Report 2012

Prudential regulation and supervision

NationalBank OF BELGIUM

Eurosystem

Prudential regulation

The crisis which continues to weaken the international financial system has taken on a strong European dimension. Nowhere but in the euro area do the interdependencies between the weight of public debt and the funding difficulties of credit institutions make themselves so keenly felt. To eliminate these adverse interactions which are fragmenting the Single European Market, and even endangering the euro area's survival, the European authorities decided to supplement the Economic and Monetary Union (EMU) by creating a banking union. The latter will have as its key component a single supervisory mechanism, but it will also need to be complemented by common recovery and resolution procedures and deposit guarantee systems. As laid down in the agreement reached at the Council of Ministers (Ecofin) on 12 December 2012, this banking union will involve the European Central Bank (ECB) taking charge, from 1 March 2014 (or no later than twelve months after entry into force of the Regulation entrusting that mission to the ECB), of the supervision of around 200 very large banking groups, and the monitoring of supervision of the other smaller institutions in the euro area. The ECB will have the right to assume direct supervision of the latter if that is justified on grounds of financial stability (section 1).

The main advantages of this new structure lie in the supervision of large systemic and cross-border banks. In supervising these large institutions, the ECB will have to take account of the ongoing work at international and European level relating to the identification and monitoring of systemic institutions, the exercise of the macroprudential mandate and, more recently, the advisability of introducing structural reforms to separate the activities of deposit banks and those of investment banks (section 2).

Apart from this significant change in the prudential architecture, the financial system will have to continue to adapt to the new solvency and liquidity requirements introduced for both banks and insurance undertakings by the Basel Committee and the European Commission (section 3).

In Belgium, too, regulatory changes were made in 2012. They concern covered bond issuance, the new policy on organising the compliance function, assessment of the fit and proper character of the management of financial institutions, and the remuneration policy of those institutions (section 4).

1. Banking union and crisis management

In his report dated 26 June 2012 [1], the President of the European Council presented an overall proposal for stabilising the Economic and Monetary Union. That proposal is based on four essential building blocks, namely: an integrated financial framework, an integrated budgetary framework, an integrated economic policy framework and a decision-making process based on democratic legitimacy and accountability.

The reinforcement of the first of these building blocks, the integrated financial framework, aims to restore financial stability in Europe. The report by the President of the European Council details the elements that should make up the integrated financial framework. As well as being based on a single rulebook, it should comprise integrated supervision and common systems for deposit insurance and bank resolution.

Following this report, the euro area summit on 29 June 2012 asked the European Commission to present proposals for establishing a "single supervisory mechanism". On 12 September 2012, the Commission published proposals granting supervisory powers to the ECB and aligning the regulation of the European Banking Authority (EBA) with the new supervisory structures. In addition, in a separate communication, the Commission stressed its intention to propose a single mechanism for managing and resolving bank crises and coordinating the application of the resolution tools for banks in the banking union. The Commission will present this proposal once its June 2012 proposal on recovery and resolution and its July 2010 proposal on a deposit guarantee system have been adopted by the European Parliament and the Council.

(1) Van Rompuy, H. (2012), "Towards a genuine Economic and Monetary Union", EUCO 120/12.

1.1 Single supervisory mechanism

Legal framework

On 12 December 2012, the Council of Ministers (Ecofin) reached agreement on a Regulation that confers specific tasks on the ECB for policies relating to the prudential supervision of credit institutions. Under that Regulation, the ECB will have exclusive competence over the prudential supervision of euro area credit institutions.

The ECB will carry out its tasks within a "single supervisory mechanism" (SSM) composed of the ECB and the national supervisory authorities. The ECB will be responsible for the effective and consistent functioning of the SSM. Countries outside the euro area can also join the SSM.

Separation of the ECB's monetary function from its prudential tasks

The establishment of the SSM is without prejudice to the relevance of the Treaty provisions applicable to the ECB itself: the ECB's independence guaranteed by the treaties and the articles relating to its decision-making bodies applies equally within the framework of the SSM.

Even after the SSM enters into force, price stability will remain the ECB's principal objective. Its new tasks must not harm the credibility of its monetary policy.

In formulating its internal rules, the ECB will ensure that its reputation is safeguarded and that monetary policy is appropriately separated from the prudential tasks.

However, it must be borne in mind that prudential expertise and information may be essential for defining

Box 1 – Categories of banks in the single supervisory mechanism

The allocation of tasks in the SSM is based on the distinction between "less significant banks" and "banks not considered as less significant" (hereinafter: "significant banks").

The significance of an institution is determined at the highest level of consolidation within the participating Member States according to the following criteria: (1) its size, (2) its importance for the economy of the European Union or of any participating Member State, and (3) the significance of its cross-border activities. If a banking group is considered as significant, all its subsidiaries and branches will be considered significant as well.

More specifically, an institution will not be considered "less significant" if it meets any of the following criteria:

(1) the total value of its assets exceeds € 30 billion; or

(2) the ratio of its total assets to the GDP of the Member State of establishment exceeds 20 %, unless the total value of its assets is below € 5 billion; or

(3) following notification by the competent national authority which considers the institution to be of significant relevance to the domestic economy, the ECB takes a decision confirming such significance after conducting a comprehensive assessment including a balance-sheet assessment of the credit institution concerned.

The precise methodology for calculating these criteria will be determined by the ECB.

The ECB may also consider that an institution is significant if it has established banking subsidiaries in more than one participating Member State, and if its cross-border assets or liabilities represent a significant part of its total assets or liabilities.

Credit institutions which have received or requested direct support from the EFSF or the ESM are regarded as significant.

monetary policy. The ECB will have to take account of the interactions and synergies between monetary and prudential policy.

Allocation of tasks in the SSM

The ECB and the national supervisory authorities jointly constitute the SSM. The ECB is responsible for the effective and coherent functioning of the SSM as a whole.

Without prejudice to that responsibility of the ECB, the allocation of tasks in the SSM is based on the distinction between "less significant banks" and "significant banks" (see box 1).

Prudential decisions concerning "significant banks" will be taken by the ECB. The national supervisory authorities are responsible for assisting the ECB in the preparation and implementation of the prudential tasks of the SSM. In the case of "less significant banks", the national supervisory authorities retain competence for taking prudential decisions.

The ECB's framework Regulation provides for procedures concerning the grant or withdrawal of credit institution authorisation and assessment of the acquisition or disposal of a qualifying holding in a credit institution. For these decisions, ultimate competence rests with the ECB even in the case of "less significant banks".

The national supervisory authorities' role in prudential supervision has yet to be clarified in a framework Regulation to be approved by the ECB on a proposal of the Supervisory Board.

That Regulation will be a key factor in the success and credibility of the SSM. It has to provide the basis for an effective system of high-quality banking supervision. It must permit maximum use of the experience and expertise of the national supervisory authorities, including for the supervision of "significant banks", without prejudice to the coherence of the SSM. The procedures for making decisions on prudential supervision must be organised so as to allow focus on the prudential activities themselves.

Preparation of the single supervisory mechanism

The SSM Regulation will be published on completion of the legislative procedure. The SSM will then be set up in accordance with the timetable laid down by the transitional provisions of the SSM Regulation.

On the basis of the thresholds specified by the SSM Regulation, and subject to the preparation of a methodology in the ECB's framework Regulation, over 90 % of the total Belgian banking sector (measured according to the assets) will be considered as significant. Once the methodology has been established, it will be possible to produce a complete list of the credit institutions considered as significant in the SSM and therefore subject to direct ECB supervision.

In Belgium, the "significant banks" category comprises both credit institutions for which Belgium is currently the home Member State and those for which it is currently the host Member State. In both cases, the Bank will contribute to the preparation and implementation of prudential supervision within the SSM.

A working group was set up at the Bank in the summer of 2012 to monitor developments concerning a banking union, and more specifically to prepare the SSM. The Bank is also contributing to the preparations in progress at the ECB, particularly regarding the practical arrangements for the SSM, the allocation of its tasks, the impact on prudential supervision and reporting, the organisation of the ECB, and macroprudential aspects.

1.2 Recovery and resolution framework and deposit guarantee systems

Apart from the SSM, the banking union also needs a recovery and resolution framework and common deposit guarantee systems.

In June 2012, the European Commission published a proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms [1]. That proposal for a Directive deals with the whole crisis management sequence, from preparation and early intervention to resolution and the financing thereof. The proposal for a Directive covers all credit institutions and some investment firms.

To improve the preparation for crisis management, the proposal for a Directive provides for drawing up recovery and resolution plans. Such plans permit exploration of the various crisis management options potentially available. In normal times, that preparation can identify and attenuate obstacles impeding an orderly crisis resolution. The recovery plan focuses, in particular, on the identification of the actions that a credit institution can take when facing a serious crisis. The aim of those actions is to restore the financial situation of the institution implementing them. In contrast, the resolution plan identifies the critical economic functions so as to permit an orderly resolution in a crisis, in order to minimise the exposure of taxpayers in the event of government intervention. In addition, the resolution plan tests the authorities' ability to use the various resolution tools at their disposal.

In connection with the preparation of these plans, the proposal for a Directive provides for the resolution authorities to take measures to reduce or remove impediments to resolvability. Those powers would include the option of requiring an institution to conclude service agreements to cover the provision of critical economic functions or services, to limit its maximum individual or aggregate exposures, to divest certain assets or to change its legal or operational structures so as to reduce complexity and ensure that its critical functions can be separated from its other functions in the event of resolution.

The European Commission's proposal for a Directive also introduces a new instrument : intra-group financial support. This is a reciprocal agreement establishing the terms of potential liquidity support measures that can be taken within the group in the event of a crisis. The agreement is voluntary in that a group is not obliged to conclude it and, if it does so, it is not necessary for all the group companies to be parties to the agreement.

The proposal for a Directive expands and harmonises the powers to intervene at an early stage and the resolution powers. Early intervention powers include the supervisory authority's power to appoint a special manager, to request

(1) Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010 of the European Parliament and of the Council.

the institution to implement the measures set out in its recovery plan, to convene a general meeting of shareholders and to request the institution to negotiate a debt restructuring plan with its creditors. The resolution powers are to be exercised by the resolution authority. The proposal would require the Member States to confer on the resolution authorities – which would have to be administrative public authorities – resolution powers, namely sale of the business to a private party, establishment of a bridge bank, separation of the assets and bail-in by the debtors.

Finally, the draft Directive would establish a mechanism for financing the resolution measures by setting up financing arrangements with *ex-ante* funding by the sector ; the arrangements would remain national. Nonetheless, the proposal provides that national arrangements could borrow from the financing arrangements of other Member States. In addition, it provides for the mutualisation of losses in the context of a group resolution.

Mention should also be made of the European initiatives aimed at greater harmonisation of the operation of deposit guarantee schemes and strengthening their ability to intervene. The proposal for a Directive tabled by the European Commission in July 2010 also intends to ensure that depositors enjoy the same protection throughout the European Union. In addition, it provides for the establishment of cross-border cooperation mechanisms between national protection funds.

As the Commission announced in its Communication of 12 September 2012, once these two texts have been adopted by the European Parliament and the Council it will propose a single resolution mechanism to manage and resolve banking crises and to coordinate the application of the resolution tools for banks forming part of the banking union.

2. Macroprudential oversight and structural reforms

2.1 Identification and monitoring of systemic institutions

One of the items on the international reform agenda developed after the crisis which erupted in 2008 is the identification of Global Systemically Important Financial Institutions (G-SIFIs), i.e. those whose failure could have a significant impact on the global financial system. For that purpose, the Basel Committee on Banking Supervision and the International Association of Insurance Supervisors (IAIS), working with the Financial Stability Board (FSB), jointly developed methodologies for identifying G-SIFIs on the basis of a series of indicators.

In November 2011, the Basel Committee published its rules text on Global Systemically Important Banks (G-SIBs). The methodology for identifying G-SIBs uses indicators divided into five categories: size, substitutability/infrastructure, interconnectedness, cross-jurisdictional activity and complexity. This methodology was applied to data collected from the 75 biggest international banks and, in November 2012, the FSB published a provisional list of 28 G-SIBs which had been identified by means of this methodology. These G-SIBs were divided into four classes (buckets) corresponding to varying degrees of estimated systemic importance and hence varying levels of capital surcharges. The FSB will update the list of G-SIBs annually.

On the basis of the Basel Committee proposal, the G-SIBs need to have additional own funds in the form of common equity Tier 1 capital, amounting to between 1 and 2.5 % of their risk-weighted assets, depending on their systemic importance. This requirement will be phased in from 1 January 2016, becoming fully effective on 1 January 2019. Institutions whose systemic importance exceeds that of the fourth bucket may be required to hold an additional 1 % capital. There are no Belgian groups currently designated as G-SIBs.

Several types of measures will be applied to the G-SIBs, in addition to the requirement to increase loss absorbency, reflected in the capital surcharges. In particular, there must be more intensive supervision of G-SIBs, and all G-SIBs must draw up recovery and resolution plans. Those plans are currently being formulated.

In regard to Global Systemically Important Insurers (G-SIIs), the IAIS published a public consultation document in 2012, presenting a G-SII identification methodology. Like the method devised for G-SIBs, that methodology uses five indicator categories: size, substitutability, interconnectedness, global activity and non-traditional, non-insurance activities. An initial designation of G-SIIs by the FSB is planned for April 2013.

In 2012, the IAIS also published a set of supervision policy proposals concerning G-SIIs. Comparable to the measures adopted for G-SIBs, these proposals encompass more intensive supervision, the establishment of effective resolution schemes, and higher loss absorption capacity. For the purpose of more intensive supervision, the authorities will have to determine which of the activities pursued by a G-SII make it systemically important, and establish a plan, called a Systemic Risk Reduction Plan, to reduce the systemic importance of the G-SII.

In the case of institutions which are not of global systemic importance but which may be important for the financial system at national or regional level, many authorities have begun to set up frameworks for the identification of Domestic Systemically Important Financial Institutions (D-SIFIs). In 2011, the Bank started applying a D-SIFI identification framework by making use of indicators comparable to those used to identify G-SIFIs.

In 2012, the Basel Committee formulated and published a series of principles for the identification and treatment of Domestic Systemically Important Banks (D-SIBs). That framework provides for the use of indicators in all the categories included in the G-SIB identification methodology, except for cross-jurisdictional activity. The Basel Committee's framework of principles for D-SIBs was also developed on the assumption that national authorities will impose higher loss absorption requirements on D-SIBs. As in the case of G-SIBs, that requirement would have to be met solely with the aid of common equity Tier 1 capital. If a banking group has been identified as a D-SIB in the country of origin, but also as a G-SIB, the authorities of that country will have to impose the higher of the requirements for D-SIBs and those for G-SIBs. The national authorities should also introduce additional requirements and any other supervision measures which they deem appropriate to address the risks posed by a D-SIB. They will need to begin applying these requirements to D-SIBs in accordance with the timetable for phasing in the framework applicable to G-SIBs, in other words from January 2016. A peer review process at Basel Committee level will be used to oversee the national implementation of the D-SIB framework.

2.2 Macroprudential mandate

Established on 1 January 2011, the European Systemic Risk Board (ESRB) – whose principal mandate is the detection of systemic risks at European level – issued a number of recommendations in 2011 for the various national authorities. Under one of those recommendations, the competent national authorities are asked to designate a specific entity for the conduct of macroprudential policy in their respective countries. The aim will be to contribute to the safeguarding of financial stability as a whole, notably by making the financial system more robust and by limiting the accumulation of systemic risks that any disruption in the financial services sector could lead to for the economy as a whole.

The financial crisis demonstrated that an individual approach to institutions and risks is not enough to ensure global financial stability, in view of the increasing interconnectedness of financial institutions in a context of financial globalisation and significant interactions between the real economy and the financial markets. The causes of instability in the financial system are not solely of internal origin, they may also come from outside, e.g. from the real sphere. Recent experience has shown that, by affecting interest rate levels, structural current account imbalances at global level have encouraged the development and proliferation of complex high-yield products. Periods of instability may also be amplified by inappropriate macroeconomic and macroprudential policies, as highlighted during the latest financial crisis.

In the euro area, the possibility of conducting macroprudential policies at national level is important as the Member States of the Monetary Union are no longer able to deploy the traditional instruments of monetary policy to prevent or reduce certain idiosyncratic macroeconomic and financial risks. So far, Belgium does not have an institutional structure responsible for macroprudential policy as recommended by the ESRB. Although the Bank's Organic Law does mention that the Bank contributes to financial stability, the existing legislation does not yet contain any clear and precise macroprudential mandate defining the objectives, tasks, instruments and responsibilities of the competent national authorities in that respect.

During the year under review, in order to comply with the ESRB's recommendations, the Belgian authorities started analysing various options for setting up an appropriate institutional structure for the purpose of establishing a macroprudential authority and developing instruments to prevent the emergence of systemic risks.

Whatever form it takes, the new institutional structure should promote the exchange of information and analyses on the risks to financial stability, create synergies in that regard between the competent authorities, and coordinate macroprudential policies in Belgium. In that context, access to information is vital. Some financial institutions are currently beyond the scope of any supervision by the authorities, yet the current financial crisis has shown that unregulated institutions or the parallel banking system could generate serious systemic risks. That risk cannot be ruled out in the future, particularly in the context of tougher prudential rules for regulated institutions, which might prompt certain institutions to transfer activities outside the scope of supervision in order to avoid the stricter rules. Various studies have been launched at international and European level to gain a better understanding of the risks associated with the parallel banking system and to reduce the systemic risks inherent in that type of activity. However, as the information currently available is still very fragmentary, it is important for the competent authorities to have the appropriate instruments and legal basis to obtain the relevant information on the subject.

As stated in section I.A.2.3 of this Report, that structure will have to form part of the new architecture designed to establish a single supervisory mechanism at European level, in order to ensure some consistency taking account of the shared responsibilities here, and to avoid the negative externalities that could result from the implementation of macroprudential instruments in an individual Member State.

Apart from the importance of an appropriate institutional structure, the ESRB recommendations also state that the competent authorities must have at their disposal instruments which can reduce the accumulation of systemic risks. So far, the arsenal of tools and instruments is still limited in Belgium. The competent authorities have only partial access to some instruments. Following the adoption of the "twin peaks" model, the Bank was given new powers and new tools within the scope of macroprudential policy. As explained in the 2011 Report, the Bank can impose additional requirements on systemic institutions if their risk profile could jeopardise financial stability. It may likewise oppose strategic decisions of those institutions if it considers that certain transactions might affect their risk profile or financial stability.

However, these instruments have a limited scope and cannot cover all institutions in the financial sector. In general, there are several types of instruments that the competent authorities should have at their disposal, but their effectiveness has not yet been entirely demonstrated, in view of the lack of experience on the subject and the diversity of financial and economic systems. A first category relates to instruments which are called microprudential but are used for macroprudential purposes. This concerns in particular the capital or liquidity requirements applied either to the entire sector or to certain categories of institutions or sectoral risks. Some of these instruments are included in the text of the CRD IV (Capital Requirements Directive IV), such as the counter-cyclical capital buffer or the "systemic" capital surcharge, designed to limit the leverage effects and to encourage banks to hold sufficient capital to cope with systemic risks. There are also other, sometimes complementary, macroprudential instruments. Thus, the imposition of maximum ratios between the amount of a mortgage loan and the value of the property to be financed, or between the borrower's outstanding debts and his income, may also be useful for reducing certain risks arising in the property sector, for instance. Taxes on property, or more generally on savings, may likewise in some respects help to reduce – or conversely, increase – systemic risks.

While the conduct of an appropriate macroprudential policy should limit the accumulation of systemic risks and thus help to maintain financial stability, it is nevertheless essential to bear in mind that macroprudential policy cannot entirely eliminate periods of instability, as risks are inherent in financial intermediation : risks associated with maturity transformation (i.e. funding long-term projects by collecting short-term deposits), credit risk, liquidity risk, etc. The best contribution that macroprudential policy can make is to strengthen the financial sector and to lower the costs inherent in periods of financial instability.

2.3 Structural reforms

The 2008 financial crisis revealed significant weaknesses in the financial system at both microprudential and macroprudential level and led to a broad agenda of international regulatory reforms, including an increase in the minimum regulatory capital requirements, enhancement of the quality of the capital which credit institutions hold, broadening of the risks for which capital requirements are imposed, introduction of liquidity rules for banks, introduction of macroprudential policies, and the establishment of frameworks to allow resolution of bank failures without the use of taxpayer funds.

Although these international measures should noticeably improve the resilience of the banks and the financial system, a question that has been raised is whether these measures are sufficient and whether structural reforms are needed in the banking sector. The term structural reforms may cover a whole spectrum of provisions, ranging from a total ban on certain activities by banks to the segregation of some activities in separate legal structures. These measures specifically aim to improve the resolution framework for banks, to avoid recourse to public funding to bail out credit institutions, to reduce risk-taking and to limit conflicts of interest.

Structural reforms have already been proposed in the United Kingdom and the United States. The British Vickers reform proposal centres on the concept of ring-fencing, which consists in isolating from the rest of the banking sector the institutions which collect deposits from individuals and SMEs. The ring-fenced banks would be allowed to pursue traditional bank lending activities, but not investment banking. However, the ring-fenced banks could engage in trading activities in connection with the treasury function, in other words hedging risk management. Investment banking activities would be prohibited for ring-fenced banks, but permitted for other legal entities in the same financial group. However, strict limits would be imposed on exposures between ring-fenced entities and other entities in the same group, together with requirements concerning independent governance and operations of the ring-fenced entities.

The Vickers reform aims to improve the possibility of resolution for banks engaging in activities vital for the economy. The goal of the measures proposed by the Vickers Commission is therefore to permit the implementation of policies which help to ensure the continuity of the critical activities of those banks should they run into difficulties, and which minimise the need to use public funds in the event of a banking crisis.

The Volcker rule in the United States aims to reduce excessive risk-taking by banks. It bans proprietary trading by banks, and the holding or sponsoring of private equity funds or speculative hedge funds. In contrast to the Vickers proposal, the Volcker rule does not permit other entities in the banking group to engage in these activities.

Following publication of the Vickers and Volcker reforms, the Belgian government asked the Bank to analyse whether it was appropriate and feasible to introduce structural reforms in Belgium. In June 2012, the Bank responded by publishing an interim report examining the question of structural reforms and presenting a preliminary analysis of a set of measures to strengthen the stability of the Belgian financial system.

The Bank's report sets out the problems in implementing the Vickers reform and the Volcker rule. One of the key challenges of the Volcker rule for the supervisory authorities would be to succeed in distinguishing between proprietary trading activities, which are prohibited, and other activities such as market-maker or hedging activities, which are permitted. All these types of operations have similar characteristics, and distinguishing between them would involve the use of highly complex rules which are liable to be circumvented.

Challenges of implementing a Vickers-type reform concern the need to ensure that ring-fenced banks do not surreptitiously engage in prohibited activities (via their treasury function), to guarantee that ring-fenced banks remain adequately "separate" from entities in their group which are not ring-fenced, and to ensure that the presence of cross-border financial institutions does not compromise the aims of the reforms. An EU Member State which unilaterally introduces Vickers-type structural reforms cannot require the ring-fencing of foreign branches of EU banks operating in its territory. Consequently, if those branches pursue activities on a sufficiently large scale in that country's financial system, an unlevel playing field may be created, since those branches will not be restricted in their activities or their intra-group operations. Furthermore, foreign subsidiaries of EU banks operating in that country could decide to become branches in order to circumvent the structural reforms.

These observations raise serious doubts about the feasibility of effective unilateral application of the Vickers reform package in a country such as Belgium, which has a large number of cross-border banking groups. However, it is useful to recognise that the Vickers-type reforms are in reality a set of policies divided into four different categories : ring-fencing or prohibition of activities, rescue and resolution, capital surcharges, and intra-group exposures. These categories, combined with consideration of certain characteristics specific to the Belgian financial system, formed the basis for defining the measures which the Bank recommended in its interim report.

The Bank's important recommendations are as follows : (1) require all domestic systemically important banks to draw up failure recovery and resolution plans ; (2) improve the effectiveness of the 2010 Law on failure resolution by specifying the role of the Bank as a failure resolution authority for both systemic and non-systemic banks ; (3) in the context of greater supervision by the Bank over Belgian domestic systemically important banks, formulate a definition of strategic decisions of those banks that includes any change in operations or activities which could potentially affect resolvability ; (4) extend the scope of the limits on intra-group cross-border exposures ; (5) apply targeted second-pillar capital surcharges to trading activities above a certain threshold, in order to increase the costs of those activities and ensure that they do not seriously impede the possibility of bank resolution ; (6) make the subsidising of savings more neutral in relation to the type of financial instrument, thus diversifying the channels whereby savings are invested in the real economy.

In October 2012, a group of experts appointed by the European Commission and instructed to examine the advisability of implementing structural reforms on the scale of the EU, published its conclusions. The recommendations of that group, chaired by the Governor of the Central Bank of Finland, Mr Liikanen, aim to strengthen deposit banks and limit the potential recourse to taxpayer support for banking groups too heavily involved in trading activities.

Like the Bank's interim report, the Liikanen group report takes account of certain characteristics of the European banking system and problems with implementing the Vickers and Volcker reforms. The Liikanen group proposes separating market-making and proprietary trading activities of deposit banks once the volume of those activities exceeds a certain threshold. The separated trading activities could be transferred elsewhere in the group, to an entity which does not collect deposits. The entities performing these trading activities cannot own or be owned by a bank. Deposit banks' exposure to these entities must conform to market conditions and be subject to strict interbank exposure limits.

The Liikanen recommendations therefore represent a compromise between the Vickers reforms and the Volcker rule. If they were imposed at European level – which would depend in particular on the response by the European Commission – that would avoid the problems of an unlevel playing field resulting from unilateral application of this type of reform by one Member State. The response to the Liikanen report will be taken into account in the Bank's final report on the feasibility of structural reforms in Belgium.

3. Solvency and liquidity requirements

3.1 Capital requirements for the banking sector

In November 2010, the Group of Central Bank Governors and Heads of Supervision of the member countries of the Basel Committee and the G20 had approved the proposals of the Basel Committee set out in two documents entitled "Basel III: A global regulatory framework for more resilient banks and banking systems", which essentially concerns solvency standards, and "Basel III: International framework for liquidity risk measurement, standards and monitoring", which deals with liquidity standards.

These new solvency and liquidity standards will be an important step towards strengthening the soundness of the banking sector after the financial crisis. The aim is to improve the sector's loss-absorption capacity in the event of an economic or financial crisis, and to enable it to continue lending to economic agents.

During the second half of 2011 and in 2012, the Committee continued to spell out its new standards, notably by publishing the document "Global systemically important banks: Assessment methodology and the additional loss absorbency requirement – final document" (see section II.A.2.1).

The Basel Committee also defined strict standards for the disclosure of information on the amount and quality of the capital; they are set out in the document dated June 2012 "Composition of capital disclosures". The purpose of these standards is to improve the transparency and comparability of capital and capital ratios. During the financial crisis, it emerged that the absence of uniform disclosures concerning the quality and amount of capital hampers assessment and comparison of the banks' capital position for both supervisors and the market. That lack of transparency was a factor which heightened uncertainty around the actual solvency of the banking sector, justifying the Basel Committee's proposal for tightening up the rules on the subject.

In regard to the method of calculating the capital requirements, the Committee similarly continued its work and produced new proposals for counterparty and market risks.

Regarding the counterparty risk resulting from transactions in derivatives, the Committee raised the standards for calculating the capital requirements for exposures to central counterparties. A central counterparty (CCP) is a clearing house positioned between the counterparties of contracts traded on one or more financial markets, becoming the buyer vis-à-vis any seller and the seller vis-à-vis any buyer, thus ensuring the successful future conclusion of the contracts to be executed. The volume of transactions in derivatives passing through CCPs is set to increase in the future, notably on account of the new EU Directive on European Market Infrastructure Regulation (EMIR), which will oblige credit institutions to use such counterparties to clear their derivative transactions. Thus, the Committee proposed a minimum risk weight equivalent to 2 % of the credit institution's volume of exposures resulting from derivative transactions on an eligible CCP, whereas there is currently no such requirement. Credit institutions' exposures to non-eligible CCPs, i.e. those not subject to prudential supervision or regulation in accordance with the international principles laid down on the subject by the International Organisation of Securities Commissions (IOSCO), will be subject to a requirement similar to that applied to exposures to industrial undertakings. A credit institution's contribution to a CCP's default fund will be subject to a specific requirement which can be calculated on the basis of an advanced method or a simplified method in which the contribution will have a 1 250 % weighting, with a maximum determined according to the volume of exposures to the CCP. The Committee plans to refine the proposed rules by the end of 2013.

As for market risk, the Basel Committee published a consultation document in May 2012 ("Fundamental review of the trading book – consultative document ") containing its proposals regarding the review of the capital requirements for market activities. The Basel Committee's key proposals on this subject concern in particular: 1° a more objective distinction between trading activities (the trading book) and other business (the banking book), in order to reduce the scope for regulatory arbitrage; 2° a new calibration for internal models of market risks and standard methods in order to take better account of the risks of extreme losses; 3° the taking into account of the liquidity of positions in the methodology for calculating the capital requirements. The Committee is also examining the possibility that, after revision, the standard methodologies can be used to determine a minimum requirement (or floor) in the case of institutions authorised to use their internal models to calculate the requirements for market risks. The consultation ended in September 2012, and the Committee hopes to finalise its proposal in 2014.

As regards the actual application of the new solvency standards, the Basel Committee was instructed to check whether its member countries are correctly applying the current international solvency standards and are ready to apply the future Basel III standards. It is in fact essential to apply these international standards fully and correctly in order to promote confidence in the global financial system. The Committee has therefore embarked on a process of examining its members' existing and future legislation.

An initial detailed examination has been conducted on Japan's legal and regulatory framework and the legislation being prepared in the United States and the European Union. The Committee published the results of that examination in October 2012. It concluded that Japan is correctly applying the new Basel III solvency standards but that, in the European Union and the United States, the texts being prepared do not conform entirely to the new standards. The Committee asked the jurisdictions concerned to take account of that finding when drafting their final regulations. The Basel Committee's assessment will be finalised when the European and American legislation has been finally approved by the authorities of those jurisdictions.

In the European Union, the proposal for a Directive and Regulation dated 20 July 2011 on implementation of the Basel III standards was negotiated in the EU Council of Ministers, which managed to reach a compromise in May 2012. The Council made no fundamental changes to the legislative texts proposed by the European Commission; it is trying to keep to an approach which ensures maximum harmonisation of the determination of the capital requirements and the amount of the capital.

However, the Council wanted to give the Member States more flexibility for imposing stricter capital requirements than the minimum standard of the Basel Committee. That flexibility is justified, in particular, by the need to equip countries with the necessary tools for managing macroprudential risks and to take account of the differences between Member States, notably the importance of the banking sector for the local economy, which may justify different requirements between countries in order to reduce the systemic risk associated with the financial sector.

Thus, the draft Directive approved by the Council permits the Member States to impose a supplementary capital buffer for systemic risk. In order to take account of the potentially adverse effects of this requirement on the other Member States, a notification procedure has been set up. That procedure obliges the Member States to notify the European Commission, the EBA and the ESRB one month in advance of any decision to introduce such a buffer, stating the reasons for doing so. The EBA and the ESRB have to assess whether that decision might have an excessively adverse impact on the financial system of other member countries or on the functioning of the Single Market. If the systemic risk requirement proposed by a Member State exceeds 5 % of the risk-weighted assets, the European Commission could oppose it.

This capital buffer for systemic risk is additional to the other supplementary requirements aimed at reducing the pro-cyclical effect of the solvency standards, and already included in the European Commission's July 2011 proposal. Under that proposal, it was possible to oblige institutions to form capital buffers in excess of the minimum requirement. In that case, institutions will have to have a fixed minimum buffer called the capital conservation buffer, in addition to the minimum requirement. In the event of excessive expansion of lending in the economy, supervisors may decide to impose an additional countercyclical capital buffer. If the institution does not have sufficient capital to cover the minimum requirement and the stipulated buffers, the supervisor will impose restrictions on the payment of dividends to shareholders. In a crisis, the supervisor may also decide to reduce the level of the required buffers in order to enable the banking sector to continue lending to the economic agents.

Apart from these capital buffers, the text of the EU Regulation approved by the Council also enables Member States to increase the capital requirements in general or, more specifically in regard to exposures to the financial sector or the property market, to impose stricter standards concerning risk concentration or additional transparency in the event of an increase in the systemic risks, in order to reduce the impact of such risks on financial sector stability. Such a power is likewise accorded to the Commission where that increased risk concerns all the member countries of the Economic and Monetary Union. However, the countries concerned must justify those measures, by demonstrating that they are appropriate to the worsening of the risks. The Council may oppose measures taken by the Member State, notably if the ESRB, the EBA or the Commission judges that there is insufficient evidence supporting the reasons put forward, particularly the increase in systemic risks, that the proposed measure is inappropriate or that it has an excessively adverse impact on the functioning of the Single Market.

This set of measures should provide Member States with the necessary instruments to conduct their macroprudential policy successfully and thus reduce the systemic risks resulting from economic or financial developments.

The European Parliament and the Council began negotiating the texts of the Directive and the Regulation in June 2012, the aim being to apply the new solvency standards as soon as possible.

The EBA has started working on the operational implementation of the forthcoming EU Directive and Regulation. On the basis of the draft texts, the EBA is required to propose technical standards to supplement the provisions of the Directive and the Regulation, and to ensure their uniform application. In that connection, the EBA has already published a set of consultation documents with the aim of specifying the technical criteria applicable to the capital calculation [1], the calculation of the requirements for counterparty risk [2] and the reporting requirements relating to the future leverage ratio. These consultation documents will be finalised when the future Directive and Regulation are approved by the European Parliament and the Council.

The Bank has been monitoring the measures taken by credit institutions to ensure that they will meet the new solvency and liquidity requirements. A number of institutions take part periodically in an impact analysis coordinated at international level, so that their progress in relation to the future standards can be monitored. In addition to this periodic analysis, as part of its assessment of the adequacy of solvency, the Bank questioned the largest credit institutions about their solvency targets, their current solvency position in relation to the new Basel III standards, and how they expected that position to change, taking account of their business plan, the economic growth forecasts, and their plans for issuing capital instruments or for reducing the risks and the likelihood of crisis situations. The examination aims to ensure that the institutions concerned will be able to amply meet the new standards within the time allowed by the provisions of the future Directive and Regulation on the subject.

(1) Consultation paper on Draft Regulatory Technical Standards on Own Funds of 4.4.2012; Consultation paper on Draft Implementing Technical Standards on Disclosure for Own Funds of 7.6.2012; Consultation paper on Draft Regulatory Technical Standards on the concept of Gain on Sale associated with future margin income in a securitisation context of 12.6.2012; Consultation paper on draft technical standards on the calculation of credit risk adjustments of 17.7.2012; Consultation paper on the application of the capital calculation methods for financial conglomerates of 31.8.2012; Consultation on technical standards on cooperatives, mutuals, savings institutions and similar institutions of 9.11.2012.

(2) EBA consultation on draft technical standards for credit valuation adjustment risk of 11.07.2012.

Box 2 – Timetable for entry into force of the Basel III standards

On the basis of the Basel Committee's recommendations, the new Basel III standards are to be phased in between 1 January 2013 and 1 January 2022. The transitional measures specified are summarised in the table. Although entry into force at European level was delayed on account of the negotiating process between the European Parliament and the Council, it is still the intention to apply the new standards as soon as possible with due respect for the same transitional measures.

The minimum level of the solvency requirements for common equity Tier 1 will be set at 3.5 % of the risk-weighted assets in 2013, and gradually increased to 4.5 % in 2015. The minimum capital requirement will be set at 8 % in 2013. From 2016 onwards, institutions must gradually build up a capital buffer in the form of common equity Tier 1, called the conservation buffer, which is to equal 2.5 % of the weighted risk volume in 2019.

In regard to the new elements to be deducted from the capital under the Basel III standards, those deductions will be phased in at the rate of 20 % a year from 2014. The future transitional measures therefore imply simultaneously a gradual reduction in the effective capital on account of the new deductions and a gradual increase in the capital requirements.

Finally, the leverage ratio will be used as an observation ratio from 2013 ; it must be published from 2015 and will become compulsory from 2018.

TIMETABLE FOR THE IMPLEMENTATION OF THE BASEL III STANDARDS
(in % of risk-weighted assets)

	2011	2012	2013	2014	2015	2016	2017	2018	From 2019
Leverage ratio	Monitoring		Observation ratio from 2013 to 2017 Disclosure starts 2015					Migration to Pillar 1	
Minimum common equity capital ratio			3.5	4.0	4.5	4.5	4.5	4.5	4.5
Capital conservation buffer						0.625	1.25	1.875	2.5
Minimum common equity plus capital conservation buffer			3.5	4.0	4.5	5.125	5.75	6.375	7.0
Phase-in of deductions from common equity Tier I				20.0	40.0	60.0	80.0	100.0	100.0
Minimum Tier 1 capital			4.5	5.5	6.0	6.0	6.0	6.0	6.0
Minimum total capital			8.0	8.0	8.0	8.0	8.0	8.0	8.0
Minimum total capital plus conservation buffer			8.0	8.0	8.0	8.625	9.25	9.875	10.5
Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital					Phased out over 10-year horizon from 2013				

Source : Basel Committee on Banking Supervision.

3.2 Liquidity requirements for the banking sector

The Basel III agreements provide for the introduction of two harmonised international liquidity standards : the liquidity coverage ratio (LCR), which requires banks to form an adequate liquidity buffer to cope with a serious liquidity crisis independently for one month, and the accompanying component, namely the net stable funding ratio (NSFR) which puts the emphasis on the soundness of institutions' structural liquidity position and encourages them to fund illiquid assets with relatively stable financing sources such as long-term funds, capital and the deposits of retail customers and SMEs. Previously, the Basel standards were confined to solvency requirements. From 2015, they will therefore be supplemented by more harmonised supervision of institutions' liquidity.

During the period under review, the Basel Committee finalised the calibration of the LCR. In the course of that revision, the Committee responded to specific concerns regarding the liquidity buffer of institutions (the ratio's numerator), and the calibration of net cash outflows in a crisis situation (the ratio's denominator). The original definition set in December 2010 for the LCR liquidity buffer included cash and central bank deposits, liquid debt securities issued by governments, quasi-public authorities and companies with a high credit rating, and covered bonds with similar characteristics. The modified definition provides for greater diversification of the eligible assets and recognition of the liquidity of certain additional financial assets. The Basel Committee decided that certain well-defined corporate bonds with a lower credit rating, exchange-traded shares and securitised assets could form part of the LCR liquidity buffer. It was also decided to reduce the assumed net cash outflows in the case of deposits and liquidity facilities granted to non-financial corporations, public and quasi-public authorities and central banks. In particular, the reduction in the obligations associated with the provision of liquidity facilities for the corporate sector could moderate the impact of the introduction of the LCR on the provision of those facilities and hence on the funding of the real economy. The Basel Committee also adopted a uniform approach to the potential liquidity flows connected with derivative contracts in the final agreement on the LCR. The potential scale of the liquidity needs relating to the provision of additional collateral to cover the counterparty risks in relation to derivative contracts was demonstrated during the financial crisis, notably in the context of the liquidity problems confronting Dexia. Finally, the Basel Committee decided to introduce the LCR in phases, beginning with a minimum requirement of 60 % in 2015, rising by 10 % each year to 100 % in 2019. This gradual introduction should prevent any distortion of financial and economic activity. Nonetheless, the Belgian supervisory authority proceeded to implement liquidity ratios similar to the LCR as early as 2011 for all credit institutions operating in Belgium. The liquidity buffers formed in that connection should enable the institutions concerned to meet the full 100 % LCR quickly, rather than phasing it in as planned by the Basel Committee.

At European level, work has continued on the transposition into EU law of the Basel III standards, of which the said liquidity ratio is a key component, via a new EU Directive and Regulation directly applicable to European credit institutions (CRD IV). In the run-up to the introduction of the LCR, this EU Regulation establishes unified liquidity reporting for all European credit institutions. During 2012, the EBA presented a proposal for this reporting, and submitted it for consultation to the European banking sector and other parties involved. That document will be finalised shortly after the adoption of the CRD IV as a harmonised liquidity reporting framework for all European credit institutions. The EBA has also been working on a set of technical standards and guidelines which are to define some aspects of the LCR in more detail.

At national level, the Bank – in its capacity as the Belgian supervisory authority – continued to use the stress test ratios introduced at the beginning of 2011, which are similar to the LCR, as the regulatory quantitative liquidity standards. At the end of 2011, the tense situation on the financial markets was reflected in an increase in the number of institutions failing to comply with this statutory liquidity limit. During 2012, however, following a turbulent final quarter in 2011, the measures adopted by the European Council and the ECB (notably the special longer-term refinancing operations, the interest rate cut on the deposit facility, and the government bond purchasing programme) alleviated the difficult conditions confronting the European banking sector on its funding markets. Against that backdrop, the Belgian banks also made use of the ECB's special longer-term refinancing operations to step up their long-term borrowing. In addition, they took advantage of more favourable funding and liquidity conditions to issue long-term debt instruments. A number of institutions also implemented action plans to secure structural improvements in their liquidity position. These concerned measures such as the expansion of their portfolio of securities eligible as collateral with the Eurosystem, reduction in the use of liquidity for non-strategic activities, the issuance of long-term paper for the retail public, etc. Finally, despite very low interest rates, the amounts deposited in regulated savings accounts continued to grow in most Belgian institutions. The Belgian banks' short-term liquidity position consequently improved from the beginning of 2012, so that the aforesaid measures by the European authorities, the turnaround in financial market conditions and the specific efforts on the part of certain institutions meant that the regulatory standards were once again satisfied during the period under review.

Apart from this standard, the Bank also undertook various individual prudential measures to improve liquidity management in certain institutions, and continued to keep a close eye on the liquidity situation of Belgian credit institutions in view of the persistent financial market tension. In addition, under the Financial Sector Assessment Programme (FSAP) exercise which the IMF arranged for Belgium at the end of 2012, the Belgian banks were subjected to a series of stress tests concerning their liquidity situation during the year under review (see section II.B.1.3).

Finally, the new Belgian regulations on issuance of covered bonds by Belgian credit institutions will enable the institutions concerned to exploit a new source of long-term (and therefore more stable) funding in the future (see section II.A.4.1). Some major Belgian institutions (Belfius and KBC) have already issued covered bonds under these new regulations. That development could make an additional contribution towards improving the structural liquidity position of institutions.

3.3 Requirements of the European Solvency II and Omnibus II Directives for the insurance sector

The first Directives on insurance were published in 1973 and 1979, concerning non-life and life insurance respectively. Since then, technical developments and supplementary requirements, notably in regard to risk management, have made it necessary to modernise those Directives.

To that end, the European Commission started work on a Directive applicable to insurance and reinsurance activities which would recast 13 sectoral Directives and bring about the thorough modernisation of a number of aspects such as governance, risk management, prudential valuation rules, including technical reserves, capital requirements, equity components eligible to be taken into account in view of their quality, and the supervision of insurance undertakings belonging to a group. Conversely, no changes were made to other aspects, such as the principles concerning authorisation or liquidation.

This work ended with the publication of Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of insurance and reinsurance, known as the Solvency II Directive.

The Directive originally specified that the new provisions would enter into force on 1 November 2012 and that the Member States must transpose them by 31 October 2012. However, the 2008 financial crisis demonstrated that the valuation methods proposed by the Directive led to high volatility in the valuation of insurance companies' assets. Such volatility proved incompatible with the medium- or long-term horizon of most of the companies' liabilities. The work was therefore redone to ensure greater capital stability, particularly in regard to the long-term guarantees (LTG). A Directive dated 12 September 2012 postponed the dates for transposition and entry into force of the Solvency II Directive to 30 June 2013 and 1 January 2014 respectively.

The changes under consideration are to form the subject of a new Directive, provisionally called Omnibus II. However, there is no unanimity either on the products which are to form part of the long-term guarantee package or on the techniques to be used (matching adjustment, counter-cyclical premium, etc.).

In July 2012, in view of the importance of what is at stake, it was decided to conduct an impact assessment before adopting the Omnibus II Directive. Difficulties emerged regarding the dates for transposition and entry into force such that some Member States and the Commission are questioning the advisability of implementing some of the provisions of the Solvency II Directive, e.g. in regard to governance (including Own Risk and Solvency Assessment or ORSA), and the reporting obligations ahead of those in the Omnibus II Directive.

Meanwhile, the Bank has started work on transposing the Solvency II Directive in its original form. Some texts were submitted for the opinion of interested parties in June and December 2012.

4. National regulatory developments

4.1 Legislation authorising the issuance of covered bonds

During 2012, a legal framework was set up in Belgium to govern the issuance of debt instruments commonly known as covered bonds [1]. Following the example of foreign legislation, it aims to offer credit institutions better (re)financing facilities. Belgian credit institutions have hitherto been at a competitive disadvantage owing to their inability to access these sources of (re)financing.

The key feature of covered bonds is the legal mechanism that was set up in order to protect holders of these debt instruments. That mechanism provides for the formation of a special pool of assets, separate from the general assets of the issuing credit institution, isolating the institution's assets allocated to covering these bonds. The special assets are segregated from the general assets by recording the credit institution's covering assets in a register maintained specifically for the purpose. This procedure is not in any way comparable to asset assignment. The assets remain on the issuing credit institution's balance sheet but are no longer part of its general assets.

While covered bonds represent a technique for mobilising claims in the same way as securitisation, more commonly known as asset-backed securities (ABS) or mortgage-backed securities (MBS), they differ from the latter in several ways. One essential difference between covered bonds and ABS/MBS is that holders of covered bonds have not only a legally guaranteed right of recourse to the cover assets, but also a right of recourse to the institution's general assets (the dual recourse principle). Covered bonds are also simpler financial instruments than ABS/MBS, which usually imply the existence of various separate risk tranches. This tranching does not exist in the case of covered bond issues. Finally, covered bonds are used only to refinance existing loans. The issuance of covered bonds does not permit transfer of the risk relating to the loans thus mobilised, since the underlying portfolio of claims remains on the balance sheet of the issuing credit institution: it therefore does not lead to any reduction in the issuing institution's capital requirements.

The special assets are the cornerstone of the mechanism protecting holders of covered bonds. In this respect, strict qualitative and quantitative requirements concerning the constituent cover assets are imposed by law.

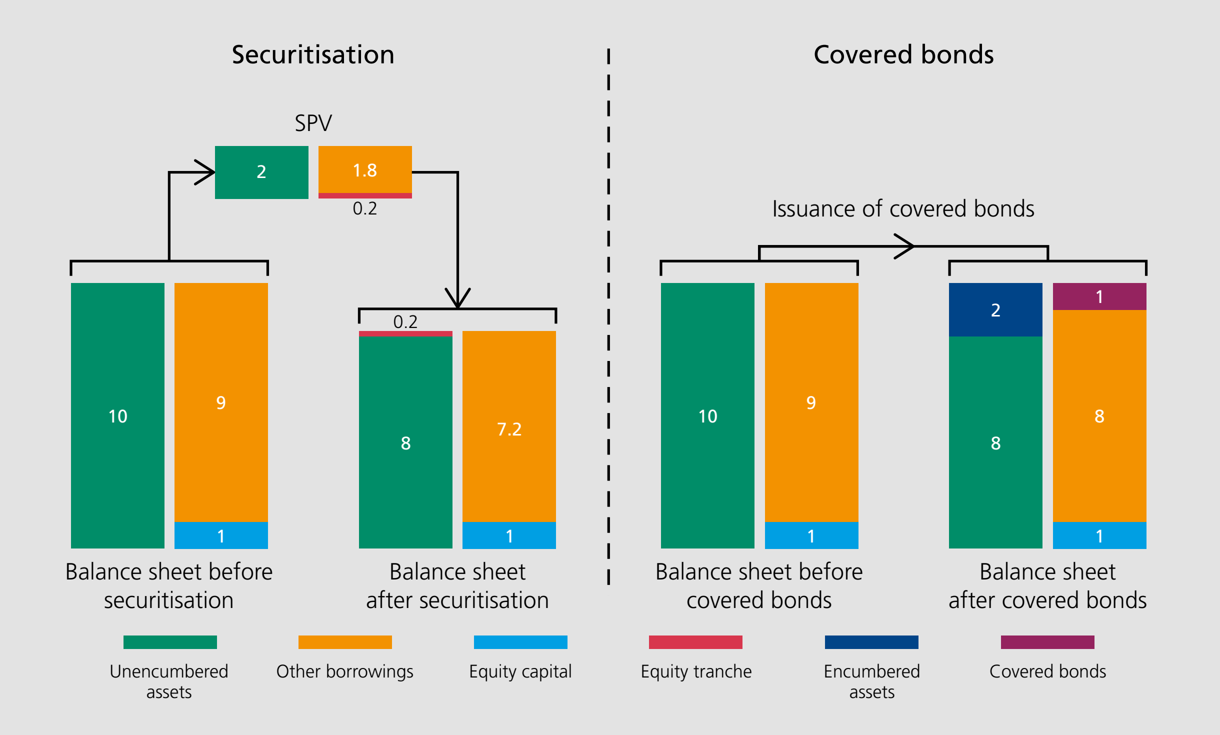
Thus, the special cover pool of assets must consist essentially of mortgage loans or claims on public entities. Those assets must represent at least 85 % of the face value of the covered bonds.

The cover assets must also be worth at least the equivalent of 105 % of the face value of the covered bonds. That is a statutory minimum. In practice, the cover level could be higher. It depends, for instance, on the coverage necessary to obtain and maintain a particular rating, set by the rating agencies, or the contractual liabilities taken on by the issuing institution.

For the purpose of calculating the above percentages, the authorities also needed to set the criteria for valuing the cover assets. Taking account of the technical questions that these provisions could raise, particularly for claims backed by real estate, the Bank issued a circular specifying the practical modalities for implementing the valuation methods.

(1) Law of 3 August 2012 introducing a legal framework for Belgian covered bonds.
Royal Decree of 11 October 2012 on the issuance of Belgian covered bonds by Belgian credit institutions.
Royal Decree of 11 October 2012 on the portfolio administrator in connection with the issuance of Belgian covered bonds by a Belgian credit institution.
Circular NBB_2012_12 on the practical arrangements for applying the Law of 3 August 2012 introducing a legal framework for Belgian covered bonds.
Circular NBB_2012_13 on the portfolio monitors in Belgian credit institutions issuing Belgian covered bonds.

CHART 1 COMPARISON OF THE IMPACT ON THE BALANCE SHEET OF SECURITISATION AND COVERED BOND ISSUANCE



Source : De Nederlandsche Bank

The August 2012 Law also introduces various parties with the role of facilitating compliance with the obligations in respect of covered bond holders. The task of the bond-holders' representative is to facilitate relations with the covered bond-holders and to ensure that their interests are respected. The cover pool monitor, appointed with the approval of the Bank, has to ensure compliance with the requirements concerning the covering assets. Finally, in the event of a problem, such as bankruptcy or removal from the list of institutions authorised to issue covered bonds, the portfolio administrator has to manage the special assets for the purpose of fulfilling the commitments specified in the covered bond issuance conditions.

The creation of a legal framework offering a new source of secured funding for credit institutions fuelled the debate on the use of the assets of Belgian banks as collateral, to the detriment of other categories of creditors, including depositors. To address that concern, a Royal Decree limiting the issuance of covered bonds was passed into law. The text stipulates that an institution cannot proceed with new covered bond issues if the total amount of the assets allocated to covering the existing covered bonds amounts to 8 % of its balance sheet total. In exceptional circumstances, the Bank has the power to grant temporary exemptions from the application of this limit, but also to impose a more stringent limit if that should prove necessary.

Owing to the special rules appropriate to covered bond issuance, there is an *ad-hoc* procedure for obtaining a general authorisation from the Bank permitting the issuance of covered bonds. That procedure involves checks on a number of essentially organisational constraints which it was deemed necessary to define in formal terms in the legislation. That authorisation thus concerns the ability to issue covered bonds and does not constitute permission to issue them, for which specific authorisation is required.

On its website, the Bank publishes a list of the credit institutions which it has authorised to issue covered bonds. It also publishes a separate list of covered bond issues by credit institutions. The covered bonds are removed from the list when they mature or are redeemed.

4.2 New policy on the organisation of the compliance function

For all institutions subject to the Bank's supervision, the compliance function is of fundamental importance for managing their integrity and protecting the financial consumer. It is a key element of a financial institution's proper organisation and good governance. In accordance with the prudential regulations, the Bank may, on the recommendation of the Financial Services and Markets Authority (FSMA), specify what is meant by an adequate independent compliance function.

It is the FSMA's responsibility to oversee the organisation of the compliance function from the point of view of respect for the rules of conduct ensuring the honest, fair and professional treatment of the parties concerned.

The two supervisory authorities harmonised and clarified their expectations regarding the organisation of the compliance function in a new joint circular dated 4 December 2012.

The new circular takes account of developments concerning the compliance function and changes in the governance of institutions. It replaces all existing circulars concerning the compliance function addressed to institutions subject to the Bank's supervision.

The circular contains 14 principles which will be taken into account in assessing the organisation of the compliance function. Those principles will be applied proportionately, taking account of the type of institution and the services provided.

The first principle describes the tasks of the compliance function : identification and assessment of the compliance risk, supervision of testing, of drafting of recommendations, and reporting on the subject of compliance risk. This is the risk that the institution may be penalised for failure to respect the rules on integrity and conduct laid down by the laws and regulations, leading to loss of reputation and possible financial damage.

The new circular describes the governance of the compliance function in detail, namely the role of the board of directors and the audit committee, if there is one, and the role of the effective management or the executive committee, if there is one (principles 2 to 5 inclusive).

The board of directors, or possibly the audit committee, must regularly assess the integrity policy and confirm the compliance charter. This circular also points out the importance of the board of directors in promoting integrity in the conduct of business (the tone at the top).

The effective management or the executive committee is responsible for managing the compliance risk, formulating the integrity policy and adopting the necessary measures to ensure that the institution has an adequate, independent compliance function at all times.

The compliance function comes directly under a member of the effective management. There should be no conflict of interests between that task and the other responsibilities of the said member. If the latter is in charge of both the compliance and the risk management functions, he/she must ensure that both tasks receive equal attention. The member of the effective management responsible for the compliance function cannot be competent for the internal audit function.

Principle 6 provides for regular reporting to the effective management and informing of the board of directors or the audit committee.

Principle 7 introduces the three lines of defence model, governing relations and communication between the operational management (first line), transversal functions, including compliance (second line), and the internal audit (third line). The circular also deals with the relationship between the compliance function and the legal function, and strongly recommends that the two tasks be carried out by two separate departments.

The circular attaches particular importance to the independence of the compliance function (principle 8). The principles (9 to 11) concerning its organisation are the same as in existing texts. The circular regulates the organisation of compliance in a group context (principle 12).

The circular prohibits the outsourcing of the responsibility for compliance. Nevertheless, an institution may on occasion use an expert to carry out precisely defined compliance tasks, or as a temporary solution in the event of a staff shortage (principle 13).

The last principle (principle 14) concerns the organisation of the compliance function in smaller institutions. These institutions can choose to make a member of the effective management responsible for compliance. That member may entrust some or all of the compliance activities to an expert, either outside the institution or within the group to which the smaller institution belongs. The supervisory authorities must be informed in advance if the institution entrusts some or all of the compliance tasks permanently to an expert.

4.3 Assessment of the fit and proper character of the managers of financial institutions

In the aftermath of the financial crisis, attention focused in particular on the need for changes in the governance of financial institutions. This triggered a national and international debate on the aptitudes required – i.e. the fit and proper character – of people called upon to fill positions at the most senior level in financial institutions. Some of these initiatives have since led to legislation or prudential policy documents to be implemented at national level.

In order to learn from recent events and enhance the clarity of the existing and future legal provisions on fit and proper character, the Bank – as the supervisory authority – decided to assess its current policy on the subject and to incorporate the conclusions of that assessment in a new prudential policy document entitled "Fit and proper standards for members of the executive committee, the directors, the effective management and the persons responsible for independent control functions of financial institutions".

The aim of this new policy is threefold. First, the Bank wants to clarify what it means by "fit" ("expertise") and "proper" ("professional integrity"). By using assessment standards, it aims to help institutions with the practical implementation of the legal provisions on fit and proper character. Institutions will thus be able to establish a better framework for their own assessment of these aptitudes. The Bank also aims to spell out what it expects of institutions in regard to fit and proper screening. Finally, the Bank wants to establish transparent communication on its fit and proper policy. In so doing, it will streamline its aptitude assessments in terms of both content and procedure.

The proposed policy as set out in a draft circular comprises a number of new ideas on fit and proper screening. For instance, it proposes a tougher approach to impending or current criminal, administrative or disciplinary proceedings concerning a person to be screened, while there is clearer guidance on the use of the interview technique by the supervisory authority.

The scope of the circular encompasses a larger group of persons than the current system. In future, fit and proper screening will concern the following:
- members of the executive committee (whether directors or not);
- other members of the management body;
- in the case of institutions with no executive committee and branch institutions, the effective management;
- persons responsible for independent control functions, namely compliance, risk management, internal audit and the actuarial function.

That scope will be enshrined in the law following the transposition of CRD IV and Solvency II into national law.

The draft circular was presented to the sector for consultation at the end of December 2012 and will be finalised during 2013.

In 2012, as part of the fit and proper procedure, the Bank issued more than 500 opinions on management appointments and reappointments.

4.4 Remuneration policy of financial institutions

The remuneration policy of financial institutions remains a major concern at both national and European level.

On 12 April 2012, the EBA published an implementation study on compliance in the various EU Member States with the CRD III provisions on remuneration and the Guidelines on Remuneration Policies and Practices of the Committee of European Banking Supervisors (CEBS)(1). The main stumbling blocks are the small number of staff in institutions falling within the scope of the restrictions under the CRD III (identified staff), the high ratios between the variable and fixed remuneration components, and the imperfect risk alignment mechanisms.

At the beginning of 2012, the Bank undertook a second in-depth horizontal analysis of compliance with the rules on remuneration by six large institutions for the year 2011. The Bank thus intends to promote a level playing field in the Belgian financial sector. That exercise shows that, overall, the response on a number of points for attention previously identified is still inadequate and, above all, patchy. In line with the conclusions of the said EBA implementation study, this concerns the determination of the identified staff and the definition of the appropriate ratios between variable and fixed remuneration. Those variable/fixed ratios are in fact a relatively simple way of ensuring that the remuneration system does not give staff excessive incentives to take irresponsible risks.

After two years of application of the regulatory framework, which have seen the emergence of a number of best practices in the Belgian sector, the Bank embarked

(1) The study is available at: http://eba.europa.eu/cebs/media/Publications/Standards%20and%20Guidelines/2010/Remuneration/Implementation-survey-on-CEBS--Guidelines-on-Remuneration--final-.pdf

on a more specific and quantitative interpretation of these requirements. Ahead of the next remuneration cycle, the Bank also intends to spend more time on testing the risk alignment of the remuneration policy.

When it comes to defining the group of identified staff, a three-stage approach is needed.

In the first and most important stage, the institution must determine which staff may have a material impact on its risk profile. The group of identified staff must therefore comprise the staff most able to influence the institution's risk profile in that they define, help to define or control that risk profile. In accordance with paragraph 16 of the CEBS Guidelines, this assessment must be conducted for the executive directors, the senior management responsible for day-to-day management, staff responsible for internal control functions and other risk-takers, a category which certainly cannot be confined solely to trading room activities. Staff at the same level of total remuneration as senior management and other risk-takers should also be included among the identified staff.

The second stage – which is new since the last horizontal analysis – consists in defining the group of identified staff following the above risk analysis so as to include at least 1 % of the total staff. If that percentage is not currently attained, it means that the concept of material impact on the risk profile needs to be more broadly defined. In principle, for large institutions, classed as such on account of their size, the nature and complexity of their activities, and their risk profile, this concerns staff who are entirely subject to all the specific requirements of the CRD III regarding variable remuneration (such as the deferral of 40 to 60 % of the variable remuneration for a minimum of 3 to 5 years, or payment of 50 % of the variable remuneration in financial instruments).

The third stage consists in examining whether the group of identified staff includes staff whose variable remuneration is less than € 75 000. If that is the case, then by way of exception, in view of the low level of their variable remuneration, these staff need not be subject to the specific requirements so long as they respect a maximum variable/fixed ratio of 1 to 1, whatever their sphere of activity in the institution. This means that, for these staff, the variable component must never exceed the fixed component of their remuneration. In the case of identified staff who exceed that threshold, all the specific CRD III requirements on deferral and the use of financial instruments must be applied to the whole of their variable remuneration.

Regarding the variable/fixed ratio, appropriate implementation means, in principle, that this ratio must not exceed 1 to 1 except in the case of trading room activities where a maximum ratio of 2.5 to 1 applies. As stated above, the exception of 2.5 to 1 does not apply to identified staff to whom the specific CRD III requirements are not applied as their variable remuneration is less than € 75 000. Exceptions to these ratios must be approved by the board of directors on the basis of a policy drawn up by the institution as part of the overall remuneration policy, specifying in detail the circumstances in which such an exception may be submitted to the board of directors.

These implementing measures are minimum standards, without prejudice to existing practices involving percentages of identified staff higher than 1 % or variable/fixed ratios of less than 1 to 1 or 2.5 to 1. Assessment of the appropriateness of a remuneration system is in fact based on the whole set of measures and their interdependence. Although the above analysis fits into a framework of risk-based supervision geared primarily to large institutions, the Bank believes that it is also relevant for other institutions. These requirements must therefore also be considered by medium-sized and small institutions as minimum standards which, moreover, are without prejudice to any existing, stricter practices in those institutions. That said, in its assessment of the remuneration policy, the Bank will also take account of the size, internal organisation, nature, scope and complexity of the activities of medium-sized or small institutions, in accordance with the proportionality rules under the CEBS Guidelines, which may be applicable either to the institution itself or to the identified staff.

It should be noted that the institution's board of directors is responsible for the remuneration policy, including compliance with the above standards. In addition, the Bank expects the implementation of the remuneration policy to form part of the annual assessment of the internal control measures by the effective management (see NBB circular_2011_05 of 14 February 2011 on the establishment of a proper remuneration policy, p. 5).

Another point to emerge from the EBA implementation study is that closer attention to disclosure of the remuneration policy and practices may reinforce implementation. On 27 July 2012, the EBA published two guidelines on this matter concerning the collection of data on remuneration by the national supervisory authorities and by the EBA itself. The first concerns the remuneration of identified staff, the second relates to high earners, i.e. staff whose remuneration exceeds € 1 million per annum. The EBA guidelines, transposed into two NBB circulars (1), are presented in the form of harmonised templates to

(1) Circulars NBB_2012_09 and NBB_2012_10, available at: http://www.nbb.be/pub/cp/domains/ki/circ/ki_circ.htm?l=fr #Gouvernance.

be used by all European supervisory authorities. The first data collection ended on 31 December 2012 and concerns figures for both 2010 and 2011. In future, institutions will have to supply these data at the end of June each year.

Prudential supervision

1. Organisation of prudential supervision : towards strong direction of prudential activities

The 2011 Report describes in detail the organisation of the supervision departments in five autonomous services following the introduction of the "twin peaks" supervision model and the integration of prudential supervision at the Bank. It also discusses at length the supervision methodology applied by the Bank, namely the four-eyes principle, and the instruments that the Bank uses to ensure that this model functions effectively. Among other things, the Report commented on the creation of three consultation forums (the Committee on Prudential Planning and Coordination, the Risk Committee and the Macro-Financial Committee) to steer the whole process.

During the year under review, a prudential supervision management cycle was introduced to enable the Board of Directors to provide clearer direction on prudential priorities and measures, on the base of a short- and medium-term risk analysis.

1.1 The master plan

The master plan forms the basis of the prudential management cycle. It sets out the prudential supervision strategy and vision for a period of three to five years, in the context of the main developments in the financial sector and taking account of the international and national regulatory developments which have been announced. It results in a series of long-term objectives.

For the master plan 2012-2015, the main parameter to be taken into account is still the persistence of the crisis affecting the financial system and forcing financial institutions not only to scale down their activities but also, and more fundamentally, to revise their business model. The financial crisis prompted a revision of the regulatory framework applicable to the financial sector. That revision includes not only a fundamental reform of the microprudential regulations, but also the establishment of macroprudential instruments and regulatory texts on recovery and resolution plans. In order to minimise the impact on society of the failure of a financial institution, there was also a debate on the need for certain risk activities of banks to be either isolated in separate entities or subject to stricter capital requirements. The steering and management of all these projects is clearly a complex matter, particularly owing to the need to manage any undesirable effects.

In the light of this, the key aims of the organisation of prudential supervision were defined. The priority must be to set up an efficient and effective process for steering supervision by strategic planning, systematically setting the prudential priorities without losing the flexibility necessary to detect and respond to any new development. In addition, it is necessary to take measures to move on from supervision geared to compliance to supervision geared to risks by extending the supervision horizon (macroprudential dimension, business model analysis, etc.) and clustering institutions according to their risk profile, with an appropriate allocation of resources. Next comes the improvement of the supervision process and its set of instruments, with particular attention to expanding and using the system of sanctions, rationalising the inspection missions and strengthening the internal control environment within operational prudential services. Finally, all these elements need to be housed in an efficient organisation based on judicious use of limited resources, with transparent internal and external communication and close cooperation and synergy among all divisions of the Bank.

At this stage, the master plan still disregards the impact of the banking union (see section II.A.1.1) and the IMF recommendations following its FSAP (Financial Sector Assessment Programme) review of the Belgian financial system (see section II.B.1.3). However, it is clear that all these developments may have a significant impact on the implementation of the master plan and will therefore necessitate adjustments to the plan.

1.2 Risk review

In implementing the master plan 2012-2015, it is appropriate from both the microprudential and the macroprudential perspective to set up an annual risk review, to determine the prudential priorities for the coming period. For the period running until the end of 2013, the financial risks described below were recognised as meriting priority and must be included as such by the various prudential services in their respective action plans. The first priority is the business model analysis, both for banking and insurance and for market infrastructures, following the impact of the financial crisis on those institutions, and against the backdrop of significant modifications to the regulations. It is also necessary to reserve an important place for analysing the interest rate risk in banking and insurance, especially on account of the low interest rate environment and the potential consequences if those rates turn around. The next priority is liquidity risk management, both in banking and insurance and in market infrastructures, particularly in the context of funding problems in the banking sector and the preparations for the introduction of international liquidity standards. For the insurance sector, this mainly concerns potential liquidity risks relating to certain products, while in the case of market infrastructures intraday liquidity risks are the primary concern.

There is a need for greater vigilance over credit risks, taking account of the slowdown in economic growth in Belgium and in the neighbouring euro area countries. That implies greater attention to asset quality, the risk parameters used and the level of reserves formed, and value reductions applied. In line with these ideas, it will also be appropriate to pay attention to movements on the property market in Belgium.

Apart from the financial risks, the following areas will also receive priority attention in the prudential supervision process:

– the development of new policies in the wake of the international standards and the best practices of foreign supervisors, in regard to assessment of the fit and proper character of the management of financial institutions;
– orientation of the scorecard risk analysis tool (described in the 2011 Report, in section 3.1.2 of "Financial stability and prudential supervision") in banking and insurance to make it an instrument which permits the clustering of institutions and thus contributes to a risk-based approach to supervision;
– further refinements to the policy on determining the capital requirements under the second pillar of the Basel Agreement, via the capital add-ons policy and the Internal Capital Adequacy Assessment Process (ICAAP);
– the fundamental revision of the reporting and analysis instruments. Following the entry into force of Basel III and Solvency II, prudential and financial reporting will be radically revised. That offers the opportunity for also adapting the analysis tools based on periodic reporting and incorporating them in the overall supervision methodology.

The priorities listed in the risk review are the guiding principle for drawing up the respective action plans of the various supervision services. However, the whole process does offer some scope for adjustments which may be necessary on account of new developments or new risks arising in the sector, detected by means of appropriate instruments at national and European level.

1.3 Three consultation committees

In the second half of 2011, the Bank set up three consultation committees to coordinate all its supervision work and integrate prudential supervision into its other tasks. They developed their activities and became fully operational in 2012.

The Committee on Prudential Planning and Coordination (CPPC) ensured the proper operational organisation of prudential supervision. In particular, it supervised the monitoring and implementation of the decisions taken by the Board of Directors in order to structure the resources allocated to supervision in coherent organisation charts between the five different services concerned with prudential supervision, and to strengthen these resources by targeted recruitment. The CPPC also planned and coordinated the conduct of the various prudential supervision support activities, particularly IT projects, the development of a general organisation structure for inspections, the operational allocation of tasks for the purpose of verifying the fit and proper character of the management of financial institutions, and budgetary procedures.

Box 3 – Monitoring of banks' business models

Following the restructuring of the financial sector, the large Belgian banks have refocused their operations on more traditional markets and products. At the same time, they need to adapt their cost structure in order to achieve sufficient structural profitability to gradually strengthen their capital in anticipation of the entry into force of Basel III. In these circumstances, the monitoring of the strategies adopted by large Belgian financial intermediaries is a crucial point for attention in the conduct of prudential policy. The Bank put the assessment of the consistency and appropriateness of the business models of the large Belgian financial intermediaries at the top of its priorities in its risk review for 2013. Analysis of these models, which determine the scope for development of the institutions concerned and their ability to withstand shocks, is a complex exercise requiring detailed examination of the numerous aspects and angles of the business of a bank, insurance company or financial conglomerate, and entailing the use of expertise from various departments at the Bank.

Those components include *inter alia* the macroeconomic assumptions (concerning growth, inflation, unemployment, wages, etc.), financial assumptions (cost of funding, interest rate, exchange rate, etc.), the economic and competitive context determining the profitability and risk constraints which banks have to confront in developing their overall strategies, the organisation and governance aspects, regulation, and the impact of current legislation on the behaviour of financial institutions.

This overall analysis must in turn serve as an anchorage point for an in-depth examination of the strategy of individual large institutions. The aim is to determine more precisely the extent to which the various business lines of these large financial institutions are profitable, and thus proceed to assess the institutions' vulnerability and sensitivity to economic or financial developments which are detrimental to the development of their activities.

The other two committees performed their respective tasks in the analysis and monitoring of financial stability. The Risk Committee (RC) piloted the risk analyses, paying attention to the interactions between the micro- and macro-prudential dimensions. It also ensured that the regulations were properly understood and consistently applied. For the purpose of coordination and to exploit the synergies between the various prudential services, the RC set up several groups (or risk teams), each responsible for a major topic relating either directly to a risk category or field, or to risk monitoring techniques or instruments, or to major components of the regulations. In forming these teams, care was taken to limit participation to managerial staff directly concerned with the various topics, but also to involve as many of those staff as possible in one of the groups so that the coordination process could be extended to the various levels of prudential supervision. That approach facilitated the general implementation of the four-eyes principle by combining the experience gained by members of the operational supervision teams with the more general approaches adopted by staff responsible for analysing financial stability or for transverse operational functions.

During the year under review, the RC's activities included comparison between institutions of the parameters used to calculate the risk weightings applied to similar assets, such as securities issued by the same sovereign or loans to the same enterprises. This type of analysis makes it possible to assess whether credit institutions evaluate identical risks in a comparable way. Such comparison exercises, which may in particular be used in connection with the Bank's validation of internal risk assessment models applied by banks, were also launched at international level.

The third committee, the Macro-Financial Committee (MFC), arranged the coordination and flow of information between the supervision services and the other departments of the Bank more directly involved in tasks which may either clarify and enrich prudential supervision or be affected by it. The main themes covered concerned cyclical developments influencing the pattern of risks within the Belgian economy and financial sector, macroeconomic projections, the credit situation overall and in certain key sectors, such as real estate, the structural characteristics of the Belgian economy influencing the activity of financial intermediaries, and analysis of economic and financial developments in the main countries where Belgian banks have substantial positions. In this context, the MFC pointed up vulnerabilities in various countries where Belgian institutions are particularly exposed, prompting more specific, detailed analyses of certain portfolios built up by those financial institutions.

In 2012, joint meetings were also held between the RC and the MFC. Their purpose was to coordinate certain major projects, particularly the analysis of the Belgian property sector, and to agree jointly on the priorities to be proposed to the Board of Directors for the 2013 risk review (see section II.B.1.2). In the years ahead, these interactions are set to intensify as macroprudential policy is developed and implemented.

Box 4 – Financial Sector Assessment Programme

Since 1999, the International Monetary Fund has conducted Financial Sector Assessment Programmes (FSAPs) aimed at the full, in-depth analysis of a country's financial sector. The objective of these assessments is to detect the main factors of vulnerability which could trigger financial crises. They concern both supervision and regulation and the risk profile of the financial system.

Financial crises can have disastrous consequences for the real economy, as is evident from the financial crisis which has beset our economies for more than five years. In that context, the IMF decided to incorporate the FSAP in bilateral surveillance or the Article IV consultations. It was also decided that from now on the 25 jurisdictions with a large or "systemic" financial sector will undergo this assessment every five years.

In view of the size of its financial sector and the importance of the cross-border groups, Belgium is now on that list of the 25 leading financial centres. As the last exercise took place in 2005-2006, Belgium's financial system underwent assessment by the IMF as part of the next Article IV consultation; this audit started in the year under review and will end in 2013.

The assessment has two main elements. The first concerns analysis of the soundness of the financial system as a whole, including via stress tests. The purpose of these tests is to analyse the vulnerability of financial institutions confronted by various macroeconomic shocks – such as a prolonged period of very weak economic growth, a fall in the prices of financial assets or property, or a significant rise in interest rates. The IMF also assesses the authorities' ability to react effectively in the event of a financial crisis.

The second element gauges the quality of the regulation and supervision of banks, insurance companies and financial markets. For the purpose of this exercise, the supervisory authorities have to assess their own legal arsenal in the light of international standards such as the Basel core principles for banks and core principles for insurance undertakings. Those principles encompass the preconditions for effective supervision, the rules on licensing, regulation and the prudential requirements relating, for example, to credit risk, market risk or interest rate risk, the oversight and supervision methodology, disclosure requirements and the prudential authorities' powers in the event of failure by institutions to respect the regulations.

The authorities must also demonstrate to the IMF teams the extent to which these standards are actually applied in practice. For the purposes of this exercise, the IMF will refer to the 2006 Core Principles for banks and the 2011 Core Principles for insurers. However, the Basel Committee very recently revised these principles for banks.

In September 2012, the Basel Committee on Banking Supervision adopted a new set of Banking Core Principles. They certainly do not imply any radical break with the 2006 principles, and care was taken to ensure adequate continuity and comparability.

The new features concern the following five aspects:
– first, the Core Principles and the associated Assessment Methodology are now brought together in a single document;

– second, the principles are reorganised to distinguish more easily between what the supervisory authorities do and what is expected of the banks ;
– third, various individual principles have been improved to take account of weaknesses which emerged in the banking sector during the financial crisis. This mainly concerns the supervision of systemic institutions, the addition of a macroprudential perspective to supplement the traditional microprudential perspective, and the adoption of supervision measures for crisis situations (recovery and resolution measures) ;
– fourth, there is greater emphasis on governance within banks ;
– and finally, the role of market discipline is further highlighted.

Although the Bank is officially still being assessed on the basis of the old 2006 Banking Core Principles, it also supplied details of the supervision of systemic institutions, its supervision in a crisis situation, and the way in which it has combined micro- and macroprudential supervision since the introduction of the "twin peaks" model in 2011. The Bank also took the initiative itself to give an in-depth account of the financial institutions' governance requirements.

The Bank was keen to demonstrate a similar proactive attitude towards the new Principles for the Supervision of Financial Conglomerates, also adopted in September 2012, which were drawn up by the trans-sectoral Joint Forum established under the aegis of the Basel Committee, the International Organisation of Securities Commissions and the International Association of Insurance Supervisors. As far as possible, the Bank undertook a self-assessment in regard to this new international regulatory framework for the supervision of conglomerates.

Within the Bank, this in-depth analysis of the financial sector deployed numerous resources in both the Prudential Services and the Legal Service and Research Department during the year under review. The FSAP conclusions are expected in May 2013.

2. Operational supervision of banks

2.1 Overview

At the end of 2012, the Banks and Stockbroking Firms Service exercised prudential supervision over 123 credit institutions and 36 investment firms.

In 2012, the prudential supervision of the banks was again dominated by the persistent financial crisis. The supervision policy defined in 2011 was maintained and reinforced where necessary. Due attention was likewise paid to harmonising the organisation of macro- and micro-prudential supervision, and to optimising the supervision instruments used.

Daily reporting of the liquidity position of systemic institutions continued to be applied in full, while details of the data to be reported were extended in order to provide a deeper understanding of the liquidity situation and underlying trends for each institution concerned. While the ECB's substantial injections of liquidity had a stabilising effect on the general liquidity situation of the banks, it must be said that there has not so far been any significant restoration of unsecured lending between banks, and that long-term funding remains scarce and expensive. The Bank obliged some banks with inadequate liquidity buffers to rebuild their buffers without delay under an action plan, and also urged them to accord greater priority to structural improvements in their liquidity and, if need be, to align their commercial policy with that goal.

The Bank plays an active part in various colleges of supervisors; in five of them it acts as the consolidating supervisory authority of a cross-border Belgian group (home supervisor) and in seven as the supervisory authority of a Belgian subsidiary of a foreign group (host supervisor). The degree of involvement in a college as the host supervisor depends *inter alia* on the importance of the Belgian subsidiary for the foreign group, or its importance in the Belgian financial sector. The process of conducting risk assessments and taking capital decisions jointly – i.e. in the college – by the supervisory authorities is now up and running. This intensive process begins with analysis

TABLE 1 NUMBER OF CREDIT INSTITUTIONS AND INVESTMENT FIRMS SUBJECT TO THE BANK'S SUPERVISION

	01-01-2012	31-12-2012
Credit institutions		
Institutions under Belgian law	47	44
Branches under the law of a non-EEA country	9	9
Branches under the law of another EEA country	52	53
Financial holding companies	7	7
Financial services groups	3	4
Financial institutions which are subsidiaries of one or more credit institutions	4	4
Credit institutions linked to a central institution with which they form a federation	2	2
Total	**124**	**123**
Investment firms		
Institutions under Belgian law	22	21
Branches under the law of a non-EEA country	0	0
Branches under the law of another EEA country	16	13
Financial holding companies	2	2
Total	**40**	**36**

Source: NBB.

TABLE 2	NUMBER OF ON-SITE MISSIONS IN 2012, BROKEN DOWN BY TYPE OF INSTITUTION					
	Large banking groups	Belgian domestic banks	Belgian domestic investment firms	EU branches	Branches of third country	**Total**
Number of missions	15	11	3	2	1	**32**

Source: NBB.

of the risks and capital targets at the level of each group banking entity. These analyses are then incorporated in a single, overall risk report which sets the capital targets for the parent company and for each European banking subsidiary in the group. The exchange of information and the joint assessments enhance the participating supervisory authorities' understanding of the group, and foster comprehensive, consistent supervision of cross-border groups.

Systemic institutions have to give the Bank advance notice of their strategic decisions, and the Bank may oppose any decisions that could be detrimental to the institution's pursuit of a sound and prudent policy, or could even seriously compromise the stability of the financial system. In 2012, the Bank examined a number of cases concerning systemic institutions, generally relating to the acquisition of activities or entities, or the disposal of large subsidiaries. The prudential benefits of this system lie *inter alia* in the testing by the supervisory authority of the basic assumptions and objectives behind these operations for the banks concerned; as a result, when issuing a notice of non-objection, the Bank often stipulates an adjustment to the project or specifies better control and monitoring of any risks.

In view of the impending entry into force of the new capital requirements under the Basel III rules, the Bank asked the banks to check their readiness to apply these new – often stricter – rules. As the introduction of Basel III is accompanied by extensive, complicated transitional rules (see section II.A.3.1), the banks had to conduct simulations of their financial position and their capital situation for the whole of this transitional period. In accordance with the expectations of the national and international supervisory authorities and market players, it is important for the banks to demonstrate that they already respect the new Basel III requirements even without resorting to the transitional measures. The Bank urges any banks expecting a shortfall to strengthen their capital or adjust their risk appetite in line with their current financial situation.

In 2012, the Bank conducted targeted, sectoral analyses on compliance with a number of new rules aimed at preventing money-laundering and terrorist financing. A key element of these regulations is the correct identification of the financial institution's customers. To combat money-laundering and terrorism, it is vital that banks know who are the ultimate recipients of the account assets, or who actually ordered the financial transactions, even if the transactions are recorded in the name of companies or *de facto* associations. On the basis of these analyses, the Bank asked financial institutions to exercise increased vigilance and discipline in this matter. It even imposed formal rectification deadlines on a number of banks requiring them to bring their organisation into line with the statutory requirements in this respect.

The Service which is responsible for the supervision of investment firms as well as banks, also conducted on-site assignments. These take the form of an inspection of the audit plan, a thematic inspection, a targeted inspection or a fact-finding mission.

Owing to the financial crisis, most of the missions in the case of systemic groups related to the management of financial risks, and particularly the risk management function, the management of liquidity and concentration risks, and the valuation of securities portfolios.

In other institutions (domestic banks and investment firms) the missions are essentially planned on the basis of a three- to five-year audit cycle. Most of the missions concern the functioning of the management bodies and the transverse supervision functions (internal audit, compliance, risk management) or specific risks relating to the activities.

In view of the specific responsibilities of the Bank as the host supervisor of European branches, missions in those institutions solely concern the application of the anti-money-laundering regulations.

2.2 Dexia

In October 2011, Dexia was forced to undertake the total, but phased, dismantling of the group (see section 3.2.1 of the volume on "Financial stability and prudential supervision" in the Report 2011). That plan involves the sale of operating entities which are still saleable, and the temporary management of assets and activities for which there is a market or a buyer. To finance the plan, it was necessary to obtain new financial guarantees from the Belgian, French and Luxembourg governments totalling a maximum of € 90 billion.

Following the October 2011 sale of Dexia Bank Belgium and its subsidiaries (now the Belfius group) to the Federal Holding and Investment Company (FHIC), which acts for the Belgian State, Dexia initiated or effected the following operations in 2012 :

- sale of the 50% stake owned by Banque Internationale à Luxembourg (BIL) in the RBC Dexia Investor Services joint venture to the Royal Bank of Canada (27 July 2012) ;
- sale of the Turkish subsidiary DenizBank to Sberbank (28 September 2012) ;
- sale of the BIL group to Precision Capital and the Grand Duchy of Luxembourg (5 October 2012) ; in that respect it should be noted that the legacy portfolio of this subgroup remained outside the scope of the sale ;
- signing on 15 March 2012 by the French State, the Caisse des Dépôts et Consignations and the Banque Postale, of a statement of intent on the creation of a new credit institution in France, which will acquire control of Dexia Municipal Agency ;
- the Dexia Asset Management sale process is well advanced, with the signing of an agreement with GCS Capital, but the deal has not yet been closed ;
- following the notification by the Spanish institution Banco Sabadell at the beginning of July 2012, stating that it wanted to exercise its option to sell its 40% stake in Dexia Sabadell, Dexia and Banco Sabadell began discussions on the arrangements for executing that operation ; those discussions are still in progress.

As the dismantling plan is based on significant intervention by the Belgian, French and Luxembourg States, it requires the European Commission's approval. In view of the extent of the state aid, and the complexity and duration of the plan, the European Commission has gradually extended its investigation. Although the Commission decided, on 21 December 2011, to open a formal investigation procedure, it also gave provisional approval for the State guarantees for the financing of Dexia SA, provided the amount guaranteed did not exceed € 45 billion. The Commission asked the States to submit a sound, reasoned restructuring plan within 3 months ; that was done on 21 and 22 March 2012.

At the end of May 2012, the Commission decided to step up its investigation procedure concerning Dexia and asked the latter to draw up a modified plan, as circumstances had changed since the first plan was submitted. In the meantime, it approved the extension of the State guarantee to 30 September 2012. On 6 June 2012, it gave its consent to an increase in the maximum amount of this temporary financing guarantee to € 55 billion. On 26 September 2012, the State guarantee was again extended to 31 January 2013.

When the new plan was drawn up, it was first necessary to take account of the fact that the Dexia banking subsidiaries would still have access to central bank financing by complying with the minimum capital requirements. Dexia also needed to further diversify its funding in order to be less dependent on central bank financing. On the basis of the prudential stability forecasts and the conditions under which the group could fund itself in the current market environment, and in that expected for the coming years, it emerged that the underlying assumptions used for previous simulations needed substantial adjustment. The new simulations are now based on the assumption of funding costs that have a very negative impact on the outlook for profits in the years ahead.

The changes to the funding plan forced the Dexia board of directors to write down the value of Dexia SA's stake in Dexia Crédit Local by € 5 billion leading to negative equity for Dexia SA. Pursuant to Article 633 of the Companies Code, the Dexia SA board therefore decided to convene an extraordinary general meeting of shareholders which – on 21 December 2012 – decided to continue the company's activities. The board also proposed a capital increase of € 5.5 billion, reserved for the Belgian State (53 %) and the French State (47 %), via the issuance of preferential shares. That operation made it possible to restore Dexia SA to a positive equity position, increase the capital of Dexia Crédit Local by € 2 billion, clear Dexia's debts to Dexia Crédit Local, and reduce the funding guarantee demanded to € 85 billion, allocated as follows : 51.41 % for Belgium, 45.59 % for France and 3 % for Luxembourg. The group should thus be able to proceed with an orderly dismantling in the coming years.

On 16 November 2012, the States submitted this new plan to the European Commission, which approved it on 28 December 2012.

In accordance with the agreements, since July 2012 the Dexia group has scaled down and unified the management of Dexia SA and Dexia Crédit Local. In practice, Dexia SA and Dexia Crédit Local exist as separate legal entities but both with the same management. On completion of the capital increase, the composition of the board of directors and specialist committees within the board will also be adapted to take appropriate account of the new shareholder structure of Dexia SA, with the Belgian and French States respectively holding 50.02 % and 44.40 % of the capital.

Meanwhile, the changes to the group structure have also led to modification of the organisation of prudential supervision, and a new cooperation agreement between the Bank and the French prudential supervision authority (Autorité de contrôle prudentiel – ACP) which supervises the Dexia Crédit Local sub-group. The Bank is still the consolidating supervisory authority for the Dexia group but as the consolidated position of Dexia is now virtually the same as the sub-consolidated position of Dexia Crédit Local, it was agreed that the group's prudential supervision will in future be conducted jointly, the Bank taking the formal decisions at consolidated level and the ACP taking those same decisions in respect of the Dexia Crédit Local sub-group.

2.3 KBC

The financial crisis of 2008 and 2009 forced the KBC group to seek state aid. The Belgian federal government and the Flemish government subscribed to non-diluting, redeemable capital instruments for a total of € 7 billion. Redemption of these instruments is subject to the Bank's prior approval. The Belgian federal government also provided a guarantee system for the KBC group's portfolio of structured credit products.

Following these operations, the European Commission obliged the KBC group to restructure and to respect a timetable for repayment of the capital injections. The restructuring plan included the dismantling of a number of activities and portfolios, and the sale of various subsidiaries. In selling entities such as Kredyt Bank and Warta (respectively banking and insurance subsidiaries in Poland), Fidea (Belgian insurance subsidiary) and KBL European Private Bankers (Luxembourg private banking group), the KBC group took some important steps in the implementation of that plan.

In regard to repayment of the state aid, the KBC group obtained the Bank's approval for repayment of an initial instalment of € 500 million to the Belgian federal government in January 2012. KBC subsequently asked the Bank if it could also repay the residue of € 3 billion of federal aid in December 2012.

The basic principle was that this repayment must not significantly weaken the KBC group's solvency, and that the group must respect not only the actual capital targets set annually by the college of supervisory authorities, but also all the new Basel III standards, even without the transitional provisions ("fully loaded").

The projections for the KBC group's financial position in the coming years, subject where necessary to a number of stress scenarios, showed that "fully-loaded" compliance with Basel III from 2013, after imputation of the repayments to be made, was not feasible without an increase in the capital. The KBC group therefore decided to arrange a capital increase totalling € 1.25 billion and to issue Contingent Capital Notes for at least € 750 million.

3. Prudential supervision of insurance

3.1 Overview

The Insurance and Reinsurance Companies Service supervises insurance companies, reinsurance companies, mutual guarantee associations and regional public transport undertakings, the latter having the ability to insure their own fleets of vehicles.

At the end of 2012, 113 companies were thus subject to the Bank's supervision, or 8 fewer than at the beginning of the year.

The changes are due to mergers, the conversion of Belgian undertakings into branches under the law of other Member States, and the total termination of activities following the transfer of portfolios to run-off or the expiry of all the insurance liabilities.

During the year under review, some Belgian undertakings were converted into branches; conversely, one large European group centralised one of its business lines in Belgium by converting subsidiaries into branches of a Belgian company. Another group is also preparing to centralise one of its business lines in Belgium; in future, the Belgian subsidiary is to operate in other Member States via freedom to provide services.

TABLE 3 NUMBER OF UNDERTAKINGS SUBJECT TO THE BANK'S SUPERVISION

	01-01-2012	31-12-2012
Active insurance undertakings	93	87
Insurance undertakings in run off	10	9
Reinsurance undertakings	2	1
Other (1)	16	16
Total (2)	**121**	**113**

Source: NBB.
(1) Mutual guarantee associations and regional public transport undertakings.
(2) In addition, at the end of 2012 the Bank exercised prudential supervision over 9 branches governed by the law of another EEA Member State; that supervision was confined to verifying compliance with the law on money-laundering.

3.2 Specific points for attention

Colleges

The collaboration between supervisory authorities for cross-border groups is organised in colleges coordinated by the consolidating supervisory authority of a group (home-country authority), with the participation of the supervisory authorities of the group subsidiaries and branches (host-country authority).

Recurring items on the agenda of these colleges concern the examination and assessment of the financial position, organisation, strategy and risks to which the group and its components are exposed. Coordination arrangements were drawn up with agreements on collaboration and the exchange of information, both in "going concern" situations – e.g. for approval of an internal model – and in stress situations. The exchange of information between the supervisory authorities was streamlined via adoption of an internet application developed by the European Insurance and Occupational Pensions Authority (EIOPA).

A number of colleges were organised in 2012 to prepare for the introduction of Solvency II. They took the form of workshops, reviews, joint inspections and teleconferences. These colleges focused mainly on the procedure preceding approval of the use of internal models to determine the capital required (pre-application procedure). In 2012,

TABLE 4 COLLEGES IN WHICH THE BANK PARTICIPATES

	The Bank is the home-country authority	The Bank is the host-country authority
Complex groups	Ageas	AXA (AXA Belgium)
	KBC Assurances	
	Belfius Insurance	
	P&V	
Local undertakings	Intégrale	
International undertakings		Allianz (Allianz Belgium and Euler Hermes)
		Generali (Generali Belgium and Europe Assistance)
		Munich Re (ERGO Life, DAS and DKV)
		HDI (HDI Gerling)
		BNP Paribas (Cardif)
		Delta Lloyd / Aviva (Delta Lloyd Life)
		Bâloise (Mercator, Euromex, Audi, Nateus and Nateus Life)
		MetLife
		Nationale Suisse (Nationale Suisse Belgium and L'Européenne)
		ING (ING Life and ING Non-Life)
		Assurances du Crédit Mutuel (Partners)
		CIGNA (CIGNA Life and CIGNA Europe)

Source: NBB.

the colleges also embarked on the initial preparations for the appraisal of the institutions' Own Risk and Solvency Assessment (ORSA), a pillar II requirement of Solvency II.

Valuation of the technical provisions in non-life insurance

In non-life insurance, the technical provisions have sometimes been used to smooth the results of insurance activities, particularly to conceal losses. In practice, when faced with weak profitability, some insurance companies temporarily cut their allocations to the provisions to achieve a corresponding improvement in the profit and loss account. However, this smoothing did not generally affect the adequacy and very prudent character of the provisions. Moreover, that was confirmed by various qualitative impact studies conducted during the preparation of the Solvency II Directive.

However, in recent years, this practice has become more worrying: some companies repeatedly reduce the level of prudence in their technical provisions. The financial crisis is clearly one of the reasons for this behaviour, as it affects the financial income of insurance undertakings. Some undertakings also anticipated the method of calculating the technical provisions under Solvency II, but without necessarily adopting the other Solvency II rules on prudence as well. The prudential authorities therefore need to pay close attention to assessing the undertakings' provisioning policies. The development of new software for assessing claims provisions by actuarial methods is enabling both insurance companies and authorities to calculate increasingly accurately the best estimate of the provisions, and the percentile of the distribution of the ultimate claims burden to which the provision corresponds.

Model dossiers

The Bank expects companies exposed to significant risks or holding a significant market position to use a risk management model which satisfies the principles specified by circular CPA-2006-1-CPA. The risk models are assessed annually by the Bank. In that connection the Bank assesses any major changes which have taken place since the previous examination of the model, compliance with the model development plan as announced by the company, and the action which the latter has taken on recommendations and points for attention which the Bank formulated in the previous year.

The provision for interest rate risk, known as the flashing-light provision

Pursuant to Article 31, § 3, second section, of the Royal Decree of 14 November 2003 on life insurance activity, insurance undertakings must form an additional provision for contracts offering a guaranteed interest rate of more than 0.1 % above 80 % of the average interest rate on ten-year linear bonds over the past five years ("pivot" rate in circular CPA-2006-2-CPA). The additional provision, which forms part of the life insurance provision, is equal to the sum for all contracts of the positive difference between the contract's inventory provision, calculated by replacing the technical interest rate with the pivot rate, and the contract's inventory reserve according to the technical basis of the contract. This additional provision is calculated at 31 December in each year. It has to be built up gradually, at the rate of at least 10 % of the total additional provision each year. The same rules apply to occupational accident insurance.

Insurance companies wishing to be exempt from the obligation to form an additional provision must submit a dossier in accordance with circular CPA-2006-2-CPA each year before 1 October of the year for which they are seeking exemption. This dossier has to satisfy the Bank that the flows generated by the assets will be enough to cover the interest rate liabilities associated with the insurance liabilities.

For 2012, in its Communication NBB_2012_04 of 29 May 2012, the Bank had prescribed the use of a benchmark risk-free interest rate curve produced by EIOPA for discounting net cash flows. The results of the calculations based on the benchmark risk-free interest rate curve were a key element in the assessment of exemption applications. This was new information which marked a clear break with the past, since undertakings had been able in previous years to choose their own interest rate curve, so long as they used it systematically over the years.

In 2012, 23 companies applied to the Bank for exemption from forming an additional provision; two of them submitted dossiers for both their life insurance and their occupational accident insurance, making a total of 25 cases. Most companies seeking exemption obtained it for all or part of the requested segments, in some cases for less than 100 % depending on the quality of the model used.

Pre-application procedure for internal models

The future Solvency II prudential framework will enable companies to calculate the regulatory capital requirements on the basis of an internal model. In its current form, the Directive gives the prudential authority six months in which to assess the model and approve its use for regulatory purposes. Owing to fears of a heavy workload concentrated in a short period, it was agreed to allow undertakings the option of submitting their model to the prudential authority in advance, via a pre-application procedure, without the authority having to formally approve or reject the model at that stage. These dossiers must show that the undertaking has sufficient control over the modelled risks to produce reliable results.

Apart from its local aspects, the pre-application process also has an international dimension. The colleges of supervisors set up to coordinate the supervision activities incorporate the pre-application process when starting or continuing their work. In some cases, the college of supervisors meets in an *ad-hoc* configuration, and brief on-site inspections are conducted on specific subjects, such as market risks, portfolio replication and risk-modelling, particularly the risk of natural disasters.

At the Bank, work on pre-applications for internal models began in 2011 for undertakings which had submitted a dossier following the communication of 18 February 2011 concerning this procedure. In all, eleven dossiers were submitted to the Bank and four undertakings announced that they would submit a dossier later.

The Bank notes that companies have already made significant progress, but that there are still some major challenges to address. The findings set out in reports to the undertakings mainly concern the implementation plans, the methodology and the use of the internal models. The inspections already carried out have enabled the Bank to draw conclusions at various levels; in regard to risks, the conclusions concern both the risks covered and the problems specific to each type of risk, including the methodology applied and the parameters used. Thus, it has often been found that credit risk was inadequately covered, that the calculation of the market risk was approximate, that the mortality tables were not prospective, and that – in the case of catastrophe risk – the undertaking was using a non-transparent vendor model. Similarly, in regard to the general modelling principles, it is already possible to draw a number of conclusions. Thus, the chosen methodology often generates simplified models, the granularity is inadequate and data quality leaves something to be desired.

Inspection missions: on-site audit topics

The prudential supervision of insurance and reinsurance companies includes conducting on-site inspections in undertakings. Those inspections are conducted by a team of inspectors separate from the teams in charge of the continuous off-site monitoring of the undertakings' prudential situation.

Forming part of a risk-based supervision approach, the inspection and supervision teams help to ensure that companies abide by the business operating conditions and, in particular, that there are no serious defects in their organisation, internal control and risk management systems.

The inspection follows an annual plan. This plan, drawn up in consultation with the supervision teams, is an integral part of the overall annual action plan of the service responsible for the prudential supervision of insurance and reinsurance companies.

The inspection missions lead to written reports detailing the purpose of the mission, the type of checks carried out, the findings and the risks detected, and setting out the resulting recommendations. At the end of the inspection process these reports are notified to the undertaking concerned. The latter is asked to comment and to state the measures that it intends to adopt in order to implement the recommendations, and the proposed timescale for doing so.

The 2012 inspection plan comprised a set of missions concerning around twenty insurance undertakings. The main purpose of those missions was to assess:

– the rules and principles applied in regard to governance and management structure;
– the risk management systems and the transverse supervision functions;
– the adequacy of the technical provisions calculated according to Solvency I;
– progress in preparing for the requirements under Solvency II, particularly the adoption of the best estimate to calculate the technical reserves and the modelling of the solvency requirements with a view to calculating the capital requirements under the future solvency rules.

Some missions were also intended to verify adherence to the measures announced by the companies following previous missions, while others aimed to compare the management practices of various undertakings for certain specific classes of activity.

4. Specific operational functions

4.1 Prudential IT supervision

Special meetings of colleges of supervisors of large international groups for which the Bank is home-country supervisor were held for the first time in 2012 on IT subjects. The IT supervisor experts of the main supervisory authorities of the foreign host country meet under the direction of the centre of expertise for prudential IT supervision.

Supervision of the continuity and reliability of IT services and the security of internal IT platforms remained central concerns. In 2012, as in previous years, particular attention was paid to the impact on IT of major reorganisations in banking groups, often a direct or indirect consequence of the financial crisis. After two years without detection of any fraud in Belgium, the resurgence of e-banking fraud in mid-2011 put the spotlight on supervision of the security of the e-banking services of Belgian financial institutions in 2012. In that respect, the Bank works closely with, *inter alia*, the Belgian financial sector association (Febelfin) and the federal police's Computer Crime Unit, in order to combat or minimise fraud. As in previous years, the security of Belgium's e-banking services generally ranks as excellent in international terms. However, vigilance is still required in view of the inventiveness of criminals, who are constantly developing and applying new fraud techniques.

The centre of expertise also plays a leading role in the ECB working group on the security of on-line payments, which reports to the ECB's European forum on retail payment security (SecurePay). This working group concentrated mainly on analysing the various threats associated with these operations and defining good security practices.

4.2 Supervision of models and quantitative methods

In 2012, the Bank's "quantitative methods" centre of expertise, which analyses risk management and measurement models, focused mainly on preparing the ground for entry into force of the Solvency II rules, which will permit the use of internal models to determine the level of regulatory capital requirements for insurance undertakings. In this context, a comparative analysis of the various institutions' practices was conducted in order to promote good practices in the sector. International collaboration, via college missions with foreign supervisory authorities and via consultation in working groups, aims to ensure a level playing field in Europe.

In the banking sphere, 2012 featured the analysis of a number of dossiers on internal models for credit risk, market risk and operational risk. The analysis approach was refined. Thus, for all application dossiers, the impact of the new models concerning the capital requirements was analysed, comparisons were made with similar models used by other institutions, sensitivity analyses were conducted jointly with the institutions, and the assumptions underlying the models were examined in workshops. These various stages result in a list of the prioritised terms and conditions for the validation of these internal models and in a clearer definition of the supervisory authorities' expectations.

5. Oversight and prudential supervision of financial market infrastructures

5.1 Overview

Since April 2011, the Bank has been responsible not only for the oversight but also for the prudential supervision of financial market infrastructures. On 18 October 2012, the Bank and the FSMA signed a memorandum clarifying the exchange of information and cooperation between the two institutions in connection with the supervision of securities settlement systems and central counterparties. That cooperation aims to prevent gaps and duplication, and to avoid any unnecessary burden on market infrastructures. In its assessment of the market infrastructures based on international standards, the Bank will consult the FSMA on aspects for which the latter is responsible. In the event of a crisis affecting a market infrastructure, there will be consultation.

The rules applicable to financial market infrastructures were amended during the year under review. In April, the Committee on Payment and Settlement Systems (CPSS)

TABLE 5 FINANCIAL MARKET INFRASTRUCTURES SUBJECT TO THE BANK'S SUPERVISION AND OVERSIGHT

	International college of supervisors / cooperative oversight agreement		The Bank acts as the sole authority
	The Bank acts as the principal authority	The Bank participates under the direction of another principal authority	
Prudential supervision			Belgian branch of BNYM
			Payment and electronic money institutions (18)
Prudential supervision and oversight	Euroclear Belgium (CIK) (ESES)	LCH.Clearnet SA/NV	Euroclear Bank [2]
	Euroclear SA/NV		Atos Worldline [3]
	Bank of New York Mellon SA/NV (BNYM) [1]		BNYM DCT
Oversight	SWIFT [4]	TARGET2 Securities (T2S) [3]	NBB-SSS
		TARGET2 (T2) [3]	Bancontact/Mister Cash [3]
		CLS	CEC [3]
			MasterCard Europe [3]

Source: NBB.
(1) BNYM SA/NV is the European headquarters of the BNYM group. The Bank is the principal authority in the college of European supervisors.
(2) The Bank works on an *ad-hoc* basis with other central banks concerned.
(3) Peer review in the Eurosystem/ESCB.
(4) Society for Worldwide Interbank Financial Telecommunication.

and IOSCO published their Principles for financial market infrastructures, which group together and reinforce the standards applicable worldwide to post-trade market infrastructures. As the Bank stated in its circular dated 20 July 2012, the CPSS and IOSCO Principles for financial market infrastructures will form the reference framework for the prudential supervision and oversight of settlement institutions. At European level, Regulation No 648/2012 of 4 July 2012 on OTC derivatives, central counterparties and trade repositories entered into force in August. The European Union is also continuing its work on the development of European legislation on central securities depositories (CSDs).

The influence of the changes to the regulatory framework and the European TARGET2 Securities (T2S) project on the business models of market infrastructures was examined. In regard to liquidity, intra-day management is still relevant, as is consideration of the risk of possible default by an infrastructure participant.

5.2 Oversight

SWIFT

The Bank acts as lead overseer of SWIFT. Central banks make SWIFT subject to oversight because this entity is crucial to the security and efficiency of the financial messages exchanged between financial institutions and financial market infrastructures throughout the world.

The SWIFT overseers recently decided to extend the number of countries concerned in this oversight. Since May 2012, apart from the G10 central banks, the senior representatives of twelve other central banks have also formed part of the SWIFT Oversight Forum, which discusses SWIFT oversight policies and oversight conclusions.

The oversight activities concern all types of operating risk that may affect the SWIFT messaging services. Special points for attention include the identification and control of operating risks, cyber-defence, operational security and operational continuity. In 2012, the SWIFT overseers also monitored some major on-going projects and, in particular, the project for the technological renovation of the FIN application, which forms the basis of the SWIFT messaging services.

Oversight of card payment schemes and retail payment systems

The banks which own the Bancontact/MisterCash debit card scheme have for some years been seeking to replace it with another scheme conforming to SEPA (Single Euro Payments Area) standards. In 2011, that position was reviewed. Bancontact/MisterCash will be retained after all. As the scheme's overseer, the Bank has monitored these developments. In particular, it recommended the establishment of a guarantee system to protect the scheme against the possible default of one of its members, in conformity with the harmonised standards of the European System of Central Banks (ESCB) applicable to card payment schemes.

At the end of 2012, as the lead overseer of MasterCard Europe (MCE), the Bank ended the coordination of the cooperative assessment of MCE's conformity with the standards laid down by the Eurosystem in 2008.

The Centre for Exchange and Clearing (CEC), which is the Belgian automated clearing centre for the exchange and clearing of retail payments between banks active in Belgium, is to migrate to the French technical platform, STET, at the beginning of 2013, in order to conform to the SEPA standards. However, the CEC will remain a Belgian system separate from its French counterpart. In 2012, the oversight focused on the preparations for that migration. In conjunction with the change of platform, the CEC is also to increase the frequency of the clearing cycles in accordance with the recommendations of the Bank's oversight concerning financial risk management.

The Bank also took part in the work of the European Forum on the Security of Retail Payments which, under the aegis of the Eurosystem and the ESCB, brings together representatives of the authorities in charge of oversight and prudential supervision. Publication of reports on the security of payment services offered via the internet and on access to payment accounts by certain players is scheduled for the beginning of 2013.

Oversight of securities settlement systems

The Bank acts as the overseer of securities settlement systems in respect of three Euroclear group entities: Euroclear SA/NV (ESA), Euroclear Bank (EB) and Euroclear Belgium. The Bank is also the overseer of its own NBB-SSS (Securities Settlement System).

ESA is the Euroclear group's parent company. It owns the securities processing platforms and offers common services for the group's (international) central securities depositaries – (I) CSDs. An international cooperation agreement – last amended in December 2011 – governs multilateral cooperation concerning the supervision of the common services which ESA provides for the group's CSDs. The Bank acts as the coordinator of ESA oversight. In this connection, the ESA policy on human resources has been examined. Apart from the usual monitoring of the operational stability of settlement platforms, the policy on management of the IT infrastructure and measures to protect against cyber crime were also analysed. Finally, an examination was launched on the recovery or resolution procedures planned in the event of default by a group entity.

As the lead overseer of Euroclear Bank (EB), the Bank assessed the EB settlement system in the light of the new CPSS and IOSCO Principles for financial market infrastructures. Since EB is a critical international institution at systemic level, the IMF included EB in its FSAP for pan-European payment and securities settlement systems, which began in the final quarter of 2012.

Euroclear Belgium mainly holds Belgian securities. It settles its operations jointly with Euroclear Nederland and Euroclear France on the unified ESES settlement platform used by these three CSDs. The Bank monitored the ESES CSD decision to join the T2S project and the development by Euroclear Belgium of services for issuers. It also paid attention to the situation regarding settlement efficiency.

Finally, the Bank monitored the implementation by the NBB-SSS operator of the recommendations made at the time of the last assessment of that system in the light of the ESCB and CESR standards for securities settlement systems.

5.3 Prudential supervision of institutions operating financial market infrastructures

Market infrastructures are still generally subject to pressure from three conflicting sources. First, the regulators, recognising the stabilising role that market infrastructures can play in systemic risk control, are inclined to extend the role of those infrastructures while raising the requirements imposed on them in order to ensure their resilience. Also, the participants in these infrastructures, who are subject to profitability constraints and/or recapitalisation requirements, oblige these infrastructures to reduce the transaction costs and thus to implement radical restructuring programmes. Finally, these two demands have to be met in market conditions where the maintenance of total issuance and transaction volumes cannot be taken for granted.

These various pressures and the regulatory initiatives now in preparation are leading to fundamental restructuring of the architecture and positioning of the players; that process has now begun and will have an impact over a number of years. In this connection, two important initiatives for systemic market infrastructures operating from Belgium merit particular mention in 2012. This concerns the creation by EB of an operational branch based in Poland, and the plans for creation of a CSD by the Bank of New York Mellon group.

These projects are being monitored by the prudential authorities, which not only have to give their approval but must also supervise the impact on the risk profile of the infrastructures concerned, particularly via the ICAAP-SREP (Internal Capital Adequacy Assessment Process – Supervisory Review and Evaluation Process).