

Report 2011

Financial stability and prudential supervision



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1. Financial system developments

1.1 International financial markets

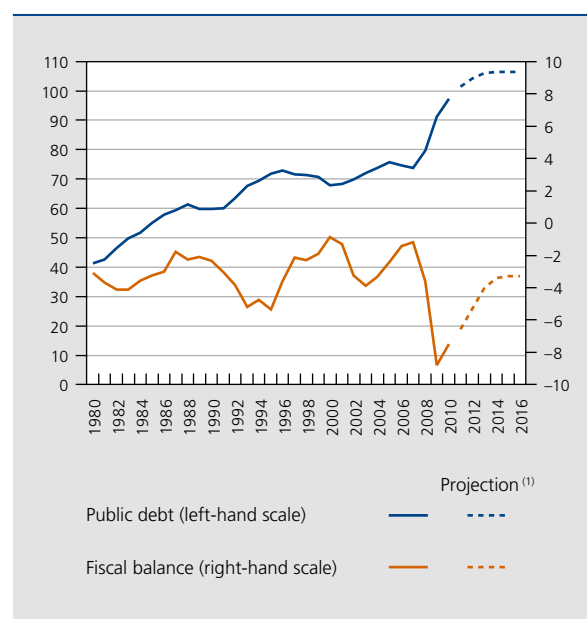
The key development in international financial markets in 2011 was the intensification and broadening of investor concerns over sovereign debt risks, particularly in regard to a number of euro area countries. This new episode in the global financial crisis, which had started in 2007 with fears over potential losses on highly-rated structured credit instruments backed by US mortgage loans, was marked by the return of a wide range of risk premia to levels not seen since the months following the failure of US investment bank Lehman Brothers in September 2008.

Market concerns about the sustainability of fiscal positions in the advanced economies had already emerged in 2010. The combination of fiscal support measures for the financial sector and, more importantly, a sharp downturn in economic activity in the second half of 2008 and 2009, had in fact led to an average fiscal deficit in excess of 8 % of GDP in 2009 in the advanced economies, and a rise in public debt by almost 18 % of the combined GDP of those countries between the end of 2007 and the end of 2009. Those deficits remained high in 2011. Apart from the worsening fiscal indicators, the perceived political or other constraints preventing the adoption of suitable measures to calm the market concerns also fuelled the financial markets' reappraisal of the potential risks associated with the sovereign debt of certain countries formerly regarded as more or less risk free.

For example, in early August 2011 a protracted political impasse in the United States over the raising of the ceiling on federal government debt was only resolved a few hours before the US federal government would have been in a situation of technical default. In these circumstances, one major rating agency decided to lower the US's AAA credit rating by one notch to AA+ (with a negative outlook),

while two others changed the outlook for the US rating from stable to negative. In spite of these developments, yields on US Treasuries remained at historically low levels, in line with yields observed in other major advanced economies with a AAA rating, such as the UK or Germany. The historically low yields on those countries' bonds, benefiting from strong demand for secure investments in a context of risk aversion on the financial markets, contrasted with the interest rate levels on bonds of some peripheral euro area countries, where market concerns over sovereign risk manifested themselves particularly strongly.

CHART 1 GENERAL GOVERNMENT FISCAL BALANCES AND PUBLIC DEBT IN THE ADVANCED ECONOMIES
(in % of GDP)



Source : IMF.

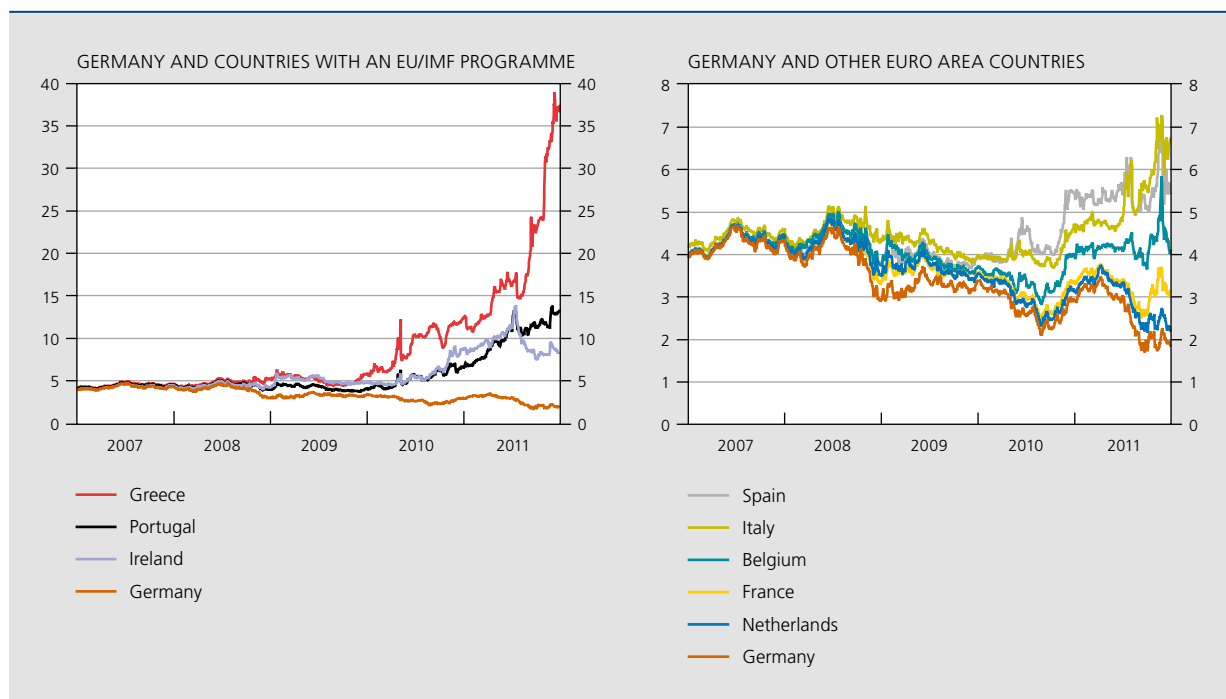
(1) The assumptions underlying this projection are explained in box A1 in the September 2011 edition of the IMF World Economic Outlook (pp. 172–175).

In 2010, increased sovereign risk concerns had already led to an increasingly sharp differentiation in borrowing costs in the euro area, with Greece, Portugal and Ireland seeing quite dramatic increases in ten-year government bond yields relative to the German ten-year benchmark. As highlighted in last year's Annual Report, these adverse developments combined with a number of downgrades of sovereign ratings led to the adoption in May 2010 of a € 110 billion EU/IMF support package for Greece and the establishment of the European Financial Stabilisation Mechanism. Six months later, the financial markets forced Ireland into an € 85 billion EU/IMF support package, to be followed by Portugal in April 2011 with a € 78 billion assistance programme.

Secondary market yields on the government bonds of the three countries with an EU/IMF financial assistance programme remained at very high levels throughout 2011, suggesting that financial markets remained suspicious about the prospects for a return to sustainable public debt burdens in these countries without some debt relief, in spite of the EU/IMF-financed austerity and restructuring programmes. Yet, in pricing the perceived sovereign risk in these countries, financial markets made fairly sharp distinctions between the three countries, with Ireland managing to regain some market confidence thanks to

resolute policy implementation, especially after the EU summit of 21 July, which lowered the cost of Ireland's external support. In Greece, on the other hand, major slippages in policy implementation and serious structural problems in the economy contributed to a complete loss of investor confidence and delayed the disbursement of the fifth and sixth tranches of the Greek support package. Greece's weak economic performance and political problems also created a further need for external funding, necessitating a second Greek support programme to stave off default. During discussions on the details of this second Greek support package, which started during the second quarter of 2011, a number of creditor countries stated that further external support was only possible if the private sector would also make a contribution to this programme. This private sector involvement was to take the form of voluntary participation by private creditors in a re-profiling of Greek sovereign debt maturities by swapping their Greek government bond holdings for new Greek debt with longer maturities, leaving the principal untouched but resulting nevertheless in a loss in net present value of around 21 %. This private sector involvement in the second Greek support package was one of the key measures agreed at the EU summit of 21 July, but the most important one was the agreement to increase the effective lending capacity of the AAA-rated European

CHART 2 TEN-YEAR GOVERNMENT BOND YIELDS IN THE EURO AREA
(daily data, in %)



Source : Thomson Reuters Datastream.

ThisThisThis spreading of sovereign risk concerns to the very core of the euro area in the second half of 2011 occurred as financial markets reassessed the sustainability of the fiscal positions of all euro area countries against the backgroundbackgroundbackgroundbackground of a significant slowing of economic growth in the second half of 2011 and the taking into account of substantial potential future fiscal liabilitiesrelated to guarantees which countries had given to the European Financial Stability Facility, or potential additional fiscal support measures for credit institutions with large exposures to the weakest euro area Member States. Towards the end of the year, risk aversion in the context of questions over the future structure of the monetary union may also have contributed to the general rise in euro area countries' CDS premiums.

In response to this new heightening of market tension in November, at the summit on 8 and 9 December the heads of state and government of the euro area and of other European countries agreed the broad outline of a fiscal compact and closer coordination of economic policy, while the existing stabilisation instruments were reinforced to cope with the short-term problems. On this last point, it was announced that the EFSF would be speedily leveraged and that the approval of the European Stability Mechanism would be brought forward so that it would be introduced sooner in July 2012. The euro area and other Member States also announced that they would consider mobilising additional resources for the IMF totalling up to € 200 billion in the form of bilateral loans, while likewise referring to the unique and exceptional character of the intended arrangements concerning private sector involvement in the support package for Greece.

The repercussions of the public debt crisis in peripheral euro area countries also had significant adverse effects on the funding situation of European banks and insurance companies, as evidenced by the close correlation between the SovX index and a corresponding index for credit default swaps referencing the senior debt of 25 major European financial institutions (iTraxx Senior Financials). Following the creation of the monetary union, banks still exhibited a significant, albeit declining, home bias in their investments in sovereign debt instruments. Consequently, a large share of European banks' exposure to the sovereign debt issued by the most vulnerable euro area countries appears on the balance sheet of these countries' domestic banking systems. In the three EU/IMF programme countries, this led to a complete loss of access to the interbank markets for these domestic banks, resulting in very heavy reliance on Eurosystem financing. However, as non-domestic banks also held substantial claims on peripheral euro area countries, the tension on sovereign debt markets spread well beyond the domestic banking systems of the weakest Member States. At the end of September 2011, European banks' cross-border exposures to the public sector of Greece, Portugal, Ireland, Italy and Spain amounted to € 246.8 billion, plus large additional exposures to other counterparties such as banks (€ 284.2 billion) or other private sector debtors (€ 932.9 billion).

Banks tend to hold very large portfolios of government securities because they can use them as collateral for their borrowings. Fluctuations in the value of these securities or rating downgrades significantly affected the quality and eligibility of large amounts of this collateral in 2010 and 2011, so that the use of these instruments for

TABLE 1 CROSS-BORDER CLAIMS OF EUROPEAN BANKS⁽¹⁾ ON VARIOUS COUNTERPARTIES IN SELECTED EURO AREA COUNTRIES
(consolidated data⁽²⁾, end of September 2011, in € billion)

	Greece	Portugal	Ireland	Italy	Spain	Total
Public sector	22.8	19.7	10.2	135.3	58.9	246.8
Banks	3.0	20.7	45.3	87.4	127.7	284.2
Other foreign claims	52.2	90.6	211.0	325.7	253.3	932.9
Potential exposures ⁽³⁾	24.2	37.5	119.9	196.9	122.8	501.2
Total	102.2	168.5	386.4	745.2	562.7	1 965.1
<i>p.m. Total end December 2010</i>	<i>115.2</i>	<i>182.2</i>	<i>396.8</i>	<i>744.5</i>	<i>577.4</i>	<i>2 016.1</i>

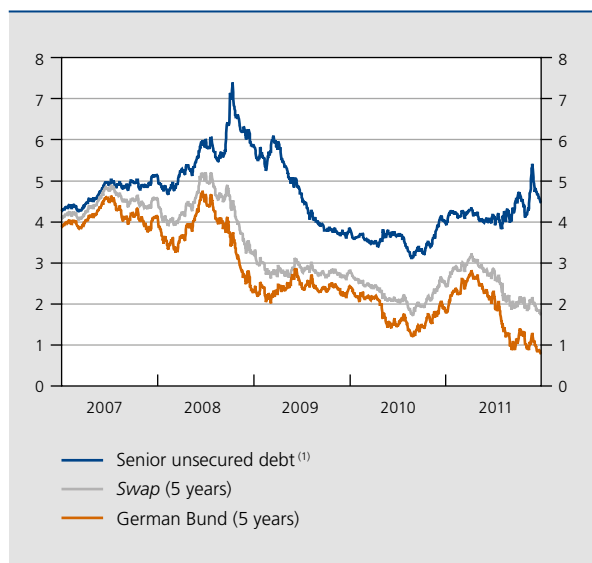
Source: BIS.

(1) Banks controlled by residents and established in Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey and the United Kingdom.

(2) Data from reporting of consolidated international banking statistics. The assets are allocated on the basis of ultimate risk, i.e. after risk transfer.

(3) Cross-border claims resulting from exposures in the form of derivatives, guarantees granted and credit commitments.

CHART 4 YIELDS ON SENIOR BANK DEBT, SWAP CONTRACTS AND GERMAN BUNDS
(daily data, in %)



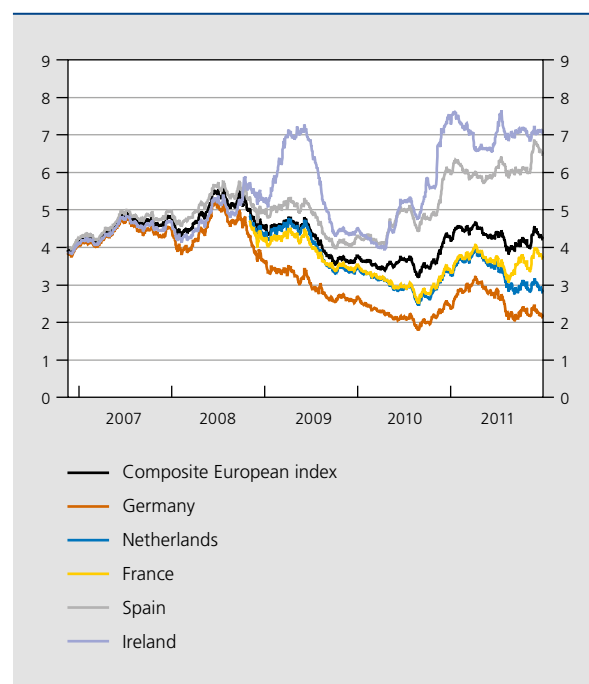
Sources : iBoxx, Thomson Reuters Datastream.
(1) iBoxx euro corporate banks senior index referencing unsecured senior bank debt denominated in euro.

the external funding for banks became more expensive or even impossible in private markets. Since the market value of some government bonds on European banks' balance sheets had fallen dramatically, that also affected the banks' access to unsecured funding markets, as potential lenders took account of these unrealised losses when assessing the solvency of their European debtors. In 2011, this contributed to a significant further increase in the average cost of European banks' senior unsecured euro-denominated debt, widening the spreads – from a low level at the beginning of 2007 – relative to five-year swap or Bund rates. Although swap rates adopted a profile slightly different from that of yields on German government bonds, they remained close to risk-free rates since the counterparty risk on these contracts is offset by the fact that no principal is exchanged during these transactions, and by the widespread use of master agreements specifying the use of collateral to cover the market value of these contracts. Conversely, in the case of unsecured borrowing, the lender bears the counterparty risk for the whole of the amount lent, which explains why, in the second half of 2011, the primary market for issues of senior unsecured bonds by European banks almost completely dried up. In response, banks made increasing use of issues of secured bonds, such as covered bonds. In core euro area countries, these covered bond markets proved relatively resilient to heightened market tension, enabling banks to

continue to issue medium- and long-term debt, despite increased tiering, with yields on Irish and Spanish covered bonds persisting at high levels and French covered bond yields decoupling from the Dutch yields in the autumn. In November, in order to support this key component of bank financing, the European Central Bank (ECB) launched a covered bond purchase programme amounting to € 40 billion.

With many markets for medium-term funding closed for European banks in the second half of 2011, refinancing shifted to short-term funding markets and increased recourse to Eurosystem financing. In the USD funding markets, European banks had to cope with a significant increase in risk aversion on the part of US money market funds, consequently losing a significant amount of short-term USD funding from this traditional provider of funds. In the unsecured short-term funding markets in euro, counterparty risk concerns also re-emerged as a determinant of borrowing conditions. While some banks simply lost access to this market, many others had to pay a premium relative to overnight-index-swap (OIS) rates, the fixed rates paid by counterparties on interest rate swaps receiving the overnight rate for a specified period. In the second half of 2011, this premium reached its highest level since the beginning of 2009.

CHART 5 COVERED BOND YIELDS
(daily data, in %)

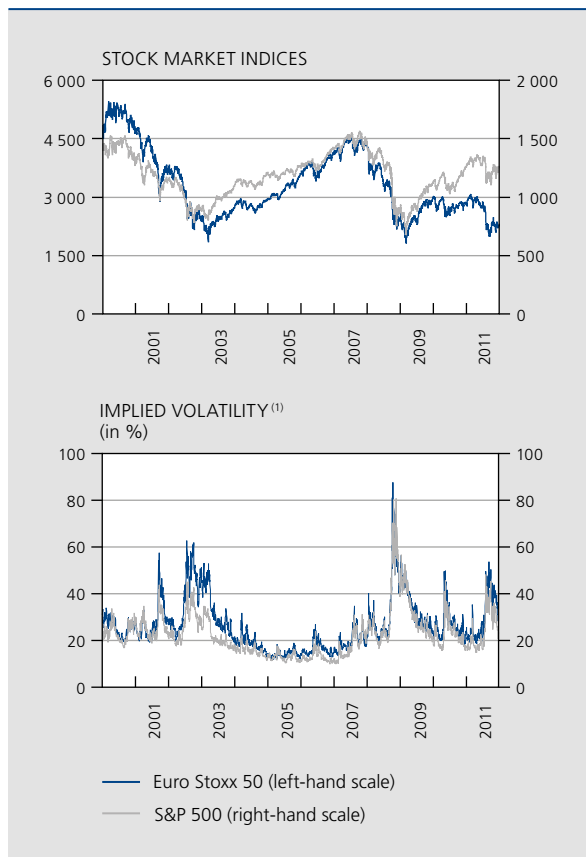


Sources : iBoxx, Thomson Reuters Datastream.

The monetary authorities responded to this new wave of funding difficulties in the second half of 2011 with supplementary measures to support the liquidity position of European banks. These measures comprised the introduction of long-term refinancing operations, relaxation of the collateral rules, and new facilities for USD funding. In order to calm the concerns of market players about the sovereign exposures of European banks, the EBA set up a supplementary stress test – presented in Box 1 – focusing on the losses incurred on sovereign debt instruments. This exercise was conducted at a time when the banks had responded to the increased market tension by improving the transparency of their sovereign exposures and liquidity position, but also by actively reducing their exposure to sovereign debt instruments and by announcing accelerated deleveraging programmes in order to improve their regulatory capital ratios faster than required by the planned Basel III convergence timeline (cf. section 2.2.2). In order to minimise the risk that such deleveraging programmes might give rise to a significant tightening of credit conditions for non-financial debtors, the European authorities put in place, as part of the EBA supplementary stress test exercise, a framework to monitor the deleveraging and recapitalisation plans of the banks identified as having a capital shortfall.

As a result of the economic growth slowdown and substantial losses on global financial markets, non-financial sectors also experienced significant spill-overs from the

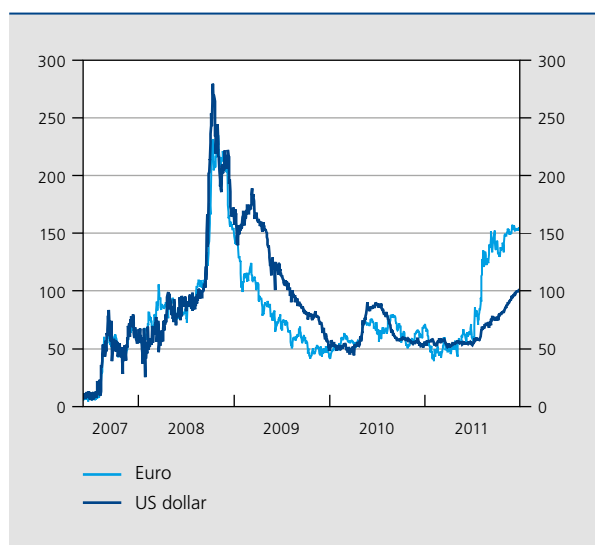
CHART 7 STOCK MARKETS
(daily data)



Source : Thomson Reuters Datastream.

(1) Based on the implied volatility derived from options on the S&P 500 and Euro Stoxx 50 indices.

CHART 6 SPREADS BETWEEN 1-YEAR LIBOR AND OIS (1)
(daily data, basis points)



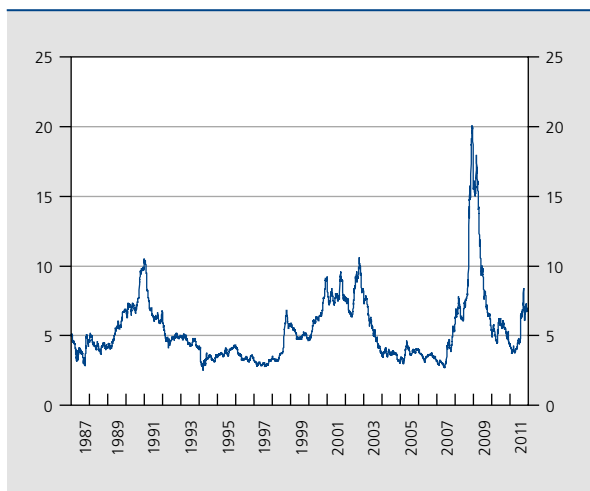
Source : Thomson Reuters Datastream.

(1) Spreads between 1-year Libor and the fixed rate paid by the counterparty on an interest rate swap receiving the overnight interest rate for a one-year period.

public debt crisis in the euro area. European stock markets suffered major losses, with the Euro Stoxx 50 down 17% relative to the end of 2010. In the US, indicators of investor uncertainty and risk aversion – such as measures of the implied volatility in stock prices or credit premiums in high-yield bonds – also rose sharply as a result of anxiety over the global economic outlook and the European debt crisis, even if the level of the S&P 500 index at the end of 2011 was the same as a year previously.

In view of their close economic and financial links with the euro area, central and eastern European countries also experienced significant fall-out from the sovereign debt crisis. The environment deteriorated particularly in countries with fiscal or external vulnerability, such as Hungary. A large volume of loans denominated in Swiss francs was an additional channel for the transmission of tension, as the euro area crisis had contributed to a strong appreciation of the Swiss franc against the euro and the Hungarian forint. In September, in order to limit

CHART 8 SPREAD ON HIGH-YIELD US BONDS⁽¹⁾
(daily data, in %)



Source : Thomson Reuters Datastream.

(1) Difference between the yield on dollar-denominated corporate bonds with a rating lower than BBB/Baa3 and the interest rate on ten-year US Treasury bills.

the scale of the impact of that appreciation on households with mortgage loans, the Hungarian government unilaterally announced a home protection plan whereby – up to the end of January 2012 – households could base their mortgage loan repayments on exchange rates significantly lower than the market rates. That forced the banking sector to recognise substantial impairments on a large proportion of their better quality mortgage loans. In December, with the banking sector's agreement, the government presented a series of additional measures, this time focusing on non-performing loans and arranging for the costs of these support measures to be shared between the government and the banks.

Box 1 – EBA stress test on European banks and assessment of capital buffers in light of the sovereign crisis

In 2011, the EBA repeated a stress test on systemic European banks, in line with similar tests conducted in 2009 and 2010.

The purpose was to assess whether a bank held sufficient core Tier 1 capital, narrowly defined to include only capital instruments of the highest quality, to cover 5 % of risk-weighted assets in both a baseline and an adverse macroeconomic scenario over a two-year period. The adverse macroeconomic scenario deviated from the baseline economic forecast by the introduction of three assumptions, namely shocks specific to the EU and relating to the sovereign debt crisis, a global negative demand shock due to recession in the US, and a USD depreciation.

Apart from its impact on the adverse scenario, sovereign risk was also tested more directly by allowing for mark-to-market losses on sovereign positions in trading books, and by imposing some specific increases in credit risk provisions on sovereign positions in the banking book.

In addition to credit and market risks which had already been tested in the previous exercises, the 2011 test introduced a more specific test on funding risk to examine the impact on banks' funding costs of a widespread increase in interest rates, but also an increase in margins in relation to risk-free rates. Since variations in spreads depend on movements in domestic sovereign debt markets, banks in more vulnerable countries faced proportionally higher funding cost increases for both their wholesale and their retail funding.

The test results were published on 15 July by 90 participating banks, including KBC Bank and Dexia group, together with detailed information on the composition of credit portfolios – focusing more specifically on sovereign and real estate exposures – and on the capital structure.



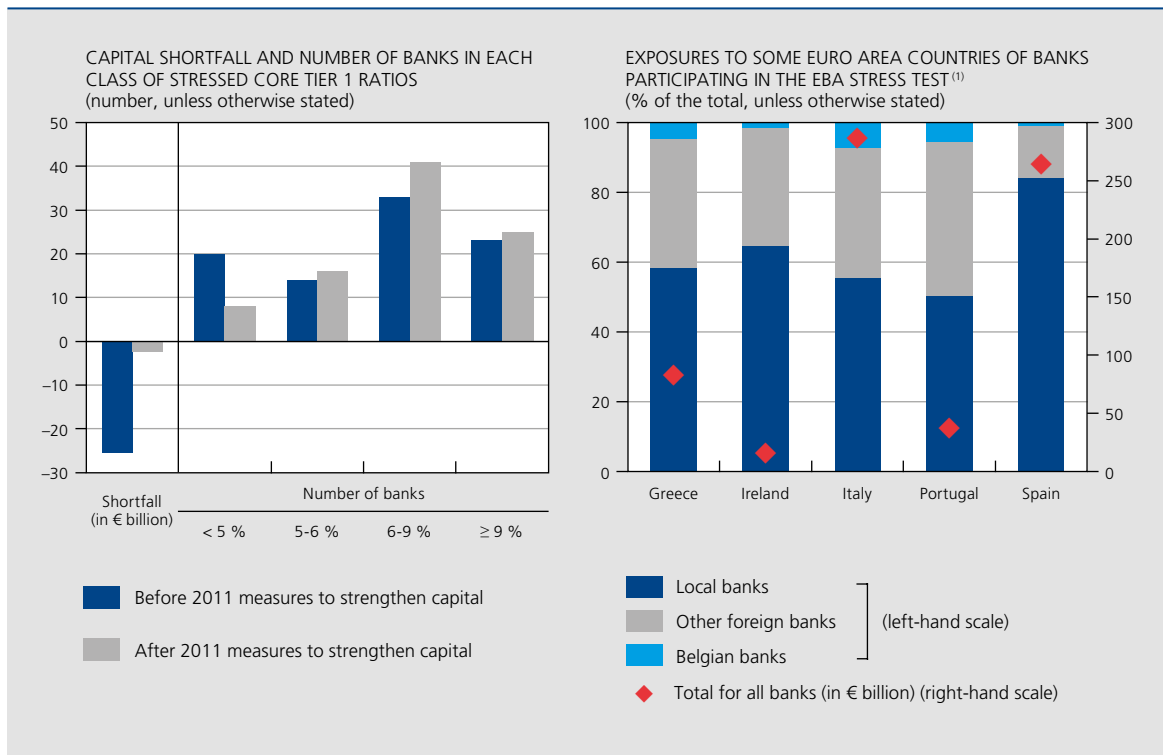
By the time the results were published, some banks had already taken or announced measures in the first half of 2011 to strengthen core Tier 1 ratios through capital injections and restructuring plans. After allowing for these measures which had brought in capital amounting to around € 50 billion, the results showed that eight banks failed the stress test with an overall capital shortfall of € 2.5 billion, and a further 16 banks showed core Tier 1 ratios in the range of 5 to 6 %. In the adverse scenario, core Tier 1 capital ratios fell on average from 8.9 % at the end of 2010 to 7.7 % at the end of 2012. Although the adverse scenario had a considerable impact, BNP Paribas, ING, KBC Bank and Dexia Group were all well above the 5 % threshold.

The main criticisms of the tests were that they did not include liquidity risks as such, that they took insufficient account of the amplification of sovereign risk in 2011, that defining or calibrating the capital requirement at 5 % was insufficiently strict, and finally, that the specific characteristics and individual weaknesses of some banks could not be taken into account owing to the use of standardised assumptions. In particular, no account was taken of various Dexia group characteristics, such as the impact of interest rate risk management on the group's liquidity position. Nevertheless, markets welcomed the detailed breakdown of individual exposures to the EEA central and local governments by country, maturity and accounting portfolios, alongside the detailed information on the capital composition and the credit portfolio.

The disclosure of sovereign exposures confirmed that the European banking sector finances a large part of the sovereign debt of peripheral euro area countries. Whereas domestic banks still hold more than 50 % of the banking sector's total exposure to their sovereign debt, Belgian banks reported shares of 7.2 % of Italian, 5.5 % of

SUMMARY OF THE RESULTS OF THE EBA STRESS TEST

(data published in July 2011)



Source : EBA.

(1) Situation at the end of December 2010.

Portuguese and 4.7 % of Greek sovereign debt holdings by European banks. Dexia also disclosed other significant exposures to these economies through its subsidiaries in Italy and Spain. If the total exposures to these economies are expressed as a percentage of the core Tier 1 capital for 30 of the largest European banks participating in the EBA exercise (excluding local banks), Dexia has the biggest proportionate exposure to Spain and Italy, the fourth biggest with respect to Greece and the seventh with respect to Portugal, putting it in second place in terms of the large European banks' exposure to the peripheral economies.

As announced at the euro area summit on 26 and 27 October 2011, 71 large European banks disclosed – on 8 December – both their sovereign debt positions and the results of a second capital buffer test on their positions at 30 September 2011. More specifically, this test measures whether, after fully accounting for the differences between book and market value of all their European sovereign exposures on that date, the banks have sufficient core Tier 1 capital to cover 9 % of their risk-weighted assets. Any capital buffer shortfall must be closed by June 2012 by issuing core Tier 1 capital, by retaining earnings, by reducing dividend payments or by selling non-strategic assets.

While KBC Bank passed this second test, Dexia reported a shortfall of € 6.3 billion. However, this result must be regarded as pro forma because the group has since undergone radical restructuring. Following the sale of Dexia Bank Belgium to the Belgian State for € 4 billion, this shortfall was reduced to € 4.2 billion for the Dexia group companies now included in the consolidation. This restructured group, which will no longer engage in any significant cross-border activities and will be drastically slimmed down, will no longer be included in the EBA sample. Dexia Bank Belgium, which did not officially take part in the EBA test, stated that it exceeded the 9 % threshold specified in the EBA scenario. It should be noted that this 9 % threshold set by the EBA is still measured according to the Basel II rules. The new Basel III rules will introduce a much stricter definition of core Tier 1 capital (common equity Tier 1 capital). This will require the Belgian banks to increase their solvency ratio gradually during the transitional period preceding the full entry into force of Basel III on 1 January 2019.

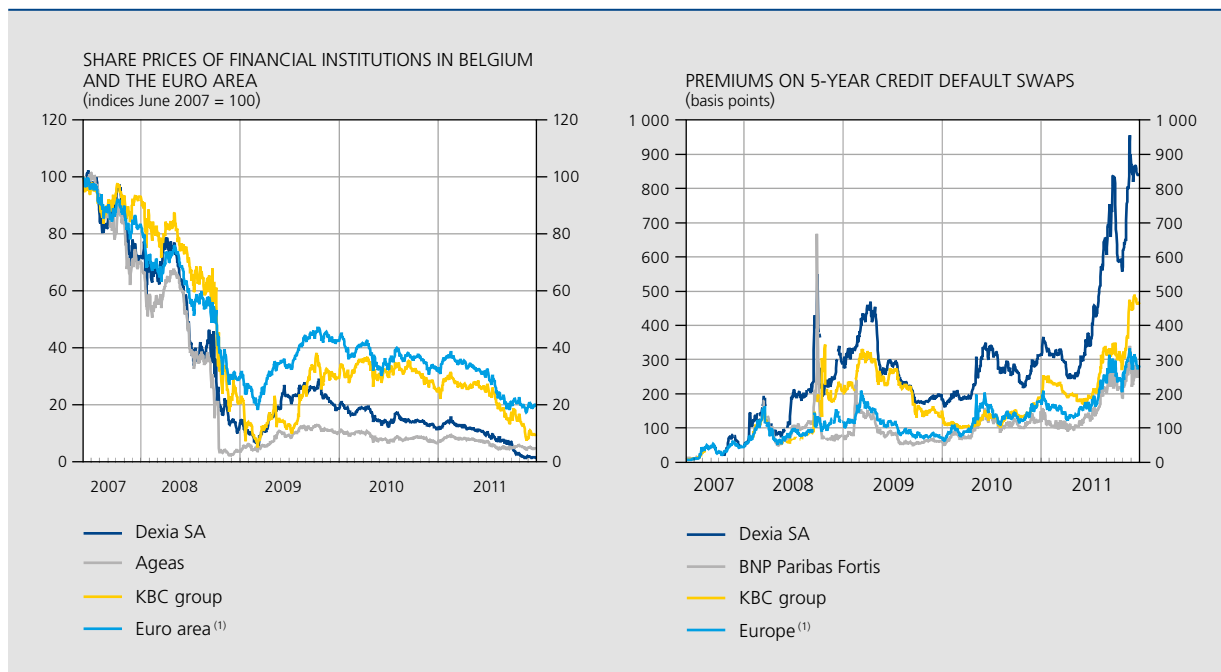
1.2 Belgian financial sector

1.2.1 Banking sector

The profitability of the Belgian banking sector fell sharply in 2011. The sovereign debt crisis and the deteriorating economic environment led to substantial impairments and losses, particularly on the portfolio of Greek government bonds and other foreign exposures, while the on-going restructurings also entailed heavy costs. These developments are all the more worrying since the Belgian banks count on being able to reserve a significant proportion of their earnings to meet the new regulatory requirements. Although all European credit institutions were affected, there was a particularly sharp deterioration in the stock market prices and premiums on credit default swaps (CDS) referencing the debt of certain institutions regarded as particularly at risk. In Belgium this applied to Dexia, whose CDS premiums reached over 950 basis points at the end of November, considerably exceeding their level during the months after the failure of Lehman Brothers in 2008.

Dexia continued to suffer from the weaknesses of its old business model, with its heavy reliance on wholesale funding in a context of renewed interbank market tension. Despite the May announcement that the original restructuring plan would be speeded up, the group's liquidity problems and its large exposures to certain euro area countries necessitated a new plan which, as in 2008, involved substantial intervention by the Belgian, French and Luxembourg States (see Box 2). KBC also modified its 2009 restructuring plan, in agreement with the European Commission (EC). That plan now includes divestment of KBC's Polish banking and insurance subsidiaries, Kredyt Bank and Warta, and the sale or liquidation of specific portfolios of asset backed securities (ABS) or collateralised debt obligations (CDO). These measures replace the floating of minority stakes in CSOB Bank (Czech Republic) and K&H Bank (Hungary), and the sale and lease back of KBC's head office in Belgium.

CHART 9 MARKET INDICATORS FOR BELGIAN AND EUROPEAN FINANCIAL INSTITUTIONS



Sources : Bloomberg, Thomson Reuters Datastream.

(1) Stock market index compiled by Thomson Reuters Datastream for the share prices of financial intermediaries, and iTraxx Senior Financials index for 5-year credit default swaps for a sample of 25 European financial institutions.

Box 2 – The new Dexia restructuring plan

Following the government's intervention in 2008, Dexia had to set up a radical restructuring plan to reduce the group's risk profile and its leveraging.

Under this plan, Dexia was to refocus its activities on traditional financial intermediation by selling off non-strategic operating entities and financial assets, and by terminating its own account trading activities. The plan also provided for cutting the group's operating expenses in order to boost its profitability.

This plan was meant to enable the financial institution to gradually scale down its short-term funding needs, which had reached € 260 billion in October 2008, or almost 40 % of the balance sheet total. These high figures were due mainly to the strong growth of the group's activities in 2005-2008, reflected in a 28 % increase in the balance sheet total, primarily as a result of the growth of the bond portfolio and the expansion of activities on non-traditional markets. This growth had been funded by ready access to the interbank market on favourable terms. Owing to the heightened tension on that market since 2008, however, it became unrealistic and undesirable to maintain that strategy.

Implementation of the restructuring plan imposed by the EC had enabled the group to cut its balance sheet total by € 130 billion (a 20 % reduction), notably by pruning the portfolio of non-strategic assets, and to reduce its short-term borrowing needs by € 160 billion between December 2008 and June 2011. The group's solvency improved, with a Tier 1 capital ratio of 11.4 % in June 2011, against 10.6 % in December 2008.



At the Bank's request, in view of the unstable financial climate prevailing since early 2011, Dexia decided to speed up this process in order to reduce its risk profile more rapidly and thus improve its financial position. That acceleration was announced on 27 May 2011.

Nevertheless, despite this announcement, and taking account of the group's vulnerability in terms of its liquidity position, the situation deteriorated rendering it impossible to continue pursuing the strategy adopted in 2008. In a context of a rapidly worsening risk profile, the Bank insisted that Dexia should submit a dismantling plan to safeguard the group's strategic entities (see section 3.2.1). The reason for the deterioration in Dexia's financial position was that Standard & Poor's placed its short-term rating on watch in May, leading to a reduction of € 22 billion in Dexia's unsecured funding. The escalating sovereign debt crisis, with a sharp fall in the value of government debt securities in numerous countries, had an even more serious impact on the group's borrowing terms since it was accompanied by a fall in the long-term interest rate against the backdrop of general fears of a slowdown in economic activity and a flight to low-risk assets. These two factors resulted in a substantial increase in the collateral (€ 15 billion during the third quarter) that Dexia had to provide to cover the third party risks associated with its interest rate swaps. In addition, a large number of securities issued by the group under a State guarantee matured in 2011, making the financial institution even more vulnerable.

Events came to a head on Monday, 3 October, when Moody's put Dexia's rating on negative watch, rendering the group's liquidity position particularly precarious and endangering its financial stability. Following that announcement, the group lost almost € 9 billion in unsecured short-term funding as well as € 7 billion in customer deposits.

In this context, Dexia was obliged to turn to the government for support in order to implement a comprehensive restructuring plan providing for the total dismantling of the Dexia Group. The aim of this plan was to restore market confidence in the group's sound entities and avoid the risk of contagion.

This plan contained the following measures:

- The acquisition by the Belgian State, on 20 October 2011, for a sum of € 4 billion, of all shares held by the Dexia Group in its subsidiary Dexia Bank Belgium, except for the shares in Dexia Asset Management. The aim of this transfer was to reduce the systemic risks and to ensure that the commercial activities of this subsidiary could continue. In order to avoid the operational risks which could arise from such a split, a Transition Committee was set up with representatives of Dexia SA, Dexia Bank Belgium and the Belgian State.
- The introduction of a new funding guarantee mechanism by the Belgian, French and Luxembourg States for a maximum of € 90 billion for Dexia SA and its subsidiary, Dexia Crédit Local. The governments assume joint but not several liability for the interbank and bond finance with a term of up to 10 years obtained by Dexia SA and its subsidiary Dexia Crédit Local. This guarantee is shared among the countries as follows: 60.5 % for Belgium, 36.5 % for France and 3 % for Luxembourg.
- The acquisition by the Caisse des Dépôts et de Consignation (CDC) and the Banque Postale of 65 % and 5 % respectively of the capital of Dexia Municipal Agency, for the purpose of refinancing the loans to French local authorities.
- The establishment of a joint venture between CDC and La Banque Postale in order to resume the lending activities to French local authorities.
- The sale of several other subsidiaries, including Dexia Banque Internationale à Luxembourg, Dexia Asset Management and Denizbank in Turkey, and the Group's stake in RBC Dexia Investor Services. The sale of these operating entities is designed to strengthen Dexia SA's capital position and thus reduce the risk for the governments.

The EC gave its provisional approval to the sale of Dexia Bank Belgium and the State guarantee covering the refinancing of Dexia SA and Dexia Crédit Local, although the amount of the guarantee was limited to € 45 billion pending a detailed restructuring plan for Dexia SA, to be submitted to the EC by no later than 20 March 2012.



The guarantee also only covers securities with a term of three years maximum, issued before 1 June 2012. The EC has yet to approve the other elements of the dismantling plan.

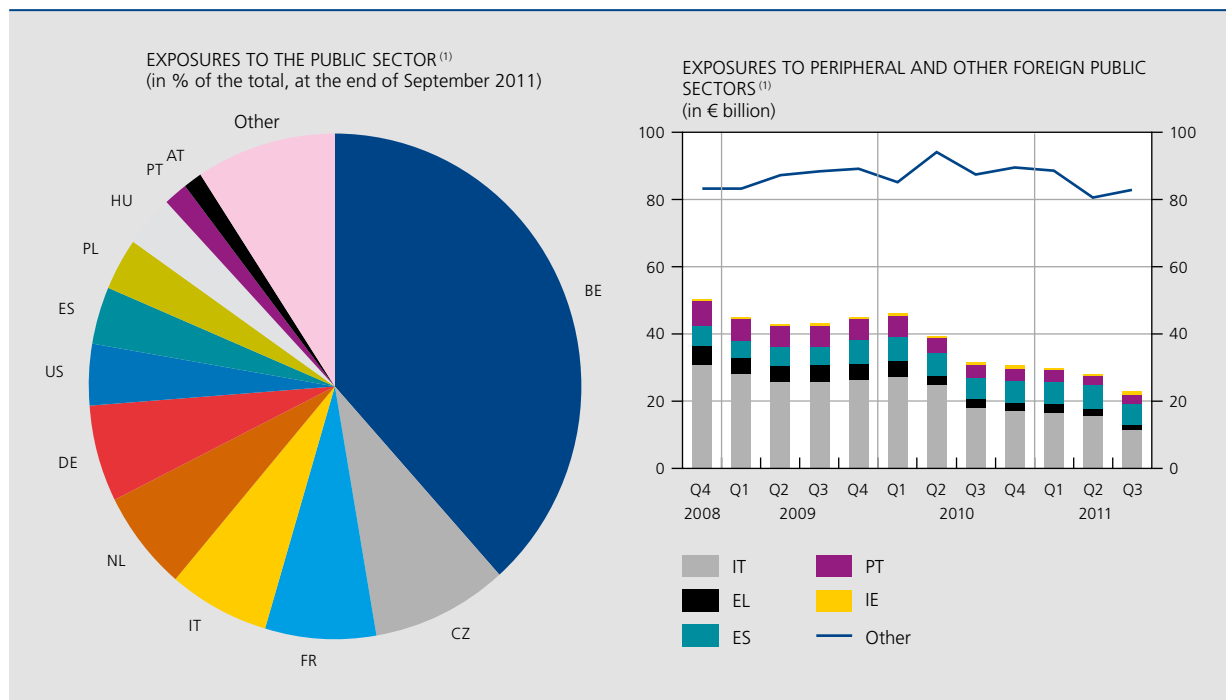
The stress tests conducted by the EBA, as described in Box 1, confirmed the extent to which the big European banks, including some Belgian banks, are exposed to the euro area countries which are under particular market pressure. When the sovereign debt crisis intensified, the Belgian credit institutions speeded up the unwinding of these risk positions in 2011 to limit any losses associated with the holding of these securities. Although these exposures have been steadily reduced since the beginning of 2010, when they amounted to € 46 billion, the total amount of exposures to the governments of these 'peripheral' countries remains considerable, standing at € 23 billion at the end of September 2011. The unwinding of these positions mainly concerned Italian, Greek and Portuguese government bonds. The total exposure to other foreign government sectors declined from € 90 billion to € 83 billion between the end of December 2010 and the end of September 2011. Over the same period, the amount of

securities issued by the Belgian State and held by Belgian banks increased from € 56 billion to € 66 billion. Since the end of 2007, the amount of Belgian government bonds in the portfolio of Belgian banks has grown by almost 43%. Together with Czech, French, Italian, Dutch and German government bonds, these securities make up the bulk of the exposures to the public sector⁽¹⁾.

The reduction of exposures to foreign counterparties was not confined to government loans. In fact, it forms part of a more general process whereby Belgian credit institutions

(1) In this context it is important to remember that the sectoral aggregate used in this report to analyse the financial situation of all Belgian banks is based on data available in the standard reporting schemes for the purpose of supervision. The consolidated basis of this scheme comprises all banking entities established in Belgium and having one or more subsidiaries. For some entities such as ING Belgium and BNP Paribas Fortis, it may be a question of a sub-consolidation. In Dexia's case, the data cover only the activities of Dexia Bank Belgium and its subsidiaries, i.e. excluding Dexia Crédit Local, Dexia Banque Internationale à Luxembourg and Denizbank. The impact of the restructuring of Dexia SA on the sectoral aggregate published in this report will therefore be limited.

CHART 10 BELGIAN BANK'S EXPOSURE TO THE PUBLIC SECTOR



Source : NBB.

(1) Exposures to the public sector in the form of loans and debt instruments, except for Belgium, for which only government bonds are included.

are reverting to their core markets and to more traditional banking activities. To that end, these institutions have terminated certain activities, closed some positions and disposed of some portfolios. In the future, the banks might have to continue this deleveraging so that – in an unfavourable climate for capital increases – they can satisfy market expectations regarding the strengthening of solvency made in any case necessary by the new regulatory requirements.

In contrast to the reduction in exposures to foreign counterparties resident both within the euro area and outside, the proportion of loans and debt securities in relation to counterparties resident in Belgium has risen since 2007. Apart from shifting the focus of activities towards Belgium or countries in which Belgian banks have built up a strategic presence, the restructuring plans also reduced exposures to corporates. Although the underlying trend was similar to that for corporate loans, interbank claims increased in both 2010 and 2011, for reasons unconnected with the Belgian banks' deleveraging strategy.

While the rise in 2010 reflects the inclusion of Bank of New York Mellon in the sectoral aggregate, the increase in the market value of derivatives on the liabilities side of the balance sheet of Belgian credit institutions in the third quarter of 2011 led to an increase in the amount of collateral that the banks are required to provide under these contracts, such collateral usually taking the form of inter-bank deposits. The volume of lending to retail customers has been rising since 2008, confirming the return to more traditional activities. At the end of September 2011, claims on those customers represented 28 % of the total portfolios of loans and advances and debt instruments. The portfolios of loans and debt instruments, totalling € 721 billion and € 215 billion respectively, still account for almost 80 % of the banks' total assets, and form the principal source of credit risk.

Among these claims, those in the form of loans and debt securities vis-à-vis foreign banking institutions still make up the major part of the total exposures towards foreign

TABLE 2 BREAKDOWN OF THE PORTFOLIOS OF LOANS AND DEBT SECURITIES HELD BY BELGIAN BANKS
(consolidated end-of-period data, in € billion)

	Total					of which vis-à-vis counterparties resident in Belgium				
	2007	2008	2009	2010	September 2011	2007	2008	2009	2010	September 2011
Loans and advances⁽¹⁾										
Credit institutions	320.8	213.2	156.1	195.8	211.3	14.8	8.2	7.9	12.3	6.3
Corporate ⁽²⁾	313.5	290.7	244.4	197.8	193.7	97.0	111.0	101.3	92.7	96.5
Retail ⁽³⁾	276.2	208.0	237.4	254.0	264.3	151.2	141.6	173.0	195.2	203.0
Central governments	16.4	13.3	14.4	11.3	6.6	9.6	6.4	8.7	3.7	4.5
Non-credit institutions ⁽⁴⁾	60.1	43.5	40.3	43.6	45.3	30.3	33.0	35.4	34.1	40.1
Total	987.0	768.7	692.6	702.4	721.1	302.9	300.2	326.3	338.0	350.4
Debt securities										
Credit institutions	80.2	63.7	53.1	36.8	27.2	1.2	0.4	0.4	1.0	0.3
Corporate ⁽²⁾	70.2	71.7	49.1	45.0	37.6	4.3	19.5	1.0	1.4	2.3
Central governments	136.6	156.7	156.7	143.4	142.4	46.1	48.1	55.3	56.1	66.0
Non-credit institutions ⁽⁴⁾	8.9	6.6	5.8	6.7	7.5	0.7	0.6	0.7	0.4	0.7
Total	296.2	298.8	264.7	231.9	214.8	49.4	68.7	57.4	58.9	69.3
Total loans and advances and debt securities	1 283.2	1 067.5	957.2	934.3	935.9	352.2	368.9	383.7	396.9	419.7

Source: NBB.

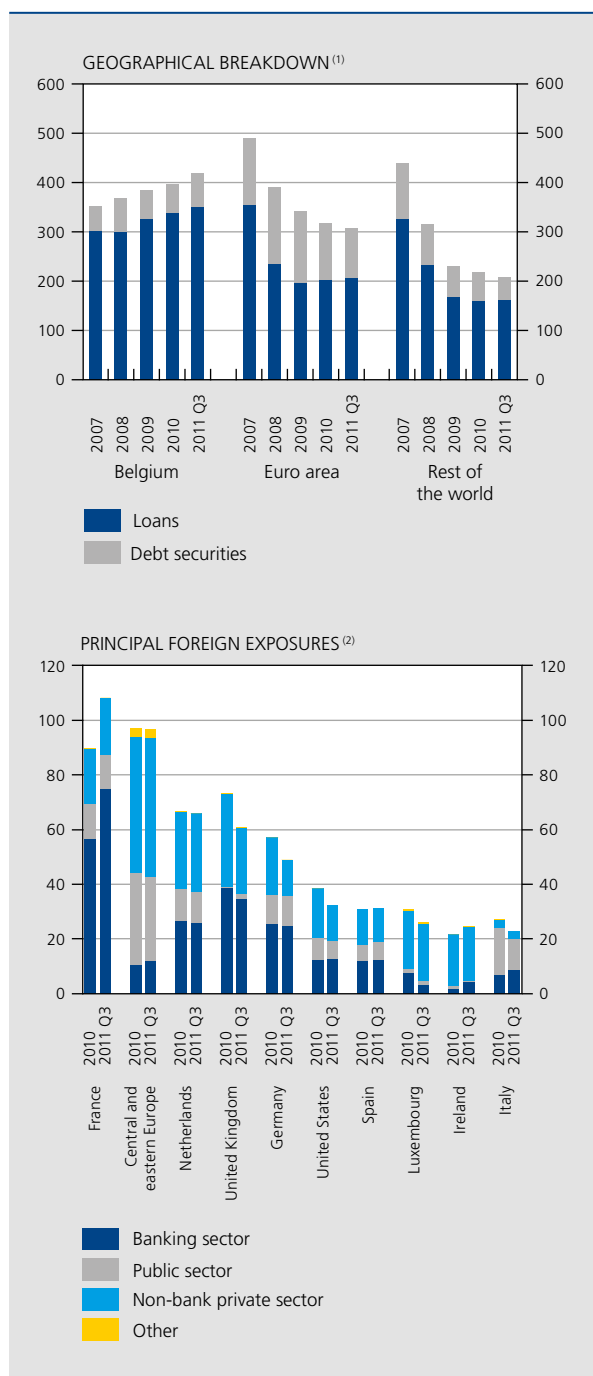
(1) Including loans and advances reported in the category "Held for trading" (respectively € 39.1, 13.5, 4.3, 28.9 and 25.9 billion at the end of 2007, 2008, 2009, 2010 and September 2011).

(2) Including claims on non-financial companies and some SMEs, and on some non-bank financial companies.

(3) Also including self-employed persons and some SMEs.

(4) Including claims on certain non-bank financial institutions and local authorities.

CHART 11 GEOGRAPHICAL BREAKDOWN OF THE ASSETS HELD BY BELGIAN CREDIT INSTITUTIONS IN THE FORM OF LOANS AND DEBT SECURITIES
(consolidated end-of-period data, in € billion)



Source : NBB.

- (1) Data obtained from the consolidated reporting of Belgian credit institutions. Distribution in accordance with the FINREP prudential reporting.
 (2) Data obtained from the consolidated reporting of international banking statistics. Data compiled in accordance with the Belgian accounting standards (Belgian GAAP). The assets are classified according to the ultimate risk, i.e. after risk transfer.

most exposed are the French banking sector (€ 75 billion), and those of the United Kingdom (€ 35 billion), the Netherlands (€ 26 billion) and Germany (€ 25 billion). In contrast to the consolidated data, the data compiled on a territorial basis reveal the intra-group flows between banking entities located in Belgium and those based abroad. Those data make it possible to identify transactions effected on the interbank market solely by banking entities based in Belgium by distinguishing between transactions with entities in the same group and those with other banks. It seems that the net funding granted by Belgian entities of credit institutions to other banking entities in the same group located abroad has increased in recent years. The difference between the amounts lent and borrowed via such transactions rose from € 102 billion at the end of 2009 to € 115 billion at the end of September 2011. Conversely, the amounts of interbank claims and debts of credit institutions resident in Belgium vis-à-vis counterparties outside their own group, partly taking the form of deposits linked to derivative contracts, have been in balance since the end of 2008, and have actually been declining in recent years.

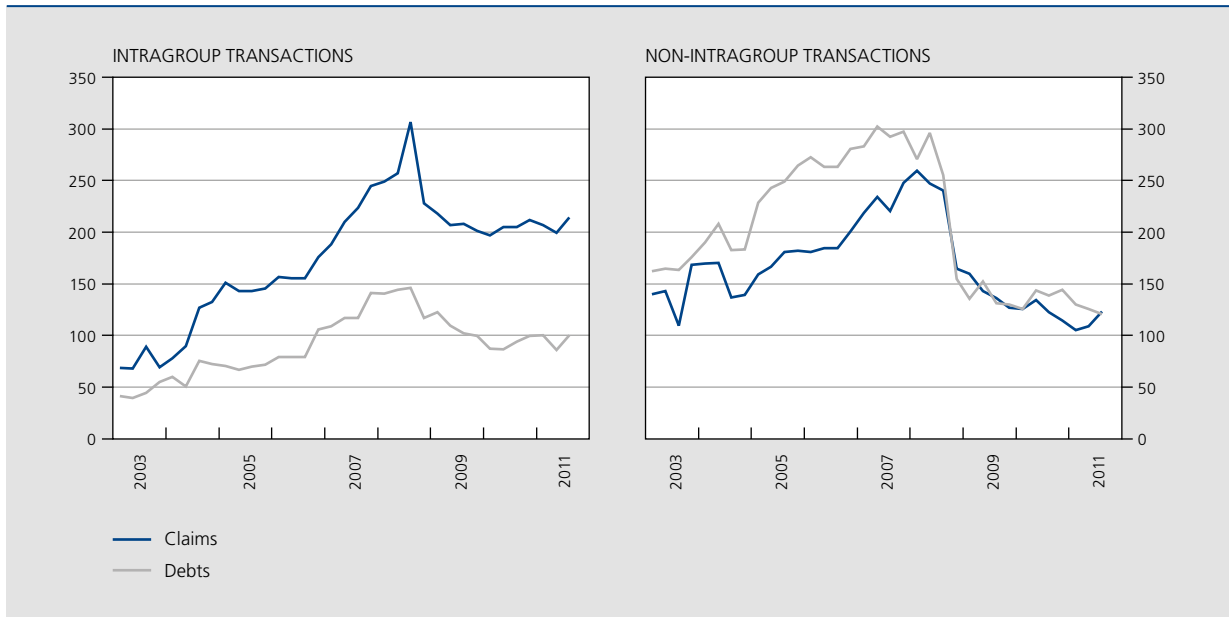
The Belgian banks are also exposed to the foreign non-bank private sector. At the end of September 2011, that sector represented 38 % of their total exposures to foreign counterparties. Those exposures are concentrated mainly in Central and Eastern Europe (€ 51 billion), the Netherlands (€ 29 billion), the United Kingdom (€ 24 billion), Luxembourg (€ 21 billion), France (€ 21 billion) and Ireland (€ 19 billion). Though the total of these exposures has shrunk considerably in the past three years, and declined by a further 10 % in the first nine months of 2011, exposures to the non-bank private sector of Central and Eastern European countries, where the Belgian banking sector developed activities via its subsidiaries, have remained at a high level. Exposures to all counterparties located in those countries increased by around 13 % from the end of 2007 to reach € 97 billion at the end of September 2011. In the case of the Dexia group, the figures in this Report relate only to the activities of Dexia Bank Belgium and therefore exclude, for example, the group's exposures to Turkish counterparties contracted by its subsidiary, Denizbank.

Although the Belgian banks endeavoured to gradually refocus their lending activities, they nevertheless had to record an increase in impaired loans which – excluding debt securities – came to € 21 billion at the end of September 2011 compared to € 15 billion at the end of 2007. During this period, the percentage of impaired loans jumped from 1.5 % at the end of 2007 to 2.9 % at the end of 2009. In 2011, it was mainly loans to households that recorded an increase in the rate of impairment,

counterparties (43 % at the end of September 2011). The foreign banking sectors to which the Belgian banks are

CHART 12 CROSS-BORDER INTERBANK INTRAGROUP AND NON-INTRAGROUP POSITIONS

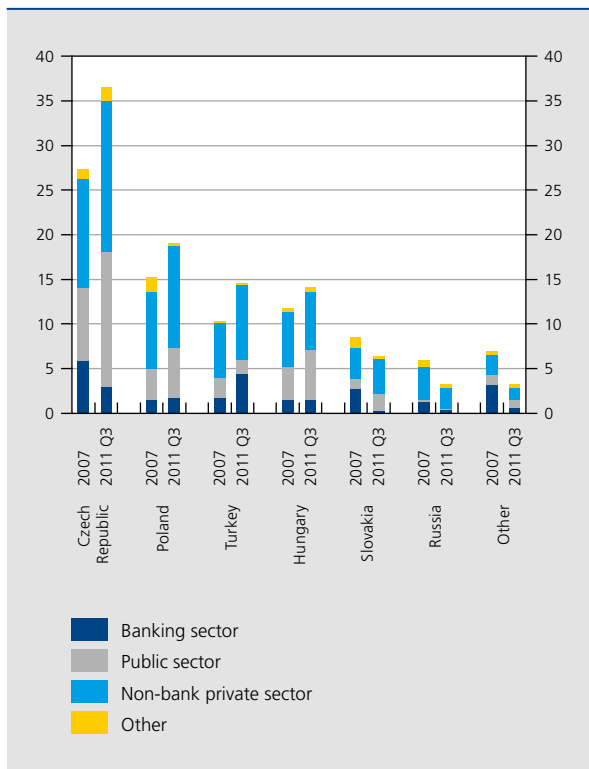
(territorial end-of-period data, in € billion)



Source : NBB.

CHART 13 CLAIMS OF BELGIAN BANKS ON CENTRAL AND EASTERN EUROPE

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



Source : NBB.

from 3.5 % to 4.0 % over the first nine months of the year. Conversely, that percentage declined for other counterparties. The cover ratio came to 41.6 % at the end of September 2011. The expected growth slowdown is liable to drive up the percentage of impaired loans recorded by the banks. Nonetheless, it is important to remember that a deterioration in the financial soundness of the economic agents takes time to be reflected in payment defaults.

More specifically regarding loans to Belgian households, the quality indicators do not point to any increase in defaults on mortgage loans, as the proportion of defaulting mortgage loans is actually down against its historical profile. Conversely, the opposite applies to consumer loans.

A large proportion of the impaired loans comprise exposures to foreign counterparties, either via the participation of Belgian banks in international corporate finance markets or project finance activities, or via the strategic presence of Belgian banks in certain countries in the form of subsidiaries. In the latter case, Belgian banks suffered as a result of the adverse developments in certain countries in 2011, notably in Ireland and Hungary. In Ireland, the risks on household mortgage loans and on firms active in the property sector were ever present, necessitating substantial provisions. In Hungary, the sharp depreciation of the forint meant a significant increase in the debt burden

TABLE 3 CREDIT QUALITY INDICATORS

(end-of-period consolidated data, in € billion, unless otherwise stated)

	Total loans granted	% of impaired claims ⁽¹⁾					Coverage ratio ⁽²⁾				
		September 2011	2007	2008	2009	2010	September 2011	2007	2008	2009	2010
Credit institutions	211.3	0.0	0.4	0.8	0.4	0.2	59.0	68.2	47.7	55.5	58.6
Corporate	193.7	2.3	2.3	4.3	4.9	4.8	37.2	47.1	46.0	43.2	45.8
Retail	264.3	2.8	3.3	3.5	3.5	4.0	27.6	33.6	39.0	41.2	37.9
Non-credit institutions	45.3	0.3	1.3	0.3	0.9	0.6	31.9	19.9	17.9	45.4	12.1
Total⁽³⁾	721.1	1.5	2.0	2.9	2.8	2.9	32.3	41.1	43.0	42.8	41.6

Source: NBB.

(1) Impaired claims (according to the IAS 39 definition) as a percentage of the total loans granted.

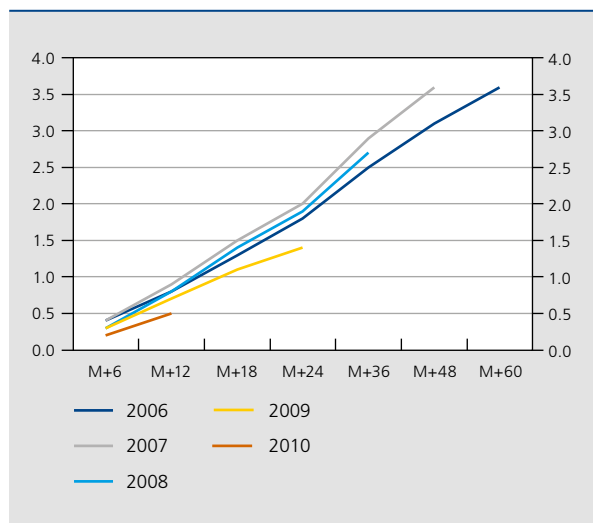
(2) In % of impaired claims covered by specific or general provisions.

(3) Includes loans to central governments.

for many households which had taken out a mortgage loan denominated in a foreign currency, mainly the Swiss franc. This led the government to set up a support plan in September, allowing households to repay their loans at the

fixed rate of 180 forint per Swiss franc, which was much more favourable than the market rate. Loan repayments on those terms will mean even bigger losses for banks active on that market, since they themselves had hedged the exchange rate risk. In consultation with the banking sector, the initial plan was supplemented in December 2011 by new measures permitting, in particular, a reduction in the debt burden for borrowers who have already missed a number of repayments. It was also agreed that part of the cost would be borne by the government, while banks could deduct 30 % of the losses due to the support plan from the amount of their bank tax liability.

CHART 14 PROPORTION OF MORTGAGE LOANS GRANTED TO BELGIAN HOUSEHOLDS WITH PAYMENT ARREARS⁽¹⁾, BY VINTAGE⁽²⁾
(in %)



Source: NBB.

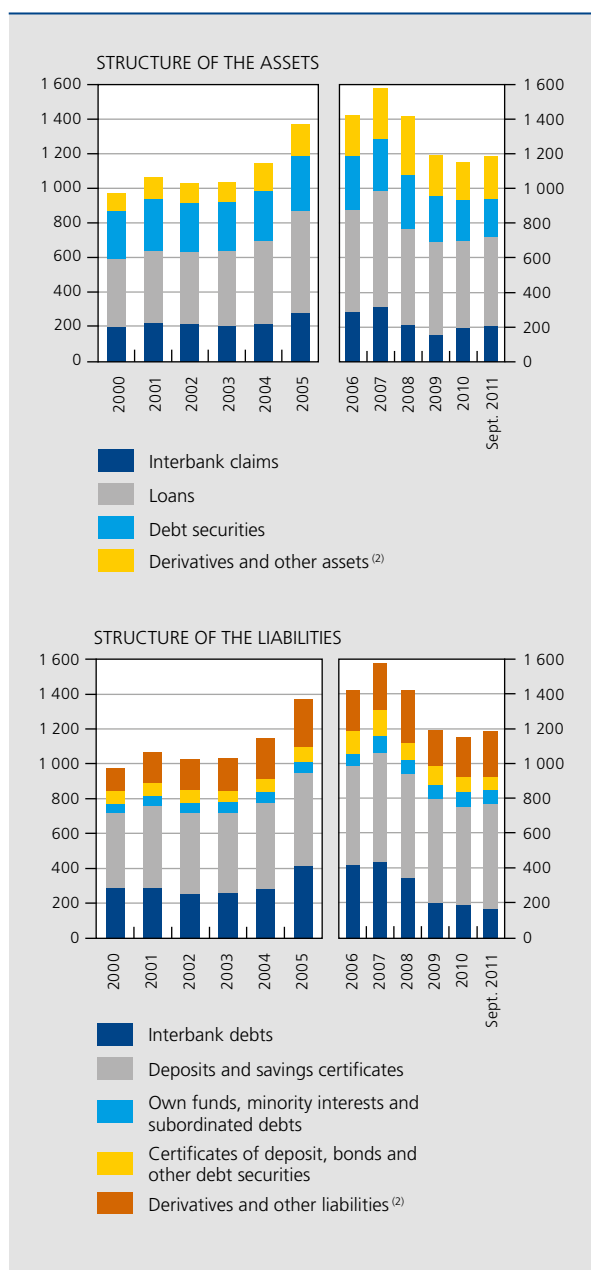
(1) A default is recorded if three payments have not been effected (in full) or if one payment remains outstanding after three months.

(2) Vintages comprise all the loans granted in the same year. For each vintage, the curve shows the number of loans in default as a percentage of the total original loans after a certain number of months since the granting of the loans. No account is taken of the possible regularisation of loans.

On average, the four biggest credit institutions record higher loan impairment rates than other institutions which focus more on the Belgian market. The business model of these smaller institutions is also geared more towards retail customers and small and medium-sized enterprises, while they obtain a higher share of their funding from household deposits. These institutions were also less affected by the financial crisis in 2008 and 2009, owing to their smaller exposure to structured products. Thus, while the balance sheet total of the Belgian banking sector declined from over € 1 700 billion at the end of June 2008 to € 1 185 billion at the end of September 2011, this reduction was attributable mainly to the four large Belgian credit institutions, partly because Fortis Bank Nederland left the consolidation scope of Fortis Bank in 2008. The expansion of the balance sheet total in 2011 reflects the temporary effects of the increase in the market value of derivatives, plus the claims and mobilisation of collateral in connection with such contracts. The

CHART 15 BALANCE SHEET STRUCTURE OF BELGIAN CREDIT INSTITUTIONS

(consolidated end-of-period data ⁽¹⁾, in € billion)



Source : NBB.

(1) Data compiled in accordance with the Belgian accounting rules until 2005 (Belgian GAAP) and the IAS/IFRS rules from 2006.

(2) Derivatives are recorded at their market value including, from 2007, income receivable and expenses payable (which are not included in the figure for 2006).

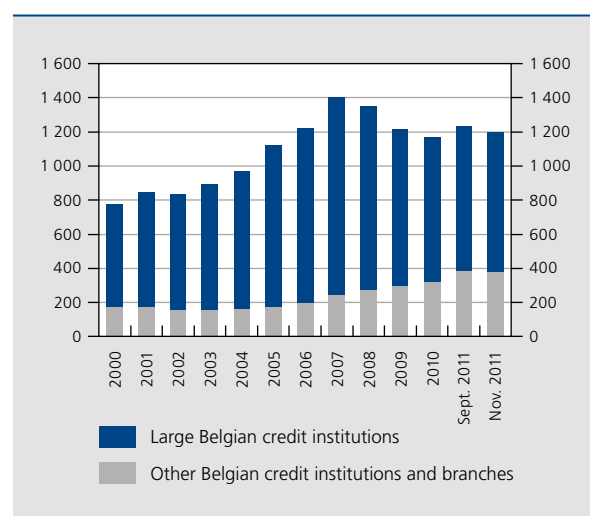
data on a company basis indicate a further contraction in the balance sheet of the four large institutions from October. Conversely, the balance sheet total of the other institutions has expanded steadily since 2001, supporting the return of the Belgian banking sector to more traditional banking activities.

The Belgian banks also reorientated their funding structure towards more traditional sources. The deleveraging of the Belgian banking sector was thus accompanied by a substantial decline in the use of wholesale funding. Since the end of 2008, the outstanding total of interbank debts and other wholesale deposits has fallen by € 124 and € 54 billion respectively, although these funding sources expanded again in the third quarter of 2011, partly as a result of the increase in the market value of derivatives on the assets side of the balance sheet, and partly owing to the rise in repo transactions to compensate for the scarcity of other funding sources. Conversely, the amount of retail deposits and savings certificates increased steadily. The proportion of funding obtained via retail customers increased from 27.9% at the end of 2008 to 40.9% at the end of September 2011. However, the success of the State notes issued in November and December 2011 depressed the outstanding amount of deposits with the Belgian banks.

In 2009 and 2010, this growth of retail customers' deposits was based largely on savings deposits, since these assets enjoyed a significant interest rate advantage over term deposits. Although this situation was reversed in 2011, that did not produce any marked change in the preferences of Belgian households, as the outstanding amount of term deposits increased only slightly, while that of savings accounts stabilised at around € 220 billion.

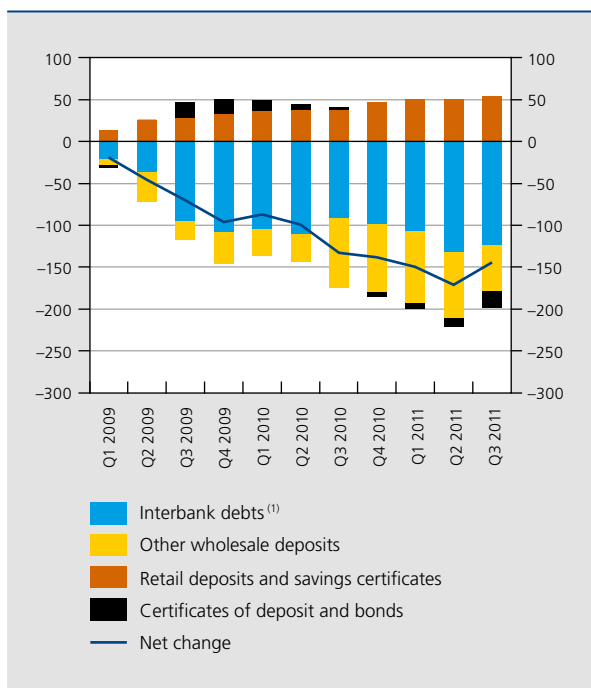
CHART 16 COURSE OF THE BALANCE SHEET TOTAL OF THE BELGIAN BANKING SECTOR

(end-of-period data, in € billion)



Source : NBB.

CHART 17 CUMULATIVE CHANGES IN DEPOSITS COLLECTED AND SECURITIES ISSUED SINCE THE END OF 2008
(consolidated data, in € billion)

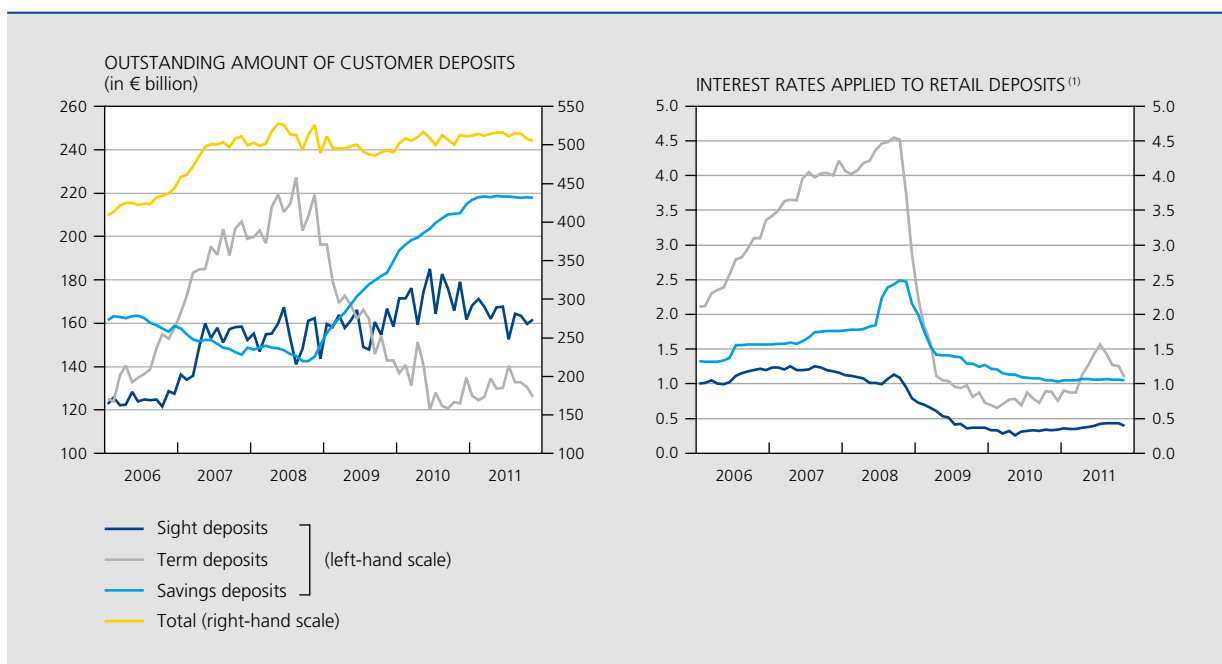


Source : NBB.
(1) Excluding amounts owed to central banks.

Alongside household deposits, medium- and long-term issues of securities form another stable source of funding. However, the total amounts obtained by issuing debt securities declined again in the first nine months of 2011. In particular, these issues were disadvantaged by the change in the rating of Belgian banks which, in 2011, in common with other European credit institutions, were downgraded or placed on watch by the leading rating agencies. These changes in the assessment of the European banks' ability to honour their obligations contributed to the drying-up of the primary market in unsecured bonds. The general mistrust of credit institutions also hampered wholesale funding in general, the reluctance of American counterparties to lend to European banks being a particular impediment to (re)financing in dollar.

In a climate which was rather unfavourable for issuing unsecured securities, some Belgian banks – and Dexia in particular – resorted to issuing covered bonds, i.e. securities backed by claims on the public sector or by mortgage loans. While use of the primary market for the issuance of covered bonds was relatively dynamic in the first half of the year under review, access to that market was subsequently curtailed. More structurally, the use of that type of funding is limited by the availability of eligible assets, extra collateral being in addition required for covered bonds in order to offer an additional safety margin for holders of

CHART 18 CUSTOMER DEPOSITS : OUTSTANDING AMOUNTS AND INTEREST RATES APPLIED
(unconsolidated data)



Source : NBB.
(1) Data on new deposits from the monthly MIR survey. The term deposit data concern deposits with a maturity of up to one year.

the securities. Since the issuance of these securities comes under specific legislation which is currently being prepared in Belgium, the Belgian banks issued their securities via their foreign subsidiaries.

Despite increased recourse to retail deposits, the Belgian banks – and especially Dexia Bank Belgium – made more use of central bank financing. The changes in the funding arrangements of the Belgian banks combined with the restructuring of their assets are intended to enable them to improve their liquidity position. The Bank bases its assessment of credit institutions' liquidity on a regulatory ratio which became compulsory in January 2011, in anticipation of the implementation of two new liquidity ratios – from 2015 and 2018 – under the Basel III rules. These two ratios are presented in more detail in section 3.2.2 of this Report. The Bank's current ratio aims to assess whether the outflow of funds which could be triggered at a one-month horizon by an exceptional liquidity shock is below the level of the liquid assets which can be mobilised during that period. Among the short-term funding sources, the scenarios adopted for the calculation of the ratio provide in particular for the withdrawal of all unsecured short-term wholesale funding, while only 20 % of retail deposits are withdrawn. The return of the Belgian banking sector to a funding structure with a stronger focus on retail deposits has limited the potential outflow of short-term funds as simulated for the calculation of the regulatory ratio.

The buffer of unencumbered liquid assets, which totalled € 203 billion at the end of September, was adversely affected in 2011 by the combined effects of the fall in the market value of certain government bonds, the increase in the collateral required by counterparties of interest rate swaps, and finally, the expansion in the volume of repo transactions which the banks used to raise funding by temporarily disposing of assets.

Between the end of 2009 and the end of September 2011, the ratio calculated for the sector as a whole, which must be 100 % or less to satisfy the regulatory requirements, dropped from 102 % to 75 %, though that was still above the figure at the end of June 2011 (70 %).

This more recent development reflects a deterioration in the short-term liquidity position of Belgian credit institutions, including Dexia Bank Belgium, the conditions on the short-term funding markets (including in dollar) being in addition increasingly characterized by reductions in volumes granted and maturities.

The effects of the sovereign debt crisis and the implementation of the restructuring plans by the large Belgian

TABLE 4 LIQUIDITY BUFFER, FUNDING STRUCTURE AND REGULATORY LIQUIDITY RATIO

(end-of-period consolidated data, in € billion, unless otherwise stated)

	2009	2010	September 2011
Total assets	1 190	1 151	1 185
of which:			
Unencumbered liquid assets	223	232	203
Total funding ⁽¹⁾	913	849	843
of which:			
Retail deposits	283	300	306
Unsecured short-term wholesale funding ⁽²⁾	267	222	182
Regulatory liquidity ratio (in %) ⁽³⁾	102	78	75

Source: NBB.

(1) Defined as the sum of the total deposits and the total issues of debt securities (including bonds).

(2) Funding maturing in the year following the reporting date. This wholesale funding comprises funds obtained from various counterparties: banks and institutional investors as well as public sector entities and large firms.

(3) Regulatory ratio at a one-month horizon. The aim of this ratio is to ensure that credit institutions hold sufficient liquid assets to withstand the impact of certain exceptional circumstances defined by the supervisory authority. In practice, the ratio compares net cash outflows in a scenario in which the liquidity position is under pressure – simulated partly by assuming that large cash withdrawals affect the various funding sources – and the buffer comprising unencumbered liquid assets. The ratio must be 100 % or less in order to satisfy the regulatory requirements.

banks were evident in the profit and loss accounts, which presented a widely varying picture in 2011. During the first three quarters of 2011, it is true that intermediation and fee-generating activities produced a gross operating profit before impairments and provisions which was close to the 2010 figure, namely € 4.7 billion against € 5.1 billion, but impairments and provisions and the extraordinary components of the profit and loss account, particularly the losses on current restructuring, drained the accounts, which ended with a net profit of just € 0.3 billion instead of € 4.4 billion in the first nine months of 2010 .

Like other European credit institutions, the Belgian banks had to record substantial impairments on Greek government bonds in their portfolio in the second and third quarters of the year under review. The massive increase in the total amount of the impairments to € 3.1 billion in the first nine months of 2011, compared to € 1.2 billion in 2010, is also attributable to the increase in loan loss provisions following the slowdown in economic growth in the second half of 2011 and developments in certain countries, such as Ireland and Hungary. Expressed as a percentage of total lending, these provisions represented 29 basis points in annualised terms, thus exceeding the level reached in the same period in 2010. In the future,

TABLE 5 INCOME STATEMENT OF BELGIAN CREDIT INSTITUTIONS
(consolidated data, in € billion, unless otherwise stated)

	2007	2008	2009	2010	First nine months		In % of bank income
					2010	2011	
Net interest income	13.30	14.48	14.89	13.77	10.11	10.49	70.7
Non-interest income	13.01	4.80	3.93	6.39	4.90	4.35	29.3
Net fee and commission income (excluding commission paid to agents)	7.35	6.76	5.66	5.15	3.94	4.08	27.5
(Un)realised gains or losses on financial instruments ⁽¹⁾	3.76	-3.83	-2.74	-0.04	0.03	-0.54	
Other non-interest income	1.91	1.86	1.01	1.28	0.93	0.81	
Bank income	26.31	19.28	18.82	20.15	15.01	14.85	100.0
Operating expenses	-16.08	-16.59	-14.61	-13.29	-9.87	-10.19	68.7⁽²⁾
Gross operating result	10.23	2.69	4.20	6.86	5.14	4.66	
Impairments and provisions	-3.18	-13.31	-7.36	-1.83	-1.21	-3.11	
Other components of the income statement	-0.39	-10.60	1.94	0.53	0.48	-1.25	
Net profit or loss	6.66	-21.21	-1.22	5.56	4.41	0.29	

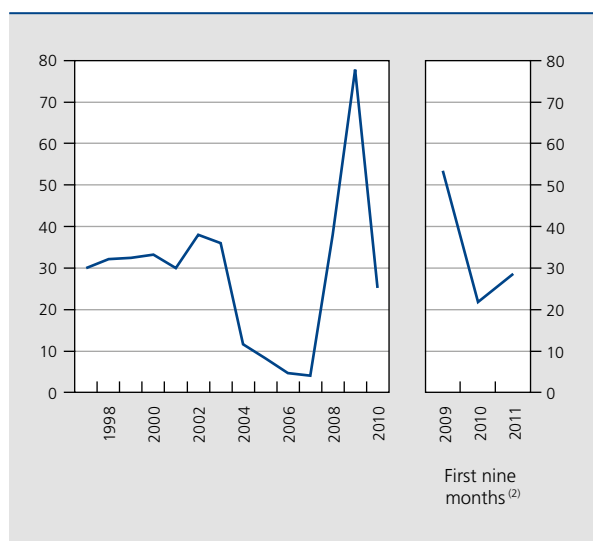
Source: NBB.

(1) This item includes the net realised gains (losses) on financial assets and liabilities not measured at fair value through profit or loss, the net gains (losses) on financial assets and liabilities held for trading and designated at fair value through profit or loss, and the net gains (losses) from hedge accounting.

(2) This is the cost-to-income ratio of the Belgian banking sector.

CHART 19 LOAN LOSS RATIO OF BELGIAN CREDIT INSTITUTIONS⁽¹⁾

(consolidated data, basis points)



Source: NBB.

(1) Net flow of new impairments for credit losses expressed as a percentage of the outstanding loans. Data from 2006 onwards relate to the loan loss ratio for the category "Loans and receivables" according to IAS / IFRS.

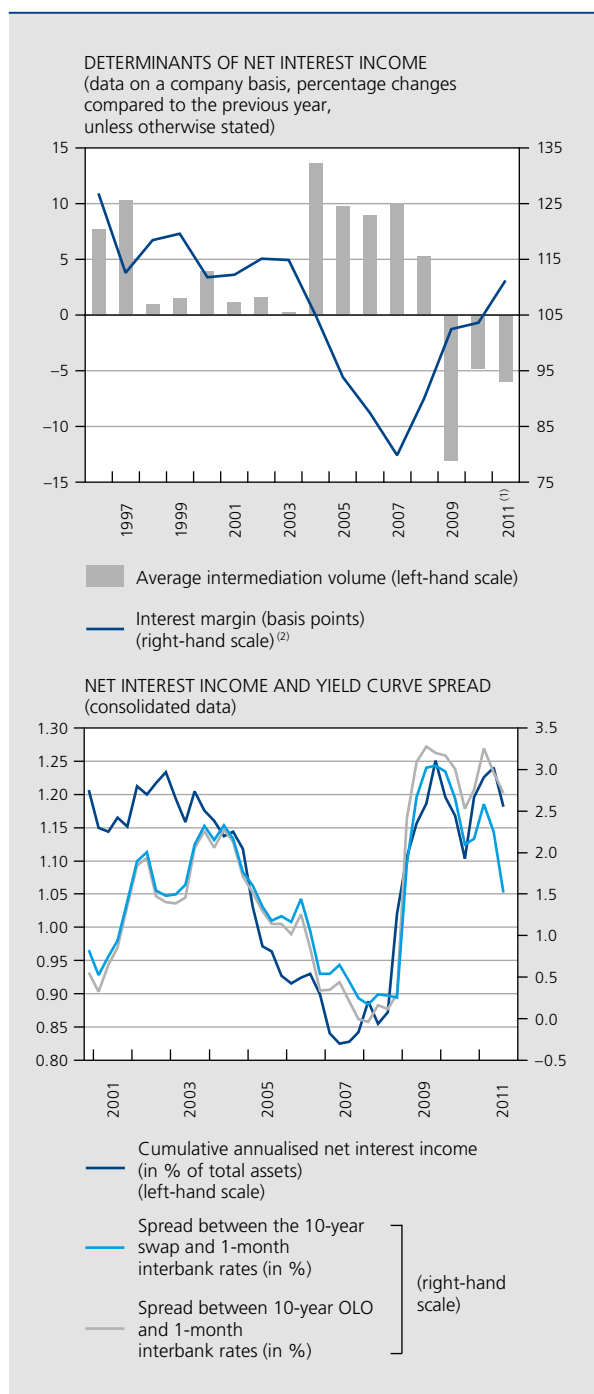
(2) Annualised.

further impairments are expected in view of the likely continuing deterioration in the economic climate.

The relative stabilisation of the gross operating result partly reflects control of operating expenses, which in 2011 matched the level recorded in 2010. However, these stable operating expenses were accompanied by lower operating income, so that the cost-to-income ratio at the end of September 2011 came to 69%, exceeding the 2010 figure of 66%.

Net interest income, the principal revenue source for Belgian credit institutions, amounted to € 10.5 billion in the first nine months of 2011, against € 10.1 billion in the corresponding period of 2010. The level of net interest income depends essentially on two factors, namely the volume of interest-bearing assets and liabilities and the interest margin, which measures the difference between the average interest rates received on the assets and those paid on the liabilities. The stabilisation in absolute terms is due to a negative volume effect combined with a new increase in the Belgian banks' intermediation margin in 2011.

CHART 20 DETERMINANTS OF NET INTEREST INCOME



Source : NBB.

(1) Annual percentages based on the first nine months.

(2) The intermediation margin corresponds to the difference between the average implicit interest rates received and paid respectively on the outstanding amount of interest-bearing assets and liabilities.

The main factor accounting for this increase is the persistence in 2011 of an interest rate structure favourable to intermediation activity between short-term liabilities and long-term assets, as is evident from the spread between the 10-year interest rates and the 1-month interbank rate.

This rate structure enabled the Belgian banks to compensate, on the one hand, for the rising cost of funding confronting them in 2011 in view of the general mistrust of credit institutions, which made wholesale funding more expensive, and on the other hand, for the negative effects of the low level of interest rates on the profits which credit institutions can derive from very cheap resources, such as sight deposits. In the future, income from the intermediation activity of Belgian banks will depend, in part, on the degree to which the banks' long-term loans and transactions are geared to the movement in OLO yields or rates more closely linked to the Bund, such as swap rates, as these two types of long-term rates became increasingly divergent in 2011. However, the pricing of the banks' long-term transactions, and especially mortgage loans, is not based purely on the funding cost but also takes account of commercial interests, in that these loans may be used as means of securing customer loyalty, in order to attract additional deposits.

To guard against the possible impact on the interest margin of a sudden change in interest rates, the banks turned to derivative contracts, primarily interest rate swaps and options. While unrealised losses were recorded on these transactions, they were far lower than in 2010. However, the sector did record other substantial losses on its assets and liabilities held for trading, particularly CDOs and shares, leading to recognition of a total loss on financial instruments amounting to € 0.5 billion, whereas that item was close to balance in 2010. This loss was the main factor accounting for the decline in the non-interest result.

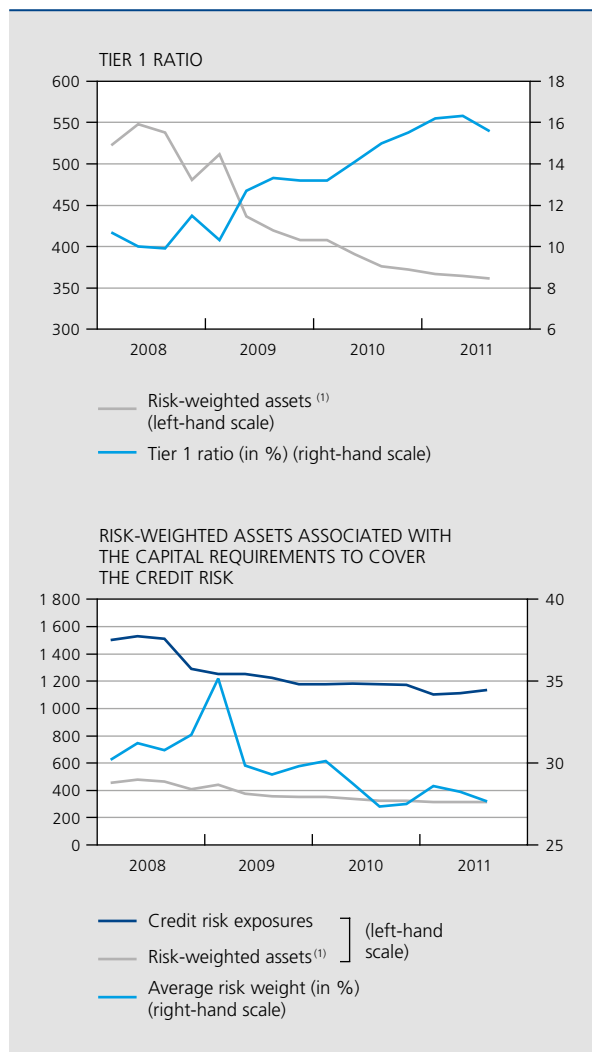
In the future, the Belgian banks will have to achieve a higher level of profitability because they need to reserve part of their profit in order to meet the new regulatory requirements, known as the Basel III rules, which will be phased in from 2013. In the case of banks receiving government capital injections, part of the profits will also have to be set aside to repay those loans, as the government support for the banking sector is temporary and the sector will have to restore its soundness on an independent basis.

Although the Tier I capital ratio of the banking sector, currently calculated according to the Basel II rules, came to a sizeable 15.6% at the end of September 2011, the application of Basel III will have a substantial impact on its principal determinants. The new rules, which will be explained in detail in section 2.2.2. of this Report, will make the requirements considerably tougher, since they will have a simultaneous impact on the two components of the own funds ratio by tightening up the definition and raising the thresholds of the regulatory capital, and increasing the risk weights applied to various asset categories.

Since 2008, the Belgian banks have succeeded in slightly increasing their Tier 1 capital stock from € 56.1 billion at the end of March 2008 to € 56.3 billion at the end of September 2011, thanks to public support and – where possible – the retention of earnings. In order to improve the quality of the capital, Basel III will impose a much stricter definition. The capital will have to be adjusted to take account of the deduction of new elements, such as assets in the form of deferred tax assets and the ‘Available for sale’ reserve. Under Basel III, that reserve – which corresponds to the unrealised gains or losses on assets available for sale – is not taken into account in calculating the regulatory capital, but is only recorded under the accounting equity. At the end of September 2011 it represented a negative amount of € 4 billion.

In the future, the Basel III rules will also impose an increase in the risk weights to be applied to certain exposures, notably interbank positions and credit risks incurred in connection with derivatives activities. These measures will affect the movement in the risk-weighted assets; in recent years their gradual decline has been the main reason for the increase in the solvency ratio according to Basel II. The contraction of these risk-weighted assets, from € 480 billion at the end of 2008 to € 361 billion at the end of September 2011, is due mainly to the reduction in the capital requirements intended to cover the credit risk, obtained by taking the credit risk positions and multiplying them by the weights applied to the various risk categories. The banks cut back their exposures by deleveraging and endeavoured to reduce their average risk weight by disposing of their riskier assets.

CHART 21 SOLVENCY OF BELGIAN CREDIT INSTITUTIONS
(consolidated data, in € billion, unless otherwise stated)

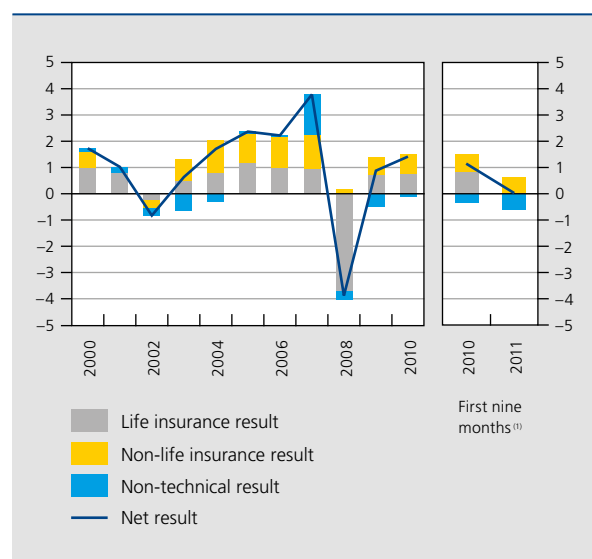


Source : NBB.
(1) The first chart shows all the risk-weighted assets while the second shows only those associated with the capital requirements to cover the credit risk.

1.2.2 Insurance companies

The profitability of the Belgian insurance sector was seriously affected by developments on the European financial markets, the sector's net profit barely reaching € 0.03 billion in the first nine months of 2011, compared to a net profit of € 1.16 billion in the same period in 2010. The main reason for this adverse development is the recording in the profit and loss account of impairments amounting to € 3.3 billion in the investment portfolio, due largely to losses on investments in sovereign debt securities and, to

CHART 22 NET RESULTS OF BELGIAN INSURANCE COMPANIES
(unconsolidated data, in € billion)



Source : NBB.
(1) Based on quarterly supervisory data reports.

a lesser extent, on equity exposures. Moreover, for the same period a gross loss of € 1.2 billion was recorded in the profit and loss account on the realisation of assets, including government bonds.

If the profit and loss account of the insurance sector is broken down into its three main components – namely the life insurance technical result, the non-life insurance technical result and the non-technical result – the sharpest deterioration was recorded in the net result of life insurance operations, essentially on account of a steep decline in net investment income. That income totalled barely € 2.4 billion in the first nine months of 2011, compared to € 5.9 billion in the first nine months of 2010. However, this sharp fall was largely offset by an accompanying decline in the cost of claims and operating expenses. In that regard, it should be noted that the life insurance technical result traditionally combines a negative result on pure insurance activities counterbalanced by a positive result on investment activities. That second element comes from investing the collected premiums in order to generate financial income. Fluctuations in the technical reserves resulting from these additional liabilities are, together with the premiums collected during the year, form the result of insurance activities. In the first nine months of 2011, that result of insurance activities was less negative (€ –2.4 billion) than in the same period of 2010 (€ –5.1 billion), and was fully offset by a positive result on investment income, although the latter was lower than in the preceding period. This situation contrasts with that in

2008, which had featured a large net loss on investments (€ –3.4 billion) and a decidedly negative technical result of € –3.7 billion.

Non-life insurance also suffered from a drop in investment income, down from € 1.0 billion in 2010 to € 0.7 billion in 2011. Since this decline was offset by an improvement in the result of insurance activities proper, the overall technical result of non-life insurance remained stable at € 0.6 billion.

In the non-technical account, there was a slight deterioration in the income from investments not attributable to assets covering the life and non-life activities and in the other results relating to exceptional items and taxes. Total investment income (in the life, non-life and non-technical accounts) fell from € 6.8 billion in the first nine months of 2010 to € 2.8 billion in the corresponding period of 2011.

The amount of life insurance premiums collected by the sector in the first nine months of 2011 was down slightly against the 2010 level. In recent years, the stronger preference of households for liquidity, owing to the ongoing economic slowdown and uncertainty on financial markets, has gradually eroded demand for life insurance products. This shift in demand may have been compounded by the predominance of the bancassurance business model in Belgium, which perhaps prompted banks needing substantial liquidity to try to channel household savings into banking products rather than life

TABLE 6 MAIN COMPONENTS OF THE PROFIT AND LOSS ACCOUNT OF BELGIAN INSURANCE COMPANIES
(unconsolidated data, in € billion)

	2008	2009	2010	First nine months ⁽¹⁾	
				2010	2011
Life insurance technical result	-3.7	0.7	0.8	0.8	0.0
Result of insurance activities	-0.3	-8.0	-7.1	-5.1	-2.4
Net investment income	-3.4	8.8	7.8	5.9	2.4
Non-life insurance technical result	0.2	0.7	0.7	0.6	0.6
Result of insurance activities	0.0	-0.4	-0.4	-0.3	-0.1
Net investment income	0.2	1.0	1.2	1.0	0.7
Non-technical result ⁽²⁾	-0.4	-0.5	-0.1	-0.3	-0.6
Net investment income	0.3	-0.7	0.2	-0.1	-0.3
Other results	-0.6	0.2	-0.3	-0.2	-0.3
Net result for the financial year	-3.9	0.9	1.4	1.2	0.0

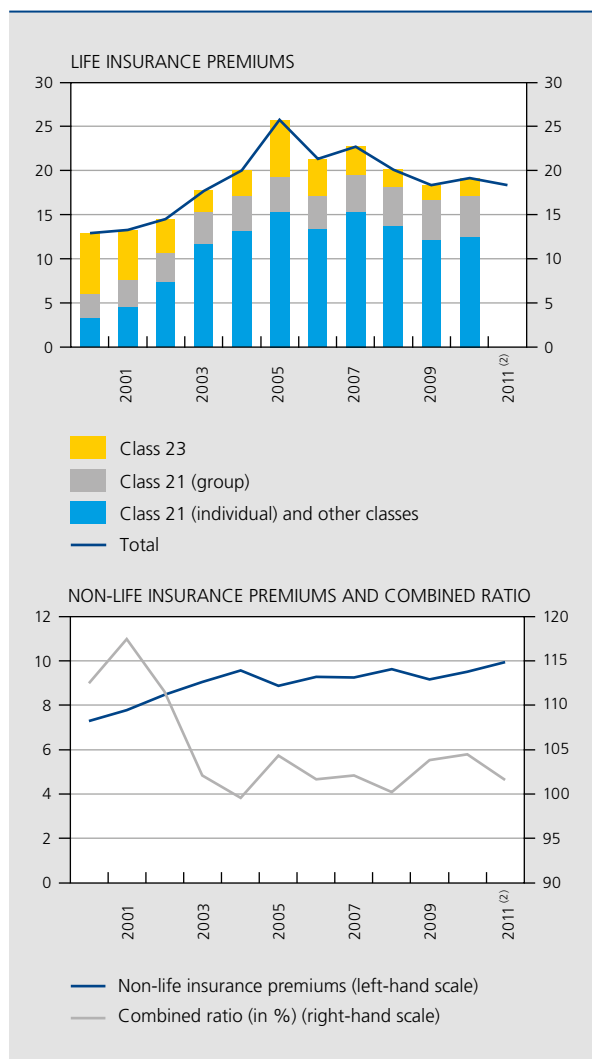
Source: NBB.

(1) Figures based on quarterly supervisory data reports.

(2) The non-technical result includes investment income not imputed to life and non-life insurance activities, plus exceptional results and taxes.

insurance contracts. Consequently, since 2009, life insurance premiums have dropped below an annual figure of € 20 billion, their lowest level since 2003. The great majority of life insurance premiums – for both individual and group policies – are collected on contracts under which the insurer bears at least part of the risks relating to financial market developments. Premiums for class 23 contracts, in which the policyholder assumes the financial risks on the investments, in fact represented only around 15 %, on average, of total life insurance premiums for the period 2004-2010. Among individual policies, those in class 21 – which offer a guaranteed yield – are still the most common.

CHART 23 PREMIUM INCOME AND COMBINED RATIO ⁽¹⁾
(unconsolidated data, in € billion, unless otherwise stated)



Source : NBB.

- (1) The combined ratio is the ratio relating the sum of the cost of claims plus operating expenses to net premium income.
- (2) Projections based on data for the first nine months. In life insurance, the breakdown of premiums by category of activity is not available on a quarterly basis.

For non-life insurance activities, 2011 brought a slight increase in the level of net premium income, less reinsurance premiums. Consequently, the combined ratio which relates the total cost of claims plus operating expenses to net premium income improved, falling from 105 % in 2010 to around 102 % in 2011. In 2009 and 2010 this inverted measure of the underlying profitability of non-life insurance operations reached its highest level since 2005. However, this ratio remained well below the peak levels seen in 2000-2002, when it exceeded 110 %. After 2002, insurance companies restored a better balance between insurance costs and premium income by raising the level of premiums, improving cost control and imposing stricter underwriting terms for certain loss-making insurance products and classes. In response to the renewed increase in the combined ratio in 2009 and 2010, premiums were revised upwards in most non-life insurance classes, and that contributed to the 5 % increase in the value of non-life insurance premiums collected in 2011, compared to 2010.

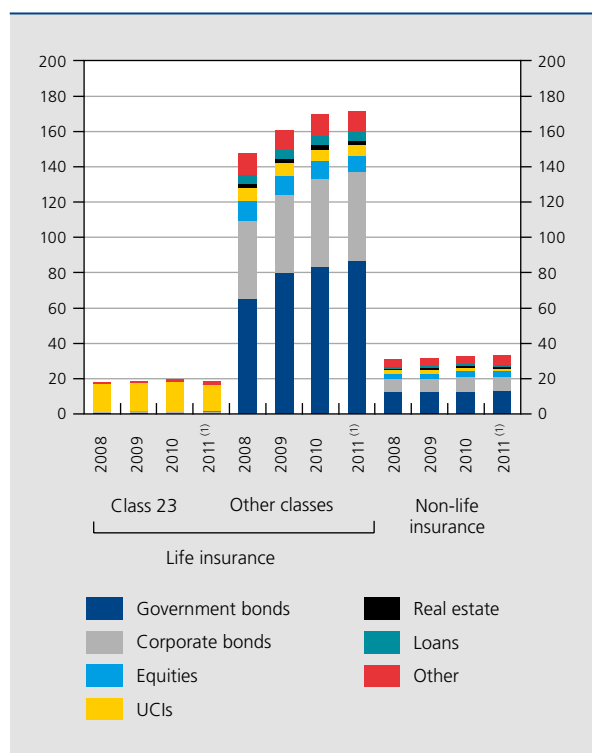
Unlike most non-life insurance premiums, which are collected under contracts renewed annually, life insurance premiums are generally collected under long-term contracts. In their case, the potential benefits payable to policyholders are far in the future. The investment of the premiums collected during that period explains why the investment portfolios built up to cover those future liabilities are much larger in the case of life insurance than in non-life insurance. The same factors also explain why life insurance activity is much more sensitive to financial market developments than non-life insurance business, as recent events have again confirmed.

The financial assets covering class 23 insurance policies are much smaller than the financial assets held on behalf of policyholders in other classes, and – in terms of outstanding amounts – represent only around 10 % of the total assets covering the life insurance liabilities.

For the purpose of their asset & liability management, insurers generally arrange an asset mix which is geared to both the structure and the characteristics of the associated liabilities, while establishing a balance between the risks on the investment portfolio and the expected yields. In the case of life insurance policies for which the insurer bears the investment risk, the covering assets are made up mainly of government and corporate bonds which represented 50 % and 30 % respectively of the investment portfolio at the end of September 2011. The covering assets relating to non-life insurance activities are a little less dominated by government bonds (40 %) and corporate bonds (24 %), in favour of a slightly larger proportion of equities and other types of assets, particularly

CHART 24 COMPOSITION OF THE COVERING ASSETS PER INSURANCE ACTIVITY

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



Source : NBB.

(1) Situation at the end of September 2011.

short-term instruments and bank deposits. The percentage of the investment portfolio of the various insurance activities composed of equities, including shares in associated or non-associated companies, declined from 10 % of the total covering assets at the end of 2007 to 5 % at the end of September 2011. The insurance sector's exposure to market risk was thus largely concentrated on fixed-income instruments, making it particularly vulnerable to interest rate fluctuations and sudden changes in credit spreads and liquidity risk premiums. In this connection, the market value of the investment portfolios of Belgian insurers suffered from the strong rise in risk premiums on a number of markets in euro area government bonds, which had a direct impact on insurance companies, but also affected them indirectly owing to their holding of securities issued by banks likewise exposed to sovereign risks.

It should be noted that, from a Belgian GAAP perspective, all investments on the balance sheet are recorded at their book value, namely the acquisition value less depreciation and impairments. [Moreover, subject to the Bank's approval, part of the unrealised gross gains on the eligible

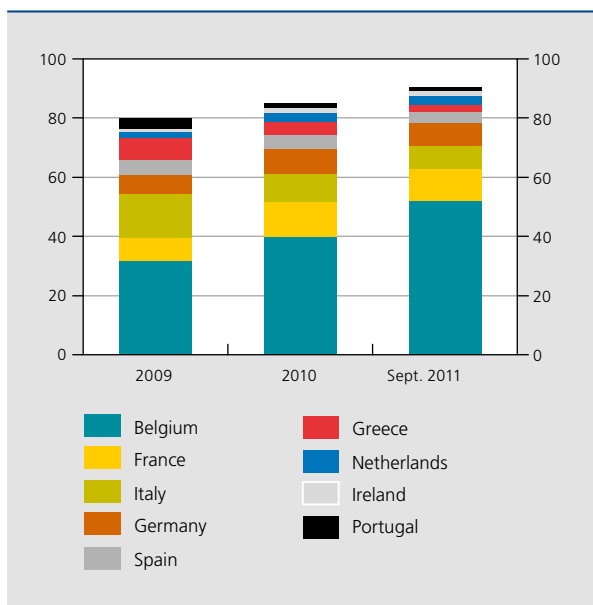
assets can be included in the regulatory solvency position. However, for the purpose of prudential analysis, assets covering the technical provisions are valued at market price, except for government bonds, which are kept at their book value owing to the underlying assumption that they will be held to maturity.

Moreover, subject to the approval of the Bank, a part of the unrealised gross gains on assets can be included in the regulatory solvency position. However, for the purpose of prudential analysis, assets covering the technical provisions are valued at market price, except for government bonds, which are kept at their book value owing to the underlying assumption that they will be held to maturity. Similarly, for the purpose of calculating the adjusted regulatory solvency position, the accounting data are adjusted for unrealised gains and losses

A breakdown of the Belgian insurance sector's main exposures to sovereign bonds issued by certain euro area countries from the end of 2009 to the end of September 2011 shows that, at a figure exceeding € 52 billion, investments in Belgian government bonds made up more than half of those exposures at the end of September 2011. Investments in sovereign bonds issued by France (€ 11 billion) and Germany (€ 8 billion) also represent a significant share of the total government bond portfolio. Exposures to a number of peripheral euro area countries (Greece, Ireland, Portugal, Spain and Italy) together make up a total of € 17 billion, with respectively 8 billion for Italy, 4 billion for Spain and 2 billion for Greece. In view of the persistent tension on the government bond markets, the total exposure to these peripheral countries was cut by more than € 5 billion in 2010 and by a further € 2.2 billion in the first nine months of 2011. All these exposures are gross positions at book value, without adjustment for any associated hedging.

As a result of the significant widening of spreads in 2011 between the yields on the government bonds of certain euro area countries and those on the German Bund, which also concerned the Belgian sovereign debt instruments, the amount of the unrealised gains on insurance companies' bond portfolios declined from € 0.3 billion at the end of December 2010 to become an unrealised loss of € 1.8 billion at the end of June 2011. In the third quarter, however, insurance companies realised a large amount of losses on their bond investments, either by recording impairments or by selling securities, significantly reducing the amount of the unrealised losses. Over the first nine months of 2011, a value reduction loss of € 3.3 billion was thus recorded on the investment portfolio, in addition to a gross loss of € 1.2 billion on the realisation of assets, largely peripheral sovereign debts. The

CHART 25 BREAKDOWN OF THE MAIN EXPOSURES TO EURO AREA GOVERNMENT BONDS
(unconsolidated end-of-period data, at book value, in € billion)



Source : NBB.

realisation of losses on such a large scale explains why, after depreciation and losses on sales, the remaining bond portfolio recorded an unrealised net gain of € 2.4 billion at the end of September 2011.

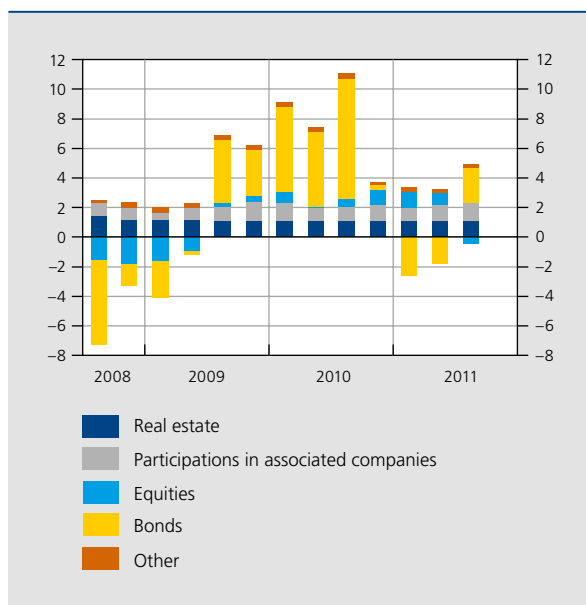
The equity exposures were also affected in the first nine months of 2011. As a result, the unrealised net gains of € 1 billion at the end of 2010 were converted to an unrealised loss of € 500 million at the end of September 2011.

Overall, considering the investment portfolio as a whole, the amount of the unrealised gains increased from € 3.7 billion at the end of 2010 to € 4.4 billion at the end of September 2011. However, that is still below the level recorded in the second half of 2009 and the first three quarters of 2010. It should be remembered that in the third quarter of 2008, insurance companies had announced unrealised losses of € 5.8 billion on their total bond holdings and € 4.8 billion on their total investment portfolio. These wide swings bear witness to the vulnerability of the insurance companies' investment portfolio to fluctuations in market values. In that regard, it is necessary to be cautious in the arrangements for sharing profits with policyholders, in view of the current uncertainty over the economic situation and financial market conditions. It is essential to avoid excessive levels of profit redistribution in order to safeguard the solvency margin. Similarly, there

is a need for caution regarding the inclusion of unrealised gains in that margin, since those gains can easily disappear, or even turn into unrealised losses from one quarter to the next, rendering the solvency position highly volatile.

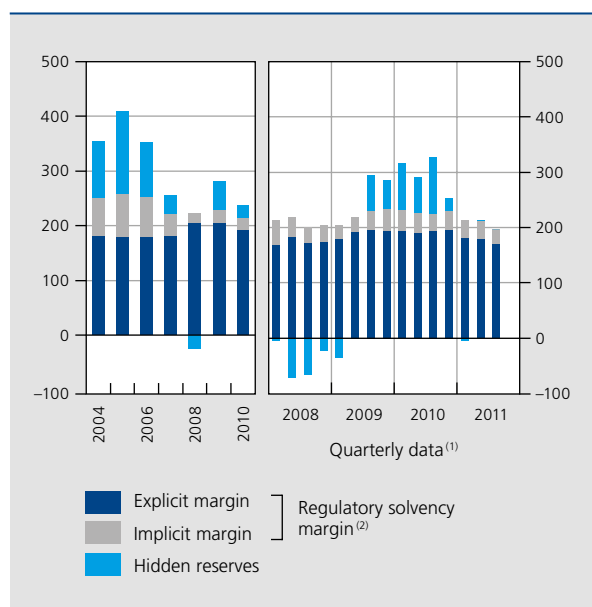
The solvency margin of insurance companies currently consists of an explicit margin which includes own funds, subordinated debts and certain other balance sheet items, and an implicit margin which, subject to the approval of the Bank, essentially comprises part of the gross unrealised gains on investment portfolios. The explicit margin was strengthened in 2008 and in the first half of 2009 by the capital increases carried out by a number of insurers in order to offset the investment losses incurred in 2008. Those increases, combined with the reserving of profits in 2009 and 2010 enabled the sector to maintain an explicit solvency margin at least equal to 165 % of the required minimum for each quarter since the end of 2009, a level of over 190 % having been reached in the second half of 2009 and in the first nine months of 2010, before dropping to 170 % in 2011. In line with the general trend in unrealised gains, the size of the implicit margin in relation to the regulatory solvency margin declined in 2008, before rising again in 2009 and 2010. It then subsided to a more modest level for each quarter in 2011. The total solvency margin comprising both explicit and implicit elements has remained more than 195 % above the minimum in each quarter since the end of 2007, and reached

CHART 26 DIFFERENCE BETWEEN THE MARKET VALUE AND BOOK VALUE OF THE INVESTMENT PORTFOLIO OF BELGIAN INSURANCE COMPANIES
(unconsolidated end-of-period data, in € billion)



Source : NBB.

CHART 27 SOLVENCY MARGIN OF BELGIAN INSURANCE COMPANIES
(unconsolidated data, in % of the minimum required margin)



Source : NBB.

- (1) The figures reported quarterly are not entirely comparable with the final figures reported annually. In particular, they take no account of any redistribution of profits to shareholders and policyholders.
- (2) This margin is composed of an explicit margin – including the own funds, subordinated debts and certain other balance sheet items – and an implicit margin which, subject to the approval of the Bank, comprises certain other specific elements, the principal one being a part of the unrealised gains on investment portfolios.

196% at the end of September 2011. Taking account of all unrealised gains or losses, including those not included in the implicit margin – in which case they form a hidden reserve or deficit – the adjusted solvency has been fairly volatile in recent years. This volatility of the adjusted

solvency shows that insurance companies cannot always count on their hidden reserves to offset heavy losses on the market value of their investment portfolios. Under the future prudential framework, Solvency II, such volatility in own funds will become the rule, since both assets and liabilities will be measured consistently with market values.

In accordance with the Solvency I prudential framework, the balance sheet valuation takes no account of the effect of interest rate reductions on the discounted value of the insurance companies' liabilities towards policyholders. In the case of long-term insurance contracts, such as life insurance or disability insurance, interest rate changes may have a major impact on the economic value of the balance sheet, since the potential long-term liabilities do not have the same maturity as the associated financial investments. While it is true that, under Solvency I, the prudent valuation rules and limits restricting concentration on certain types of assets compensate for the fact that the liabilities are not valued at market prices, the current regulations on solvency – by taking partial account of unrealised capital gains on financial investments, but not the valuation of the liabilities at market price – still do not accurately reflect the challenges which the low interest rate environment presents for insurance companies. By adopting a more comprehensive approach centred on the economic value for assessing the adequacy of the capital of insurance companies, the Solvency II framework will better reflect the challenges relating to the valuation of the assets and liabilities, and the potential effects on the volatility of the own funds. Box 3 sheds more light on the potential effects of Solvency II for Belgian firms, on the basis of the results of the latest quantitative impact study by the European authorities.

Box 3 – Belgian results of the latest quantitative impact study (QIS5), conducted in connection with Solvency II

In order to introduce a risk-based regulatory framework permitting an assessment of the adequacy of the capital of insurance and reinsurance companies, the Solvency II framework adopts a detailed approach to the various types of risks (both quantifiable and non-quantifiable) facing insurance and reinsurance companies. It constitutes a fundamental regime change in relation to the simplified approach of Solvency I and the general principle of prudence which serves as the benchmark in determining the technical provisions under the current regime. Consequently, the introduction of Solvency II will not only change the methodology for calculating the solvency requirements for insurance companies, but will also have a considerable impact in areas such as the regulatory valuation rules for assets and liabilities, the methods of calculating best estimate technical provisions, and the criteria used to determine and classify eligible capital components. The Solvency II framework will introduce a "ladder of intervention" in the form of two capital levels to be achieved: the Minimum Capital Requirement

(MCR) and the Solvency Capital Requirement (SCR). The SCR is set at a higher level than the MCR, in order to trigger progressive prudential responses if a company falls below the SCR threshold while still meeting the MCR. However, if the MCR is no longer complied, it will be necessary to withdraw the operating licence of insurance and reinsurance companies if they prove incapable of rapidly restoring the amount of capital to the level of the minimum requirement.

In connection with the Solvency II project, the European Insurance and Occupational Pensions Authority (EIOPA) and the EC conducted a fifth quantitative impact study (QIS5) on the future calculation of the solvency margin. The aim of QIS5 is to gain a better understanding of the impact of the proposed methodology on the basis of the financial situation of insurance companies at the end of 2009, and to test the standard formulas for calculating the capital requirements. The exercise also aims to identify any remaining methodological and practical problems in the application of the standard formula, in order to propose possible modifications or simplifications. The QIS5 results therefore provide only a partial indication of the ultimate impact of Solvency II.

For the Belgian market, 58 insurance companies took part in the QIS5 exercise on an individual basis, and four insurance groups on a consolidated basis. A detailed report of the main results for the Belgian market is available on the Bank's website. The sample of companies provides good coverage of the domestic market in both life insurance (92 % of market premiums) and non-life insurance activities (64 % of market premiums).

The overall results of QIS5 for the sample of Belgian insurance companies participating in the exercise indicate that the available capital would increase from € 19 billion to € 25 billion in comparison with the present statutory balance sheet. This increase in the available capital to absorb unexpected future losses essentially reflects the switch to valuation of the assets and liabilities at market prices, which has the effect of increasing the difference between these two components of the balance sheet. The € 6 billion additional capital generated by the switch to the valuation of the assets and liabilities at market prices is due essentially to unrealised gains on investments and the reduction in the level of technical provisions, as a result of taking account of the market value of the liabilities.

However, this € 6 billion extra capital under Solvency II is offset by a similar increase in the capital requirements under the SCR, because – according to the standard formula – the capital requirement would have been € 14 billion at the end of 2009, instead of € 8 billion according to Solvency I. This substantial increase compared to Solvency I is due mainly to more exhaustive quantification of the underlying risks, and a risk tolerance level set at a Value-at-Risk threshold of 99.5 % over a one-year period.

SUMMARISED RESULTS OF QIS5 FOR THE SAMPLE OF BELGIAN INSURANCE COMPANIES

(in € billion, unless otherwise stated)

	Available capital ⁽¹⁾	Capital requirement	Surplus capital	Solvency ratio of the Belgian sample (in %)	Solvency ratio of the European sample (in %)
SCR	25	14	11	179	165
MCR	24	9	15	271	466
Solvency I	19	8	11	230	310

Sources: EIOPA, NBB.

(1) The available capital for the calculation of the MCR includes only Tier 1 capital elements, excluding Tier 2 and Tier 3 which form part of the available capital according to the SCR.



The SCR is determined in several stages. The first step is to calculate and total the individual SCRs for the different risk modules (€ 30 billion). Next, significant adjustment factors are applied to take account of the benefits of diversification between the various types of risks (€ 11 billion), the loss absorption capacity of future profit sharing with policyholders, and deferred taxes (€ 8 billion), and by adding a capital requirement to cover operational risks (€ 3 billion). If the components of the SCRs are examined for each individual risk module, the QIS5 results for Belgian insurance companies show that 59 % of the capital requirements are attributable to market risk hedging. That percentage is similar to the average for the European sample (57 %). The SCRs for the insurance risk in non-life insurance excluding health insurance (17 %) and life insurance (13 %) together represent 30 % of the total SCR requirements, before taking into account of the risk diversification and the effects of loss absorption. Here, too, the percentages are close to those found for the European sample (16 % and 13 % respectively). That is also generally the case for the SCRs of Belgian companies relating to counterparty default risks (4 %) and health insurance risks (8 %). It should be noted that the calibration of the parameters in the standard formula takes account of the situation on the financial markets in 2008 and 2009, and that the method used to quantify the individual risks remains complex for a standard formula.

Overall, the QIS5 results show that the eligible capital provides 179 % coverage of the SCR, the current solvency ratio for the sample of companies being 230 %. The minimum capital requirement is covered at the rate of 271 % by the eligible capital. Comparison of the level of the SCR under Solvency II with that under Solvency I shows that the surplus capital is comparable to that under Solvency I (€ 11 billion). Unsurprisingly, large differences are also found between the QIS5 results for the various companies taking part, according to the investment risk profile, the types of insurance activities, the company's size, the use of approximations and simplifications in the standard formula, and divergences in the interpretation of certain technical specifications of the QIS5.

In the second quarter of 2011, in order to test the resilience of the European insurance sector in a crisis situation in a Solvency II environment, EIOPA conducted its second European stress test. One group and two Belgian companies of systemic importance took part, representing market coverage of more than 50 % of the premiums, if account is taken of the Belgian subsidiaries of foreign groups participating in the stress test on a consolidated basis. Although the sector was quite well represented in this test, the level of representativeness was still lower than in the QIS5, so that it is difficult to compare the findings of these two exercises. This stress test measures the impact of various scenarios on the year-end 2010 balance sheets drawn up in accordance with the Solvency II rules and applying the standard formulas to calculate the SCR and the MCR used in the technical specifications of the QIS5 exercise (see box 3). Three main scenarios (baseline, adverse and inflation) reproduce various macroeconomic environments. The baseline scenario corresponds to a moderately stressed situation and is based on a realistic projection of macroeconomic variables for 2011. The adverse scenario introduces severe stress on the baseline scenario variables, while the inflation scenario causes a reverse movement in interest rates compared to the adverse scenario, namely a steep rise, all other market and credit risks remaining unchanged. Each scenario is

reflected in a range of assumptions concerning the independent risk factors (interest rates, share prices, property prices, spreads, natural catastrophe events, claims inflation and shocks concerning mortality and longevity rates). An individual sovereign stress scenario was tested separately on the basis of assumptions concerning country-specific widening of the sovereign spreads. After the test, the results for the various risk factors were aggregated on the basis of correlations comparable to those of the QIS5, but with the diversification effects limited to the main risk categories. The results of each scenario compare the reduction in available capital to the situation before taking account of the shocks defined in the test, and the MCR and SCR coverage ratios before and after taking account of those shocks.

Taking the sample of Belgian companies as a whole, the available capital – which totalled € 10.7 billion at the end of 2010, would have contracted by around € 3 billion in the worst case scenario, causing the average solvency ratio (SCR coverage ratio) to fall from 170 % to 122 % under Solvency II. The MCR coverage ratio would drop from 379 % to 272 % on average in the adverse scenario. However, the results vary considerably from one company to another, ranging from solvency ratios above the sample average to ratios well below that figure.

TABLE 7 SUMMARISED RESULTS OF THE EIOPA STRESS TEST FOR THE SAMPLE OF BELGIAN INSURANCE COMPANIES

(in € billion, unless otherwise stated)

	Available capital	Surplus capital	SCR ratio percentages ⁽¹⁾	MCR ratio percentages ⁽¹⁾
Before the stress test	10.7	4.4	170	379
After the baseline scenario	9.1	2.8	145	322
After the adverse scenario	7.7	1.4	122	272
After the inflation scenario	9.9	3.6	157	349
After the sovereign stress scenario	9.2	2.9	146	325
After low yield scenario 1	8.6	2.3	136	303
After low yield scenario 2	9.5	3.2	150	334

Source: NBB.

(1) Available capital in % of the capital requirements.

The main risk factors contributing to the widespread reduction in available capital in the stress scenarios are a decline in interest rates, a fall in share prices and commercial real estate prices, and a widening of the spreads on government bonds in the context of a separate sovereign stress scenario. In relative terms, measured by the change in available capital in relation to the starting level, the interest rate risk and the share price risk are the main risk factors in the adverse scenario, while risks specific to insurance (natural catastrophe events, pandemics) are the dominant factors in the baseline and inflation scenarios. Taking all scenarios together, it is the stress on sovereign debt spreads that is by far the most significant risk factor, with an average reduction in available capital of 14 %.

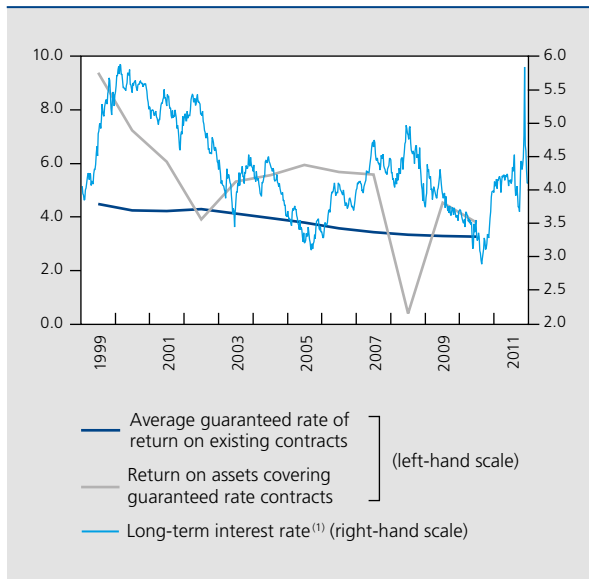
In the second half of 2011, in a separate scenario, EIOPA also tested the resilience of insurance companies to a low interest rate environment. Such an interest rate scenario over a long period is considered more relevant for the insurance sector than the parallel movement in interest rates used for the main stress test. Such a declining yield curve scenario is particularly challenging for insurance portfolios involving a guaranteed yield for policyholders, which are difficult to reconcile with an investment portfolio generating lower returns. Two yield curves were used to revalue the assets and discount the projected cash flows on the liabilities side. The scenario 1 yield curve shows a clear downward trend and is U-shaped, flattening out after a period of 10 years; the scenario 2 curve reflects the lowest levels recorded for the euro yield curve up to the end of August 2010. The results show that, on average for the sample, the increase in the life insurance technical provisions more than offsets the upward revaluation of the assets, especially in the more adverse scenario 1. Overall, available capital would decline by

20 % in scenario 1 and by 12 % in scenario 2, reducing the SCR coverage ratio to 136 % in scenario 1 and 150 % in scenario 2, compared with 170 % before application of the stress test assumptions.

The outstanding amount of life insurance policies offering guaranteed returns and the level of the interest rates offered are particularly important risk parameters for insurance companies when the interest rates on risk-free investments fall to very low levels, as happened during the year under review. In the 1990s, insurance companies had tended to offer their customers a guaranteed return of 4.75 %, which was the statutory ceiling in force up to the end of June 1999. In July 1999, the legislature reduced that ceiling to 3.75 %. In the case of exit from a supplementary pension plan, the current legislation requires companies to guarantee a minimum return of 3.25 % on employers' contributions and 3.75 % on personal contributions. For competition reasons, insurance companies have tended to offer the same minimum return conditions for group insurance contracts.

The profitability of insurance contracts guaranteeing such returns was eroded when long-term interest rates began to drop below those levels. The sector has gradually modified that adverse structure by marketing contracts offering guaranteed yields which are more in line with risk-free interest rates. These yields are no guaranteed for future premiums, for which the guaranteed rate will correspond to the market risk-free interest rate prevailing at the time of the premium payments. Moreover, some contracts specify that the guarantee is limited in time, and that, at the end of that period, the contract reserve (i.e. the amount of savings built up) is technically regarded as a new premium with a new guaranteed interest rate in line

CHART 28 GUARANTEED RATE OF RETURN ON CLASS 21 CONTRACTS



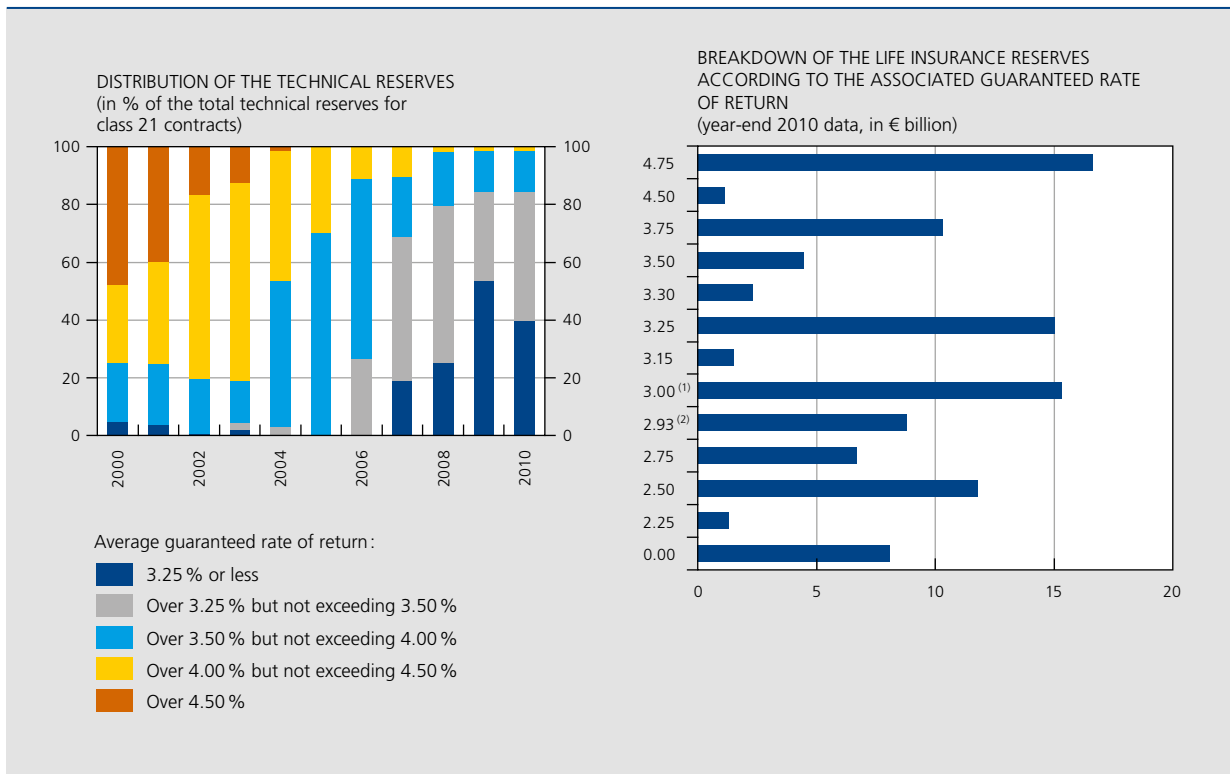
Sources : Thomson Reuters Datastream, NBB.
 (1) Yield on the secondary market in ten-year Belgian government loans (OLOs) (weekly data).

with prevailing market conditions. These measures contributed to a reduction in the guaranteed average return on class 21 contracts: it declined from 4.5 % at the end of 1999 to 3.2 % at the end of 2010. It should also be noted that the actual returns on the investments covering class 21 contracts have only partially recovered since the slump in 2008 caused by the fall in share prices following the collapse of Lehman Brothers. These net returns came to barely 4.5 % in 2009 and 3.8 % in 2010.

The decline in the average guaranteed return on individual life insurance contracts was seen throughout the sector, since the proportion of the technical reserves in class 21 held by companies guaranteeing an average return of 4 % or more dropped from 75 % at the end of 2000 to less than 1.4 % in 2010. At the end of 2010, around 85 % of the sector's technical reserves were held by insurance companies offering a guaranteed average return of 3.5 % or less.

Yet the legacy contracts offering high guaranteed yields still represent a substantial amount of liabilities. The life insurance reserves associated with guaranteed yields of 4.75, 4.5, 3.75 and 3.5 % came to €28 billion at the

CHART 29 DISTRIBUTION OF CLASS 21 LIABILITIES



Source : NBB.
 (1) Outstanding amount of life insurance reserves guaranteeing a 3 % return.
 (2) Outstanding amount of life insurance reserves guaranteeing returns different from those shown in the chart, with an average guaranteed return of 2.93 %.

end of 2010. These returns are usually associated with contracts concluded a long time ago, in most cases guaranteeing these yields on future premiums as well. Most of the recent increases in life insurance reserves concern policies offering a lower guaranteed yield, including a large number of policies providing only a capital guarantee but offering a larger range of profit-sharing rates and mechanisms. However, the biggest reduction in the interest rate risk for insurance companies resulted from the introduction of greater flexibility in the determination of the guaranteed yield. Whereas in the 1990s, the guaranteed yield prevailing at the time of conclusion of the contract generally also applied to all future premiums, most of the contracts concluded during the past decade have only guaranteed the yield prevailing at the time of collection of the premium, so that the guaranteed yield can be adjusted according to changing market conditions. However, some of these contracts also offer policyholders more flexibility, allowing them to terminate their policies

more easily or to reduce them without incurring heavy penalties. That means that some insurance companies are exposed to a greater risk of surrendercancellation, especially if interest rates rise strongly. In those circumstances, they would face a choice between increasing the yield on their contracts or accepting a reduction in their volume of business; in both cases, that would impair the profitability of class 21.

In order to guard against the effects of low interest rates on the profitability of guaranteed return contracts, insurance companies have to form an additional provision for contracts offering a guaranteed return above a certain threshold (defined as 10 basis points higher than 80 % of the average yield on ten-year government bonds on the secondary market over the past five years). Insurance companies can spread the amounts to be allocated to this provision over a maximum of ten years. The threshold for this additional provision was 3.26 % in 2011.

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.

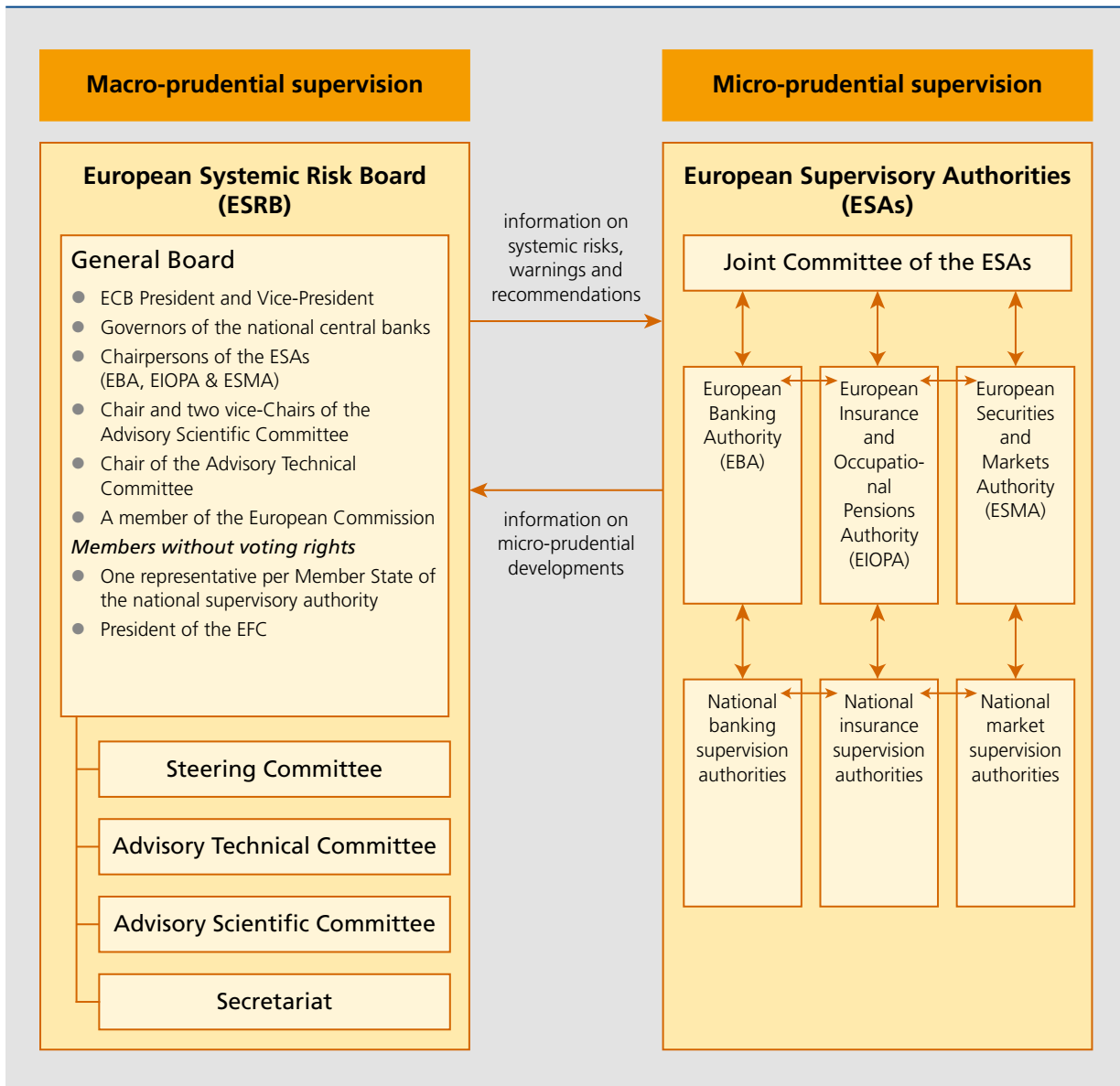
The ESRB⁽¹⁾ is responsible for the macro-prudential oversight of the financial system in the EU. Its task is to contribute to the prevention of systemic risks to the EU's financial stability which may arise from developments

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.

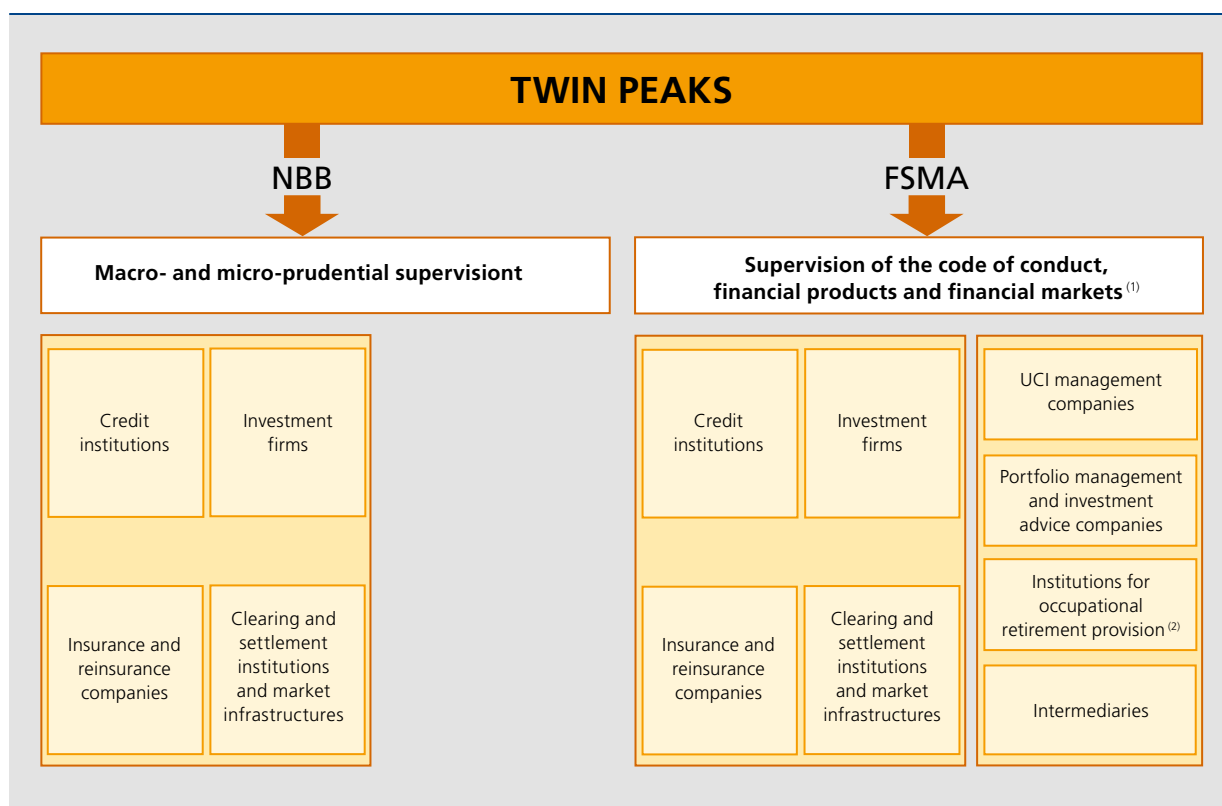
The first – transitional – stage saw the establishment of the Committee for Systemic Risks and System-relevant

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 31 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 SIFs. 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 SIFs (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 SIFs 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 multi-lateral 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.

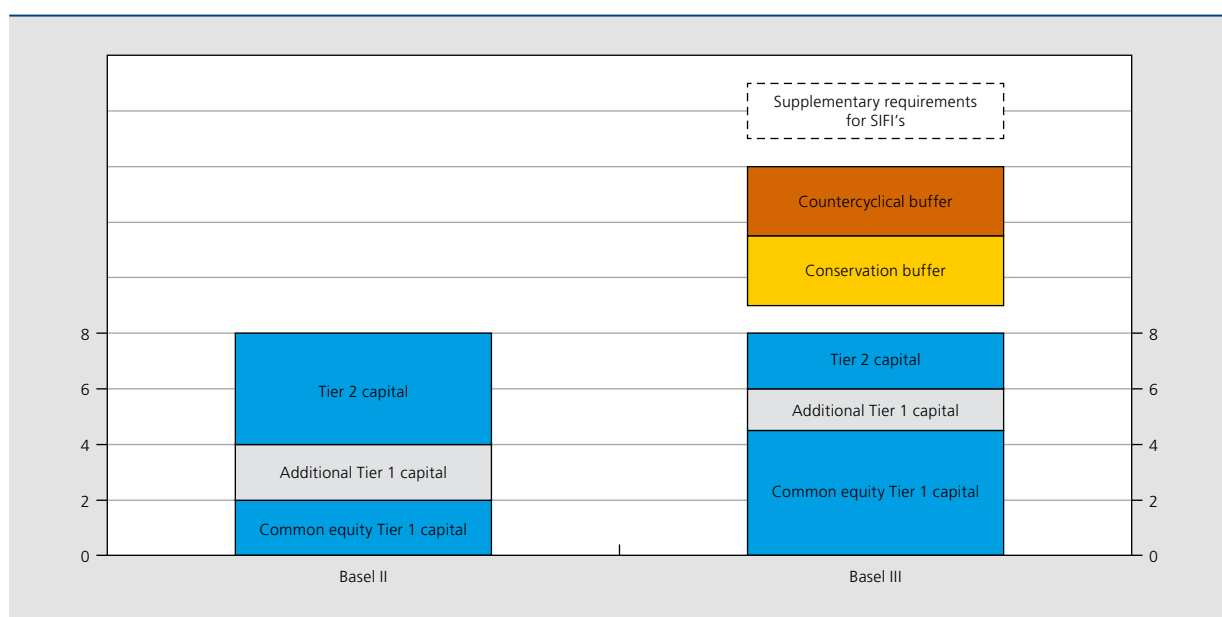
In order to take account of the systemic risk resulting from the interconnection between large credit institutions, particularly due to the derivatives market, the capital requirements relating to interbank exposures were also increased. At the same time, incentives are provided for the use of centralised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

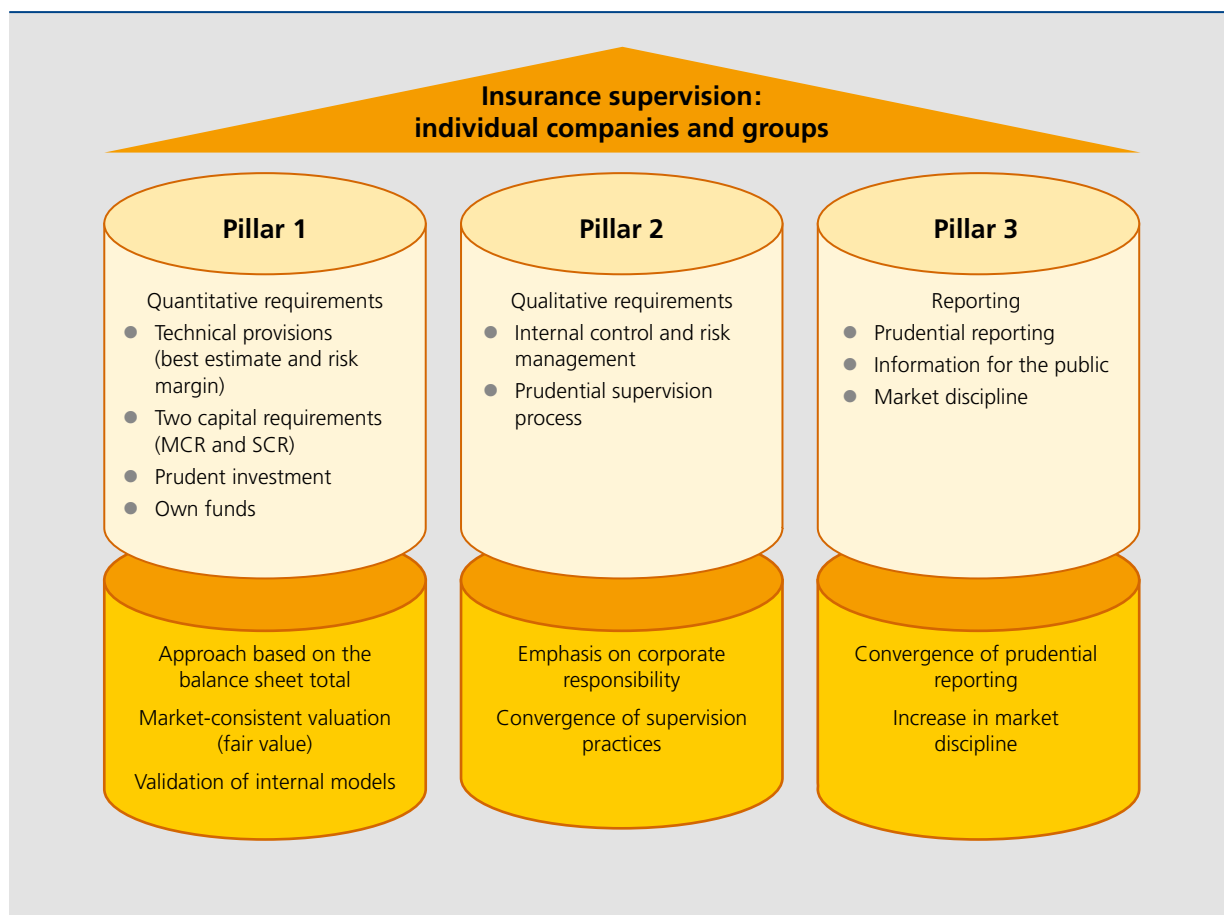
The structure of Solvency II is modelled on Basel II and is broadly similar for pillars 2 and 3. Obviously, the quantitative requirements of pillar 1 are specific to insurance.

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

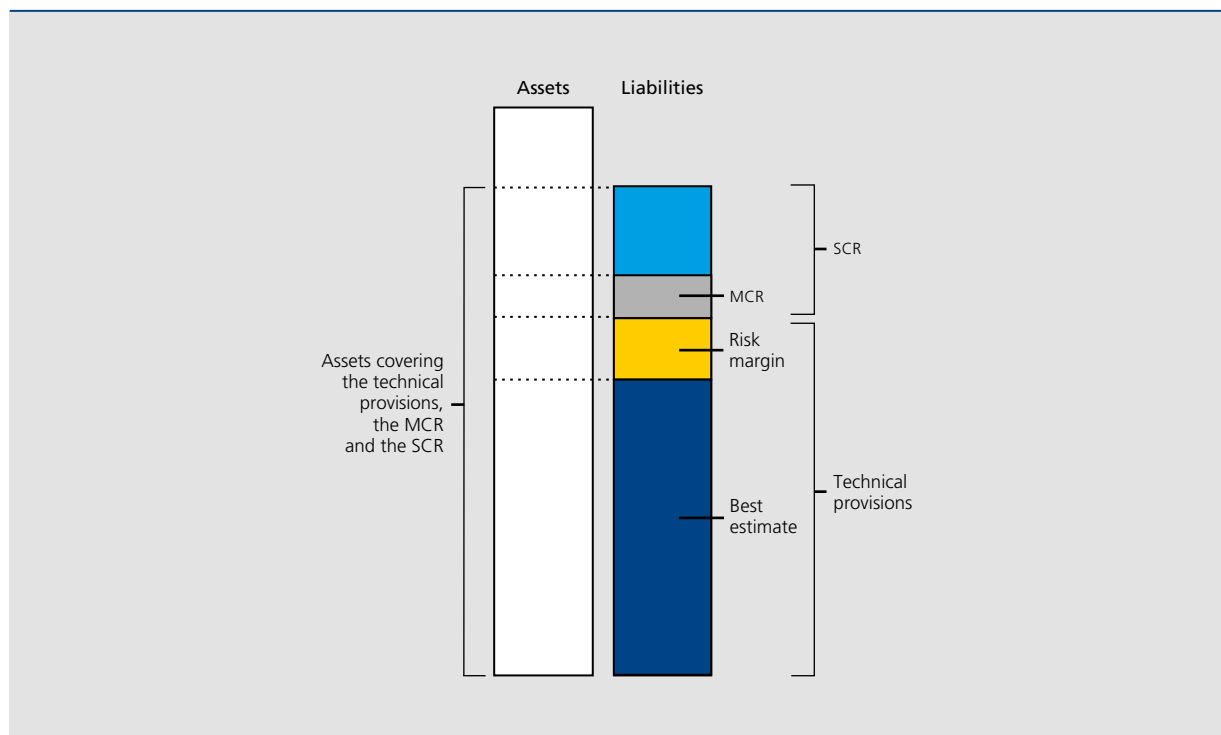
the requirements for the various modules. The addition of the capital requirements by means of correlation matrices ensures that the overall capital requirement also meets the stipulated 99.5% confidence level.

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 multi-lateral 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 depositories (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.

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

(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.

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.

(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.

2.2.8 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.

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.

3. Prudential supervision

3.1 Methods of applying prudential supervision

3.1.1 General organisation

The introduction of the ‘twin peaks’ model and integration of prudential supervision at the Bank have permitted a new emphasis while utilising the opportunities for synergy with other departments of the Bank. As a result of the financial crisis, it seemed necessary to adjust the supervision model. The financial crisis had revealed the limits of the traditional distinction between the micro-prudential supervision of individual financial institutions and macro-prudential supervision centred on the maintenance of financial stability. That distinction is tending to become blurred both in monitoring and in prudential regulations. Regarding risk analysis, the interconnections between institutions and financial markets and the specific role of systemic banks in contagion effects result in strong interactions between the micro- and macro-prudential dimensions. As regards the regulations, the new Basel III framework, which in principle constitutes an instrument for the supervision of individual institutions, also incorporates macro-prudential instruments such as the countercyclical capital buffer, which the authorities are to be able to use to ensure financial stability. The desire to improve the coordination of micro- and macro-prudential supervision was therefore one of the primary motives behind the reforms of the method of organising supervision at both Belgian and European level.

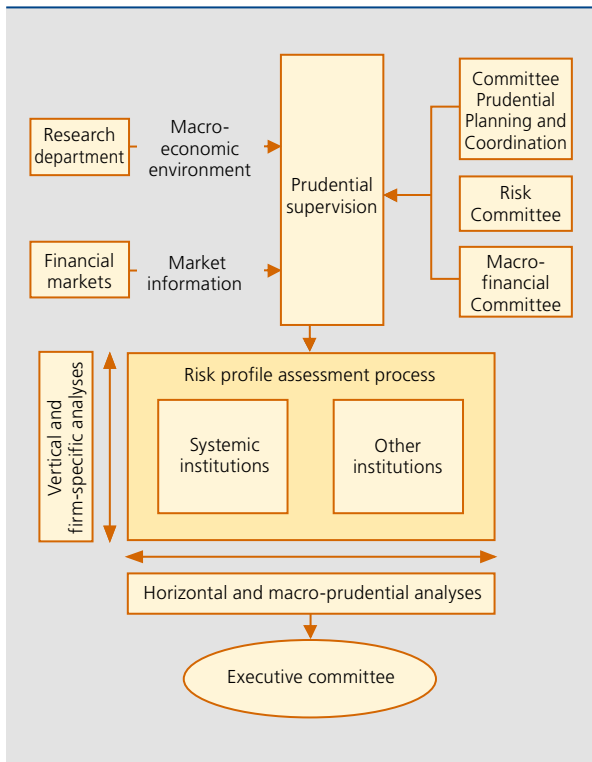
The financial crisis led to a spate of new legislative initiatives, presented in detail in chapter 2.2, which have had a considerable impact on all components of prudential supervision. International bodies, in particular, have strongly encouraged measures permitting tighter, more effective and more reliable prudential supervision. A good

example is the November 2010 report by the Financial Stability Board (FSB) on the intensity and effectiveness of the supervision of systemically important financial institutions (SIFIs)⁽¹⁾. In October 2011, the FSB published a follow-up report setting out additional recommendations on the supervision of SIFIs⁽²⁾.

The Bank took those recommendations as the basis for adjusting the organisation of prudential supervision. Apart from the organisational changes made by the switch to the ‘twin peaks’ supervision model, it ensured continuity in the exercise of supervision and in the legal precedents applied. That was guaranteed by the staff of the former Banking, Finance and Insurance Commission (CBFA) who were transferred to the Bank, where prudential supervision was organised according to the ‘four-eyes’ principle. This model is based on a vertical approach combined with a horizontal approach. The vertical analyses are conducted by operational supervision teams who assess the enterprise as a whole and coordinate the supervision on the basis of a risk analysis and an audit plan for each institution. At the same time, the horizontal analyses of the sector as a whole and of each type of risk considered separately are intended to determine the risks and vulnerabilities in a transverse perspective. In that way, these analyses contribute to the assessment of the risk profile of each individual institution by permitting a better understanding of the complexity of the financial business. This integrated risk assessment process also receives support from the other Bank entities, which contribute their expertise in macroeconomic analysis or their knowledge of financial markets for the benefit of prudential supervision.

(1) *Intensity and Effectiveness of Systemically Important Financial Institution (SIFI) Supervision.*

(2) See the website www.financialstabilityboard.com.



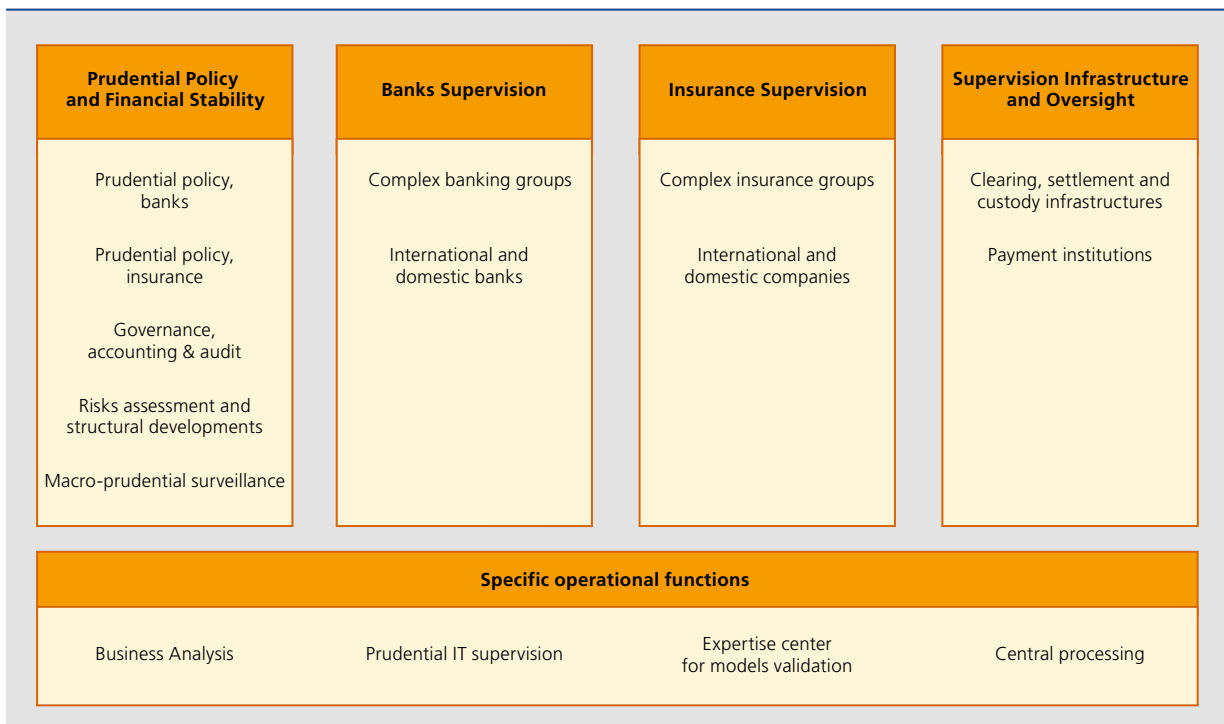
Operational supervision is conducted by the three autonomous services entrusted respectively with the supervision of banks and investment firms, insurance and reinsurance companies, and market infrastructures. These services are responsible for the vertical dimension of supervision. A fifth service is in charge of transverse operational functions for other operational services. This concerns, in particular, the supervision of the IT systems of financial institutions and the validation of the internal models used by banks and insurers to calculate the capital requirements.

To ensure that the new supervision model is effective, three consultation bodies have been created at the Bank. The first, a prudential planning and coordination committee, aims to ensure the good operational organisation of prudential supervision. The second, a risk committee, directs the risk analyses, ensures the consistent application of the regulations, and organises the interaction between the micro- and macro-prudential dimensions of supervision. Finally, the third body is a macro-financial committee, responsible for arranging the interaction between the Bank's prudential functions and its other macroeconomic and financial functions.

The Prudential Policy and Financial Stability service defines the prudential policy, identifies vulnerabilities, particularly systemic ones, and conducts horizontal analyses on the sector and on the various types of risks and their interactions. This service is responsible for the horizontal dimension of supervision.

3.1.2 Supervision methodology

The Bank has introduced a set of instruments for identifying the risk profile of each institution and specifying the method of defining the capital requirements under the second pillar of the Basel framework. In future, these



instruments will be used to supervise the banking sector. They will be extended to the supervision of insurance once they have been adapted to the specific needs of that sector, taking account of the new Solvency II framework.

The second pillar of the Basel II Accords, set out in Title XII of the Bank's regulation of 15 November 2011 on the capital of credit institutions and investment firms, describes the prudential surveillance process, which is to be embodied in an integrated set of instruments based, on the one hand, on the institution's obligation to devise an internal capital assessment process and to set capital targets commensurate with its own risk profile and the quality of its internal controls (Internal Capital Adequacy Assessment Process – ICAAP), and, on the other hand, on the obligation of the supervisor concerned to assess the adequacy and quality of the institutions' capital in the light of their risk profile, and to intervene where necessary by using the various prudential measures at its disposal (Supervisory Review and Evaluation Process – SREP).

The supervisor's role will therefore consist partly in watching over the quality of the risk management and the internal control of institutions, and partly in ensuring that the internal capital adequacy assessment process is satisfactory at all times. These two prudential aims are closely linked and should encourage the dialogue between supervisors and institutions so that, in particular, an adequate solution can be quickly found in the event of any shortcomings.

In order to assess the institution's ICAAP, including the adequacy of its capital, the supervisor must be able to form an opinion on the following points:

- the level of the institution's exposure to all risks identified as material (identification of its risk profile);
- the adequacy and reliability of the institution's internal control and its ICAAP;
- the adequacy of the institution's capital;
- the quality of its capital, in which context the supervisor must also be able to judge whether capital is the most appropriate means for the institution to guard against any vulnerabilities.

The SREP must be structured consistently for all institutions, regardless of their profile, strategy or management model. The ability to gather and verify all relevant information and the procedures used for analysing risks, based to a significant extent on the findings of the Bank's on-site inspections, are key factors in maintaining the quality and consistency of the prudential assessment process. That requires an efficient risk analysis system which can function as a prudential tool for organising the use of the prudential resources and for planning, formalising and

conducting the risk assessments. It provides the structure and sequence of steps in the process of determining the institutions' risk profile. This prudential evaluation process (SREP) can be envisaged as a cycle comprising four separate stages:

- gathering the relevant information;
- analysing and evaluating the risk profile;
- summing up the analyses and finalising the risk profile (scorecard system);
- defining the prudential measures.

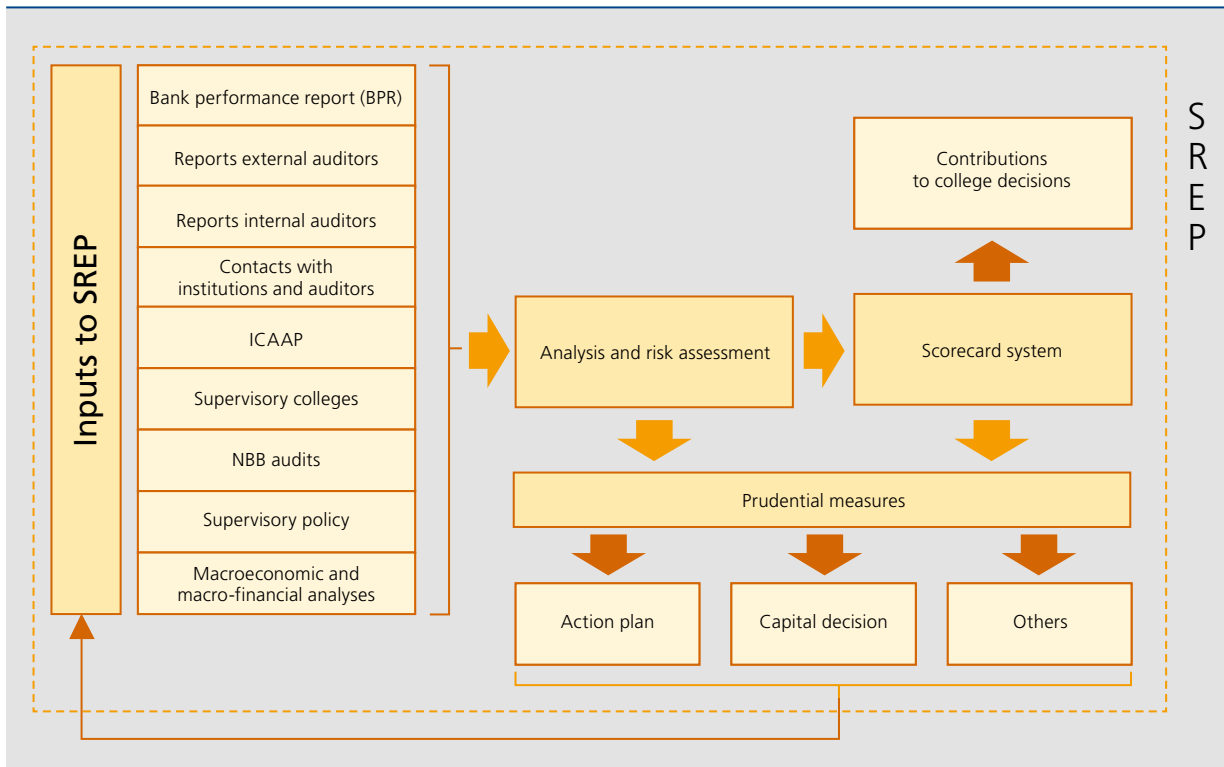
The development of the regulatory prudential framework, and more specifically the implementation of the Basel II Accords and their second pillar, was a good opportunity for reforming and modernising the risk analysis instrument.

Although there has been no change in the primary aims of the previous risk analysis instrument, namely the determination of an institution's risk profile, identification of the prudential priorities and definition of a supervision plan, special emphasis has been placed on the integration and formalisation of the analysis and supervision work. In the process, the new instrument – called the scorecard system – forms the basis for a structured dialogue both with the institutions concerned and with their approved commissioners and the competent supervisory authorities, notably via the colleges of supervisors.

In the new risk analysis instrument, the prudential priorities are defined according to the following three factors: the importance of the institution and its activities for the Belgian financial system, the quality of the institution's shareholdership and the institution's risk profile. There is a score corresponding to each of these factors, namely the impact score, the shareholdership support score and the risk score. An institution's risk score is based on four cornerstones: the general situation of the institution, such as its governance and financial position; the transverse supervision and support functions, such as the internal audit, compliance and risk management functions; the risks inherent in the institution's activities; and the institution's internal process of assessing its capital needs (ICAAP).

The first implementation phase concerned credit institutions and investment firms, and ended with the launch of the application in June 2009. The scorecard system is being extended to include insurance companies from 2012.

The scorecard system was so designed that it also complies with the stipulations of the European Banking Authority (EBA) on joint analysis of the risks of cross-border institutions, as laid down by Article 129(3) of European Directive



2006/48/EC relating to the taking up and pursuit of the business of credit institutions. On the basis of that article and the EBA rules, the Bank developed its policy and methodology for assessing the solvency of credit institutions. In this connection, the European directive provides for a joint decision between the supervisors concerned on the adequacy of the solvency of cross-border credit institutions, both on a consolidated basis at the level of the parent company and in respect of the entities forming part of the group. That assessment has to take account of the risk analysis as indicated by the scorecard, and the appropriateness of the institution's policy and internal process concerning capital adequacy (ICAAP). In this connection, the Bank has told a number of institutions that they should hold more capital than the minimum required by the first pillar. Up to now, such decisions have been expressed in the form of a capital ratio in the strict sense, or Tier 1.

To determine the capital requirement for a credit institution, in particular under Article 129(3), the Bank assesses three elements. First, it looks at the credit institution's ICAAP. In accordance with the regulation on the capital of credit institutions and investment firms, each credit institution is expected to conduct an exhaustive analysis of its risks, to quantify those risks sufficiently prudently and to define a policy on the adequacy of its capital. The Bank assesses the appropriateness of that policy and the risk quantification. Where economic capital models are used to measure the risks, special attention focuses on

the diversification effects which the institution takes into account, or on the fact that the amount of capital covering the credit, market and operational risks, as measured by the institution, is not less than the minimum capital requirement relating to those risks. As regards the definition of the internal capital used for the purpose of the ICAAP, the Bank expects institutions to take account only of the existing capital components capable of absorbing losses on the assumption that they remain in business (going concern). The results of the stress tests conducted by the credit institutions form the second element considered by the Bank. One aim of these tests is to ensure that the institution can satisfy the minimum solvency requirements defined by the Bank, and can continue its essential business during periods of recession. The results of the EBA stress tests are used as the benchmark for the institutions taking part. Finally, the Bank also takes account of the results of the risk assessment relating to the business of the credit institutions. Using the scorecard system, the Bank quantifies and assesses all the risks to which the institution is exposed. The quantification of the credit, market and operational risks is based mainly on the minimum capital requirements under the first pillar. The Bank also takes account of an additional amount of capital to cater for risks which are not properly covered by the minimum capital requirements, and more particularly, the concentration risk, the general interest rate risk inherent in non-trading activities, and the institution's strategic or business risk. In its assessment, the Bank also considers the institution's

management quality, profitability and potential support by its shareholders.

3.1.3 Monitoring of domestic systemic institutions

One of the lessons of the financial crisis which erupted in 2007-2008 was that the supervisory authorities did not have the tools to tackle the failure of large financial institutions. Many governments therefore felt compelled to intervene to rescue large institutions in distress, in order to avoid the collapse of the financial system.

The crisis therefore highlighted the problem of systemic financial institutions (SIFIs), which – by definition – are institutions whose failure could have a serious impact on the financial system. Financial institutions which are not systemic on a global scale may nevertheless be of systemic importance, at regional (e.g. European or American) or national level. The failure of such institutions would entail substantial costs for the regional or national financial system, forcing the government to intervene to prevent the failure, with the risk of moral hazard mentioned earlier. Consequently, many regional and national authorities are trying to identify which financial institutions are locally systemic, with the aid of methodologies comparable to those devised at global level.

In Belgium, the Bank has designed a methodology for identifying systemically important financial institutions at national level. In accordance with the international framework, the Belgian methodology uses indicators relating to size, substitutability and interconnection, with reference to the domestic financial system. The substitutability indicators reflect the shares of business in the various sectors of the Belgian financial system, while the interconnection indicators are used to assess the extent to which financial institutions have substantial liabilities towards their counterparties in Belgium. At the same time, since systemic importance is hard to measure and some data are not suitable, the method for identifying SIFIs at national level supplements these quantitative indicators with a qualitative assessment by the supervisory authority.

Under the Organic Law, the Bank has to identify the SIFIs at national level and inform the institutions concerned. They are then required to notify the Bank of all proposed strategic decisions. If the Bank considers that the financial institution has an inappropriate risk profile, or if a strategic decision could have an adverse impact on the financial system's stability, the Bank may impose specific measures on the institution concerned. Section 2.1.2 describes the Bank's other powers in regard to these domestic SIFIs.

The FSB recommends that financial institutions of global systemic importance should also be subject to a range of measures designed to improve their resilience and thus reduce the likelihood of serious problems or bankruptcy. In particular, those measures provide for closer supervision, the obligation to increase the ability to absorb losses, the preparation of recovery plans in which the institutions identify and assess potential responses to a range of serious shock scenarios concerning solvency or liquidity, and resolution plans devised by the authorities and specifying the options which – should the occasion arise – would permit the orderly dissolution of the financial institution while minimising the use of public money and the impact on the financial system.

The establishment of recovery and resolution plans is coordinated at international level. The authorities of the G20 countries are currently working, within the FSB framework, on the development of recovery plans with their main cross-border credit institutions. The conclusions of the European Council of 10 May 2010 on crisis prevention, management and resolution also call for European coordination of the recovery and resolution plans.

In Belgium, the Bank works with the domestic SIFIs to guide them in the development of their own recovery plans. It launched a pilot project with guidelines specifying the approach to be adopted in producing such a plan. The recovery plan aims to identify the measures which a credit institution can take to cope with a serious solvency or liquidity shock. The plan, prepared by the credit institution itself, must examine the measures which it can take in a series of extreme scenarios and which enable it to rectify its situation. This plan, which assumes that the government does not intervene, must include measures of last resort, such as the disposal of significant activities or assets. In addition, the Belgian authorities were invited to attend the meetings of the Crisis Management Group of the institutions for which the Bank is the host supervisor. Certain elements of the plans were presented at those meetings. For its part, the resolution plan evaluates the options available to the authorities – and the impediments to their implementation – for managing a banking crisis if the recovery plan has failed to restore a credit institution's soundness. The options considered in the resolution plan aim at the orderly resolution of a crisis. Work on the resolution plans was postponed pending the European developments concerning the crisis management framework, which will have a significant influence on the measures which the authorities can take to manage a banking crisis.

3.1.4 Specific operational functions relating to prudential supervision

As a result of the reorganisation of prudential supervision, a number of transversal functions were brought together in a new service at the Bank, more specifically the prudential supervision of IT, the analysis of quantitative methods, the centralised processing of certain licences, the examination of 'fitness & propriety' and the 'business analysis' function.

Prudential IT supervision aims at conducting a transversal analysis of the IT risks incurred by financial institutions. This supervision mainly takes the form of on-site inspections to assess management, continuity, security, internal control and, where appropriate, outsourcing of IT systems. The reference frameworks used are based on internationally accepted standards, such as the ISO standards. Following the integration of prudential supervision at the Bank, the expertise and resources are also available for the Bank's oversight of payment and securities settlement infrastructures. At supervisory colleges of large international groups for which the Bank acts as home supervisor, meetings focusing on information technology were held for the first time in 2011 with IT supervision experts of the main foreign host supervisors.

From the start of 2011, the Bank also has played an active and leading role in the working group on the security of on-line payments, which reports to the ECB's SecurePay Forum on Retail Payment Security. The working group has concentrated on defining for the euro area supervisory authorities sound practices for securing internet banking transactions, and analysing the various threats associated with such transactions.

In 2011, as in previous years, special attention was given to supervision of continuity and reliability of IT services and to the security of internal IT platforms of banking and insurance groups undergoing drastic reorganisation. After two years without any frauds in Belgium, a surge in e-banking fraud prompted to focus again on the supervision of the security of e-banking services offered by Belgian financial institutions. For that purpose, the Bank works in close collaboration with the Belgian financial sector association (Febelfin) and the federal police's Computer Crime Unit to combat or curtail fraud. As in previous years, the security of Belgium's e-banking services generally ranks as excellent in international terms. However, vigilance is still required in view of the inventiveness of criminals, who are constantly developing and applying new fraud techniques.

The purpose of analysing quantitative methods is to make a detailed appraisal of the risk assessment and risk

measurement models used in the insurance and banking sectors and in market infrastructures for all types of risk (life and non-life risks, market risk, credit risk, operational risk etc.). To that end, the Bank assesses the appropriateness of the quantitative aspects of risk management, mainly via on-site inspections by auditors specialising in these techniques jointly with "generalist" auditors examining the more qualitative aspects. These on-site inspections of quantitative methods, while forming part of conventional auditing work, concentrate on validating the internal models used by supervised institutions for determining the regulatory capital requirements. Actually, the new legislation on the supervision of credit institutions and insurance companies expands the scope for using internal models approved by the supervisor, replacing the more standard 'one size fits all' methods.

In 2011, the first priority for the insurance sector was the preparation for entry into force of Solvency II, which will also permit the use of internal models for regulatory capital requirements. For that purpose, the Bank has continued to develop its expertise and methodology for supervising these models, e.g. by conducting a general survey of models for non-life risks (including natural disasters), a horizontal analysis of the technique of replicating portfolios, and an in-depth study of the economic scenario generators. Assignments were carried out in connection with the pre-application of internal models under Solvency II, and for the implementation of rules permitting exemption from an additional provision for the interest rate risk on life insurance offering a guaranteed yield and for industrial accident business.

Particular attention is given to the level playing field in Europe, using information obtained by participating in an informal working group of quantitative experts in the European Insurance and Occupational Pensions Authority (EIOPA), and by carrying out various assignments jointly with other European supervisors.

In the banking sector, a large number of dossiers were submitted in 2011 for the use of internal ratings-based (IRB) credit risk models; it related to new models, to the follow-up of terms and conditions imposed in the past, or to the extension to a Belgian subsidiary of models used at group level.

Furthermore assignments relating to market activities were carried out, partly as a result of the new regulations (Capital Requirements Directive – CRD III), stipulating that new models must be developed by the end of 2011 for other types of risk (stressed VaR, incremental risk charge and comprehensive risk method). In addition, the Bank prepared for the introduction of the regulations on

counterparty risk (credit valuation adjustment) which will enter into force at the end of 2012. Finally, other assignments were carried out relating to economic capital and operational risk.

Since 1 April 2011, the Bank has conducted a centralised and transversal processing of institutional operating dossiers of undertakings transferred to its prudential supervision. In addition, a new environment necessary for the new relationship between the Belgian Financial Services and Markets Authority (FSMA) and the Bank, also forms part of those transversal operational functions known as 'central processing'. They result from the 'twin peaks' model introducing a dual supervision model based on two supervisors responsible for specific tasks. More particularly, the transversal functions concern the processing of the following:

- 'fit & proper' dossiers, concerning professional integrity, based in particular on the absence of any breach of the relevant financial legislation cited in Article 19 of the Banking Law and the appropriate experience of the directors of institutions subject to prudential supervision. It involves the use of an extensive questionnaire which institutions have to submit for each candidate. In order to improve the procedure, an analysis of the various stages has been performed;
- notifications of activities under freedom to provide services by institutions subject to prudential supervision in the European Economic Area (EEA) and, in some cases, outside it;
- dossiers of approved external auditors and actuaries;
- contacts between the FSMA and the Bank, in the form of requests for opinions, communication or information related to dossiers of supervised institutions.

In addition, this "centralised processing" unit acts as system owner and IT correspondent for the IT applications of prudential supervision, for which the emphasis in 2011 was on ensuring continuity following their transfer to the Bank. Finally, it is the first point of contact or guidance for any institution applying for a licence.

Lastly, the purpose of business analysis is to screen and if necessary improve the processes in the various prudential supervision services, in particular by acting as an intermediary to the Bank's IT department. In 2011, these analyses mainly focused on a stock-taking exercise of the various information flows, on optimising the 'fit & proper' process and on defining user requirements for new releases of reporting tools.

3.1.5 Deposit guarantee system and contribution to financial stability

The Royal Decree of 14 November 2008, amended by the Programme Law of 23 December 2009, modified the mechanism of contributions levied on financial institutions in connection with the deposit guarantee scheme. The Royal Decree of 14 November 2008 raised the guarantee to € 100 000 per depositor, while also establishing the Special Protection Fund for deposits and life insurance, financed by annual contributions amounting to 0.31% of the total deposits eligible for repayment. Article 169 of the 2009 Programme Law later increased the annual contribution payable to the Special Fund to 0.15%.

The sector contested this mechanism and therefore tried to develop an alternative proposal. Moreover, an action for annulment was brought before the Constitutional Court, concerning both the annual contribution and the one-off initial fee. In regard to the annual contribution, the plaintiff argued in particular that the contribution of the banks was calculated solely on the basis of deposits covered by the protection system, and that the plaintiff was therefore disproportionately affected compared to financial institutions which are wholly or largely funded in other ways. Apart from this alleged breach of Articles 10 and 11 of the Constitution concerning the principle of equality and non-discrimination, the plaintiff also claimed a violation of Articles 170 and 172 of the Constitution whereby the King has no power to determine an essential element of taxation. While the Constitutional Court ruled that the contribution and initial fee were not a tax but a payment not covered by Article 172 of the Constitution, it nevertheless decided that the legislature must respect the principle of equality and non-discrimination. In particular, the Court considered that account must be taken of the risk that the government would actually have to intervene, and that the deposits placed with a credit institution were no indication of that risk. The Constitutional Court therefore annulled the provision relating to the annual contribution. However, the effects of the annulled provision were maintained until 31 December 2011 to allow the legislature to amend the contested provision.

In that connection, the Bank – and before it the Committee for Systemic Risks and Systemic Financial Institutions (CSRSFI) – responded to a number of requests from the Minister of Finance concerning this case. First, the CSRSFI examined the alternative proposal produced by the sector. This was based on a set of fixed contributions divided into three components, namely a contribution under the deposit guarantee system, a financial stability contribution and a financial activity tax. The sector proposed that the contributions to the deposit guarantee scheme and the

financial stability contributions should both be weighted on the basis of risk factors.

The CSRSFI stated its preference for a two-part contribution. The first part is based on the deposit guarantee system for which the contributions would be risk-weighted. For that purpose, the CSRSFI decided in favour of a scheme comparable to the system proposed by the European Commission (EC) in its proposal for a directive, in order to align the Belgian system straightaway with the European developments. Moreover, to take account of the risks connected with the funding structure of credit institutions, and more particularly their potential dependence on the wholesale funding markets, the CSRSFI advocated introducing a financial stability contribution based on that wholesale funding and intended to build up a resolution fund.

The Minister of Finance therefore asked the Bank to submit a proposal for laws and regulations addressing the objections of the Constitutional Court and introducing a two-pillar system generating amounts equivalent to the levies in 2011. The draft texts were passed to the Minister of Finance in September 2011. They were in three parts. The first text is a draft law introducing a financial stability contribution and amending the calculation of the contribution to the deposit guarantee scheme for Belgian credit institutions by adding a risk weighting. The second is a draft Royal Decree developing the technical criteria for calculating the contribution to the deposit guarantee scheme. Finally, the third is a draft Royal Decree on the organisation of the resolution fund responsible for collecting the financial stability contributions. These texts formed the basis of the law of 28 December 2011 introducing a financial stability contribution and amending the Royal Decree of 14 November 2008. This law introduces a resolution fund financed by a financial stability contribution equivalent to 3.5 basis points of the wholesale funding, calculated as the total liabilities less the guaranteed deposits and the capital. This new contribution is due from all credit institutions incorporated under Belgian law, for which the law also introduces a risk-based system for the calculation of the contribution to the deposit guarantee scheme⁽¹⁾. In contrast, in the case of investment firms and branches of non-EU banks subject to the deposit guarantee system in Belgium, contributions remain risk-insensitive.

3.2 Prudential supervision of banks

In 2011 the prudential supervision of banks was dominated by the financial crisis, which affected all institutions in varying degrees. Surveillance of liquidity and solvency

was greatly tightened up by supplementing the regulatory periodic reporting with ad hoc reporting, the content, scope and frequency of which is determined according to the evident or assumed risks. Thus, systemic banks now have to inform the Bank daily of their liquidity position (see also section 3.2.3). Other reporting concerns their exposure to specific asset classes such as government bonds or structured credit.

In the year under review, application of the new prudential rules on remuneration policy also became reality. The banks' existing practices were examined in the light of the new rules, and a number of banks had to make significant changes to their policy.

The application of the new SREP methodology as described in section 3.1.2 of this Report will give the supervisory authority a powerful tool for charting and evaluating the risks facing the banks, and – where necessary – stipulating additional capital to cover them. This risk assessment and the decision on the capital, which must take place at least once a year, will form the basis for a continuous prudential dialogue with the banks, the aim being to achieve better risk control.

3.2.1 Actions concerning the Dexia group

Faced with mounting problems in obtaining adequate funding for its activities on the market, on 10 October 2011 Dexia announced its decision to implement a global restructuring plan, the central feature being the sale of most of its operating subsidiaries and the obtaining of a new State guarantee for its funding.

The persistence of the financial crisis which, since 2008, has affected the financing of first the banks and then governments, has had a serious impact on the liquidity situation of the financial markets, severely testing Dexia's business model. That model was based on the principle that, thanks to its high credit rating, the group did not need to offer collateral in order to secure constant access to the interbank market, which was very liquid at that time; this therefore enabled Dexia to grant long-term loans, primarily to public authorities but also to businesses and households, and furthermore to build up a substantial bond portfolio. Consequently, a fundamental change in the strategic choice of such a business model cannot be made in a short space of time. Furthermore, another part of the funding came from the group's retail bank, Dexia Bank Belgium, which granted intra-group loans to entities which had no access to the deposit market.

⁽¹⁾ See the Special Protection Fund website (www.bijzonderbeschermingsfonds.be) for a summary of the deposits covered by the guarantee system.

Since, in the autumn of 2008, Dexia had to seek State aid to resolve its serious liquidity problem, the EC imposed a restructuring plan to achieve substantial reductions in the size of its balance sheet and in its short-term funding. The EC approved this plan on 26 February 2010, and in 2011 Dexia proceeded to implement it, but the persistence of the crisis and the absence of investors meant delays in selling off the bond portfolio, and made it virtually impossible to sell certain entities.

Since 1 April 2011, as the consolidating supervisor of Dexia, the Bank in collaboration with its counterparts in the core college of supervisors, namely the French and Luxembourg supervisory authorities, and the general college, namely all the European and non-European supervisory authorities of Dexia subsidiaries or branches, has kept a close watch on the essential improvement in Dexia's risk profile in the course of the group's restructuring. In this connection, the supervisory authorities conducted an overall risk assessment which led to a decision on the capital of the financial holding company Dexia SA/NV and its component entities. The risk analysis showed that the liquidity risk, the financial position of the reference shareholders, the market risk and the revised business plan in the light of the financial crisis were the main risks facing the group. The college of supervisors formally notified Dexia of this assessment and of its capital decision.

The escalating sovereign debt crisis had a severe impact on Dexia as a specialist in lending to public authorities. At the same time, the financial markets increasingly shunned the planned asset sales intended to reduce the need for funding. The assets could only be sold at rock-bottom prices entailing heavy losses. Moreover, falling interest rates led to a significant increase in the cash collateral required by counterparties in interest rate hedging operations. In these circumstances, and in order to anticipate any further escalation of the crisis, the supervisory authorities demanded, in the second quarter of 2011, that Dexia should immediately start work on an overall emergency plan which, if the situation so required, comprised possible scenarios for breaking up the group, sheltering customer deposits and transferring the illiquid assets to a separate entity.

Although Dexia was able to continue to reduce its risks, thanks to the speedier sale of certain assets such as the American financial products portfolio at the beginning of the summer, a series of factors made the financial markets increasingly doubtful about the success of the Dexia group restructuring. A succession of negative press articles reported delays in implementing the Dexia restructuring plan approved by the EC, the threat of downgrading of the credit rating owing to Dexia's exposure to Greece,

the group's low profitability and the financial situation of the reference shareholder, the Municipal Holding Company. The mounting mistrust led to a dramatic fall in share prices and rising credit default swap premiums, which progressively blocked Dexia's access to the inter-bank market.

To halt any further deterioration in Dexia's liquidity position, the Bank instructed the group, at the end of August 2011, to implement its emergency scenarios without delay by executing the accelerated sale of the bond portfolio and initiating the process of selling off a number of the group's major operating entities.

The decision by the credit rating agency Moody's, at the beginning of October 2011, to place the group's long- and short-term ratings under review once again negatively impacted Dexia's ability to raise unsecured short- or medium-term funding, at a time when the group faced customer deposit withdrawals. When the liquidity forecasts showed that Dexia could no longer avoid asking for emergency finance from the central banks, the only option was to dismantle the group.

Over the weekend of 9 and 10 October 2011, the board of directors presented its overall restructuring plan to the Bank. That plan involved a number of strategic decisions, including the sale of the group's main operating entities. In particular, Dexia Bank Belgium and its subsidiaries – except Dexia Asset Management – were sold to the Federal Participation and Investment Company (FPIC), acting on behalf of the Belgian State. Under the plan, the residual Dexia group will also receive financial guarantees from the Belgian, French and Luxembourg governments up to a maximum of €90 billion. Dexia immediately started talks with international investors interested in acquiring Dexia Banque Internationale à Luxembourg, on which a memorandum of understanding was signed on 20 December between on the one hand, Precision Capital, a Qatar investment group and the Luxembourg State, and on the other, Dexia SA/NV. In France, negotiations began with the Caisse des Dépôts et Consignations and the Banque Postale with a view to concluding an agreement on the financing of the French local authorities, which would involve the partial sale of Dexia Municipal Agency, a group Société de Crédit Foncier which refinances loans to local authorities by issuing covered bonds.

The other Dexia group entities, namely Denizbank, RBC Dexia Investor Services and Dexia Asset Management, are also to be sold to foreign investors in the near future.

The Bank declared that it had no objection, in principle, to this restructuring plan which, at the end of the period

under review, was yet to be approved by the EC. On 17 October 2011 the EC decided to start a formal investigation procedure into the sale of Dexia Bank Belgium to the Belgian State. To safeguard financial stability, it gave its provisional approval, i.e. for a six-month period.

On 21 December the EC also provisionally approved the State guarantee for the financing of Dexia SA/NV and Dexia Crédit Local, although it set a maximum of € 45 billion pending a restructuring or liquidation plan to be submitted (ik schrap deze zinsnede omdat de staten het plan indienen) to the EC by no later than 20 March 2012. The guarantee will be limited to securities with a maximum maturity of three years, issued before 1 June 2012.

The Bank is now making sure that the financial and operational risks inherent in the implementation of the restructuring plan – and in particular the separation of Dexia Bank Belgium from the residual group – are identified and properly managed. A transition committee comprising representatives of the FPIC, the residual Dexia group and Dexia Bank Belgium, is responsible for maintaining operational continuity and ensuring the orderly execution of the operations severing the links between the residual group and Dexia Bank Belgium.

3.2.2 Liquidity management supervision

The acute liquidity shortages which the Dexia Group experienced again in 2011 once more highlighted the crucial importance of liquidity management by credit institutions and the need for close monitoring and regulation of this aspect by the supervisory authority.

On the basis of an analysis of the prudential approach to liquidity risk, conducted in the wake of the financial crisis, and following consultation between supervisory authorities at international level, the Belgian prudential supervision authority decided, in 2009, to tighten up its liquidity policy still further, in line with earlier initiatives. In practice, it introduced stress test ratios for observing the liquidity position of credit institutions. The aim of these ratios is to reveal the extent to which the liquidity position of the institutions concerned can withstand the impact of certain exceptional circumstances defined by the supervisory authority. Those ratios are calculated on the basis of the periodic liquidity reports submitted by the institutions concerned to the supervisory authority. In these reports, the institutions have to declare the amount of the buffer comprising liquid financial assets at their disposal on the reporting date, and the projected and potential cash flows for the next twelve months. These standard reports form the basis for calculating observation ratios, taking account

of assumptions adopted by the supervisory authority and applied in the same way to all Belgian credit institutions. These assumptions are comparable to those used by foreign supervisory authorities.

In addition, the Belgian supervisory authority has updated its qualitative requirements for the management of liquidity risks in accordance with the latest international recommendations. In September 2008, the Basel Committee had published new qualitative guidelines for the liquidity management of credit institutions⁽¹⁾, concentrating on the liquidity management dimensions brought to the fore by the financial crisis, such as the institutions' contingency funding plans, the impact of complex financial instruments on the liquidity position, the development of stress tests for the liquidity position of institutions, the liquidity risks associated with off-balance-sheet vehicles, and other contingent liquidity exposures, cross-border liquidity flows and the management of liquidity positions in various currencies, and coordination and communication between national supervisory authorities and central banks. Finally, monitoring of the liquidity position of Belgian financial institutions was intensified, with an increase in the frequency of liquidity reporting and shorter reporting deadlines.

The financial crisis also led to a fundamental shift of focus in the international debate between supervisory authorities regarding liquidity standards. In particular, the Basel Committee and the Committee of European Banking Supervisors (CEBS), the forerunner of the EBA, took steps towards broad harmonisation of liquidity policy between the national supervisory authorities. To that end, these international bodies published the harmonised qualitative guidelines mentioned above, which all credit institutions must respect, and in December 2010 they concluded an agreement on the worldwide introduction of two uniform quantitative standards (the Basel III liquidity standards) in order to reduce the maturity mismatch between bank assets and liabilities. The first standard, the liquidity coverage ratio (LCR), will oblige credit institutions to hold sufficient high quality liquid assets – capable of being used in repo transactions on the money market or with central banks – in order to cope with a crisis which would seriously impede their refinancing capacity for a period of one month. The LCR is intended to mitigate short-term liquidity risks and is comparable, in terms of methodology, to the regulatory ratios which the Belgian supervisory authority uses to observe the liquidity position of credit institutions, although it employs other parameters, definitions and assumptions for the stress scenario. This ratio will be supplemented by the introduction of a net

(1) *Principles for Sound Liquidity Risk Management and Supervision*, Basel Committee on Banking Supervision, September 2008.

stable funding ratio, intended to ensure that the bank's illiquid assets and potential off-balance-sheet liabilities are financed by funding regarded as stable. The purpose of introducing this second liquidity standard is to improve the structural liquidity position of the banks, to prevent long-term illiquid assets from being financed to an excessive extent by very short-term funding. Preparations have begun at European level for the application of the Basel Committee ratios to all European credit institutions. Quantitative impact studies (QIS) have been conducted to analyse the impact of the implementation of these ratios. For more details, see Box 4 in section 2.2.2.

In the light of these international developments and with a view to the introduction of the LCR from 2015 onwards, the Belgian supervisory authority therefore decided that, from the beginning of 2011, the stress test ratios for observation of the liquidity position would be adopted as the mandatory liquidity limits for all Belgian credit institutions. In some cases, the supervisory authority may grant waivers for institutions whose regulatory liquidity ratios exceed these regulatory limits, if appropriate by imposing supplementary conditions, such as more frequent reporting or the activation of the institution's contingency funding plan. That option might be used, for example, in the case of an institution deploying its liquidity buffer in extreme circumstances, or in the context of a specific business model whereby the standard would be structurally exceeded. The analysis of developments concerning this regulatory ratio, presented in section 1.2.1, shows that from 2009 Belgian credit institutions gradually improved their short-term liquidity position in anticipation of the imposition of these ratios from 2011. However, that gradual improvement was interrupted by the escalation of the sovereign debt crisis which, in particular, restricted access to long-term funding.

Use of this standard did not prevent the Bank from continuing its individual prudential measures in respect of institutions with an excessive liquidity risk or inadequate liquidity management, and maintaining very close monitoring of the liquidity position of certain financial institutions. In Dexia's case, though the existing liquidity buffers were initially sufficient to permit restructuring of the business on the planned timescale, the deterioration in the group's liquidity position was one of the factors prompting the Bank to require a faster reduction in the risk profile (see Box 2, section 1.2.1). In addition, the Bank continued to support and play an active part in the international consultations on the introduction of the aforesaid harmonised quantitative standards for liquidity risk.

3.2.3 Supervision of cross-border banking groups

Banking supervision is increasingly taking place in an international context, especially in the case of cross-border banking groups. Since the supervision of individual banks is currently still the responsibility of the national supervisory authorities, colleges of supervisors comprising the consolidating supervisory authority ("home supervisor") and the supervisory authorities of the subsidiaries or significant branches ("host supervisor") are accorded a coordinating role, with the specific task of not only exchanging all relevant information but also conducting joint risk assessments and taking joint decisions on the adequacy of the capital of the cross-border group and its components. When the Bank acts as the home supervisor, its supervision focuses on the following aspects:

- steering the college of supervisors in accordance with European and international rules and the observed best practices;
- conducting – for the first time in 2011 – a joint risk assessment and a joint ICAAP assessment and arriving at a joint capital decision;
- establishing the infrastructure to prepare for crisis management in the event of a serious crisis;
- extending the sphere of activity of the college of supervisors to include new topics such as macro-prudential supervision, IT risks and non-financial risks;
- conducting (EBA) stress tests.

When the Bank acts as host supervisor for a significant branch or subsidiary, it concentrates on the following topics: contributing actively to the work of the college and defining the supervision policy for the group, as a member of the (core) college of supervisors, and taking an interest in all aspects which determine the position and risks of the host country entity within the group, such as intra-group exposures and the transfer of assets and liabilities. Notwithstanding the increasing role of the colleges of supervisors and the coordinating function of the home authority, the host authority nevertheless carries ultimate responsibility for the supervision of subsidiaries of foreign groups.

Some Belgian banking groups, such as KBC and Dexia, benefited from public intervention in the form of a capital injection or guarantees covering assets or liabilities, and must now implement restructuring plans imposed by the EC. Those plans, which are far from easy to carry out in view of the persistent financial crisis, have a substantial influence on the policy and financial position of those institutions. Although the banking supervisor is not involved in these restructuring plans, the Bank keeps a close eye on their execution, and in certain cases has to give its approval, namely where strategic decisions are concerned.

3.2.4 College of supervisors

The Bank exercises prudential supervision on a consolidated basis over the Dexia and KBC cross-border banking groups, for which it is the home supervisor. That consolidated surveillance does not mean that the Bank supervises each individual company included in the consolidation scope of the banking group concerned. In the case of regulated companies, it means that each supervisory authority remains responsible for supervising those companies on an individual, sub-consolidated basis. As the home supervisor, the Bank is responsible for steering and coordinating the colleges of supervisors for Dexia and KBC. The supervision of those international banking groups is conducted on the basis of Memoranda of Understanding (MoUs) between the supervisory authorities, which define the collaboration procedure and practical arrangements.

The general multilateral college supervising Dexia, which meets once a year, comprises the authorities of eleven European and four non-European countries. The Bank together with the French Autorité de contrôle prudentiel (APC) and the Luxembourg Commission de surveillance du secteur financier (CSSF) forms the core college that meets each quarter. The Bank is the consolidating supervisor for the whole Dexia group, while the APC and the CSSF are the supervisory authorities responsible respectively for the French and Luxembourg banking sub-groups.

The general multilateral college supervising KBC meets once a year and comprises the authorities of ten European and four non-European countries. In 2011, the core college of KBC consisted of supervisory authorities from nine European countries (Bulgaria, Czech Republic, Germany, Hungary, Ireland, Luxembourg, Poland, Slovakia and the United Kingdom). However, that number will decline as KBC executes its divestment plan approved by the EC.

The colleges are intended to improve the supervision of cross-border banking groups. They act as a forum enabling the supervisory authorities to consult one another in order to gain a more accurate picture of the risk profile of the banking group, its risk management and risk control, and hence to coordinate the prudential measures of the various supervisory authorities. The tasks of the college of supervisors include exchanging information, agreeing on the allocation of tasks and the delegation of responsibility, and defining prudential supervision programmes.

In accordance with the new European regulations, from 2011 onwards the colleges are to conduct a joint risk assessment and issue a joint capital decision on each cross-border banking group. This assessment process, the SREP, is to lead to a joint decision on the adequacy of the

capital according to the risk profile of the banking group in question, and a decision on the minimum capital that each group must maintain, on a consolidated basis and at the level of its European subsidiaries, in addition to the regulatory amount calculated under pillar 1. This risk assessment and the capital decision must then form the basis of the joint home host supervisory plan for 2012.

Under this new European legislation, the Bank, as the home supervisor of Dexia and KBC in the college of supervisors concerned, is thus responsible for identifying and assessing the risks facing each group, then verifying whether the group and its component entities have sufficient capital to cover those risks. This joint exercise does not alter the fact that each supervisory authority remains responsible for the prudential surveillance of the entities subject to its supervision.

The process leading to a joint risk assessment and a joint capital decision by the college for the two banking groups was an exercise which dominated the college activities in 2011.

For both banking groups, the Bank produced a draft report setting out the risk assessment on a consolidated basis. For that purpose, it used an internal risk analysis system of assessing, by means of a score card, the solvency, liquidity and profitability of the banking group, and the risks inherent in the group's activities, such as credit risk, market risk, interest rate risk and operational risk, by a quantitative measurement of the risks and a qualitative measurement of their management. The Bank also assessed the banking group's governance and risk and control functions, such as the internal audit, risk management and compliance. The host supervisors were asked to carry out the same exercise for the entities subject to their supervision, in order to take account of their own risk assessment in the preparation of the draft report setting out the consolidated risk assessment.

This report on the risk assessment was discussed in detail and then approved by the college of supervisors of the banking groups concerned. On the basis of that risk assessment and the process of determining and assessing the capital adequacy (ICAAP), the college discussed the draft capital decision at consolidated level. It reached agreement in principle on the capital decision to be adopted on a consolidated basis for the banking group concerned. In regard to the capital decision to be adopted at the level of the local European entities, the host supervisors explained their proposals to the college.

For the two banking groups, the Bank formalised the joint risk assessment and joint capital decision at

TABLE 8 CREDIT INSTITUTIONS SUBJECT TO THE BANK'S SUPERVISION

	Home	Host	Solo
Large institutions	DEXIA KBC	BNP Paribas ING	
Other	5 ⁽¹⁾	20 ⁽²⁾	8

Source: NBB.
 (1) Of which three with a college of supervisors organised by the Bank.
 (2) Of which five with a college of supervisors in which the Bank participates as host authority.

consolidated level by asking the host supervisors for their formal approval at the end of the college meeting, and requesting that they pass on the draft capital decisions produced by the host supervisors for the local European entities.

The European legislation stipulates that the entire procedure must be completed within four months following communication of the risk assessment to the host supervisors, though that time limit was extended to six months until 31 December 2012. For both the Dexia group and the KBC Group, the joint capital decision was delivered on time.

Once they became final, this joint risk assessment and joint capital decision were communicated by the Bank, as the home supervisor, to the institution concerned, together with a reasoned decision. In order to ensure a due process, the group's management had already been informed orally, during the decision-making process, of both the methodology and the focus of this work.

The work of the college concerning Dexia and KBC also covered the stress tests and risk assessments conducted by the EBA. In addition, for KBC a special college was created to deal with that group's use of the Advanced IRB approach for calculating the capital requirements necessary for covering the credit risk.

As host supervisor of the ING and BNP Paribas groups, the Bank played an active part in the core colleges of each of those two groups. This work by foreign colleges of supervisors concerned in particular the joint risk assessment and joint capital decision relating to these cross-border groups, and topics such as internal governance and non-financial risks.

3.2.5 Cross-border stability group

On 1 March 2011 the CBFA and the Bank held the inaugural meeting of the cross-border stability group (CBSG) for Dexia, attended by representatives of the banking supervisory authorities, central banks and finance ministries of Belgium, France and Luxembourg. The inaugural meeting of the CSBG for KBC took place on 1 April 2011, with representatives of the banking supervisory authorities, central banks and finance ministries of Belgium, Bulgaria, the Czech Republic, Hungary, Ireland, Luxembourg, Poland and Slovakia.

The organisation of these CBSGs conformed to the EU Council's aim of having a CBSG for all large European financial groups by mid-2011. The institutional framework of these CBSGs is laid down in the memorandum of understanding (MoU) dated 1 June 2008 on cooperation between financial supervisory authorities, central banks and finance ministries of the EU on cross-border financial stability. This MoU provides for the devising of crisis management procedures based on the legal powers of the individual authorities and on existing mutual networks (including the colleges of supervisors).

At the CBSG meetings for Dexia and KBC, there was a report on the European and international initiatives relating to crisis management. The banking supervisory authorities concerned explained the systemic importance of the banking group, discussed potential crisis triggers and dealt with the development of a recovery plan. The central bankers and finance ministries concerned discussed the crisis resolution arrangements for the various countries.

3.3 Prudential supervision of insurance companies

At the start of the work on transposing the Solvency II Directive which, in principle, is to be completed by 31 October 2012 for entry into force on 1 November 2012, it was decided to completely redraft the law on the prudential supervision of insurance companies. That redrafting prompted the Bank to re-examine the provisions of the current legislation. Some particularly important or fundamental aspects relating to the prudential legislation, such as the submission to the Bank of accounts drawn up in accordance with the Belgian accounting standards (Belgian GAAP), the role of the approved commissioners and the maintenance of a maximum interest rate for life insurance, are currently being analysed. The Bank is exploring the various options and will conduct ad hoc consultations on its proposals. It is also addressing

these issues in its quarterly contacts with the sector. In addition, the Bank has set up a Solvency II discussion forum in order to facilitate informal exchanges of ideas on subjects important to the insurance sector and on the main developments in European legislation concerning Solvency II. This forum meets every two months and is attended by the directors of six large Belgian insurance companies, including an insurance holding company

3.3.1 Prudential supervision measures

In a context of severe financial market tension, the supervisory authorities have kept a close watch on how these exceptional circumstances are affecting the financial position and results of the supervised institutions. One of their specific concerns related to the implications of the downgrading of the ratings of a number of countries. In particular, the Bank conducted a survey on securities issued by peripheral euro area countries and held by insurance companies, and at the same time paid special attention to insurance company exposures to financial institutions.

The information thus obtained was used for the purpose of horizontal analyses and formed the basis for sectoral consultations on the involvement of the private sector in the second assistance programme for Greece. The information was also passed on to EIOPA in connection with the collection of data at European level. This should enable EIOPA to obtain a clearer picture of the financial situation of the large insurance groups in Europe, and to devise strategic options to cope with a possible emergency situation.

These analyses and surveys did not reveal any insurmountable situation requiring immediate action in the form of a recovery or financing plan. Nevertheless, the Bank is monitoring developments in the situation very closely, and making the necessary preparations to permit rapid intervention in institutions whose financial situation is ailing. In particular, scenarios have been developed for analysing the impact of financial market stress on the financial position of a number of insurance companies. Large insurance groups also contributed to the design of a stress test by EIOPA (see section 1.2.2).

In connection with its supervision of insurance companies, the Bank granted licence applications submitted by insurers for the pursuit of activities in new insurance classes, and also granted permission for the opening of branches. In addition, it noted the intention of some companies to engage in business under the rules on freedom to provide services, whereby the supervisory authorities of the country where the services are provided must be

informed of the intentions of the companies concerned. The Bank approved mergers and disposals, changes to the shareholdership of companies and the appointment of new directors.

Owing to the persistent financial market tension, a number of supervised institutions struggled to respect the required solvency margin, and prudential measures had to be taken to deal with the situation. A number of businesses underwent restructuring or reorganisation. The Bank ensured that these operations went smoothly.

The forthcoming adoption of a new prudential regime was another focal point. The results of firms taking part in the fifth quantitative impact study under the Solvency II project (QIS5) were analysed in detail (see Box 3 in section 1.2.2). The conclusions of that analysis are satisfactory, but firms which did not participate need to be made more aware that the new regulatory framework will soon come into force, and that it is not advisable to continue postponing the acquisition of the necessary expertise on the subject.

Finally, the Bank also examined dossiers concerning the models and exemptions relating to the additional provision for the interest rate risk, both for life insurance activities offering a guaranteed yield and for workers' compensation insurance. For the dossiers on models, the analyses produced very satisfactory results, as all the models submitted achieved a high, or even maximum, score. In the case of the exemption dossiers, the situation is likewise positive, and most firms submitting a dossier qualify for substantial or full exemption.

3.3.2 Pre-application process for internal models

In the context of pillar 1 of the new prudential framework, Solvency II, insurance companies can calculate their capital requirements on the basis of an internal model provided they have the supervisor's authorisation. Insurance companies were asked to take part in a pre-application process so that the preliminary work could begin on the validation of applications for the use of internal models (application process).

In 2011, the Bank started work on the pre-application process for internal models in the case of companies which had submitted a dossier in response to the circular of 18 February 2011 and been authorised by the Bank to take part in the pre-application process. The criteria for determining whether a company qualified for the pre-application stage were defined with reference to the criteria proposed in the guidance issued by the Committee of

European Insurance and Occupational Pension Supervisors (CEIOPS), the forerunner of EIOPA: 'CEIOPS Level 3 guidance document on Solvency II: Pre-application process for Internal Models' dated March 2010. Altogether, in response to the pre-application circular, 11 dossiers were submitted to the Bank and a further four companies have indicated that they will probably submit one in 2012.

The Bank also contacted certain companies which it had expected to submit a pre-application dossier but which had not done so. These are companies belonging to complex groups, with a large market share or engaging in specific activities for which the standard formula seems inappropriate owing to the second criterion in the CEIOPS guidelines, namely the systemic character of the companies in question.

On the basis of the dossiers received, the Bank determined which companies are accepted for the pre-application process. The companies' internal models vary in the degree to which they conform to the Solvency II Directive. Companies which have not been approved by the Bank for participation in the procedure will have to supplement their dossiers and resubmit them later, once they have adapted their internal models in line with the directive's requirements.

The analyses began after receipt of the dossiers on 30 April, and most companies were contacted for the purpose of discussing the dossiers submitted. In addition, the colleges of supervisors set up to coordinate the supervision work incorporated the pre-application process in their activities. Where appropriate, a college of supervisors was set up and brief on-site inspections have already been conducted on specific subjects (market risk, replicating portfolio, non-life internal models, natural disasters), or will begin shortly. This work will continue in 2012 and will be extended to all companies accepted for the pre-application process.

Having carried out this work, the Bank found that companies have already made significant progress, but it also identified a number of major challenges. The findings discussed in reports to the companies mainly concern the implementation plans, methodology and detailed arrangements for the use of the internal models. They are discussed at meetings of the Solvency II Forum.

3.3.3 Supervision of insurance groups

The organisation of group supervision aims to anticipate the requirements of the Solvency II regime by increased harmonisation and the consistent application of the rules

in order to ensure, with the aid of a European single rule book, a high standard of effective supervision over cross-border groups. The primary aims are not only to protect policyholders and safeguard financial stability, but also to prevent regulatory arbitrage and maintain a level playing field.

In connection with the supervision of insurance groups, the Bank attends nine colleges of supervisors. It chairs three of those colleges as the home supervisor, and takes part in the others as the host supervisor. For two other insurance groups, the creation of a college of supervisors with the Bank as the home supervisor is currently under consideration. Finally, in the case of smaller groups, cross-border coordination operates mainly on a bilateral basis via coordination committees.

In the past year, the Bank has conducted specific supervision measures for groups for which it is the home supervisor. As the host supervisor, it has regularly consulted the other supervisors of groups in which an entity comes under Belgian prudential supervision.

At the meetings of a college of supervisors, the various supervisory authorities and representatives of the insurance group are asked to exchange information and comment on a number of specific subjects. The main aspects addressed are the conduct of a stress test, monitoring of the financial position, analysis of intra-group transactions, processing of the pre-application dossier, and analysis of certain specific risks, such as catastrophe risk.

TABLE 9 INSURANCE COMPANIES SUBJECT TO THE BANK'S SUPERVISION

	Home	Host	Solo
Complex groups	KBC-group Dexia-group Ageas-group Ethias-group P&V-group	AXA-group Secura (Group QBE)	
International enterprises		29	
Other	4		53

Source: NBB.

The action plan for the colleges of supervisors in which the Bank is the home supervisor comprised, in addition to the general objectives, three specific aims: the exchange of the QIS 5 results and a follow-up discussion, definition of a timetable for processing the pre-application dossier for internal models at group level, and the conduct of a crisis simulation exercise based on the current emergency plan.

3.4 Oversight and prudential supervision of financial market infrastructures

Since the adoption of the 'twin peaks' supervision model in April 2011, the Bank has been responsible for both the oversight of the financial market infrastructures and the prudential supervision of the regulated institutions which operate those infrastructures. The Bank's oversight of the payment and settlement infrastructures forms part of its responsibility of promoting the security and efficiency of the financial system as a whole. The prudential supervision is intended to ensure that the market infrastructures are robust at microeconomic level, thus helping to maintain the confidence of the institution's counterparties and to promote financial stability. In order to pool expertise and reinforce the synergies between the oversight function and that of prudential supervision, these two functions are performed by the same team.

Many infrastructures subject to the Bank's oversight and/or supervision have an international dimension. Some limit their operations to the euro area while others are active worldwide. In accordance with the principles of cooperation in oversight and supervision, the Bank assumes the role of lead overseer/supervisor of international infrastructures located in Belgium, such as the Society for Worldwide Interbank Financial Telecommunication (SWIFT) and Euroclear. As the corollary to that, the Bank also takes part, under the direction of the central banks or supervisory authorities of the countries concerned, in the oversight and cooperative supervision of international infrastructures based outside Belgium but providing services for Belgium.

3.4.1 Oversight

SWIFT

The Bank acts as lead overseer of SWIFT, since the company is based in Belgium. The oversight of SWIFT is conducted jointly with the G10 central banks. SWIFT is not a payment system but provides essential messaging services for payment and securities settlement infrastructures throughout the world. The Bank's oversight of SWIFT is justified by the institution's crucial importance for the security and efficiency of payment and securities settlement systems.

TABLE 10 FINANCIAL MARKET INFRASTRUCTURES SUBJECT TO THE BANK'S SUPERVISION AND OVERSIGHT

	International college of supervisors / cooperative oversight agreement		The Bank acts as the sole authority
	The Bank acts as the principal authority	The Bank participates under the direction of another principal authority	
Prudential supervision	Bank of New York Mellon SA/NV (BNYM) ⁽¹⁾		Belgian branch of BNYM Payment and electronic money institutions (±15)
Prudential supervision and oversight	Euroclear Belgium (ancienne CIK) (ESES) Euroclear SA/NV	LCH.Clearnet SA/NV	Euroclear Bank ⁽²⁾ Atos Worldline ⁽³⁾
Oversight	SWIFT	Target2 Securities (T2S) ⁽³⁾ Target2 (T2) ⁽³⁾ CLS	NBB-SSS Bancontact/Mister Cash ⁽³⁾ CEC ⁽³⁾ MasterCard Europe ⁽³⁾

Source: NBB.

(1) BNYM SA/NV is the European headquarters of the BNYM group. The Bank is the principal authority in the college of European supervisors.

(2) The Bank works on an ad hoc basis with other central banks concerned.

(3) Peer review in the Eurosystem.

In 2011, SWIFT supplied the overseers with an updated version of its self-assessment report on the High Level Expectations (HLEs) forming the framework for the oversight of SWIFT's activities. The conformity with the HLEs demonstrated by SWIFT does not reflect the opinion of the overseers but is SWIFT's own assessment regarding the HLEs.

In 2011, one of the main focal points of the oversight activities was the monitoring of new projects launched by SWIFT as part of the SWIFT 2015 strategy. The overseers analysed these projects since they have an impact on the critical services of FIN and SWIFTNet. FIN is the SWIFT store-and-forward messaging service, while SWIFTNet is the internet-protocol-based platform which offers a broad range of other SWIFT products and services, in addition to FIN. The other areas included in the SWIFT oversight are cyber defence, IT audit activities, security risk management and corporate risk management.

OVERSIGHT OF CARD PAYMENT SCHEMES AND RETAIL PAYMENT SYSTEMS

In 2010, the assessment reports concerning the conformity of the domestic card payment schemes with the harmonised standards of the European System of Central Banks (ESCB) were finalised and submitted for peer review. For Belgium, the Bank assessed the conformity of the Bancontact-MisterCash system. Progress was also made in that period on the assessment of the international card payment systems. The Bank acts as lead overseer for MasterCard Europe, which has its headquarters in Belgium.

In late 2011/early 2012, the Eurosystem was to present a report on the assessment of these domestic and international systems for the sector as a whole in Europe. The main findings will be published on an aggregate basis. As is usual in any assessment exercise, the results for each entity assessed may give rise to recommendations addressed directly to the authority in charge of the governance of that entity. The latter is then expected to produce an action plan to implement those recommendations, or to show that an equivalent risk reduction will be achieved by appropriate organisational adjustments.

In regard to retail payment systems, the oversight concerned the Centre for Exchange and Clearing (CEC), which is the Belgian automated clearing centre. This system, which belongs to the banking sector and is operated by the Bank, processes retail payments in the form of transfers (domestic and SEPA – Single European Payments Area), credit and debit cards, direct debits and the exchange of cheques. Settlement takes place once a day on a multilateral net basis. In the risk classification used at

European level, the CEC is regarded as important but not systemically critical. Conformity with the standards applicable to this category of system had already been assessed previously. In recent years the Bank, in its role as overseer of the CEC, has tightened up its requirements concerning the management of the financial risks, and recommended that the system should increase the frequency of settlement cycles. The aim is to limit the amounts concerned if a participant were to be unable to meet its obligations. An agreement was concluded with the CEC's owners on the establishment of multiple settlement cycles, which implies a fundamental change for this system. The introduction of these new settlement arrangements could be linked to another major project to be carried out shortly, namely the CEC's migration to an automated clearing house compatible with the SEPA standards.

OVERSIGHT OF SECURITIES SETTLEMENT SYSTEMS

The Bank exercises its responsibilities regarding the oversight of securities settlement systems (SSS) in respect of four entities offering settlement services in Belgium, namely the companies in the Euroclear group (Euroclear SA/NV – ENV, Euroclear Bank – EB and Euroclear Belgium) and NBB-SSS, the settlement system for Belgian government debt and other fixed term income marketable securities.

ENV is the Euroclear group's parent company. It owns the securities processing platforms and offers a number of common services for the group's (international) central securities depositories – (I)CSDs –. While the oversight of these (I)CSDs is always conducted individually by each competent authority, an international cooperation agreement was drawn up for the coordination of the regulatory initiatives connected with the common services offered by ENV to group CSDs. The Bank is in charge of coordinating this multilateral cooperation process.

Since Euroclear decided to abandon its single platform project and instead to modernise the existing local platforms, the overseers of the Euroclear group wanted to make certain that the needs of each market were duly taken into consideration in drawing up the investment plan. Regarding the internal governance of the project, the IT governance and the various local and group committees which determine the project priorities were judged appropriate. In the case of the external governance, a questionnaire was sent to the local CSDs of Euroclear and to selected participants in the Market Advisory Committees, in order to examine how the latter assessed their role in the Euroclear decision-making process and to see whether Euroclear's decisions were properly communicated and explained to the market.

The Bank is also in charge of supervising Euroclear Belgium, the central securities depository for Belgian securities, which is one of the national CSDs included in the Euroclear group. Euroclear Belgium operates on the same IT platform – ESES (Euroclear Settlement for Euronext-zone Securities) – as Euroclear France and Euroclear Nederland. The governance structure of the three ESES CSDs has also been harmonised. The overseers and supervisory authorities of these three countries concluded a cooperation agreement on subjects connected with the ESES CSDs. The authorities also adjusted the ESES arrangements concerning crisis communication, owing to the high probability that an IT incident on the ESES platform would affect the three CSDs.

Finally, the Bank is also the overseer of the international CSD of the EB group. This institution, which provides settlement and depository services for international securities such as bonds, equities and collective investment funds, underwent an assessment in 2011 in relation to the standards of the ESCB-CESR (Committee of European Securities Regulators), the forerunner of ESMA. Specific attention focused on liquidity risk management.

In 2011, following an analysis of the implications of a long-term IT breakdown affecting both the active data centres and the two back-up centres for the (international) CSDs of the Euroclear Group, the Bank asked EB to conduct a more detailed analysis of its own specific services, notably the interdependences with other market players and infrastructures. That analysis is to supply fuller information on EB's ability to perform the critical functions, even in the extreme scenario in which all data centres are out of action for a period of five days. In particular, it will consider EB's ability to set priorities for systemic operations, the accessibility of historical data, and the interactions with counterparties (participants, central banks, depositors and correspondents).

As well as assessing Euroclear, in 2011 the Bank completed the assessment of the NBB-SSS system in the light of the ESCB-CESR recommendations for securities settlement systems. A scheme for implementing the recommendations⁽¹⁾ was agreed with the operator.

3.4.2 Prudential supervision of institutions operating financial market infrastructures

As stated in the introduction to this section, alongside the oversight of payment and securities settlement infrastructures the Bank also conducts the prudential supervision of institutions directly linked to those infrastructures, if they have the status of credit or payment institutions. In

Belgium, this applies in particular to the Bank of New York Mellon (BNYM), the Euroclear group and the payment and electronic money institutions.

In 2009 and 2010, the BNYM group, which is active mainly in clearing, settlement and custody, implemented a strategy to strengthen its presence in Europe via its Belgian entity, BNYM SA/NV, by effecting acquisitions and establishing branches. The group continued its strategy in 2011 by integrating into its German branch a German company acquired in 2010, and by opening a new branch in France. The Bank supervised the integration of the entities acquired from the point of view of the three main risks inherent in clearing, settlement and custody activities, namely operational risk, liquidity risk and credit risk. In anticipation of the outcome of this first phase of the reorganisation of the group's presence in Europe, the Bank also undertook to hold periodic meetings with the regulators in whose jurisdiction the BNYM SA/NV branches are located, in order to prepare for the establishment of a college of supervisors as prescribed by CRD III. That college was formally set up in the closing months of 2011.

During 2011, the prudential supervision of the Euroclear group concentrated mainly on monitoring the group's profitability, against the backdrop of the abandonment of the strategic 'Single Platform' programme in 2010 and the change of management team. Special attention also focused on the proper transposition of the CRD III principles concerning remuneration policy, intended to establish a clear, strong link between the remuneration received by a group's managers and the pursuit of the group's long-term interests. In addition, a cooperation agreement on the supervision of settlement/delivery operations outsourced by Euroclear Belgium to Euroclear France was concluded between the Belgian authorities (the Bank and the FSMA) and the French (Autorité des marchés financiers and the Banque de France) on 1 July 2011, in order to enable the Belgian authorities to continue supervising Euroclear Belgium's compliance with its obligations under Belgian law.

Finally, the prudential supervision of payment institutions became fully operational in 2011, since the European Directive of 13 November 2007 on payment services in the internal market set the date of 30 April 2011 as the deadline for regularising the situation of payment service providers already active on 25 December 2007. A number of entities meeting those conditions were therefore granted approval as payment institutions following the analysis of their licence applications.

In addition, various companies wishing to launch activities in the field of payment services submitted their plans

Box 5 – Synergy for the oversight and prudential supervision of Euroclear

Although the Bank and the former CBFA had already been working together for some years in regard to the Euroclear group, now that the prudential supervision and oversight of Euroclear have both been placed with a single entity at the Bank it is possible to develop more synergies on the following aspects:

- Data collection to ensure that all prudential and oversight information is shared and to eliminate any duplication.
- Harmonisation and coordination of supervision activities so that:
 - a) duplication is avoided and maximum use is made of the available expertise, e.g. by focusing certain on-site prudential checks on oversight points for attention;
 - b) teams in which prudential supervision and oversight are integrated conduct certain risk analyses which allow the two approaches to be combined from an overall perspective;
 - c) analyses and conclusions relating to oversight and supervision form the subject of mutual discussions and checks in order to arrive at analyses and conclusions covering both aspects.
- Contact with the institution: in order to speak with one voice regarding oversight and prudential supervision of high risk classes, such as liquidity risk, operational risk, governance or credit risk. For each requirement or formal recommendation addressed to Euroclear, there will be systematic reference to the statute concerned, namely prudential supervision or oversight.
- Transition to a common annual plan comprising an oversight section and a prudential section, thus comparing the risk analysis conducted from the micro-prudential angle with that from the point of view of systemic risk.

to the Bank to determine whether the services envisaged actually fell within the scope of the payment services directive. A number of those companies submitted formal

approval applications following that preliminary analysis. Some of them were granted approval as payment institutions, and began operating during 2011.

TABLE 1 CARTOGRAPHY OF THE INSTITUTIONS SUBJECT TO THE NATIONAL BANK OF BELGIUM'S SUPERVISION⁽¹⁾
(end-of-period data)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Financial holdings										
<i>Total</i>	10	8	8	9	7	7	7	6	6	6
Credit institutions										
Credit institutions governed by Belgian law	65	61	59	54	51	52	51	48	48	48
Institutions for electronic money	–	–	–	–	–	–	2	2	2	2
Belgian branches of credit institutions governed by non-EEA countries' law	10	10	9	9	8	9	9	9	9	9
Belgian branches of credit institutions governed by EEA countries' law	36	38	36	41	46	49	47	47	50	52
<i>Total credit institutions</i>	111	109	104	104	105	110	107	104	107	109
Payment institutions governed by Belgian law										
<i>Total</i>	0	0	0	0	0	0	0	0	0	9
Settlement institutions governed by Belgian law and with settlement institutions equated institutions										
<i>Total</i>	0	0	0	2	2	2	2	2	2	2
Insurance companies										
Insurance companies governed by Belgian law	123	118	118	110	107	106	100	97	97	96
Belgian branches of insurance companies governed by another EEA country's law	73	66	60	58	54	50	51	51	50	53
Belgian branches of insurance companies governed by another non-EEA country's law	6	5	3	3	0	0	0	0	0	0
According to specialisation										
Life insurance	30	31	31	30	29	29	30	29	28	26
Non-life insurance	140	127	122	116	109	104	99	95	93	96
Mixed insurance	32	31	28	25	23	23	22	23	24	25
Reinsurance	0	0	0	0	0	0	0	1	2	2
<i>Total insurance companies</i>	202	189	181	171	161	156	151	148	147	149
Free service provision										
Credit institutions	411	433	471	489	506	522	564	571	587	641
Insurance companies	629	670	681	740	762	791	878	873	893	976
<i>Total free service provision</i>	1 040	1 103	1 152	1 229	1 268	1 313	1 442	1 444	1 480	1 617
Stockbroking firms with Belgian license⁽²⁾										
<i>Total</i>	40	37	36	31	27	26	23	23	23	22

Source : NBB.

(1) The nominative list of all institutions subject to the Bank's supervision can be consulted on its website : www.nbb.be.

(2) As part of the division of tasks agreed on with the FSMA, another sixteen branches of foreign investment firms governed by other EEA countries' law are subject to the Bank's supervision.

TABLE 2 BALANCE SHEET STRUCTURE OF CREDIT INSTITUTIONS GOVERNED BY BELGIAN LAW, BY PRODUCT⁽¹⁾

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

	2002	2003	2004	2005	2006	2007	2008	2009	2010	September 2011
Assets										
Loans and advances to credit institutions	214.8	206.8	212.6	277.3	285.7	320.8	213.2	156.1	195.8	211.3
Loans and advances to other than credit institutions	421.3	428.8	482.9	591.8	591.0	666.2	555.6	536.5	506.6	509.9
<i>p.m. Mortgage loans</i>	93.6	117.4	132.0	154.7	189.7	208.3	132.2	158.3	178.5	185.0
Debt instruments	278.0	283.0	291.0	320.0	319.3	296.2	298.8	264.7	231.9	214.8
Equity instruments	13.0	18.0	31.0	48.0	64.4	52.8	15.9	8.8	5.8	4.8
Derivatives	-	-	-	-	51.8	120.5	223.1	135.1	133.2	168.7
Other assets	97.5	96.4	125.7	132.2	109.7	122.0	115.6	89.3	77.7	75.4
Total assets	1 024.6	1 033.0	1 143.2	1 369.3	1 422.0	1 578.4	1 422.1	1 190.5	1 151.1	1 184.7
Liabilities										
Debts to credit institutions	254.9	257.3	281.6	412.6	415.3	431.7	276.2	167.6	177.2	151.8
Deposits ⁽²⁾	406.6	416.7	456.1	502.7	556.4	582.4	557.4	541.8	511.4	543.7
<i>p.m. Regulated savings deposits</i> ⁽²⁾	110.5	129.0	146.9	153.8	142.7	131.1	129.2	163.5	186.4	193.7
Bonds and other debt securities	128.8	115.2	113.9	119.5	159.3	179.1	124.4	150.0	125.3	111.0
Derivatives	-	-	-	-	72.1	122.3	232.7	147.8	148.5	184.9
Subordinated liabilities	25.8	23.9	23.7	24.3	25.7	36.0	37.0	30.2	29.4	27.0
Other liabilities	187.7	232.9	273.2	273.2	145.9	159.6	145.3	99.4	102.1	110.6
Total equity and minority interest	30.5	32.2	35.0	37.0	47.3	67.3	49.1	53.7	57.2	55.8
Total liabilities	1 024.6	1 033.0	1 143.2	1 369.3	1 422.0	1 578.4	1 422.1	1 190.5	1 151.1	1 184.7

Source: NBB.

(1) Data based on Belgian accounting principles (Belgian GAAP) until 2005 and on IAS/IFRS-standards from 2006 onwards.

(2) Deposits booked at amortised cost.

TABLE 3 MAIN COMPONENTS OF THE INCOME STATEMENT OF CREDIT INSTITUTIONS GOVERNED BY BELGIAN LAW⁽¹⁾
(consolidated data, in € billion)

	First nine months										
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	
Net interest income	12.7	12.2	12.8	12.7	12.8	13.3	14.5	14.9	13.8	10.1	10.5
Non-interest income	11.9	10.7	11.4	12.8	13.9	13.0	4.8	3.9	6.4	4.9	4.4
Net fee income	7.2	6.5	7.2	7.9	6.7	7.4	6.8	5.7	5.2	3.9	4.1
(Non-)realised capital gains or losses on financial assets and liabilities	2.2	1.8	2.0	2.2	3.6	3.8	-3.8	-2.7	0.0	0.0	-0.5
Other non-interest income	2.5	2.4	2.2	2.7	3.6	1.9	1.9	1.0	1.3	0.9	0.8
Gross operating income (banking product)	24.6	22.8	24.2	25.5	26.6	26.3	19.3	18.8	20.2	15.0	14.8
Expenses	-18.4	-16.9	-17.4	-18.5	-14.8	-16.1	-16.6	-14.6	-13.3	-9.9	-10.2
Staff expenses	-8.1	-7.7	-7.8	-7.9	-9.0	-9.2	-9.2	-7.9	-7.4	-5.6	-5.6
Impairment losses and provisions	-2.2	-1.5	-0.5	0.4	-0.4	-3.2	-13.3	-7.4	-1.8	-1.2	-3.1
Tax expenses (-income) and other income	-0.9	-0.5	-1.1	-0.8	-1.7	-0.4	-10.6	1.9	0.5	0.5	-1.3
Net profit or loss	3.2	4.0	5.2	6.6	9.7	6.7	-21.2	-1.2	5.6	4.4	0.3

Source : NBB.

(1) Data based on Belgian accounting principles (Belgian GAAP) until 2005 and on IAS/IFRS-standards from 2006 onwards.

TABLE 4 KEY FIGURES OF CREDIT INSTITUTIONS GOVERNED BY BELGIAN LAW⁽¹⁾
(end-of-period consolidated data, in € billion, unless otherwise stated)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	September 2011
Large banking groups										
<i>Balance sheet total</i>	907.5	913.2	1 010.7	1 229.2	1 348.0	1 488.8	1 326.8	1 092.0	1 003.2	1 005.2
Customers' holdings	465.4	453.9	482.1	532.0	667.4	700.9	612.8	622.5	559.8	561.0
Loans and advances to customers	381.2	384.9	433.2	535.1	553.8	619.0	505.0	481.7	450.7	444.7
Risk asset ratio (in %)	12.8	12.4	12.6	11.1	11.2	10.8	16.2	17.0	19.2	19.0
Net after tax results	2.9	3.6	4.6	5.7	9.2	6.2	-20.9	-1.5	5.0	-0.2
Return on average assets (in %)	0.4	0.4	0.5	0.5	0.7	0.4	-1.4	-0.1	0.5	0.0
Return on average equity (in %)	12.6	14.2	17.3	19.9	23.1	13.7	-40.8	-3.8	11.1	-0.6
Cost-income ratio (in %)	73.2	72.8	70.6	72.3	55.5	60.6	86.3	77.7	65.5	68.4
Total of Belgian credit institutions										
<i>Balance sheet total</i>	1 024.6	1 033.0	1 143.2	1 369.3	1 422.0	1 578.4	1 422.1	1 190.5	1 151.1	1 184.7
Customers' holdings	535.3	531.9	570.1	622.1	715.7	761.6	681.8	691.9	636.7	654.6
Loans and advances to customers	421.3	428.8	482.9	591.3	591.0	666.2	555.6	536.5	506.6	509.8
Risk asset ratio (in %)	13.1	12.8	13.0	11.5	11.9	11.2	16.2	17.3	19.3	19.1
Net after tax results	3.2	4.0	5.2	6.6	9.7	6.7	-20.6	-1.2	5.6	0.3
Return on average assets (in %)	0.4	0.4	0.5	0.5	0.7	0.4	-1.3	-0.1	0.5	0.0
Return on average equity (in %)	11.8	13.6	15.8	18.5	22.4	13.2	-36.5	-2.6	10.5	0.7
Cost-income ratio (in %)	74.7	73.9	72.0	72.6	55.7	61.1	86.1	77.7	65.9	68.7

Source: NBB.

(1) Data based on Belgian accounting principles (Belgian GAAP) until 2005 and on IAS/IFRS-standards from 2006 onwards.

TABLE 5 MAIN COMPONENTS OF INSURANCE COMPANIES' BALANCE SHEET

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

	2002	2003	2004	2005	2006	2007	2008	2009	2010	September 2011 ^(a)
Assets										
Investments	110.3	125.2	143.3	166.5	183.7	201.7	202.7	214.9	229.5	229.8
<i>All activities with the exception of class 23</i>	94.6	107.9	124.4	141.7	158.3	177.2	184.6	195.8	209.9	211.5
Shares ⁽¹⁾	15.8	13.8	15.1	17.9	18.8	19.8	13.4	11.4	11.9	10.0
Debt securities	58.9	72.2	88.2	101.2	115.2	130.0	136.6	151.5	165.9	168.3
Land and buildings	2.4	2.4	2.6	2.6	2.5	2.6	3.1	3.1	3.0	3.1
Investments in affiliated undertakings	7.4	8.0	8.2	9.2	11.0	14.2	15.7	16.9	16.8	15.5
Mortgage loans and others	10.1	11.5	10.3	10.8	10.7	10.6	15.9	13	12.3	14.6
<i>Class 23</i>	15.8	17.3	18.9	24.8	25.5	24.6	18.1	19.1	19.5	18.3
Shares ⁽¹⁾	13.1	13.4	13.7	19.5	21.2	19.5	13.6	14.9	15.2	n.
Debt securities	2.1	2.6	3.2	4.1	3.8	4.6	4.2	3.9	4.1	n.
Others	0.6	1.3	2.0	1.3	0.4	0.5	0.3	0.3	0.2	n.
Reinsured part of technical provisions	6.0	6.2	6.6	5.2	4.9	4.8	7.0	6.6	6.8	7.0
Claims and other assets	9.8	11.0	13.8	13.3	13.2	13.8	14.1	12.9	12.0	13.1
Total assets	126.1	142.4	163.7	185	201.9	220.4	223.8	234.4	248.5	250.1
Liabilities										
Own funds	7.9	8.8	9.4	10.2	10.7	11.9	14.2	14.5	14.6	14.3
Technical provisions	106.9	120.8	137.8	156.5	169.9	185.5	188.0	198.5	210.9	214.5
Life insurance (with the exception of class 23)	63.8	76.2	88.9	103.7	115.2	130.6	139.4	149.2	160.4	165.4
<i>Class 23</i>	16.0	17.5	19.2	25.0	25.7	24.7	18.2	19.2	19.6	18.4
Non-life insurance	22.4	23.1	24.2	22.7	23.3	24.0	24.8	24.2	24.9	25.1
Other provisions	4.6	5.0	5.5	5.1	5.7	6.2	5.5	5.9	6.0	5.6
Reinsurance companies' deposits	2.3	2.4	2.5	2.7	2.6	2.7	4.8	4.7	4.9	5.1
Debts	6.9	8.2	11.8	13.5	16.5	17.6	14.5	14.3	15.4	14.3
Other liabilities	2.1	2.2	2.2	2.0	2.2	2.6	2.3	2.5	2.7	1.8
Total liabilities	126.1	142.4	163.7	185	201.9	220.4	223.8	234.4	248.5	250.1

Source: NBB.

(1) Including shares in undertakings for collective investment.

(2) Based on quarterly report's data.

TABLE 6 MAIN COMPONENTS OF INSURANCE COMPANIES' INCOME STATEMENT

(unconsolidated data, in € billion, unless otherwise stated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2010	2011
First nine months ⁽¹⁾													
Technical account in life insurance													
Net premiums written	12.8	13.1	14.4	17.7	20.0	25.2	20.4	21.9	19.5	18.6	18.9	14.0	13.4
Individual class 21, 22 and 26	3.3	4.7	7.4	11.7	13.1	14.9	12.6	14.5	13.1	12.2	12.5	n.	n.
Group class 21 and 23	2.8	3.0	3.2	3.5	3.9	3.9	3.8	4.2	4.4	4.6	4.6	n.	n.
Class 23	6.8	5.6	3.8	2.4	2.9	6.4	4.1	3.2	1.9	1.7	2.0	n.	n.
Claims paid (-)	4.8	5.4	6.9	7.9	8.5	10.2	13.0	13.0	15.3	13.5	12.7	8.9	11.0
Change in the provisions for claims (-)	9.1	7.8	6.4	12.9	15.2	20.5	12.4	13.3	2.9	11.5	11.8	9.0	3.7
Premiums after insurance costs	-1.1	-0.1	1.2	-3.1	-3.7	-5.4	-5.0	-4.4	1.3	-6.5	-5.5	-3.9	-1.2
Net operating expenses (-)	1.0	1.1	1.1	1.2	1.2	1.3	1.4	1.6	1.6	1.6	1.6	1.2	1.2
Result of insurance activities	-2.2	-1.2	0.0	-4.3	-4.9	-6.8	-6.4	-6.0	-0.3	-8.0	-7.1	-5.1	-2.4
Net investment income	3.2	2.0	-0.3	4.8	5.7	8.0	7.4	6.9	-3.4	8.8	7.8	5.9	2.4
Technical result life insurance	1.0	0.8	-0.2	0.5	0.8	1.2	1.0	1.0	-3.7	0.7	0.8	0.8	0.0
Technical account in non-life insurance													
Net premiums written	7.3	7.8	8.5	9.1	9.6	8.9	9.3	9.3	9.7	9.2	9.5	7.1	7.4
Claims paid (-)	5.3	5.8	5.9	5.7	5.7	5.6	5.9	6.3	6.5	6.6	6.8	5.0	5.1
Change in the provisions for claims (-)	0.6	0.9	0.9	0.8	1.0	1.1	0.8	0.5	0.4	0.4	0.4	0.3	0.2
Premiums after insurance costs	1.4	1.2	1.7	2.6	2.9	2.3	2.6	2.5	2.8	2.2	2.3	1.7	2.0
Net operating expenses (-)	2.3	2.5	2.7	2.8	2.9	2.7	2.8	2.7	2.8	2.6	2.7	2.0	2.2
Result of insurance activities	-0.9	-1.4	-1.0	-0.2	0.0	-0.4	-0.2	-0.2	0.0	-0.4	-0.4	-0.3	-0.1
Net investment income	1.5	1.4	0.7	1.0	1.2	1.5	1.3	1.5	0.2	1.0	1.1	1.0	0.7
Technical result non-life insurance	0.6	0.0	-0.3	0.8	1.2	1.1	1.2	1.3	0.2	0.7	0.7	0.6	0.6
Non-technical account													
Total technical result life and non-life insurance	1.6	0.8	-0.5	1.3	2.0	2.3	2.2	2.2	-3.5	1.4	1.5	1.5	0.6
Residual net investment income	0.5	0.6	0.1	-0.2	0.3	0.7	0.5	1.7	0.3	-0.7	0.2	-0.1	-0.3
Other and exceptional results	-0.3	-0.4	-0.4	-0.4	-0.6	-0.6	-0.5	-0.1	-0.7	0.2	-0.3	-0.2	-0.3
Net result	1.7	1.0	-0.8	0.6	1.7	2.4	2.2	3.8	-3.9	0.9	1.4	1.2	0.0
p.m. Return on equity (in %)	21.5	12.1	-10.4	7.3	18.0	23.3	20.8	31.7	-27.3	6.3	9.9	7.6	0.2
p.m. Combined ratio non-life (in %)	112.5	117.5	111.6	102.1	99.6	104.3	101.7	102.1	100.2	103.8	104.5	104.6	101.6

Source: NBB.

(1) Based on quarterly report's data.

TABLE 7 LEVEL AND COMPOSITION OF INSURANCE COMPANIES' SOLVENCY MARGIN

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

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	September 2011 ⁽²⁾
Life												
Explicit margin	4.1	4.3	4.1	4.5	5.9	6.9	7.8	8.5	11.0	12.3	12.3	10.4
<i>In % of required margin</i>	158	154	131	128	143	144	146	144	177	185	172	141
Implicit solvency margin	2.4	2.9	3.3	3.1	3.3	4.2	4.3	2.4	1.1	1.5	1.4	1.9
Future profits ⁽¹⁾	1.7	2.0	1.9	1.8	0.8	0.7	0.7	0.5	0.4	0.3	0.2	0.8
Unrealised capital gains	0.7	0.9	1.4	1.3	2.6	3.5	3.7	2.0	0.8	1.2	1.2	1.2
<i>In % of required margin</i>	93	104	106	87	81	88	81	41	18	23	20	26
Total solvency margin	6.5	7.2	7.3	7.6	9.2	11.1	12.1	11.0	12.2	13.8	13.8	12.4
<i>In % of required margin</i>	251	258	237	215	223	232	227	185	195	208	192	168
Non-life												
Explicit margin	3.9	4.2	4.2	4.9	4.8	4.8	5.0	5.7	5.8	5.1	5.0	5.5
<i>In % of required margin</i>	256	273	251	285	270	280	275	302	301	284	274	288
Implicit solvency margin	0.5	0.5	0.6	0.5	0.8	0.9	1.0	0.7	0.3	0.5	0.5	0.4
Unrealised capital gains	0.5	0.5	0.6	0.5	0.8	0.9	1.0	0.7	0.3	0.5	0.5	0.4
<i>In % of required margin</i>	33	35	35	31	43	54	54	37	14	27	25	20
Total solvency margin	4.4	4.8	4.8	5.5	5.6	5.8	6.0	6.4	6.1	5.5	5.5	5.8
<i>In % of required margin</i>	289	308	286	316	313	334	329	340	315	312	299	308
All activities												
Explicit margin	8.0	8.6	8.2	9.5	10.7	11.7	12.8	14.2	16.8	17.4	17.4	15.9
<i>In % of required margin</i>	194	197	173	179	181	180	179	183	206	206	193	171
Implicit solvency margin	2.9	3.5	3.9	3.6	4.1	5.1	5.3	3.1	1.4	2.0	1.9	2.3
Future profits ⁽¹⁾	1.7	2.0	1.9	1.9	0.8	0.7	0.7	0.5	0.4	0.3	0.2	0.8
Unrealised capital gains	1.2	1.5	2.0	1.8	3.3	4.4	4.6	2.7	1.0	1.7	1.2	1.5
<i>In % of required margin</i>	71	79	81	69	70	79	74	40	17	24	21	25
Total solvency margin	10.8	12.0	12.1	13.1	14.8	16.9	18.0	17.3	18.2	19.4	19.2	18.2
<i>In % of required margin</i>	265	276	254	248	251	259	253	223	223	230	214	196

Source : NBB.

(1) In life insurances.

(2) Based on quarterly report's data.

Conventional signs

n.	not available
p.m.	pro memoria
€	euro
\$	US dollar

List of abbreviations

Region or country

BE	Belgium
DE	Germany
IE	Ireland
EL	Greece
ES	Spain
FR	France
IT	Italy
NL	Netherlands
AT	Austria
PT	Portugal
CZ	Czech Republic
HU	Hungary
PL	Poland
US	United States

Other

ABCP	Asset-backed commercial paper
ABS	Asset-backed security
ACP	Autorité de contrôle prudentiel
BIS	Bank for International Settlements
BNYM	Bank of New York Mellon
BPR	Bank Performance Report
CBFA	Banking, Finance and Insurance Commission
CBSG	Cross-border stability group
CCP	Central counterparties
CDC	Caisse des Dépôts et de Consignations
CDO	Collateralized debt obligation
CDS	Credit default swap
CEBS	Committee of European Banking Supervisors
CEC	Centre for Exchange and Clearing
CEIOPS	Committee of European Insurance and Occupational Pension Supervisors
CESR	Committee of European Securities Regulators
CET1	Common equity Tier 1
ComFrame	Common framework for the supervision of internationally active insurance groups
COREP	Common reporting framework
CPSS	Committee on Payment and Settlement Systems
CRD	Capital requirements directive
CSRSFI	Committee for Systemic Risks and System-relevant Financial Institutions
CSSF	Commission de surveillance du secteur financier
EB	Euroclear Bank
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
EEA	European Economic Area
EFC	Economic and financial committee
EFSF	European Financial Stability Facility
EIOPA	European Insurance and Occupational Pensions Authority
EMIR	European Market Infrastructure Regulation
ENV	Euroclear SA/NV
ESA	European Supervisory Agency
ESCB	European System of Central Banks
ESES	Euroclear Settlement for Euronext-zone Securities
ESFS	European System of Financial Supervisors
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
EU	European Union
FATF	Financial Action Task Force
Febelfin	Belgian financial sector federation
FINREP	Financial reporting framework
FPIC	Federal Participation and Investment Company
FSB	Financial Stability Board
FSMA	Financial Services and Markets Authority

G20	Group of Twenty
GAAP	Generally accepted accounting principles
GDP	Gross domestic product
G-SIFI	Globally systemically important financial institution
HLE	High-level expectations
IAIS	International Association of Insurance Supervisors
IAS	International Accounting Standards
IASB	International Accounting Standards Board
ICAAP	Internal capital adequacy assessment process
(I)CSD	(International) Central securities depository
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
IRB	Internal ratings-based
ISO	International Organization for Standardization
LCR	Liquidity coverage ratio
Libor	London interbank offered rate
MCR	Minimum capital requirement
MIR	Monetary financial institutions interest rates
MoU	Memorandum of understanding
NBB	National Bank of Belgium
NBB-SSS	Securities settlement system
NSFR	Net stable funding ratio
OECD	Organisation for Economic Cooperation and Development
OIS	Overnight index swap
OLO	Linear bonds
OTC	Over-the-counter
QIS	Quantitative impact study
SCR	Solvency capital requirement
SEPA	Single Euro Payments Area
SIFI	Systemically important financial institution
SME	Small and medium-sized enterprises
SREP	Supervisory Review and Evaluation Process
SWIFT	Society for Worldwide Interbank Financial Telecommunication
TR	Trade repository
UCI	Undertakings for collective investment
VaR	Value-at-risk

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