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 macroprudential 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).