1. Financial system developments

1.1 International financial markets

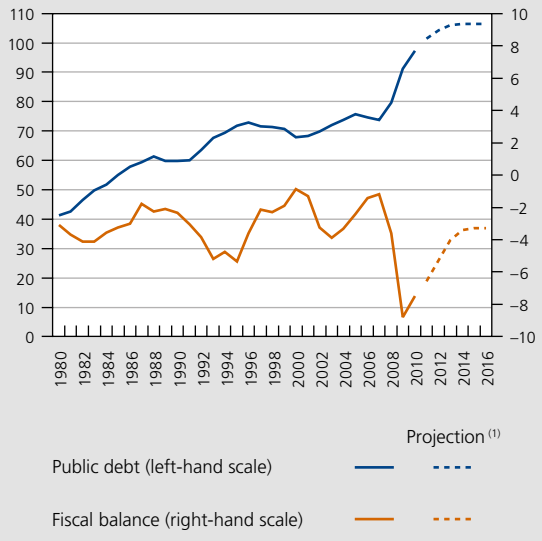
The key development in international financial markets in 2011 was the intensification and broadening of investor concerns over sovereign debt risks, particularly in regard to a number of euro area countries. This new episode in the global financial crisis, which had started in 2007 with fears over potential 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.

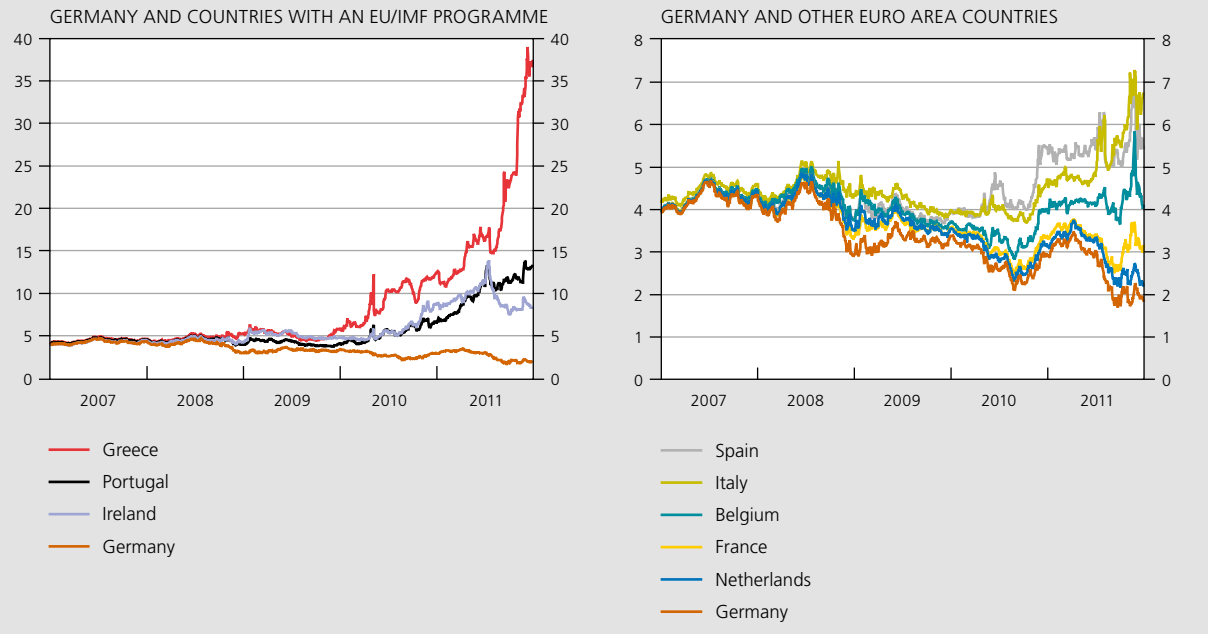
(1) The assumptions underlying this projection are explained in box A1 in the September 2011 edition of the IMF World Economic Outlook (pp. 172–175).

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.

Financial Stability Facility (EFSF) to € 440 billion by raising the total amount of guarantees from euro area Member States to € 780 billion.

The adoption of this comprehensive package in July was in part motivated by the significant contagion resulting from the sovereign risk problems in the three EU/IMF programme countries and affecting the much larger Italian and Spanish sovereign bond markets, where yields had risen strongly in the first three weeks of July to reach almost 6 %. Market reaction to the 21 July measures was tepid, however. In addition to concernsconcerns that the actual implementation of these measures would take quite some time, markets were sceptical about whether the simple extension of the EFSF's effective lending capacity to € 440 billion would be sufficient to copecopecope with potential refinancing needs in Italy or Spain, should these countries lose market access. From late July to early August, tensions on sovereignbond markets thus tended to spread further to the large southern European countries, and were amplified by the publication of business surveys showing a significant slowdown in the pace of economic growth in Europe and other major areas of the global economy. In early August, the Italian and Spanish 10-year government bond yields spiked to 6.2 %, their highest levels since the creation of the euro area. Against the backdrop of this growing contagion, the Eurosystem reactivated its Securities Markets Programme and began buying Italian and Spanish government bonds, restoring calm to the markets. However, as these moves were intended and understood to be only a temporary solution pending the implementation of the agreed changes to the EFSF, they predictably failed to take the place of more fundamental measures addressing the root causes of the sovereign risk problems. When these measures were not forthcoming at the speed and on the scale expected by the markets, a new wave of risk aversion gathered pace, and increasingly led to contagion of core euro area countries as well.

The spreadingspreadingspreadingspreading of the sovereign debt crisis, first to Italy and Spain and later to a number of core euro area countries such as France, Austria and Belgium, contributed to the surge in the SovX credit default swap index to more than 350 basis points in the last week of September. The rise in this index – measuring the average level of premiums on five-year credit default swaps referencing the sovereign debt of nineteen western European countries – to its highest level since this series was calculated for the first time, was drivenby a broad-based increase in individual countries' five-year CDS premiums, including those of Germany and other AAA-rated countries such as France or Austria. In response to these developments, euro area policy-makers signalled that a new set of measures would be considered, including plans to leverage the EFSF's lending capacity and a recapitalisation of the European banking sector on the basis of a new assessment of the capital buffers of the banks that took part in the stress test conducted earlier in 2011 by the European Banking Authority (EBA) (cf. Box 1). These measures were approved by the heads of state and government on 26 and 27 October, together with details of the second support package for Greece with more substantial private sector involvement than announced in July, in the form of debt swaps. However, the boost to market confidence was destroyed when the Greek Prime Minister announced plans to organise a referendum on the Greek policy measures to be adopted as part of this second Greek support package. Government bond risk premiums and CDS spreads reversed the tightening that had occurred in anticipation of the EU summit on 26 and 27 October, and contagion forces returned at full strength, even affecting core euro area countries. France, with a triple-A rating, saw its five-year CDS premium – the price which investors are willing to pay for an insurance contract covering a potential credit event concerning French government bonds – rise to a record height of 250 basis points on 23 November. The Belgian CDS reached almost 400 basis points at that time, up from 143 basis points at the end of June 2011 and 217 basis points at the end of 2010. Even the premium on German credit default swaps exceeded 100 basis points.

CHART 3 CREDIT DEFAULT SWAP INDICES FOR EUROPEAN SOVEREIGN DEBT AND FOR THE SENIOR DEBT OF EUROPEAN FINANCIAL INSTITUTIONS

(daily data, basis points)

Sources : Bloomberg, Thomson Reuters Datastream.
(1) Index measuring the average level of five-year CDS premia referencing the sovereign debt of 19 western European countries.
(2) Index measuring the average level of five-year CDS premia referencing the senior debt of 25 large European financial institutions.

ThisThisThisis spreading of sovereign risk concerns to the very core of the euro areain 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**
p.m. Total end December 2010	*115.2*	*182.2*	*396.8*	*744.5*	*577.4*	***2 016.1***

Source: BIS.

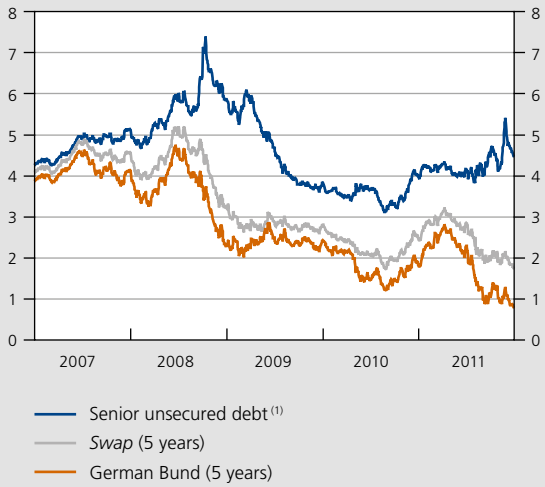
(1) Banks controlled by residents and established in Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey and the United Kingdom.

(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.

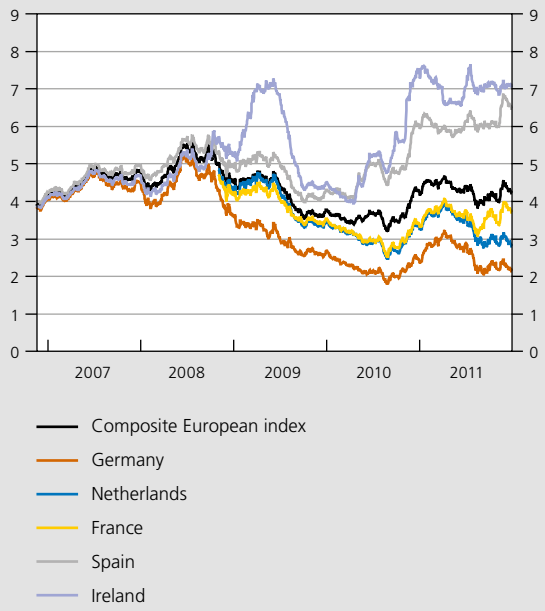
(1) iBoxx euro corporate banks senior index referencing unsecured senior bank debt denominated in euro.

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 affectedaffectedaffecteded 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.credit. 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 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 6 SPREADS BETWEEN 1-YEAR LIBOR AND OIS [1]

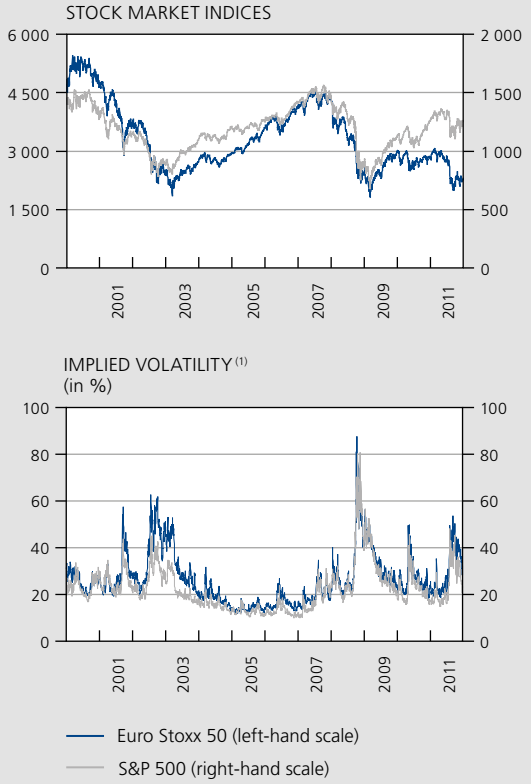
(daily data, basis points)

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.

CHART 7 STOCK MARKETS

(daily data)

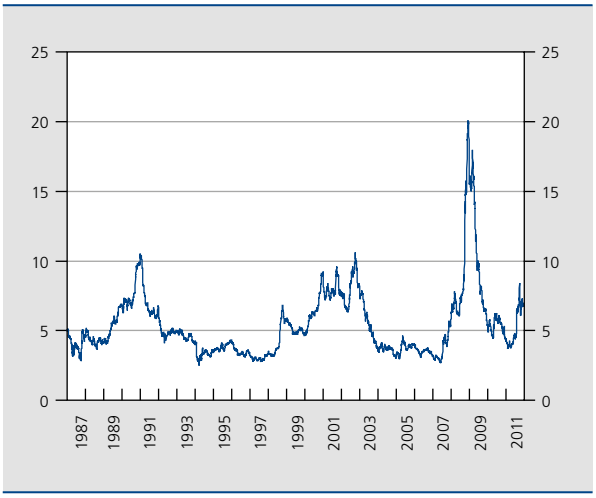


Source : Thomson Reuters Datastream.

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

CHART 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.

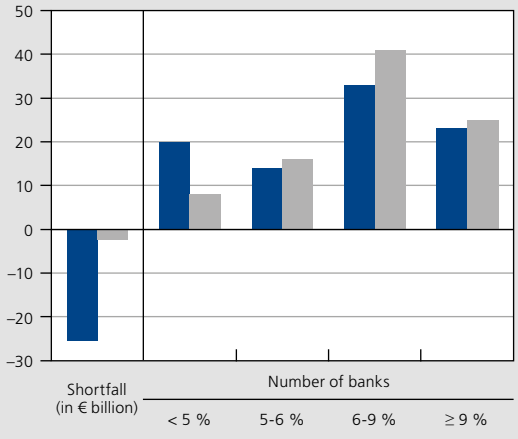
The main criticisms of the tests were that they did not include liquidity risks as such, that they took insufficient account of the amplification of sovereign risk in 2011, that defining or calibrating the capital requirement at 5 % was insufficiently strict, and finally, that the specific characteristics 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

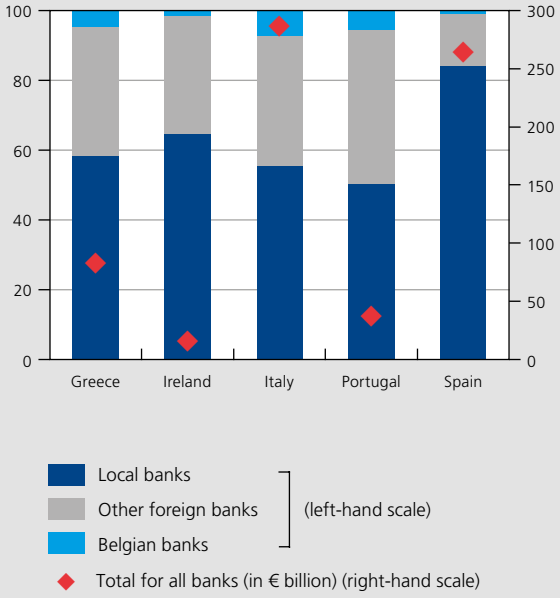
SUMMARY OF THE RESULTS OF THE EBA STRESS TEST

(data published in July 2011)

CAPITAL SHORTFALL AND NUMBER OF BANKS IN EACH CLASS OF STRESSED CORE TIER 1 RATIOS
(number, unless otherwise stated)



EXPOSURES TO SOME EURO AREA COUNTRIES OF BANKS PARTICIPATING IN THE EBA STRESS TEST [1]
(% of the total, unless otherwise stated)



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.

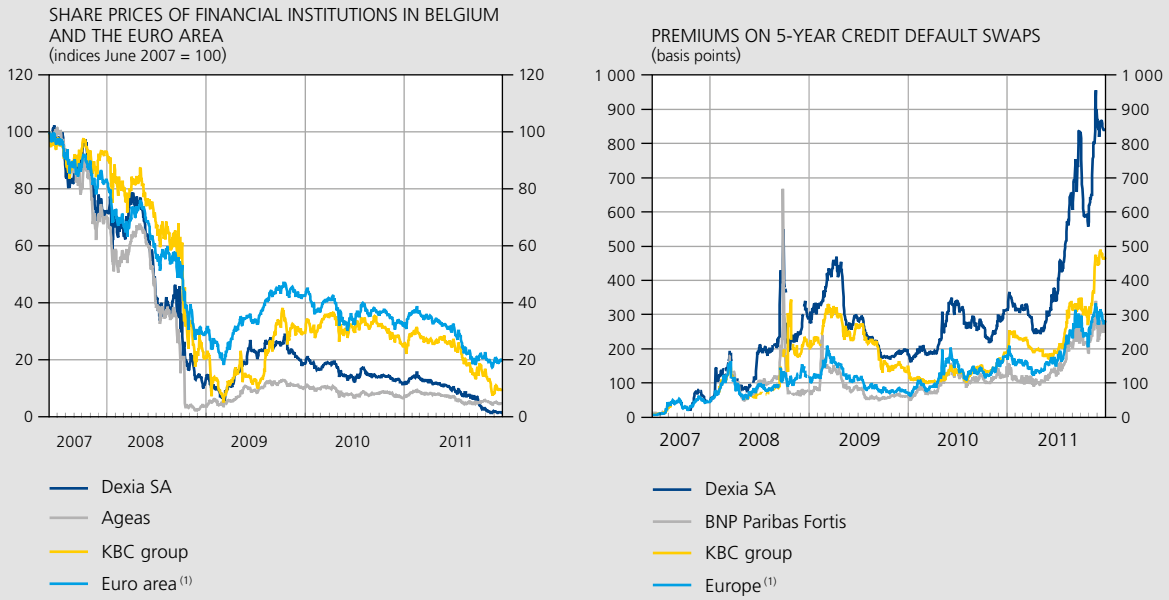
1.2 Belgian financial sector

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 Luxemburg.
- 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.

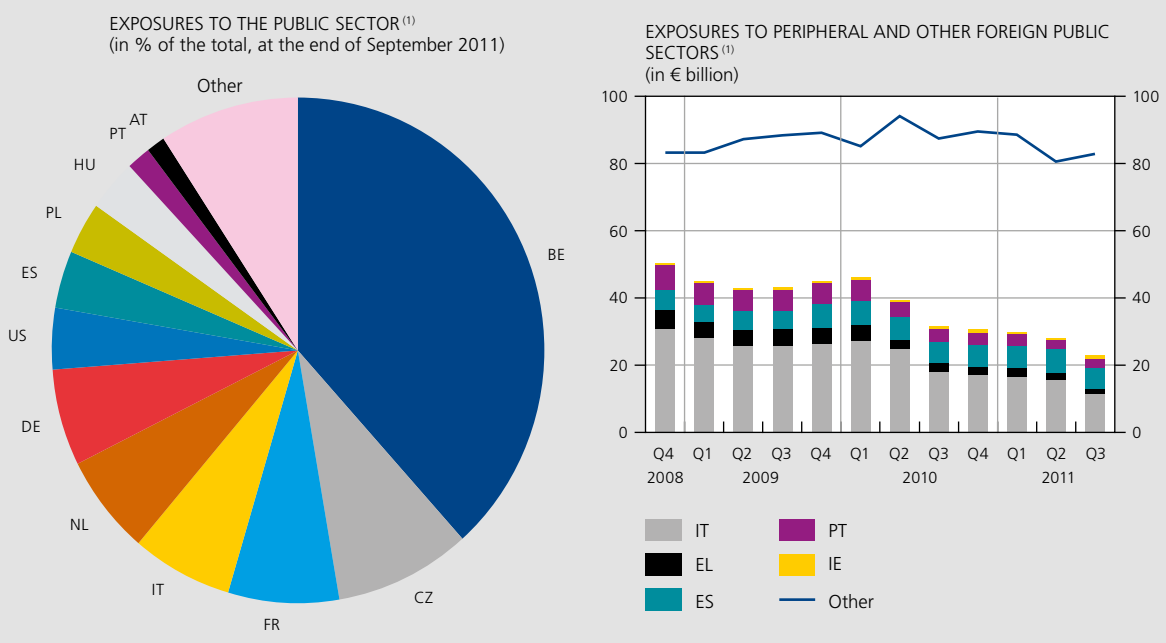
The guarantee also only covers securities with a term of three years maximum, issued before 1 June 2012. The EC has yet to approve the other elements of the dismantling plan.

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 interbank 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

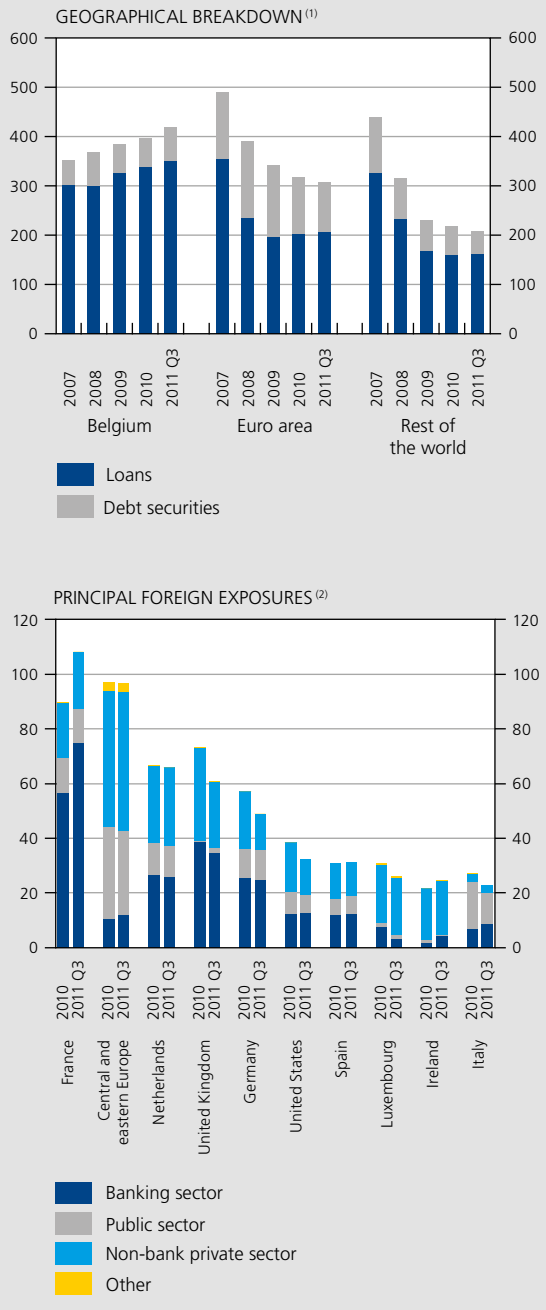
TABLE 2 BREAKDOWN OF THE PORTFOLIOS OF LOANS AND DEBT SECURITIES HELD BY BELGIAN BANKS
(consolidated end-of-period data, in € billion)

	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.

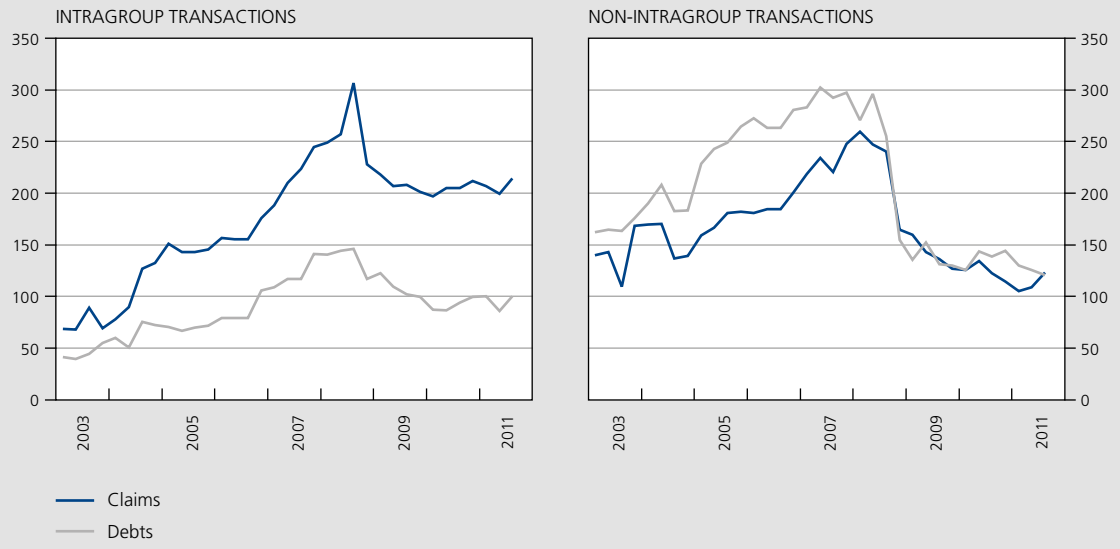
counterparties (43 % at the end of September 2011). The foreign banking sectors to which the Belgian banks are most exposed are the French banking sector (€ 75 billion), and those of the United Kingdom (€ 35 billion), the Netherlands (€ 26 billion) and Germany (€ 25 billion). In contrast to the consolidated 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,

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

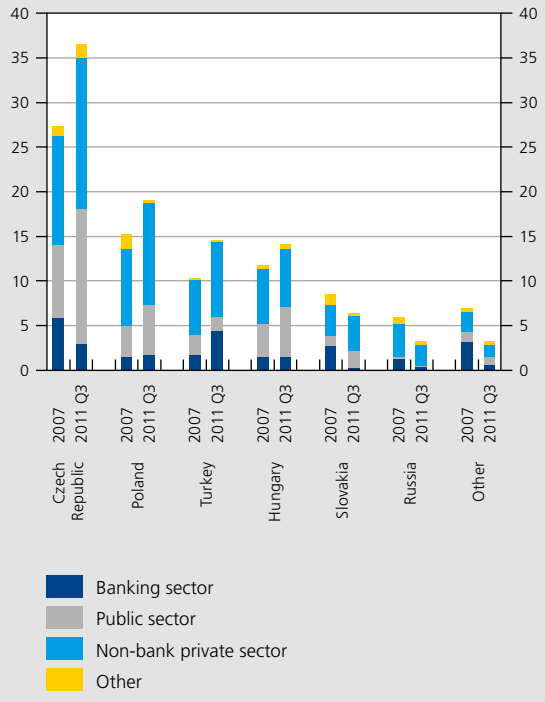
(territorial end-of-period data, in € billion)



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)

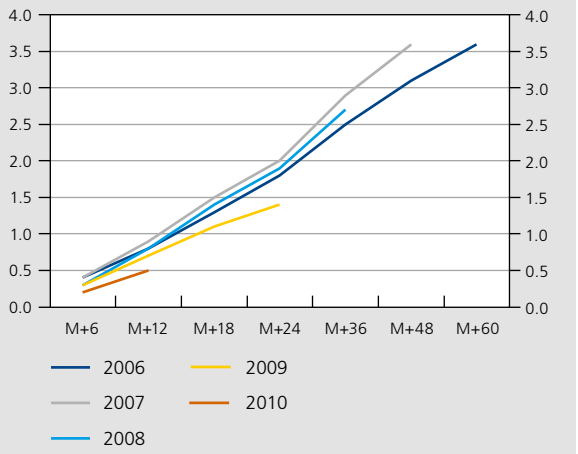
	Total loans granted	% of impaired claims[1]					Coverage ratio[2]				
	September 2011	2007	2008	2009	2010	September 2011	2007	2008	2009	2010	September 2011
Credit institutions	211.3	0.0	0.4	0.8	0.4	0.2	59.0	68.2	47.7	55.5	58.6
Corporate	193.7	2.3	2.3	4.3	4.9	4.8	37.2	47.1	46.0	43.2	45.8
Retail	264.3	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 %)

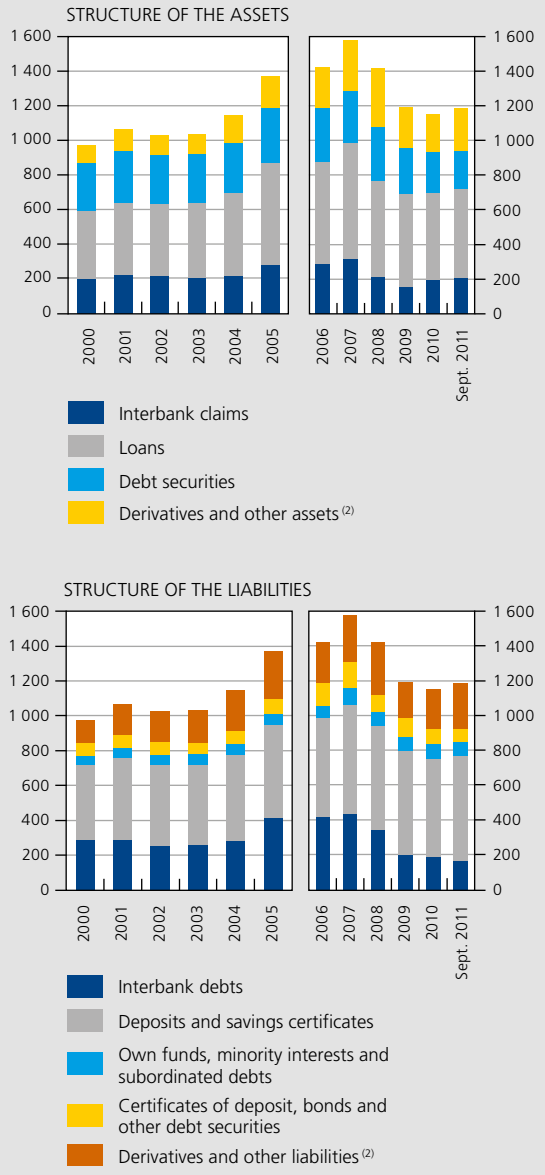


Source : NBB.
(1) A default is recorded if three payments have not been effected (in full) or if one payment remains outstanding after three months.
(2) Vintages comprise all the loans granted in the same year. For each vintage, the curve shows the number of loans in default as a percentage of the total 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).

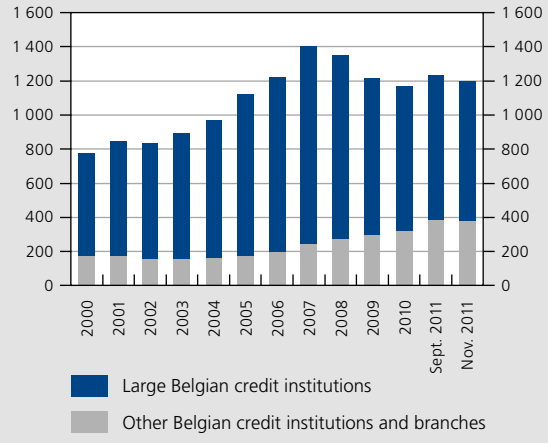
data on a company basis indicate a further contraction in the balance sheet of the four large institutions from October. Conversely, the balance sheet total of the other institutions has expanded steadily since 2001, supporting the return of the Belgian banking sector to more traditional banking activities.

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

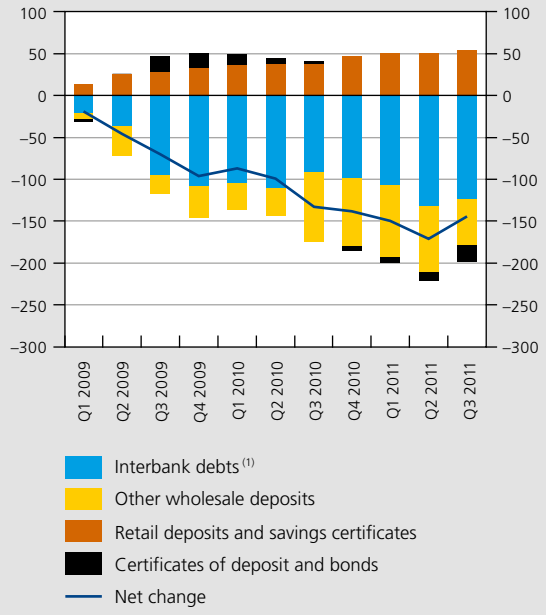
(end-of-period data, in € billion)



Source : NBB.

CHART 17 CUMULATIVE CHANGES IN DEPOSITS COLLECTED AND SECURITIES ISSUED SINCE THE END OF 2008

(consolidated data, in € billion)



Source : NBB.

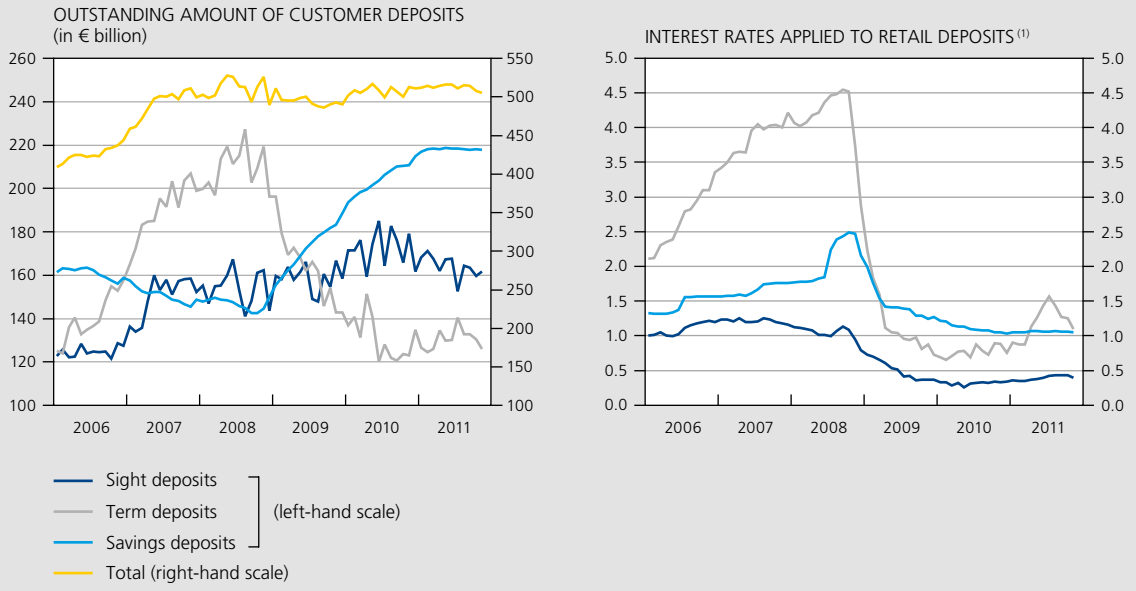
(1) Excluding amounts owed to central banks.

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 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 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.

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**	

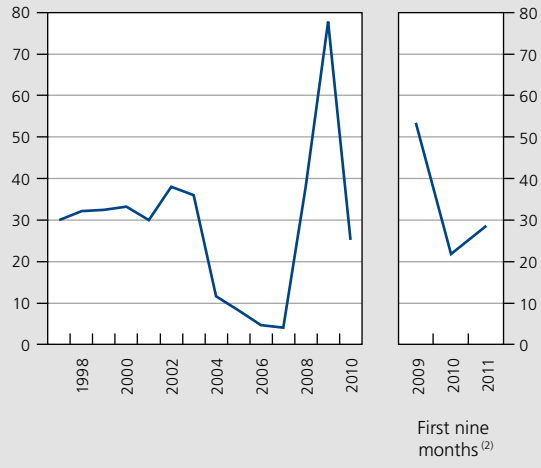
Source : NBB.

(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.

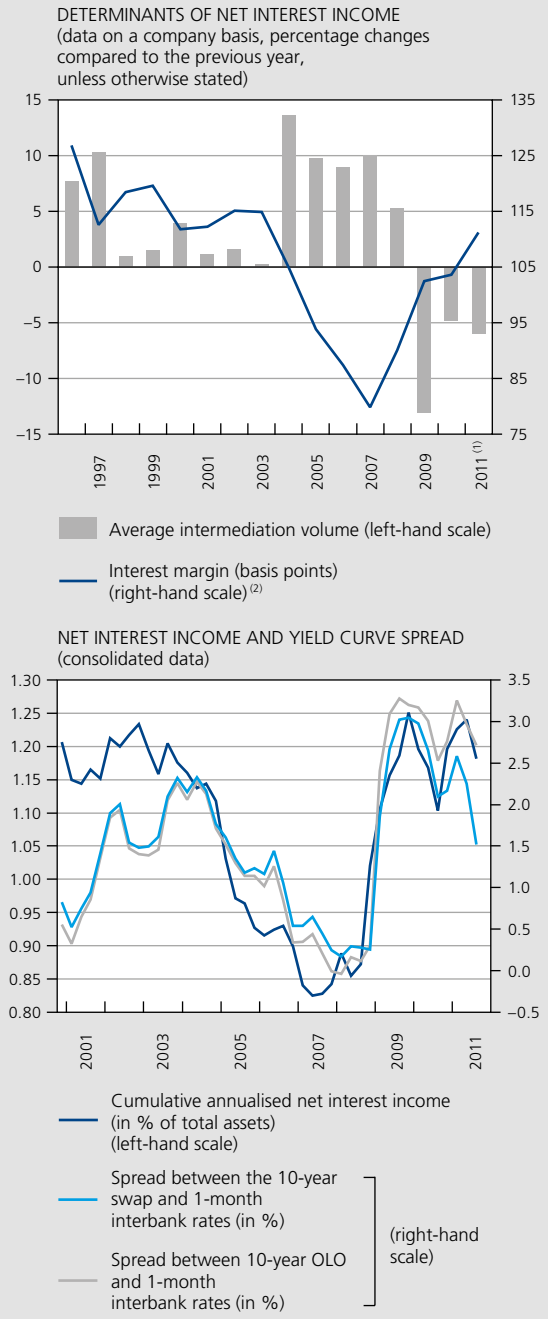
(2) Annualised.

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.

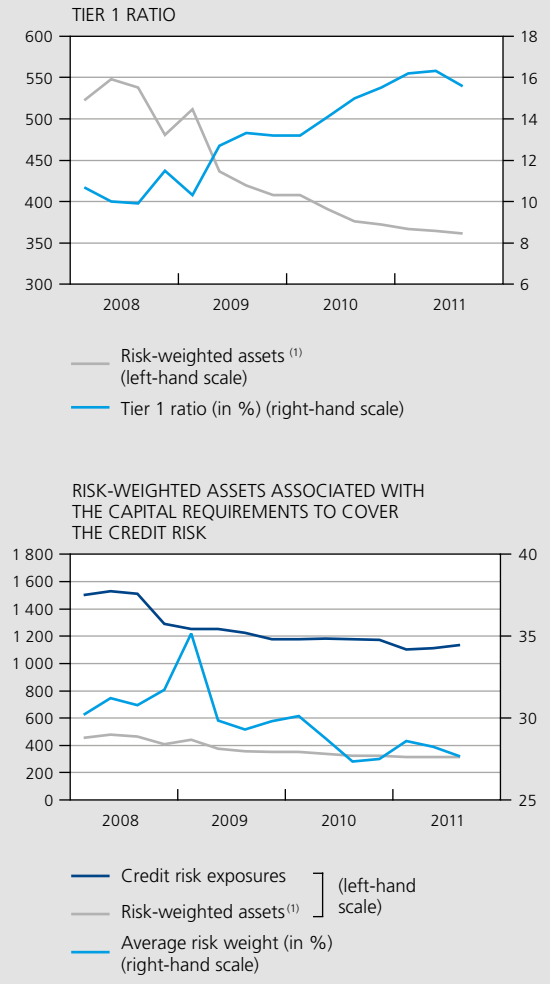
In the future, the Belgian banks will have to achieve a higher level of profitability because they need to reserve part of their profit in order to meet the new regulatory requirements, known as the Basel III rules, which will be phased in from 2013. In the case of banks receiving government capital 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.

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.

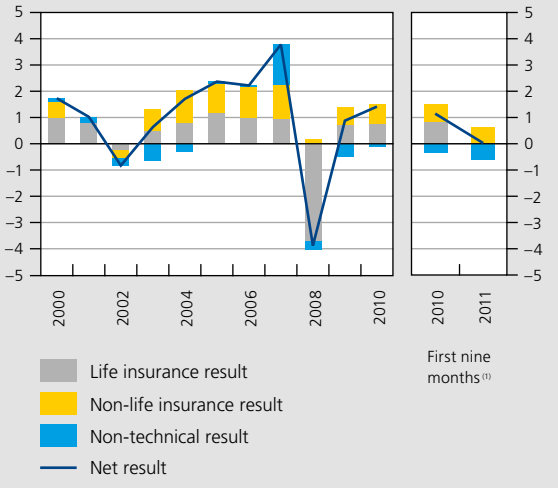
In the future, the Basel III rules will also impose an increase in the risk weights to be applied to certain exposures, notably interbank positions and credit risks incurred in connection with derivatives activities. These measures will affect the movement in the risk-weighted assets; in recent years 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.

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 theseadditional 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)

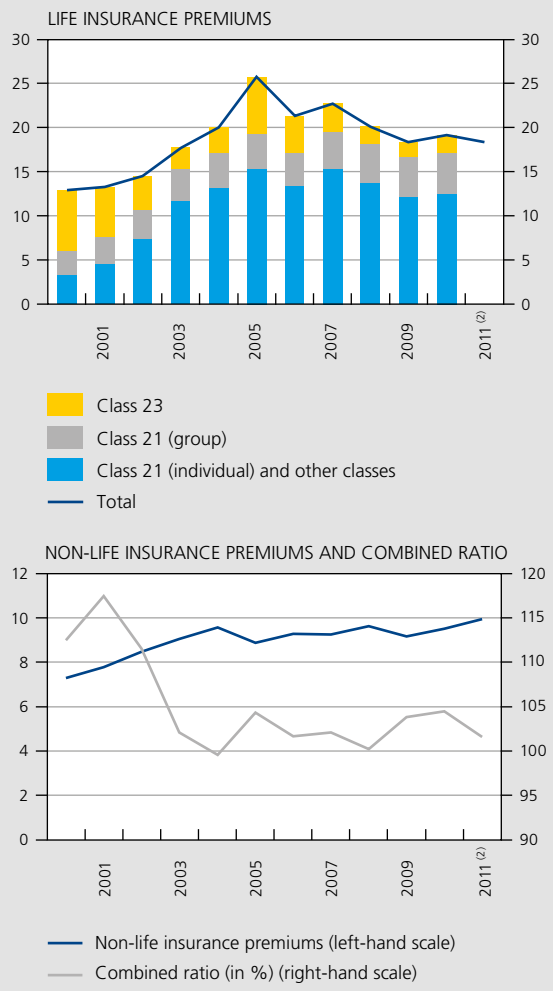
	2008	2009	2010	First nine months[1]	
				2010	2011
Life insurance technical result	–3.7	0.7	0.8	0.8	0.0
Result of insurance activities	–0.3	–8.0	–7.1	–5.1	–2.4
Net investment income	–3.4	8.8	7.8	5.9	2.4
Non-life insurance technical result	0.2	0.7	0.7	0.6	0.6
Result of insurance activities	0.0	–0.4	–0.4	–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.

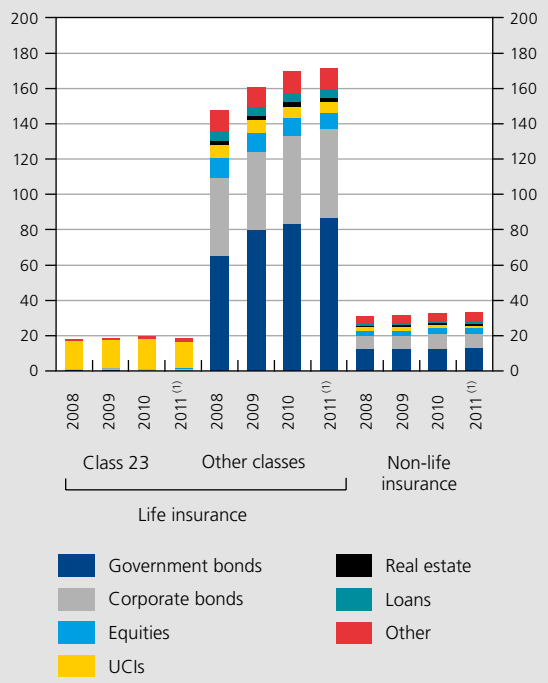
Unlike most non-life insurance premiums, which are collected under contracts renewed annually, life insurance premiums are generally collected under long-term contracts. In their case, the potential benefits payable to policyholders are far in the future. The investment of the premiums collected during 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.

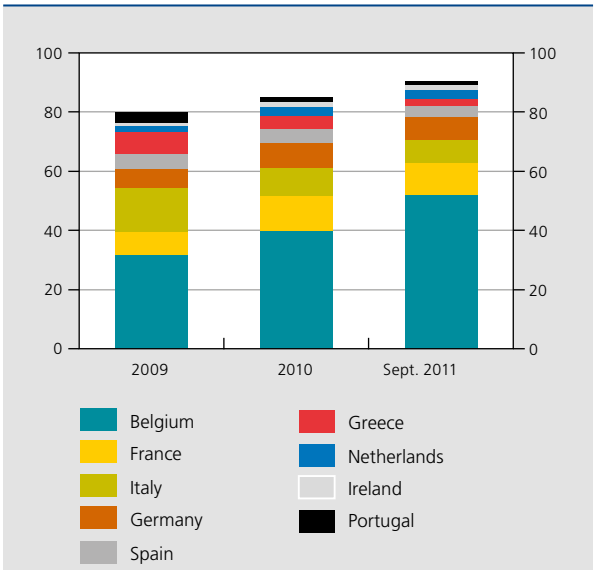
Moreover, subject to the approval of the Bank, a part of the unrealised gross gains on assets can be included in the regulatory solvency position. However, for the purpose of prudential analysis, assets covering the technical provisions are valued at market price, except for government bonds, which are 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 unrealized 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 reductionloss 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.

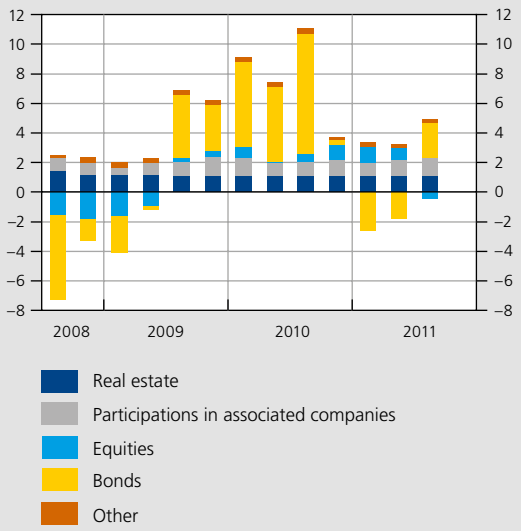
The equity exposures were also affected in the first nine months of 2011. As a result, the unrealised net gains of€ 1billion at the end of 2010 were converted to an unrealised loss of € 500 million at the end of September 2011.

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

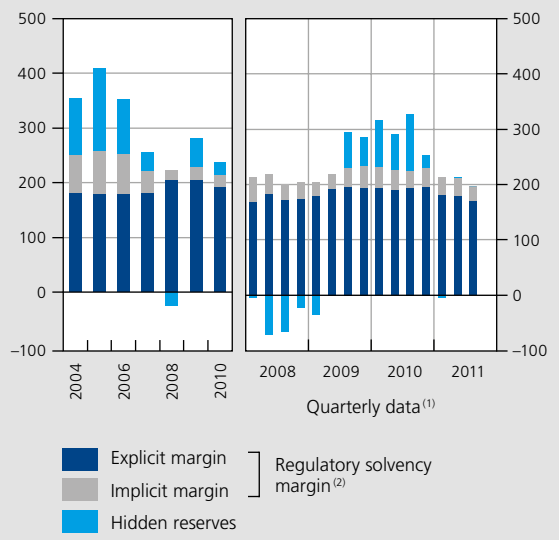
(unconsolidated end-of-period data, in € billion)



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.

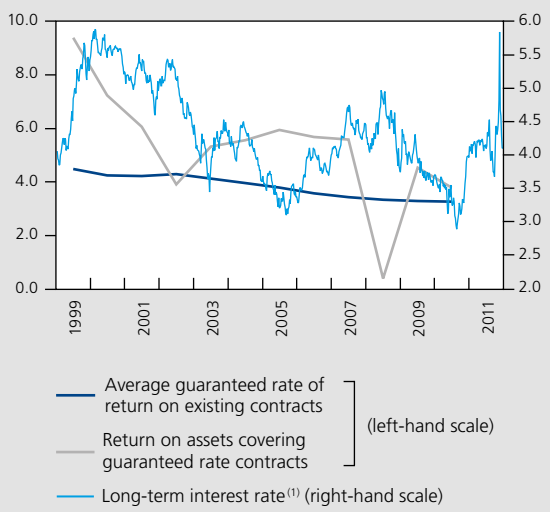
The main risk factors contributing to the widespread reduction in available capital in the stress scenarios are a decline in interest rates, a fall in share prices and commercial real estate prices, and a widening of the spreads on government bonds in the context of a separate sovereign stress scenario. 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



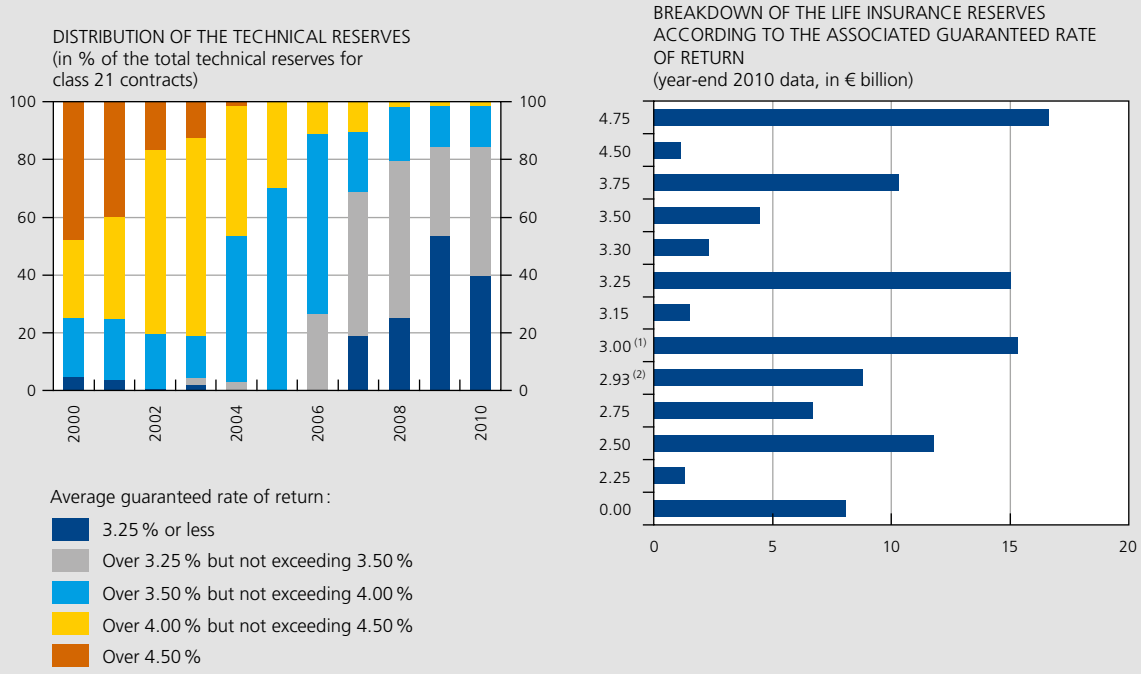
Sources : Thomson Reuters Datastream, NBB.
(1) Yield on the secondary market in ten-year Belgian government loans (OLOs) (weekly data).

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.