until it's earned, municipal premium. So the municipal business is already a bigger factor in our total economics.

The asset-backed business will run off pretty quickly, as we said, and the premiums will go with it. So one of the things we will be doing as we go forward is breaking that out for investors, so you can see the health of our going-forward franchise and the economics of the run-off of the ABS business.

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And in fact, if you look at our -- if you look at our slide program that we've put on our website and you look at our press release, you'll see that the public finance-related earned premium for the quarter, for the second quarter, was up 24% when you exclude refundings and up, I think, 16 or 18% for the first half of the year, which is evidence of the robust nature of our new originations in the first half.

Axel Miller *- Dexia - CEO*

Sabrina, by the way, just to add a little something to what Bob eloquently said, as he mentioned, and as I mentioned earlier, we do believe that there is a space for credit enhancement in the public finance markets going forward.

To take the hypothetical case that rating agencies would suddenly decide that all 30,000 issuers would deserve a AAA rating. Essentially removing all economic metrics out of this business, hypothetically, what's the downside to Dexia, assuming what we assume, that FP and ABS are adequately covered.

The downside actually is fairly limited in that the capital that would be available for normal public finance work, would be redeployed elsewhere. So it wouldn't be used for public transit business, it would buy it back by definition. It would be sort of slowing down to nothing.

It's not the case that we envisage because I think there is a very compelling series of arguments to show that there should be a great enhancement market going down the road, with the interesting economics for us.

But again, that we will see once things have adapted and adjusted. That's something where we will, I think, have more clarity on a year or two years down the road. But in the base case that we are following, I think there are still lots of interesting things to be done.

Sabrina Blanc *- Societe Generale Securities - Analyst*

Okay. Thank you very much.

Operator

Thank you. The next question we have comes from the line of Pierre Flabbee of Landis Bank Kepler. Please go ahead with your question.

Pierre Flabbee *- Landis Bank Kepler - Analyst*

Good afternoon. I have a couple of questions regarding the financial product portfolio still. First, what would be the ideal size to which you expect to reduce it? And what could be the timetable to achieve this goal?

And I have an additional question. I heard that the gap with the market value of this portfolio was $4 to $5 billion. Is it after the $700 million depreciation, which has been taken in Q2?

Axel Miller *- Dexia - CEO*

Bob, do you want to take this one?

Bob Cochran *- FSA - CEO*

Okay. The ideal size for the FP portfolios one that, at a minimum, is supported only by municipal guaranteed investment contract sources, which is a market that has been in existence for a long time and is one that I think will not be cyclical.

Municipal issuers that are issuing bonds to fund construction projects regularly look for high quality deposits that have some degree of flexibility that can be drawn down as construction expenses are incurred, there's several other purposes, reserve funds and the like and generally in the past,

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at least, we've been able to realize funding from that market at sub-LIBOR levels. I would think we'll want to continue that part of the business and that's about half of the available funding that you see on the current balance sheet.

So something under $10 billion I think would be where we're headed. The average life of our liabilities overall is about 6.6 years. So it's going to take awhile for that number to come from $18 billion down to, say, $9 billion going forward.

To answer your second question, the numbers referred to in terms of negative mark-to-market at -- I think it's actually $4.3 billion. And Axel's remark was just that if you actually had to try to sell the entire portfolio at once, you'd probably put pressure on the -- on fair value pricing, but $4.3 billion is the current negative mark and that is inclusive of the billion that went through the income statement, of which $300 million was what we estimate the real economic damage, the other $700 million being a mark that we believe will return to zero. So by definition, since we haven't compared anything else, we think all of the rest will return to zero as well.

Pierre Flabbee *- Landis Bank Kepler - Analyst*

I have just a follow-up. I'm curious to know what would the $4.3 billion look like at the end of the first quarter of this year?

Bob Cochran *- FSA - CEO*

I think it was $3.9 billion, Joe?

Joe Simon - *FSA-CFO*

$3.8 billion

Bob Cochran *- FSA - CEO*

$3.8 billion.

Joe Simon - *FSA-CFO*

It was actually described on slide 179.

Bob Cochran *- FSA - CEO*

You may not have our slide program in front of you, but 179, if you just take a note and look at that later.
It should break that out for you.

Pierre Flabbee *- Landis Bank Kepler - Analyst*

Okay. Thank you very much.

Bob Cochran *- FSA - CEO*

Yes.

Axel Miller *- Dexia - CEO*

Pierre, just maybe in addition, on the side of FP, we do like muni funding. We actually -- this is an activity that we have in other parts of the banking group. We do like muni funding as long as it's well invested and that we don't have the kind of situations we're having now where liabilities can be accelerated.

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So to that extent, if you look at the contribution of muni funding to the global side of the FP portfolio, it's about 40% of the current funding now, so you can apply that to the global side of the portfolio and that gives you some indication as to the level of reduction of that portfolio going forward.

Pierre Flabbee - ***Landis Bank Kepler - Analyst***

Okay. Understood.

Operator

Okay. Thank you. The next question we have is from the line of Mr. Barry Cohen of Knott. Please go ahead with your question.

Barry Cohen - ***Knott Partners - Analyst***

Yes, gentlemen. I actually have several questions. So -- what I'm going to try to do is I'm going to ask them once at a time just to make it easy for everybody. Is that okay?

Unidentified Company Representative

Sure.

Barry Cohen - ***Knott Partners - Analyst***

Okay. Great. Thank you. Can you tell me the $300 million of additional capital, which you put into FSA, was that cash? Is it equity? Were you issuing kind of intercompany debt and that's being used as kind of like double leverage?

Rembert von Lowis – ***Dexia - Member of the Management Board***

It could be either cash, it could be also some form of hybrid capital. We have not decided yet what kind of contribution it will be. But the equivalent of cash would be $300 million.

Barry Cohen - ***Knott Partners - Analyst***

Okay. And could you just kind of run us through? I mean, you kind of were like suggesting various numbers and we didn't get any hard numbers. What is -- at Dexia, what is the amount of equity at Dexia as it stands today? I know you have like, from what I could tell, like 4 or 5 different versions of what equity is. But could you give us kind of a sense of what that is?

Rembert von Lowis - ***Dexia - Member of the Management Board***

We have different versions of equity, like any bank, of course. Our tier one equity amounts to EUR13.8 billion. That's the regulatory capital, the regulatory Tier 1 capital, including hybrid capital and the hybrid capital accounts for approximately EUR1.4 billion of this EUR13.8 billion.

Barry Cohen - ***Knott Partners - Analyst***

Yes. And then you -- and what is -- what is common equity?

Rembert von Lowis - ***Dexia - Member of the Management Board***

What is common equity? I don't have the number exactly in mind. The amount of common equity?

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Barry Cohen - ***Knott Partners - Analyst***

Yes.

Rembert von Lowis - ***Dexia - Member of the Management Board***

8.6 billion is the total currently. Net wealth of the company, it's 8.6 billion. After deduction of the 7 billion accumulated OCI reserve. That's --

Barry Cohen - ***Knott Partners - Analyst***

Right. Right. I understand. Okay.

Rembert von Lowis - ***Dexia - Member of the Management Board***

That's your --

Barry Cohen - ***Knott Partners - Analyst***

And then I think you mentioned earlier that there was some -- a loss that was -- that you took through the P&L, but because it was already accounted for, I think in the OCI that it's not accounted for. Again, could you just kind of work me through that again? I want to -- I didn't quite hear it, my phone wasn't all that well.

Rembert von Lowis - ***Dexia - Member of the Management Board***

Okay. When an asset is accounted for, when a bond is accounted for, as available for sale, and when the market value, the fair value of the bond is below cost, the up fronts, the negative difference goes to a reserve, an OCI reserve, without going through the P&L. So it hits the equity, the common equity, without going through P&L.

Barry Cohen - ***Knott Partners - Analyst***

So basically you just recognize a loss, which you had already recognized through equity?

Rembert von Lowis - ***Dexia - Member of the Management Board***

Exactly.

Barry Cohen - ***Knott Partners - Analyst***

Is that what you were trying to say?

Rembert von Lowis - ***Dexia - Member of the Management Board***

Yes.

Barry Cohen - ***Knott Partners - Analyst***

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Okay. I just wanted to make sure I heard that correctly. Now I don't know if this is a technical issue, but given that you're essentially, as Dexia, guaranteeing, essentially, liquidity and the credit of the financial products portfolio, why are you not, from an accounting perspective, required to actually move that onto Dexia's balance sheet?

Rembert von Lowis - *Dexia - Member of the Management Board*

Barry, what we are going to do is we ensure that the risks, the liquidity risks, but also the counterparty risks of the financial products portfolio will be taken over by Dexia. But there are several ways to do so, to meet that objective. We can transfer the whole portfolio to Dexia. We can also establish some form of guarantees. And we have not chosen yet what would be the form under which Dexia will take over the risk linked -- the risks linked to this portfolio.

And once we have done that, the accounting impact could be different. If it's a transfer, of course, then all the assets will be booked at Dexia. If it's just a guarantee, it would have a different impact on Dexia's accounting.

Barry Cohen - *Knott Partners - Analyst*

And can you give us a sense in the quarter of like the level of covered bonds that you issued and what the impact of that was to your treasury group?

Rembert von Lowis - *Dexia - Member of the Management Board*

Pardon me. Can you repeat the question. I didn't understand.

Barry Cohen - *Knott Partners - Analyst*

What -- if I remember correctly, in the last quarter you mentioned that you were issuing covered bonds at a very attractive rate over LIBOR. And then you're essentially taking that capital and putting it back into the interbank market at a bigger spread. So I was wondering if you could kind of give us a sense of like how much of that activity took place this quarter?

Alain Delouis - *Dexia - Member of the Management Board*

Well as you know, we issued roughly two-thirds of our long-term spending through covered bonds, mainly French and German covered bonds in Europe. During the first half of the year, we have been a little bit in advance compared to the budgetary targets for the first six months, in terms of volume. We are around, I would say, EUR8 billion to EUR9 billion issues under AAA formats during the first half of the year.

In terms of spread, at the slightly increased margin, we're about between 8 to 10 basis points, both last figures. What I mentioned in my presentation is that on the asset side, the commercial margins on new production, have increased more than these eight to 10 basis points, so that at the end of the day, the margin has increased compared to last year.

Barry Cohen - *Knott Partners - Analyst*

Yes. Okay. Well I appreciate it. I look forward to the full outlook on the, I think it's the 29th. Thank you for your time.

Operator

Thank you. Your -- the final question comes through from the line, again, of Francesca Tondi of JPMorgan. Please go ahead.

Francesca Tondi - *JPMorgan - Analyst*

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Hi. For a very quick clarification. Can you give us an even rough breakdown of your OCI reserve for Dexia at the end of the quarter? Given you've given us a total amount of EUR7 billion negative? I don't seem to have seen in the presentation, but apologies if it's in one of the slides.

Rembert von Lowis – ***Dexia - Member of the Management Board***

Actually we were not really prepared to take questions about Dexia. We just wanted to give you an idea of the total net results of the group. And just looking at the numbers I have, so the total OCI reserve amounts to minus EUR7.0 billion, as we said. This is after tax.

Pre-tax, it is EUR8.8 billion in rough numbers and of that EUR8.8 billion, EUR8.5 billion is relative to the bond portfolio and the rest, there are some positive and some negative numbers, which relate to the equities, to the CTA, cash per head reserve and so on.

Francesca Tondi - ***JPMorgan - Analyst***

And then you can't break them down any further, the EUR8.5 billion fixed income part?

Rembert von Lowis – ***Dexia - Member of the Management Board***

At this stage, no. We will have more details in two weeks when we release Dexia results.

Francesca Tondi - ***JPMorgan - Analyst***

Okay. Thank you. That's fine.

Operator

Okay. Thank you. We have a late question coming through from the line of Jaap Meijer of Dresdner. Please go ahead.

Jaap Meijer - ***Dresdner - Analyst***

Hi. Good evening. A question about the increased exposure to the spread portfolio. Of course this exposure increased from 5 billion to 18 billion. If you transferred it to Dexia, I presume that will come into the risk weighted assets and therefore has a hit on the solvency ratio. How does it work if you actually give a guarantee of this size, the magnitude? Is it also reflected then in risk weighted assets for Dexia?

Axel Miller - ***Dexia - CEO***

It's not yet reflected in risk weighted assets. What is already reflected in the risk weighted assets is the 5 billion liquidity facility that has been extended to FSA. If we decide to transfer the whole portfolio, but this is not necessarily what we are going to do.

We said that this is not necessarily what we are going to do. What we said is that we would take over in the credit risks. The form of this transfer is not very clear to us. But if we were to transfer the whole portfolio, of course, it would increase the risk weighted assets at Dexia.

Jaap Meijer - ***Dresdner - Analyst***

By how much would that be?

Axel Miller - ***Dexia - CEO***

It would also be reduced as a consequence of the fact that the liquidity facility would be terminated.

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Jaap Meijer *- Dresdner - Analyst*

Right. But net-net, there's going to be -- it's going to decrease?

Axel Miller *- Dexia - CEO*

The net -- what is the net of that transfer? It would be, probably, of the order of EUR2 billion to EUR3 billion in euros, risk weighted assets.

Jaap Meijer *- Dresdner - Analyst*

EUR2 billion to EUR3 billion risk weighted assets?

Axel Miller *- Dexia - CEO*

Yes. Take that number as a rough estimate.

Jaap Meijer *- Dresdner - Analyst*

It seems very low for an EUR18 billion portfolio.

Axel Miller *- Dexia - CEO*

A little bit more than EUR120 billion risk weighted assets at the group level.

Jaap Meijer *- Dresdner - Analyst*

Yes, I know. You plug in $300 million in FSA, but there's absolutely no assurance this is going to be it. We have seen many companies plugging in more capital in their monoline insurance and then walk away at the end because it's getting too expensive, the rating agencies have been changing the models, the stress losses are ever increasing and also demanding more and more buffers.

So even though you would be exceeding the AAA requirements, I don't think there's any guarantee that you will actually maintain the AAA rating and S&P just downgraded the outlook and Moody's was already all negative, and I don't think they will change their minds. So can there be any assurance this is going to be it? Or is this going to be ever, ever increasing, this capital infusion?

Axel Miller *- Dexia - CEO*

Well I think FSA is in the business of writing insurance. I'm not. And I think we've taken a number of precautions to tell you that we are all working in an environment where visibility has been reduced, uncertainty has been increased, and in the summer of 2008, writing out assurance on such things is something that I think would be foolish to do.

What we have done was to go through a long process and a deep process of trying to ascertain all the options we had from the very radical to the very benign. What we are doing here, really, I'm convinced, is the right set of measures to preserve the value that we have still today to stay on the public finance market in the United States for all the reasons that we have been through on a number of occasions over this call. This is the view we have for the future.

Assurance, I can't give. If rating agencies, tomorrow morning, wake up and put everybody on AAA, that would be a new element. If tomorrow, we realize that the whole market is free to get financing without going through monolines insurance companies, that would be another set of events.

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Another scenario, which we find is much more probable is that there remain deep rooted causes for the ultimate investors in securities, which have been AAA enhanced so far by the monoline industry to continue to have an appetite for that. Forget that we've got lots of managers out there who want to have liquidity and risk analysis..

There are lots of reasons for us to help people who do not have the time or the will to do it. So that's dedicated thinking we are doing about all of this and this is why we believe that not only putting $300 million, but reinforcing and allocating the capital strengths of FSA to its public finance business is the good decision to take at this point in time. Now we are giving you all the elements of the equation. If you've got another idea about that, then that's a legitimate view and we would respect that, but it's not our view.

Jaap Meijer *- Dresdner - Analyst*

Yes, but I'm just afraid that Dexia shareholders will pay for the difficulties of FSA and it could be an -- it could be ever, ever increasing costs going forward. On the ABS insurance --

---

Axel Miller *- Dexia - CEO*

That's why we are trying to give you all of the elements of the reasons why. We have, today, about $8 billion of claims paying resources, which are sitting into FSA. We've seen lots of scenarios, where the amount of final losses are not even approaching that. That's one way to look at that.

The other number, which I think is interesting is $4 to 4.5 billion of adjusted book value, which is also sitting into the company. This is franchise value, which is really belonging to our shareholders. And we have to have a look at it.

Of course that can't be done at any cost and just by quote, unquote, if I am putting words in your mouth, shouldn't do pouring good money after bad. But that's not at all how we view this situation. We do --

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Jaap Meijer *- Dresdner - Analyst*

No, I'm aware of this.

Axel Miller *- Dexia - CEO*

We do think we are adequately dealing with certain legacy things and that we are redirecting capital strengths where it ought to be, i.e. in public finance, which happens to be core strategy for Dexia.

Jaap Meijer *- Dresdner - Analyst*

Has it crossed your mind to actually hive off the ABS insurance into a trust? And what would have been the potential cost to actually just get rid of the whole exposure?

Axel Miller *- Dexia - CEO*

We've looked at a number of structures and I think lots of people who are in much more difficult situations than FSA is at this point in time have looked at lots of structures. I'm not going to belabor on all the things we have looked at because I think it would be a loss of time. But essentially, this is an alternative that we are not looking at. Because economically it makes very little sense at this point in time.

Jaap Meijer *- Dresdner - Analyst*

How much charges would you have to take for that? So to rationalize your utilization, to actually continue? Or to put it in any way in the run off? How much losses would you have prevented by keeping it, actually, what you're doing now? Instead of hiving it off?

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Axel Miller *- Dexia - CEO*

I'm trying to understand your question there.

Jaap Meijer *- Dresdner - Analyst*

Well the option you actually put it in run off? The ABS insurance portfolio. But the other option would be just to hive it off into a trust and then plug in more capital. So what would be the potential costs for that decision? So what's your -- but it must be more attractive to keep it on your books rather than to hive it off?

Axel Miller *- Dexia - CEO*

Well the short answer is this is something, which would then essentially create a split between policy holders on the structured finance side.

Jaap Meijer *- Dresdner - Analyst*

Yes.

Axel Miller *- Dexia - CEO*

And policy holders on the public finance side.

Jaap Meijer *- Dresdner - Analyst*

Yes.

Axel Miller *- Dexia - CEO*

And to my knowledge, except in very stressed and extreme situations, this hasn't been done so far in the industry.

Jaap Meijer *- Dresdner - Analyst*

But SCA has done this.

Axel Miller *- Dexia - CEO*

In other circumstances. Yes.

Jaap Meijer *- Dresdner - Analyst*

Well --

Bob Cochran *- FSA - CEO*

Axel, if I can jump in, I would say that we really can't abandon the policy holder obligations that we have directly. What SCA has done, Ambac has just done and others are trying to do with their Wall Street and other bank counterparties, on the really big toxic exposures, is attempt to negotiate a settlement.

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But we're fortunate and I think that the important distinction is that we don't have those exposures and that's why we're not going down the same road and I don't believe Dexia has; Although this is not a pleasant process to take these charges, they're really not at all of the same order or the same range of uncertainty, as the other companies.

And you can see that in all three rating reports. Even the Moody's negative outlook, is a more a systemic point and they're quite clear that they think the underwriting at FSA, though we made the HELOC mistake, is -- was substantially better and subjected the company to substantially more modest risks than the others are dealing with.

Jaap Meijer *- Dresdner - Analyst*

Yes. Yes. No, it's clear. On -- I'm a bit worried about the ratings of Dexia though. Because we've seen the outlook of S&P on the operating units of Dexia and particularly they highlighted the risk of FSA. With these measures, of course, Dexia's exposure to FSA has massively increased. So what does this imply for the ratings of the operating units of Dexia and what is implied for a potential capital increase at Dexia itself?

Rembert von Lowis - *Dexia - Member of the Management Board*

I think that it is correct to say that our experience with FSA, at least the losses incurred by FSA are taken to a consolidated level by Dexia and these losses are -- will not be changed in terms of capital increase or capital injection. So I --

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Jaap Meijer *- Dresdner - Analyst*

The guarantee has increased from 5 billion to 18 billion, so your exposure to FSA has massively increased.

Rembert von Lowis - *Dexia - Member of the Management Board*

The losses incurred by FSA, which are the problems that we are facing, which are worrying the rating agencies, a lot is incurred by FSA, are not changed as a consequence of this capital injection. And actually, these are the losses that FSA is incurring that pose problems. So I don't believe that this capital injection changes anything to Dexia's rating.

As you said, our own credit rating, which is AA flat for us, of course, has been put on a negative outlook as a consequence of the volatility generated by FSA's losses and again this capital injection changes nothing today.

Jaap Meijer *- Dresdner - Analyst*

Well, actually, they mentioned the 5 billion credit line as being one of the reasons why they reduced your outlook. So the increased exposure, again, I think this will be quite negative for Dexia itself. Which seems logical to me. But I know -- never mind. On the spread portfolio, how much is actually now underwater of the 18 billion? How much is the market value of this?

Rembert von Lowis - *Dexia - Member of the Management Board*

I don't know exactly. We are going to provide all the details about Dexia itself on the 29th of August.

Jaap Meijer *- Dresdner - Analyst*

Okay. But it's probably logical that it has widened from the $3.8 billion in the first quarter, I guess, due to the widening of the spreads in the second quarter?

Rembert von Lowis - *Dexia - Member of the Management Board*

I expect the number to have widened slightly, yes.

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Jaap Meijer *- Dresdner - Analyst*

Yes. All right. All right. Thank you.

Operator

Thank you. We return also to the line of Jean-Pierre Lambert of KBW. Please go ahead.

JP Lambert *- Keefe, Bruyette & Woods - Analyst*

Yes. Thank you. The -- a further question related to the capital requirements. It seems like the rating agencies are flagging to a potential change in the modelization and additional capital requirements for monolines in view of their leverage. That's the first question, what is your view on that and what will be your reaction?

And the second question is what is the risk of a change of supervisory regulation in the U.S., out of the insurance, if you want, arm into more of the banking arm? And would that have -- is that something, which is being considered in the U.S.? And what would be the consequences eventually, as you can see? Thank you.

Axel Miller *- Dexia - CEO*

Well in terms of changing the capital model requirements, I think most of the thinking, as high as it's been done, if you want my advice, not unduly as a result of most of the monoline companies having, today, a dual type of exposure on the municipal finance world on the one hand and on the ABS and structured finance world on the other hand.

Whilst we have, on our part, avoided the worst of that stuff, being CDO of ABS, we clearly haven't entirely stepped out of the mine field by insuring some of these Helocs and CES lien transactions and second lien transactions.

And I think to the extent that type of underwriting needs to draw -- to need certain lessons in terms of capital model requirements, I think that's the only thing that will be unnatural. That's also one of the reasons why going forward, we want to step away from that activity and continue to be active into municipal finance.

I'm not aware of deep thinking within rating agencies that would suggest that we would have to dramatically increase or change the calculation of capital requirements for a municipal only business for the very simple reason that most of the issues, or sort of large scale issues related to the industry, most of them stemming out of the ABS sector.

So that's probably part of the answer. But again, turning back to a sort of more blunter -- blunt reaction, to the extent there would be changes to the economic model under which monolines would be working, well, clearly we'll have to draw the consequences ultimately on that.

But we don't see a scheme, for the time being, where we couldn't by redirecting FSA on this core public finance set of competencies and franchise, extract the right level of economic value as Bob said, in the immediate term. So it clearly is in excess of 20% and we believe that there is a good business case for that to be active in on the long term depending on the risks that are underlying.

On the regulatory side, Bob and I are not aware of, today, elements which would suggest that there would be a major overhaul of the regulatory framework surrounding monolines, but maybe I'm not well informed. Do you have another piece of information to share with us at that point?

Bob Cochran *- FSA - CEO*

No, that's correct Axel. Certainly things have been considered. There was discussion in Washington -- at the height of the crisis, in the first quarter, of some sort of federal or federal regulatory framework for the monoline industry and that has been rejected. The New York Insurance Department, which is really the preeminent regulator in the financial guarantee market, I'm sure, will be tightening its standards.Everyone seems to agree, including the rating agencies, that the model, there's no reason for the model to change or the risk perceptions to change for public finance.

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The reaction that you have seen is an idiosyncratic increase in risk allocation to certain types of structured finance, particularly mortgage-backed securities. But even then, all of that has been consistent with the basic model for AAA.

Axel Miller *- Dexia - CEO*

Okay?

JP Lambert *- Keefe, Bruyette & Woods - Analyst*

Okay. Thank you very much.

Axel Miller *- Dexia - CEO*

Before closing this conference call, because there are no further questions, I'd like to make sure that we are clear on the FP issue. Two points. One, we do believe that this is the right thing to do economically to avoid crystallization of economic losses, which otherwise we would not incur.

Just to make sure that everybody understands what we have been saying to you all along, the fact that even if all of these assets and liabilities were to be taken at a Dexia level, the net effect of a reduction of the risk weighted assets linked to the abandonment of the liquidity lines, compensated by the increase of risk-weighted assets that would then flow into Dexia's balance sheet, would remain perfectly manageable within our current solvency environment and would probably result, all things being considered, into an increase of our risk-weighted assets at the tune of 250 million to a maximum to 350 million, which is largely within the maneuvering room that we have with our current Tier 1 ratio.

So that's the reasoning behind the ASP and I do believe that's the sound economic reasoning we have to follow to be able to allow that activity to get out of FSA's hands and able to redirect the capital charge that was associated with that.

That will be structured in this matter, in the coming two months. Thank you all of us for your continuing presence around this call. It's been a long day and we will reporting on our full year results on the 29th of August. So thanks to all and good night.

Operator

Ladies and gentlemen, that will conclude today's conference call. You may now disconnect.

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