3. Savings and financing the Belgian economy

3.1 Businesses take advantage of low interest rates to raise their borrowing from resident banks

Belgian businesses turn to bank lending to fund higher investment

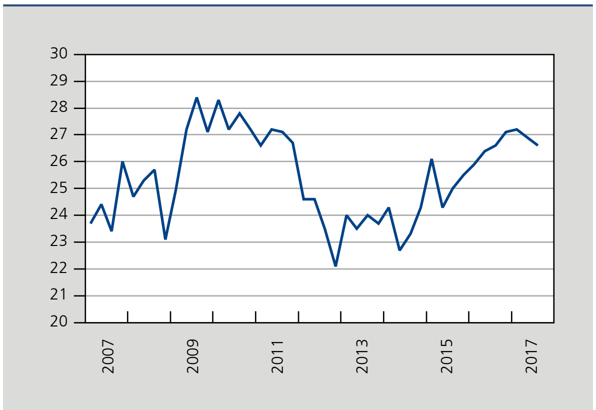
Economic and financial circumstances were exceptionally conducive in 2017 for businesses to expand their operational capacity. As noted in the previous chapter, for instance, their fixed capital formation remained dynamic, amounting to € 45.3 billion in the first nine months of the year. Belgian non-financial corporations lifted their real or financial investment abroad by € 3.4 billion during the same period.

The intensity of the investment – funded in part through operating surpluses and cash reserves – was such that businesses' outstanding cash and bank deposits did not grow any further in 2017 after the first quarter, and subsequently declined a little. Cash reserves nevertheless remained high at the end of the third quarter, amounting to € 115.7 billion or 26.6 % of GDP – slightly below the peak recorded in the third quarter of 2009, when companies had stockpiled cash due to their low level of investment activity during the recession.

Despite this, the increase in businesses' profits and the scale of their cash reserves do not seem to have diminished demand for bank loans. This at least is what the Eurosystem's bank lending survey (BLS) suggests, with internal resources barely cited as an explanation for the demand for bank lending in 2017. Demand rose again, incidentally, in line with higher investment and other borrowing requirements, such as those relating to mergers and acquisitions and restructuring. Heightened demand in the final quarter of the year had more to do with financing inventories and working capital, as expressed in a larger percentage of short-term loans within overall bank lending in that period.

CHART 38 NO FURTHER INCREASE IN CORPORATE CASH RESERVES

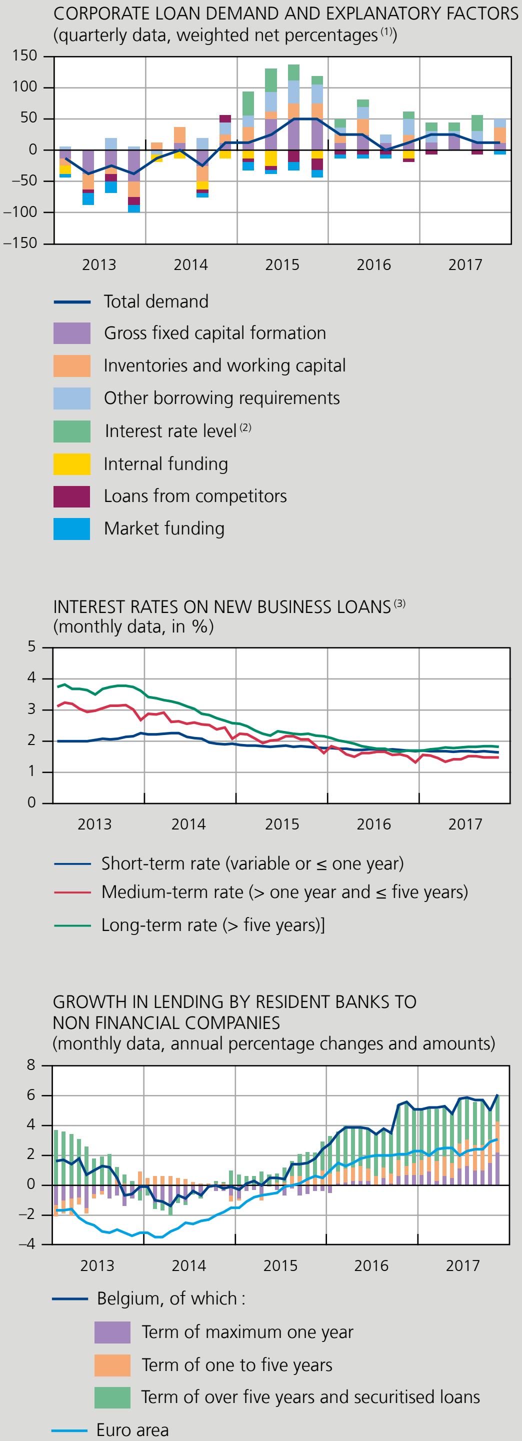
(currency and deposits of non-financial corporations, in % of GDP)



Sources: NAI, NBB.

Aside from increased borrowing requirements, demand for credit continued to be buoyed by very low interest rates. The ECB's monetary policy remained accommodating in 2017, enabling banks to continue to finance themselves at low cost, while competitive pressures once again encouraged them to ease margins a little on the loans they provided. Medium- and long-term rates for bank lending remained extremely low as a consequence, close to rates at less than one year. However, long-term interest rates rose slightly – by 12 basis points from the end of 2016 – to an average of 1.81 % in September 2017, in keeping with the general financial market trend.

CHART 39 GROWTH IN BANK LENDING UNDERPINNED BY FUNDING REQUIREMENTS AND LOW INTEREST RATES



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.

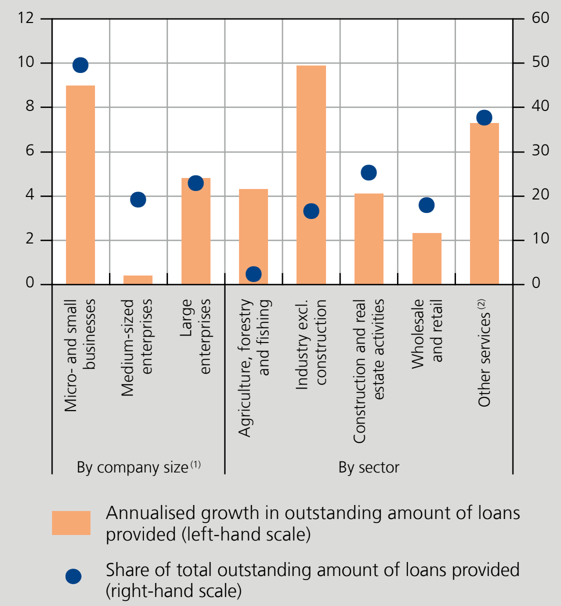
(3) Loans up to and including € 1 million.

Against this backdrop, growth in bank lending to businesses gathered further momentum in 2017, reaching 6.1 % year-on-year in November and substantially outpacing the 3.1 % increase for the euro area. This growth has been primarily attributable over the past three years to long-term loans. All the same, short- and medium-term loans – those with a term of less than five years – made a stronger contribution to the increase in the final months of 2017.

Growth in loans provided by Belgian banks in 2017 chiefly benefited micro- and small businesses, with the outstanding amount of loans granted to such firms climbing 9 % between the third quarter of 2016 and the same period in 2017. The increase was much more substantial than that for medium-sized and large enterprises, which saw growth in loans provided of 0.4 % and 4.8 % respectively. In addition, all sectors drew more heavily on bank lending in 2017, albeit to a varying degree. Growth in borrowing was more pronounced in industry and in sectors focusing on services to businesses. It was more moderate in

CHART 40 BANK LENDING GROWS MORE ROBUSTLY AMONG MICRO- AND SMALL BUSINESSES

(loans provided by resident banks, data on 30 September 2017, in %)



Source: NBB (Central Corporate Credit Register).

(1) Micro-businesses are defined as companies that use the micro format to prepare their financial statements and as small businesses that use an abbreviated format. Companies that submitted full financial statements are deemed to be medium-sized or large enterprises depending on whether or not they exceed one or more of the specified thresholds for number of employees (50 FTEs), turnover (€ 9 million) and total assets (€ 4.5 million). Data for companies whose scale has not been determined are not included.

(2) Excluding financial activities and insurance.

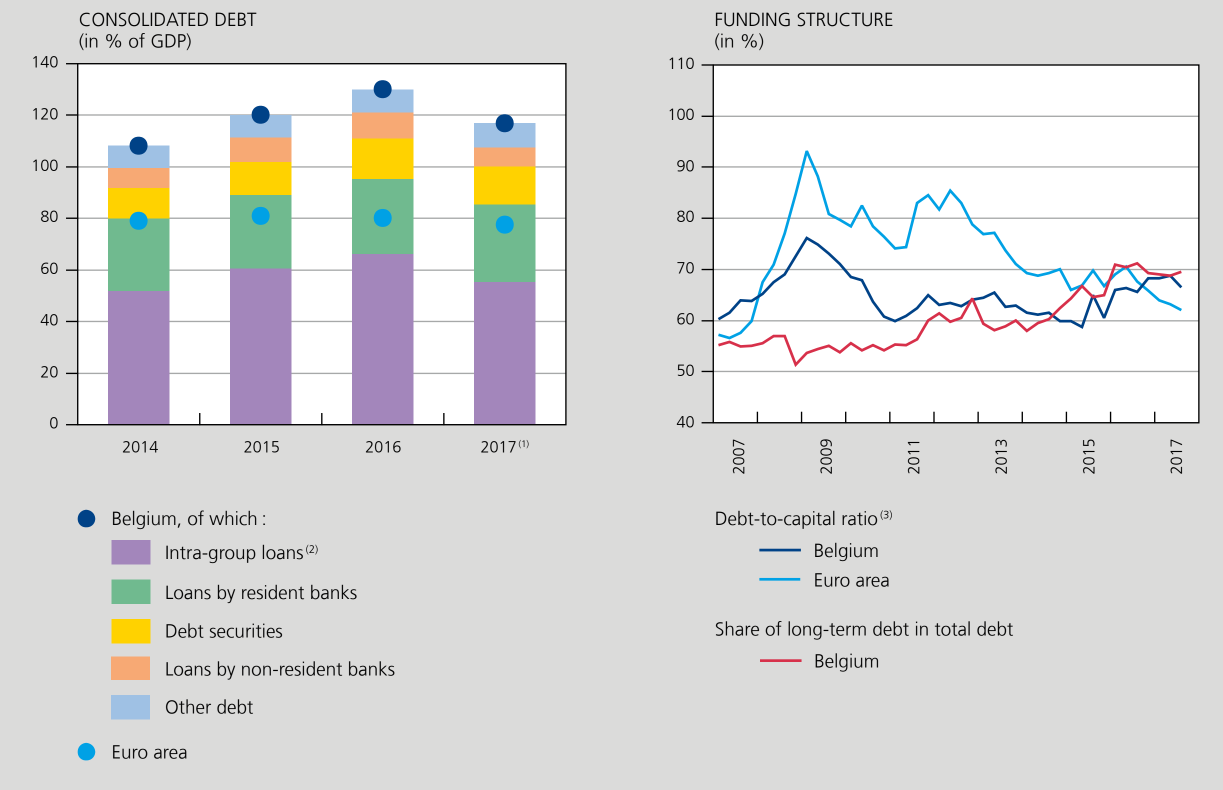
the wholesale and retail sectors, and also in construction and real estate. Despite this lower growth, at the end of September 2017, the two latter sectors still accounted for just over a quarter of loans by resident banks to Belgium-based non-financial corporations.

Overall, new loans received by Belgian businesses from resident banks during the first three quarters of 2017 amounted to € 6.4 billion, including securitised loans, according to the financial accounts statistics. Broader use of bank lending was accompanied by a reduced call on market funding, and especially on funding via bonds. This is evident from the fact that repayment of loans contracted in that form from the other institutional sectors exceeded the value of new bond issues. As a result, the volume of debt instruments issued by non-financial corporations was down € 375 million over the first three quarters of 2017, having risen € 13.5 billion in the previous year, due primarily to AB InBev's bond issue to fund the acquisition of SABMiller. Reduced issuance of debt instruments since mid-2016 suggests that, all things considered, the corporate sector purchase programme (CSPP) implemented by the Eurosystem has not had any significant direct impact on Belgian businesses, other than possibly through the downside pressure that the measure exerted on bond market rates. This is partially attributable to the small number of Belgian businesses whose bonds have a sufficiently high rating to qualify for purchase under the programme. It is also possible that some Belgian-based firms may have benefited indirectly – via shareholdings or intra-group loans – from funds raised through the issue of bonds by associated companies in Belgium or abroad.

Corporate debt levels fell overall in 2017, largely due to movements in intra-group funds

Despite the rise in borrowing, overall corporate debt levels contracted considerably between the end of 2016 and the third quarter of 2017. The decline arose primarily from

CHART 41 CORPORATE DEBT CONSISTS CHIEFLY OF INTRA-GROUP AND LONG-TERM LIABILITIES



Sources: EC, ECB, NBB.
(1) Situation on 30 September 2017.
(2) Loans provided by foreign non-banking corporations and the captive financial institutions and money lenders sector.
(3) Non-consolidated data.

a € 39.1 billion fall in outstanding intra-group loans [1], which was largely attributable to the repayment by a large enterprise of a debt to a company from the captive financial institutions and money lenders sector. Furthermore, outstanding loans provided by non-resident banks also declined in the first three quarters of the year, by € 11.1 billion.

As a result, on 30 September 2017, consolidated corporate debt amounted to € 507.7 billion, or 116.9 % of GDP. It thus remained well above the euro area average, which came to 77 % of GDP. The difference ought to be qualified, however, given the substantial intra-group liabilities of Belgian non-financial corporations towards foreign entities or captive financial institutions and money lenders. Adjusted for these liabilities, which account for almost half of the total, Belgian corporate debt to other sectors came to € 266.9 billion or 61.4 % of GDP. The scale of intra-group debt is typical of Belgium and also of a small number of other European countries, including the Netherlands, Ireland and Luxembourg.

The capital ratio of Belgian non-financial corporations had exceeded the euro area average for a prolonged period, but this ceased to be the case in 2017. The debt-to-capital ratio amounted to 66.5 % in the third quarter of 2017, compared with an average of 62 % for the euro area, reflecting the sharp rise in the debt levels of Belgian-based businesses in 2016, whereas balance sheets in the euro area have been pruned more or less steadily since the end of 2011. The more rapid increase in Belgium's corporate debt level apparent recently is substantially attributable to the funds borrowed via various channels by AB InBev. The recent decline in investment in equity capital, the volume of which had previously been boosted by the notional interest deduction scheme, also pushed up the debt-to-capital ratio, albeit to a more limited degree. The relevant tax deduction has become less attractive due to successive reductions in its reference rate – the yield on ten-year linear bonds (OLOs) issued by the Belgian government – and the fact that it has not been possible since 2013 to carry tax deductions over from one tax year to another.

It should also be noted that businesses chiefly contracted new loans with long terms and at historically low interest rates, which could compress both refinancing risk and interest charges.

(1) Amount estimated based on data from the financial accounts, which aggregate loans provided to non-financial corporations by the foreign non-financial sector and by the captive financial institutions and money lenders sector. This is a consolidated amount that does not take account of loans provided by non-financial corporations to other resident non-financial corporations.

3.2 New increase in household debt

Net formation of financial assets declined further in 2017

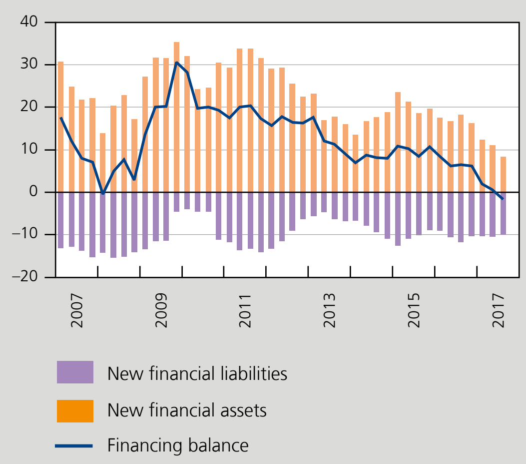
The trend seen since 2010 towards a lower rate of accumulation of new financial assets by households continued in 2017, since the total amount of their consumer spending and real investment more or less equalled their disposable income. The cumulative balance of financial transactions by households fell year-on-year to minus € 1.7 billion by the end of the third quarter of 2017, its lowest level since 2007.

This was again accompanied by the regular and steady accumulation of new liabilities to the tune of € 3.1 billion a quarter in 2017, compared with € 2.6 billion in 2016. For their part, new investment declined in the first nine months of 2017 to € 0.8 billion a quarter, as opposed to € 3.5 billion during the corresponding period of 2016.

Households focusing more on riskier financial assets

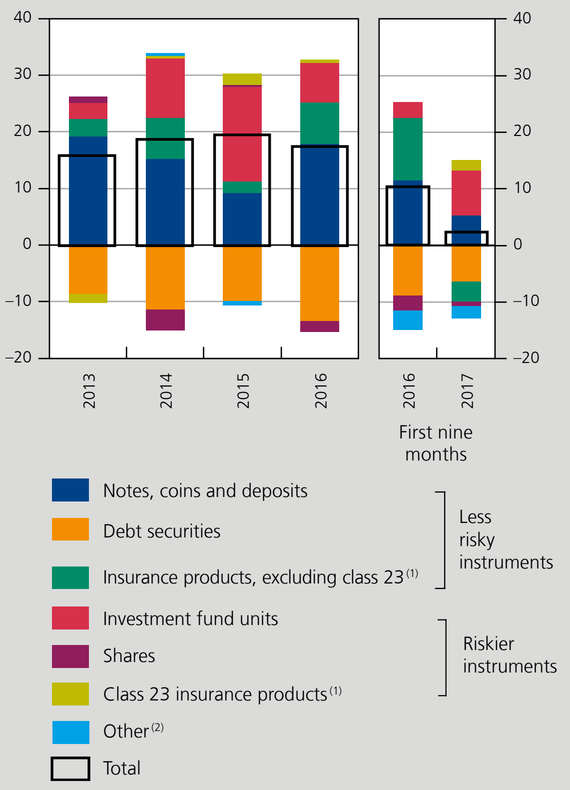
Having faced exceptionally low returns for several years, households not only purchased fewer financial assets, they also focused more on instruments associated with higher risk levels and which therefore offer a certain level of return. This increase in risk appetite reflected the upturn in economic growth and the clear improvement

CHART 42 LOWER BALANCE OF HOUSEHOLD FINANCIAL TRANSACTIONS
(in € billion, moving average over four quarters)



Source : NBB.

CHART 43 LESS, BUT RISKIER FINANCIAL INVESTMENT
(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, so far as they have been recorded, trade credit as well as miscellaneous assets of general government and financial institutions.

in household confidence to which this gave rise, as well as attractive financial market developments such as price increases and limited volatility.

The pursuit of higher returns, necessitating the holding of riskier assets, translated into the sale of debt securities – principally government and corporate bonds and savings certificates – to the amount of € 6.3 billion, which meant households realised potential capital gains on the portfolios in question. Insurance products with guaranteed capital (specifically those belonging to class 21) were adversely affected by the low interest rate environment and by a strategic shift in insurance company policy. The companies in question responded to the potential reinvestment risk inherent in this situation by scaling back production of these products, which have become less profitable; households meanwhile cashed them in to the tune of € 3.6 billion. Finally, they also reduced their investment in the shape of cash and deposits, from € 11.5 billion in the period from January to September 2016 to € 5.3 billion. The funds released were mainly placed in current accounts (€ 3.8 billion) and savings accounts (€ 2.8 billion).

Conversely, households acquired investment fund units amounting to € 7.9 billion, and, to a lesser extent, insurance products without capital guarantee, such as those belonging to class 23, for a sum of € 1.9 billion. But they once again offloaded individual shares, primarily listed equities, for a total of € 0.8 billion.

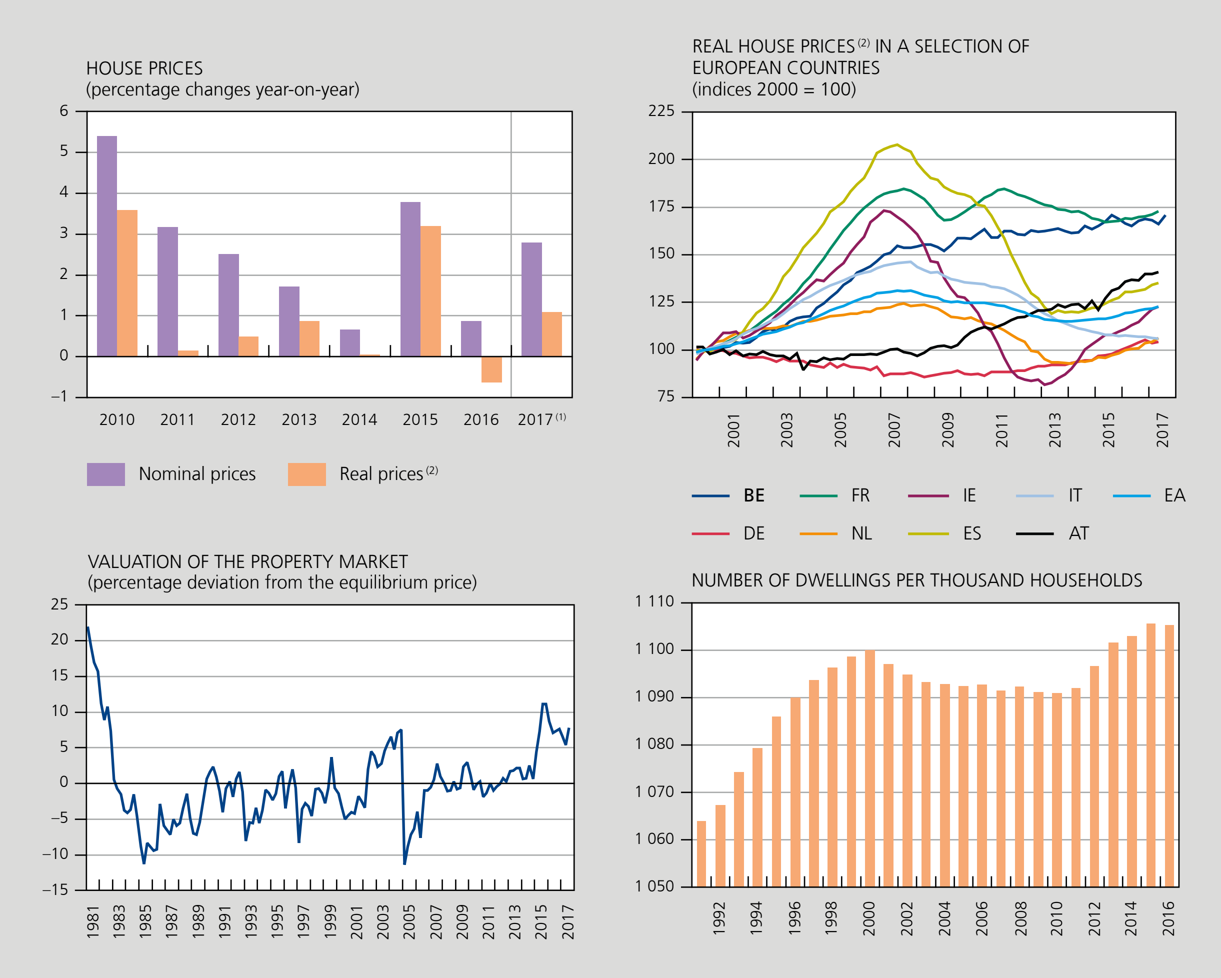
Changes to taxes levied on income from movable assets also impacted households' decisions on their financial investment. The tax on speculation was scrapped in 2017, having been introduced in 2016 for capital gains realised by private investors on the stock exchange within less than six months. At the same time, the maximum amounts payable for the tax on stock market transactions applicable to all operations were almost doubled, rising in the case of equities from € 900 to € 1 600. Lastly, withholding tax on dividends and interest was raised from 27 % to 30 % on 1 January 2017.

Other changes also had the potential to alter household behaviour. The government introduced a 0.15 % tax, for instance, on outstanding assets held by private individuals in securities accounts where these amount to at least € 500 000. This applies to holdings of equities, bonds and investment funds, as well as other exchange-tradeable financial products such as warrants, certificates and trackers, but excludes registered securities. Nor does investment in life insurance and pension savings products attract the tax, which may have stimulated investment in class 23 insurance products in particular. Other new elements have also come into effect since 1 January 2018, including an exemption from the 30 % withholding tax on the first € 627 in dividends, and a cap of € 940 (compared with € 1 880 previously) on the tax-exempt interest on savings accounts. These adjustments are primarily intended to encourage private individuals to invest in the real economy – in the form of shares – by discouraging investment in savings accounts. Finally, one of the changes that did not affect household transactions in 2017 was also aimed at pension saving: where contributions had previously entitled savers to a 30 % reduction in tax up to an annual ceiling of € 940, they are permitted as of 2018 to pay in above that limit to a maximum of € 1 200 per year, in which case the applicable tax reduction is reduced to 25 %.

Households show continued interest in real estate against the backdrop of a relatively stable market

Property prices in Belgium have been rising strongly for over three decades now, with no genuine downward

CHART 44 THE HOUSING MARKET IN BELGIUM AND IN A SELECTION OF EUROPEAN COUNTRIES



Sources: DGS, OECD, NBB.
(1) First three quarters of 2017 relative to the corresponding period in the previous year.
(2) Deflated by the national accounts final consumption expenditure deflator.

correction being triggered even against the backdrop of the economic and financial crisis that began in 2008. Corrections of this kind have, by contrast, occurred in several European countries, among them Spain, Ireland and the Netherlands. House prices have, however, been rising again in the past few years in virtually all European countries – particularly in the euro area periphery, but also in the Netherlands and Germany, and sharply so in Austria.

Growth in property prices accelerated somewhat in Belgium between 2016 and 2017, with a nominal year-on-year increase of 2.8 % in the first three quarters of 2017. Deflated by the final consumption expenditure deflator, the figure amounts to a real price increase of 1.1 %. House prices had continued to rise between 2011 and 2016, but the pace of growth had eased. The recovery in 2017 appears to have put an end to that pattern. A clear but short-lived acceleration also occurred in 2015, even though tighter tax rules on mortgage loans – in the Flemish Region in particular – might have mitigated this.

According to the estimates of an econometric model that takes account of various demand factors – household disposable income, mortgage rates, demographic trends and key changes in taxes on real estate – house prices in 2017 are believed to have been approximately 6.5 % higher than their estimated equilibrium value. This was less than in 2015, when the deviation had risen sharply to 11.1 %. The reduction is chiefly attributable to the slower rate of increase in property prices, which therefore remains lower than what the determinants in the model suggest, but also in part to the recent expansion of the housing stock. The number of dwellings increased by 5.5 % between 2010 and 2016, while the number of households rose 4.1 % over the same period, which suggests a better match between the housing supply and demographic trends. It should also be noted that real estate prices being close to the value estimated according to the underlying fundamental determinants in no way implies that the property market is not facing any risks. Property prices could fall substantially should one of the determinants deteriorate sharply – due to an increase in interest rates, for instance, or a shock to household income.

Activity in the secondary real estate market, which was clearly influenced by the reforms implemented by the Regions since 2015 with regard to the tax deductibility of mortgage loans, moved closer to its customary levels in 2016. It picked up again in 2017, albeit at a moderate rate, as the Royal Federation of Belgian Notaries recorded a rise of barely 1 % in the number of transactions in the first three quarters of the year compared with the corresponding period in 2016.

Increase in household debt once again primarily due to mortgage loans

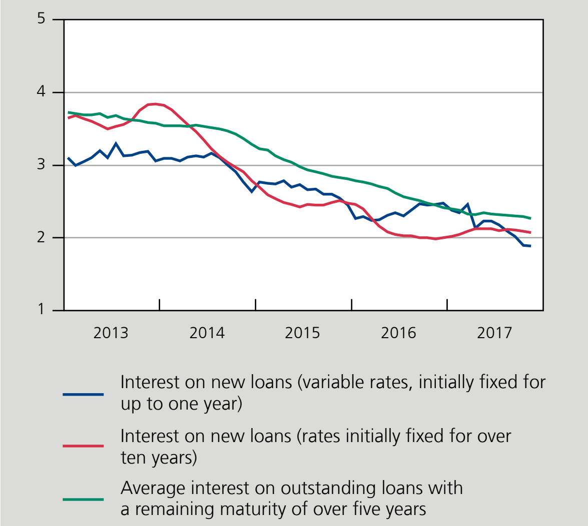
The financial environment in 2017 thus remained conducive to renovation projects and property purchases. Low interest rates continued to be a key factor underpinning demand for residential property investment. Although interest rates on new mortgage loans with a term of over ten years were slightly higher than their November 2016 trough (1.99 %), they remained extremely low, amounting to 2.07 % in November. Rates for loans with variable interest and a fixed-rate period of no more than one year continued to decline, falling from 2.48 % at the end of 2016 to 1.89 % at the end of November 2017. Consequently, taking account of the increase in consumer prices, real interest rates on new home loans remained around zero.

Successive reductions in recent years in the interest rates applying to new mortgage loans meant that the average rate of interest on outstanding loans with a residual term of over five years also declined in 2017, reaching 2.27 % in November.

At the same time, the Eurosystem's BLS shows that participating banks reported a certain tightening of credit terms since the beginning of 2016, although this was neither generalised nor continuous. Closer analysis of the survey suggests that it resulted from an increase in the margins on standard loans (in 2016) and, more recently, on riskier loans. This development may have been mitigated, however, by competitive pressures.

CHART 45 INTEREST RATES ON NEW PROPERTY LOANS REMAIN VERY LOW

(in %, monthly data)



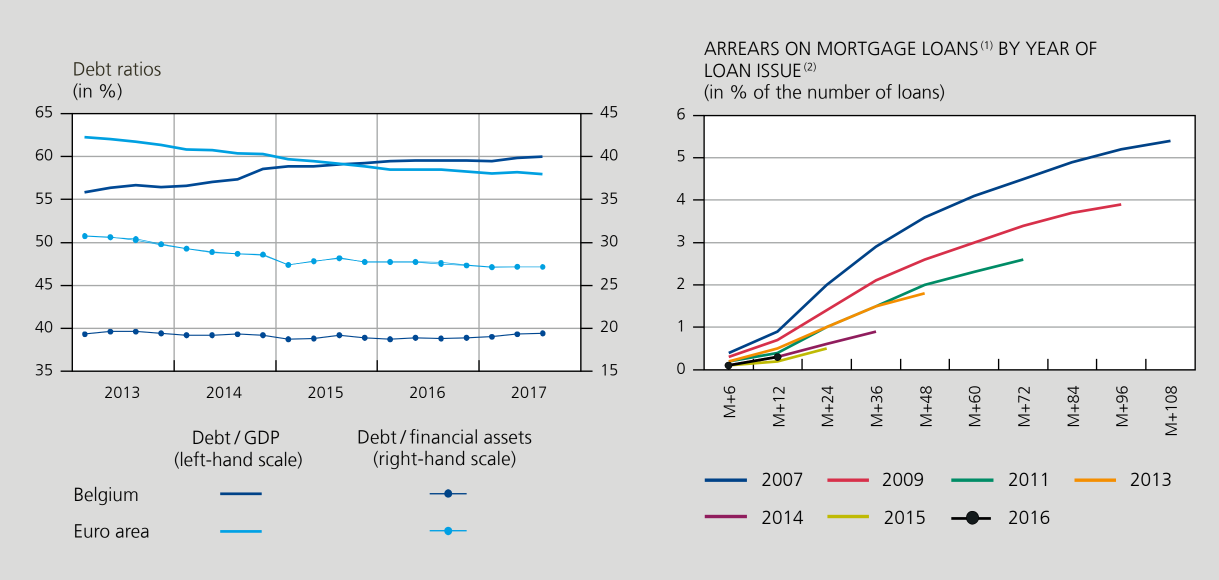
Source: NBB.

Household demand for property finance remained robust in 2017. Compared with previous years, however, it related more to newbuilds and purchases, with outstanding renovation loans more stable. This combined with higher property prices to drive an upward trend in the average amount of mortgage loans.

As a result, outstanding mortgage loans hit a record high of € 222 billion in September 2017. Since property loans account for the lion's share of household debt, the latter continued to trend upwards in the third quarter of the year, to 59.9 % of GDP. This ratio is currently higher than the average in the euro area, where the downward trend that began at the end of 2009 continued in 2017, albeit at a slower pace. Household debt in the euro area fell to 57.9 % of GDP by the end of September 2017.

The arrears recorded by the Central Individual Credit Register do not provide evidence, however, of any general vulnerability to debt on the part of households. The percentage of mortgage loans in arrears declined further in 2017 to 1 % at the end of December, compared with 1.1 % at year-end 2016. The situation has improved in recent years, as confirmed by the default rate per loan issue year, measured over time and without taking account of regularisations. In 2007, 0.9 % of mortgage loans were no longer being serviced after one year, compared with just 0.3 % in 2016. Similarly, 0.5 % of

CHART 46 DEBT RATIO CONTINUES TO RISE



Sources: ECB, NBB.

(1) Default is deemed to be where 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. Any regularisation of loan contracts is not taken into account.

contracts issued in 2015 had been in default at least once after a period of two years, compared with 2 % of those granted in 2007.

Non-mortgage credit only accounted for 14.5 % of total household debt, but was generally more prone to default. An improvement was noted in 2017 in this regard, too. The average amount of borrowing associated with loans and instalment sales stabilised, while that of credit lines declined. In the case of arrears, the default rate on loans and instalment sales also declined month by month, to 9.3 % at the end of December (compared with 9.7 % at the beginning of the year), while that on credit lines, which had been on an upward trend between 2012 and 2016, stabilised in December 2017 at 5.1 %.

Although households' debt levels have risen, their substantial volume of financial assets mitigated the associated risk, as their aggregate financial situation generally remains robust. This reflects the fact that, despite the weakness of new investment, the balance of their debts and their financial assets did not deteriorate fundamentally in the course of the year: the ratio stood at 19.4 % at the end of September, which was still clearly lower than that for the euro area as a whole (27.1 %).

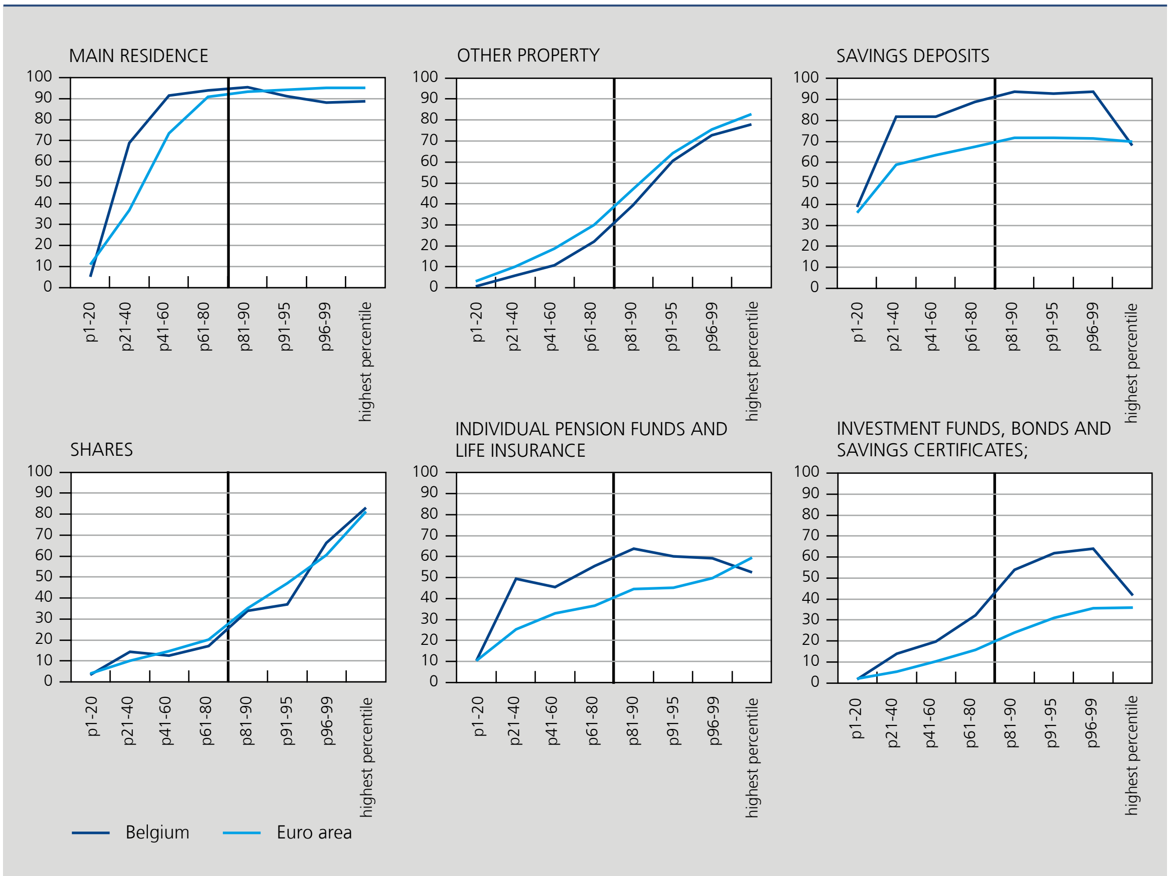
Vulnerabilities from a microeconomic point of view can, however, be found in the structure of household debt, based on data from the Household Finance and Consumption Survey (HFCS). Some households may be viewed as running a risk, as their level of debt is high relative to their income or because of the high ratio between the sum borrowed and the value of the purchased property. A rise in interest rates or a deterioration in labour market conditions, for instance, would then have the potential to weaken the limited debt servicing capacity of the households in question. It should be noted, incidentally, that households' financial assets are unevenly distributed: they are relatively concentrated among households that are free of debt, while in the case of households that do carry debt, these assets are more likely to be held by those with a favourable debt-to-income ratio. In other words, the financial capacity of Belgian households only partially helps to bolster the sustainability of their mortgage debt.

Box 4 – Distribution of wealth components among households in Belgium and the euro area

Belgian households display substantial financial wealth. Microeconomic data on the distribution of household savings can help explain certain developments in the overall economy that are revealed by the financial accounts. Assets held by a small part of the population tend, moreover, to contribute more substantially to an unequal distribution of wealth, while more widely distributed assets are more likely to reduce inequality. Disaggregated data can also thus help to explain inequality. The Household Finance and Consumption Survey (HFCS)(1) is conducted across the euro area and allows the distribution of household investment to be analysed. The most recently available data for this three-yearly survey relate to 2014. However, the degree to which households invest in particular assets, depending on their wealth, and the fundamental differences that emerge as a result, hardly change over the years. This is the source that has been used here to determine the extent to which possession of the various wealth components in Belgium corresponds with

UNEQUAL DISTRIBUTION OF WEALTH COMPONENTS IN BELGIUM AND THE EURO AREA

(holders of the various wealth components in % of households in 2014, by net wealth percentile(1))



Source: HFCS 2014.

(1) Households are broken down into percentiles (hundredths) according to their total net wealth – i.e. the sum of the value of all their real and financial assets minus the sum of all their outstanding debts; they are then ranked in ascending order.

(1) For a description and analysis of the 2014 outcomes in Belgium, see: Du Caju, P. (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. The key results for the euro area are summarised in: Household Finance and Consumption Network (2016), *The Household Finance and Consumption Survey: results from the second wave*, ECB Statistics Paper Series No. 18, December.

or deviates from that in the broader euro area. It should be reiterated in this regard that, viewed in aggregate, at over 309 % of GDP, the financial wealth of Belgian households is far greater than the euro area average of 214 %.

For the purposes of this analysis, households are split into percentiles (hundredths) according to their total net wealth: i.e. the sum of the value of all their assets less the sum of all their outstanding debts. Ownership of the various assets is generally seen to rise in both Belgium and the euro area as a household's net wealth increases. All the same, there are several noteworthy differences between the various wealth components. Possession of certain assets varies sharply between wealthier and less wealthy households, while other assets feature in a larger number of portfolios and are hence distributed more evenly across the population. Savings deposits and home ownership, for instance, are distributed more equally, whereas it is primarily the richest households that own equities and other real estate. It may be inferred from this that the pattern of investment in shares, unlike that of savings deposits, is determined by a relatively small proportion of the population. Income inequality is reduced, meanwhile, by widespread home ownership, while investment in other real estate tends to increase inequality. Consequently, the growth in investment in supplementary real estate reflects the investment behaviour of a fairly small part of the population.

There are several clear differences between Belgium and the euro area. The findings of the 2014 survey show, for example, that almost 77 % of Belgian households hold one or more savings accounts, compared with a euro area average of roughly 60 %. Individual pension funds and life insurance – the third pension pillar – are more widespread in Belgium than in the euro area: 44 % as against 30 %. Furthermore, a quarter of Belgian households save in the form of bonds, savings certificates or funds, compared with just one household in eight in the euro area. Belgian households' relatively large appetite for financial investment of this kind compared with euro area households is found in all wealth quintiles. At the same time, significantly more Belgian households own their main residence: in 2014, this was the case for roughly 70 % of households in Belgium and for 61 % in the euro area. The difference is most apparent in the second and, to a lesser degree, the third wealth quintiles.

In addition to their main residence, about 19 % of Belgian households own other real estate (to rent, for leisure use or for business purposes). The equivalent percentage for the euro area as a whole is higher (24 %) and the difference is found across the entire distribution of wealth. Lastly, some 18 % of Belgian households hold listed or unlisted shares (including in self-employed businesses); the proportion in the euro area averages a broadly equal 19 %. Distribution across wealth groups is also fairly comparable.

The generally widespread possession by Belgian households of four types of asset – savings deposits; individual pension funds and life insurance; investment funds, savings certificates and bonds; and, lastly, their main residence – makes Belgium (along with Slovakia) one of the euro area countries with the least unequally distributed total net wealth. The richest 1 % of households in Belgium, for instance, own 12 % of total net wealth, compared with a euro area average of 19 %. The 5 % (10 %) richest households in Belgium own 30 % (43 %) of total net wealth, as opposed to 38 % (51 %) in the euro area.

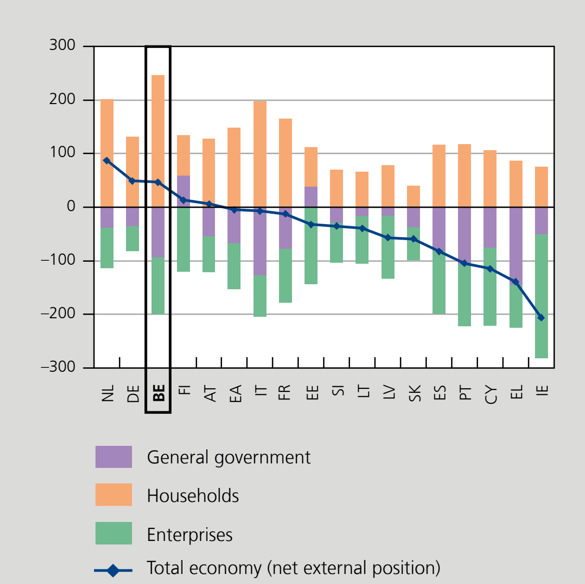
The economy's overall financial position remains favourable

Belgian households have the most substantial net financial wealth, relative to GDP, of any country in the euro area. This exceptionally comfortable situation helps place Belgium in a net creditor position that is among the highest in the euro area. The substantial net financial wealth of its households amply compensates for the net liabilities of Belgium's government and business, and ensures the country its net creditor position. Within the euro area, the Netherlands, Germany, Finland and Austria also boast net creditor positions. According to the national financial accounts, Belgium's net claims on other countries amounted at the end of September 2017 to € 200 billion, or 46 % of GDP.

The outstanding financial assets and liabilities of the domestic sectors are important when identifying macroeconomic imbalances. The EC, for instance, focuses for its macroeconomic imbalance procedure (MIP) not only on government borrowing, but also on elements such as the net external position and consolidated private debt. To this

CHART 47 NET FINANCIAL WEALTH [1] REMAINS POSITIVE

(in % of GDP, end-September 2017)



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.

end, uniform threshold values are applied to EU countries based on historical debt levels, below or above which the situation might be viewed as unsustainable. With reference to the net external position, the threshold value for which is –35 % of GDP, the Belgian economy is therefore well outside the danger zone. The EC applies threshold values of 60 % of GDP for public debt and 133 % for consolidated private debt. The fact that, just as for public debt, the threshold value has been exceeded for private debt (177 % of GDP at the end of September 2017) does not necessarily imply that the latter entails sustainability risks. To start with, the consolidated debt of Belgian non-financial corporations includes a substantial amount of cross-border intra-group loans, which ought ideally to be stripped out of the debt definition. Adjusted for such loans, Belgian private debt works out at 121 % of GDP, which is below the threshold value. The threshold values, when viewed more widely, are merely indicative; when assessing the sustainability of private debt, account should also be taken of other factors that determine financial health, such as the quantity and quality of the assets and/or of the equity capital balancing these debts.

Aside from the structural risks arising from the debt positions, policy – above all macroprudential policy – aims to limit the cyclical risks associated with lending. More specifically, since 2016, it has been ascertained based on the credit-to-GDP gap whether banks need to form a countercyclical capital buffer (CCyB). Despite the relatively strong growth in lending, this indicator currently works out at below 2 percentage points of GDP, which is the figure recommended by the European Systemic Risk Board (ESRB) as the threshold value for forming a CCyB. As Belgium's macroprudential authority, however, the NBB bases its calculation of the buffer not only on the lending pattern but also on an evaluation of the other cyclical risks that can hit the financial system. The buffer has so far not been activated and so amounts to 0 % of the risk-weighted assets.

3.3 Banking sector benefits from the economic revival, but still faces significant challenges

The restructuring drive that occurred during the financial crisis and the years that followed means that Belgian banking is financially healthy, enabling the sector to both promote and benefit from the economic recovery. Nevertheless, the banks still face onerous challenges. The prolonged period of low interest rates is starting to weigh on the intermediation margin, their principal income source, prompting an attempt to offset this loss by raising their production volume – and thereby triggering intense competition in certain key markets. This heightened competition should not be accompanied by behaviour that could prove harmful to the financial health of credit institutions. For this reason, the Bank stressed in a press release on 21 November 2017 that the recent vigorous growth in mortgage lending had arisen in part due to unusually relaxed lending criteria, and called on the sector to respond by making itself less vulnerable to a real estate shock. Belgium's banks must also ensure that commercial margins, which have declined sharply in recent years, continue to reflect the risks associated with new loan business and do not weigh unduly on the future profitability of the credit institutions.

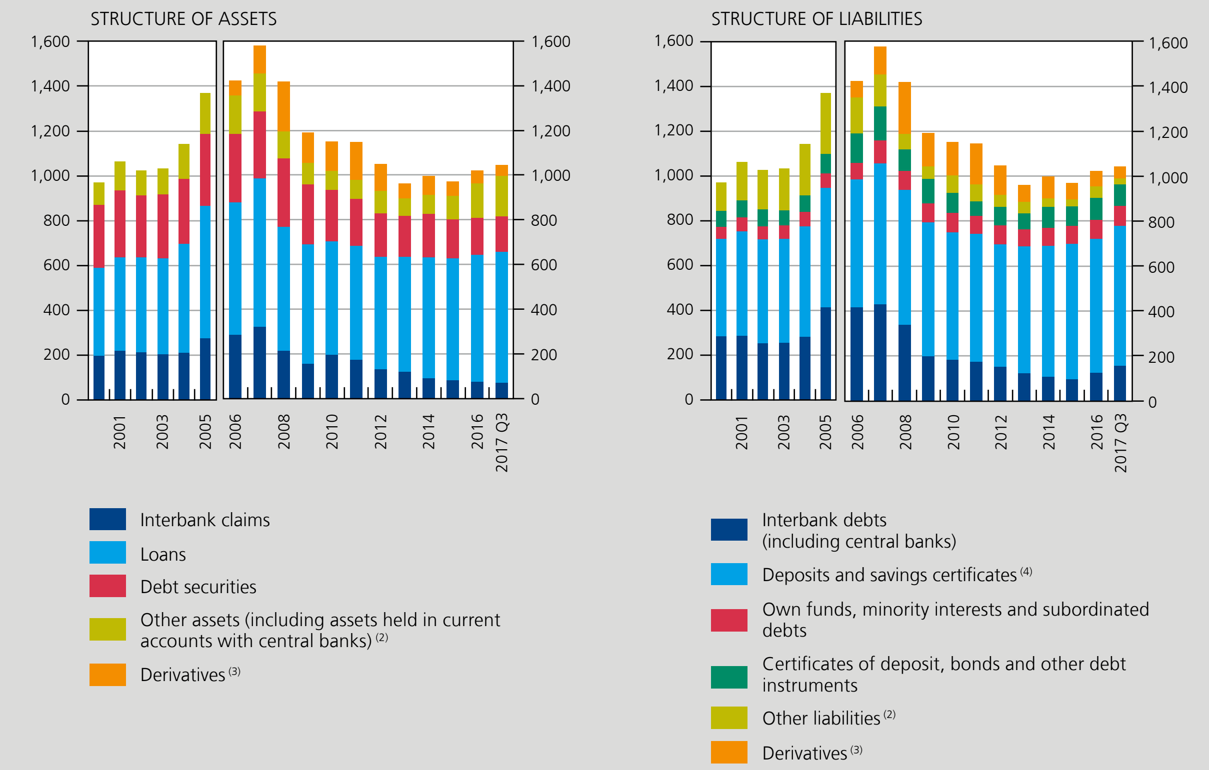
Completion of banks' balance sheet restructuring accompanied by recovery in lending to private sector

Banks in Belgium reduced their assets by over a third between the end of 2007 and the end of 2014, mainly by disposing of interbank and international operations. As a result, the sector's balance sheet, measured on a consolidated basis [1], shrank over the course of the period to € 996 billion (248 % of GDP) from € 1 578 billion (458 % of GDP). Having gone through this process, the financially healthy banking sector has enjoyed the positive effects of

(1) The consolidated basis includes not only the activities of the banking sector in Belgium, but also those of Belgian banks' foreign-based subsidiaries.

CHART 48 ECONOMIC RECOVERY GIVES FRESH BOOST TO BANK LENDING TO THE PRIVATE SECTOR

(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, defined benefit provisions and 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 no longer form part of the "other liabilities", but are included under different items on the liabilities side.

the economic revival since 2015, encouraged by accommodating monetary policies of the central banks. Belgian banks' total assets came to € 1 044 billion (almost 240 % of GDP) at the end of September 2017. The increase reflected factors such as a rise in bank lending to the private sector, encouraged by the abundance of cash made available to the banks. Loans by the Belgian banking sector to Belgian and foreign households and non-financial corporations rose by € 37 billion and € 13 billion respectively between the end of 2014 and September 2017.

The banks have scaled back their exposure to the public sector in recent years, in contrast with their lending to the private sector. Their portfolio of government bonds, which accounts for the majority of this exposure, had been reduced from € 180 billion at the end of 2014 to € 156 billion at the end of September 2017. This trend gathered pace in the recent period, as the market conditions created by the ECB's asset purchase programme encouraged the banks to sell part of their portfolio – allowing them to realise capital gains – or at least not to renew positions as they matured. Furthermore, the banks have steadily diversified their portfolio of government bonds – and 2017 was no exception – following a clear trend towards concentration in the Belgian market during the sovereign debt crisis of 2011 and 2012 against the backdrop of financial system fragmentation in the euro area. Exposure to the Belgian public sector nevertheless still accounted for over half that portfolio on 30 September 2017.

Exposures to commercial and residential property in Belgium continue to grow rapidly as part of a general increase in lending

Within their lending to the private sector, loans by banks to Belgian non-financial corporations have risen by almost

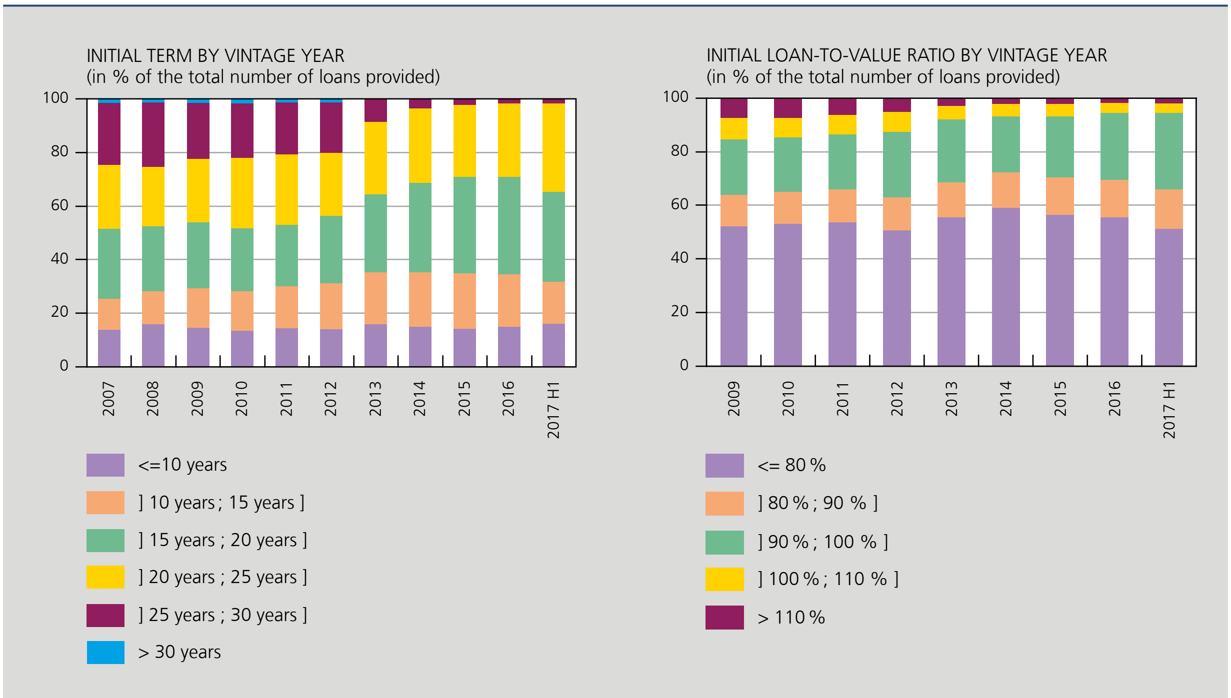
€ 11 billion since the end of 2014, € 5 billion of which was in the last 12 months alone. The loans in question totalled € 129 billion as at 30 September 2017. As previously noted, growth in bank lending was fairly general, but it was particularly marked in industry and services to business. Credit growth was once again relatively vigorous among Belgian enterprises in the construction and real estate sectors, though without hitting the same high level as the past ten years. Taken together, these businesses accounted for 25 % of the banks' portfolio of loans to Belgian non-financial corporations at the end of September 2017, making them the most important single sector. This has contributed to the banking sector's increasing exposure to commercial and residential property in Belgium.

More generally, Belgian banks focus a larger proportion of their activities on the domestic mortgage market. The total outstanding amount of mortgage loans to Belgian households has risen, for example, by over 5 % year-on-year in the past two years, peaking at € 194 billion at the end of September 2017. Gross mortgage loan business amounted to € 50 billion over the past 12 months, with € 15 billion of this comprising the internal refinancing of loans previously taken out by bank clients. External refinancing – i.e. where the loan is refinanced with another bank – came to € 4 billion. Net new business thus hit a record level of just over € 30 billion year-on-year. Some borrowers have refinanced their mortgage loans several times, which means it is no longer possible to determine the refinanced portion of the banks' portfolio accurately. However, over a third of Belgian mortgage loans can be estimated to have been refinanced since the end of 2014. Refinancing has once again risen a little since mid-2017, probably due to borrowers anticipating possible interest rate rises in response to the announced gradual winding down of the ECB's accommodating monetary policy. The refinancing of mortgage loans involves early redemption fees, which positively impact the banks' net interest income at the moment they are collected. But this does not diminish the fact that reducing the level of interest on these contracts – with the new rate generally fixed for the entire remaining term of the loan – puts additional pressure on the profitability of this portfolio, alongside the lower rates on new business.

Vulnerabilities have built up in the Belgian mortgage portfolio

The banks' general focus on mortgage lending has also intensified competition, as expressed in a decline in commercial margins on new loans, calculated as the difference between the rates that clients pay on the contracts and the market financing rates for comparable maturities.

CHART 49 CLEARER SIGNS OF VULNERABILITY IN THE BANKS' MORTGAGE LOAN PORTFOLIOS



Source : NBB.

What's more, growth in mortgage loans since 2015 has no longer been accompanied by a tightening of lending criteria, as was the case between 2012 and 2014. The criteria were, in fact, loosened somewhat in the first half of 2017. The average term of new mortgage loans lengthened again, for instance, while the average debt-service-to-income ratio (DSTI) for borrowers ceased to decline and even deteriorated slightly, despite longer terms. Moreover, the share of new business accounted for by mortgage loans where the amount borrowed is equal to more than 80 % of the value of the financed property (loan-to-value ratio, LTV) rose to 50 % again in the first half of 2017, having eased from 50 % to 41 % between 2012 and 2014. Other trends, such as the increase in the average amount borrowed and the rise in household debt, lend weight to the picture of substantial and growing vulnerabilities in this portfolio, even though default rates remain relatively low. In view of this, the Bank deems it necessary to replace the macroprudential measure introduced in 2013 – an increase of five percentage points in the risk weighting calculated using internal models – with a measure consisting of two components: a linear one applying equally to all loans, which therefore ensures continuity with the previous measure, and a more targeted component to be applied in the form of a multiplier that would depend on the average risk of the portfolio at each bank. The effect would be to impose a proportionally higher capital requirement on banks whose mortgage loan portfolios are exposed to greater risk and which therefore contribute more substantially to systemic risk. This new provision, announced in the Bank's press release of 21 November 2017, is discussed in detail in the second part of this Report (see part II.B.1).

In spite of the intense competition in certain segments of the Belgian market, banks have not unduly bolstered their international presence, as they did previously. Belgian banks' foreign assets only account for slightly less than a quarter of the sector's total assets and consist primarily of loans to households and to non-financial corporations in a few strategic markets, including the Netherlands, the Czech Republic, Turkey, Luxembourg and Ireland.

Belgian banks still have surplus liquidity despite increase in lending to the private sector domestically and internationally

The banking sector ended the third quarter of 2017 with surplus liquidity, reflecting the ample availability of liquidity in the euro area and despite the increase in lending to households and businesses. A more substantial proportion of this liquidity has been reinvested recently in the Eurosystem. As a result, assets held in current accounts with the central banks rose from € 69 billion in September 2016 to € 120 billion in September 2017, having been fairly stable for some years. This development is attributable to the extremely low level of short-term market interest rates, which makes deposits with the central banks more economical, even at a negative rate of interest, than investing in the interbank market.

The increase in the Belgian banking sector's surplus liquidity can be explained in part by growth in deposits from other Belgian or foreign credit institutions, which came to € 121 billion in September 2017, compared with € 103 billion in the previous year. Belgian banks also made more intensive use of the liquidity lines provided to the sector by the ECB in the context of targeted longer-term refinancing operations (TLTRO II), doing so to the tune of € 10 billion during the same period. In this way, they were able to finance themselves cheaply for a prolonged period. Deposits by Belgian and foreign households rose by € 7 billion and € 5 billion respectively.

A substantial proportion of the new bank deposits were the result of repurchase agreements (repos), where Belgium's banks pledge securities to other credit institutions in exchange for liquidity, which is repaid when the contract matures. This has prompted a virtually persistent increase since the beginning of 2017 in the percentage of encumbered assets in the banking sector's total assets, which rose to 14.2 % in September. Other elements also caused the proportion of encumbered assets to increase, including the issue of covered bonds.

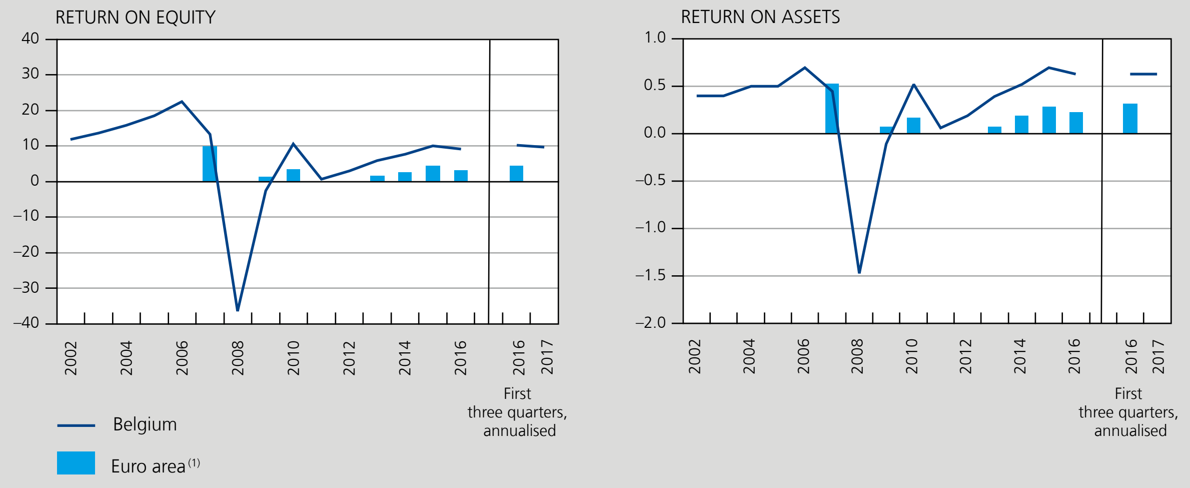
Although a bigger proportion of the assets is encumbered and is hence no longer liquid, Belgian banks still enjoy a robust liquidity position, as shown by their liquidity ratios. The sector's liquidity coverage ratio (LCR), which requires a bank to maintain sufficient high-quality liquid assets to be able to sustain the total net outflow of funds for 30 days during a period of stress, is still well above the required 100 %. However, the breakdown of the banks' liquid asset buffer has changed as a result of the developments described above, and now comprises a larger proportion of current account credits with the central banks and less government paper.

Belgian banks reported another set of good results in 2017

Despite the persistently low level of interest rates, Belgian banks have shown relatively high profitability since the end of 2014 compared with that of other credit institutions in the euro area. The sector recorded a net profit of € 4.9 billion in the first nine months of 2017, which meant that the annualised return on equity approached 10 % for the third year in a row, compared with 0.6 % for assets.

CHART 50 RETURN ON BANKING SECTOR EQUITY AND ASSETS IN BELGIUM AND THE EURO AREA

(consolidated data, in %)



Sources: ECB, NBB.

(1) Data available from 2007.

TABLE 9 INCOME STATEMENT OF BELGIAN CREDIT INSTITUTIONS

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

	2013	2014	2015	2016	First nine months 2016	First nine months 2017	In % of operating income
Net interest income	13.3	14.5	14.9	14.8	11.2	10.7	59.8
Non-interest income	7.0	6.2	7.1	7.6	5.5	7.2	40.2
Net fee and commission income (including commission paid to agents)	5.0	5.3	5.9	5.6	4.2	4.6	25.9
(Un)realised gains or losses on financial instruments (1)	0.8	−0.1	1.2	1.5	0.8	0.6	
Other non-interest income	1.3	0.9	0.1	0.5	0.5	2.0	
Operating income	20.3	20.7	22.0	22.4	16.6	17.9	100.0
Operating expenses	−12.4	−12.7	−12.9	−13.1	−9.9	−10.5	58.8 (2)
Gross operating result	8.0	8.0	9.1	9.3	6.7	7.4	
Impairments and provisions	−3.0	−1.3	−1.3	−1.8	−0.7	−0.5	
Impairments on loans and receivables	−2.3	−1.3	−1.1	−0.9	−0.7	−0.2	
Impairments on other financial assets	0.0	0.0	−0.0	0.0	0.0	0.1	
Other impairments and provisions	−0.6	0.1	−0.1	−0.9	0.0	−0.3	
Other components of the income statement	−1.8	−2.2	−1.7	−1.8	−1.3	−2.0	
Net profit or loss	3.3	4.5	6.1	5.7	4.8	4.9	

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.

Box 5 at the end of this section provides a more detailed comparison of the results of the Belgian banking sector with that of the euro area.

The high level of profitability in Belgium nevertheless has to be seen in the light of returns demanded by shareholders. For the recipients of the funds invested by shareholders, these returns correspond with capital costs, which for many institutions represent a profitability target that can have an impact on the banks' internal management. Capital costs are difficult to measure, though, as they are influenced not only by the institution's risk profile, but also by elements that cannot be observed, such as market uncertainty. According to a survey by the European Banking Authority (EBA), most European banks place their capital costs at between 8 % and 10 %.

The solid results achieved by the banking sector in the first nine months should also be qualified, as these were boosted by the restructuring of a large banking group, which meant that new entities were included in the consolidation perimeter for the Belgian banks in 2017. This expansion was a major factor behind the increase in bank operating income to € 17.9 billion in the first nine months of the year, compared with € 16.6 billion for the same period in 2016. The total income from more structural sources of profitability, such as net interest income and net fee and commission income, by contrast, remained stable.

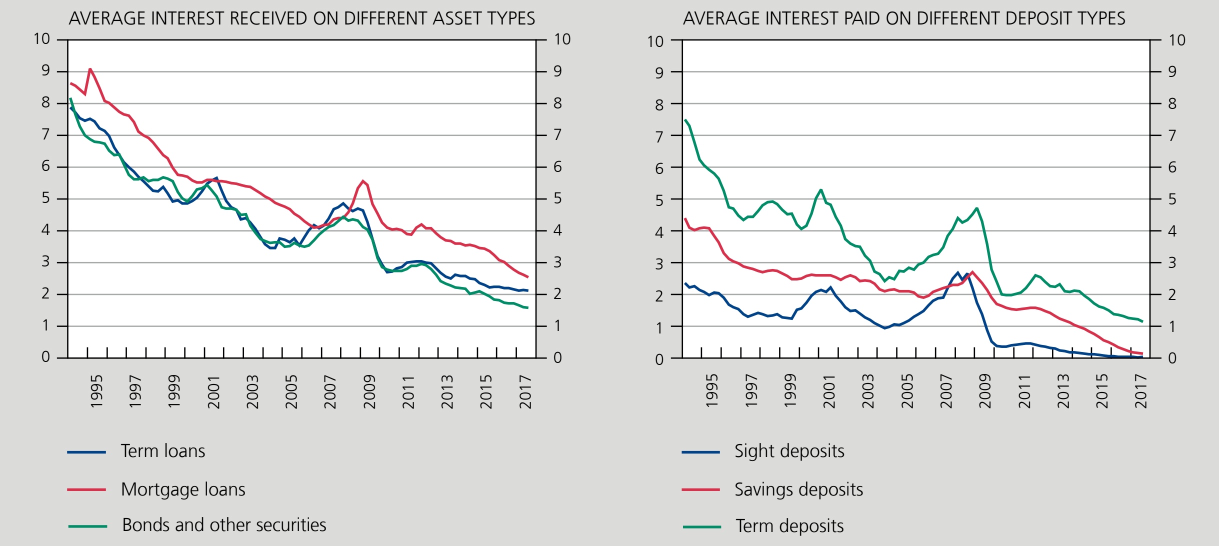
The increase in operating income was primarily attributable to the improved level of non-interest income, which chiefly reflected the previously cited expansion of the banking sector's consolidation perimeter. Also contributing to this was a € 450 million increase in net fee and commission income, as brighter economic prospects encouraged the sale of investment fund units. Gains on financial instruments, by contrast, were down a little, due to a further slight increase in long-term interest rates : unrealised gains, which are recognised when the market values of securities increase, and gains on the sale of securities declined accordingly to € 580 million in the first nine months of 2017, compared with € 760 million in the previous year.

Banks are seeking to diversify their income sources in response to intensified pressure on their interest margins

Having remained resilient until recently, banks' net interest income fell by € 430 million in the first nine months of 2017. The decline is attributable to the contraction of net interest margins, which meant the impact outweighed profits generated by the growth in lending to the private sector. Faced with lower returns on their assets in 2017, Belgium's banks were no longer able to bear down on their financing costs as they had done in recent years. This was particularly the case with rates on sight and savings accounts, which had already been pegged back in the

CHART 51 FACED WITH LOWER ASSET RETURNS, BANKS WERE NO LONGER ABLE TO KEEP THEIR FUNDING COSTS DOWN

(interest rates on the various outstanding assets and liabilities of Belgian credit institutions (1); non-consolidated data, in %)



Source : NBB.

(1) These rates are calculated as the ratio of the cumulative flows of interest paid and received over 12 months to the average outstanding volume of the corresponding assets or liabilities during the period under review.

second half of 2016 to a lower limit of 0 % and 0.11 % respectively (including fidelity premiums).

The pressure that the low interest rate environment is exerting on their net interest income has also prompted banks to modify their business model with a view, among other things, to diversifying their income sources. Some institutions have already announced that they intend to expand their sales of investment products. New technologies also offer banks the opportunity to broaden their commercial offering by developing new distribution channels as well as new products and services. At the same time, as already evident in the payments business, the rise of new technologies could also encourage new players to enter certain segments, thereby fuelling competition. What's more, the development of technological tools frequently requires significant and risky investment that can be beyond the reach of smaller institutions.

Digital tools could nevertheless enable the sector to ease its cost structure, which has so far proved relatively rigid. The ratio of Belgian banks' costs to their income has scarcely moved from 60 % for some years now. Their operating expenses came to € 10.5 billion in the first nine months of 2017, up almost € 700 million compared with the corresponding period in 2016. This higher expenditure is due largely to the restructuring of a bank group previously referred to, which resulted in the integration of new entities in the sector's consolidation perimeter. Operating income grew to a similar extent, however, and so the sector's cost-to-income ratio remained stable at 59 %.

Staff costs accounted for just under half of total operating expenses in the first three quarters of 2017. These have been stable since 2014, even though Febelfin statistics suggest that employment in the sector contracted by about 13 % between 2010 and 2016 – a paradox that can be explained by the rise in average wage costs in the sector, reflecting changes in the personnel structure. Figures for 2016 show that Belgian banks mostly recruited holders of Master's degrees or PhDs to managerial posts, while the proportion of clerical staff within the workforce has been clearly diminishing for some years now.

Favourable economic climate and cautious reserve policy limit the need for fresh provisions

The improved economic climate in Belgium and abroad also contributed to the sector's good results through a further reduction in provisioning. Provisions came to € 450 million in the first nine months of 2017, which is barely 3 % of banking income. By way of comparison, the ratio in 2013 was close to 15 %. The low level of additional provisions partially reflects the high quality of Belgian banks' assets: non-performing loans as a percentage of the Belgian banking sector's total loans and advances stood at 3 % at the end of September 2017, well below the euro area's second-quarter average of 5.4 %. The current level of outstanding provisions already covers almost 46 % of non-performing loans, moreover, which reduces the necessity to take extra provisions under the current rules. It is nonetheless possible that provisioning by the Belgian banks will be raised in the future following the introduction of the IFRS 9 accounting standard on 1 January 2018. The latter specifies that loan loss provisions will no longer be calculated on the basis of losses incurred but on probable future losses, and that such provisions should be made at the first visible sign of deterioration in credit quality and for the entire residual term of the contract.

Solvency position of the Belgian banks remains at a respectable level

The Belgian banks' risk-weighted assets have gradually increased since the end of the deleveraging process in 2014, in line with the general balance sheet trend. These rose from € 370 billion at the end of 2016 to € 374 billion at the end of September 2017. Risk-weighted assets largely comprise credit risk weightings, which amounted to € 314 billion at the end of September, compared with € 308 billion at the end of 2016. The higher level of risk-weighted assets means that the capital requirement for the Belgian banks has risen. Common equity Tier 1 (CET1) capital also recorded a slight increase, to € 60.7 billion, with the result that the CET1 ratio remained stable around 15.7 %. This still puts the Belgian banks, on average at least, in a comfortable solvency position that is amply ahead of regulatory requirements.

The regulatory minimum Tier 1 basic capital requirement under CRD IV (the Capital Requirements Directive) was 5.75 % in 2017, compared with 5.125 % in 2016, due to the increase in the capital conservation buffer to 1.25 %. The buffer will amount to 2.5 % by year-end 2019. The capital requirement was raised further for systemically important institutions; as from 2018, the extra buffer will amount to 0.75 % for less systemically important banks and 1.5 % for more systemically important ones. On top of these Pillar 1 capital buffers, there will be Pillar 2 buffers set individually for each institution based on its risk profile (see the "Prudential regulation and supervision" part of this Report). CRD IV further states that transitional measures relating to some capital deductions will also gradually disappear by around 2018. If CRD IV had been fully in place in September 2017, CET1 ratios would have merely edged down to 15.4 %, still a respectable level.

TABLE 10 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)

	2013	2014	2015	2016	September 2017
Tier 1 capital	55.6	53.4	55.1	60.0	60.7
of which:					
Common equity Tier 1	–	51.5	53.3	58.1	58.7
Risk-weighted assets	339.4	349.8	345.4	369.7	374.4
of which:					
Credit risk	287.7	290.1	282.8	308.1	313.8
Market risk	9.9	7.1	9.5	6.1	7.1
Operational risk	34.2	34.9	36.0	38.7	39.6
CVA	–	8.2	6.9	5.5	4.5
Other	7.6	9.5	10.3	11.0	9.4
Tier 1 ratio (in %)	16.4	15.3	16.0	16.2	16.2
Common Equity Tier 1 ratio (in %)	–	14.7	15.4	15.7	15.7
Liquidity coverage ratio (in %)			137	140	144

Source: NBB.

Box 5 – Belgian banks are achieving better results than those of the euro area, but substantial challenges remain

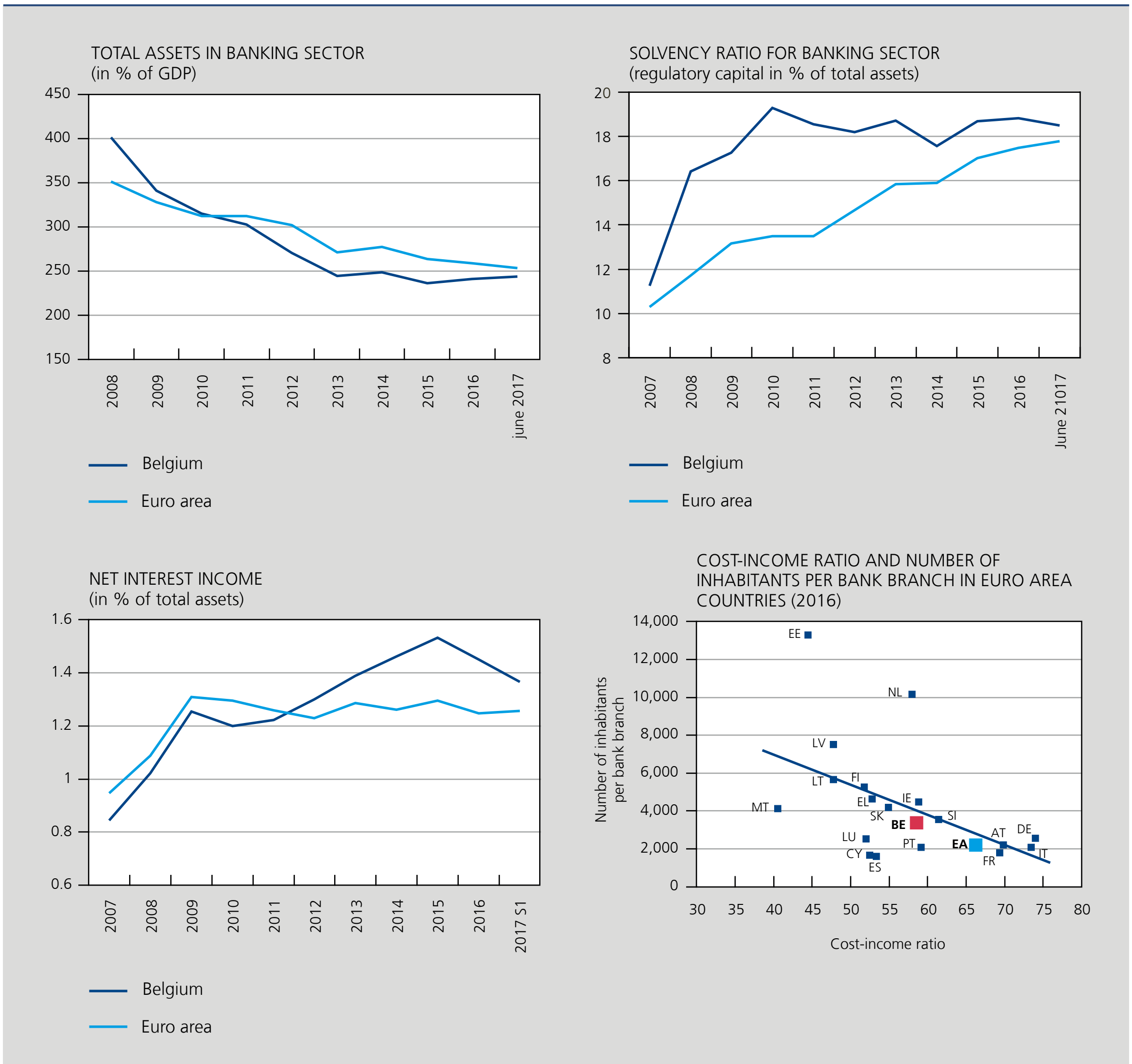
The 2008 financial crisis badly affected the Belgian banks, which suffered major exceptional losses on the winding up of activities and on other impairment charges and provisioning. This exerted intense pressure on their profitability, with the return on their assets falling to –1.5 % in 2008, which was by far the worst result in the euro area.

At that point, Belgium's banking sector embarked on the restructuring of its business model in accordance with concessions some of the banks made to the European Commission in exchange for the state aid they received at the height of the crisis. Like other European banks, they sharply reduced their interbank transactions and their international operations. However, this process began somewhat earlier in Belgium and went relatively further than elsewhere in the euro area: between the end of 2008 and 2010, Belgian banks scaled back their balance sheets by almost 20 %, bringing their total assets expressed as a percentage of GDP below the European average.

Some of these measures had a positive impact on profitability and consequently on banks' solvency. Belgian banks divested themselves of a substantial proportion of their low-margin assets (interbank loans) between 2008 and 2012, bolstering their net interest margin in the process. This margin, calculated as the ratio of net interest income to total assets, rose from 100 to 130 basis points. The banks also used their first post-crisis profits to strengthen their solvency position. The Belgian banking sector's solvency ratio – which expresses the relationship between the level of regulatory capital and total assets – rose from 16.4 % to 18.2 % between 2008 and 2012, compared with an increase from 11.7 % to 14.7 % for all euro area credit institutions combined.

COMPARISON OF BALANCE SHEET AND PROFIT INDICATORS FOR BELGIAN BANKS WITH THOSE OF THE EURO AREA

(on a consolidated basis)



Sources : ECB, NBB.

The sharp decline in interest rates after 2012 was also very favourable at first to the Belgian banking sector's net interest income as the banks were quick to benefit from the fall in their funding costs, while their interest receipts followed the trend more gradually because of the larger proportion of fixed-rate loans in Belgium than elsewhere in the euro area. Consequently, Belgian banks' net margins rose from 2012 onwards until peaking in 2015. Net margins at other euro area banks were relatively stable over that period.

Although the euro area banks' net interest income increased less sharply, they nevertheless recorded higher non-interest income than the Belgian banks (in the shape of fees, gains on financial instruments, etc.), as the latter have pursued more traditional business models since the financial crisis, geared towards banking services for retail and business clients. Moreover, the structural reforms in Belgium since 2014 have introduced a regulatory framework for the sector's trading activities.

The increase in operating income also contributed to a decline in the banking sector's cost-to-income ratio, which fell in Belgium from 85 % in 2008 to 58 % in 2016, compared with a reduction from 72 % to 66 % in the euro area as a whole. Substantial differences are nevertheless still apparent between countries, which can be traced in part to the varying scale of their banks' branch networks. More generally, these differences also indicate that Belgium's banks still have some room for manoeuvre in which to improve the efficiency of their service, given that their operating expenses have barely fallen in absolute terms since the beginning of the crisis.

The return on the Belgian banks' assets was well above that of the euro area as a whole at the end of 2016 – the most recent year for which full data are available. The greater part of this difference relates to the high numbers in certain euro area countries for provisions and impairments and exceptional losses (fines, litigation costs, etc.). These led to risk costs – the amount of provisions and impairments relative to operating income – amounting to 21.4 % in the euro area at the end of 2016, compared with just 7.9 % in Belgium. As explained in the chapter on the euro area (see section 1.3), the high rates of default in some countries represent a considerable hindrance to the European banking sector's profitability.

Belgian banks still have to contend with significant challenges, even though, according to the different profitability scenarios set out above, they find themselves in a healthier-than-average situation than European banks as a group. The Belgian banking sector's balance sheet and income structure shows greater exposure to a more prolonged low interest rate environment or a sudden fall in interest rates. Despite the efforts made in the past, Belgium's banks therefore need to further bolster their profitability, by structurally tapping into a more diverse range of income sources and improving the efficiency of their operations.

3.4 Insurance sector remained under pressure in 2017

Belgian insurance companies faced persistently difficult market conditions in 2017, despite the economic recovery. The low interest rate environment poses a significant challenge to their life insurance activities, while non-life business began to stabilise.

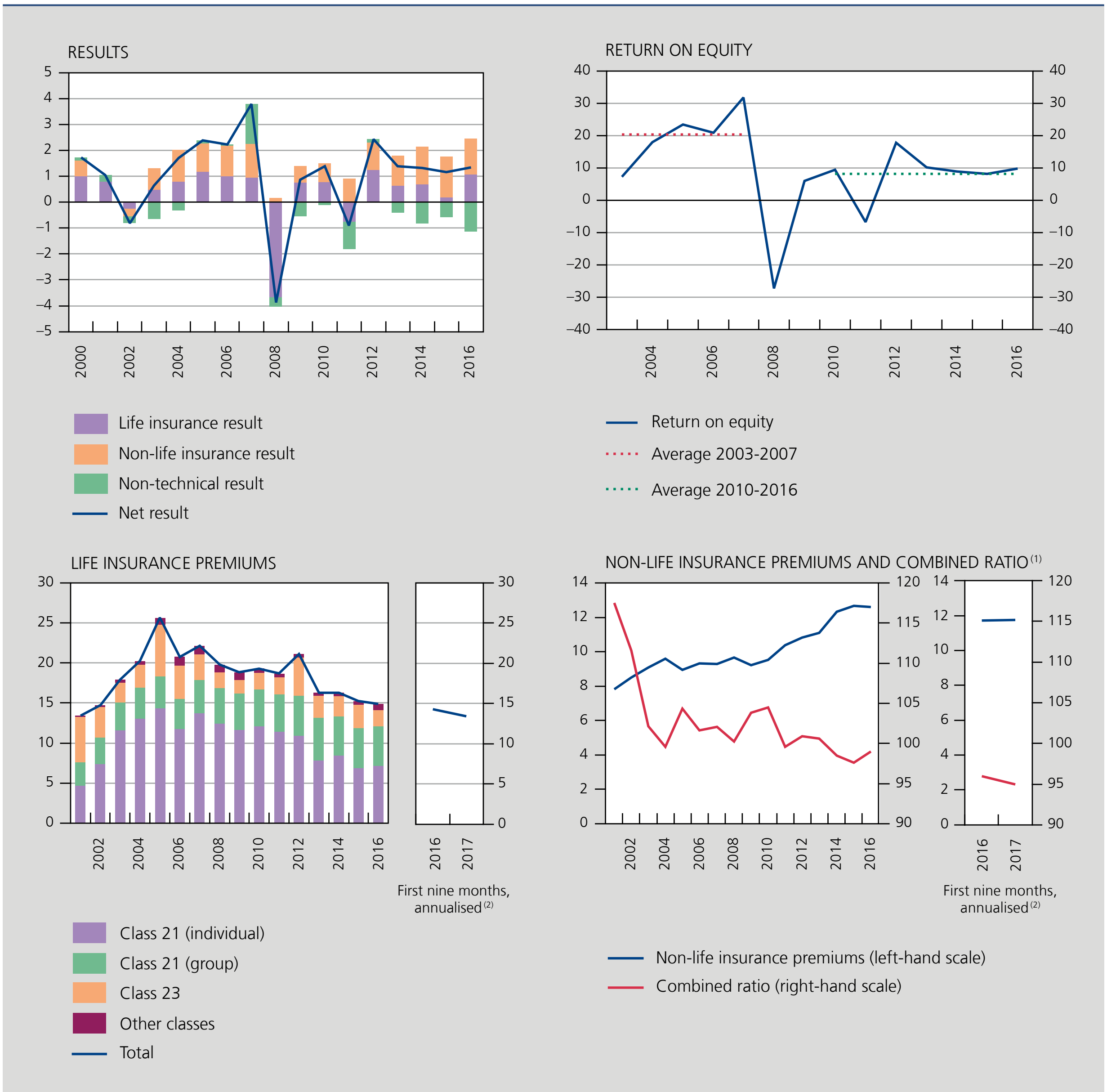
Non-life insurance profits remained stable, while life insurance recorded a low level of profitability

The insurance sector as a whole reported net profits of € 1.3 billion in 2016 and a 9.8 % return on equity. The figures were in line with those of the three previous years, yet remained well below their level before the financial crisis. Sector profits in the 2003 to 2007 period averaged € 2.1 billion and the return on equity 20 %, albeit in an economic and financial environment that proved unsustainable in the long term.

Non-life insurance results have been relatively constant since 2012 at around € 1.4 billion. Premium income – which came to € 12.7 billion in 2016 – has also remained stable for two years now, and this was also the case during the first nine months of 2017, which might indicate possible market saturation. The trend towards stagnating premiums poses a significant challenge to the non-life insurance sector, which currently faces fierce competition in the Belgian market and a slowdown in premium collection in certain traditional segments. The net combined ratio, which compares the total cost of claims and operating expenses to net premium income, rose slightly in 2016, reflecting sector cost trends, before declining in the first nine months of 2017. The combined ratio remained below 100 % for most insurance categories, suggesting healthy cost management in the sector. Third-party motor insurance was an exception, with a ratio of 102 % in September 2017, although this was down on the figure at the end of 2016.

Life insurance business activity, meanwhile, has fallen off substantially since the financial crisis. Profits of € 1.1 billion in 2016 were up considerably on the previous year, but were largely underpinned by realised capital gains, which came to € 1.6 billion. The sector's premium income slid to what amounted to the lowest level since 2002, influenced

CHART 52 **INSURANCE COMPANY PROFITS DO NOT YET REFLECT THE ECONOMIC RECOVERY**
(non-consolidated end-of-period figures; premiums and results in € billion, combined ratio and return on equity in %)



Source: NBB.
(1) The combined ratio expresses the sum of the cost of claims plus operating expenses relative to net premium income.
(2) The figures for net premium income in the first nine months have been extrapolated to allow year-on-year comparison. The combined ratio refers to the situation after nine months (not annualised).

by the hefty decline in individual class 21 products, while the figures for group insurance were stable. Investment income, not including realised gains, has also declined since 2012 due to low interest rates and the more concrete manifestation of reinvestment risk. The country's insurance companies have adjusted to this environment by scaling back or ending the output of class 21 products and by focusing more on new products that are better aligned with the current economic situation, most notably class 23 products, where the investment risk is borne by policyholders. The business model of the life insurance companies could gradually shift in the future towards activities in asset management. Although premium income for products of this type remained very low in 2016, it rose considerably in the first nine months of 2017, in sharp contrast with the further decline shown by class 21 figures.

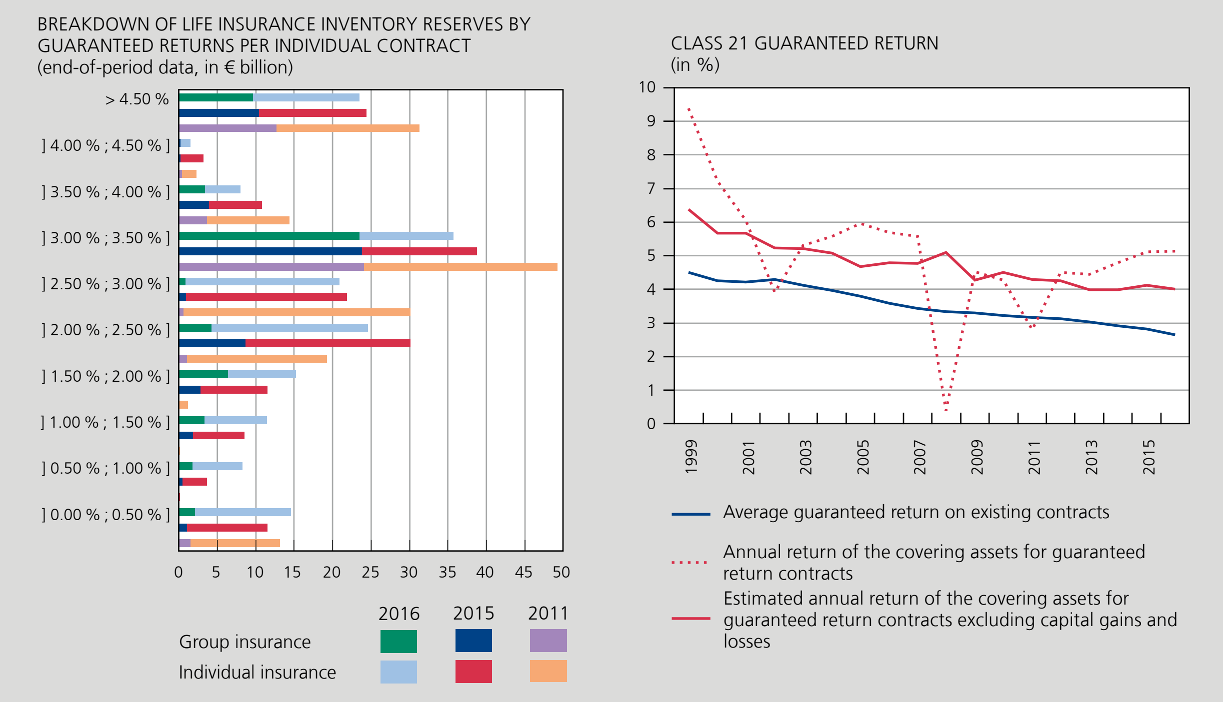
Liabilities with high guaranteed returns are slowly declining

Total inventory reserves for guaranteed-return contracts fell from € 164.3 billion to € 163.7 billion between the end of 2015 and end-2016, the most recent period for which detailed annual data are available. This contraction in reserves was chiefly caused by individual insurance, the outstanding amount of which fell further, by just under 2 %. The downward trend in technical provisions for individual class 21 products that began in 2013 points to deteriorating activity across the sector. The trend is the result of declining net receipts, as the new premiums, the interest rates offered and possible profit-sharing no longer offset withdrawals – the capital paid out to the policy-holder when contracts mature or are surrendered. Group insurance, by contrast, recorded an increase of 3 %.

Although reserves for contracts with guaranteed returns of over 2 % declined (–11 % between 2015 and 2016) in favour of lower-return agreements (+40 % over the same period), contracts with a guaranteed return on accrued and/or yet-to-be accrued reserves (based on future premiums) exceeding 4.5 % nevertheless still represented € 23.5 billion in 2016, or 14 % of inventory reserves. The comparable figure for 2015 was € 24.5 billion and for 2011 € 31.3 billion. Most contracts guaranteeing the policy-holder a high return also promise the same on future premiums. At the end of 2016, agreements of this kind accounted for 88 % of inventory reserves on contracts with a return in excess of 4 %. The negative impact of these contracts on profitability and solvency has led some insurance companies to mount major surrender campaigns for several years now, in which they use exit premiums to encourage policy-holders to terminate their contracts. The outstanding amount of guaranteed-return life insurance contracts and the level of this return are, indeed, extremely important potential risk parameters for the insurance companies in a period in which interest rates on risk-free investment are continuing to fall.

Persistently low interest rates are forcing insurance companies to offer contracts more in line with market conditions, with the average guaranteed return on class 21 agreements falling from 2.82 % in 2015 to 2.62 % in 2016 – or, more specifically, from 2.64 % to 2.44 % for individual insurance and from 3.19 % to 2.96 % for group insurance. Insurers also imposed time limits on guarantees and promoted sales of class 23 agreements, which do not

CHART 53 CONTRACTS WITH A HIGH GUARANTEED RETURN REMAIN SUBSTANTIAL



Source: NBB.

offer guaranteed returns and are mostly tied to public or internal investment funds, sometimes managed by the group's fund manager. In addition, hybrid products were developed, combining features of classes 21 and 23.

Low interest rate environment poses threat to insurers' investment income

The average annual return of the covering assets of guaranteed-return contracts was 5.13 % in 2016 for the sector as a whole. This percentage was largely underpinned, however, by realised capital gains, as the return adjusted for gains and impairments worked out at 4 %. Furthermore, the average duration of life insurance liabilities (10.8 years) is longer than that for assets (8.4 years): weighted according to the assets and liabilities, the difference in duration in 2016 was estimated at 1.8 years. These two factors mean that insurers offering guaranteed returns are exposed to a reinvestment risk. If the current low level of interest rates were to persist, a substantial amount of maturing securities with a high rating (AAA or AA) will have to be reinvested in instruments offering a lower return. In this scenario, the effective return on the assets, which is still currently higher on average than the guaranteed return, would no longer be sufficient, in theory, to cover the guaranteed returns on previously concluded agreements.

Various instruments have been defined under prudential regulation to ensure that the interest rate risks are covered [1]. Unless conditional exemption is granted, for example, insurance companies are required to form additional annual provisions – generally called "flashing-light provisions" – to ensure that they can still meet their future obligations, despite the low interest rate environment. These provisions came to € 7.6 billion at the end of 2016, roughly equal to the previous year.

The maximum reference rate for long-term life insurance contracts has been held at 2 % in 2018, and the minimum rate for employer-guaranteed returns on supplementary pensions at 1.75 % for member and employer contributions. Although these two reference rates are set within different legal frameworks, they are revised together annually to ensure that the second rate does not exceed the first. Employers might shun the system if the guaranteed return for supplementary pensions were set at too high a level, as they would be no more able than the insurance companies to pay the guaranteed interest.

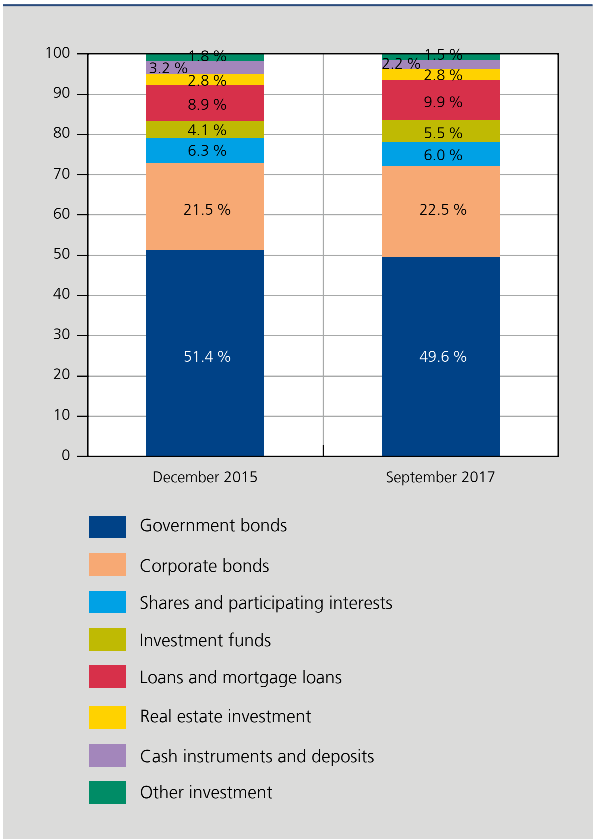
(1) The specific regulatory requirements for mitigating the interest rate risk are dealt with in more detail in the sections on insurance companies in the "Prudential regulation and supervision" part of this Report. The "flashing-light provision" is discussed specifically in box 16 of this section of the Report.

Investment showing some signs of a search for yield

In view of weak returns on their traditional portfolios, some insurance companies have attempted to shift their investment to higher-yielding assets in order to meet the obligations arising from their life insurance contracts. Although this portfolio adjustment is proceeding slowly and in step with longer-term assets, the proportion of government bonds and liquid assets has been declining for several years now, while that of loans and investment funds is growing. By the end of September 2017, bonds still accounted for the majority of portfolio holdings, at € 194 billion, with government securities making up € 133 billion (€ 76 billion of which was in Belgian government bonds) and corporate bonds € 61 billion. Almost 63 % of these securities commanded a high rating (AAA or AA), with that level remaining stable throughout the past year. The loan portfolio has been growing for a number of years now and was worth € 27 billion by the end of the third quarter of 2017, accounting for 10 % of investment

CHART 54 PROPORTION OF GOVERNMENT BONDS AND LIQUID ASSETS DECLINED SLIGHTLY, IN FAVOUR OF LOANS AND INVESTMENT FUNDS

(proportion of each asset class at market value in the total assets, excluding class 23 investment)



Source: NBB.

excluding class 23. To put this in context, exposure to mortgage loans in Belgium's neighbours was closer to an average of 5 %, with the exception of the Netherlands, where it came to 17 %. The rise of this type of portfolio reflects how insurers are diversifying their investment and suggests that certain companies are searching – albeit to a limited extent – for yield. The value of assets held to cover technical provisions for class 23 contracts amounted to € 35 billion, with these assets mostly held in units of undertakings for collective investment (UCIs).

Box 6 – Insurers have a part to play in funding infrastructure projects

As institutional investors, insurance companies play a part in the funding of the economy, especially infrastructure projects. Life insurance activities are linked to long-term liabilities, and so investment in long-term projects is perfectly aligned with these companies' needs. All the same, insurers showed very little interest in investment of this kind until the new Solvency II prudential rules came into force in January 2016, because of the onerous capital requirements associated with such investment, which is frequently unrated and has long maturities.

The European Commission responded, as part of the implementation of the Investment Plan for Europe, by amending the legislation relating to the Solvency II rules to lower the capital requirements for certain investment in infrastructure projects and in European long-term investment funds, with a view to making these more attractive to European insurers. In June 2017, the EC also proposed the creation of a separate asset class, with specific capital requirements, for investing in businesses active in infrastructure projects. As the competent supervisory authority for the insurance companies, the Bank issued a Circular in February 2017 (1) to provide additional information on the definition of and criteria for qualifying investment in infrastructure project entities according to Solvency II, intended to help insurance companies make the necessary risk assessments, given that infrastructure projects are subject to specific risks that these companies must be able to manage.

In September 2017, infrastructure projects in Belgium accounted for just 0.7 % of total insurance company investment, while barely 62 % of these projects met the criteria to qualify for reduced capital requirements. What is more, only 14 of the 68 insurance companies subject to Solvency II reported that they invest in infrastructure projects, with several major insurers not active in this area at all. Assuralia, the association of Belgian insurance companies, ascribes this to the fact that the improvements to Solvency II take no account of the specific characteristics of the Belgian federal system: the funding of numerous infrastructure projects is currently guaranteed by the Regions rather than the federal government, which means they do not qualify for reduced capital requirements, as these only apply to investment guaranteed at federal level. The EC is due to examine this point, however, during its review of Solvency II scheduled for the end of 2018.

Insurers are willing to invest in infrastructure projects, which are very attractive to them in a low interest rate environment because of the illiquidity premium on offer, but they feel that there are too few high-quality projects available and that their funding has not been sufficiently standardised. They are therefore calling for a platform to be developed that could connect project initiators with insurers – a proposal that had likewise been made previously by the Belgian pension funds, which are supervised by the FSMA. They too could help fund infrastructure projects, despite their lower balance sheets (an estimated € 30 billion for the sector as a whole, compared with € 240 billion in investment for life insurance). Less than 1 % of the pension funds' investment currently takes this form.

Despite the cited difficulties, investment in infrastructure by the Belgian insurance companies has risen by € 230 million since December 2016 (most recent available figures) to almost € 2.2 billion in September 2017, of which € 671 million was invested in projects in Belgium. This investment takes the shape of loans or of shares in projects (government-guaranteed or otherwise), and of stakes in public-private partnerships or in European

(1) See section E.2.6 of this Report's "Prudential regulation and supervision" part.

long-term investment funds. They are used to fund projects such as the construction of hospitals, social housing, roads, airports, prisons, schools or energy sector infrastructure.

Wider participation by Belgium's insurers and pension funds in financing infrastructure projects would enhance the success of the National Pact for Strategic Investments announced by the government. But this has to be in line with the general risk policy set out by each company.

Slight improvement in insurers' solvency, but widespread differences remain

Solvency is calculated under the Solvency II system as the ratio of an insurer's eligible own funds to the capital requirements set according to its risk profile. The average weighted ratio of the sector as a whole stood at 192 % on 30 September 2017, suggesting a comfortable solvency position and a substantial improvement on the previous year's ratio of 165 %. This reflects the fact that certain insurers had supplemented their equity through capital increases, which bolstered the favourable impact of the modest rise in interest rates. Insurers' balance sheets are calculated at market value under Solvency II, which means that a rise in interest rates actually results in a sharper decline in the value of the insurers' liabilities than in their assets, since the duration of the former is longer than that of the latter. This is expressed in net terms in an increase in equity at market value.

All the same, there are widespread differences between the country's insurers, whose ratios ranged from 100% to 400% in September 2017, with a median of 170%.