C. Banks and investment firms

In 2016, the banking sector conducted its business in a context of only gradual economic recovery and persistently low interest rates. That situation had two effects: it put pressure on the sector's profitability and caused a credit default problem in some European banks.

In these circumstances, the SSM focused very specifically on the supervision of banks' business models, and drew up standards for the appropriate management of non-performing loans. It also accorded priority to governance, and that resulted, for instance, in a thematic analysis of the functioning of the management bodies of significant institutions. The methodology concerning prudential supervision and evaluation was refined, e.g. to take account of the results of the stress tests in which 51 large European banks took part. The Bank participated in all this work via the Joint Supervisory Teams. At national level, management of the Optima crisis received particular attention.

During the year under review, the operations to finalise the Basel III framework continued, with the final stage involving revision of the calculation of the risk-weighted assets. Nevertheless, when this Report went to press, a final agreement had still not been reached. The European Commission issued proposals for adapting the regulatory framework on the capital requirements in order to transpose key elements of the Basel III standards at European level. Finally, as regards Belgium, the rules on options and national discretions were brought into line with the expectations defined by the ECB on the subject, and the scope of the Banking Law was extended to include investment firms. Turning to the implementation of the new regulations, the preparation of the new IFRS 9 accounting standard was monitored, as was compliance with the rules on remuneration policy.

1. Mapping of the sector and operational aspects

1.1 Population and classification of Belgian banks according to the SSM criteria

In 2016, the Belgian banking landscape saw the departure of eight institutions, leaving a total of 108. That reflects the steady consolidation of the banking sector. At the beginning of 2012, Belgium still had 124 active credit institutions, including 47 incorporated under Belgian law. During 2016, three Belgian institutions were removed from the list, two following a merger with another institution and one – namely Optima Bank – as a result of bankruptcy. The latter's parent company, Optima Group, was removed from the list of financial holding companies at the same time. Two branches under the law of a non-EEA member country were converted to branches governed by the law of an EEA member country. The registration of these new EEA branches was offset by the deletion of others, so that the number of branches ultimately declined by two units.

Via the SSM, the ECB exercises direct supervision over all institutions considered significant, and is assisted in that by the national supervisory authorities. The latter continue to maintain direct supervision over less significant entities in the euro area (of which there are about 3 500), that supervision being subject to ECB oversight. The ECB may also exercise direct supervision over less significant institutions if that is necessary for consistent application of its supervision rules.

Taking account of these factors, the Bank divided the Belgian banking population into three categories:

– "significant institutions" subject to direct ECB supervision: the Bank's team assigned to a credit institution (or banking group) forms an integral part of the Joint

TABLE 25 NUMBER OF INSTITUTIONS SUBJECT TO THE BANK'S SUPERVISION

	31-12-2015	31-12-2016
Credit institutions	116	108
Under Belgian law	37	34
Branches governed by the law of an EEA member country	52	50
Branches governed by the law of a non-EEA member country	10	8
Financial holding companies	7	6
Financial services groups	4	4
Other financial institutions (1)	6	6
Investment firms	34	33
Under Belgian law	20	20
Branches governed by the law of an EEA member country	12	11
Financial holding companies	2	2

Source: NBB.
(1) These are specialist subsidiaries of credit institutions and credit institutions associated with a central institution with which they form a federation.

Supervisory Team (JST) which, under the direction of a coordinator from the ECB and in accordance with the SSM governance rules, is in charge of supervising that institution (or banking group);

– "less significant institutions" subject to the direct supervision of the Bank: the Bank's supervision teams exercise primary supervision over these institutions in accordance with the rules and procedures drawn up by the ECB for that category of banks. The ECB concludes agreements with the national supervisory authorities in order to harmonise that supervision as far as possible. When devising supervision instruments for this category of institutions, the Bank always examines whether such instruments already exist at the ECB (e.g. for the supervision of significant institutions), and whether they can be applied with due proportionality to smaller, local, specialist institutions;
– institutions outside the scope of the SSM: branches of banks governed by the law of a non-EEA member country and investment firms remain subject to the Bank's supervision in accordance with the rules and procedures which it drew up for that purpose in conformity with the laws and regulations on the subject, but taking care to maintain consistency with the rules and best practices of the SSM.

TABLE 26 BELGIAN BANKS GROUPED ACCORDING TO THE SSM CLASSIFICATION CRITERIA

Significant institutions

Belgian parent

Argenta
AXA Banque Europe
Belfius
Degroof Petercam
Dexia
KBC (KBC Banque, CBC)

Non-Belgian SSM-member parent

BNP Paribas (BNP Paribas Fortis, Bpost bank)
Crédit Mutuel (Beobank, Banque Transatlantique)
ING (ING Belgium, Record Bank)
Banca Monte Paschi Belgio
MeDirect
Puilaetco Dewaay Private Bankers
Santander
Société Générale

Non-Belgian non-SSM member parent

Bank of New York Mellon

Less significant institutions

Byblos Bank Europe
Datex, CKV
CPH
Crelan (Crelan, Europabank)
Dierickx, Leys & C°
ENI
Euroclear
Finaxis (ABK, Delen, Bank Van Breda)
Anbang (Anbang Holding, Banque Nagelmackers)
Shizuoka Bank
United Taiwan Bank
Van de Put & C°
VDK Spaarbank

Source: NBB.

1.2 Operational aspects

Governance

The good governance of credit institutions is one of the SSM's priorities, as shown by the surveys which it conducts periodically on the whole sector, and the great importance that it attaches to good governance in its Supervisory Review and Evaluation Process (SREP).

In that regard, the SSM conducted a thematic analysis on the functioning of the management bodies of significant institutions, concerning their composition and functioning, and the quality of the flow of information and the detailed discussions. The analysis also verified the extent to which the institutions implemented a risk management policy and process capable of identifying, measuring and monitoring at all relevant levels the risks that they accept in the course of their activities. In this work, the supervisory authorities did not base their analysis solely on documents but also visited the institutions, e.g. by attending a meeting of the institution's board of directors as an observer. A horizontal comparison was conducted on the results of this study, permitting analysis of existing Belgian governance practices.

The thematic analysis revealed that good governance depends less on the institution's legal structure, size or complexity than on the effectiveness of the actual mechanisms that the institution sets up. Although the SSM did see some progress, there is still considerable scope for improvement, as described in box 9.

Box 9 – Main points for attention in regard to governance in significant institutions

Regarding governance (composition, organisation and functioning of the board of directors)

Composition of the board

The board needs to be of an appropriate size: if too big, it hampers interactive discussions; if too small, it may compromise the diversified composition of specialist committees.
The board's independence needs to be strengthened.
The board's expertise needs to be improved, at both collective and individual level.
Clear succession planning is needed.

Organisation and functioning of the board

In certain cases, the frequency and duration of the meetings need to be increased to ensure that all items and subjects on the agenda for the board are discussed in detail.
The documents concerning items on the agenda must be made available several days in advance.
The directors must be more closely involved with drawing up the agenda.
Interaction between the board and the committees needs to be improved to limit the asymmetry of information between members.

Strengthening the board's oversight of the internal control environment

The risk management function and the audit functions must have an appropriate place in the governance of the credit institution.
Those functions must have direct access to the board and report to it regularly on their activities.

Quality and exhaustiveness of the information

The information supplied to the board needs to be clearer and more complete. When very detailed information is provided, it must be preceded by a summary highlighting the main points. The minutes of the meetings must be sufficiently detailed and reflect the dynamics of the debates (questions and answers).
Data aggregation must not prejudice the clarity of the information supplied.

Quality of the debates and consideration of a risk perspective when taking decisions
There is a need to improve the quality of the board's debates and the board's capacity to question the general management totally independently and to exercise oversight over the management.
The board must do more to incorporate the risk factor in strategic discussions and demonstrate its ability to exercise effective supervision over the risk management and risk control functions.

The risk appetite framework (RAF)

Architecture of the RAF
The RAF must define the level of risk tolerance for the various financial and non-financial risks to which the institution is exposed.

RAF indicators
The risk metrics should reflect the institution's business model, size and complexity.
There should be a proper balance between static metrics and forward-looking metrics (such as stress test results).
The number of metrics (between 20 and 30) should be suited to the institution's risk profile and the metrics must be collated in a sufficiently clear and detailed table.
Limits of the RAF: need for more appropriate limits and better limit monitoring

The limits must be determined at a level that permits effective risk management
The escalation procedure for breaches of the limit must be better defined and described.
Data aggregation needs to be reviewed if it hampers the efficient reporting of limit breaches.

RAF governance
The RAF needs to be embedded in the institution's decision-making processes in the same way as the business plan, strategy, solvency and liquidity planning and the remuneration policy.
The board must be closely associated with the RAF approval and monitoring process.

RAF and strategy
The RAF must be drawn up and used so as to facilitate debate within the institution (at the level of the board of directors, executive committee, risk management function, internal audit, etc.).
The RAF must be extended to all entities and all business lines.

The main conclusions concerning Belgian institutions were that they generally performed slightly better than average in regard to governance, though they also scored well in regard to the organisation of the boards compared to other SSM institutions. The results concerning the risk appetite framework aspect were slightly below the average, particularly as regards the RAF limits and governance.

Inspections

The rise in the number of on-site inspections in the banking sector recorded in 2015 continued in 2016. Those inspections mostly concerned significant institutions subject to ECB supervision, and are always conducted by joint teams of inspectors, i.e. teams comprising inspectors from various supervisory authorities in the SSM.

In accordance with the supervision priorities set by the ECB, the inspections mainly considered the financial risks incurred by the banks and the design of their business model. As regards inspections which do not fall within the ECB's competence, the emphasis was on the prevention of money-laundering and terrorist financing, as stated in chapter F.2 of the "Prudential regulation and supervision" section of this Report.

Internal models

In 2016, the work centred on checking internal models relating to credit risk assessment under Pillar 1 [1] and focused more specifically on major changes made to models already approved. Similarly, in parallel with the processing of new applications, a number of follow-up missions took place concerning internal models under Pillar 1. Mention should also be made of the work on the approval of an internal model relating to counterparty risk, especially as there are few other examples on the subject in Europe.

1.3 Bankruptcy of Optima Bank

Optima Financial Planners (OFP) obtained a banking licence in 2011 following the acquisition of, and merger with, Ethias Banque SA. This new credit institution operated on the Belgian financial market with a business plan that aimed to combine traditional banking services with advisory services for wealthy customers, based on analysis of their assets and guidance on their investment in real estate, insurance products and financial instruments.

Optima Bank began operating in a turbulent period, in the midst of the sovereign debt crisis, at a time when banks needed to win back the confidence of the markets and their customers (restructuring plans, deleveraging of balance sheets, return to local markets and a simple business plan) and when, furthermore, both prudential regulation and the prudential supervision architecture were undergoing reform.

The application submitted in July 2011 by OFP to the Bank notifying the latter of its intention to acquire the shares in Ethias Banque SA was fundamentally different from the previous notification rejected in 2010 by the Banking, Finance and Insurance Commission (CBFA), which was still the competent supervisory authority at that time. Following detailed examination of this new dossier and the differences between it and the dossier previously submitted to the CBFA, the Bank decided on 9 November 2011 that the main areas of concern raised by the CBFA had been satisfactorily clarified in the new dossier, and that there were no longer any issues blocking OFP's acquisition of the shares in Ethias Banque SA. However, on some aspects, the Bank did state conditions and points for attention requiring work by the new bank following the merger.

(1) The Basel framework for banking supervision comprises three pillars. Pillar 1 concerns the capital requirements. Pillar 2 concerns prudential supervision and evaluation whereby the supervisor can adapt the capital requirements according to the bank's profile. Pillar 3 aims to reinforce market discipline by an increase in the information communicated by the banks.

As any new entity undergoes a launch phase during which the organisation has to be fine-tuned and synergies achieved between the merged entities, the NBB also granted Optima Bank a transitional period for rationalising the post-merger bank around its new business plan. In return, Optima Bank was subject to close "monitoring" during this initial phase. In that regard, the Bank kept watch over compliance with the approval conditions that every credit institution must satisfy, and the conditions and points for attention which had been stated when the *nihil obstat* was granted.

In the course of this surveillance, the Bank subsequently noted that the organisational structure resulting from the merger was limited, and that there was a discrepancy between, on the one hand, the Bank's prudential expectations and the institution's declarations, and on the other hand their rigorous implementation in practice. In 2013, the Bank therefore carried out an inspection to examine the organisation of the sales network and assess the working of the independent control functions (compliance, risk management and internal audit). Following that inspection, the organisation was marked "unsatisfactory" on the various points examined, giving rise to a large number of high-criticality recommendations.

Another point for attention concerned the trend in profitability, which was clearly much less favourable than OFP's previous performance and the figures budgeted at the time of the merger. It was evident that, in the new economic and financial context, the assumptions in the notification dossier concerning the growth of brokerage fees relating to real estate and insurance instruments were being fulfilled to a far lesser degree than expected, and that, with these mounting problems, the reputation of Optima Bank had been damaged by the revelations at the beginning of 2012 about its dispute with the tax authorities, while the costs were higher than expected.

As early as July 2013, the NBB had urged Optima Bank, in the light of a comprehensive assessment of all the risks that it faced, to form additional capital buffers on top of the minimum capital requirements. These additional buffers (commonly known as Pillar 2 buffers) were intended to cover in particular the losses expected in the next twelve months. In 2014, at the NBB's insistence, Optima Bank not only reduced its risk positions but also increased its capital by € 4.4 million. Apart from Optima Bank's general inability to ensure the profitability of its business model, a number of specific, rather unwise management decisions were also taken, entailing high costs. One example was the decision – in the fourth quarter of 2013 – to offer the "Premium" savings account on which the interest rate was well above the market rate ; that led to a much bigger inflow of deposits than expected, generating a seriously negative interest margin.

At the beginning of 2014, having concluded that Optima Bank would be unable, on its own, to get back on track both organisationally and financially, the Bank asked the institution to seek an experienced external partner as a matter of urgency. It also imposed a range of recovery measures concerning both solvency (increase in the capital) and profitability (cost control), and also liquidity (maintenance of balance sheet liquidity).

In the second half of 2014, Optima Bank's situation was assessed repeatedly.

Since Optima Bank had not fully implemented the measures which the NBB had stipulated, nor had it found a partner, the Bank eventually decided that the institution had to implement several options in its recovery plan, namely it must stop granting loans, sell off its loan portfolio, and stop collecting new deposits; that must be done immediately, and not from 2015 as Optima Bank itself had announced in a press release.

In this connection, the Bank envisaged various scenarios (immediate withdrawal of the licence, progressive dismantling) and concluded that progressive dismantling was preferable in order to protect depositors, creditors and employees. The experience of the financial crisis had in fact demonstrated that resolving problems within a bank by drastic deleveraging under controlled conditions could produce better results than immediate liquidation implying a forced sale of the assets, often at a loss.

From then on, the NBB focused primarily on the credit institution's liquidity situation. Up to that point, Optima Bank had always been sufficiently liquid, in any case from a "going concern" perspective. However, once a bank goes into run-off, its liquidity has to be analysed from a "gone concern" angle, i.e. by examining the quantity of liquid assets available to the institution to cover the deposits repayable to customers in the event of liquidation.

At the NBB's request, Optima Bank set out a gradual resolution procedure whereby asset components such as loans would be terminated in an orderly manner or assigned to other banks, and the holding of customer deposits would be phased out. In order to ensure that the run-off went smoothly, Optima Bank arranged a new € 7 million capital increase at the beginning of 2015 at the request of the NBB, and the main shareholder personally guaranteed a sum of € 20 million which would be enough to cover any liquidity shortfall following resolution, including in a creditors' arrangement procedure. It was planned to maintain the banking licence until all liabilities towards depositors had been settled.

In August 2015, in the light of the progressive reduction of the loan portfolio and the duration of certain loans, and with a view to Optima Bank's subsequent relaunch, the NBB authorised Optima Bank to raise a limited volume of funds, but only from professional counterparties capable of analysing Optima Bank's specific situation and its future business plan, and setting appropriate borrowing terms. However, in mid-October 2015, in analysing Optima Bank's liquidity reports, the NBB found that funds had been raised from entities which could not be classified as professional counterparties. The NBB told Optima Bank that such operations did not conform to the conditions which it had set, and prevented any new or renewed borrowing from such entities.

The controlled run-off went as planned: between September 2014 and March 2016, the loans were reduced from € 213 million to € 24 million (incidentally, except in a few cases Optima Bank was able to assign the loans at their book value), and the deposits declined from € 665 million to € 87 million over the same period.

At the beginning of 2016, the NBB analysed new information during its appraisal of the plan that Optima Bank had submitted with a view to relaunch as an investment firm. That analysis aroused suspicions of serious irregularities which a subsequent inspection confirmed. In particular, it emerged that the main shareholder had made secret, complex arrangements to channel cash out via Optima Group and the real estate division, without any genuine consideration in favour of Optima Bank. The NBB considered that, taking account of the institution's precarious situation and the cumulative losses, the application of such practices detrimental to the bank could seriously affect its liquidity unless they were stopped. These findings led to a breakdown of the NBB's confidence in Optima Bank's governance.

In view of the seriousness of the matter and this breakdown of trust, the NBB had to conclude that the bank's directors and management were no longer able themselves to conduct an orderly resolution of the banking business. In that situation, and in order to achieve that resolution as far as possible, on 13 May 2016, the NBB appointed a special commissioner to be constantly on the premises with a team empowered to oppose any transaction that would be contrary to the NBB's decisions.

At the beginning of May 2016, when confronted with these findings, the Optima Bank management declared that Optima Bank would voluntarily give up its licence as a credit institution and its aim of becoming an investment firm. The main shareholder then undertook to grant Optima Bank, by way of redress, a subordinated loan of € 10.8 million (payable by no later than 15 July) to ensure the orderly resolution of the banking business.

At the beginning of June, the press reported the problems facing Optima Bank, causing unease in the absence of any proactive communication by the institution itself. Meanwhile, the irregularities found had also undermined the possibility of a relaunch on the basis of approval other than as a bank, posing the threat of significant costs of staff lay-offs on top of the liquidity shortage.

In order to avoid a bank run and ensure equal treatment of creditors in an arrangement procedure, it was decided to halt outgoing payments unless the main shareholder could prove that he could meet his commitments. On 8 June 2016, in the absence of any proof of that, the bank's management decided to suspend the repayment of depositors.

When it became clear that sufficient resources to save the bank would not be forthcoming, and as the main shareholder had failed to meet his commitments, the Optima Bank management concluded that a bankruptcy situation existed. Consequently, the board of directors of Optima Bank filed for bankruptcy on 14 June 2016. The Ghent commercial court declared the bankruptcy on 15 June 2016.

In accordance with its responsibilities towards less significant institutions, the NBB systematically informed the SSM of the changing financial position of Optima Bank and the recovery measures required.

The NBB notified the authorities in charge of the Belgian deposit guarantee system that Optima could not repay its depositors, and the guaranteed deposits of Optima Bank customers were reimbursed under the scheme.

In the final phase of the Optima Bank case, the NBB examined whether Optima Bank was eligible for resolution by the Belgian resolution authority, namely the National Bank's Resolution College. In fact, as stipulated in the Banking Law, the Resolution College was consulted at the end of May 2016 in order to determine whether or not Optima Bank satisfied the first resolution condition, namely whether it was failing or likely to fail. The Resolution College agreed with the analysis whereby Optima Bank met this first resolution condition, and therefore had to assess the degree to which the other two conditions necessary for initiating a resolution procedure were also fulfilled. Such a procedure can only be opened if three conditions are met simultaneously: 1) the institution is failing or likely to fail; 2) there are no other ways of preventing its failure; and 3) resolution of the institution is in the public interest. In consultation with the Single Resolution Board, and as stipulated by the SRM Regulation, it was decided that Optima Bank did not meet all three conditions. It was considered that the third condition was not met because resolution was not in the public interest. That judgment was based on a range of criteria laid down by law. In addition, the Resolution College informed the commercial court competent to declare the bankruptcy of Optima Bank that no resolution procedure would be launched for the institution, thus enabling the court to declare the bankruptcy.

In July 2016, the Federal Parliament decided to instruct a commission of inquiry to establish the causes of Optima Bank's bankruptcy. The Governor and the Honorary Governor of the NBB were heard on 21 September 2016 and, at the request of the commission of inquiry, the NBB opened a data room making available all relevant documentation on the supervision which it had carried out. The commission of inquiry indicated that it envisages publishing its report by the end of March 2017.

2. Supervision under the single supervisory mechanism

2.1 Supervision priorities for 2017 and risk assessment

During the year under review, which is the second full year of its operation, the SSM concentrated on the main challenges for the banking sector identified via its risk analysis. The macroeconomic circumstances are seriously affecting the future profitability of credit institutions. Weak economic growth is not favourable for business expansion, and in recent years it has been accompanied, in some countries, by a substantial rise in loan defaults. The low interest rates exert downward pressure on interest margins in general. The arrival of newcomers on the market (FinTech) gives the banks some opportunities for expanding their activities, but it also increases the pressure of competition. In these circumstances, the SSM expects the banks to adapt their business model. It has set itself the priority of developing better methodologies and tools for analysing the profitability of banks subject to the SSM and their ability to adapt in order to maintain a level of profitability in line with the cost of capital while keeping an acceptable level of risk. More specifically, the SSM has prepared a thematic analysis of business models; the analysis will start in 2017 and will make it easier to detect profitability weaknesses in banks and to judge the adequacy of the measures to be taken under the banks' strategic plans.

The excessive level of non-performing loans is one of the key factors influencing the profitability of some European banks and their ability to support the real economy. On that subject, the SSM drew up detailed and exhaustive standards concerning the appropriate management of those loans, and asked some banks to submit a concrete plan for reducing the volume of their non-performing loans. Regarding the adequacy of the credit risk cover, it also launched a thematic analysis on the preparation of credit institutions for application of the IFRS 9 accounting standard which will enter into force in 2018 and will have a considerable influence on the volume of credit provisions.

In regard to capital adequacy, as part of the biennial EBA exercise, the SSM subjected most of the banks that it supervises to a stress test, to verify their resilience to crisis situations. The results of that exercise were used in the 2016 Supervisory Review and Evaluation Process (SREP).

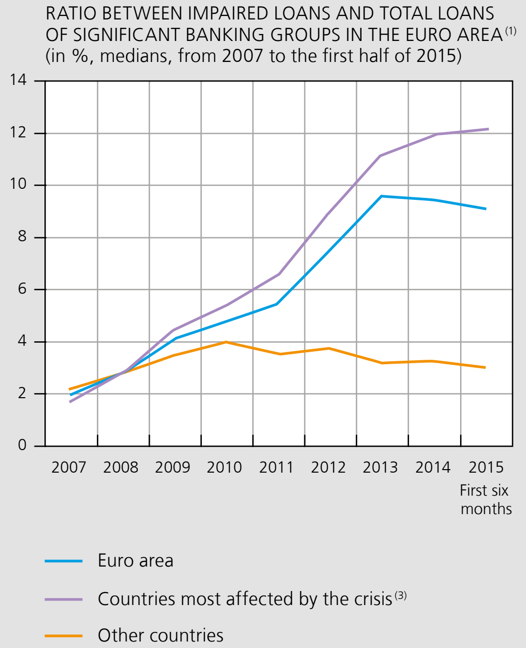
2.2 SSM guidance on non-performing loans

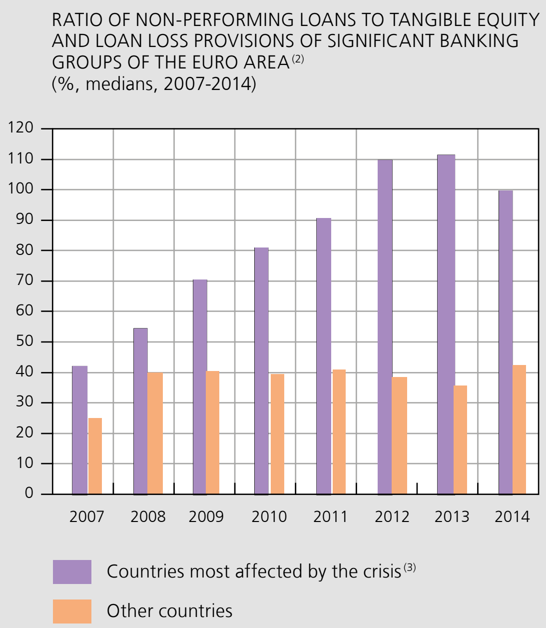
A considerable number of European banks have relatively high ratios of non-performing loans, and that has a serious impact on their profitability and on their ability to meet the capital requirements; it therefore also limits their capacity for lending to the real economy.

Aware of the need to restore the asset quality of European banks, the ECB had already conducted a comprehensive assessment in 2014 which justified an increase in the loan portfolio coverage of numerous banks and drove the ECB to further intensify its work on non-performing loans.

Taking account of the large and persistent volume of non-performing loans in some European banks, the appropriate treatment of such loans remained a priority for the ECB. Reducing them entails deploying various instruments and diverse policies. However, a range of obstacles may hamper that reduction, such as the vulnerabilities concerning the solvency of some banks and the absence of a developed secondary market for this type of loans. Other serious hurdles include the inefficient and lengthy legal procedures

CHART 104 NON-PERFORMING LOANS OF SIGNIFICANT BANKING GROUPS





Source: ECB.
(1) Public data on 55 significant banking groups.
(2) Public data on 60 significant banking groups.
(3) The countries most affected by the crisis are Cyprus, Greece, Ireland, Italy, Portugal, Slovenia and Spain.

for recovering claims, and the associated costs, as they contribute to a significant reduction in the value of those claims. The problems that Member States experience since the introduction of the BRRD in establishing "bad banks" to take on these claims likewise curtail the development of the secondary market in non-performing loans and the clean-up of the banking sector in general.

However, these constraints must not prevent credit institutions from taking appropriate measures to manage their non-performing loan portfolio in the optimum way. That is the context in which the ECB defined its guidance on the subject[1]. In accordance with the principle of proportionality, the guidance is aimed primarily at institutions with a high non-performing loan ratio, i.e. above the average for banks in the SSM area.

The guidance requires credit institutions to define credible strategies for tackling their non-performing loan portfolio with the aim of progressively reducing those loans. That strategy must include quantitative targets to be achieved per portfolio in regard to the level of non-performing loans; a detailed plan of the options to be implemented, such as additional write-downs of the claims concerned; the grant of certain temporary concessions to customers, such as payment postponement; the seizure and realisation of the assets received as collateral; sale of the portfolio to investors or bad banks; securitisation of the claims. These measures must be tailored to the type of portfolio, the bank's financial plan, and – of course – the legal framework and judicial system applicable.

The credit institution must provide sufficient financial resources, notably in terms of available capital, for successfully conducting its strategy for reducing non-performing loans and consequently adapting its financial plan. Finally, it must set up an appropriate organisation for dealing with non-performing loans, including internal departments responsible exclusively for that .

The ECB guidance also clarifies the regulator's expectations regarding the identification and assessment of non-performing loans and the depreciation policies where the existing regulations or recommendations are silent or not very specific on those subjects, the aim being to limit the use of divergent practices in Europe.

Although this guidance for credit institutions is not binding, it will provide standards for judging the adequacy of the strategy and organisation set up by each institution to manage the loan portfolio. Credit institutions will therefore have to justify any deviations from this guidance.

The ECB also asked a number of credit institutions with a particularly high ratio of non-performing loans to submit, by the beginning of 2017, a formal plan for reducing the volume of those loans, as an integral part of the SREP decision. The ECB hopes that these institutions will submit a plan which is both credible and highly ambitious, as that is essential to safeguard their ultimate viability. These plans will be examined by the ECB and must be adjusted if necessary. The ECB will keep a close eye on their implementation.

2.3 SREP methodology and results

In 2016, credit institutions subject to the SSM underwent a new SREP evaluation on the basis of the methodology developed by the SSM in 2015 and taking account of the new factors described below.

On the one hand, banking groups under the SSM were subjected to a stress test exercise harmonised on the basis of their situation at the end of 2015 (see box 10 below). The SSM took account of those results in its SREP decisions to ensure that the euro area banking groups have sufficient capital to withstand an economic crisis.

The SSM also had to revise the methodology used in 2015 as regards determination of the Pillar 2 requirements, to take account of the clarifications made by the European Commission and the EBA concerning European legislation, aimed at ensuring a harmonised approach at European level. In consequence, the following adjustments were made to the SREP methodology:

- The calibration of the Pillar 2 requirements was adjusted compared to 2015 by excluding from those requirements the proportion of the capital conservation buffer not yet applicable under the national laws transposing the fourth Capital Requirements Directive (CRD IV)[2]. That part of the buffer had been incorporated in the Pillar 2 requirement in 2015 in order to ensure a constant demand for capital during the transitional period up to the end of 2018, and equivalent treatment between euro area banking groups, in the knowledge that, in some countries, the legislature had opted not to arrange a transitional period for applying that buffer.
- The Pillar 2 requirements were still expressed in terms of CET 1, but the SSM also set an SREP requirement in terms of total capital equal to 3.5 % of the risk-weighted assets (RWA) in addition to the CET 1 requirements.

(1) ECB draft guidance to banks on non-performing loans (September 2016).
(2) Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC.

This new requirement ensures that, in accordance with the European legislation, any shortfall in tier 1 and tier 2 elements in relation to the minimum stipulated by the European regulations is made up by an equivalent amount of CET 1 elements.

– As regards the account taken of the stress test results, the SSM concentrated mainly on CET1 capital losses resulting from the "adverse" scenario. As is already the case in other European countries, notably in the United Kingdom, the SSM decided not to incorporate the stress test results in the Pillar 2 requirement but to use them to set a target (known as "Pillar 2 guidance") in terms of the amount of CET 1 capital. The Pillar 2 guidance was drawn up in order to ensure that, in a serious crisis, the CET 1 ratio remains above the sum of 5.5 % of CET 1 plus the amount of the systemic capital buffer for banks classed as global systemic groups as defined by the FSB.

The banks concerned are asked to take account of this Pillar 2 guidance in their capital planning and to respect it in normal times, as that amount is considered necessary to enable them to withstand a crisis period and – like the capital buffers – can be used during such a period.

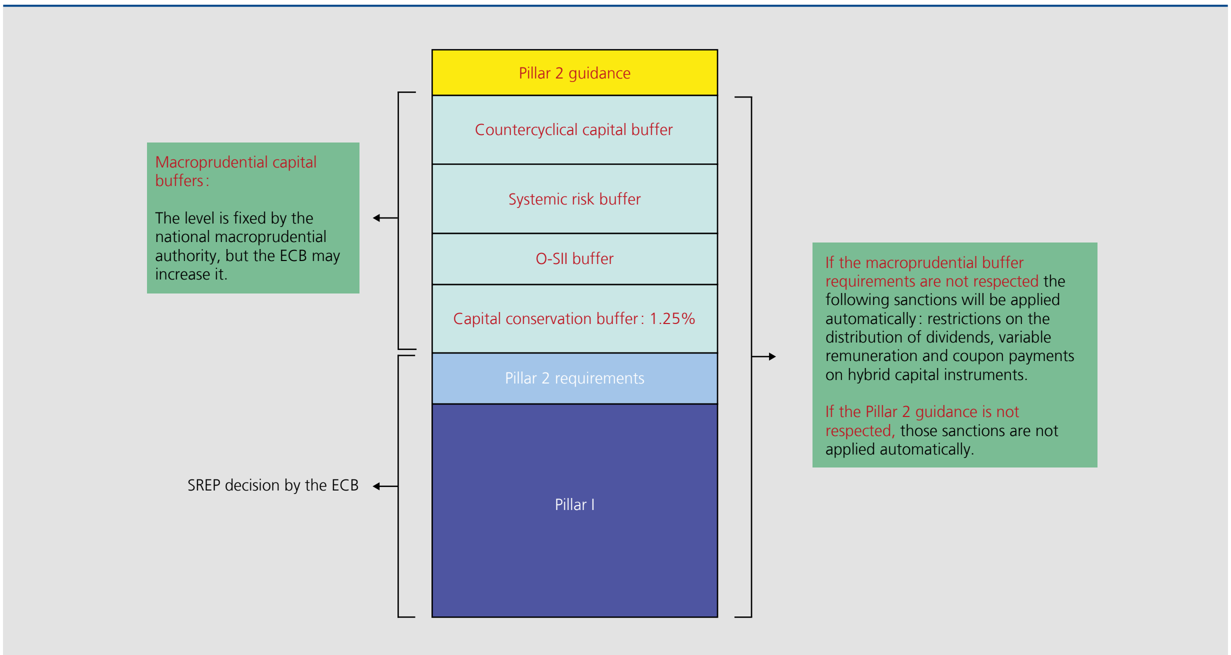
In contrast to the Pillar 2 requirement, the Pillar 2 guidance is additional to the level of CET 1 necessary to cover the capital buffer requirements. Failure to meet that objective does not lead to automatic prudential measures such as the withholding of dividends, variable remuneration or coupon payments on additional capital instruments, measures applicable in cases of non-compliance with the capital buffer requirements. In the event of failure to respect the Pillar 2 guidance, the bank concerned must inform its prudential supervisor, and the SSM will decide on prudential measures taking account of the specific circumstances.

When the ECB introduced this Pillar 2 guidance into the methodology, it also allowed for the fact that the Pillar 2 requirements laid down in 2015 already partially included the effects of an adverse stress test. It therefore made a general, downward adjustment to the calibration of those requirements to limit duplication between the Pillar 2 requirements and the new Pillar 2 guidance.

In regard to banks under the SSM, the main effect of these various measures was to reduce the Pillar 2 requirements, which on average declined from 3.1 % to 2 % of the risk-weighted assets applicable in 2016, and approached the levels of Pillar 2 requirements imposed on European banks not subject to the SSM.

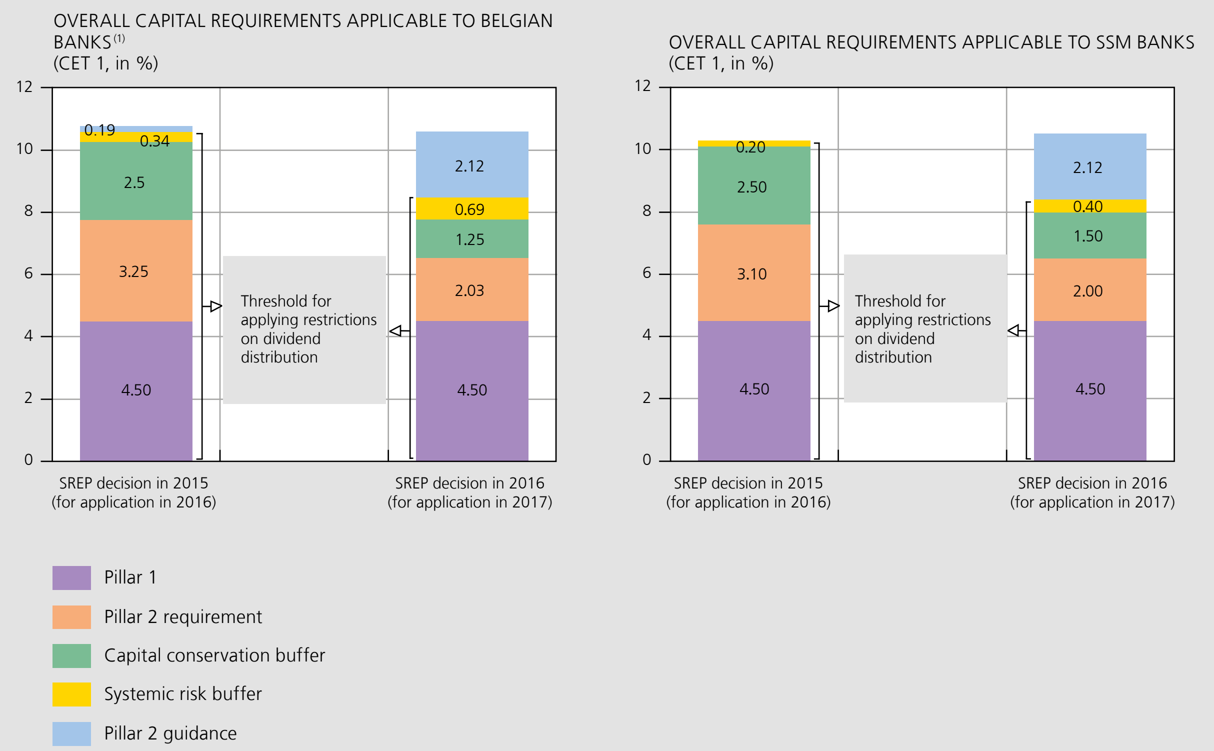
That had the corollary effect of lowering the CET 1 ratio threshold (the trigger point for the Maximum Distributable Amount) from 10.3 % in 2016 to 8.4 % for 2017 ; if the

CHART 105 STRUCTURE OF THE CET 1 CAPITAL REQUIREMENTS



Source : NBB

CHART 106 AMOUNT AND STRUCTURE OF THE CET 1 CAPITAL REQUIREMENTS



Sources: ECB, NBB.
(1) Unweighted average of banks considered significant, including BNP Paribas Fortis and ING Belgium, but excluding Dexia.

institution does not respect that threshold, it will be obliged to restrict the payment of dividends, variable remuneration or coupons on additional tier-1 capital instruments. The risk for investors in capital instruments in SSM banks has therefore moderated compared to 2016, which should facilitate access to the capital market and the revival of banking activities.

However, this reduction in the Pillar 2 requirements was offset, on average, by the introduction of the Pillar 2 guidance, ensuring that demand for CET 1 capital will be kept relatively constant in 2017 compared to 2016, and that the new methodology does not in itself imply any lowering of the banking sector's resilience.

The picture is similar for Belgian banks supervised by the SSM, with Pillar 2 requirements cut from 3.25 % in 2016 to 2.03 % on average in 2017, and a reduction in the Maximum Distributable Amount trigger from 10.6 % to 8.5 % in 2017. Conversely, total demand for capital in terms of the CET 1 ratio is down slightly from 10.8 % to 10.6 % taking account of the Pillar 2 guidance. This small reduction reflects the improvement in the risk profile of certain Belgian banks during 2016.

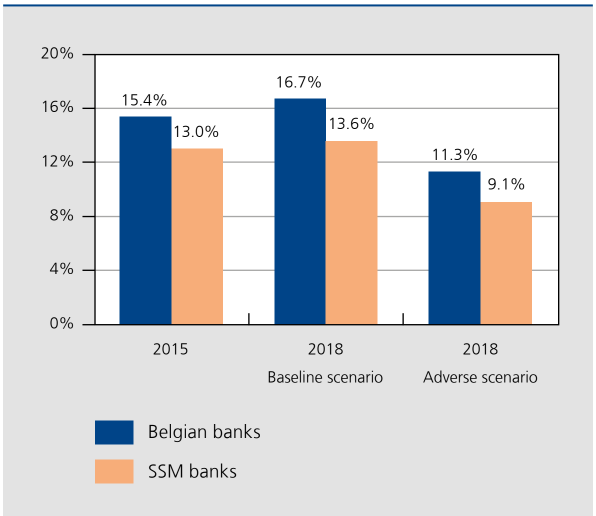
Box 10 – Stress test on European banks in 2016

In 2016, in accordance with the European regulations, the EBA coordinated a stress test in which 51 large European banks took part, 37 of them being established in the SSM member countries and subject to the ECB's direct supervision. Two of those institutions are based in Belgium: Belfius Bank and KBC Group [1].

Like the previous ones, the stress tests conducted on a European scale in 2016 were intended to provide the supervisory authorities, banks and market players with a common analytical framework permitting comparison and assessment of the capacity of large EU banks and the EU banking system to withstand adverse economic shocks. The stress tests comprised a baseline scenario and an adverse scenario, both with a three-year horizon (2015-2018). The assumptions for the macroeconomic variables in the baseline scenario corresponded to the European Commission's autumn 2015 forecasts. The adverse scenario, designed by the ESRB, was a hypothetical scenario reflecting the systemic risks considered to represent the most serious threats to the stability of the European Union's banking sector [2]. Since the adverse scenario in the stress test was hypothetical, its estimated impact should not be regarded as a forecast of the banks' profitability. Moreover, the results take no account of any response to shocks by the banks, since the test was based on the assumption of a static balance sheet. Nevertheless, the stress test results can usefully serve as an analysis instrument for assessing the resilience of bank balance sheets to the specific shocks considered.

Unlike the stress test conducted at European Union level in 2014, the 2016 test did not include any pass/fail threshold relating to the common equity Tier 1 ratio (CET 1 ratio) in the adverse scenario. Rather, it was designed to be used as a crucial input into the Supervisory Review and Evaluation Process (SREP), where mitigating management actions and potential dynamics of balance sheets may also be considered, with the primary aim of setting Pillar 2 capital guidance.

AVERAGE CET 1 RATIO (IN %)



Sources: NBB and ECB.

(1) ING Belgium and BNP Paribas Fortis, subsidiaries of foreign banking groups, took part in the stress test via their parent companies. Their results are therefore not consolidated in the Belgian average shown in the chart.
(2) For more information on the baseline scenarios and the adverse scenarios in Belgium and in the European Union, the reader is referred to the 2016 Macroprudential Report of the National Bank of Belgium (pp. 14-16).

The chart above compares the average CET 1 ratio of the Belgian banks (Belfius and KBC) and SSM banks at the beginning and end of the stress test period, in the baseline scenario and in the adverse scenario.

The Belgian banks were in a good starting position compared to the sample of large SSM banks taking part in the stress test. At the start of the test, their CET 1 ratios averaged 15.4%, contrasting favourably with the average starting value of 13.0% for the CET 1 ratio in the sample of SSM banks. The Belgian banks and euro area banks likewise recorded better starting solvency ratios than at the time of the 2014 stress test.

In the baseline scenario, the Belgian banks' CET 1 ratio increased on average by 1.2 percentage points between 2015 and 2018, while that of the SSM banks rose by an average of 0.6 percentage point over the same period. Both increases were due largely to the favourable macroeconomic and financial forecasts issued by the European Commission for Belgium and the euro area, and to a number of EBA methodological assumptions (for example, the baseline scenario did not include any market risk shock for "available-for-sale" and "fair value option" positions).

The adverse scenario had a broadly similar impact on the Belgian banks and the SSM banks: between the end of 2015 and the end of 2018, their CET 1 ratios dropped by 4.1 and 3.9 percentage points respectively. In both cases, the strong decrease in the CET 1 ratios was due to the very severe recession simulated by the ESRB, which implied *inter alia* a substantial contraction in GDP, a significant rise in unemployment, a marked drop in property prices and an increase in interest rates accompanied by a widening in spreads for Belgium and the euro area.

Taking account of their initial CET 1 ratios and the estimated fall in those ratios in the adverse scenario, the estimated ratios of the Belgian banks at the end of 2018 in the adverse scenario averaged 11.3%, i.e. well above the average ratio of 9.1% achieved by the SSM banks. The more favourable starting positions of the Belgian banks and their 2016 stress test results also reflect, at least in part, the adjustments that those banks have made since 2014, including the strengthening of their capital position, deleveraging, lowering of the risks associated with their core business lines, and reduction in legacy assets inherited from the crisis. This last item had seriously depressed the banks' results at the time of the 2014 stress test.

Overall, the results of the two largest Belgian home banks participating in the 2016 stress test demonstrate an improvement in their resilience to shocks since 2014. This is a welcome development in an environment that nevertheless still represents a challenge for the profitability of European banks.

3. Regulatory aspects

3.1 International regulations

During the year under review, the Basel Committee on Banking Supervision continued its work on finalising the Basel III framework with reforms of the regulatory standards applicable to the banking sector. Since the global financial crisis of 2008, this international body for consultation between bank supervisory authorities and central banks has constantly striven to draw up and specify a framework of sound standards to strengthen the banks' capital and liquidity buffers, which had proved inadequate during the crisis.

The standards already finalised and being phased in as part of those regulations put the emphasis on strengthening the shock absorption capacity of the banks' capital buffers, introducing supplementary macroprudential buffers, liquidity standards and a leverage ratio. However, the cornerstone of these reforms concerning the Basel III framework is the revision of the calculation of the denominator of the risk-weighted capital ratio for the banks, i.e. the risk-weighted assets. The current banking regulations permit the banking sector to use internal models to calculate their credit, market and operational risks associated with their exposures and activities. These models generate risk-weighted assets for which the bank is required to hold a minimum percentage of regulatory capital. During the crisis, a number of questions were raised concerning the transparency, comparability and complexity of the methods of calculating these risk-weighted assets, and particularly the role of the internal models. Consequently, the Basel Committee is working on a new, hybrid approach to enhance comparability and prevent the abuse of internal models, cutting down their use for portfolios and risks considered difficult to model, and imposing stricter conditions on their use in the case of portfolios and risks more amenable to modelling. It was agreed that this hybrid approach must not lead to any substantial increase in the capital requirements for banks making proper use of these internal models.

In practice, the framework provides for reform of the methods of calculating the credit risk. The internal model approach is no longer permitted for equity exposures, and can only be used to estimate the probability of default for loans granted to financial institutions and large non-financial undertakings. It can therefore no longer be used to estimate other parameters for defining the risk-weighted assets, such as the loss given default and exposure at default. The regulations are also likely to lay down minimum levels for the parameters generated by the internal models, and a revision of the standard approach for calculating the capital requirements for credit risks, attributing risk weightings more sensitive to the underlying risks.

Moreover, it will probably no longer be permissible to use internal models to calculate the capital requirements associated with operational risks.

Finally, the completed package is expected to provide for the introduction of a minimum level (the "output floor") of capital requirements calculated by means of an internal model, representing at least a yet to be determined percentage of the capital requirements defined by the Basel Committee and calculated by standard approaches.

With the completion of this overhaul of the methods of calculating the risk-weighted assets, the Committee will thus come to the end of the reform agenda initiated after the global financial crisis. The transposition of the various standards which have been drawn up should be very gradual, considering the impact on the capital requirements of certain banks and the current economic climate. When this Report went to press, no global agreement had yet been reached at international level.

Restoration of the credibility of the internal models and reduction of any unjustified disparities in their results were also among the SSM's objectives. The fact that similar risks form the subject of divergent risk assessment is another cause for concern in the SSM. At the beginning of 2016, the ECB therefore launched a project on this subject: the Targeted Review of Internal Models (TRIM). The TRIM project aims to strengthen the credibility, adequacy and relevance of the internal models. To achieve that, the TRIM will harmonise the supervision over internal models and, subsequently arrange targeted inspections of the most relevant internal risk models. During the year under review, the TRIM focused on two topics: harmonisation of supervision by drawing up uniform expectations and inspection techniques for credit, market and counterparty risk models, and conducting analyses on the qualitative aspects of the credit risk models. In that sense, this project is the cornerstone of the reforms aimed at improving the methods of calculating the regulatory capital of banks.

In April 2016, the Basel Committee on Banking Supervision also published new standards concerning the interest rate risk in the banking book. These standards [1] replace the "Principles for the management and supervision of interest rate risk" issued by the Basel Committee in 2004.

The adjustment to the framework for interest rate risk in the banking book was justified by the changes since 2004 in both the market and in prudential supervision, particularly the current low yield environment, since persistently low interest rates or a sudden rise in rates are both major challenges for the banking sector. The purpose of this framework adjustment is partly to improve and harmonise the detection, measurement, management and assessment of the interest rate risk in the banking book, and also to ensure that institutions have sufficient capital to bear the losses resulting from that risk. However, the Basel Committee judged that the interest rate risk in the banking book was too heterogeneous to permit adequate international harmonisation and standardisation. That risk therefore remains, as before, a Pillar 2 risk in relation to which the banks may be subjected to additional capital requirements on an individual basis, depending on their own situation.

These are some of the main changes compared to the 2004 framework:

- More specific guidelines on managing and measuring the interest rate risk in the banking book, particularly as regards the behaviour assumptions to be taken into account (e.g. for savings accounts and current accounts with Belgian banks) and the preparation of a series of interest rate shock scenarios to be considered a minimum.
- A broader and more specific requirement on disclosure of certain quantitative parameters on the basis of the said scenarios, and certain qualitative information, in order to improve consistency, transparency and comparability.

(1) BCBS "Standards for Interest rate risk in the banking book", 12 April 2016.

– An adapted standard approach for measuring and managing the interest rate risk in the banking book; banks can adopt that approach voluntarily or it may be imposed on them by the competent supervisory authority.
– A stricter approach in the case of outlier banks, specifying that institutions for which the negative impact of the interest rate shock scenarios applied exceeds 15 % of the Tier 1 capital must undergo an additional survey and/or be obliged to take supplementary measures or to increase the level of their capital.

The new framework will enter into force from 2018. At the moment, the EBA is adapting the May 2015 Guidelines [1], to bring them into line with the new Basel framework. The SSM is currently also examining how to adapt the methodology on the interest rate risk in the banking book to ensure that it conforms to this new framework, and to supplement it where the Basel Committee has left a degree of freedom, in order to ensure an improved and more harmonised prudential approach to the interest rate risk.

Finally, during the year under review, the European Commission issued proposals on updating the CRR and the CRD IV. The European Parliament and the European Council will discuss those amendment proposals in 2017. The proposals aim to implement – slightly later – in the EU some other key elements of the Basel III regulations. In transposing the Basel standards, they take account of the specific characteristics of the European context. First, the leverage ratio, which imposes a minimum capital requirement based on the size of the bank's assets and some of its off-balance-sheet items, is introduced as a binding ratio. It supplements the risk-weighted capital ratio and aims to prevent banks from resorting to excessive debt financing. The leverage ratio had already been introduced as an observation ratio. Next, the European Commission proposes that, similarly for the second Basel II liquidity standard, the net stable funding ratio (NSFR) should be made binding for European banks. That ratio obliges the banks to provide sufficient stable funding sources to cover the illiquid or less liquid assets on their balance sheet. Third, these amendments also contain proposals for introducing the new Basel Committee methods of calculating the capital requirements for market and counterparty risk which serve to determine the risk-weighted capital ratio. The new methodology relating to market risk entails a fundamentally different approach, in imposing higher requirements in the face of risky positions in the banks' risky trading books.

Apart from the implementation of these elements of the Basel III regulations, the proposed amendments to the CRR and the CRD IV also include measures to reduce the burden of reporting and disclosure obligations for small institutions. Moreover, the European Commission is still keen to maintain less complex regulatory standards for those institutions, in order to make banking regulation more proportional.

The proposals likewise include adjustments to the Pillar 2 approach of the supervisory authorities, and set out details of the TLAC requirements for G-SIB's [2].

Finally, as explained in box 11, the treatment of sovereign risks or risks relating to exposures to governments is still under scrutiny.

(1) EBA/GL/2015/08, Guidelines on the management of interest rate risk arising from non-trading activities, 22 May 2015.
(2) See chapter B, 1.2 in the "Prudential regulation and supervision" section of this Report.

Box 11 – International initiatives relating to sovereign risks

The banking crisis and the solvency problems that it caused for some countries in the European Union and elsewhere demonstrate that sovereign exposures are not all risk-free by definition. Historically, governments have often suffered financial stress before, during or after bank crises. When tension arises, the links between banks and governments can often act as a shock absorber and stabiliser via various channels and in different forms, but they also risk triggering a self-perpetuating negative spiral – also called the sovereign-bank nexus – which may have serious financial and macroeconomic consequences, causing systemic risks and financial instability.

Past measures all aimed to strengthen the fiscal sustainability of governments. The recent reforms of the financial regulations and the internal reinforcement planned under the resolution regime and the Basel III regulations applicable to the banks aim to increase the resilience of the various players in the financial system. However, it remains to be seen whether those measures will be enough to reflect the internal risks associated in particular with credit institutions' exposures to governments and to the public sector in the broad sense, and thus to mitigate the risk of mutual contagion.

In 2015, the ESRB [1] published a report on the current regulations concerning sovereign risks, and in 2016, a European working group [2] examined the treatment of the capital and liquidity requirements imposed on banks and insurance undertakings to cover their exposures to sovereigns and public authorities.

On the basis of academic research and conceptual and empirical analyses, the Basel Committee is likewise conducting an in-depth study of sovereign risk sources and channels in the banking sector. In addition, it is assessing and taking stock of the existing regulations, and judging on their merits the potential policy options for modifying the current regulatory framework. That thorough exercise covers all entities in the public sector, including central governments, central banks, regional authorities, local authorities and entities governed by public law. Financial players use the exposures on public sector entities for the purpose of managing liquidity, limiting credit risk, asset-pricing, intermediation and investment. When working out any adjustments, the Committee therefore takes account of various considerations, such as the important but heterogeneous role played by sovereign exposures in the banking sector, the financial markets and the broader economy, the implementation of monetary and fiscal policy, and other aspects of relevance for financial stability. However, no concrete regulatory proposal has yet emerged.

Finally, attention should be drawn to a recent initiative taken at the request of the ESRB, which consists in analysing the feasibility and the advantages and disadvantages of issuing bonds backed by a diversified pool of European government bonds.

(1) ESRB report on the regulatory treatment of exposures to sovereign borrowers, March 2015.
(2) EFC-High Level Working Group on the Regulatory Treatment of Sovereign Exposures.

3.2 Belgian regulations

The CRR contains all the rules applicable in a harmonised manner to all European banks (single rulebook). This Regulation also contains a large number of national options and discretions which may be implemented by the competent local supervisory authority or, in certain cases, on a temporary basis, by the EU Member State itself. In 2016, in the course of an exercise to harmonise the use of these national discretions in the SSM, the ECB – as the competent supervisory authority – decided on an unequivocal interpretation of these options and discretions for banks subject to its direct supervision, and passed a specific ECB Regulation on that subject [1].

The Bank published an amending Regulation [2] to bring the Regulation of 4 March 2014 on these discretions into line with the ECB rules. With a view to harmonisation and equal treatment, the existing specific NBB Regulation [3] imposing stricter liquidity requirements on credit institutions in Belgium was thus repealed with effect from October 2016. The Bank also took the opportunity to defend the maintenance of its discretionary powers to restrict exposures on foreign parent companies and subsidiaries, for both significant and less significant institutions, considering that excessive exposures can hamper the efficient resolution of problematic situations, and pending finalisation of the European banking union, particularly the entry into force of its third pillar concerning the European Deposit Guarantee System.

In the autumn of 2016, the ECB in collaboration with the competent national authorities launched a similar project on these option arrangements in the case of less significant institutions. The Belgian regulations will be adapted further in 2017 once the results of that project are known.

During the year under review, the legal framework applicable to investment undertakings was also

(1) ECB Regulation (EU) 2016/445 of 14 March 2016 on the exercise of options and discretions available in Union law (ECB/2016/4).
(2) National Bank of Belgium Regulation of 26 July 2016 amending the National Bank of Belgium Regulation of 4 March 2014 on the implementation of Regulation (EU) No. 575/2013.
(3) Regulation of 2 June 2015 on the liquidity of credit institutions.

adapted. The Banking Law, as amended by the Law of 25 October 2016 on the legal status and supervision of investment firms, and containing miscellaneous provisions, now includes a new Book XII containing provisions applicable to investment firms (1).

This new architecture takes account of both the allocation of powers between the Bank and the FSMA since the Twin Peaks reform, and the peculiarity whereby the rules applicable to stockbroking firms differ from those concerning portfolio management companies and investment advisers; it also takes account of the fact that the requirements applicable to stockbroking firms are similar to those applicable to credit institutions.

In terms of content, the legislature wanted to avoid changing the prudential rules applicable to stockbroking firms and maintain the specific characteristics of the existing system of supervising those firms. The changes to the content are confined to transposition of the new European prudential requirements introduced by the CRD IV directive and, in part, by the MiFID II directive (2), and the provisions of the FICOD (3) and BRRD (4) directives.

For reasons of proportionality, the law distinguishes various categories of stockbroking firms (in addition to the category of "systemic" stockbroking firms) which are subject to different organisational requirements, namely: small stockbroking firms, significant stockbroking firms and other stockbroking firms (stockbroking firms which do not meet the criteria of the other two categories). Most of the 20 licensed stockbroking firms are small. A single stockbroking firm meets the quantitative criteria defining significant stockbroking firms.

The criteria determining whether a stockbroking firm is significant differ from those applicable to credit institutions (see box 12). It seemed disproportionate to require the smallest stockbrokers, often family firms, to form a risk committee and an audit committee. That is why the law makes an additional distinction within non-significant stockbroking firms, based on the amount of customers' securities received on deposit.

(1) This amendment was accompanied by the adoption of a second Law of 25 October 2016 on access to the provision of investment services and on the status and supervision of portfolio management companies and investment advice firms, containing the provisions on investment undertakings in general (definition of the concept of investment services, compulsory publication of lists of approved investment undertakings, protected names, etc.) and repeals the Law of 6 April 1995 on the status and supervision of investment firms.
(2) Market in Financial Instruments Directive: Directive 2014/65/EU of 15 May 2014 on markets in financial instruments. In regard to investment undertakings (including investment firms) this text contains provisions on access to the activity (authorisation), checks on the shareholdership, and freedom of establishment in the member countries of the European Economic Area.
(3) Financial Conglomerates Directive: Directive 2002/87/EU of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate.
(4) The BRRD applies only to investment firms whose authorisation covers investment services comprising dealing on own account and underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis (Article 2 (1), points 3 and 23).

Box 12 – The three categories of stockbroking firm in the Banking Law and the governance requirements

1° Significant stockbroking firms (1)

These are stockbroking firms which attain or exceed one of the following three quantitative thresholds (2):
– number of employees averaging 250 people over the whole financial year concerned;
– balance sheet total of € 43 million;
– net annual turnover of € 50 million.
The Bank may decide on the basis of qualitative criteria that a stockbroking firm must be classed as significant.

The obligation to form an executive committee is introduced with the option of waiver depending on the size and risk profile of the stockbroking firm. Article 504 of the Banking Law provides for the formation within the legal administrative body of 4 separate committees (audit committee, risk committee, remuneration committee and nomination committee). As in the case of credit institutions, account may be taken of the organisation set up within a group in order to waive these obligations (3).

(1) A systemic stockbroking firm, recognised as such, is considered significant for the purposes of the governance requirements.
(2) See Article 486 of the Banking Law. These criteria already appeared in the Law of 6 April 1995. The Law of 6 April 1995 already specified that account could be taken of the inclusion of the stockbroking firm concerned in a financial group which had an audit committee and/or a remuneration committee at group level.
(3) The Law of 6 April 1995 already specified that account could be taken of the inclusion of the stockbroking firm concerned in a financial group which had an audit committee and/or a remuneration committee at group level.

This regime corresponds to that applicable to significant credit institutions.

2° Other stockbroking firms

These are stockbroking firms which attain or exceed no more than one of the three quantitative thresholds mentioned in point 1° and whose total of clients' financial instruments received on deposit is € 5 billion or more.

The obligation to form an executive committee is introduced but accompanied by a waiver option depending on the size and risk profile of the stockbroking firm. The obligation to form an audit committee and a risk committee within the legal administrative body is accompanied by the option of authorising a joint audit and risk committee. That corresponds to the regime applicable to non-significant credit institutions pursuant to Article 3, 30° b) of the Banking Law. As in the case of credit institutions, account may be taken of the organisation established within a group in order to waive these obligations.

3° Small stockbroking firms

These are stockbroking firms which attain or exceed no more than one of the three quantitative thresholds mentioned in point 1° whose total of clients' financial instruments received on deposit is less than € 5 billion for two consecutive accounting years.

There is no obligation to form an executive committee, nor any obligation to form the aforesaid committees within the legal administrative body. This regime corresponds to the previous regime applicable under the Law of 6 April 1995 to small stockbroking firms. In most cases, they are family stockbroking firms not involving any external personnel.

However, the Bank may define a small stockbroking firm as an "other stockbroking firm" on the basis of qualitative criteria, with the resulting consequences in regard to governance obligations.

In practice, only stockbroking firms that meet the criteria for small stockbroking firms can be established in the form of a private limited company (SPRL) and/or limited partnership, as that is the only stockbroking firm category which has no obligation to form an executive committee or an audit committee, and is therefore able to reconcile the governance requirements applicable to an SPRL or limited partnership.

3.3 Reporting, accounting and governance

In regard to governance, accounting and reporting, three subjects merit highlighting for 2016, namely the monitoring of the implementation of the new International Financial Reporting Standards 9 (IFRS 9), use of the IFRS for prudential reporting, and developments concerning remuneration.

IFRS 9 impact study

IFRS 9, Financial Instruments, which will replace IAS 39 from 2018 (1), will have a major impact on the accounts of credit institutions. The primary aim of IFRS 9 is to remedy the "too little too late" effect of the "incurred losses" model used under IAIS 39 by switching to an "expected losses" model. The latter is more in line with the prudential requirements. The main expected effect of this standard is an increase in the credit risk provisions. In April 2016, wishing to promote robust and consistent implementation of the IFRS 9 in the European Union, but also to anticipate any repercussions on capital, the EBA launched an initial study of the qualitative and quantitative impact of this standard on a sample of banks

(1) Subject to adjustments made by the International Accounting Standards Board (IASB) to IFRS 4 (Insurance contracts) and permitting postponement of application of the standard beyond 2018 for certain insurance undertakings.

representative of the European market. The results of that study – in which the Bank took part and which is independent of the European Union's endorsement of the IFRS 9 – were published by the EBA on an aggregate basis.

The main findings can be summarised as follows:

- The smallest banks are at a less advanced stage in regard to the project, mainly because they have fewer available resources.
- The relevant bodies concerned in the project have not yet all been systematically involved.
- Most of the institutions polled intend to make maximum use of the definitions, data, systems and models already used in credit risk management and regulatory monitoring.
- While many participants are planning a parallel run, it will be limited in view of the short time between completion of the implemention of the IFRS 9 project and application of the standard.
- Data availability and quality are the main challenges reported by participating banks, which will need to use various internal and external sources of information.
- Overall, the impact of the IFRS 9 section on "Classification and measurement" of financial instruments should be less than that of the expected loss impairment model.
- The interpretation of certain key concepts such as the "significant increase in credit risk" is a challenge in itself and has yet to be finalised.

For each of these findings, the EBA formulates a number of recommendations for the attention of the sector; together with its guidelines on the measurement and recognition of expected credit losses, consistent with those of the Basel Committee, they should support European credit institutions in achieving a high quality implementation of the standard.

The EBA also notes that the participating banks were still at an early stage of the project at the time of the survey, and they therefore had to make significant simplifications in order to provide the requested estimates. A second impact study will therefore be launched at the beginning of 2017.

The ECB also extended the EBA questionnaire to a selection of less significant credit institutions, and began a thematic study of the implementation of IFRS 9 by significant credit institutions. In 2016, in parallel with these studies in which it participates, the Bank also launched a qualitative and quantitative analysis of the impact of IFRS 9 on less significant Belgian credit institutions which are at the head of a group and therefore draw up consolidated accounts in accordance with the IFRS. That analysis will continue in 2017.

Communication by the Bank on the use of the IFRS for prudential reporting

Credit institutions in Europe report financial information periodically to the competent supervisory authorities via the European Financial Reporting Framework (FINREP). Under the SSM, the FINREP reporting requirements were extended by the ECB Regulation of 17 March 2015 on reporting of supervisory financial information. For Belgium, that means that all credit institutions will now be required not only to draw up the current FINREP reports at a consolidated level on the basis of the IFRS rules, but also to disclose FINREP information on an individual company basis.

Since the ECB Regulation contained no specific provision on the accounting law applicable, the FINREP information at individual company (solo) level had to be reported on the basis of the accounting rules in the country concerned. In Belgium, that implied that the FINREP on an individual basis had to be drawn up under Belgian Generally Accepted Accounting Principles (BE GAAP). In order to facilitate production of the individual FINREP on the basis of BE GAAP data, the Bank decided to publish a concordance table (mapping).

Since then, in conformity with the CRR, the ECB has decided to grant *ad-hoc* authorisation, subject to certain conditions, for the use of IFRS for supervisory reporting by entities considered significant. To avoid the emergence of disparities between the supervision arrangements applied to significant institutions and those reserved for less significant institutions, the Bank also decided to grant the latter – case by case and under the same conditions – the option of using IFRS for their financial reporting. That means that credit institutions which fulfil the conditions can now draw up the individual company FINREP on the basis of IFRS instead of BE GAAP.

Remuneration policy: horizontal analysis and transposition of the EBA Guidelines

In 2016, in collaboration with the SSM, the Bank again conducted an in-depth horizontal analysis of compliance by significant institutions with the rules on remuneration policy. By comparing institutions with one another according to the same method, the Bank intends to promote a level playing field within the Belgian financial sector. In this instance, the analysis concerned eight significant institutions and related to performance in 2015 for which variable remuneration had been paid at the beginning of 2016. In this connection, the Bank focused particular attention on the implementation of its recommendations from the previous year.

The results of this horizontal analysis were set out in a Circular letter which the Bank adopted in order to transpose the EBA Guidelines of 27 June 2016 on sound remuneration policies into the Belgian prudential framework. Aspects covered by these Guidelines include : governance requirements, implementation of the remuneration policy in a group context, the process for selecting Identified Staff, the distinction between fixed and variable remuneration for the purpose of calculating the exact ratio between those two components, the requirements on the risk alignment of the remuneration policy, etc. The EBA Guidelines form an integral part of the aforesaid Circular, and from 1 January 2017 will form the basis of the actual supervision of the remuneration policy and practices of financial institutions. A few guidelines are based on a series of points for attention identified by the Bank on the basis of its annual horizontal analyses of the remuneration policy of significant institutions. Thus, in the light of that horizontal analysis, attention should be paid to the following points :

- meticulous documentation of the Identified Staff selection process ;
- the importance of transparency, at the level of both the remuneration policy itself and its actual implementation ;
- the specific role of the risk committee in regard to remuneration policy ; and
- sufficient variation in the postponement of variable pay (as regards both the proportion of the postponed pay and the duration of the postponement).

The Circular letter also confirms the Bank's guideline stating that – by way of exception, owing to the moderate level of their variable remuneration – staff receiving variable pay of no more than € 75 000 need not be subject to specific requirements concerning the payment postponement and payment in the form of financial instruments.

At European level, on 30 March 2016, the EBA published a report entitled "Benchmarking of remuneration practices at the European Union level and data on high earners", concerning performance in 2014. That report is based on the remuneration data of a representative panel of institutions put together by the national supervisory authorities, including the Bank. The document reports a number of trends at European Union level, such as a substantial rise in the number of Identified Staff and a further fall in the ratio between fixed and variable pay. The inadequate harmonisation of the institutions' remuneration practices within the European Union, particularly as regards payment postponement and payment in the form of financial instruments, remains an important point of attention.