Savings and financing the Belgian economy

4. Savings and financing the Belgian economy

4.1 Financing conditions support transactions by non-financial corporations

Belgian businesses expanded their assets again in 2016

The year 2016 saw Belgium's corporations draw on enhanced profitability and lower funding costs to boost production capacity, and their fixed capital investment remained particularly high in the first nine months of the year. This worked out at € 41.6 billion after already touching high levels in 2015. Meanwhile, some corporations went down the mergers and acquisitions route to grow their activities, in some cases also by taking stakes in the assets of non-resident corporations. Cross-border transactions have bolstered outward direct investment since 2015: recent developments are the subject of box 4. SABMiller's acquisition by AB InBev involved exceptionally high amounts in 2016,

TABLE 10 NET TRANSACTIONS BY NON-FINANCIAL CORPORATIONS
(consolidated data, in € billion)

	2011	2012	2013	2014	2015	First nine months 2015	First nine months 2016
Non-financial assets	56.3	54.4	53.3	58.4	59.5	45.2	41.5
Gross fixed capital formation	50.9	52.5	52.7	55.9	57.8	41.3	41.6
Other non-financial assets [1]	5.5	1.9	0.5	2.4	1.7	3.9	–0.1
Financial assets	111.5	63.3	0.9	42.9	18.1	24.8	47.7
Currency and deposits	1.4	–8.8	5.9	–7.5	–1.5	1.8	11.0
Intra-group assets [2]	102.9	67.4	–0.8	57.4	18.9	22.9	–4.4
Other	7.2	4.6	–4.3	–7.1	0.7	0.1	41.0
Financial liabilities	114.1	52.3	1.0	45.9	24.7	28.7	28.7
Bank loans	3.7	–1.7	5.7	–2.7	0.2	1.1	2.1
Debt securities	3.2	6.3	5.6	4.8	5.4	2.9	12.9
Intra-group liabilities [2]	92.3	38.4	–6.3	34.5	17.8	23.8	20.0
Other	15.0	9.3	–4.0	9.2	1.3	0.9	–6.3
p.m. Gross operating surplus	*86.4*	*85.2*	*85.8*	*88.9*	*94.8*	*72.2*	*76.4*

Sources: NAI, NBB.
(1) Comprise changes in inventories and purchases of non-financial, non-manufactured assets.
(2) Transactions with foreign non-banking sector, as well as captive financial institutions and money lenders, excluding those involving debt securities.

making up the bulk of the € 47.7 billion in new financial assets acquired by non-financial corporations in the first nine months [1].

Investment by non-financial corporations in 2016 was bolstered by internal resources released through earnings growth. The gross operating surplus they generated in the first nine months of the year actually rose from € 72.2 billion in 2015 to € 76.4 billion in 2016. Some corporations did not spend all their surplus on gross fixed capital formation or direct investment and put it towards further strengthening their cash reserves. All in all, Belgium's non-financial corporations amassed € 11 billion in cash or bank deposits in the first nine months of 2016. By the end of the third quarter, these reserves had grown to 25.2 % of GDP, compared with 24.2 % a year earlier. Their healthier cash positions may point to something of a wait-and-see attitude on the part of corporations, not being able to identify investment opportunities or sufficiently assured return prospects in the current climate. At the same time, their cash reserves serve as a guarantee for the future in the sense that these should enable corporations to at least partly finance future projects, while greasing the wheels of corporate operations by boosting working capital.

(1) The acquisition had not been completed by the end of the third quarter of 2016 and the earmarked financial resources were largely kept in liquid assets. The financial accounts do not therefore include the transaction as a stake in foreign companies.

Box 4 – Mergers and acquisitions : multinational corporations and the Belgian economy

With cheap funding and ample cash at their disposal, some corporations have hit the acquisition trail and M&A activity has been rising across the world, after slumping in the aftermath of the financial crisis. Cross-border transactions are included in statistics on foreign direct investment (FDI) and reflect the increasing weight of multinational corporations.

Across the world, the annual ratio of direct investment to GDP reached its highest level since the onset of the financial crisis in 2008, on the back of higher numbers of cross-border mergers and acquisitions among other factors. Manufacturing industry, in particular, experienced a wave of consolidation in 2015 that appears to have continued into 2016, even if the outcome of the Brexit vote and the US presidential elections later in the year may put the brakes on international investment. Direct investment in the shape of stakes in corporations' equity capital suggests that, in Belgium too, mergers and acquisitions were relatively plentiful from 2015, particularly those effected by Belgian corporations abroad. No statistics are available for 2016 just yet, but these are bound to be highly influenced by the acquisition of SABMiller by AB InBev.

Against this backdrop, this box will examine the degree of internationalisation of Belgium's corporations as well as the consequences of this for the wider Belgian economy. It will cover both financial aspects – the economy's net income from inward and outward FDI – and real consequences, e.g. multinationals' contributions to value added, capital spending and employment.

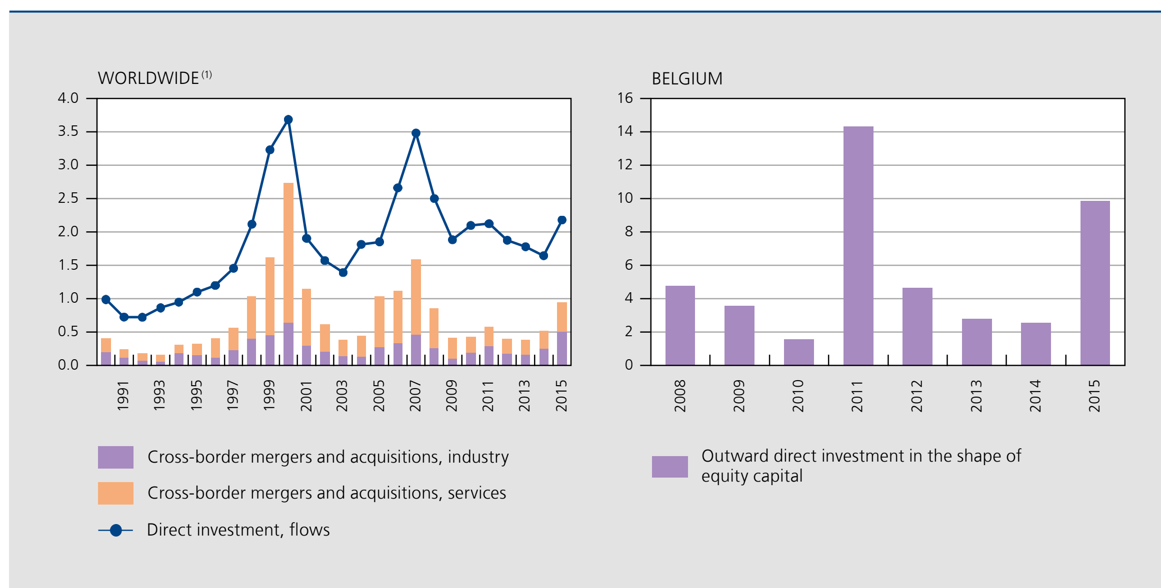
FDI inflows and outflows corroborate Belgium's position as an open economy. Outstanding volumes of incoming and outgoing FDI as a ratio of GDP – at 215 % and 213 % of GDP by end-2015 respectively – are much higher than the averages recorded by euro area countries (132 % and 156 % of GDP). However, a large proportion involves capital in transit and reflects policies to attract FDI, in particular fiscal incentives such as the notional interest deduction [1].

Belgium receives more direct investment than it sends abroad. Its net outward investment position worked out at a negative –2 % of GDP by the end of 2015 – atypical for a developed economy with sizeable total net external assets, as is clear from positive net direct investment outflows in Belgium's neighbouring countries.

(1) For more information, see Duprez C. and Ch. Van Nieuwenhuyze (2016), "Belgium's inward and outward foreign direct investment", NBB, *Economic Review*, September, pp. 45-63.

GREATER MERGERS AND ACQUISITIONS ACTIVITY SUPPORTS DIRECT INVESTMENT

(in % of GDP, year-on-year flows)



Sources: UNCTAD, NBB.
(1) Average of inward and outward capital flows.

Unlike its neighbours, Belgium is currently losing income from its direct investment relationships abroad (–1.9 % of GDP in 2015), weighing down its current account. This unfavourable financial performance is the net outcome of both a negative net outward direct investment position and relatively low returns on Belgium's direct investment abroad. FDI returns reflect a whole host of factors, including currency fluctuations, economic growth in foreign markets and taxation. Compared with its neighbouring countries, Belgium's outward FDI reflects an under-representation of markets outside the euro area while the actual investment masks a large proportion of intra-group lending aimed at tax optimisation under the notional interest deduction scheme and relatively few equity stakes of the sort that are common in mergers and acquisitions.

FOREIGN DIRECT INVESTMENT AND RETURNS

(in % of GDP, 2015, unless otherwise stated)

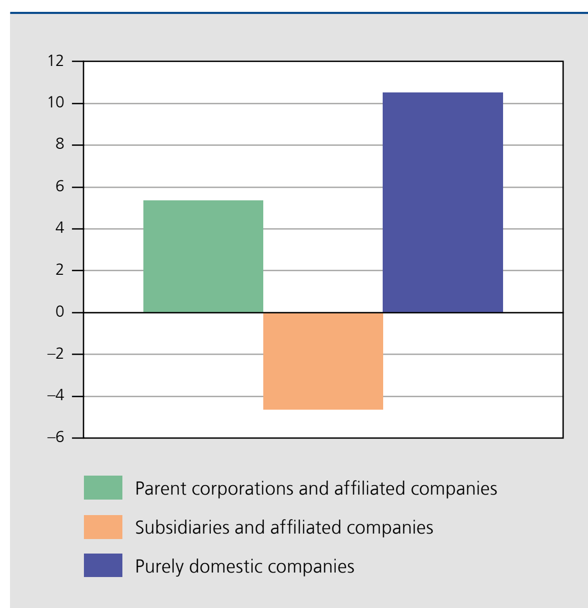
	Belgium	Germany	France	Netherlands
Net outward direct investment (outstanding amounts)	–2.0	17.8	22.7	100.6
Income from net direct investment	–1.9	1.3	1.9	3.6
Return on outward direct investment (in %, 2013-2015 averages)	2.5	5.0	4.9	4.6

Sources: ECB, NBB.

Multinational corporations – both parent companies and subsidiaries – make a large contribution to economic activity in Belgium. Although relatively few in number (1 % of the total number of private sector companies in 2014), they account for a substantial proportion of value added (38 %). However, they have a smaller number of employees (29 %) and therefore record higher-than-average productivity. They also play a significant part in Belgium's external competitiveness as they are major contributors to the country's net exports (1.3 percentage points of GDP in 2014). Lastly, multinationals enhance growth potential: between 2008 and 2014, they accounted for 33 % of real private sector investment and for no less than 63 % of the R&D spend.

EMPLOYMENT: MULTINATIONALS VS DOMESTIC COMPANIES (1)

(in %, changes between 2008 and 2014)



Source: NBB.

(1) This analysis only includes corporations with paid employees that did not change their status in the period, i.e. from domestic to multinational or vice versa.

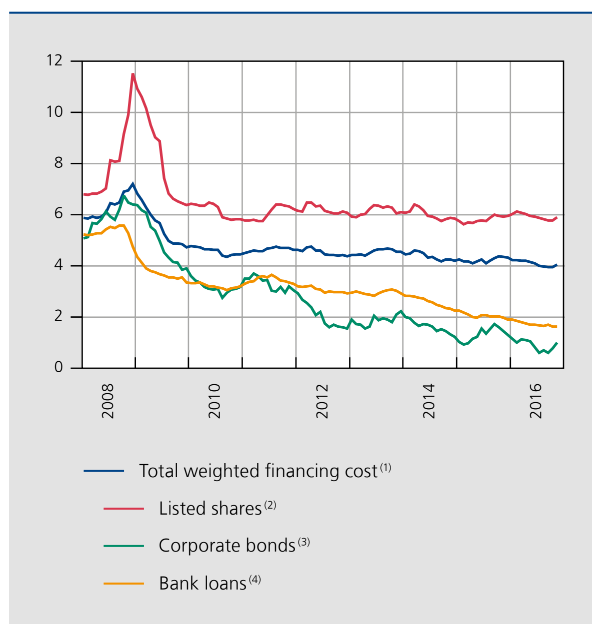
The multinational presence did not bring only advantages: in the 2008-14 period, employment in subsidiaries of foreign groups proved less stable than at Belgian parent corporations. Although admittedly an unusual time – i.e. the aftermath of the financial crisis with some corporations facing sudden excess capacity – making it hard to draw any general conclusions, a series of restructuring plans announced by key multinationals in 2016 would appear to confirm these observations.

Companies increasingly tapped non-bank financing resources in 2016

Despite growing cash reserves, a few corporations still rely on sources of external funding to shape their investment projects, particularly large-scale ones. AB InBev was a case in point in 2016 : its takeover of SABMiller was part-financed through a bond issue. In fact, this accounted for the largest proportion of the € 12.9 billion in new net liabilities recorded by non-financial corporations in the first nine months of 2016. Although exceptional in terms of the actual amounts involved, the bond issue is a close match to similar operations carried out by firms since 2012. From that year, significant falls in long-term returns made this resource even cheaper for companies able to tap the bond market.

In the first nine months of 2016, non-financial corporations also enjoyed intra-group funding to the tune of € 20 billion, which they either received from affiliated entities established abroad or from financial holding companies or treasury companies in Belgium itself[1]. Once again, SABMiller's acquisition by AB InBev accounts for much of the size of the resources tapped via this channel in 2016. The rest of these transactions capture financial services provided by some Belgium-based corporations within their own groups. This type of activity has become very popular since Belgium introduced tax allowances for risk capital in 2005, sparking a significant inflow of foreign direct investment, more specifically in the shape of investment in equity capital. But this tax break has gradually become less attractive since 2012, mostly because of lower yields on ten-year linear bonds known as OLOs. These serve as the reference rate for calculating notional interest that Belgium-based companies can offset against corporation tax.

CHART 45 FUNDING VIA BOND ISSUANCE STILL CHEAPEST
(monthly data, in %)



Sources : Barclays Capital, Thomson Reuters Datastream, NBB.
(1) Obtained by weighting the cost of funding by listed share issuance, bond issues and bank loans according to their respective shares in the total outstanding amount of these financial liabilities.
(2) Estimated on the basis of a dividend discount model (see box 19 in the 2005 Annual Report).
(3) Return on an index of euro-denominated bonds issued by Belgian non-financial corporations, with maturities of more than one year and with ratings in excess of Baa : the index is weighted to reflect the outstanding amounts.
(4) Weighted average rate applied by resident banks to business loans. The weighting is based on the outstanding amount of the various types of credit.

Bank lending grows on loan demand from SMEs and increasingly favourable loan conditions

Having less access to market funding or resources provided by affiliated companies, SMEs turned to banks for funds more keenly than they had in the recent past. Lending to SMEs by resident banks between the fourth quarter of 2015 and the third quarter of 2016 rose by an average 3.6 % on an annual basis. Loans to large corporations were also up, albeit to a lesser degree, notching up an average rise of 1.7 % in the same period. Credit provided to all categories of Belgian companies together showed robust growth in 2016 : an annualised 5.5 % in the month of November compared with 2.4 % at the end of 2015. Ignoring the specific effect of the AB InBev transactions at the end of the year, loan growth was still supported by growing demand – although less intense than in 2015, according to the banks – and by favourable loan conditions. The bank lending survey (BLS) revealed a demand for credit supported by inventories and working capital, mergers and acquisitions and restructuring. Fixed capital investment was another driver in 2016, but less than in 2015.

The highly accommodating policies of the Eurosystem have made money market funding very cheap indeed for euro area banks. They also had access to the expanded asset purchase programme (APP) and the targeted longer-term financing operations (TLTROs) to boost their lending capacity, and at very attractive lending rates too. In Belgium, these measures brought on downward revisions of credit risk and intensified competition between banks, translating into a fresh narrowing of commercial margins on standard loans and to

(1) In Belgium's financial accounts, holdings and treasury companies are included in the "captive financial institutions and money lenders" sector.

TABLE 11 LENDING BY RESIDENT BANKS TO NON-FINANCIAL CORPORATIONS: GROWTH BY COMPANY SIZE

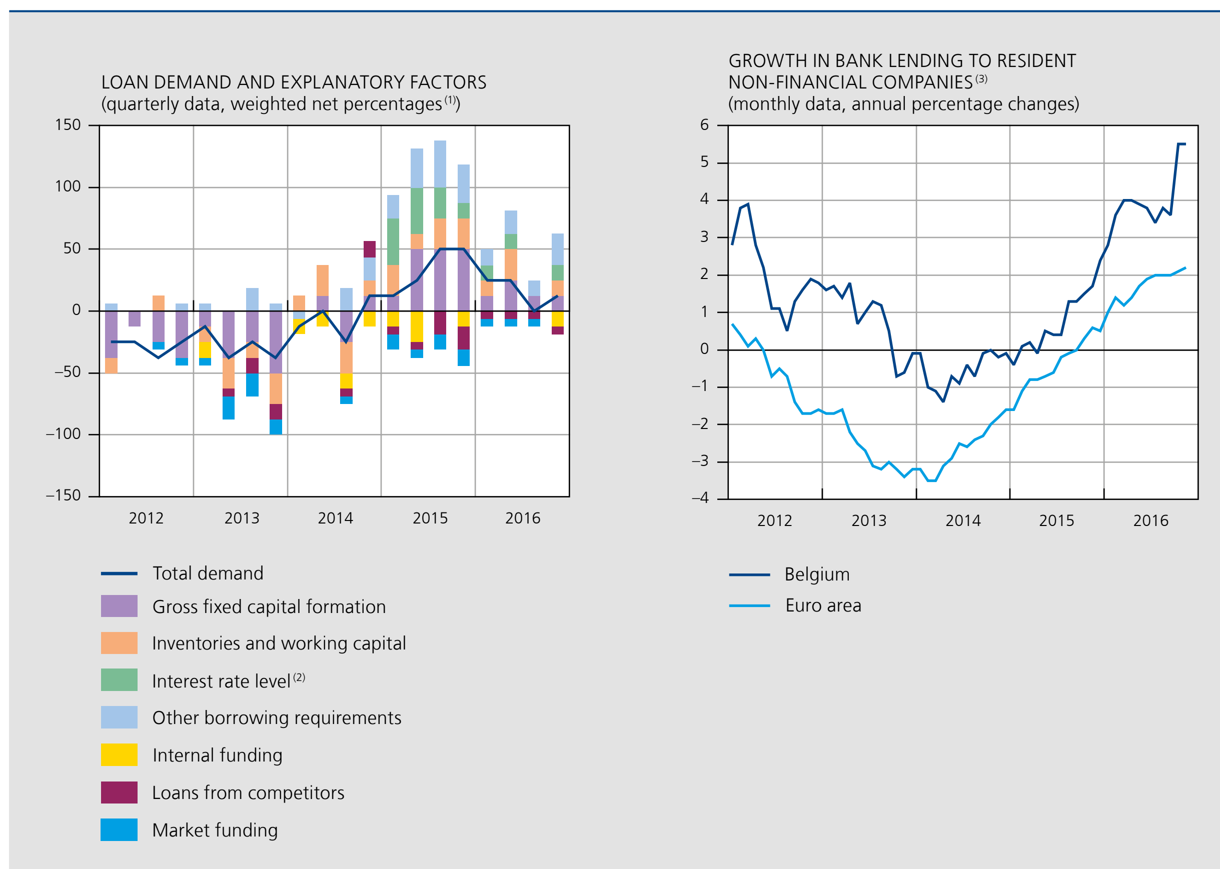
(average annualised gowth rates[1], in %)

	2005Q1-2016Q3	2005Q1-2008Q4	2009Q1-2016Q3	2015Q4-2016Q3
SMEs	5.1	9.1	2.9	3.6
Small businesses	4.9	9.3	2.6	3.8
Medium-sized businesses	5.4	8.8	3.6	3.3
Large corporations	2.2	10.9	−2.4	1.7

Source: NBB (Central Corporate Credit Register).
(1) Annualised average of quarterly growth. Not included are the second quarter of 2012 and the fourth quarter of 2014, which saw a break in the statistical series.

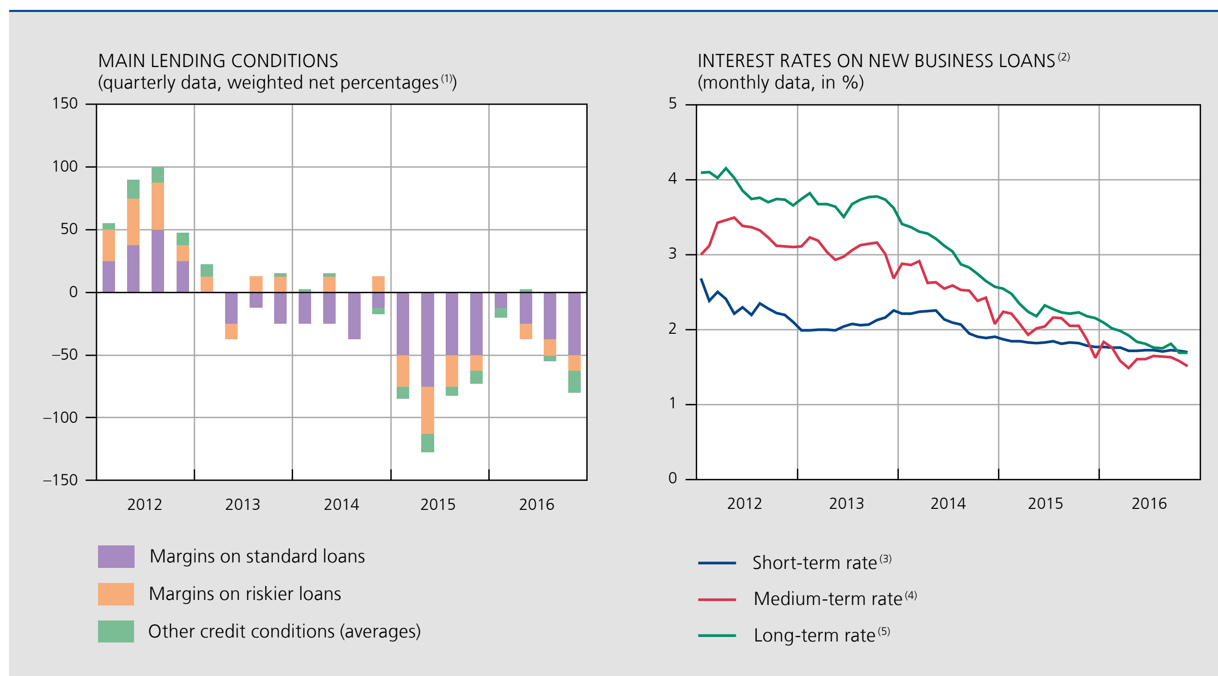
a lesser degree also on riskier loans. Long-term interest rates on loans to resident non-financial corporations eventually plumbed historical lows in 2016, similar to short-term rates, while Belgian banks also eased some other loan conditions unrelated to interest rates, such as restrictions on volumes and terms of loans and/or other covenants specified in loan arrangements with companies.

CHART 46 SIGNIFICANT INCREASE IN BANK LENDING, DESPITE SLOWING DEMAND GROWTH



Sources: ECB, NBB.
(1) A positive (negative) net percentage corresponds to a factor contributing to borrowing demand going up (down).
(2) A factor first included in the survey from the first quarter of 2015.
(3) Resident bank lending only (including securitised loans).

CHART 47 EVEN BETTER LOAN CONDITIONS



Source: NBB (BLS and MIR survey).
(1) A positive (negative) percentage corresponds to a tightening (easing) of loan conditions.
(2) Loans of up to € 1 million.
(3) Variable rates, initially fixed for up to one year.
(4) Rate initially fixed at between one and five years.
(5) Rate initially fixed for more than five years.

Non-financial corporations' debt ratio remains high, but funding structure is robust

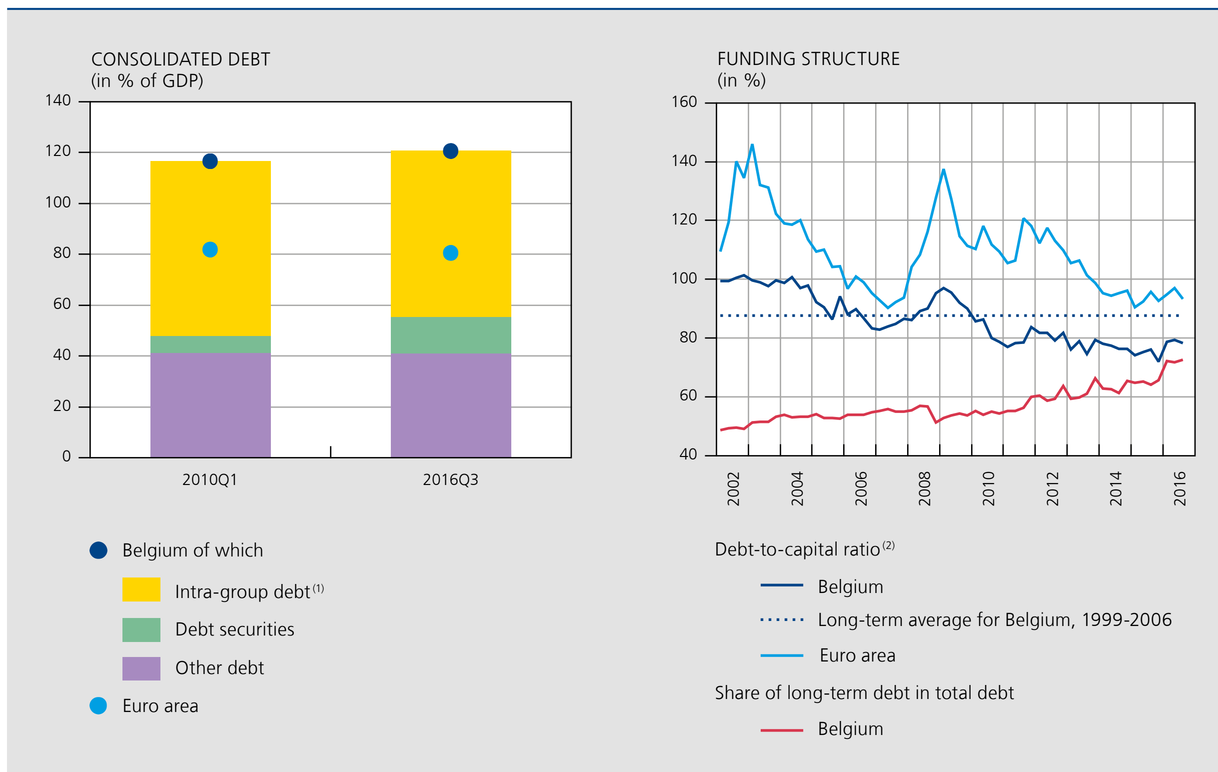
Non-financial corporations' consolidated gross debt ratios rose to 120.6 % of GDP in September 2016 from 116.1 % at the end of 2015, an increase wholly attributable to AB InBev's financial transactions as it turned to debt financing to prepare for its takeover of SABMiller. Disregarding these latter transactions, debt ratios would in fact have fallen slightly.

Belgian non-financial corporations' levels of debt remained high (80.5 % of GDP) when compared with euro area corporations, but it should be remembered that debts at non-financial corporations in Belgium largely reflect intra-group funding. Rather than meeting a real funding need, such finance is often more of a redistribution of resources across a group, possibly for tax reasons, and a liability that comes with an equal claim on a group entity. If this type of funding is excluded, non-financial corporations' debt ratios in Belgium worked out at 55.3 % of GDP.

In the euro area at large, non-financial corporations' debt ratios peaked in 2010, but Belgium has seen a continued slight rise on the back of recovering bank lending (part of other debt) and debt securities issuance (corporate bonds). This latter category rose to a record 15 % of GDP at the beginning of 2016, compared with 7.1 % in early 2010. Although influenced on the upside by AB InBev's transactions in 2016, bond markets have been increasingly tapped in recent years, with the low interest rate environment playing a major part.

Belgian non-financial corporations' relatively high – and rising – debt ratios do not spell immediate danger to debt sustainability, as is clear from their relatively healthy funding structure. For one thing, the debt-to-capital ratio is relatively low, both compared with its own long-term average and compared with euro area corporations. That said, the ongoing fall in this ratio – supported by the notional interest deduction since 2006 – would appear to have run its course. From 2012 on, this has been partly attributable to this notional interest deduction scheme constituting less of a tax advantage. Secondly, corporations are increasingly attracting long-term finance to limit refinancing risk, and the proportion of long-term debt – i.e. over one year – rose to a high of 72.2 % of consolidated debt in

CHART 48 HIGH CORPORATE DEBT LEVELS, BUT RELATIVELY ROBUST FUNDING STRUCTURE



Sources: ECB, NBB.
(1) Loans provided by foreign non-banking corporations, captive financial institutions and money lenders.
(2) Non-consolidated data.

the third quarter of 2016. This coincided with greater uptake of non-bank financing resources, i.e. corporate bonds that typically have longer maturities. Lastly, despite higher debt levels and longer terms to maturity, interest rate charges (interest payments as a percentage of gross operating surplus) continued to decline further thanks both to accommodating monetary policies and the higher operating surplus.

4.2 Positive and negative effects of the low interest rate environment on households' assets and liabilities

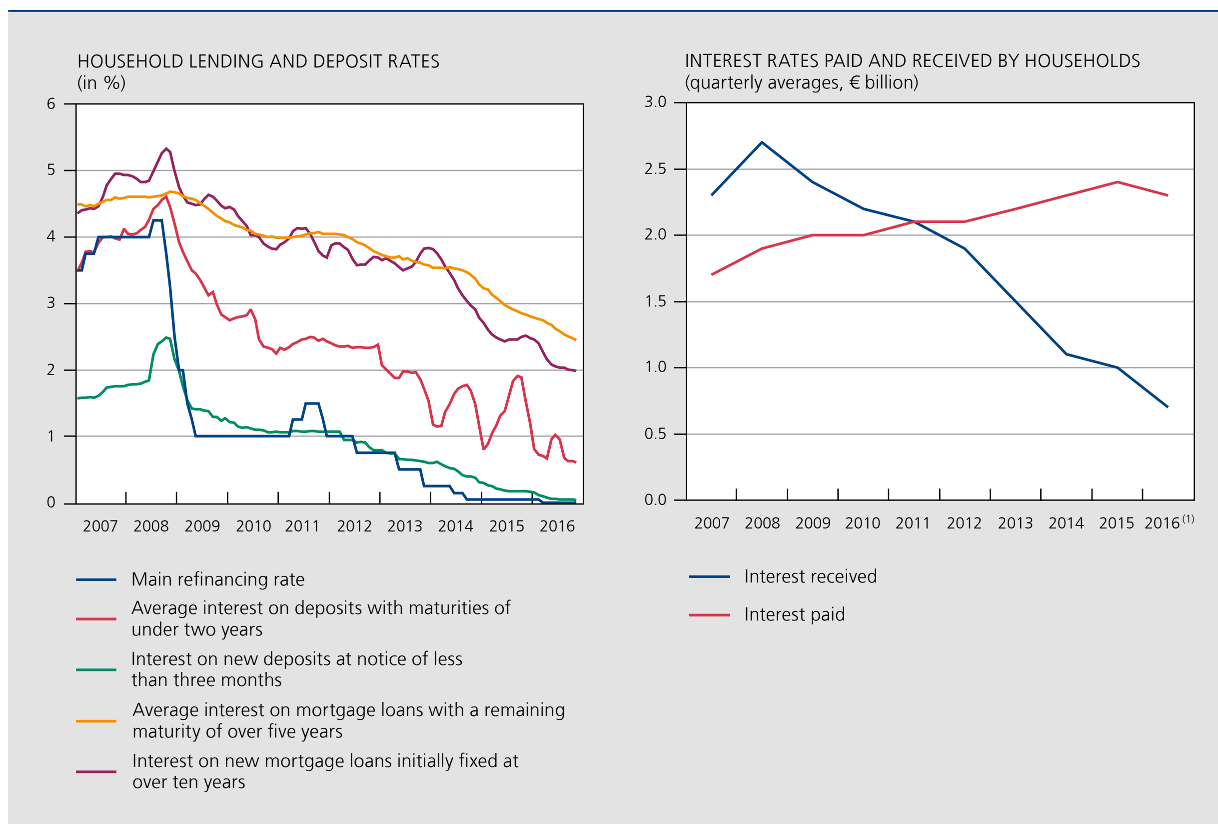
Sharply lower money market rates since 2009 – a result of the ECB's highly accommodating monetary policies – have been largely passed on to financial institutions' customers and clients, particularly households, in the shape of retail rates on both deposits and loans. While transmission was only partial until 2013, it became much fuller from 2014 and banks' commercial margins have stabilised since. In addition to retail rates, monetary policy also affected other types of interest-bearing assets, such as government and corporate bonds.

Lower returns on households' interest-bearing assets – the bulk of their savings – inevitably suffered from the drop in income from financial assets invested in these types of instruments. Interest received in the first nine months of 2016 again contracted to average € 0.7 billion a quarter, compared with € 1 billion in 2015. In 2009, when interest rates were higher, these quarterly averages still came in at € 2.4 billion.

For private individuals and their financial situations there is some good to be had from the low interest rate environment as well, as they attract fresh liabilities at lower interest rates. Existing loans may also benefit if they have variable interest rates or are up for refinancing. However, a significant increase in liabilities has somewhat weakened the perceptible effect on interest paid by households.

Lower interest rates also have an impact on asset prices. Between 2009 and 2016, households enjoyed

CHART 49 LOW INTEREST RATE ENVIRONMENT’S IMPACT ON INTEREST PAID AND RECEIVED



Source: NBB.
(1) Averages for the first three quarters.

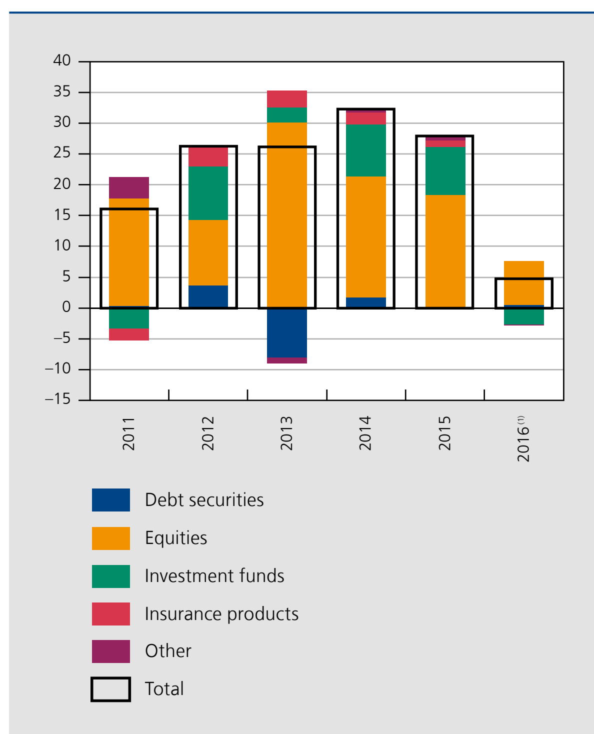
favourable valuation effects on their financial wealth in keeping with generally positive developments in the financial markets, cushioning the repercussions of lower interest income. Gains were mostly locked in on equity portfolios and investment funds in the period. In 2016, by contrast, volatile financial markets made for rather less substantial valuation effects : whereas equity prices had notched up increases of a total € 7.1 billion in the first three quarters of 2016, the overall portfolio of investment funds as held by households faced negative valuation effects to the tune of € 2.6 billion. Overall, though, losses incurred in the financial markets – caused by the interest rate hike by the US Federal Reserve, weaker economic activity in China and the referendum in the United Kingdom – were short-lived and limited in size.

Households’ interest earnings may have contracted since the onset of the financial crisis, but their financial wealth has generally continued its uninterrupted upward trajectory. Portfolios have grown on the back of asset revaluations (€ 174 billion) and fresh investment (€ 203 billion). Nominal house prices have more than doubled since 2000 and house price falls during the great recession were very minor both in size and duration when compared with quite a few euro area countries. Property price increases consistently slowed between 2011 and 2014 but picked up sharply in 2015, notwithstanding property tax reforms, in the Flemish Region in particular. In 2016, the year-on-year growth rate of property prices slowed significantly, amounting to barely 0.7 % in the first three quarters. In real terms, property prices declined by 0.9 %.

Deviations in house prices from their equilibrium value – as determined by econometric models factoring in fundamental determinants such as households’ disposable income, mortgage rates and demographic pressures – were estimated at 6 % in 2016. This is less than in 2015, when market overvaluation was sharply up, to 10.9 % in the fourth quarter, particularly as mortgage interest relief reforms in the Flemish Region did not cause any negative pressure on growth in property prices.

CHART 50 POSITIVE VALUATION EFFECTS OF HOUSEHOLD FINANCIAL ASSETS

(in € billion : annual data, unless otherwise stated)



Source : NBB.
(1) First nine months.

Activity in the residential property market was strongly affected by devolution to the regions as well as by tax relief reforms for mortgage loans that came into effect on 1 January 2015. This was particularly true in the Flemish Region, which had seen secondary market transactions rocket in the last quarter of 2014 and then veer sharply down the year after. In 2016, property activity perked back up and ended up closer to its usual levels. The total number of property transactions in Belgium grew 11.3 % in the first three quarters of the reporting year.

As the box below outlines, the actual mix of both negative and positive effects of low interest rates on household income and financial assets is rather complex. It depends on households' financial situations (in debt or in credit) as well as the composition of their assets, which tends to vary according to wealth.

Box 5 – Low interest rates and asset valuations : distribution effects

Persistently low interest rates have a wide range of effects on households' financial positions. To gauge the actual impact of the low interest rate environment, a highly simplified distinction is sometimes made between households that save and households that borrow, with savers losing out on interest earnings while borrowers find it easier to repay their loans. Monetary policy's transmission mechanisms in general and, more specifically, the eventual effects of low interest rates are so complex that too simple an analysis can give rise to a highly distorted picture. For one thing, current low interest rate policies also make for more stable macroeconomic and financial environments supportive of growth and employment, and so also affect households' earned incomes and the security of these. Low interest rates do indeed have negative household income effects, as they depress income from financial assets – whereas they push up the value of bonds, equities and property, and so cause positive valuation effects. But alow interest rate policy is also a positive for income as it makes it easier to pay down debt. As the composition and size of their net wealth will vary from one household to the next (or between groups of households), low interest earnings or charges and positive valuation effects will be different for each and every one of them.

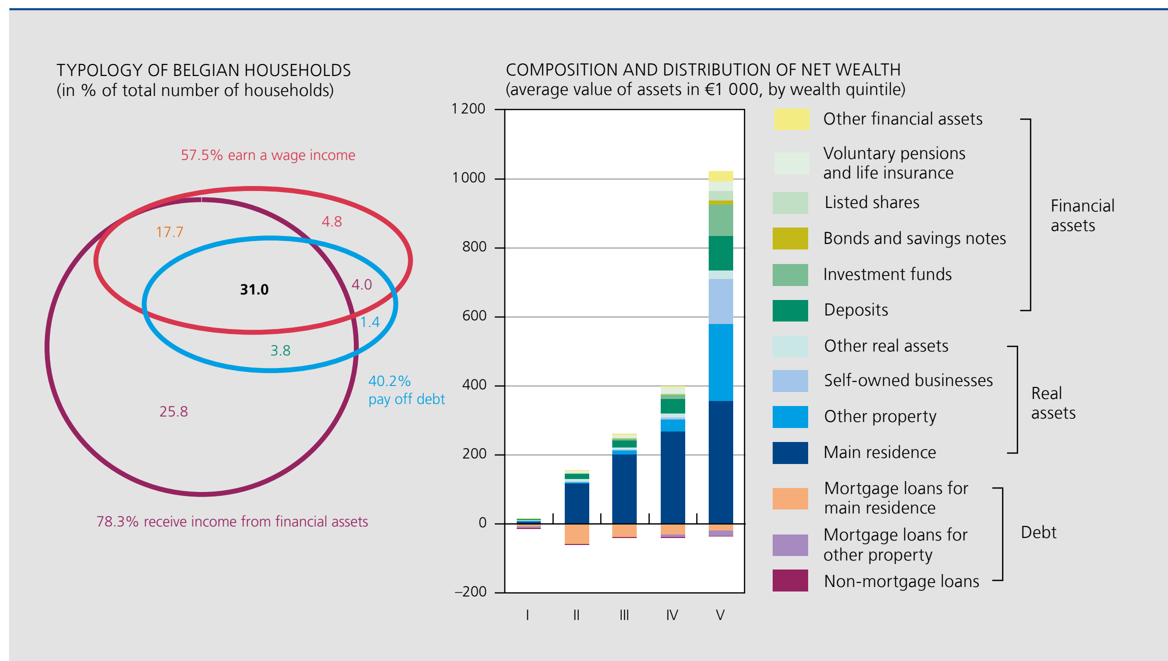
The sheer complexity of the issue can be illustrated by data taken from the Household Finance and Consumption Survey (HFCS)[1], with 2014 the most recent year for which survey results are available. These reveal that nine in

(1) For a description and analysis of the 2014 outcomes, see Du Caju Ph. (2016), "Household wealth in Belgium : initial findings of the second wave of the Household Finance and Consumption Survey (HFCS)", NBB, *Economic Review*, September, pp. 27-43.

every ten households have labour incomes from regular employment, enjoy incomes from a portfolio of financial assets (and so receive interest or dividends) or are repaying debt (and so pay interest). One-third of households surveyed falls into all three categories at the same time: they earn wages, have financial incomes and repay debt. Besides, the vast majority of households repaying debt also receive income from financial assets and, vice versa, nearly half of households with incomes from financial assets also repay debts. This goes to show that the Belgian population cannot be fitted into any simple breakdown of specific groups that do or do not benefit from specific interest rate developments.

The size and composition of net wealth vary greatly from one household to the next. Households in the lowest wealth quintile – i.e. the 20 % least wealthy households – own little in the way of assets, which typically comprise deposits and other real assets (vehicles or other valuables). Wealth in the three intermediate quintiles, which we might refer to as the middle classes for the sake of convenience, primarily takes the shape of home ownership, plus deposits and – to a lesser degree – individual voluntary pensions and life insurance. This group typically also has the largest amount of outstanding mortgage debt. In contrast, wealthier households tend to own properties with higher average values than middle-class households, but these account for less than half of their total wealth. Richer households' wealth is also made up of other property and a range of financial assets.

COMPLEX DISTRIBUTION ASPECTS OF LOW INTEREST RATES AND ASSET VALUATIONS
(2014)



Source: NBB (HFCS 2014).

Distribution data suggest that positive valuation effects as a result of low interest rate policies are chiefly felt in the highest wealth quintile as equities, bonds and investment funds are almost exclusively owned by these particular households. Voluntary pensions and life insurance – which typically focus on the rather longer term and tend to become worth more when interest rates fall – are more equally distributed across the higher wealth quintiles. Property, and more specifically the main residence, is the most important wealth component for all groups of

households. All these quintiles benefit from capital gains but the wealthiest households more so in absolute terms, as their real estate tends to be the most valuable. Cheaper property finance due to low interest rates ends up in the pockets of people in the middle net wealth quintiles, as those in the lowest quintile are not usually home owners and don't have mortgage loans. Both in absolute terms and relative to their assets, households in the middle quintiles typically have larger mortgage debts than do those in the wealthiest quintile.

Even after weighing up all aspects, the distribution effects of the current low interest rate environment remain hard to establish. For the wealthiest households, low interest rates spell lower income from financial assets, but this group also benefits most from capital gains. Households in the middle quintiles find it easier to finance their homes thanks to a lower interest burden: while interest on their deposits falls, the value of their property increases. The least affluent households, in their turn, do not usually profit from capital gains: those with savings lose income, those with consumer credit and the few who own their own homes pay less interest on their loans. It is also hard to measure the indirect effects of a low interest rate policy on household wealth and incomes. After all, low interest rate policies bring macrofinancial stability, a necessity both for a smoothly operating economy and for supporting and growing household labour incomes and financial wealth.

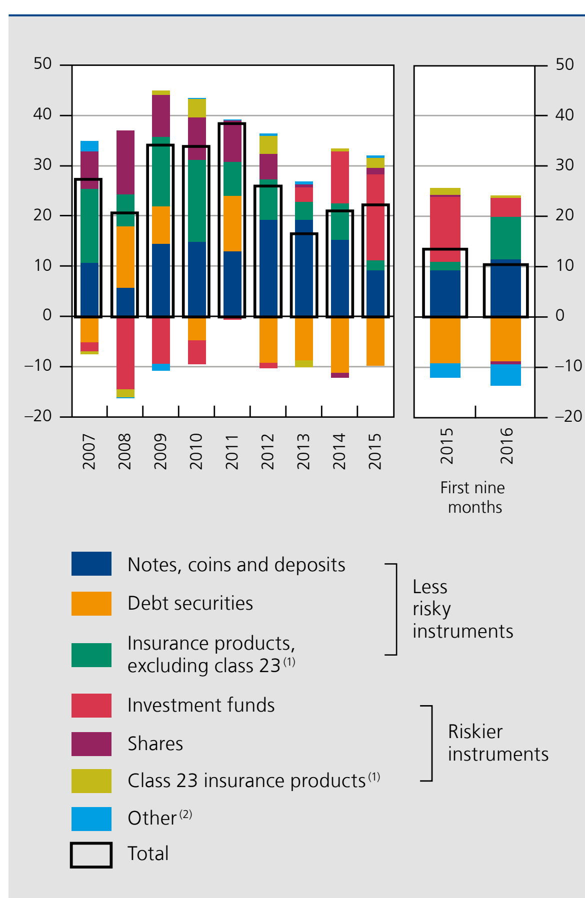
New financial assets: search for yield grinds to a halt

Despite the low interest rate environment, Belgian households continued to prefer savings in the shape of liquid assets, e.g. savings deposits or long-term, low-risk assets such as capital-protected insurance products. In the first three quarters of 2016, households put € 11.5 billion into deposits in total, more than they had in 2015. Insurance products excluding those without capital guarantee (class 23) and pension funds attracted € 8.4 billion. So the bulk of household savings were channelled mostly into deposits and insurance products in the first nine months of the year, while the remainder was spent on investment fund units (€ 3.8 billion, significantly less than the year-earlier € 13 billion). Lastly, households continued selling out of their debt securities, to the tune of € 8.9 billion. Although involving only a moderate counterparty risk, interest rate risk may have made these assets less attractive. Households also jettisoned € 0.5 billion worth of equities. The search for yield that had started in 2013 appeared to have ground to a halt in 2016.

The investment choices made by households in 2016 were influenced by a number of factors, ranging from lack of confidence and uncertainty – fostering a wait-and-see attitude and encouraging precautionary saving against a backdrop of volatile financial markets and concerns over geo-political conditions – to the tax treatment of the various financial assets.

The year saw households lose heart on several occasions. The deterioration at the beginning of 2016 reflected their perception of general economic conditions and their own

CHART 51 PREFERENCE FOR LIQUID OR LONG-TERM, BUT NOT VERY RISKY PRODUCTS
(in € billion)



Source: NBB.
(1) These items comprise the net claims of households on technical insurance reserves, on pension funds and on standardised guarantee schemes.
(2) This item comprises, insofar as they have been recorded, trade credit as well as miscellaneous assets of general government and financial institutions.

financial situations, while their assessment of the labour market underpinned their choices by the autumn.

Changes were also afoot in taxes levied on income from movable assets. The withholding tax on interest, dividends and royalties was bumped up again on 1 January 2016, to 27 % from 25 % – and raised to 30 % in early 2017. Special tax deals still apply to some products, such as regulated savings deposits (exemption on the first interest income band of € 1 880, which is hardly used given very low interest rates: 15 % for amounts over), guaranteed-return insurance products (under certain conditions) and specific State notes (withholding tax of 15 % on Leterme State note yields).

Alongside structural taxes on financial wealth income, the government introduced a 33 % tax on financial speculation from 1 January 2016: this affected gains realised within six months of purchase, applied to households and listed assets only (equities, equity certificates, warrants, options or other equity-based financial instruments). This tax was scrapped at the start of 2017.

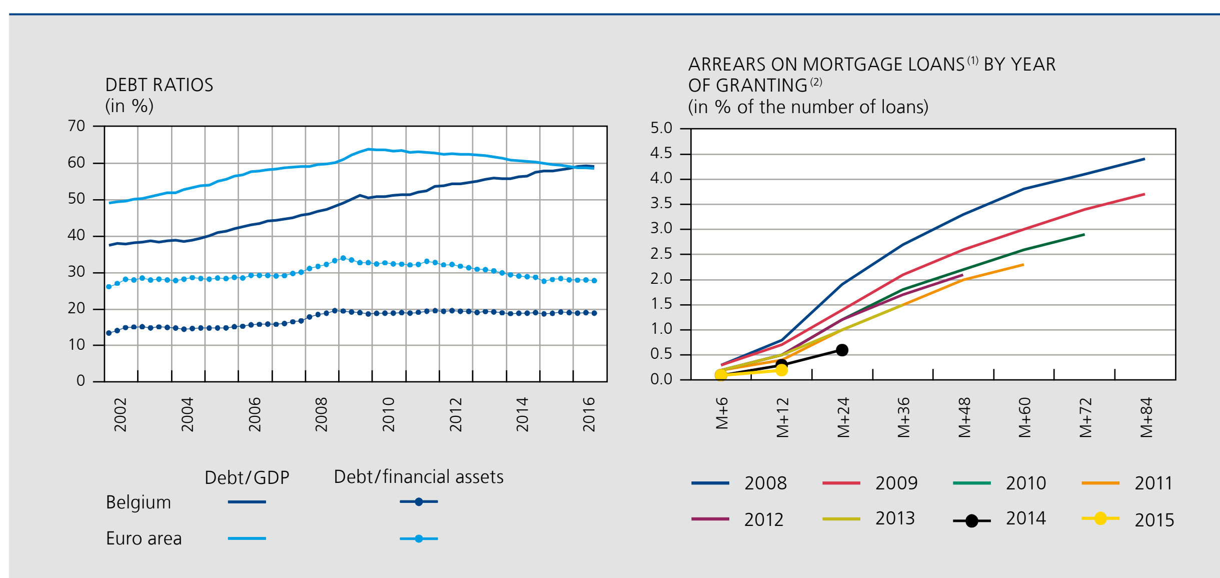
Higher withholding tax and the introduction of the speculation tax may have kept households from investing in the equity markets and pushed them towards more property investment. Between 2013 and 2016, household activity in the equity markets slumped compared with the four previous years: cumulative net transactions in equities stood at € 30 billion between the first quarter of 2009 and end-2012, while these were virtually nil (€ 0.5 billion) between 2013 – when the withholding tax was raised from 21 % to 25 % – and 2016, the year in which it went up to 27 %.

Household debt ratio still rising

Low interest rates continued to shore up household loan demand, particularly for mortgage loans. Although banks actually tightened their non-interest-rate-related loan conditions slightly, the pace of mortgage loan growth stabilised at around 5.4 %. With outstanding mortgage loans continuing to grow fast (to € 205 billion), the gross household debt ratio increased trendwise, working out at 59.1 % of GDP in the third quarter of 2016. Since the beginning of 2016, the debt ratio of Belgian households has been above the average for the euro area, which has been marked by a deleveraging process since the end of 2009 and which has seen the household debt ratio gradually come down from 63.9 % to 58.7 % of GDP in the third quarter of 2016.

Microeconomic data from the HFCS point up important vulnerabilities or pockets of risk in the debt structure. Some households are taking on large debts as a proportion of their incomes or their liquid assets – as is apparent

CHART 52 HOUSEHOLD DEBT LEVELS KEEP RISING, BUT DEFAULTS REMAIN RELATIVELY FEW



Sources: ECB, NBB.

(1) A loan is registered as in default when a due sum has not been paid either in part or in full within three months following its due date or within one month after formal notice has been served by recorded delivery letter.

(2) Loans are grouped by the year they were granted, with the curves showing the number of loans past due for each year as a percentage of the total number of original loans, after a set number of months following their issue. No account is taken of any regularisation of the loans.

from the loan-to-value (LTV) ratio, i.e. the value of the amount borrowed relative to that of the property – or are displaying limited repayment capacity. 2014 survey data show that 13 % of outstanding mortgage debt is to be repaid by households that need 40 % of their disposable incomes to do so. Such households typically have little in the way of assets and relatively often agree loans with higher LTVs.

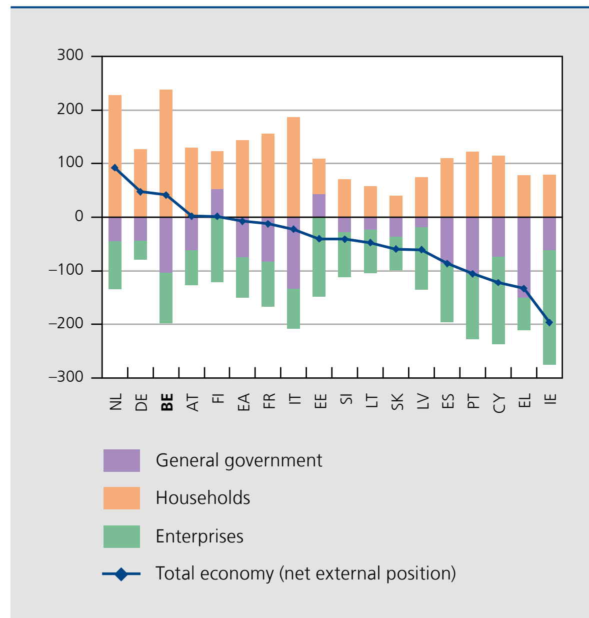
For these reasons, the European Systemic Risk Board (ESRB) formally flagged up heightened risks in the Belgian mortgage market in November 2016, as it did for seven other countries. A less supportive macroeconomic environment – with rising interest rates, for instance, or a deterioration of labour market conditions and the business cycle – would threaten household repayment capacity. In anticipation of such a scenario, the Bank has taken various measures in its capacity as macroprudential authority to address and mitigate the risks related to the property market and a rising household debt ratio.

At this point, relatively low and stable levels of arrears on loans by households – as a percentage of total loans – as registered by the Central Individual Credit Register (CICR) suggest that the current debt service burden is still manageable for most households. In fact, mortgage loan arrears are even falling slightly on the back of an improved macroeconomic climate and, more specifically, reduced joblessness. In addition, accommodating monetary policy has reduced the total interest burden facing households, even if their overall debt levels have increased – thanks in part to loan refinancing. Quite possibly, in these cases, non-interest-rate-related loan conditions have also been changed, further alleviating the repayment burden. These refinancing transactions, which often entail fixed-rate mortgages, help households to retain beneficial interest rate conditions for the remaining term of their loans, with the risks of any upturn in interest rates devolved to their banks.

Despite the further advance in the debt ratio, Belgian households continue to display healthy aggregate financial positions, as demonstrated among other factors by the ratio of debt to financial assets, which has remained stable and is lower in Belgium than in the broader euro area. Incidentally, Belgian households have the largest net financial wealth in the euro area, as a percentage of GDP.

This high financial wealth also contributes to the favourable financial position of the broader Belgian economy, the so-called net external position. After all, the difference between the financial assets and liabilities of domestic sectors translates into either a net creditor or a net debtor position relative to other countries. Its households' sizeable net wealth puts Belgium in a select group of net creditor countries in the euro area, together with the Netherlands, Germany, Austria and Finland. On national financial accounts statistics, Belgium's net claims on other countries amounted to € 201 billion or 48.3 % of GDP by end-June 2016

CHART 53 NET FINANCIAL WEALTH (1)
(in % of GDP, end-June 2016)



Sources: ECB, NBB.
(1) Difference between the outstanding amounts of financial assets and liabilities. Luxembourg and Malta are not included in view of the high volatility of their data.

4.3 2016 another good year for Belgian banks

In the first nine months of 2016, Belgium's banks achieved robust results, as they had done in 2015. Annualised return on equity neared 10 %, while assets yielded 0.6 %. The sector at large recorded profits totalling € 4.8 billion in the period, compared with a year-earlier € 4.4 billion. Despite a refocusing of activities back to the Belgian market, the country's financial institutions generated one-third of their net profits outside national borders, as they kept up a strong presence in a number of foreign "strategic markets" such as East and South-Eastern Europe, the Netherlands, Ireland, Switzerland and Luxembourg. Unlike in 2015, however, Belgium's banks saw a few fundamental sources of income dip down and were unable to leverage several temporary factors that had previously benefited them. Consequently, gross operating result shrank by nearly € 200 Emillion on the corresponding period of 2015.

TABLE 12 INCOME STATEMENT OF BELGIAN CREDIT INSTITUTIONS

(consolidated data; in € billion, unless otherwise stated)

	2012	2013	2014	2015	First nine months 2015	First nine months 2016	In % of operating income
Net interest income	13.6	13.3	14.5	14.9	11.2	11.2	67.2
Non-interest income	4.5	7.0	6.2	7.1	5.6	5.5	32.8
Net fee and commission income (including commission paid to agents)	4.5	5.0	5.3	5.9	4.5	4.2	25.3
(Un)realised gains or losses on financial instruments [1]	0.0	0.8	−0.1	1.2	1.2	0.8	
Other non-interest income	0.0	1.3	0.9	0.1	−0.1	0.5	
Operating income	18.1	20.3	20.7	22.0	16.8	16.6	100.0
Operating expenses	−13.0	−12.4	−12.7	−12.9	−9.9	−9.9	59.5 [2]
Gross operating result	5.0	8.0	8.0	9.1	6.9	6.7	
Impairments and provisions	−2.6	−3.0	−1.3	−1.3	−0.6	−0.7	
Impairments on loans and receivables	−2.0	−2.3	−1.3	−1.1	−0.9	−0.7	
Impairments on other financial assets	0.8	0.0	0.0	0.0	0.0	0.0	
Other impairments and provisions	−1.5	−0.6	0.1	−0.1	0.3	0.0	
Other components of the income statement	−0.8	−1.8	−2.2	−1.7	−1.9	−1.3	
Net profit or loss	1.6	3.3	4.5	6.1	4.4	4.8	

Source: NBB.

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

(2) Cost/income ratio of the Belgian banking sector.

Low interest rate environment leads to slight fall in net interest income

Gross operating result in the first nine months of 2016 contracted, among other factors, as net interest income edged down by nearly € 100 million, despite a robust increase in lending to Belgium's non-bank private sector. The 2016 interest margin ended up at roughly the same level as in 2015, averaging 168 basis points compared with 169 in the first nine months of 2015, bringing an end to their uninterrupted advance since 2008.

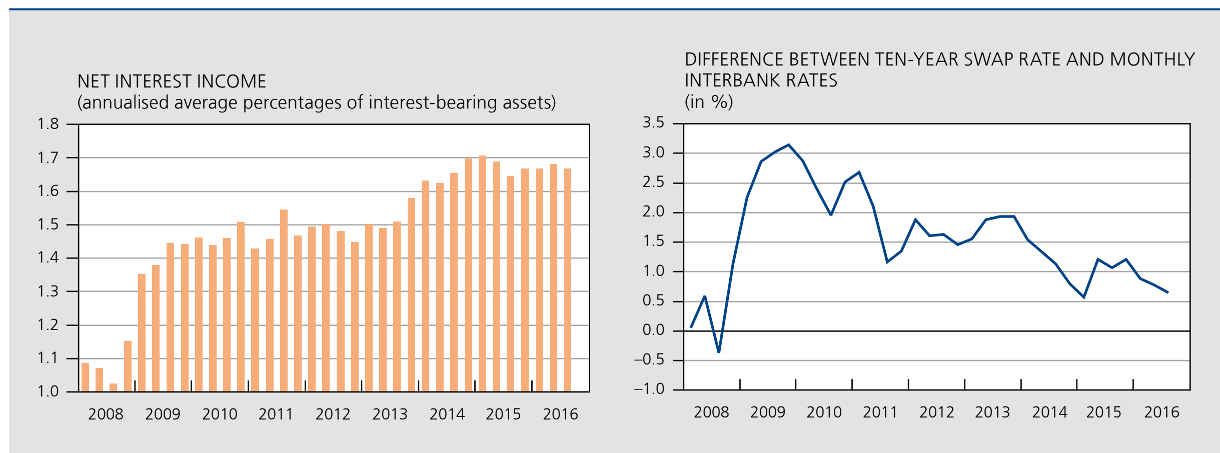
The various components of the interest margin came under pressure in 2016. For one thing, intensified competition in the Belgian market caused commercial margins on certain products to shrink. Commercial margins reflect the difference between interest rates charged by banks on loans (or paid on deposits) and their corresponding market rates. The intermediation margin, another component of total interest margin, is determined by the yield curve. It was also squeezed for new transactions, as evidenced by a further narrowing of the spread between ten-year and one-month rates. However, the effects have so far been mitigated by the Belgian banks' balance sheet structure, i.e. liabilities with shorter terms to maturity than assets.

In 2016, the country's banks were still able to cushion the subdued returns on assets by cutting funding costs, with most of them reducing rates on savings and sight accounts for Belgian households to 0.11 % (including fidelity premiums) and 0.00 % respectively. Mostly taken in the second quarter, these measures caused interest margins to widen temporarily, but they had started to contract again by the third quarter.

With interest rates on deposits having reached a lower bound, there is very little room for further reductions, which is likely to depress interest margins in the future. Meanwhile, margins are also slowing in the wake of the sale of high-yielding debt securities, possibly facilitated by the ECB's expanded asset purchase programme (APP). The many refinancings of mortgage loans since 2014 – which have speeded up the decline in returns on this portfolio – have a similar effect, even though new loans command higher commercial margins than the original loans. In this context, the early redemption fees banks earned

CHART 54 BELGIAN BANKS' INTEREST MARGINS PERSISTENTLY HIGH IN 2016

(quarterly consolidated data)

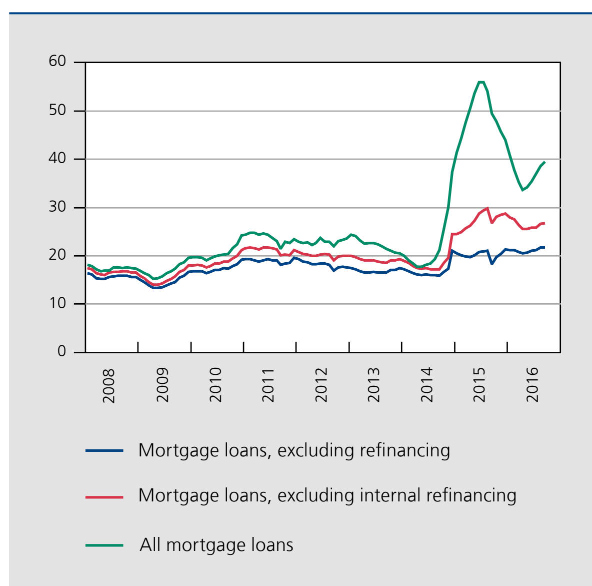


Sources: Thomson Reuters Datastream, NBB.

on refinancing transactions were also lower in the first nine months of 2016, providing less support to interest margins and interest income. Internal as well as external refinancings fell to € 18 billion, still a respectable amount but well below the figure for the corresponding period of 2015 (€ 31 billion). These may also have involved lower-interest loans as many of them had been refinanced before, also depressing early redemption fees in 2016.

CHART 55 SIGNIFICANT REFINANCING OF MORTGAGE LOANS IN 2016, BUT LESS THAN IN 2015

(new mortgage loans, nine months cumulative; in € billion)



Source: NBB.

Various components of non-interest income declined sharply

Non-interest income also fell, from € 5.6 billion in the first nine months of 2015 to € 5.5 billion in 2016. This was mainly due to the contraction of around € 0.3 billion in net commission income – caused by falling fees on the sale of investment funds and, to a larger extent, on the issue and transfer of securities. Volatility in the financial markets combined with a range of tax factors to reduce the number of transactions. Gains on financial instruments were also down, as unrealised gains – which are recognised when the market values of securities increase – were less substantial. Conversely, gains on the sale of securities were higher – albeit to a lesser degree – on the back of sales of high-yielding equities and debt securities. Non-interest income was also supported by other sources of income, such as dividends received.

Operating expenses remain relatively stable but loan loss provisions fall again

Operating expenses at Belgian banks worked out at € 9.9 billion for the first nine months of 2016, about the same level as in 2015. Unlike in previous years, spending on staff remuneration across the sector is inching down as a number of restructuring programmes are starting to bear fruit. Other operating expenses remained stable, despite higher bank taxes and contributions – particularly the higher contributions to the European Single Resolution Fund (ESRF).

Lower banking income combined with stable operating expenses to cause a slight deterioration in the Belgian

banking sector's cost/income ratio, which grew to 59.5 % in the first nine months of 2016 from 58.9 % in 2015.

Impairments and provisions, which were already back at respectable levels due to reductions that got under way in 2011, continued to fall throughout 2016. About half of the € 0.7 billion figure recorded for the first three quarters derived from foreign portfolios. Subdued net provisions reflected both a quality improvement in bank assets and reversals of excess provisions previously made.

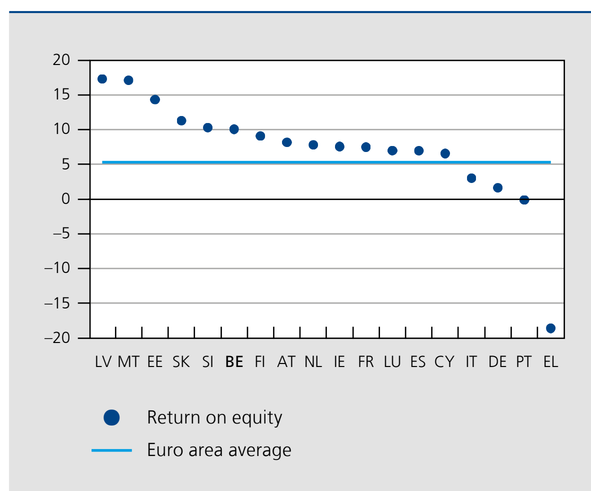
Banks gird up for the future and take range of measures to keep profits up

Relative to their shareholders' equity as well as to total assets, returns in the Belgian banking sector were twice that of the euro area average in 2016. The banking industry's relatively high profitability levels were partly attributable to exceptional developments, such as tax losses carried forward by one of the country's biggest banks. Return on equity at 10 % slightly distorts the sector's real profitability and it should not in any way be assumed that profitability will return to pre-crisis levels. That said, despite the minor slowdown in the reporting period, Belgian banks do enjoy healthy underlying profitability and find themselves in a robust starting position from which to face a time in which their capacity to turn a profit will be tested.

Income from mark-to-market gains on portfolios of financial instruments or the sale of securities will no longer be as high as in the past, while money made from early redemption fees on mortgage loans are a temporary boon. Interest margins may well narrow if the low interest rate environment in the euro area persists. However, a sudden sharp rate hike might also hit institutions that fail to hedge properly against higher short-term rates: their funding costs would rise whereas the returns on many of their assets are fixed for the medium or longer term. Lastly, the extremely low levels of loan loss provisions look unsustainable, if only because some of this is due to impairment reversals. At the same time, digitalisation of bank services will eventually stoke up competition in key segments of the market – e.g. asset management – and may adversely affect Belgian banks' capacity to generate profits on such business.

CHART 56 BANKING SECTOR IN BELGIUM COMMANDS HIGHER RETURN ON EQUITY THAN IN MOST EURO AREA COUNTRIES

(first-half data 2016, in %)



Source: ECB.

Digitisation of bank product offerings may present a whole host of challenges to incumbent players, but it also provides many opportunities to make their activities more efficient. And so, numerous banks have announced large-scale restructuring plans and savings in areas such as branch office networks and workforce, both in the past and today. As it turned out, spending cuts proved quite moderate in 2016 but these are likely to gain traction in the future. Of course, any such measures entail potential risks, not only at the operational level, but also in terms of corporate governance and possible loss of know-how, but these are an inevitable part of the process of banks adjusting their cost structures to their new business models. Cost/income ratios of Belgian banks may recently have slotted back into their pre-crisis levels, but this recovery has in part been enabled by temporary factors, which suggests that the sector's cost structure is due for more sweeping reforms. The transition to fresh business models goes hand in hand with a focus on more diversified sources of income, preferably from activities that generate fees and are less tied in with interest rates. In fact, the 2016 fall in other types of income sounds a cautious note on the ability of banks to find structural replacements for interest income.

If, despite all their measures, banks find they cannot achieve sufficient profitability, they might be tempted to seek yields by allocating a larger proportion of their portfolios to riskier, but higher-yielding sub-segments. To date, there has been little sign of this in the Belgian banking sector, something that is corroborated by a significant increase in the money Belgian banks place with central banks.

Belgian banks continue to grant a lot of mortgage loans

More than ever, Belgium's banks would appear to be targeting the domestic mortgage market. In 2016, low

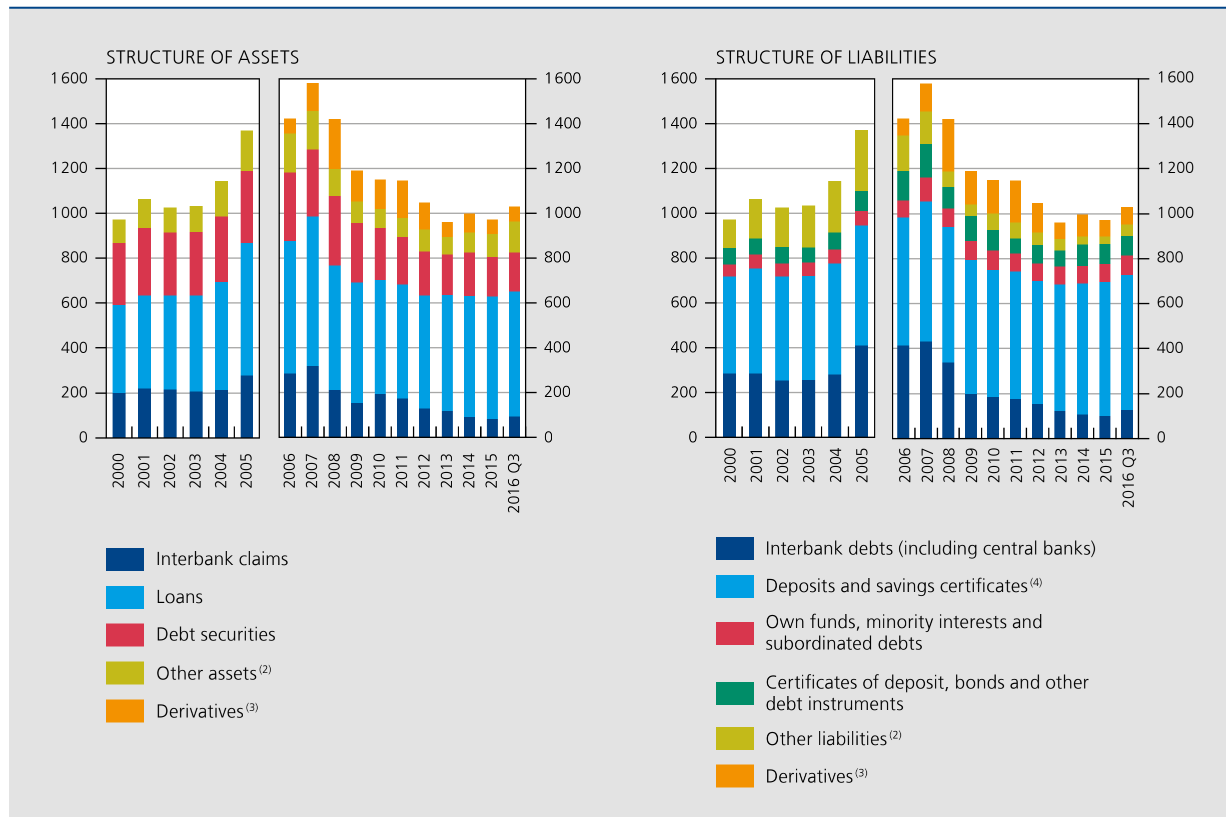
interest rates led to a further increase in the mortgage loan portfolio and the total outstanding amount of mortgage loans to Belgian households rose to € 184.2 billion at the end of September 2016, from € 174.9 billion at end-September 2015, i.e. year-on-year growth of over 5 %. Gross new business in mortgage loans worked out at € 50.6 billion in the period, including € 14.7 billion in internal refinancing, with external refinancing – i.e. where borrowers turn to a different bank – amounting to € 6.9 billion.

In 2015 and 2016, the upswing in mortgage loans was no longer accompanied by a further tightening of lending criteria, as it had been between 2012 and 2014. While mortgage loans with terms to maturity in excess of 25 years as a proportion of new mortgage business only grew by 2 % in 2016, there was no further decline in the percentage of new loans with a debt-service-to-income (DSTI) ratio in excess of 50 %, despite low interest rates. One finding that stands out even more is that low interest rates also triggered a further rise in average amounts contracted in new loans. This took new mortgage business to higher average loan-to-value ratios (LTVs), i.e. the size of the mortgage in relation to the value of the property. Although these trends were well within the boundaries agreed in banks' lending policies, this does imply that a not insubstantial portion of new business still commands high LTV and DSTI ratios.

Lending criteria have recently been identified as one of the vulnerabilities of the Belgian mortgage market. The surge in mortgage loans further increased household debt burdens, while prices again grew and the Belgian housing market became more overvalued in 2015, before both slowed down somewhat. These observations have prompted the Bank, as part of its remit as macroprudential authority in Belgium, to extend a macroprudential measure applied since 2013 and to announce its intention to implement a new measure that more specifically

CHART 57 BELGIAN BANKS COMPLETE DELEVERAGING PROCESS

(balance sheet structure of Belgian credit institutions; end-of-period data, on a consolidated basis (1); in € billion)



Source: NBB.

(1) Data compiled according to Belgian accounting rules (Belgian GAAP) until 2005 and according to IAS/IFRS standards from 2006.

(2) "Other assets" mainly comprise balances with central banks, shares, tangible and intangible assets, and deferred tax assets. "Other liabilities" are primarily short positions, liabilities excluding deposits and debt instruments, provisions and liabilities for defined benefit obligations.

(3) Derivatives are recognised at market values, including – from 2007 – income receivable and charges payable (which are not included in the data relating to 2006).

(4) From the third quarter of 2014, savings certificates are no longer included in "deposits and savings certificates", but rank under "certificates of deposit, bonds and other debt instruments". Liabilities linked to transferred assets are no longer recognised under "other liabilities", but are included under different items on the liabilities side.

targets loans with high LTVs. Section A of the "Prudential regulation and supervision" part of this Report offers a more detailed discussion of the various measures.

Exposures to non-financial and financial sectors up again in 2016

This expansion of the domestic mortgage loan portfolio fits into a broader process that is seeing Belgium's banks refocus on their traditional intermediation activities as well as on their strategic markets, and on the Belgian market first and foremost. Between 2008 and 2013, Belgian banks downsized their activities, especially the cross-border transactions that had reached high levels before the financial crisis. Their total assets shrank from € 1 578 billion at the end of 2007 – i.e. 458 % of GDP – to € 961 billion at the end of 2013. The aggregate balance sheet of the Belgian banking sector has been at around € 1 000 billion since then: total assets stood at € 1 030 billion by the end of September 2016, or 246 % of GDP.

For the first nine months of 2016, most key asset items recorded a rise on end-2015 figures.

Loans to households, mainly mortgage loans, agreed in Belgium and in some strategic markets outside Belgium rose by a total € 9 billion to € 230 billion, and accounted for 22 % of the Belgian banking sector's total assets. The portfolio of loans to Belgian non-financial corporations grew to € 120 billion at the end of September 2016 – i.e. 12 % of total assets – from € 115 billion at end-2015.

Exposures to the public sector in the form of loans and debt securities which, because of the unrest in government bond markets in 2011 and 2012, had largely shifted to Belgian public authorities, fell by € 2 billion. This fall particularly reflects lower claims on the Belgian public sector thanks to sales under the ECB's public sector purchase programme (PSPP), although Belgium's share of outstanding claims on the public sector was still close to 50 % by the end September 2016.

Having fallen sharply in 2007, outstanding loans to banking financial corporations (€ 94.5 billion at end-September 2016) and to non-bank financial corporations (€ 27.1 billion) were back on the rise in the first three quarters, up by € 12.7 billion. More specifically, the country's banks invested in the wholesale market the excess of deposits garnered from the non-financial private sector, particularly in the form of reverse repos (funding granted secured by collateral). A proportion of the required funding for this business was also tapped in the form of repos (funding received secured by collateral), which might point to a potential search for yield – a possibility when counterparties or collateral differ in quality. Wholesale transactions thus also increased on the liabilities side, although less markedly so than on the assets side. Belgium's banks also attracted more ample funding from central banks and locked in the cheap funding provided under the TLTRO II programme.

In terms of funding of the Belgian banking sector, the most notable driver in 2016 turned out to be a sharp increase in deposits of households and non-financial corporations, another feature of the Belgian banks' return to a more traditional business model. This type of funding has generally increased as a proportion of the sector's balance sheet total since 2007 and chipped in 48 % by the end of September 2016. Outstanding household deposits expanded by € 19 billion in the first nine months of the year, to € 359 billion, and mainly involved sight accounts, as savings deposits remained virtually stable.

Balance sheet trends have left quality of assets untouched

The various trends affecting the balance sheets of Belgium's banks in 2016 – e.g. the shift in new mortgage business to higher LTV ratios – did not cause any deterioration in the quality of the assets. At 3.4 % by end-September 2016, the percentage of impaired loans was down yet again – from 3.6 % at the end of 2015 – as a lower total of non-performing loans combined with an increase in the total portfolio. Note that these consolidated statistics cover both Belgian portfolios and the foreign portfolios held by Belgian banks. Generally speaking, this latter set of portfolios still has a bigger share of non-performing loans. More specifically, the ratio sharply improved for loans to non-financial corporations. In terms of Belgian mortgage loans, the quality of Belgian banks' portfolios improved slightly – despite a few remaining pockets of risk – as the percentage of mortgage loans that were in arrears declined to 1.1 % at the end of October 2016 from 1.2 % at the end of 2015.

Belgian banks continue to enjoy comfortable solvency and liquidity positions

All other things being equal, better-quality debtors ensure a lower probability of default for bank assets, as determined by banks' internal models. However, in risk-weighted asset calculations, this positive effect is more than wiped out by the rise in exposures subject to credit risk. Risk-weighted assets rose from € 345 billion at the end of 2015 to € 358 billion at the end of September 2016. At the same time, common equity Tier 1 capital (CET 1) went from € 53 billion to € 55 billion so that

TABLE 13 BREAKDOWN OF TIER 1 CAPITAL AND RISK-WEIGHTED ASSETS, SOLVENCY AND LIQUIDITY RATIOS
(end-of-period data, on a consolidated basis, in € billion, unless otherwise stated)

	2012	2013	2014	2015	September 2016
Tier 1 capital	55.9	55.6	53.4	55.1	57.0
of which:					
Common equity Tier 1	–	–	51.5	53.3	55.2
Risk-weighted assets	352.7	339.4	349.8	345.4	357.7
of which:					
Credit risk	301.0	287.7	290.1	282.8	298.3
Tier 1 ratio (in %)	15.9	16.4	15.3	16.0	15.9
Common Equity Tier 1 ratio (in %)	–	–	14.7	15.4	15.4
Liquidity coverage ratio (in %)				137.0	135.0

Source: NBB.

Belgian banks' CET1 ratio was unchanged at an average 15.4 %. This puts them, on average at least, in a comfortable solvency position that is amply ahead of regulatory requirements, as EBA stress tests also established [1].

As of 2016, the Capital Requirements Directive (CRD IV) prescribes the gradual implementation of various add-on buffers. The capital conservation buffer, which consists of a fixed margin on top of the required minimum, was set at 0.625 % for 2016 and will gradually rise to 2.5 % by 2019. A countercyclical buffer will need to be activated in the event of excessive lending growth in the economy – this was set at 0 % in Belgium in 2016. Lastly, add-on buffers were imposed on eight banks within the framework provided by CRD IV, as these banks have been designated as systemically important in Belgium. The Directive also envisaged a gradual phasing-out of transition measures by 2018. If CRD IV had been fully in place in 2016, CET1 ratios would have merely edged down to 15.2 %, which is still a respectable level.

Although Belgium's banks saw the proportion of encumbered assets rise in 2016 due in part to increased repo transactions, the sector continued to enjoy a comfortable liquidity position. On average, the short-term liquidity coverage ratio (LCR) fell back a little – to 135 % at the end of September 2016 from 137 % at the end of 2015 – but was still well in excess of regulatory requirements.

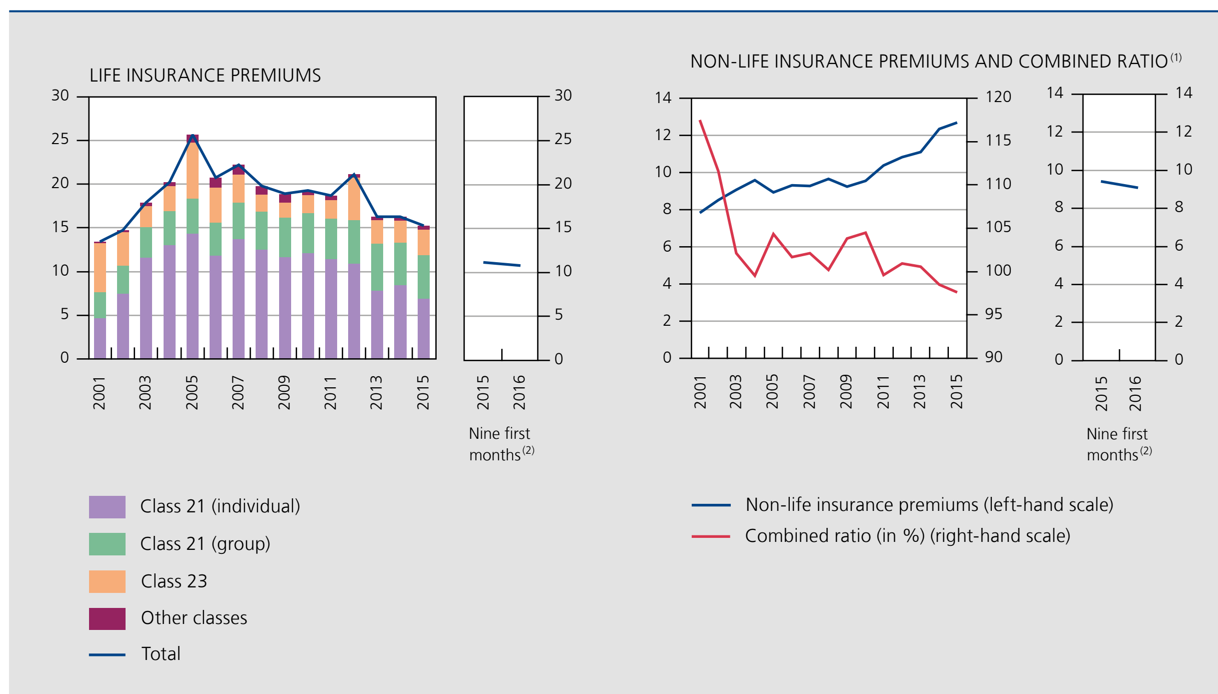
(1) For more information about these tests, see Section C.2 of this Report's "Prudential regulation and supervision" part.

4.4 Insurance sector profitability declined in both 2015 and 2016

Belgium's insurance companies have seen their net result on a downward trajectory since 2012. In 2015, it contracted to € 1.2 billion, while return on equity – which had averaged 20 % before the financial crisis – shrank to 8.2 %. Partial data available for the first nine months of the year suggest that this negative trend persisted into 2016. A set of data collected for a sample of five Belgian insurance groups shows annualised return on equity to have edged back again, to 7.4 %. However, these figures need to be treated with some caution as they do not include the full sector. That said, these are the only meaningful data available, as detailed three-month figures based on individual statutory accounts of all of Belgium's insurance companies have ceased to be available since the new Solvency II regulatory framework came into force in 2016.

While the sector's non-technical result – mainly income from investment not imputed to life and non-life insurance activities, as well as exceptional items and taxes – remained negative in 2016 (-€ 0.6 billion in 2015), the decline in profitability was chiefly attributable to deteriorating results in the life insurance sector. Despite the locking-in of significant capital gains on sales, the downturn to € 0.2 billion in 2015 reflected falling income from investment – due to persistently low interest rates and a gradually more concrete manifestation of reinvestment risk, as well as lower premium income. In the first nine months of 2016, income from gross life insurance premiums continued to slow as the low interest rate

CHART 58 FALL IN LIFE AND NON-LIFE PREMIUM INCOME
(non-consolidated data; in € billion, unless otherwise stated)



Source: NBB.
(1) The combined ratio relates the sum of the cost of claims plus operating expenses to net premium income.

environment made these products less attractive in savers' eyes. Compared with the year-earlier period, this income contracted by 3.2 % to € 10.7 billion.

By contrast, non-life profitability kicked sharply ahead in 2015 on the back of higher premium income. Non-life insurance activities returned profits of € 1.6 billion in the year. However, 2016 saw a reversal of fortunes: net premium income fell by 3.6 % in the first nine months compared with the year-earlier period. But the net combined ratio, which compares the total cost of claims and operating expenses to net premium income, remained close to 100 %, showing that insurance companies are maintaining a sound balance between insurance costs and premium income. It is worth noting, though, that these generally solid results were not achieved in all insurance classes of non-life business: in some, costs were higher than premiums.

Insurance companies' profitability squeezed by lower premiums and high guaranteed returns

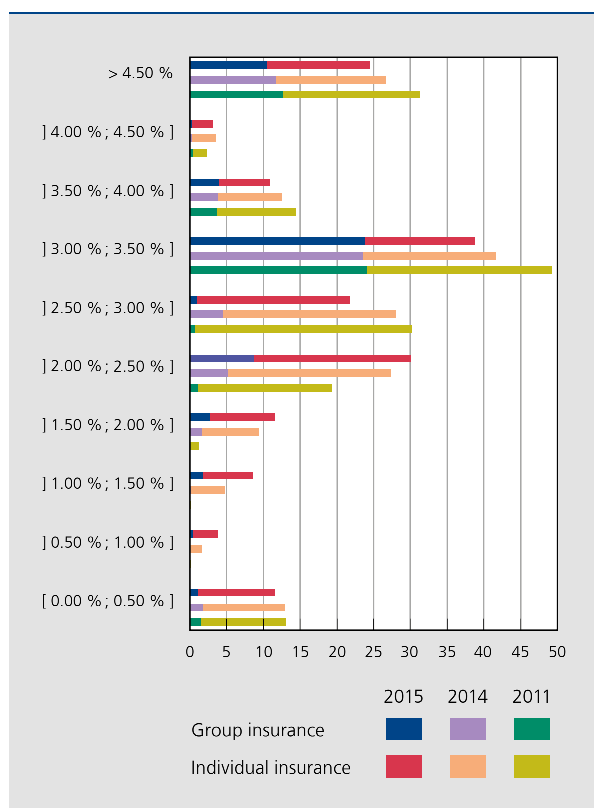
Investment income is being kept down by falling premiums but also by the low interest rate environment, particularly in life insurance, where the average duration of liabilities exceeds that on assets and where guaranteed returns to be honoured remain high.

Total inventory reserves for guaranteed-return contracts fell from € 168.2 billion to € 164.3 billion between the end of 2014 and end-2015, the latest period for which detailed annual data are available. This contraction in reserves was caused by individual insurance, where reserves narrowed by nearly 5 %. Group insurance, by contrast, recorded an increase of 3 %. Although the share of contracts with guaranteed returns of over 2 % is steadily decreasing in favour of lower-return agreements, contracts for which the guaranteed return on accrued and / or yet to be accrued reserves (based on future premiums) exceeded 4.5 % amounted to € 24.5 billion, or 15 % of inventory reserves. The comparable figure for 2014 was € 27.4 billion and for 2011 € 31.3 billion.

If current low interest rates are here to stay, significant amounts of high-rated securities (AAA or AA) coming to maturity will have to be reinvested in lower-yielding assets. There is a real risk, then, that the effective return on assets will not be enough to cover the guaranteed interest rates on contracts entered into earlier.

CHART 59 CONTINUED HIGH PROPORTION OF CONTRACTS WITH HIGH GUARANTEED RETURNS

(breakdown of life insurance inventory reserves by guaranteed returns per individual contract; end-of-period data, in € billion)



Source : NBB.

The outstanding total of life insurance contracts with guaranteed returns and the actual rates paid on them are therefore very important risk parameters for insurance companies at a time of falling interest rates on risk-free investments.

Insurers respond by adapting their products and lowering costs

Persistently low interest rates are forcing insurance companies to offer contracts more in line with market conditions, taking the average guaranteed return of class 21 agreements down from 2.91 % in 2014 to 2.82 % in 2015 – or, more specifically, from 2.72 % to 2.64 % for individual insurance and from 3.25 % to 3.19 % for group insurance. At the same time, insurers imposed time limits on guarantees and promoted sales of class 23 agreements linked to investment funds and without any guaranteed returns. In addition, hybrid products were developed, combining features of classes 21 and 23.

To ensure their profitability potential, insurance companies have been further adapting their activities and cost structures. Business models guaranteeing sustainable profitability, even in adverse economic conditions, are a necessary precondition for maintaining the stability of the broader sector. In this context and using the results of transversal analyses of the insurance sector, the Bank decided to take specifically targeted actions to bolster, in a sustainable way, the profitability of selected institutions.

In addition, it may prove necessary for insurers to slash operating expenses further, possibly through consolidations, in order to align cost structures with the shrinkage in activity volumes. Various insurers have announced restructuring plans, which should be seen against a backdrop of falling employment in the insurance industry. Assuralia statistics put average numbers of employees at insurance companies at 22 800 in 2015, down from 23 300 in 2008. The average number of intermediaries – i.e. agents and brokers – shrank to 9 600 from 10 900.

TABLE 14 GUARANTEED RETURNS AND ADDITIONAL PROVISIONS

(non-consolidated data ; in %, unless otherwise stated)

	2011	2012	2013	2014	2015
Long-term yields (OLO – ten years)	4.01	2.06	2.56	0.83	0.98
Average guaranteed returns existing contracts	3.17	3.12	3.04	2.91	2.82
Group insurance	3.59	3.54	3.41	3.25	3.19
Individual insurance	3.01	2.95	2.88	2.72	2.64
Additional provisions (in € billion)	2.5	3.0	4.1	5.5	6.6

Source : NBB.

Range of regulatory measures put in place

Previous prudential rules oblige insurance companies to book additional annual provisions in their accounts to ensure they can meet their liabilities despite low interest rates. For reasons of caution and continuity, it has been agreed that these provisions, for which no exemptions have been granted since 2013 and which stood at € 6.6 billion by the end of 2015, will stay in place over the period of the transition to Solvency II. In fact, these additional provisions will also need to be topped up unless a conditional exemption is granted (renewable annually).

The maximum reference rate for long-term life insurance contracts was cut to 2 % in early February, from 3.75 %, and will be kept at the same level in 2017. From 1 January 2016, employer-guaranteed returns on supplementary pensions were set at 1.75 % for member and employer contributions. Without these cuts, employers might well have scrapped the supplementary pension system altogether as they would have been in the same position as insurers and unable to pay the guaranteed returns.

The Bank has recommended that insurers curb any distribution of profits to shareholders and policy-holders in order to safeguard their fundamental resilience in the longer term, while also suggesting that they consider their interest margin levels. In this context, new regulatory provisions governing profit-sharing were put in place, specifying that the Bank may constrain profit-sharing in some instances, factoring in insurer profitability and solvency. Improving the solvency of financial institutions by retaining earnings and / or raising capital will be the key to insurers being able to meet the new challenges of the economic cycle and ever more rigorous regulatory requirements. Given these constraints, the Bank has cautioned reticence on the part of insurers when realising capital gains, as this should fit into a preventive strategy primarily focused on meeting contractual obligations.

Solvency II has been in place since 1 January 2016. This new regulatory framework, which has brought radical change to the sector, obliges insurers to maintain eligible own funds to cover solvency requirements, known as the solvency capital requirement (SCR). Portfolios now being valued on the basis of market prices may be causing greater fluctuations in the equity amounts classified but should also make it easier to assess the financial risks facing insurers, which in turn should make it easier to anticipate the impact of low interest rates on their future solvency.

Solvency of Belgian insurance is generally robust, but remains varied

The sector's solvency ratio, calculated as eligible own funds relative to SCR, stood at 165.4 % by the end of September 2016. Ratio fluctuations in the course of the year may be explained both by changes in shareholders' equity – which goes up and down with the volatility of the financial markets – and trends in the SCR amount of the individual companies. Average solvency levels in the sector remain comfortable despite the downturn in the third quarter. Current levels appear robust enough for insurers to face down a lengthy period of low interest rates, as is corroborated by EIOPA stress tests [1]. This general observation nevertheless masks a degree of divergence : although quite a few insurers are very well capitalised indeed, an analysis of solvency margins under Solvency II suggests that some are much more vulnerable. The Bank has urged the relevant institutions to take specific measures to meet the requirements. The low interest rate environment in which the new prudential regulatory framework is put into force might well prompt a restructuring at

(1) For more information, see Section D of this Report's "Prudential regulation and supervision" part.

TABLE 15 OWN FUNDS, CAPITAL REQUIREMENTS AND SCR RATIO
(in € billion, unless otherwise stated)

	01-01-2016	31-03-2016	30-06-2016	30-09-2016
Solvency requirements	17.9	18.3	18.0	19.2
Total eligible own funds	32.9	31.5	32.8	31.8
SCR ratio (%)	183.7	171.8	182.0	165.4

Source : NBB.

TABLE 16 COMPOSITION OF INSURANCE COMPANIES' BALANCE SHEETS
(2016Q3, market value, in € billion)

Assets		Liabilities	
Investment	279.4	Technical insurance reserves, excluding class 23	245.5
Government bonds	147.5	Life insurance reserves, excluding health insurance	211.7
Corporate bonds	62.4	Non-life insurance reserves, excluding health insurance	17.6
Lending and mortgage loans	27.0	Health insurance reserves	16.2
Equities and participating interests	16.1		
Investment funds	13.4		
Property	7.8		
Other investment	5.3		
Other assets	28.5	Other liabilities	33.7
Assets linked to class 23 activities	31.0	Class 23 technical insurance reserves	30.5
Total assets	**338.9**	**Total liabilities**	**309.7**
		Surplus of assets over liabilities	**29.1**

Source: NBB.

the sector's weakest entities or takeovers by other, more robust, players. The Bank is watching events closely as they unfold.

Insurers' balance sheet composition does not suggest general search for yield

In view of the low returns on their traditional portfolios, some insurance companies are attempting to shift their investment to higher-yielding assets in order to meet their obligations arising from life insurance contracts. For several years now, government bonds have been falling as a proportion of these portfolios, despite developing slowly in step with longer-term assets. By the end of September 2016, bonds still accounted for the majority of portfolio holdings, at € 209.8 billion, with government paper making up € 147.5 billion and corporate bonds € 62.4 billion, and over 60 % of these securities commanding high ratings (AAA or AA). The loan portfolio, which has been growing robustly for a number of years now, was worth € 27 billion by the end of the third quarter of 2016, accounting for 10 % of investment. The rise of this type of portfolio reflects how insurers are diversifying their investment and underscores how some are continuing to search for yield. The value of assets held to cover technical provisions for class 23 contracts amounted to € 31 billion, with these assets mostly held in units of undertakings for collective investment (UCIs).