2. Prudential regulation

2.1 Supervision architecture

2.1.1 European institutional framework

As a result of the financial crisis which began in 2007, it was felt necessary to progress towards more integrated prudential supervision at European level, to match the increasing integration of the financial markets and ensure more uniform application of the prudential legislation across the European Union (EU). In September 2009, following the recommendations issued in February 2009 by the Committee of Experts chaired by J. de Larosière, the European Commission (EC) presented a set of legislative proposals aimed at reinforcing the prudential supervision framework and reducing the likelihood and seriousness of financial crises in the future, by setting up the European System of Financial Supervisors (ESFS). These legislative proposals were adopted by the European Parliament and the Council of the EU in November 2010, and the ESFS was established on 1 January 2011.

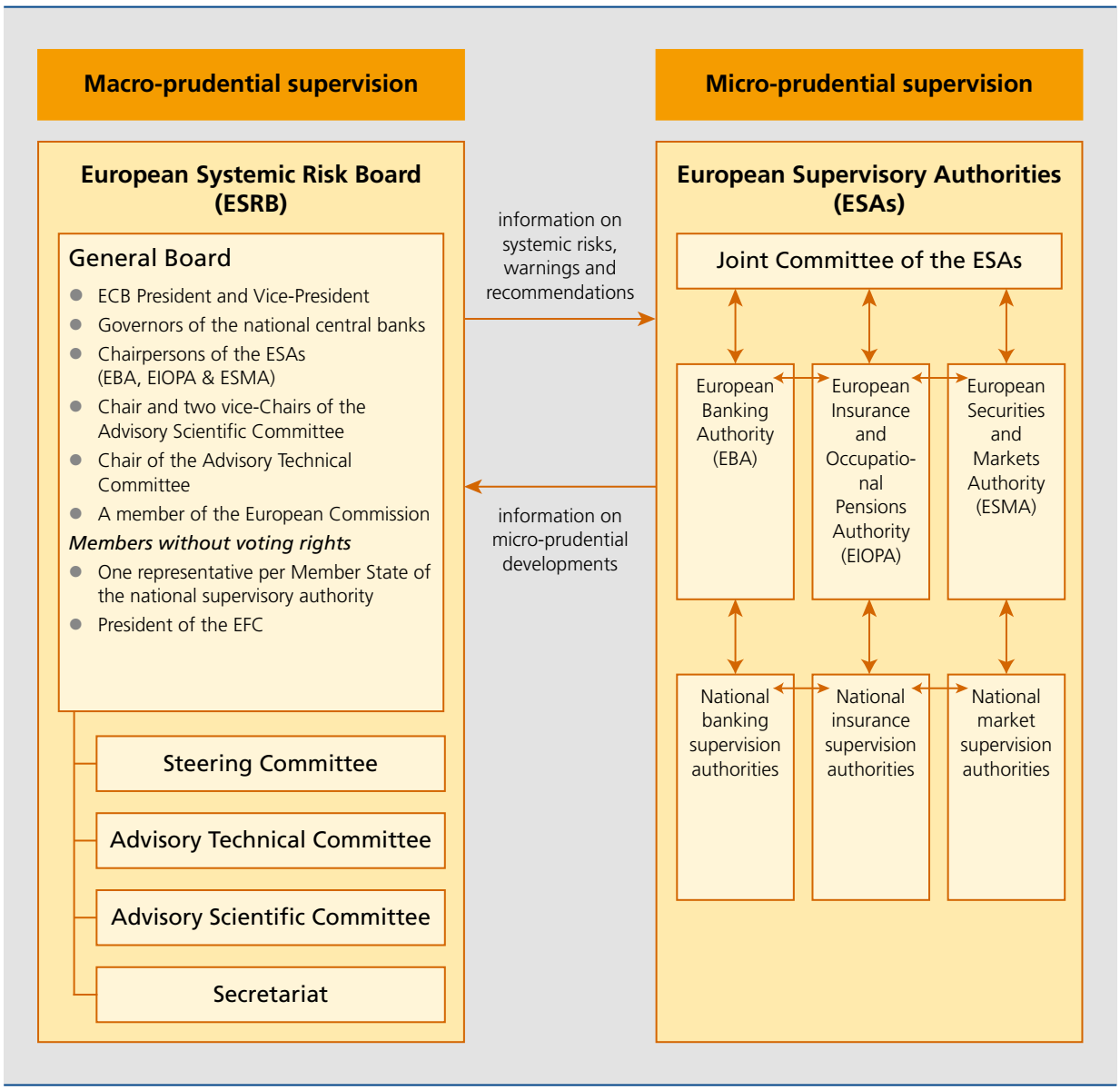
The ESFS comprises the European Systemic Risk Board (ESRB), a European macro-prudential supervision body, and the European Supervisory Authorities (ESAs), responsible for strengthening micro-prudential supervision in Europe, particularly in regard to cross-border aspects, in the three sectors comprising banking, insurance and the securities markets. The ESFS aims to ensure not only better systemic risk prevention but also the necessary harmonisation of the prudential rules and practices at European level, while reinforcing cooperation between national authorities.

The ESRB[1] is responsible for the macro-prudential oversight of the financial system in the EU. Its task is to contribute to the prevention of systemic risks to the EU's financial stability which may arise from developments within the financial system and macroeconomic developments, so as to avoid periods of widespread financial distress.

In the performance of that task, the ESRB is to collect and analyse all the relevant and necessary information for detecting the emergence of systemic risks. Once systemic risks have been identified, and if they are considered significant, the ESRB may warn the European institutions, the Member States and the European and national supervisory authorities, and issue recommendations for remedial action in response to the risks identified. Where appropriate, and in order to give them more weight, the ESRB may make those warnings and recommendations public. In addition, if the ESRB determines that an emergency situation may arise, it can issue a confidential warning addressed to the EU Council and provide the Council with an assessment of the situation in order to enable the Council to assess the need to adopt a decision addressed to the ESAs, determining the existence of an emergency situation. The ESRB is also responsible for monitoring the follow-up to its warnings and recommendations. Finally, the ESRB cooperates closely with the ESAs and provides them with the systemic risk information required for the performance of their tasks. Thus, the ESRB and the ESAs are to produce a common set of quantitative and qualitative indicators (risk dashboard) to measure systemic risk.

The ESRB comprises a number of bodies: the General Board, the Steering Committee, the Secretariat, the Advisory Scientific Committee and the Advisory Technical Committee.

(1) Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board, OJEU L 331, 15/12/2010, p.1.



The General Board takes the decisions necessary to ensure the performance of the tasks entrusted to the ESRB. The Steering Committee assists in the decision-making process of the ESRB by preparing the meetings of the General Board and monitoring the progress of the ESRB's ongoing work. The Secretariat is responsible for the day-to-day business of the ESRB. The Advisory Scientific Committee and the Advisory Technical Committee provide advice and assistance for the General Board on issues relevant to the work of the ESRB. They thus play a key role in the preparation of the ESRB's decisions.

In October 2011 the ESRB adopted its first recommendations on loans in foreign currencies, and addressed them to the Member States, the national supervisory authorities and the European Banking Authority (EBA). These recommendations aim to prevent the risks to financial stability in a number of EU Member States resulting from loans in foreign currency granted to non-financial businesses and households. The recommendations thus adopted specifically aim to strengthen the resilience of the financial system by implementing measures not only to increase the solvency of borrowers and give them better information on the risks which they incur in contracting loans in foreign currencies, but also to improve the risk management and ensure sustainable funding for the financial institutions themselves. Finally, in order to rectify excessive growth of foreign currency lending, the authorities are asked to take stricter measures, where necessary, to limit this type of lending.

The Bank is a member of the ESRB, as a national central bank and as a national authority responsible for the prudential supervision of credit institutions and insurance

companies. The Bank is also represented in the Advisory Technical Committee and plays an active part in the business of a number of working groups set up by that committee. In addition, the Belgian Financial Services and Markets Authority (FSMA) is likewise a member of the ESRB as the authority responsible for financial market surveillance.

There are three ESAs[1]: the EBA, the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA).

The European legislature has given them extensive responsibilities.

The ESAs are to contribute to improving the effectiveness of the regulation and surveillance of financial institutions. To that end, their tasks include providing opinions to EU institutions and developing guidelines, recommendations and draft technical standards based on the European legislation applicable in their respective sphere of competence; that is probably the main innovation, in view of the binding character of these technical standards, once they are adopted by the EC. The ESAs may also conduct peer reviews of the competent authorities in order to draw up guidelines and recommendations and to identify best practices, to strengthen the consistency of supervisory practices.

They are also responsible for ensuring that the competent national authorities apply the European legislation correctly, by ensuring that the taking of risks is appropriately regulated and supervised, preventing regulatory arbitrage and promoting equal conditions of competition. They also arrange mediation and the settlement of disagreements between competent authorities, with a view to the effective supervision of financial institutions. In addition, they have power to take action in emergency situations.

It is also the role of the ESAs to strengthen coordination and cooperation between the national supervisory authorities, be it by stimulating and facilitating the delegation of tasks and responsibilities among competent authorities or by ensuring the coherent functioning of the colleges of supervisors, and taking part in the development and coordination of recovery and resolution plans, and methods of dealing with failed financial institutions.

Their tasks also include monitoring and assessment of market developments in their respective area of competence, and contributing to the monitoring, assessment and measurement of systemic risk. To that end they may collect information from the national supervisory authorities and, under certain conditions, from financial institutions. The ESAs cooperate closely with the ESRB, notably by communicating the information necessary for the performance of its tasks and ensuring that its warnings and recommendations are properly followed up.

Finally, the ESAs keep watch over the integrity, transparency and orderly functioning of the financial markets and consumer protection.

The ESAs comprise a Board of Supervisors, a Management Board, a Chairperson, an Executive Director and a Board of Appeal.

The Board of Supervisors takes the decisions and defines the guidance necessary for the performance of the tasks and business of the Authority. The Management Board ensures that the Authority carries out its mission in accordance with the rules defining its operation. The Chairperson represents the Authority and is responsible for preparing the work of the Board of Supervisors, while the Executive Director is in charge of the day-to-day management of the Authority and the preparation of the work of the Management Board. The Board of Appeal is a joint body of the ESAs with the role of deciding on appeals against ESA decisions.

A Joint Committee was also established. It serves as a forum in which the ESAs cooperate regularly and closely on subjects of mutual interest and thus ensure the cross-sectoral consistency of their activities.

In the past year, the EBA and the EIOPA have conducted and coordinated European stress tests in the banking and insurance sectors. Details of the stress tests conducted by these two ESAs were presented earlier in chapter 1.1 and section 1.2.2 of this Report.

As an authority responsible for supervising credit institutions, financial conglomerates, investment firms, payment institutions and electronic money institutions and insurance and reinsurance companies, the Bank is a member of the EBA and the EIOPA. In addition, the FSMA is a member of the ESMA as an authority responsible for supervising institutions for occupational retirement provision.

(1) Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC, OJEU L 331, 15/12/2010, p. 12.

Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC, OJEU L 331, 15/12/2010, p. 48.

Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC, OJEU L 331, 15/12/2010, p. 48.

2.1.2 The new supervision architecture for the Belgian financial sector – Introduction of the "twin peaks" model

Following the review of financial sector supervision in Europe, a similar process took place in Belgium on changes to the prudential supervision architecture.

On the basis of the recommendations of the Special Commission[1] and the Lamfalussy Committee[2], and drawing inspiration from developments in other EU countries, the Belgian authorities decided to make changes to the supervision of the financial sector, and more specifically the interaction between the Bank and the former Banking Finance and Insurance Commission (CBFA), switching to a "twin peaks" model. The foundations of the new architecture were laid by the Law of 2 July 2010[3], known as the "Twin Peaks" Law.

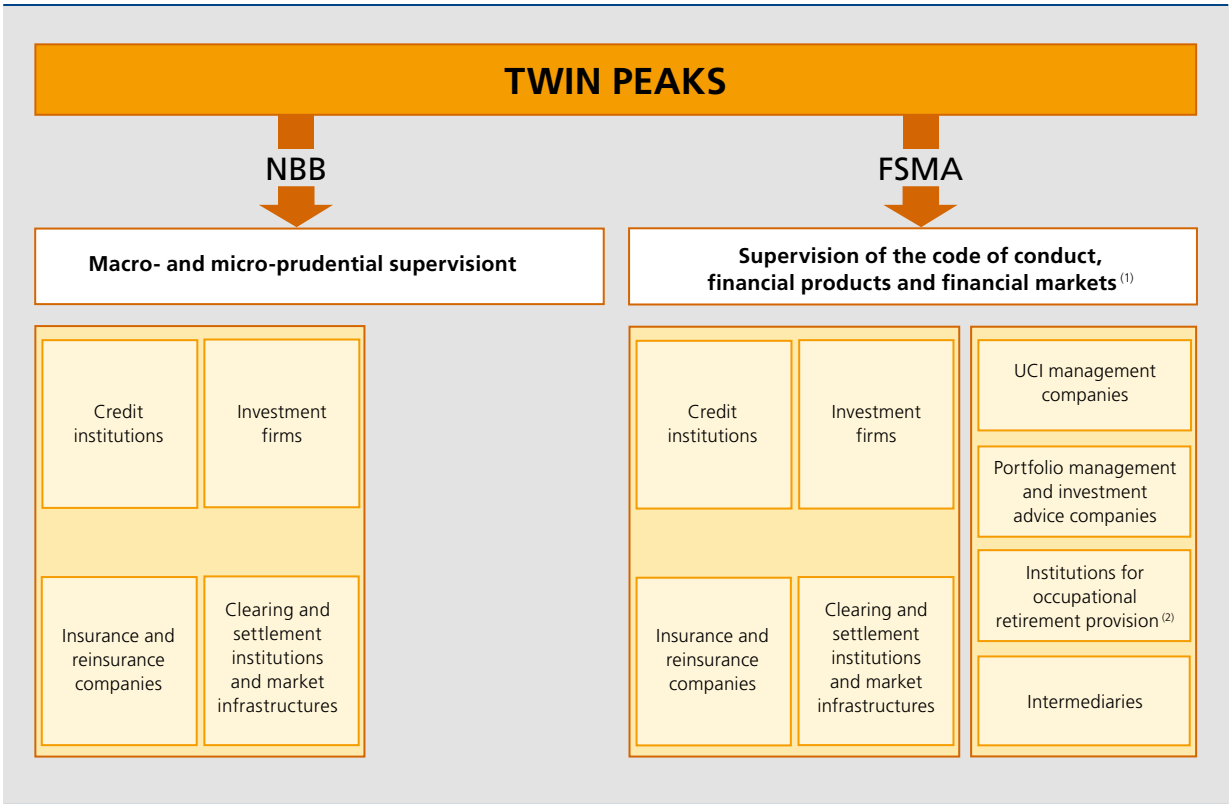
In view of the radical impact of this reorganisation (particularly the need to amend more than 25 current laws), it was decided to conduct this restructuring in two stages.

The first – transitional – stage saw the establishment of the Committee for Systemic Risks and System-relevant Financial Institutions (CSRSFI). Chaired by the Governor of the Bank, it comprised members of the boards of directors of the Bank and the CBFA. The CSRSFI was operational from 21 October 2010 to 31 March 2011. It was responsible for the surveillance of systemic risks and the prudential supervision of systemically important financial institutions (SIFIs).

The new supervision model proper was established by the promulgation of the Royal Decree of 31 March 2011[4]. This massive decree conferring special powers entered into force on 1 April 2011.

Since that date, financial supervision has been based on two pillars. One pillar is the Bank, which will from now on perform the various macro-prudential and micro-prudential supervision functions, and the other is the

(1) Final report of the High Level Group on a New Financial Architecture, 16 June 2009.
(2) Report by the Special Commission set up to examine the financial and banking crisis, *Parl. Doc.* Chamber 2008-09, doc.52, no.1643/002.
(3) Law of 2 July 2010 amending the Law of 2 August 2002 on the supervision of the financial sector and financial services, and the Law of 22 February 1998 establishing the Organic Statute of the National Bank of Belgium, and containing miscellaneous provisions (*M.B.* 28 September 2010). See in particular Article 26, § 1, of that law.
(4) Royal Decree of 3 March 2011 implementing changes to the financial sector supervision structures (*M.B.*, 9 March 2011).



(1) The FSMA is also in charge of prudential supervision of: (i) UCI management companies, (ii) portfolio management and investment advice companies, and (iii) institutions for occupational retirement provision.
(2) The Bank and the FSMA must produce a report by no later than 31 December 2013 which will form the basis for the decision on transferring the prudential supervision of these institutions to the Bank.

"new CBFA", renamed the FSMA, responsible for supervising financial markets investment instruments, financial product marketing, and the rules of conduct applicable to financial sector players, and protection for consumers of financial services.

The allocation of powers between the Bank and the FSMA features strict separation between the supervision of prudential provisions and that of the rules of conduct. The aim of prudential supervision is to examine whether financial institutions are capable of meeting their commitments, and thus to guarantee that they are properly organised and sound. That supervision concerns the rules on organisation, solvency, profitability and liquidity. Whereas micro-prudential supervision looks at individual financial institutions, macro-prudential oversight considers the financial system as a whole, including the interconnections between financial institutions. It aims to prevent the emergence of tension in the system as a whole, notably by keeping watch over financial stability and supervising SIFIs. The rules of conduct are intended to ensure honest, fair and professional treatment for investors, customers and other parties concerned. Supervision of the rules of conduct aims to protect these persons by ensuring compliance with the requirements concerning due care in their treatment and the integrity and expertise of the financial institution.

As a result of the new allocation of powers regarding financial supervision, since 1 April 2011 the Bank's existing functions have been extended to include the individual prudential supervision of the following financial system players:

- credit institutions;
- investment firms with the status of brokerage firms;
- insurance companies;
- reinsurance companies;
- clearing institutions;
- settlement institutions and the equivalent;
- payment institutions;
- electronic money institutions;
- surety companies.

In the case of the institutions listed above, the Bank has taken over the prudential supervision powers of the former CBFA and the CSRSFI, which ceased to exist on 1 April 2011.

The Bank is responsible for licensing these institutions, and for ensuring subsequent compliance with the licence conditions. If appropriate, it may impose remedial measures, revoke licences or implement winding up and restructuring procedures. The Bank also acts as a supervisory authority under the anti-money laundering regulations[1].

It should be noted that the category introduced by the "Twin Peaks" Law comprising SIFIs (institutions which used to come under the CSRSFI) still applies in the final architecture, as the specific powers of the CSRSFI in regard to these institutions have been transferred to the Bank[2]. Systemic financial institutions thus have to inform the Bank of their proposed strategic decisions. The Bank may oppose any plan which it considers contrary to a sound and prudent policy on the part of the institution, or if it risks upsetting the stability of the financial system. In addition, the Bank may impose specific measures if it considers that an institution presents an inappropriate risk profile or if the policy which it adopts could have a negative impact on the stability of the financial system. Those measures may, in particular, take the form of special requirements concerning solvency, liquidity, risk concentration and risk exposures.

To enable the Bank to exercise these powers, the SIFIs have to report to the Bank on developments concerning their activities, their risk profile and their financial situation under specific reporting requirements imposed on these institutions.

In the supervisory spheres for which it is responsible, the Bank may issue regulations to supplement the laws or regulations on technical points[3]. These regulations only take effect following their approval by Royal Decree and their publication in the Moniteur belge/Belgisch Staatsblad. Apart from this regulatory power, the Bank may also issue circulars addressed to institutions subject to its supervision, clarifying a particular rule or practice applicable.

As already stated, on 1 April 2011 the CBFA was renamed the FSMA. That name corresponds better to its new tasks, namely: financial market supervision, financial product supervision and supervision of certain financial players, some of whom are also subject to prudential supervision (institutions for occupational retirement provision, UCI management companies, and portfolio management and investment advice companies), supervision of the rules of conduct, and contribution to the financial education of savers and investors.

Obviously, the Bank and the FSMA will continue to work closely together and exchange information in order to ensure the surveillance and prudential supervision of the financial system.

(1) Law of 11 January 1993 on prevention of the use of the financial system for the purpose of money laundering and terrorist financing.
(2) Article 36/3 of the Law of 22 February 1998 establishing the Organic Statute of the National Bank of Belgium.
(3) See Article 12bis, § 2, of the Law of 22 February 1998 establishing the Organic Statute of the National Bank of Belgium.

2.2 International and national developments

2.2.1 International developments

The unprecedented financial crisis which erupted in 2007 did not only lead to a reform of the financial sector supervision architecture in Europe and in Belgium, but also uncovered weaknesses in the regulation and supervision of the financial sector and, in general, shortcomings in the international financial and monetary system. In view of the interdependence of the financial markets and the global economy, it was essential to initiate financial sector reforms at international level. Moreover, that international coordination is crucial for reducing the scope for regulatory arbitrage and ensuring a level playing field.

In that context, since the first summit in Washington in November 2008, the G20 heads of state and government have met on multiple occasions to redesign the strategic profile of the new global financial architecture and to ensure sustainable, more balanced global growth which creates jobs. The Financial Stability Board (FSB) was made responsible for developing and promoting the implementation of efficient financial regulation and supervision. It was also given the task of coordinating, at international level, the work of the national authorities and the various international bodies concerning financial regulation and supervision, such as the Basel Committee on Banking Supervision. The responsibilities of the International Monetary Fund (IMF) were extended to include the multilateral surveillance of external imbalances.

In 2010, substantial progress was made in the sphere of financial regulation, with the key agreement concluded on 20 November 2010 between the G20 heads of state and government, concerning reinforcement of the prudential rules on solvency and liquidity, on the basis of the work of the Basel Committee. The aim of these new rules, known as Basel III, is to improve the ability of the banking sector to absorb shocks in a crisis situation and thus enable the sector to continue performing its financial intermediation role, while reducing government intervention. The new measures concerning solvency aim to improve the quality and quantity of the capital required, to increase international harmonisation and to ensure better risk coverage. Regarding liquidity, the Basel Committee introduced two minimum standards. The first aims to assess whether a credit institution can survive a one-month period of stress without having to resort to exceptional assistance. The second aims to ensure that the assets of credit institutions are funded by stable resources. The Basel III rules are set out in more detail in sections 2.2.2 and 3.2.2 of this Report. The G20 heads of state and government have undertaken to implement these measures in accordance with the timetable set by the Basel Committee.

In 2011, the practical progress on reforms was overshadowed somewhat by the sovereign debt crisis in Europe, and it was not possible to arrive at specific, precise decisions in all the priority spheres initially fixed by the G20. Nevertheless, during the year under review decisions were taken on four points, including at the summit of heads of state and government in Cannes on 3 and 4 November.

First, recent experience has shown that many financial institutions, and particularly SIFIs, did not hold sufficient own funds to cope with periods of crisis. Nevertheless, these large institutions are 'too big to fail' and, in the event of financial difficulties, the public authorities have to intervene to avoid jeopardising financial stability. In order to reduce the risk of a financial crisis and the risk of moral hazard for these entities, the G20 agreed on a set of measures aimed at reinforcing the supervision and regulation of global systemically important financial institutions (G-SIFIs), in accordance with the FSB's recommendations[1]. This new overall scheme provides in particular for increased capital requirements from 2016, the amount ranging between 1 % and 2.5 % (in percentage of the risk-weighted assets) depending on the systemic character of the institution in question. This requirement will be phased in from 1 January 2016 and become fully operational from 1 January 2019. An additional amount of 1 % may also be imposed on institutions which increase their systemic importance. These supplementary standards are to permit the absorption of losses and thus reduce the cost of public intervention. In addition, this new framework provides for tighter, more effective supervision as well as requirements relating to cross-border cooperation and the development of recovery and resolution plans. In November 2011 the FSB published the list of 29 G-SIFI's which will have to comply with the new rules. This list will be updated annually in November. In the case of Belgium, Dexia is the only institution listed. However, the list was compiled on the basis of 2009 data, before the Franco-Belgian group was dismantled, so that Dexia will be deleted from the list. An initial, general assessment of the implementation of these measures at national level is planned for the end of 2012. In accordance with Article 36/3, §2, of the Bank's Organic Law, the Bank has also established a methodology consistent with the one developed at international level in order to identify national systemic institutions (see section 3.1.3).

(1) See in particular the FSB document "Policy Measures to Address Systemically Important Financial Institutions", 4 November 2011

Next, over-the-counter (OTC) derivatives markets may entail significant risks to the stability of the global financial system in view of their size and the lack of transparency in this type of market. These shortcomings were highlighted, in particular, by the failure of Lehman Brothers. In that context, in 2009 the G20 undertook to regulate these markets. At the summit in Cannes, the G20 heads of state and government reiterated their firm resolve to ensure that OTC derivatives contracts are traded on exchanges or electronic trading platforms, and cleared through central counterparties by the end of 2012. These contracts must also be recorded in central databases, thus facilitating transparency and supervision (see section 2.2.5). In order to encourage banking institutions to use central counterparties, non-centrally cleared contracts will be subject to higher capital requirements. In view of the FSB's findings on progress so far[1], it will be necessary to act quickly to take important measures, particularly in terms of legislation, in order to achieve the aims set by the G20. The FSB's OTC Derivatives working group will have the task of actively monitoring the consistency of the implementation of these reforms.

Third, the reforms of the credit institution regulations would be pointless if the shadow banking system were left unregulated. Failure to regulate these entities could in fact result in significant regulatory arbitrage and might encourage the regulated financial institutions to circumvent the rules applicable to them by developing their activities via the shadow banking system. According to the data collected by the FSB, these entities represent around $ 60 000 billion, or roughly 50 % of bank assets. In view of their importance and their close links with the regulated banking system, these institutions may be a major source of systemic risks. In order to avoid these perverse effects, the G20 heads of state and government decided to strengthen the regulation and oversight of the shadow banking system, in accordance with the FSB's recommendations[2]. The FSB has identified five spheres: (i) banks which interact with institutions in the shadow banking system, (ii) money market funds, (iii) other shadow banking system entities, (iv) securitisation, and (v) securities lending activities. However, the technical details have yet to be established and the FSB will continue working on the subject, though there could be changes in the future, depending on financial innovation.

(1) Second progress report on OTC derivatives market reforms implementation, 11 October 2011.

(2) Shadow Banking: Strengthening Oversight and Regulation, Recommendations of the Financial Stability Board, 27 October 2011.

(3) Principles of Sound Compensation Practices, 2 April 2009.

(4) Circular 2009_34 of 26 November 2009.

(5) Directive 2010/76/EU of the European Parliament and of the Council of 24 November 2010 amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies, OJ L 329 of 14 December 2010.

(6) Follow-up peer review on compensation practices, 11 October 2011.

Fourth, remuneration practices have contributed to the sometimes excessive risk-taking by financial institutions, thus exacerbating the crisis. In this context, back in 2009 the FSB[3] issued standards to strengthen governance and the transparency of remuneration, to bring remuneration more into line with risk management. At the end of 2009, the former CBFA set out these principles in a circular[4]. In Europe, remuneration policy has been subject to more stringent rules since 1 January 2011[5].

Although the FSB, in monitoring peer reviews[6], has reported progress in the implementation of the principles and standards concerning remuneration practices, over 40 % of the jurisdictions which are members of the FSB still do not respect these new rules. The G20 therefore repeated its desire to see the FSB standards implemented as quickly as possible. The G20 also agreed on the need to consider supplementary guidelines on the definition of "significant risk takers" and on their scope (see section 2.2.7).

Important progress was likewise achieved in regard to the control of money laundering and terrorist financing, with increasing numbers of Member States adopting the principles spelt out by the FSB (see section 2.2.6). The G20 heads of state and government also drew attention to the importance of the work relating to (i) reducing the reliance of authorities and financial institutions on external credit ratings, (ii) international accounting standards (see section 2.2.9), and (iii) the coordinated implementation of macro-prudential policy tools and frameworks in order to limit the accumulation of risks in the financial sector.

Following the decisions of the G20 heads of state and government, the surveillance and monitoring of the implementation of the financial regulation reforms will be stepped up. The FSB, in collaboration with other international bodies, is responsible for coordinating and monitoring the implementation of the various reforms. Monitoring will take the form of a scoreboard, which will be presented annually to the G20 heads of state and government and report on progress made and shortcomings identified.

The governance of the FSB will also be reviewed. The FSB will be given an appropriate institutional basis with legal personality. The composition of the Steering Committee will be revised to include representatives of the chairmanship of the G20 and members of the leading financial systems, as well as regions and financial centres not currently represented. Regional groups will thus be created, permitting greater representativeness. Belgium is now part of the European Regional Group.

2.2.2 Capital requirements and Basel III framework

In July 2009, as an initial response to the financial crisis, the Basel Committee formulated some proposals, known as Basel 2.5, intended to strengthen the capital requirements relating to securitisations and the market risks of the trading book. Those proposals were incorporated in European Directive 2010/76/EU (Capital Requirements Directive or CRD III) which had to be transposed by the EU Member States by the end of 2011. In regard to the rules on securitisation, the CRD III introduced specific risk weightings for re-securitisations. These are higher than those applicable to traditional securitisations, in order to take account of the increased risk of such exposures. Also, in regard to Asset-backed Commercial Paper (ABCP) programmes, the directive no longer permits institutions to use the external ratings accorded to commercial paper if they also provide support for the ABCP programme, e.g. via a liquidity line.

In the case of the trading book, the changes introduced by CRD III mainly affect the treatment of the specific exposure risk and the qualitative and quantitative requirements applicable to internal models. In that context, the directive introduces a higher weighting for default risk and migration risk. The specific risk relating to equity exposures is increased from 4 % to 8 %. Regarding the use of internal models for both specific and general risks, the directive requires institutions to calculate an additional capital requirement based on the Value-at-Risk (VaR) in periods of financial market tension (stressed VaR).

The directive also stipulates that the treatment of trading book securitisations and re-securitisations must be aligned with that of the banking book. However, in this connection the directive grants a transitional period up to 31 December 2013, in which institutions will calculate their capital requirements on the basis of the maximum requirements obtained on net long positions or net short positions. In addition, the directive introduces specific treatment for activities based on correlation trading.

Finally, the CRD III extended until the end of 2011 the provision of Directive 2006/48/EC whereby the capital requirements calculated by means of an internal model approved by the supervisory authority must not be less than 80 % of the requirements calculated by the standardised methods specified in the directive. This directive also extended to assets recorded at fair value outside the trading book the obligation to make supplementary value adjustments to take account of the uncertainty associated with the valuation already specified for trading book positions.

These provisions were implemented in the Bank's regulation of 15 November 2011 on the capital of credit institutions and investment firms, but at the end of the period under review it had not yet been endorsed by royal decree.

At the end of 2010 the Basel Committee on Banking Supervision formulated additional proposals for strengthening the international prudential standards on solvency and introducing uniform liquidity requirements.

These proposals, approved by the Group of Governors and Heads of Supervision and agreed by the G20 in November 2010, formed the subject of two documents published by the Basel Committee, entitled "Basel III: a global regulatory framework for more resilient banks and banking systems', which essentially deals with solvency standards, and "Basel III: International framework for liquidity risk measurement, standards and monitoring'", which deals with liquidity standards.

These new solvency and liquidity standards are a key step towards strengthening the soundness of the banking sector after the financial crisis. The aim is to improve the sector's ability to absorb losses in an economic or financial crisis, and to be able to continue lending to economic agents. These proposals supplement the Basel Committee's proposals on governance, risk management, market transparency and resolution mechanisms of international banking groups.

On 20 July 2011, following publication of the Basel Committee proposals, the EC also published its proposal for a European directive and a European regulation to implement the Basel III rules in the EU. The negotiations on that text between the EC and the Council began in the fourth quarter of 2011.

The EC proposal has two main aims.

The first concerns maximum harmonisation of the rules applicable by credit institutions in regard to solvency and liquidity with a view to creating a single internal market in financial services. To that end, the EC proposes abolishing, as far as possible, the current national discretionary powers in the banking directive, but also replacing part of the directive by a European regulation directly applicable to credit institutions in order to achieve maximum harmonisation. The provisions which the Member States must apply, particularly those defining the powers of the competent authorities such as the powers to impose penalties or, in certain circumstances, to stipulate additional requirements concerning capital or liquidity, will be set out in a minimum harmonisation directive. The European

regulation will contain the provisions directly applicable to credit institutions, notably the minimum capital and liquidity standards and the methods of calculating those standards. In practice this means that Member States will have less freedom to impose more stringent standards for the sector as a whole regarding the minimum capital and liquidity requirements. However, they will be able to impose additional requirements for both capital and liquidity, either via the 'pillar 2' approach, i.e. for individual institutions, to take account of their specific risk profile, or by stipulating an additional capital buffer. This proposal aimed at maximum harmonisation is still being debated by the EC and the EU Member States. Although the approach aimed at setting out in a regulation the provisions applicable to credit institutions has the advantage of creating a harmonised framework at European level, it restricts the Member States' ability to intervene by preventing them from increasing the capital or liquidity requirements in general for the sector as a whole, where that proves necessary to prevent the emergence of systemic risks, and in particular if that were recommended by European authorities such as the EBA or the ESRB. Some Member States consider that the primary responsibility for preventing systemic risks rests with the national authorities, as the cost of a financial crisis is essentially borne by the Member State concerned, so that the Member States must have all the necessary macro-prudential tools at their disposal.

The second aim of the EC proposal is to transpose the Basel III standards into European law, taking account of Europe's specific characteristics. The content of the text which is spelt out below essentially covers the new definition of the regulatory capital, the new calibration of the minimum requirements, the introduction of the additional capital buffer, the introduction of a liquidity coverage ratio (LCR) which is advisory until 1 January 2015 and compulsory thereafter, the introduction of a leverage ratio under pillar 2, with the intention of making it compulsory after 2018, and the transitional measures proposed by the Basel Committee. The Basel Committee proposals on institutions presenting a systemic risk to global financial stability are not included in the EC proposal, but should be introduced later. Moreover, the EC is still working on its proposal for a directive concerning a crisis management and resolution framework in Europe (see section 2.2.3). This proposal for a directive should take account of certain Basel Committee proposals, particularly those on the possibility of converting subordinated debt instruments (or Tier 2) and, if appropriate, senior debts (bail in) into common equity Tier 1 capital – (CET1) comprising ordinary shares and reserves.

The new EC proposals on solvency essentially aim to reinforce the quality and quantity of the required capital, to ensure better risk coverage by means of appropriate requirements, and to introduce macro-prudential elements into the solvency standards in order to limit the systemic risks resulting from procyclicality and interconnections between financial institutions.

The crisis was a reminder that the risks needed to be covered by good quality capital, with the losses being absorbed first by the capital and reserves. It was also found that the definitions of own funds were inconsistent between countries, and that there was a lack of transparency regarding the true quality of the capital of financial institutions.

The EC proposes a revision of the definition of own funds, placing the emphasis on the concept of CET1 which comprises exclusively the capital represented by shares fulfilling certain eligibility criteria and the reserves. The EC proposal is slightly different from that of the Basel Committee as the latter explicitly proposes accepting only ordinary shares in CET1. That results from the lack of a uniform definition of "ordinary share" at European level, taking account of the differences in company law between Member States. The EC also proposes harmonising the deductions and adjustments to be applied to the own funds, e.g. the deduction of goodwill or investments in other financial institutions, by generally applying them at the level of CET1. In contrast, the European draft provides for the possibility of consolidating insurance companies instead of deducting investments in them, in accordance with the Basel Committee proposal, in order to take account of the structure of European financial groups which develop banking and insurance activities jointly.

In addition to the components of CET1, institutions will still be able to take account of hybrid debt instruments in constituting their capital in the strict sense, or Tier 1, provided those instruments are perpetual, offer total flexibility regarding the payment of remuneration, and permit the coverage of losses if necessary; these then constitute the additional Tier 1 capital. This new definition of Tier 1 capital and CET1 is much stricter than the current definition in that the elements to be deducted from the capital have been extended (to include deferred taxes, in particular), prudential adjustments which tended to increase the capital have been abolished, and the eligibility criteria for capital instruments have been revised to ensure that they bear losses if the business continues as a going concern and in the case of liquidation. Subordinated instruments with a minimum maturity of 5 years may still be taken into account to calculate the total own funds forming the Tier 2 capital.

In its proposal, the EC takes account of the Basel Committee proposals aimed at reinforcing the capital

requirements for credit risks on activities in derivatives by imposing a capital charge for potential losses of market value resulting from deterioration in the creditworthiness of the counterparty.

In order to take account of the systemic risk resulting from the interconnection between large credit institutions, particularly due to the derivatives market, the capital requirements relating to interbank exposures were also increased. At the same time, incentives are provided for the use of centralised clearing institutions for derivatives business, in order to reduce the credit risk.

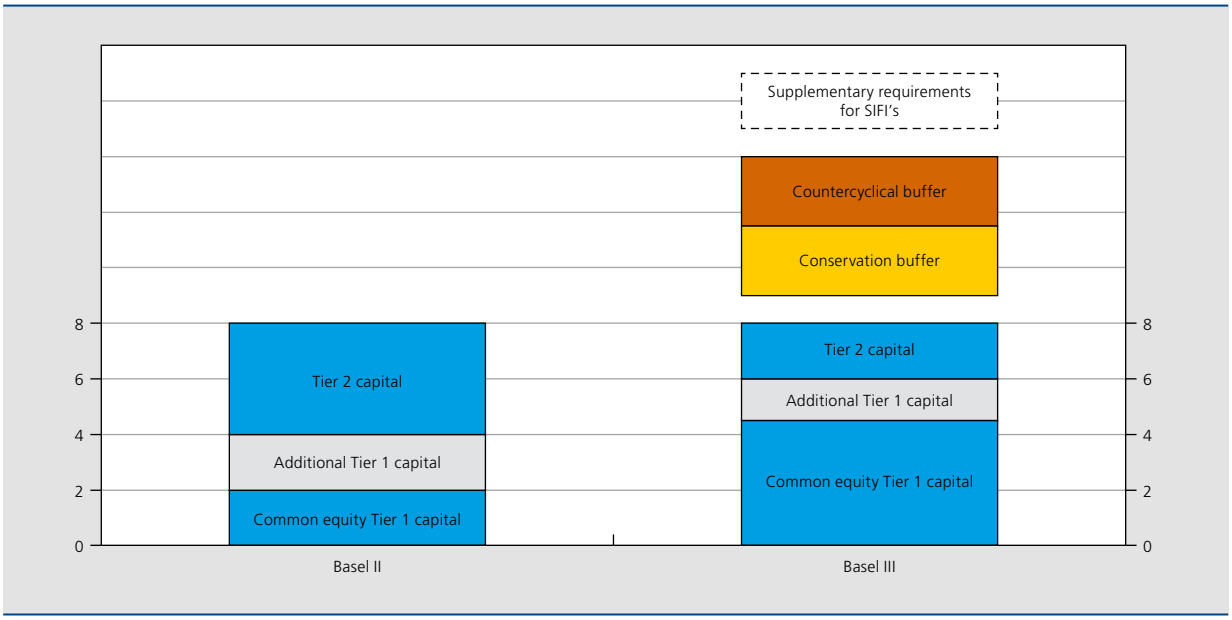
To limit the procyclical effect of the solvency standards, the EC proposes requiring institutions to form a capital buffer in excess of the minimum requirement. Institutions would have to have a minimum fixed CET1 buffer called the capital conservation buffer, in addition to the minimum required. Supervisors could decide to increase this buffer in the event of excessive credit growth in the economy by means of a second buffer, the countercyclical capital buffer. If the institution does not have sufficient capital to cover the minimum requirement and the stipulated buffer, the supervisor will impose restrictions on the distribution of dividends to shareholders. In the event of a crisis, the supervisor will also be able to decide to reduce the level of the required buffer in order to enable the banking sector to continue lending to economic agents.

One point to emerge from the financial crisis was that a number of institutions increased their debt ratio excessively during the growth period which preceded the crisis. However, they had to reduce that debt rapidly when the crisis erupted. In order to limit this risk of rapid debt reduction (deleveraging), in accordance with the Basel Committee proposals the EC proposes the eventual imposition of an additional debt ratio limiting the total volume of credit during growth periods. Initially, this ratio will not be binding, so that its calibration can be refined. The ratio will supplement the institution's solvency ratio and will compare the total volume of the business – calculated in simplified form on the basis of gross accounting data – with the capital. The debt ratio will limit the risk of error associated with the modelling of the risk volume by means of risk weightings or parameters (in particular the risk of default and the loss in the event of default) in the calculation of the solvency ratio. The minimum level of the debt ratio is not defined in the EC proposal, whereas the Basel Committee had proposed a level of 3 %. That is justified since this ratio would have to be applied as a guide, pending finalisation of its calibration, until 1 January 2018, the date on which it would become a compulsory minimum ratio.

Under the current requirements, the total capital must cover 8 % of the risk-weighted assets. Also, half of the total capital must consist of Tier 1 capital, half of which may comprise additional Tier 1 capital,. In practice, this

CHART 30 MINIMUM REGULATORY CAPITAL REQUIREMENTS UNDER BASEL II AND BASEL III

(unconsolidated end-of-period data, in € billion)



Source : Basel Committee

means that, on the basis of the European directives, the minimum core Tier 1 ratio is 2 % and the Tier 1 ratio is 4 %.

From its analysis of the banking crises, the Basel Committee concluded that this level of requirement was insufficient to ensure that institutions were sufficiently resilient to these crises. The Basel Committee therefore proposed a new calibration of the minimum requirements, fixing the minimum level of the required CET1 at 4.5 % of the risk-weighted assets, while the minimum level of the Tier 1 capital will be 6 % and the minimum level of the total own funds will be 8 %. In addition to this minimum required level there is a conservation buffer of 2.5 % to be covered by the CET1, which in practice increases the amount of CET1 to be constituted at any time to 7 %. In the event of excessive credit growth, a countercyclical buffer must be formed of up to 2.5 % of CET 1. In practice, these new minimum levels are at least three times the current requirements. As stated in section 2.2.1, systemic financial institutions (SIFIs) will have to meet an additional requirement ranging from 1 % to 2.5 % of CET1. The EC is also to add to its proposal in this respect. In 2010 the Basel Committee conducted a study on the impact of these new standards (see box 4).

Box 4 – Results of the quantitative impact studies (QIS), conducted in connection with Basel III

In December 2010, in connection with the implementation of Basel III, the Basel Committee on Banking Supervision published a quantitative impact study (QIS) examining the impact on the global banking system of these new rules on the quality and level of capital, improvements to risk assessment, restriction of excessive leverage, and liquidity. This exercise, conducted by 263 banks in 23 countries, 94 of them having Tier 1 capital in excess of € 3 billion, being internationally active and well diversified (Group 1 banks), was based on figures as at the end of December 2009. A similar exercise was conducted at European level.

The exercise took no account of transitional measures, such as the gradual introduction of deductions and new capital ratios. It assumed full and immediate application of the new Basel III rules at the end of 2009, excluding any possible action by the banks, notably in terms of raising capital, adjusting the portfolio or reserving the profits generated.

On the basis of these very strict assumptions, the average CET1 ratio was 5.7 % for Group 1 banks and 7.8 % for Group 2 banks (comprising banks not belonging to Group 1).

In relation to the minimum of 7 % CET1 per institution, which includes the minimum requirement of 4.5 % and the capital conservation buffer of 2.5 %, the overall capital shortfall at the end of 2009 was € 577 billion for the Group 1 banks and € 25 billion for those in Group 2.

In comparison with the current Tier 1 ratio, the CET1 ratio under the Basel III rules is greatly influenced by the changes to the definition of eligible capital and, to a lesser extent, those concerning the calculation of the risk-weighted assets. The increase in the risk-weighted assets has a greater impact on Group 1 institutions (23 % on average) than on banks in Group 2 (4 % on average).

The debt ratio averaged 2.8 % for Group 1 banks and 3.8 % for Group 2 banks. These ratios should be compared with the current advisory minimum of 3 %.

Since that exercise, the banks have continued to increase the level of their capital by issuing shares or reserving profits. They have also modified the structure of their portfolio. Nonetheless, the current economic climate means that it is not easy to comply promptly with the new Basel III requirements. It is therefore important for the banks to take the necessary measures to meet the new solvency and debt level requirements as soon as possible.

The quantitative impact studies organised by the Basel Committee also examined the positions of the participating banks in regard to the two harmonised liquidity standards which it had developed. These are the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR), intended to ensure that both the short-term liquidity and the more structural liquidity position of credit institutions are sufficiently sound (see also section 3.2.2).

The results concerning the LCR show that the sample of participating banks had a liquid asset buffer which enabled them, on average, to meet 83 % (Group 1 banks) and 98 % (Group 2 banks) of their funding needs in the event of the simulated scenario. Almost half (46 %) of the participating banks already had an adequate liquid asset buffer to respect the LCR. Those buffers consist largely of cash (5 %), reserves at the central bank (19 %) and government bonds with a zero weighting according to the standardised Basel II approach to credit risk. For the Belgian banks taking part, this ratio generally seems to be stricter than the Belgian regulatory ratio in regard to stress tests. Although these two standards are based on the same methodology and aim to ensure that the bank has an adequate liquidity buffer to withstand a one-month crisis scenario, there are differences between the two ratios in a number of parameters defining the volume of the liquidity buffer and the crisis scenario. The Basel III ratio does not allow the liquidity buffer to include all assets used by credit institutions as collateral in transactions with the central banks, and that is the main reason why some credit institutions will still need to make an effort to respect the LCR on its scheduled entry into force at the beginning of 2015. To achieve that, the banks may, in particular, adjust the composition of their liquidity buffer, reduce the short-term funding which they obtain from the market, or reduce the potential liquidity need associated with off balance sheet activities. Overall, the introduction of the Belgian stress test ratio already seems to have triggered efforts to improve the liquidity position of Belgian credit institutions, and that will also ease the transition to the LCR. However, the sovereign debt crisis is hampering additional measures to improve the short-term liquidity position.

The results of the impact study also indicate that the participating Belgian and foreign banks which make extensive use of retail customers' deposits already satisfy the second Basel III ratio, the NSFR. At the end of 2009, this ratio averaged 93 % and 103 % respectively for the international sample of participating banks in Groups 1 and 2. That ratio is not expected to come into force until the beginning of 2018, so that institutions which do not satisfy it will have time to take steps to strengthen their structural liquidity position.

2.2.3 Changes in the crisis management framework

In 2010, Belgium improved its banking crisis management framework, via the Law of 2 June supplementing the recovery measures for credit institutions, insurance companies and clearing institutions. The degree to which that framework will require revision in the coming months will depend partly on European developments on the subject.

A key element of this debate should be the EC proposal for a directive on crisis management, not yet published, which largely concerns the banking sector. This proposal for a directive should harmonise the approaches of national authorities in various respects, tackling the whole crisis management sequence, from crisis preparation and prompt intervention to resolution and the corresponding funding. It will address an essential element of crisis preparation, namely recovery and resolution plans. These plans should ensure that both credit institutions and their authorities are better prepared for a crisis, by exploring in advance the various options potentially available for managing a crisis. In normal times, these plans contribute to identify and address the obstacles to orderly resolution. In addition, the proposal for a directive aims to harmonise the powers of the authorities responsible for supervision and resolution, both in a pre-crisis context when preventive measures may prove necessary, and in a crisis requiring the implementation of curative and resolution measures. The EC proposal could considerably increase the powers of most national resolution authorities, as it could provide, in the last resort, for the possibility of involving creditors in the event of a crisis (bail in), rather than national authorities (bail out). Moreover, it should provide mechanisms for coordination between national authorities in the event of cross-border measures being implemented, and a mediation role for the EBA in the case of disagreements between national authorities. Similarly, these proposals should include a section on crisis financing, via the establishment of resolution funds permitting an orderly resolution which would not destabilise

the financial system. These funds would act as a supplement to the deposit guarantee funds.

Finally, attention should also be drawn to the European initiatives aimed at greater harmonisation of the operation of deposit guarantee schemes and an increase in their intervention capability. The EC proposal for a directive likewise aims to offer depositors the same protection throughout Europe. In addition, it provides for the establishment of cross-border cooperation mechanisms between national protection funds.

2.2.4 Insurance

DEVELOPMENTS IN THE EU: SOLVENCY II

In recent years the European insurance sector has undergone a number of fundamental changes. The difficult circumstances facing the sector at the start of the past decade, and the shortcomings in the current regulatory and supervisory framework (Solvency I), prompted the regulators to change the way in which the solvency position of insurance companies will be regulated. In contrast to the rules specifying the capital requirements for banks, based on the Basel framework developed by the Basel Committee, the solvency framework for insurance and reinsurance companies is a purely European matter.

The European Parliament and the European Council approved the Solvency II Framework Directive on 25 November 2009, and were thus able to take account of the impact of the financial crisis. That text, officially presented by the EC on 10 July 2007, embodies the basic principles of a new solvency regime geared entirely to the risk profile of insurance and reinsurance companies, and replacing the requirements of the current Solvency I framework. At the same time, this directive comprises a recasting of the principal existing directives for the insurance sector. Solvency II will apply to all insurance and reinsurance entities in the EU (around 5 000 companies and mutual insurance associations).

With the Solvency II regime, the EC aims to harmonise the application of regulations, increase the integration of the EU insurance market, further enhance the effectiveness of consumer protection, and make the sector more competitive. The current regulations are considered to be out of date as they are not forward-looking, they do not cover all the risks and do not provide a genuine incentive for companies to improve their risk management. Moreover, the existing regulations did not introduce a uniform method of calculating the technical provisions, the capital requirements are insensitive to the underlying risks and, furthermore, they are counterintuitive in that greater prudence in the assessment of the technical provisions drives up the capital requirements. Finally, the requirements concerning good corporate governance, risk management and internal controls are not sufficiently precise.

The Solvency II Directive is based on a number of key elements:
- consistency with economic reality, which means consistent valuation of the assets and liabilities at market prices;
- risk sensitiveness, which implies that the capital requirements are tougher the greater the risks facing the company;
- a 3-pillar architecture with quantitative, qualitative and disclosure requirements promoting better risk management;
- compatibility with other international provisions such as those developed by the International Accounting Standards Board (IASB), the banking regulations and the international insurance supervision standards.

The Solvency II Directive is a framework directive and therefore confines itself to setting out the main principles to be developed in the implementing measures and EIOPA guidelines and recommendations. In June 2011 the EC ended its informal consultation of the Member States on the measures for implementing the Solvency II Directive. In the autumn of 2011, a draft text of these implementing measures was submitted to the Member States for information. However, the enforcement measures proposed in the Solvency II Directive are still subject to change, since they were based on a text of the directive which has not been finalised. The Omnibus II Directive will amend the Solvency II Directive and modify its content, in particular by introducing a number of transitional provisions. The discussions between the EC, the Council and the European Parliament, known as the "trialogue", with a view to adoption of the Omnibus II Directive are to start in April 2012. In principle, the Omnibus II Directive should enter into force at the end of 2012. It lays down the following principles:
- the Solvency II Directive is to be transposed either before 1 January 2013 or before 31 March 2013;
- the new prudential rules will be phased in during 2013;
- in regard to a number of points requiring the approval of the supervisory authority, such as the use of an internal model and undertaking-specific parameters, the approval process will begin in June 2013;
- the regime will enter into force in full on 1 January 2014.

During 2011, EIOPA continued to work on technical standards and recommendations detailing certain

implementing measures. The main recommendations and technical standards are to be finalised by the end of 2012. For that purpose, it is planned to forward the technical standards to the EC in September 2012, following a consultation period which will take place in around May 2012. This means that the technical standards supporting the implementing measures for the Solvency II Directive will not be published before February 2013.

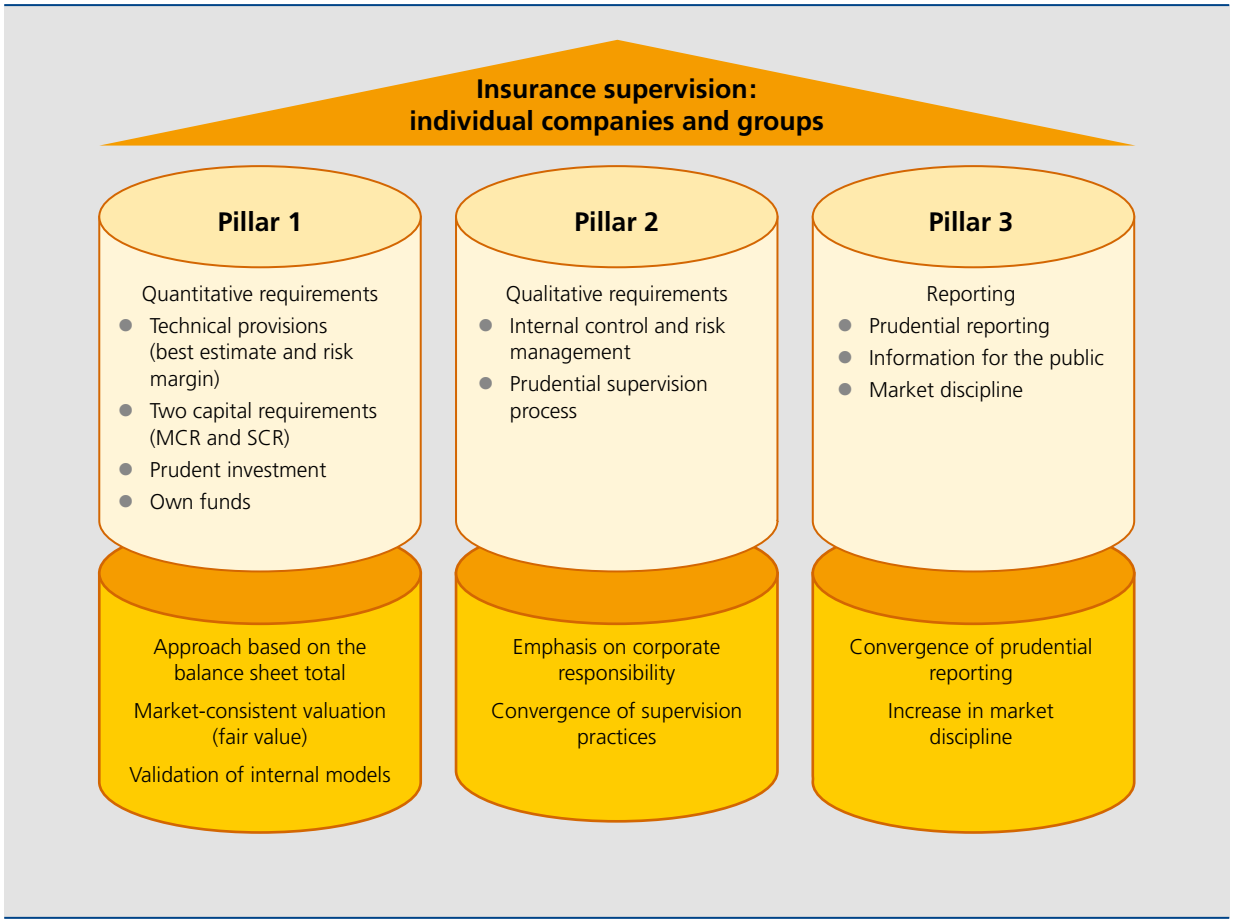
The structure of Solvency II is modelled on Basel II and is broadly similar for pillars 2 and 3. Obviously, the quantitative requirements of pillar 1 are specific to insurance.

Under the first pillar, the directive states that the technical provisions must be determined consistently in relation to market prices, and that they must be valued at an amount for which they could be transferred to another company. In regard to certain insurance liabilities, the financial markets offer instruments which replicate their cash flows (replicating portfolio). The valuation of such insurance liabilities equals the market value of such financial instruments. However, this type of valuation will be impossible for most insurance liabilities, in the absence of replicating financial instruments. The market-consistent valuation of these liabilities is the sum of the best estimate plus a risk margin.

The best estimate corresponds to the current weighted average value of the future cash flows. This means that any future cash flows must be weighted according to the cash flow probability, and that the cash flows must also be discounted using the relevant risk-free interest rate term structure. Since the best estimate is an average and does not take into account the cost of holding capital against unexpected losses from the portfolio, it is rather unlikely that another insurer would take over the liabilities if only the best estimate is transferred. That is why, when determining the technical provisions, it is necessary to compensate the best estimate by a margin, known as the risk margin.

That margin is equal to the capital cost to the company of maintaining the insurance liabilities on the balance sheet (cost of capital). It is not easy to calculate, as future capital requirements have to be calculated according to clearly defined assumptions for the whole term of the liabilities.

The future cash flows are discounted by means of a risk-free yield curve. For the purpose of calculating the provisions, and particularly for modelling the cash flows, it is necessary to take account of all foreseeable factors which may influence the cash flows. To do that, the liabilities



have to be divided into homogenous risk groups. Next, it is necessary to examine the factors which may influence the cash flows of the risk group. For example, the cash flow modelling has to take account of expected mortality and disability rates, contract options and management interventions.

The directive contains two capital requirements: the Solvency Capital Requirement (SCR) and the Minimum Capital Requirement (MCR). The SCR is defined as the capital needed to cover potential losses in the coming year with a confidence level of 99.5 %. The requirement can be set according to a standard formula, an internal model or a partial internal model.

The standard formula for calculating that requirement is modular in its structure. For each risk to which the company is exposed, the capital needed to achieve the required confidence level of 99.5 % is quantified. A capital requirement is thus set for each of the sub-modules, and these requirements are then aggregated by means of correlation matrices in order to obtain the overall capital requirement.

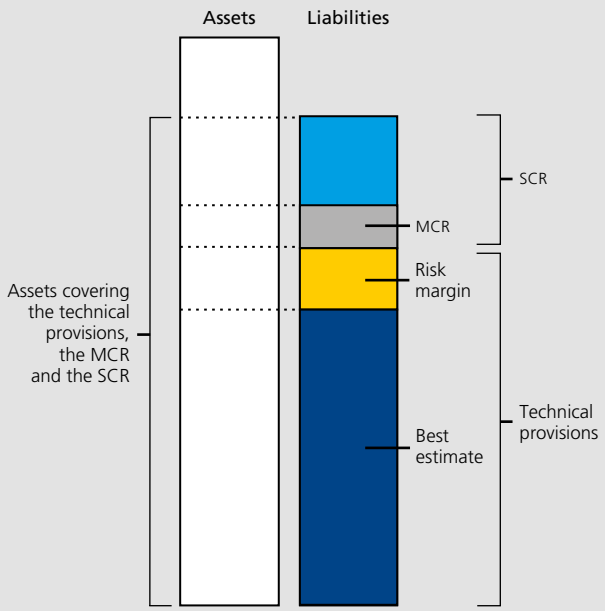
The probability of negative developments occurring simultaneously for all types of risks is very low. The overall requirement is therefore considerably less than the sum of the requirements for the various modules. The addition of the capital requirements by means of correlation matrices ensures that the overall capital requirement also meets the stipulated 99.5 % confidence level.

In regard to internal models, the directive lays down the criteria which the models must satisfy.

The MCR is the amount of capital below which the company's risk is unacceptable. It is calculated via a formula and depends on the premiums and technical provisions, with a floor and a ceiling expressed as a percentage of the SCR. The MCR can be compared with a minimum capital requirement which, if not respected, triggers the immediate intervention of the supervisory authority in order to remedy the situation without delay.

Under the Solvency II regime, the SCR must be respected, otherwise the supervisory authority intervenes and insists that the company must have a financial recovery plan in order to rectify the situation. If the company breaches the MCR, the supervisory authority takes more vigorous action and demands refinancing of the company in the short term. If that plan does not rectify the situation, the supervisory authority will withdraw the licence to pursue insurance activities.

CHART 31 SOLVENCY II PILLAR 1 – SUMMARY OF REQUIREMENTS



Source: NBB.

The directive specifies that the capital is to comprise two elements. One element consists of the basic own funds defined as the difference between the market value of the assets and the liabilities, and the other is the ancillary own funds, comprising off balance sheet elements which, subject to the approval of the supervisory authority, form part of the own funds, such as the uncalled subscribed capital. The elements of own funds are tiered according to the degree to which they are available or can be called up to absorb losses at all times.

The second pillar contains requirements regarding the method of organisation of the company and specifies various aspects of the governance system: internal control, audit, actuarial function, risk management, fit & proper rules, and outsourcing. These rules are already largely familiar. Companies are also expected to conduct their Own Risk and Solvency Assessment to assess all the risks that they face and judge whether they have sufficient capital in relation to those risks.

The directive contains a number of other provisions on the way in which the supervisory authority exercises its powers (supervisory review process).

Finally, the third pillar states what must be disclosed to the public and reported to the supervisory authority, and the disclosure procedure. In its reporting to the supervisory authority, the company will have to produce a Solvency and Financial Condition Report, the content of which is specified in the regulations.

IAIS developments

Apart from the work on Solvency II, the Bank monitors what is being done at international level by the International Association of Insurance Supervisors (IAIS). Special attention is devoted to the development of a common framework in order to improve the supervision of international insurance groups (the Common Framework for the Supervision of Internationally Active Insurance Groups, or ComFrame).

On 1 July 2010 the IAIS began developing ComFrame which should enable supervisory authorities to improve the effectiveness of cross-border group supervision and bring it into line with current developments in international insurance and reinsurance groups. ComFrame is to form the basis of better collaboration between supervisory authorities in different jurisdictions, the aim being to move towards an integrated, international, and convergent approach to the supervision of these groups. In three phases lasting one year each, the ComFrame working group is preparing technical documents on the framework's elements in collaboration with the relevant stakeholders. The first phase ended on 1 July 2010, and a concept paper on the aims and components of ComFrame was presented for consultation. On the basis of reactions by members and observers, a strategic discussion was launched in November 2011 on the continuing development of this framework.

On 12 December 2011 the Bank acceded to the multilateral memorandum of understanding (MoU) under the IAIS umbrella, which aims to establish a formal basis for collaboration and the exchange of information between supervisory authorities facing cross-border aspects in the supervision of insurance companies. At the end of 2011, 21 supervisory authorities in the insurance sector had signed this multilateral cooperation agreement.

2.2.5 International and EU developments in clearing and settlement

At the beginning of 2010, the Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO) embarked on the task of revising the standards which they had issued for post-trade market infrastructures. It is of the utmost importance that these market infrastructures should be robust and capable of withstanding financial shocks, since they are the point at which the claims and payments of financial market participants converge. The infrastructures stood up well to the recent tumult, but the crisis led to proposals for making them even more robust and shock-resistant.

In March 2011, the CPSS and IOSCO published a consultation document with a proposal for revised standards. This new version of the standards integrates the previously separate sets of standards applicable to the various types of infrastructures, namely payment systems, central counterparties and securities settlement systems. An annex to the consultation document contained the expectations of the overseers (High Level Expectations) regarding critical service providers, such as the Society for Worldwide Interbank Financial Telecommunication (SWIFT) (see section 3.4.1). In comparison with the current standards, some new spheres are addressed, such as general business risk, and the requirements are tightened up regarding the techniques for avoiding and managing instances of default by a participant in the market infrastructure, and as regards the monitoring of operational, credit and liquidity risks, and management of the risks resulting from the prevention of interdependences between the various financial market infrastructures. The consultation period closed at the end of July 2011. A final

version of the standards is expected at the beginning of 2012.

In 2009, the G20 decided to make OTC derivatives markets worldwide more secure and transparent. This is to be achieved mainly by compulsory central clearing of OTC derivatives contracts through central counterparties (CCPs), and by the reporting of trades and positions via trade repositories (TRs). The agreed deadline for full implementation is the end of 2012. In July 2010 the United States passed the Dodd Frank Act which also contains a section on central clearing and the reporting of transactions in derivatives. It is still in the process of being implemented. The EMIR (European Market Infrastructure Regulation) is the European initiative in the form of a draft Commission Regulation [(1)]. The European Council and the European Parliament have to take a joint decision on the subject and are still negotiating the final text. Among other things, the draft EMIR contains rules on the compulsory use of CCPs for transactions in OTC derivatives. Compulsory central clearing will apply to categories of standardised derivative contracts yet to be defined, such as interest rate swaps or credit default swaps.

A CCP acts as a counterparty interposed between the parties to a contract: it is the buyer for the seller and the seller for the buyer. That makes it possible to standardise the counterparty risk of the original parties and manage it centrally. The draft EMIR also lays down a code of conduct and prudential rules to be respected by the CCP and the TR, and regulates the establishment of standards and the supervision of the CCP and the TR. The secondary legislation will be based on the standards now being drawn up by the CPSS and IOSCO.

The draft EMIR will have a substantial influence on the functioning of the post-trade processing of derivative transactions. One of the points which the draft EMIR is concerned about is the creation of a global level playing field. The regulations and their implementation will also have an impact at macro-financial level, e.g. in that they may influence the overall level of collateral requirements.

The EC has announced its intention to intervene in regard to the rules on securities settlement. At the beginning of 2011 it organised a market consultation on the subject, and held working group meetings with the Member States. The aim is to bring about further integration of post-trade processing in the EU. In that connection, the EC could issue a proposal for European legislation on central securities depositaries (CSDs). That proposal would aim to address the diversity of settlement arrangements in the EU in order to create a more integrated European market. To that end, the EC envisages setting up a harmonised regulatory framework for CSDs, defining their services, laying down rules on the recognition and supervision of CSDs, and rules on access to CSDs for participants, securities issuers and other CSDs. The consultation also aimed to ascertain opinions on the possibility of imposing penalties to strengthen settlement discipline, to ensure that settlement actually takes place at the time foreseen. That could benefit the working of the settlement system and curb short selling via abuse of the settlement process. The EC also examined the advisability of harmonising the settlement period, i.e. the time lapse between conclusion of a transaction and its settlement.

(1) Proposal for a regulation of the European Parliament and of the Council on [OTC] derivatives, central counterparties and trade repositories of 15 September 2010.

2.2.6 Legislation on money laundering

Since October 2008 the Financial Action Task Force (FATF), an intergovernmental body which aims to design and promote policies for the control of money laundering and the financing of terrorism at both national and international level, has been reviewing the 49 recommendations issued previously in order to correct any shortcomings revealed by recent developments. That should lead to a new set of recommendations and interpretative notes which will have to be approved at the plenary meeting in February 2012 and then transposed into the European and national laws on the subject.

Since numerous FATF recommendations have significant implications for financial institutions and their regulatory and supervisory authorities, the Belgian prudential authority is actively involved in this work.

The principal innovations for financial institutions and their regulatory and supervisory authorities concern risk assessment. A new interpretative note requires both public authorities and financial institutions to base their approach on an objective, up-to-date risk assessment. The authorities must assess the risks present at national level and inform the financial institutions so that the latter can incorporate that information in their own assessment of the risks inherent in their activities, in order to define and apply appropriate risk management and mitigation procedures. On that basis, these financial institutions will be able to relax their vigilance if the risks are low, but will be obliged to increase their vigilance when the risks are higher. The application of a risk-based approach is likewise spelt out in other guidance notes such as the one on the recommendation concerning due diligence, which stipulates that financial institutions must base their risk analysis on relevant criteria concerning the characteristics

of the customer, the product or service offered, the distribution channel used and the country or geographical region where the customer is based.

A new interpretative note is devoted to the recommendation on the exercise of supervision by the authorities, in order to set out the FATF's expectations regarding both the use of the risk-based approach in organising and exercising supervision, and the monitoring of the risk-based approach applied by financial institutions. In regard to the exercise of risk-based supervision, the FATF requires the competent authorities to work on the basis of a clear and up-to-date understanding of both the risks present within the country and the specific risks facing each financial institution. As regards the supervision of financial institutions adopting the risk-based approach, the interpretative note will stipulate that it must include a revised risk assessment for the financial institution in question and tailoring of the policies, procedures and internal control in accordance with that risk analysis.

The FATF will also recommend that all electronic transfers should likewise contain information on the transfer recipients. The responsibilities of the various financial institutions which may be involved in such transfers will also be spelt out.

In view of the development of international treaties on the fight against corruption, new increased vigilance obligations will be set out in regard to business relationships with customers who are "politically exposed persons" at national level. There will also be further details and clarification on the obligations concerning identification of the customers and actual recipients, the possibility of reliance on a third party, the obligation on financial groups to apply a group policy, the obligation to analyse the risks associated with innovations, the scope of the countermeasures which may be required against countries which do not correctly apply the FATF recommendations, and the obligations concerning international cooperation between competent authorities.

2.2.7 Recent developments in governance and remuneration policy

GOVERNANCE

Following the financial crisis of 2007-2008, a number of weaknesses were identified in the internal governance of financial institutions. Various international bodies, such as the Organisation for Economic Cooperation and Development (OECD) and the Basel Committee[1] felt it necessary to reinforce the established principles on good governance (internal governance or corporate governance). During the year under review, these international initiatives were incorporated in two instruments of European law: the EBA Guidelines on Internal Governance and the governance section of the CRD IV proposal.

The EBA Guidelines on Internal Governance were published on 27 September 2011. The primary aim of this document was to consolidate and update all the existing guidelines of the EBA's predecessor, the Committee of European Banking Supervisors (CEBS), particularly in accordance with the Basel Committee document mentioned above, but also to add a number of new sections and, finally, to reflect a number of lessons from the crisis in the form of new specific requirements concerning governance.

The main new points in the guidelines on internal governance are as follows:

- The role and functioning of the management board is developed in great detail. The board must again be able to assume its responsibility in determining and monitoring the general business strategy and particularly the institution's risk appetite. Guidelines have also been added on nominations, succession issues and the required qualifications for board members. In addition, the guidelines examine in more detail the use of committees and the management of conflicts of interests;
- Risk management is central to the internal control system, and the Chief Risk Officer has a key function in that. The February 2010 High Level Principles for Risk Management were also incorporated;
- The document continues the development of key principles such as 'know your structure' and 'understand your structure' so that highly complex business structures will remain manageable in the future;
- The group dimension of governance is dealt with in more detail, seeking a balance between the interests of the group and those of local stakeholders of subsidiaries such as depositors or investors;
- On the subject of remuneration, the document refers to the CEBS Guidelines on Remuneration Policies and Practices dated 10 December 2010;
- The transparency requirements concerning implementation of the governance principles are tightened up;
- A section on "business continuity" was added.

The EBA is currently also working on specific guidelines concerning 'fit & proper' requirements for people responsible for the actual management of an institution. The mandate for this was explicitly added by CRD III in Article 11 of the CRD.

(1) Enhancing Corporate Governance for Banking Organisations, October 2010.

At the Bank, the EBA Guidelines on Internal Governance will lead to a revision of the circular dated 30 March 2007 on the Prudential Expectations of the CBFA regarding the governance of financial institutions. That revision will begin in the first quarter of 2012. One of the basic points of that circular, namely the maintenance of cross-sectoral consistency between the banking and insurance sectors, will be retained, in the conviction that governance must satisfy the same strict standards in both sectors. The maintenance of this basic point is particularly important for an integrated supervisory authority like the Bank which, from that angle, has to ensure a level playing field between the various institutions subject to its supervision.

The governance section of the CRD IV proposal, dated 20 July 2011, is the outcome of the Green Paper on Corporate Governance in Financial Institutions published by the EC in June 2010. The EBA Guidelines on Internal Governance already take account of expectations concerning the CRD IV proposals regarding governance. Ensuring that the board takes responsibility and establishing a risk management function are likewise key elements of the CRD IV proposal. Nevertheless, the proposal differs from the EBA Guidelines on certain points. First, the proposal for a directive pays particular attention to the establishment of a risk committee and a nomination committee, as regards both their composition and the qualifications required of members, and the time which they spend on the committee's activities. Second, it specifies the production of transparency requirements relating to governance in general and risk management in particular. Thus, institutions would have to publish a risk management declaration approved by the board, describing the relationships between the real risk profile, the risk appetite defined by the board and the business strategy of the institution. The latter would also have to publish a description of the flow of information on risk management between the executive committee and the board. Finally, the proposal for a directive lays down detailed requirements concerning the diversity of the board's composition.

At Belgian level, governance will therefore be subject to much more detailed, binding rules in the future, although the typical Belgian legal requirement concerning the report by the senior management[1] is already an important step in that direction, as this report already deals with the institution's internal organisation. While the risk management declaration mentioned earlier is included as such in CRD IV, there will need to be a discussion at Belgian level to establish how to coordinate the senior management report with the directive. Be that as it may, the aim should be to place responsibility explicitly with both the senior management (the executive committee, if any) and the management board, each in respect of its own role regarding governance in general and risk management in particular.

REMUNERATION POLICY

During 2011 the EBA produced guidelines on the collection of remuneration data by the national supervisory authorities and by the EBA itself. CRD III did not only introduce substantive requirements concerning the appropriateness of the actual remuneration policy, but also provided for two types of remuneration data to be collected. One concerns quantitative data on the remuneration of staff who have a significant impact on the institution's risk profile, and the other concerns quantitative data on large salaries (i.e. staff earning over € 1 million).

The data must be collected for the first time by the end of June 2012 and will on that occasion relate to figures for both 2010 and 2011. The EBA Guidelines take the form of templates to be used in a harmonised manner by all European supervisory authorities, including Belgium.

At the end of 2011 the EBA also drafted an implementation study on compliance with the remuneration provisions laid down by CRD III and with the CEBS Guidelines on Remuneration Policies and Practices (published on 10 December 2010). When CRD III came into force, there was great concern about the level playing field, not only between the EU and third countries[2], but also between the Member States themselves. The implementation study due for publication in the spring of 2012 will present a detailed status report on that question in particular. It will address not only the actual transposition of the relevant provisions of CRD III, but also the supervisory arrangements and their intensity in the various Member States, as well as any shortcomings in the current regulatory framework.

The Bank uses horizontal screenings to check on institutions' compliance with CRD III. During the period under review, the regulatory framework was also supplemented by the transposition of the relevant provisions of CRD III by laws, regulations and circulars.

At a time when citizens are being asked to make major efforts, especially in Europe where the soundness of financial institutions is still fragile and could require further government intervention, it is essential to see a

(1) See in particular Article 20 § 5 of the Banking Law, as specified in more detail in circular CBFA 2008 12 of 9 May 2008 entitled "Report by the senior management on the assessment of the internal control system and declaration by the senior management concerning periodic prudential reporting".

(2) The question of the level playing field between the EU and third countries is examined in detail in the second FSB Thematic Review on Compensation, Peer Review Report, October 2011.

change of attitude and culture in remuneration practices. Appropriate policies on the subject are particularly important in that many institutions do not meet the new capital requirements defined by the Basel III Accord. Moreover, in its coalition agreement, the new federal government stated that the stipulation that remuneration policies in the financial sector must be linked to long-term results will be supplemented by restrictions on the payment of bonuses for financial institutions which, in one way or another, receive government support.

At the beginning of 2011, a first extensive horizontal screening was undertaken to check compliance by the big banks with the CRD III rules on remuneration policies. By using the same method to compare institutions with one another, the Bank intends to promote a level playing field in the Belgian financial sector. During this screening, interviews were conducted with remuneration committee chairmen, and on-site inspections were carried out. Following this supervisory exercise, it became evident that the big banks have already made considerable progress in regard to remuneration policies, but that further work is needed on a number of remaining problems, such as which employees should be subject to the remuneration policy, the application of the remuneration policy at group level, and the link between remuneration and risk-taking, particularly as regards the proportions between the fixed and variable pay components. The supervisory policy devised on the basis of this exercise is now being implemented proportionately in respect of the other institutions. At the end of 2011 a second exercise was launched with the aim of more actively persuading institutions to modify their policies to bring performance-related pay in 2011 into line with the CRD III requirements.

The Law of 28 July 2011 (1) was used to transpose the CRD III remuneration provisions which required a legal basis. There are not many of them, and they were transposed very faithfully. The main additions and adjustments to the Banking Law (2) are as follows:

- Credit institutions must have, as part of their internal organisation, remuneration policies and practices which permit and encourage sound and effective risk management.
- Provisions on the establishment, composition and functions of the remuneration committee have been added. The legislature opted to establish parallels between the audit committee and the remuneration committee. Thus, as in the case of the audit committee, only large institutions which exceed certain numerical thresholds are required to set up a remuneration committee.
- The legal basis has been provided for the remuneration policy publication requirements.
- There is provision for measures and penalties in the case of an inappropriate remuneration policy.

The other provisions on remuneration were transposed by a regulation combined with a circular. The CBFA regulation of 8 February 2011 (approved by the Royal Decree of 22 February 2011) faithfully reproduces the technical provisions of CRD III. In order to be interpreted correctly this regulation has to be read in conjunction with the CBFA circular on remuneration dated 14 February 2011 (CBFA_2011_5). The latter refers to the relevant CEBS Guidelines on Remuneration Policies and Practices, which form an integral part of the Belgian prudential framework regarding remuneration policies. Apart from that reference, the circular also specifies a small number of points for Belgium. The main parts of the regulation are the definition of the categories of staff whom the remuneration policy concerns, the statement of a number of governance principles in connection with the remuneration policy, the definition of a set of principles relating to risk alignment for the purpose of the remuneration policy, and finally, the listing of the elements of the remuneration policy which must be made public.

In principle, the remuneration policy only applies to staff whose professional activities have a significant influence on the institution's risk profile, referred to as 'identified staff' to be designated by the institution itself. This particularly concerns people involved in senior management, risk-taking and control functions, and all employees whose total pay puts them on the same level of remuneration as persons performing senior management or risk-taking functions. However, the CEBS Guidelines state that it is advisable to apply certain remuneration principles to a broader group of personnel than just the identified staff, and that other principles apply, by their nature, to the institution as a whole, and hence to all its employees. Following the horizontal screening at the beginning of 2011, the Bank urged the big banks to review the methods which they use to designate the identified staff, since the group of persons thus selected is too small. The Bank stressed that this group must be extended to include, in particular, the management of the dealing rooms and staff performing managerial functions immediately below executive committee level.

In the CRD IV proposal, the governance section concerning remuneration policy specifies, *inter alia*, the role of the board of directors and the independent functions concerning the remuneration policy. These aim to ensure the

(1) The provisions other than those concerning remuneration were transposed into Belgian law by an adjustment to the Bank's capital regulations. These provisions entered into force on 31 December 2011.

(2) Exactly parallel adjustments and additions were made to the Law of 6 April 1995.

necessary independence and expertise when decisions are taken on the remuneration policy. The CEBS Guidelines specify that the board is responsible not only for defining the remuneration policy and monitoring its implementation, but also for taking individual decisions on the remuneration of the most senior staff and the highest earners. Following the horizontal screening at the beginning of 2011, the Bank placed the emphasis on governance in the group context, as it is crucial that the remuneration policy be applied consistently throughout the group, including in entities outside the EU. The big banks had to make a number of adjustments in this respect.

As a general principle, an institution must think about the type of remuneration policy which conforms to its strategy, values and long-term objectives, and the associated tolerance and risk control. The remuneration policy must not encourage excessive risk-taking, and the institution must be capable of pursuing a perfectly flexible bonus policy. If need be, it must be possible for (postponed) variable pay to be reduced to nothing. Guaranteed variable pay is not acceptable. This leads to a number of more specific rules, such as the deferral of the payment of variable remuneration, payment of part of the variable remuneration in the form of instruments, and determination of an appropriate ratio between fixed and variable components. The CEBS Guidelines clarify the interaction between these specific rules and also indicate how they can be applied proportionately according to the institutions' size and internal organisation, and the nature, scope and complexity of their activities. Following the horizontal screening at the beginning of 2011, the Bank had to state that the techniques which institutions have devised for taking account of the risks in variable pay were still imperfect and could not yet guarantee an appropriate link between variable pay and risk-taking. In this respect, the institutions were asked to make a greater effort in the future. Meanwhile, the Bank stipulated that the ratios of fixed to variable pay must be moderated and that the variable component should be spread over a longer period than the strict minimum.

The data to be published on the remuneration policy comprise a combination of qualitative and quantitative information. The quantitative data - centred mainly on the practical arrangements for payment of variable remuneration - must only be provided in aggregate form, in order to protect personal data. The data can be published in the annual report or in a separate remuneration report.

2.2.8 Transposition of CRD II[1] - Strengthening the supervision of cross-border financial groups

Directive 2009/111/EC (CRD II) forms a step along the road towards strengthening the Community framework of cross-border group supervision and crisis management. The existing Directive 2006/48/EC was amended to ensure better coordination between the authorities responsible for supervising those groups. For that reason, it is appropriate to set up a college of supervisors for each group. That college will be chaired by the supervisory authority responsible for surveillance of the group on a consolidated basis, and will also comprise the authorities responsible for supervising, on the one hand, the group subsidiaries, and on the other hand, significant branches located in other EU countries.

The college's role, in addition to ensuring the exchange of information between supervisory authorities, is to improve the coordination of prudential activities and actions. In particular, the college aims to conduct a joint assessment of the risks and of the adequacy of the solvency of the group concerned and of its European subsidiaries, and to decide jointly on the margins to be stipulated for own funds, if appropriate. The colleges of supervisors have to facilitate the conduct of routine surveillance and the management of emergency situations. The lack of information between the competent authorities of the Member States of origin and the host Member States may prejudice the financial stability of the host Member State. The rights to information accorded to the supervisory authorities of the host Member State are therefore reinforced, particularly in the event of a crisis affecting "significant branches". To that end, the concept of a "significant branch" was defined. The competent authorities must pass on the information essential for the performance of their tasks concerning the management of financial crises and the mitigation of systemic risks.

The law transposing the directive introduces the obligation to set up colleges of supervisors, and contains rules on the Bank's participation in the colleges of supervisors established by other supervisory authorities. Similar regulations were prepared in respect of investment firms. The law includes an obligation on the prudential authority, when performing its duties, to take account of European convergence in supervision practices in accordance with the European Directive. Among other things, that means that it takes part in the activities of the EBA and that it abides by the guidelines, recommendations, standards and measures agreed by the EBA, or states its reasons for not doing so.

(1) Law of 28 July 2011 transposing various directives on the supervision of the financial sector and containing miscellaneous provisions, and the Royal Decree of 4 October 2011 amending the Royal Decree of 12 August 1994 on the supervision on a consolidated basis of credit institutions, investment firms and UCI management companies, and the Royal Decree of 20 December 1995 on foreign investment firms.

2.2.9 Developments in accounting standards and financial reporting

The main developments concerning accounting standards and prudential reporting are currently being initiated at international level, and the Bank contributes by playing an active part in the various European and international working groups.

In 2010 and 2011 the IASB, which issues the International Financial Reporting Standards (IFRS), continued the fundamental reforms of the standards for financial instruments and insurance contracts. As these standards will have significant implications for Belgian financial institutions which apply the IFRS standards[1], the Bank is keeping a very close eye on their development.

At the level of the international standard on financial instruments (IAS 39/IFRS 9), in October 2010 the IASB completed the first phase of the reform, namely that concerning the recording and valuation of financial instruments on both the asset and the liability sides of the balance sheet. The second phase concerning hedge accounting resulted in the publication of a draft proposal at the end of 2010, which will be followed by two rounds of consultations in 2012 (general rules and macro-hedging). After that comes the third phase concerning the formation of provisions (impairment) for loans and debt securities held as assets. This third phase will have significant implications for financial institutions and prudential supervisors, as is evident from the debate over the formation of provisions for sovereign credit risk in 2011. The IASB is continuing its work on this last subject via a new consultation launched in 2012. In all, the IASB expected to complete the finalisation of the new standard on financial instruments by the end of 2012, with a compulsory implementation date which might be postponed until 2014, subject to the endorsement of the European institutions regarding its application in Europe.

The IASB has made substantial progress in producing the new IFRS4 standard (Phase II) on insurance contracts. Initially planned for June 2011, the IFRS4 (Phase II) is not now expected to be finalised until later in 2012. A number of important questions need to be resolved before then, notably on the accounting treatment and presentation of results relating to insurance activities.

In 2011 the IASB also published a number of new IFRS standards, some concerning the consolidation rules (IFRS10, 11 and 12 – to replace the existing standards) and one on fair value measurement (IFRS13, Fair Value Measurement). These standards have not yet been endorsed for application in Europe .

In 2010 and 2011 there was intense activity concerning the European work – in which the Bank is also involved – on the prudential reporting of credit institutions (in the EBA) and insurance and reinsurance companies (in EIOPA).

In the case of the insurance sector, there was progress on the new reporting standards under the future Solvency II regime. In October 2011, EIOPA organised an initial public consultation on all the harmonised European requirements which are to apply from 2014 under Solvency II.

In regard to the banking sector, in 2010 the EBA first adapted the Common Reporting Framework (COREP) for prudential reporting in line with CRD III, and that adaptation was then implemented in Belgium via the Circular of 23 August 2011. Next, the EBA initiated the changes to the COREP and the Financial Reporting Framework (FINREP) which will be necessary in connection with the implementation of the future CRD IV. Here it should be noted that the aim will be to have a prudential reporting framework which is harmonised and compulsory for all EU Member States by 2013. Though this new framework will entail some major changes for Belgian institutions, they will be less than those in other European countries where the FINREP framework has not yet been implemented.

Regarding the national accounting standards applicable to enterprises in the financial sector, attention should be drawn to the publication of the Royal Decree of 13 March 2011 amending various Royal Decrees on the annual accounts and the consolidated accounts of certain enterprises. This decree transposed European Directive 2006/46/EC for credit institutions and insurance and reinsurance companies, and by that token it requires the publication of additional information on off-balance-sheet arrangements and transactions with related parties.

(1) Up to 2011, use of the IFRS standards was compulsory for the compilation of the consolidated accounts of credit institutions, and will become compulsory from 2012 for the consolidated accounts of insurance and reinsurance companies.