# Report 2017

## Prudential regulation and supervision

NationalBank
OF BELGIUM
Eurosystem

# A. FSAP : assessment of the Belgian financial sector and IMF recommendations

In 2017, the International Monetary Fund (IMF) conducted an analysis of the Belgian financial sector and Belgian financial regulations. This Financial Sector Assessment Program (FSAP) is a five-yearly exercise for countries with a systemically important financial sector, such as Belgium. The last time Belgium was assessed was in 2012-2013.

This analysis forms part of the IMF's supervisory function, along with its missions under Article IV, involving an extensive analysis of the socio-economic policy of the Member State in question. An FSAP is a financial sector analysis by the IMF that considers three main topics.

First, it assesses the financial sector's resilience by trying to identify systemic risks and sources of potential financial contagion between the various components of the financial sector. An essential tool enabling the IMF to examine the financial sector's resilience is the stress test, in which the IMF assesses the influence of extreme macroeconomic shocks on the portfolios of banks and insurance companies, for example.

Second, the IMF also checks the quality of the supervisory framework. On the one hand, it examines the microprudential supervision framework where the Basel Core Principles for Effective Banking Supervision and the Insurance Core Principles set the standard. In 2017, in view of the size of the financial conglomerates in the Belgian financial sector, the IMF also examined the supervision of these *bancassurance* groups on the basis of the Principles for the Supervision of Financial Conglomerates. Another key element of the mission concerned macroprudential supervision which, since the financial crisis, has formed an integral part of prudential supervision. For Belgium, the 2017 FSAP was the first opportunity to obtain an IMF analysis of the National Bank's still quite new macroprudential policy, including the Bank's initiatives in the residential real estate sector. During this mission, the IMF also examined the way in which the Bank conducts the oversight of SWIFT[1].

Third, an FSAP also focuses on the crisis management arsenal, i.e. the set of tools available to a Member State to prevent and combat financial crises. To that end, the IMF conducts interviews not only with the supervisory authority but also with other crisis management players, such as the resolution authority (in Belgium, the Resolution College set up at the Bank) and the deposit guarantee system (in Belgium, the Guarantee Fund for Financial Services).

The FSAP generally comprises several missions. For instance, the IMF's visit to Belgium in 2017 included a brief preparatory mission and two detailed missions lasting two weeks each. During these missions, various IMF experts held interviews with the Bank, the Financial Services and Markets Authority (FSMA), the Federal Public Service (FPS) Finance, the Finance Office, the aforesaid crisis management players and a whole range of market participants.

The IMF also held meetings with the European Central Bank (ECB) and the Single Resolution Board (SRB), the authority responsible for the resolution of the leading banks in the euro area. With the entry into force of the first and second pillars of the Banking Union, the supervision and resolution framework became largely European. The ECB

(1) SWIFT (Society for Worldwide Interbank Financial Telecommunication) is a limited liability cooperative company established in Belgium and specialising in the exchange of financial messages between financial institutions and financial market infrastructures.

and the SRB are now responsible for the supervision and resolution of credit institutions deemed significant (significant institutions : SIs), under the single supervisory and resolution mechanisms. It should be noted that an FSAP of the euro area as a whole is taking place in parallel with the Belgian FSAP. That exercise is very important in view of the Banking Union and the primarily European character of financial regulations in the European Union.

The Belgian FSAP mission was prepared with the aid of questionnaires, completed in advance by the Bank, the ECB, the FSMA and FPS Finance. This written approach gives the IMF an initial view of any vulnerability in the financial sector and the quality of the regulatory and prudential framework before the on-site mission.

On completion of an FSAP mission, the IMF publishes its recommendations, in which it states the entities to which those recommendations are addressed (e.g. the Bank, the federal government, the ECB) and the timescale for implementing them. These recommendations are not binding but they carry considerable weight. Thus, most of the recommendations resulting from the 2012-2013 FSAP on banking supervision were transposed into the Banking Law [1] and the Law of 25 April 2014 establishing the mechanisms of a macroprudential policy [2]. This concerns among other things the granting of the macroprudential authority mandate and the resolution authority mandate to the Bank, the introduction of preferential treatment for retail deposits in the event of bankruptcy, and the requirement whereby credit institutions must submit their strategic decisions to the supervisory authority for prior approval. Since the last FSAP, the supervision framework and the prudential regulations have therefore undergone radical change. The 2017 FSAP will reveal the areas in which Belgium is on the right track and those where the situation could be improved.

These recommendations are expected to be approved by the IMF Executive Board in March 2018. They will be presented in a Financial System Stability Assessment (FSSA), accompanied by technical notes focusing on specific subjects. These recommendations could also have some influence on the agenda of the supervisory and regulatory authorities in the years ahead. The next FSAP is scheduled for 2022.

(1) Law of 25 April 2014 on the legal status and supervision of credit institutions and stockbroking firms.
(2) Law of 25 April 2014 establishing the mechanisms of a macroprudential policy and spelling out the specific tasks devolved to the National Bank of Belgium.

# B. Macroprudential policy

*The purpose of the Bank's activities in performing its macroprudential mandate is to safeguard overall financial stability. The Bank fulfils part of that responsibility jointly with the ECB, which was given a number of powers concerning macroprudential policy under the single supervisory mechanism (SSM).*

*During the year under review, the Bank maintained its watch on the risks concerning residential real estate and developed new measures to address the vulnerabilities found. The Bank also has to take a number of recurrent macroprudential decisions. That concerns the quarterly fixing of the countercyclical capital buffer rate applicable to credit exposures in Belgium, and the annual preparation of the list of domestic systemically important banks. Furthermore, in 2017, a new macroprudential instrument was added to the list of instruments available to the Bank in connection with its mission of contributing to the stability of the financial system.*

*In regard to the extension of the macroprudential framework, during the period under review, the Bank continued to develop its risk assessment framework in order to strengthen the link between the wide range of data used in risk analysis and the available macroprudential policy options. In addition, analyses of broader risk developments in the financial system gave rise to a report on asset management and the shadow banking system in Belgium, and a report describing the use of financial derivatives by Belgian banks and insurers, the resulting risks and the regulations on the subject. Finally, during the year under review, the Bank also monitored the risks connected with climate change and the transition to a low-carbon economy.*

## 1. Residential real estate

In recent years, the Bank has kept a close eye on the risks associated with developments on the Belgian housing market and those relating to the banks' mortgage loan portfolios, more especially in the riskier sub-segments. In its analyses, the Bank noted in particular the sustained growth of mortgage lending, the growing debt of Belgian households, some (as yet moderate) signs of a potential overvaluation of property prices, and some relaxation of the lending criteria. In their analyses of the risks to financial stability in Belgium, the Organisation for Economic Cooperation and Development (OECD), the IMF, the ECB and the European Systemic Risk Board (ESRB) also drew attention to developments on the Belgian housing market. At the end of 2016, the ESRB issued a warning to eight Member States, including Belgium, on the basis of an analysis of the medium-term risks.

In 2016, the Bank had extended by one year a macroprudential measure adopted in 2013[1]. That measure, in force until 27 May 2017, provided for a flat-rate, 5 percentage point increase in the risk-weighting coefficients applicable to Belgian mortgage loans for which the own funds requirements are calculated using internal models.

In the first half of 2017, in view of the persistence of the various vulnerabilities, the Bank had wanted to take a new measure to ensure continuity with the previous measure which had meanwhile expired, while also targeting the riskier sub-segments. The aims of this measure were twofold: to strengthen the resilience of the banking sector in the face of any shocks on the mortgage market, and to discourage excessive risk-taking, because if the

(1) This measure originally entered into force via a Bank Regulation approved by the Royal Decree of 8 December 2013, then implemented in 2014 for a two-year period pursuant to Article 458 of the CRR.

Belgian housing market were to take a less favourable turn, the riskier segments of the mortgage loan portfolios could become a source of heavier-than-expected loan losses for the banks.

The government did not approve this Bank proposal by Royal Decree, but in June it asked the Bank to conduct a new risk assessment and, at the same time, to extend the measure that had expired in May. The Bank therefore issued a recommendation to the banks concerned so that they would continue to apply that measure, and undertook to produce a new analysis of the housing market by the end of October.

That analysis showed that the vulnerabilities evident in the past had not been resolved (see section 3.3. of the "Economic and financial developments" part of the Report). Mortgage lending has continued to grow by more than 5 % per annum since July 2015, and consequently the household debt ratio was in the region of 60 % of GDP in 2017, a level which now exceeds the euro area average. The rise in house prices seen in recent decades is still persisting and various indicators suggest some overvaluation of the housing market. In particular, the strong growth of mortgage debt reflected the large proportion of recent mortgage loans with a high loan-to-value ratio, i.e. the amount of the mortgage loan in relation to the value of the property being financed, and a high debt-service-to-income ratio, i.e. the monthly debt repayment in relation to the borrower's income. In addition, the favourable developments seen in the past as regards tighter lending conditions seem to have come to an end, and a new easing of those conditions has actually been observed recently. Finally, the banks' commercial margins continue to diminish, possibly indicating that competition on the market is driving them to take insufficient account of the aforesaid risks in setting their rates.

On the basis of that analysis, the Bank therefore considers that there is still a need for a new, stricter, more targeted measure than the one which has expired, both to maintain the banks' resilience and to limit the excessive accumulation of systemic risks. In the Bank's opinion, the Belgian banks should mobilise capital amounting to around € 1.4 billion to enable them to absorb potential significant shocks on the Belgian residential property market.

The Bank examined various options and decided on a two-pronged measure [1]. The new proposed measure would first comprise a linear component, i.e. one targeting all loans in the same way, thus ensuring continuity with the previous measure. This linear component would correspond to a 5 percentage point surcharge in the risk weighting calculated in accordance with internal models. A second, more targeted, component would apply according to the average risk of each bank's portfolio, using a multiplier. In this case, the initial (microprudential) risk weighting would be multiplied by a factor of 1.33. This means that banks holding a riskier mortgage loan portfolio and therefore contributing more to systemic risk would be subject to a proportionately higher capital requirement.

Taken together, the two components would result in the creation of a buffer amounting to around € 1 500 million consisting of common equity Tier 1 capital (CET1). That would correspond to an increase in the average risk weighting of Belgian mortgage loans from 10 % to 18 % (5 % increase due to the first component and 3 % due to the second component), a ratio which would be slightly higher than the European average.

This measure was submitted to the ECB under Article 5 of the Single Supervisory Mechanism Regulation (SSM Regulation [2]), and the procedure in the various competent European institutions, stipulated by Article 458 of the Capital Requirements Regulation (CRR [3]), is currently ongoing. If the European institutions raise no objections, the measure will enter into force in the second quarter of 2018, once the Belgian government has approved a new Royal Decree.

## 2. Countercyclical capital buffer

Once a quarter, the Bank has to set the countercyclical capital buffer (CCyB) rate applicable to credit exposures on counterparties located in Belgian territory. The aim of the CCyB is to support sustained lending throughout the cycle by strengthening the banks' resilience in the event of an increase in the cyclical systemic risks (e.g. in the case of excessive credit growth). It uses a wide range of information, including a vast array of indicators considered relevant for signalling the rise in cyclical systemic risks [4]. However, neither the credit developments – although they bear witness to some dynamism in lending to non-financial corporations and Belgian

(1) See the Bank's press release dated 21 November: "The National Bank intends to strengthen the resilience of Belgian banks to any problems relating to mortgage loans and property shocks".
(2) Council Regulation (EU) No. 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions.
(3) Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No. 648/2012.
(4) See "Setting the countercyclical buffer rate in Belgium: A policy strategy" (www.nbb.be).

**TABLE 21** COUNTERCYCLICAL BUFFER RATES IMPOSED BY FOREIGN AUTHORITIES
(in %)

| Country | Current buffer rate | | Future buffer rate | |
|---|---|---|---|---|
| | Percentage | Entry into force | Percentage | Entry into force |
| Hong Kong | 1.875 | 01-01-2018 | 2.50 | 01-01-2019 |
| Iceland | 1.25 | 01-11-2017 | unchanged | |
| Lithuania | | | 0.50 | 31-12-2018 |
| Norway | 2.00 | 31-12-2017 | unchanged | |
| United Kingdom | | | 0.50 | 27-06-2018 |
| | | | 1.00 | 28-11-2018 |
| Slovakia | 0.50 | 01-08-2017 | 1.25 | 01-08-2018 |
| Sweden | 2.00 | 19-03-2017 | unchanged | |
| Czech Republic | 0.50 | 01-01-2017 | 1.00 | 01-07-2018 |
| | | | 1.25 | 01-01-2019 |

Sources: BIS, ESRB.

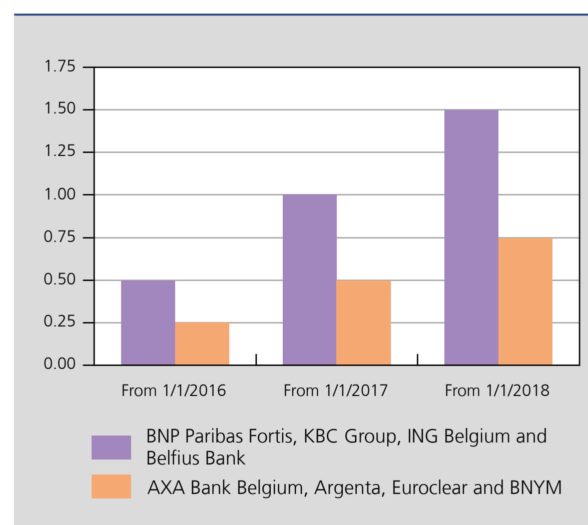
households – nor the other indicators used pointed to any increase in systemic risks during the year under review. The countercyclical buffer rate applicable to credit exposures on counterparties located in Belgium was therefore held at 0 % throughout that period. Each decision on the countercyclical buffer rate is submitted to the ECB and published every quarter on the Bank's website together with a selection of key indicators.

Belgian banks also have to apply the buffer rates imposed by foreign authorities on their credit exposures in those countries. The table below gives an overview of the current and future countercyclical buffer rates. During the year under review, in response to the ESRB's Recommendation on recognising and setting countercyclical buffer rates for third-country exposures, the Bank identified three third countries where those exposures were material (the United States, Switzerland and Turkey) and defined a framework for monitoring cyclical systemic risks in those countries.

## 3. Domestic systemically important banks

In the fourth quarter of the year under review, on the basis of the methodology of the European Banking Authority (EBA), the Bank confirmed the list of eight Belgian domestic systemically important banks (D-SIBs or "O-SIIs")(1) drawn up in 2016. BNP Paribas Fortis, KBC Group, Belfius Bank, ING Belgium, Euroclear, Bank of New York Mellon (BNYM), Argenta and AXA Bank Belgium therefore retain their status as O-SIIs.

**CHART 86** LEVEL OF THE CAPITAL SURCHARGE FOR BELGIAN O-SIIS
(in % of the risk-weighted assets)




Source: NBB.

(1) In EU legislation, D-SIBs are called other systemically important institutions (O-SIIs).

The first six banks were automatically designated as O-SIIs on the basis of their quantitative systemic importance score[1]. Argenta and AXA Bank Belgium were classified as O-SIIs according to information obtained from supplementary indicators. The supplementary indicators taken into account are the banks' shares in deposits and loans in Belgium. The choice of these supplementary indicators is justified because indicators which are national in scope are considered more appropriate for designating domestic systemically important institutions than European or global indicators.

The capital surcharges announced in 2015 for these O-SIIs still apply[2]. The high economic and social costs that failure of these institutions would entail are the reason for boosting their resilience by means of additional capital requirements. In 2018, the capital surcharge is 0.75 % of the risk-weighted assets for Argenta, AXA Bank Belgium, BNYM and Euroclear, and 1.5 % for Belfius Bank, BNP Paribas Fortis, ING Belgium and KBC Group[3].

## 4. Macroprudential instrument concerning a funding requirement

During the year under review, a new macroprudential instrument was added to the arsenal available to the Bank for performing its mission of contributing to the stability of the financial system. This new macroprudential instrument should be considered in the context of the Bank Resolution and Recovery Directive (BRRD)[4] and fulfils the need to be able to apply a bail-in[5] to an entity undergoing resolution without jeopardising the stability of the financial system.

Every institution must meet a minimum requirement for own funds and eligible liabilities (MREL) in order to be able to absorb losses and effect a recapitalisation if a bail-in is applied. This minimum requirement is fixed by the resolution authority and must comprise an amount sufficient to be used for the bail-in, enabling the institution to remain in business, if appropriate, and maintaining market confidence in the institution. In any event, the MREL must be at least equal to 8 % of the total liabilities to qualify for recourse to a resolution fund or the use of public financial stabilisation instruments.

It is also necessary to ensure, especially in the case of systemic events, that the bail-in can be applied without compromising confidence in the banking sector, if financial stability is to be preserved. The bail-in of eligible debts will take place with due regard for the ranking of claims. Confidence in the banking sector could be eroded if deposits were to be affected by the bail-in. Since the principle of equal treatment for creditors of equal rank must be respected, deposits can only be excluded from the scope of the bail-in if institutions have a sufficient quantity of lower level instruments which can be used before others to cover losses.

The addition of a new macroprudential instrument enables the Bank to oblige institutions to hold sufficient lower ranking instruments, as the Bank now has the power, as the macroprudential authority, to impose a funding requirement comprising a) common equity Tier 1 (CET1) or additional Tier 1 or Tier 2 capital, b) subordinated debts, c) claims such as those referred to in Article 389/1, 2°, of the Law of 25 April 2014, namely Non-Preferred Senior claims (see chapter C below) and if appropriate d) other debt eligible for application of the bail-in. This requirement can be imposed individually for all credit institutions or investment firms, or for a sub-category of them, and on an individual or consolidated basis for financial holding companies, mixed financial holding companies or mixed holding companies. As the macroprudential authority, the Bank can also determine the method of calculating the minimum funding requirement and the respective shares of the funding sources in that minimum requirement referred to in a) to d).

This macroprudential instrument does not in any way replace the microprudential MREL imposed on institutions; instead, it supplements that. If the Bank were to decide to activate this new instrument, it would in all cases need to notify the ESRB and the ECB before adopting the measure, in the same way as when applying other macroprudential instruments.

## 5. Extension of the macroprudential framework

In the first quarter of the year under review, the ESRB published a report on the way in which the Member States had complied with its Recommendation of

(1) That score is calculated as an aggregate of the mandatory indicators relating to the size, complexity, interdependence and substitutability of the banks, the indicators being assigned fixed weighting factors. When a bank's systemic importance score exceeds a certain threshold, the institution is automatically classified as an O-SII. Nevertheless, the authorities can use other indicators or apply different weighting factors to the indicators stipulated by the EBA to designate additional banks as O-SIIs.

(2) See the "Annual disclosure regarding the designation of and capital surcharges on Belgian O-SIIs (1 December 2017)". (www.nbb.be).

(3) Without prejudice to the ceilings provided for in Article 14 §5 of Annex IV to the Belgian Banking Law.

(4) Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No. 1093/2010 and (EU) No. 648/2012, of the European Parliament and of the Council.

(5) The bail-in instrument comprises a mechanism for absorbing the losses of an institution in the process of resolution, the institution then being recapitalised by the write-down or conversion of equity instruments or other eligible liabilities. The write-down and/or conversion is carried out as far as possible in accordance with the ranking specified by the usual insolvency procedures. The losses must be borne first by the shareholders, followed by the holders of additional Tier 1 equity, then Tier 2 equity, other subordinated creditors and, finally, the creditors of other eligible liabilities.

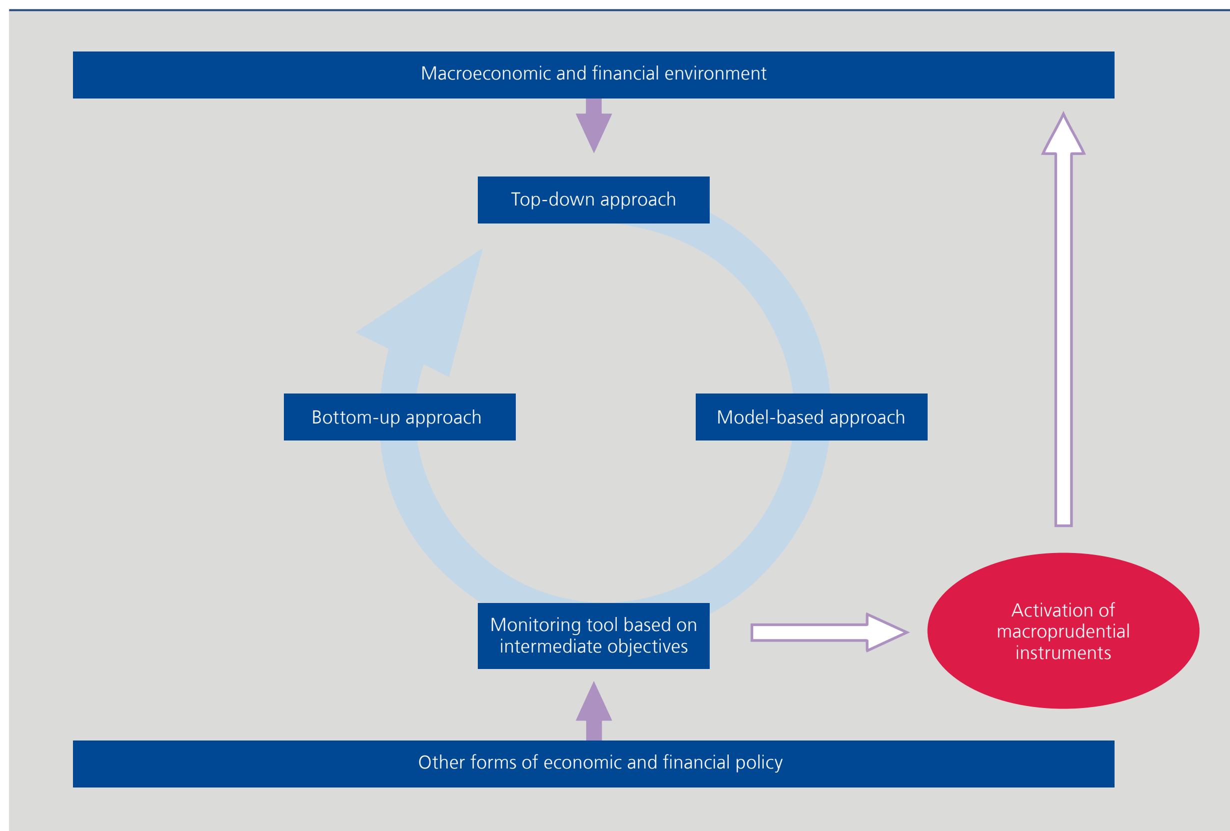
4 April 2013 on intermediate objectives and instruments of macroprudential policy[1]. In that Recommendation, the ESRB lists four intermediate objectives for macroprudential policy in the banking sector. Those intermediate objectives serve as quantifiable, operational specifications for the mission of maintaining financial stability as the ultimate aim of macroprudential policy. The Bank's macroprudential framework was judged fully compliant with the Recommendation.

Nevertheless, the Bank continued to develop its risk assessment framework during the year under review. More specifically, on the basis of the data used for risk assessment[2], a list of indicators was drawn up for the four intermediate objectives of macroprudential policy in the banking sector. The indicators cover the accumulation of risks in financial institutions (banks, insurers and other financial institutions), the non-financial private sector (households and non-financial corporations), financial markets and the property market. In addition, for each intermediate objective, indicators were listed which can warn of the materialisation of such risks and, if appropriate, indicate the need to release certain macroprudential measures.

The aim of this extension of the risk assessment framework is to strengthen the link between the wide range of data used in the risk analysis and the macroprudential policy options available to the Bank. More specifically, the monitoring tool based on the intermediate objectives makes it easier to identify the appropriate policy options for reducing the risks detected. In order to choose the most appropriate instruments, it is necessary to link the instruments and their expected transmission mechanism to the underlying risks and the macroprudential policy objectives[3].

(1) See "ESRB Recommendations on intermediate objectives and instruments of macroprudential policy (ESRB/2013/1)" and "ESRB Recommendation on intermediate objectives and instruments of macroprudential policy (ESRB/2013/1): Follow-up – Summary Compliance Report" (www.esrb.europa.eu).
(2) The Bank's macroprudential risk analyses are based on a top-down approach, a bottom-up approach, and a model-based approach (see the Bank's Macroprudential Report 2016).
(3) See "The Belgian macroprudential policy framework in the banking sector" (www.nbb.be).

**CHART 87** EXTENSION OF THE BANK'S MACROPRUDENTIAL RISK ASSESSMENT FRAMEWORK




Source: NBB.

TABLE 22 INTERMEDIATE OBJECTIVES OF MACROPRUDENTIAL POLICY IN THE BANKING SECTOR AND MACROPRUDENTIAL INSTRUMENTS AVAILABLE TO THE BANK [1]

| Intermediate objective | Category | Instruments |
|---|---|---|
| Mitigate and prevent excessive credit growth and leverage | Capital | Countercyclical capital buffer, sectoral capital requirements (real estate, exposures within the financial sector), systemic risk buffer, leverage ratio |
| | Lending limits | Recommendation on loan-to-value and debt-service-to-income limits, restrictions on large exposures |
| Mitigate and prevent excessive maturity and liquidity transformation (maturity mismatch and market illiquidity) | Liquidity | Net stable funding ratio, liquidity coverage ratio |
| Limit the concentration of direct and indirect exposures | Capital | Sectoral capital requirements (real estate, exposures within the financial sector), systemic risk buffer, leverage ratio |
| | Lending limits | Recommendation on loan-to-value and debt-service-to-income limits, restrictions on large exposures |
| Limit the systemic impact of misaligned incentives in order to reduce moral hazard | Capital | Capital buffer for global systemically important institutions and other systemically important institutions, systemic risk buffer, leverage ratio |
| | Liquidity | Net stable funding ratio, liquidity coverage ratio |

Source: NBB.
(1) The table shows only the Bank's main instruments in the various categories. A number of instruments (e.g. the sectoral capital requirements, the systemic risk buffer) can be used for more than one intermediate objective.

## 6. Monitoring of the shadow banking sector and asset management

The 2016 report by the High-Level Expert Group (HLEG) on the future of the Belgian financial sector [1] makes a series of recommendations aimed at strengthening the resilience and competitiveness of the Belgian financial sector, to enable it to continue contributing to the sustainable growth of the Belgian economy. That is the background to the request made to the Belgian supervisory authorities to submit a report in 2017 to the Minister of Finance on the risks associated with the shadow banking sector and its interconnections with other (financial) sectors in Belgium, and in particular the systemic risks associated with development of the asset management sector in Belgium.

In the third quarter of the year under review, in response to that request, the Bank and the FSMA presented and then published a joint report on asset management and the shadow banking system in Belgium [2]. The size of these different but overlapping sectors in Belgium can be defined and measured in various ways. A first key aim of the report is therefore to define the concept of shadow banking, to mark the dividing line between that shadow banking sector and the asset management sector in Belgium, and then to clarify the mutual relationship between the two.

Asset management refers to the part of the financial system that manages financial assets for investors, either via the collective management of investment funds or by discretionary management of individual investors' portfolios, or by providing investment advice. The size of this sector may be described in a number of ways, depending on which activities are considered to be Belgian. For instance, at the end of 2016, the net asset value of Belgian investment funds totalled € 144 billion, and Belgians owned units in foreign investment funds amounting to € 189 billion. Belgian asset managers managed assets totalling € 248 billion, both on a collective basis (Belgian and foreign funds) and on a discretionary basis. Finally, Belgian banks were active in

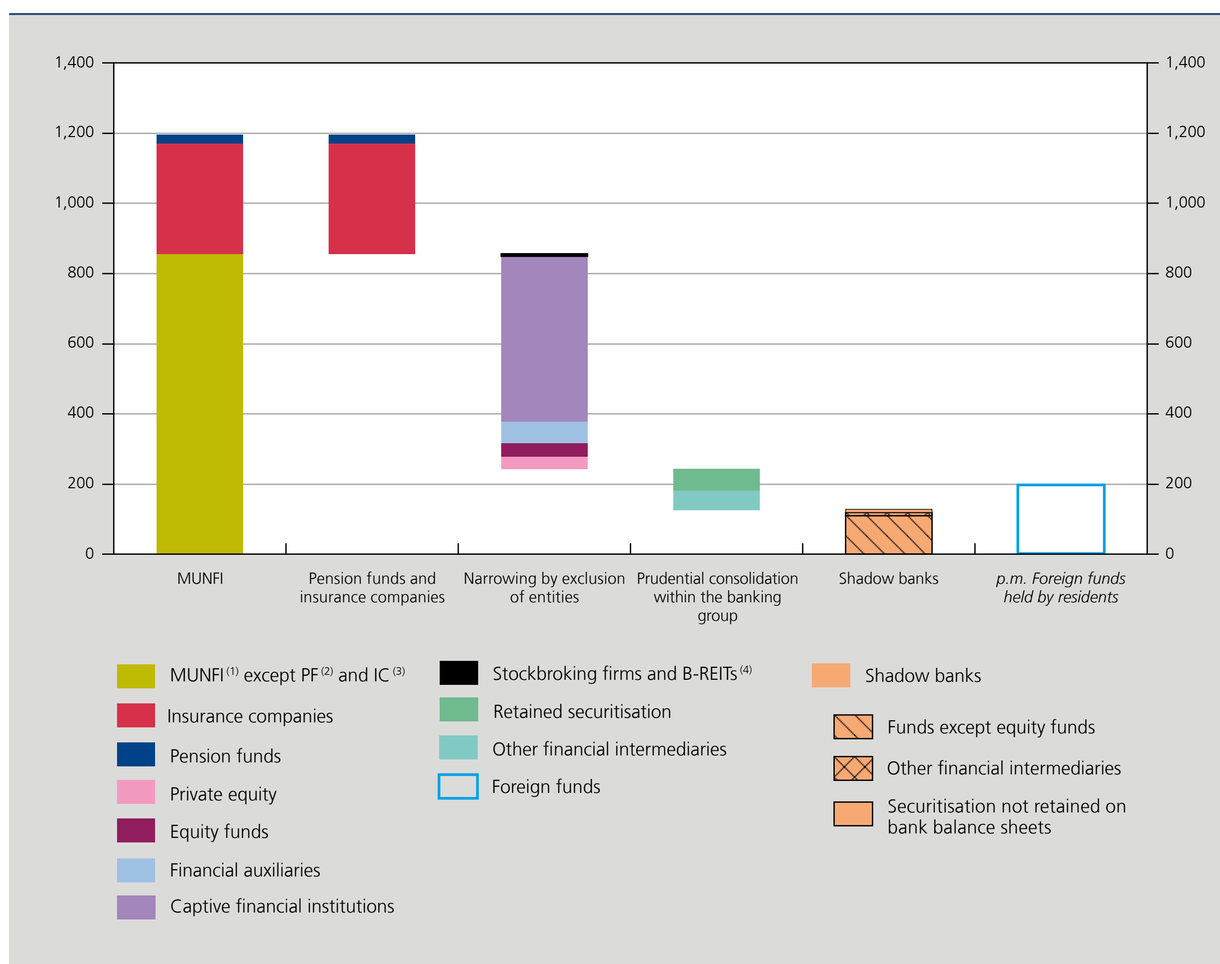
(1) "The future of the Belgian financial sector". Report of the High-Level Expert Group (HLEG) established on the initiative of the Belgian Minister of Finance, 13 January 2016.
(2) "Report on Asset management and Shadow banking", September 2017 (www.nbb.be).

the sector for a sum of € 531 billion, both in managing their own assets (via a Belgian or foreign asset management company which they owned, or via their own private and institutional banking activities) and in the marketing of third party funds.

Shadow banking refers to a form of credit intermediation without the participation of ordinary banking system entities and activities. In the report, this sector is defined for Belgium according to two different methodologies, namely the Financial Stability Board (FSB) method and the EBA method. The narrow FSB measure starts with non-bank financial intermediation in general, and then reduces it to non-bank financial intermediation effected by entities outside the prudential consolidation scope of a banking group and posing bank-like risks for the financial system. This narrow definition results in a figure of € 128 billion (30 % of GDP), comprising money market and other funds excluding equity funds (€ 111 billion overlap with the asset management sector), other financial intermediaries such as leasing and factoring companies, and commercial credit companies and mortgage lenders with the exception of those consolidated in a banking group (€ 7 billion), and securitisation vehicles except for securitisation retained on the balance sheets of Belgian banks (€ 10 billion). According to the EBA methodology, the overlap between the asset management sector and the shadow banking sector is considerably smaller, since that methodology considers that shadow banking entities include only money market

**CHART 88** DEFINITION OF THE BELGIAN SHADOW BANKING SECTOR ACCORDING TO THE NARROW FSB CRITERION

(at the end of 2016, in € billion)




Source: NBB.
(1) MUNFI (Monitoring Universe of Non-bank Financial Intermediation).
(2) PF: pension funds.
(3) IC: insurance companies.
(4) B-REITs: Belgian real estate investment trusts.

funds and alternative investment funds (AIFs)[1] providing leverage of more than 300 %, or granting or buying loans. According to this approach, the Belgian shadow banking sector only represents a total of € 19.4 billion (5 % of GDP).

The asset management sector and the shadow banking sector form part of a more market-oriented financial system, where part of the financial intermediation takes place outside the banking sector. This funding arrangement offers a valuable alternative to bank finance and thus widens the diversity of credit sources and investment options for investors. On the other hand, it may engender systemic risks, particularly if it is linked to banking activities such as liquidity transformation and maturity transformation and / or the creation of credit and leverage, and may give rise to points for attention concerning investor protection.

For the part of the shadow banking sector that overlaps with the asset management sector, the main risk is the liquidity risk, and in particular the risk of sudden, large-scale redemptions. However, that risk – which arises because most of these funds are open-ended and therefore comprise a variable number of units[2] – is already partly absorbed by the current regulations and the regulations being prepared on various subjects, including the diversification of assets and liabilities and liquidity management instruments. In this context, it should be noted that the asset management sector and the shadow banking sector, contrary to their sometimes negative connotations and the idea that they avoid any regulatory framework, are duly subject to regulatory requirements, although the details differ from the regime applicable to financial institutions such as banks.

In addition to the direct risks, the asset management sector and the shadow banking sector may also generate (systemic) risks indirectly, in particular via their interconnections with other financial institutions and the real economy. Those interconnections, which may take the form of both contractual and non-contractual debts and claims, tend to be limited for households and non-financial corporations (e.g. investment in funds). However, for financial institutions, they are more significant and more complex, particularly in the case of interconnections between conglomerates. Nonetheless, it should also be noted that, in the specific case of Belgium, no systemic points for attention were found apart from those already identified at international level.

On the basis of the analyses conducted, the HLEG report makes a series of recommendations on policies to be adopted for monitoring systemic risks in the asset management sector and the shadow banking sector. First, there is a need for a greater exchange of information between the competent authorities and initiatives to improve reporting by the shadow banking entities concerned, so that this sector can be defined and supervised in a more appropriate way. Next, it is necessary to introduce periodic monitoring of the Belgian shadow banking sector. In this context, the Bank and the FSMA undertake to update the statistics annually and, as far as possible, to add new and more refined data and risk analyses. As the shadow banking sector is international in character, that exercise will also be in line with the activities of the international authorities (such as the FSB and IOSCO : the International Organisation of Securities Commissions) concerning monitoring, risk assessment and policy implementation. The Bank and the FSMA will thus continue to contribute to these international activities.

In addition, two more specific recommendations were made on the subject of the two principal risks detected in the HLEG report. In regard to the liquidity risk of open-ended funds, the FSMA will maintain its efforts to ensure that fund managers keep a proper watch over their liquidity risks, and will make liquidity risk management tools available to all Belgian investment funds. In the case of the risks relating to interconnections between conglomerates, and more particularly those resulting from non-contractual obligations (step-in risk), supervision over the adequacy of the risk management within financial conglomerates needs to be further reinforced and extended.

## 7. Report on derivatives

In the aforesaid HLEG report on the future of the Belgian financial sector, the Belgian supervisory authorities were also asked to present to the government, before the end of the year under review, a report on developments in the use of financial derivatives in the Belgian financial system and the resulting systemic risks. In December of the year under review, the Bank thus submitted its report to the Minister of Finance, comprising an analysis of the use of financial derivatives by Belgian banks and insurance companies, and the associated risks, together with a review of the new regulatory framework introduced after the financial crisis.

(1) Alternative investment funds are funds which are not covered by the European rules on UCITS (undertakings for collective investment in transferable securities). They are generally funds that invest in alternative strategies, such as hedge funds, private equity funds and property funds.
(2) An open-ended fund is an investment fund that offers the possibility of issuing or redeeming shares. People investing in these funds can easily enter or leave, and many open-ended funds permit daily redemptions.

The report begins with a general description of the characteristics of the various types of financial derivatives and the purposes for which they can be used by financial institutions. More specifically, financial derivatives can be used for risk-hedging, for market-making activities and providing services to customers, and to take positions in order to benefit from existing or expected differences between buying and selling prices or other fluctuations in prices or interest rates. The report then proceeds to explain the mechanisms whereby the use of derivatives may generate systemic risks. Derivatives may expose the counterparties to a wide range of risks, even if they are used for hedging. Systemic risks relating to the use of derivatives may result, in particular, from the sectoral concentration of positions held by a number of financial institutions via derivatives, and from the interdependence between financial institutions resulting from their mutual transactions in derivatives.

Next, the report describes the changes introduced in the regulatory framework in the wake of the financial crisis which directly or indirectly concern derivatives: the adjustments to the Basel III regulatory framework, the adoption of the Solvency II framework for insurance companies, the entry into force of the European Regulation on over-the-counter derivatives, central counterparties and trade repositories (European Market Infrastructure Regulation: EMIR), the proposal for an EU Regulation on the recovery and resolution of central counterparties (CCPs), and the BRRD.

Finally, the report draws on the data given to the supervisory authority to analyse the developments in the use of derivatives by Belgian banks and insurance companies. As regards the nature of the products, it is interest rate swaps that predominate among the financial derivatives used, in the case of both banks and insurance companies in Belgium. The analysis also shows that the Belgian banking sector's exposures to derivatives have declined sharply since the financial crisis. At the same time, the fall in interest rates since the crisis has had a substantial negative impact on the market value of the Belgian banks' exposures to derivatives and on the net interest income from derivatives [1]. In general, insurance companies make far less use of derivatives than banks.

While the analysis of the data collected by the supervisory authority reveals certain trends in the activities of banks and insurance companies concerning derivatives, the limitations inherent in those data nevertheless make it impossible to discern all the key developments. For one thing, the detailed data on derivatives at transaction level, which must now be reported pursuant to the EMIR legislation, and which could supply information on many aspects of activities concerning derivatives, cannot yet be fully utilised. Also, as a large proportion of transactions in derivatives are now cleared by central counterparties, the availability of detailed data still does not mean that the authorities are able to gain from the system a full impression of all the counterparties on both sides of the centrally cleared transactions. The central counterparties' systemic importance, which arises naturally from the EMIR requirement concerning central clearing for standardised derivatives, highlights the need to establish an effective recovery and resolution framework for those central counterparties, as is currently being discussed in Europe.

The report reveals some important points for attention concerning the policies to be adopted. First, although the use of derivatives has declined and the hedging of some risks by derivatives may reduce those risks, their use may also lead to new risks and wide fluctuations in the income of financial institutions. In view of the very complex and technical nature of derivatives, it is also important for financial institutions to have adequate risk management structures so that the governing bodies of those institutions can gain a general idea of the use of financial derivatives within the institution and thus make an accurate assessment of the associated risks.

## 8. Risks relating to climate change and the transition to a low-carbon economy

The international agreement reached at the Paris Climate Change Conference (COP21) is among the reasons for the recent increase in attention to the potential impact on financial stability of climate change and the eventual transition to a low-carbon economy. In a 2017 report, the FSB mentioned that the amount of financial assets subject to direct climate risks or transition risks came to between $ 4 000 and 43 000 billion, according to various studies. While these estimates are still imprecise, particularly in view of the long time-scale to be considered, they nevertheless indicate the potential importance of these risks.

The classification of the various risks confronting the financial sector in view of climate change and the transition to a low-carbon economy is generally accepted at international level. The direct risks mainly concern the liabilities of non-life insurers and the potential increase in the claims burden resulting from extreme climatic conditions, but also exposures to counterparties located in

(1) The reason is that the maturities of investment on the assets side of the bank balance sheet are longer than the maturities of the funding on the bank's liabilities side. Since a number of banks generally hedged themselves against interest rate increases, the steep decline in interest rates over recent years led to losses on derivatives (interest rate swaps) used to hedge that risk.

regions of the world considered the most vulnerable to climate change. The transition risks concern among other things the exposures to the sectors that are the heaviest consumers of fossil fuels and/or the most vulnerable in the event of a sudden energy transition, including the real estate sector. The transition to a low-carbon economy also leads to the development of green finance. These instruments may likewise present credit risks, particularly in view of the relatively innovative nature of the activities concerned and the long-term character of the investment funded, or reputation risks (e.g. in the event of failure to respect the commitments concerning the green nature of the project) when these products are issued or marketed by financial institutions.

The monitoring of the various financial risks associated with climate change, and particularly their potential impact on financial stability, is an important attention point for the Bank. The Belgian financial sector's exposures to the direct risks are relatively minor, except for the non-life insurance sector. The indirect risks could prove more significant. However, a more accurate measure of those exposures requires a more refined analysis framework than the currently available data permit. That framework will need to be developed in the near future on the basis of the methodology devised and approved at international level. Apart from the efforts to be made by the supervisory authorities, it is desirable for all the players concerned, including non-financial entities, to give more publicity to the aforesaid risk exposures. Initiatives such as those of the FSB via its Task Force on Climate-related Financial Disclosures should be encouraged.

In any case, it is not desirable to influence – via legislation – the strategic choices of financial institutions concerning climate or energy, e.g. by means of higher or lower capital requirements for certain types of exposures. Nonetheless, the Bank's macroprudential mandate is to guarantee continued financial stability in Belgium, and it is therefore the Bank's duty to monitor any excessive systemic risks that arise, whether they be due to climate change or any other factor.

# C. Recovery and resolution

*During the year under review, the Bank's work on recovery and resolution mainly concerned resolution in the banking sector. While the European institutional framework remained relatively stable, its implementing provisions – some of which have yet to be defined – were discussed at European and international level. At the same time, a new category of unsecured creditors was introduced in Belgian law in order to facilitate the application of the bail-in instrument. The Single Resolution Board (SRB), in cooperation with the national resolution authorities, continued to draw up resolution plans for significant credit institutions and the financing of the European and national resolution funds was stepped up. The Bank also published a Circular[1] on the implementation of the various EBA guidelines on crisis management, concerning both recovery and resolution plans and various modalities of intervention or resolution.*

*As regards financial market infrastructures, at the end of 2016, the European Commission had published a proposal introducing a legal framework for the recovery and resolution plans of central counterparties whose importance is growing in view of the obligation to clear certain types of derivatives via such institutions. The discussions at European level continued during the year under review.*

*As regards insurance companies, the European Insurance and Occupational Pensions Authority (EIOPA) analysed the various national recovery and resolution regimes. As it found wide variations between Member States, it made recommendations aimed at greater harmonisation of those regimes. Implementation of those recommendations would entail future adjustments to the regulatory framework.*

## 1. Resolution of banks and investment firms

### 1.1 Institutional and legal framework

The European institutional and legal framework concerning resolution remained relatively stable during 2017. It is based on the BRRD, which defines a framework for the recovery and resolution of credit institutions and investment firms, and on the SRM Regulation[2], which establishes the single resolution mechanism (SRM).

While the European framework defines an overall approach to resolution, some of its implementing provisions have yet to be determined, e.g. by the EBA or the SRB in accordance with their respective competences. In particular, the SRB launched a reflection with the aim of devising, within the Banking Union, an approach on a range of horizontal topics including, for example, the definition and calibration of the MREL, the mapping of critical functions performed by European banking groups, the operational continuity of entities in resolution, and the access to market infrastructures in resolution.

Some international developments also enriched the discussions on the implementation of the resolution framework in Europe. For example, in December 2016, the FSB launched a consultation on the internal total loss-absorbing capacity, or internal TLAC, i.e. the loss-absorption capacity of the subsidiaries of a banking group subject to a single point of entry resolution strategy (i.e. a banking group in which the bail-in instrument would only

(1) Circular NBB_2017_29 of 30 November 2017 – EBA guidelines on crisis management.

(2) Regulation (EU) No. 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No. 1093/2010, OJ L 225 of 30.7.2014.

be applied to one legal entity within the group, the single point of entry, in order to cover all the group's losses). In response to the FSB consultation, in February 2017, the NBB stressed the importance of such a mechanism in the implementation of the single point of entry resolution strategy, and raised a number of technical arguments demonstrating that some instruments, such as collateralised guarantees, cannot ensure that one of the conditions necessary for implementing such a strategy is met, namely the upstreaming of losses to the parent company and the downstreaming of capital to the subsidiaries in resolution. The FSB published the final version of its guiding principles on the internal total loss-absorbing capacity in July 2017.

At the same time, the implementation of the European framework also required adjustments to the Belgian legislation in order to facilitate the use of the new resolution instruments that it introduces. In 2017, Belgium followed the initiative already taken in several Member States, including France, to facilitate the application of the bail-in instrument by introducing a new class of debt instrument (Non-Preferred Senior).

In the event of a bank resolution, the shareholders must be the first to bear the losses, followed if necessary by the institution's creditors. In accordance with the no-creditor-worse-off (NCWO) principle, no creditor may incur greater losses than those it would have incurred if the institution had been wound up under normal insolvency proceedings. The creditors have to contribute towards the losses according to the ranking of their claims in bankruptcy, and creditors of equal rank must receive equal treatment (*pari passu*).

The resolution authority identified a number of obstacles concerning unsecured creditors, hampering the use of the bail-in instrument. The first is the presence in this rank of unsecured deposits. While the legal framework permits the absorption of losses by unsecured deposits, including corporate deposits, the resolution authorities nevertheless face a considerable risk of contagion for the real economy.

Next, among the unsecured creditors, there are highly complex products, such as structured products (which package various financial instruments, such as derivatives, within a single debt instrument), so that it may prove impossible to effect their write-down or conversion within a reasonable period of time.

Although the legal framework provides for the possibility, in exceptional circumstances, of excluding from the scope of application of the bail-in instrument certain liabilities normally eligible for bailing in, that option needs to be qualified as it could contravene the NCWO principle. "Traditional" debt instruments which, unlike the debt instruments which would be excluded, can be more readily written down or converted would consequently have to bear greater losses, after which the holders of those traditional debt instruments would be entitled to claim compensation from the resolution fund.

To resolve these two problems, a new category of unsecured creditors (Non-Preferred Senior) was created which, in the event of competing claims on the credit institution's assets, would be repaid after the ordinary unsecured creditors but before creditors holding subordinated debt. For the application of the bail-in instrument, this means that they will have to bear part of the losses after the subordinated creditors but before the ordinary unsecured creditors.

To qualify as Non-Preferred Senior, debt instruments must meet a range of requirements. They must be debt instruments with an initial maturity of not less than one year and the contractual terms must stipulate that the holder is a junior unsecured creditor. Debt instruments subject to conditions which would make it too difficult to apply the bail-in instrument are excluded.

With this initiative, Belgium anticipated the European Directive [1] amending the BRRD on the basis of which a new category of debt instruments is introduced into the creditor hierarchy at a rank directly above that of the subordinated instruments issued by banks (see section D.3.1. below).

At European level, the year under review was marked by the resolution of a number of banking crises which provided a test for the new European resolution rules (see box 10).

(1) Directive (EU) 2017/2399 of the European Parliament and of the Council of 12 December 2017 amending the Bank Recovery and Resolution Directive as regards the ranking of unsecured debt instruments in insolvency hierarchy.

## Box 10 – Italian and Spanish banking crises

The year 2017 saw the resolution of several banking crises which enabled the new resolution rules adopted at European level to be put to the test.

The Monte dei Paschi di Siena bank had to resort to Italian state aid to support its liquidity and solvency positions, notably by means of a capital increase amounting to over € 5 billion. This government aid did not require resolving the group as the increase in capital could be considered precautionary(1), being justified by the results of a stress test exercise conducted by the competent authorities. In accordance with its policy on state aid, however, the European Commission stipulated that the holders of subordinated debts of the Monte Paschi group must share in the losses by accepting a reduction in the amount of their claims equal to over € 3 billion. Nevertheless, private investors were partially spared these losses as it was considered that they had not been adequately informed of the risks incurred when investing in the form of subordinated debts and that, consequently, they should receive compensation on the grounds of mis-selling (sale of products inappropriate to the investor's knowledge and risk profile).

The competent supervisory authority had to deem the Italian banks Banca Popolare di Vicenza and Veneto Banca failing or likely to fail due to their inability to restore their profitability and solvency in a sustainable way. In view of the activities and size of these institutions, the SRB considered that these two banks did not meet the public interest requirement as defined by the BRRD. It therefore concluded that no resolution measure was necessary, the consequence being the liquidation of these two institutions. The Italian authorities were able to avoid a disorderly liquidation by first recapitalising these two entities for an amount of € 4.8 billion and transferring their healthy assets and deposits to the Italian banking group Intesa for € 1. The remaining assets and liabilities of the residual entities of these two banks essentially comprise a portfolio of non-performing loans and the capital and existing subordinated debts, which will be used to cover the losses. The difference was financed by debt guaranteed by the Italian government to the tune of € 12 billion in order to facilitate an orderly liquidation.

In Spain, Banco Popular similarly had to be deemed failing or likely to fail due to a severe liquidity crisis, which was the result of a loss of confidence among the creditors following the difficulties the bank experienced in improving its financial situation, weighed down by an excessive volume of non-performing assets. In view of the size of Banco Popular in Spain, the SRB considered that resolution measures aimed at preserving the bank's essential activities were necessary. It therefore proceeded immediately with a valuation of the assets and concluded that the whole of the capital and the subordinated debts had to be used to cover the existing losses. That made it possible to sell the Banco Popular to the Santander group for € 1.

In the above four crisis cases, the authorities used the tools introduced by the BRRD to preserve financial stability, the risk of a bail-in for depositors. However, it must be said that state aid was still needed to resolve some crisis situations, as in the case of the Italian banks. The local authorities considered that the aid was inevitable to avoid economic disruption in Italy, and more particularly in the regions where the banks in question operated. These cases show that it is difficult to exclude, *a priori*, state aid in a crisis situation, particularly if several large institutions are affected at the same time.

That aid was considered compatible with the European rules on state aid and with the BRRD. In the case of Banca Popolare di Vicenza and Veneto Banca, the aid was intended to facilitate the liquidation of banks which would cease to operate. In the case of Monte Paschi, the aid could be granted on the basis of a special BRRD provision which permits a precautionary recapitalisation. In accordance with its general policy, the European Commission ensured that the shareholders and holders of subordinated debt bore the losses, to prevent the state

(1) The BRRD makes provision for the precautionary recapitalisation mechanism, which enables a state to recapitalise a bank without triggering a resolution mechanism. The amount of the recapitalisation must be based on the level of theoretical losses estimated by the supervisory authority in a stress test exercise, and cannot be used to cover existing losses.

aid being used to cover existing losses. That policy highlighted the difficulty of using debt instruments held by retail customers to cover the losses incurred, as that could damage customers' confidence, whereas one of the aims of the crisis resolution is to restore confidence in the financial system.

The speed with which other entities could be found to take over the activities of the banks in crisis also helped to maintain financial stability. Without the rapid takeover of the entities and activities concerned by other investors, it would probably have been very difficult for the authorities to stop cash withdrawals and avoid a disorderly liquidation. It thus seems that having access to sufficient liquidity sources in the case of a bank resolution is essential for the success of a resolution procedure.

Finally, these cases also highlighted the importance, in the event of resolution, of considering the situation of not only the failing bank but also the entities associated with it, more particularly the foreign banking subsidiaries. Those subsidiaries may be affected by the failure of the parent institution and by the resolution or restructuring measures taken, which could disrupt financial stability in the host countries of those subsidiaries.

## 1.2 Resolution plans

The BRRD requires a resolution plan to be developed for each European banking group. The preparation of a resolution plan is aimed at improving a group's resolvability. Under the Directive, a banking group is deemed resolvable if the resolution authority can either liquidate all its constituent legal entities via normal insolvency proceedings or resolve it by applying the various resolution tools and powers at their disposal while safeguarding the stability of the financial system and ensuring the continuity of critical functions performed by the group.

The SRM Regulation gives the SRB responsibility for preparing the resolution plans of significant and/or cross-border credit institutions, and those subject to the ECB's direct supervision. Responsibility for drawing up the plans for other less significant institutions falls to the national resolution authorities.

Designing resolution plans is an iterative process which, depending on the complexity of the banking group, may extend over several years. In that connection, the SRB devised a sequential approach defining various stages in the preparation of resolution plans. In order to design a plan that fully complies with the BRRD's requirements, the SRB defined five stages in resolution plan development. The first stage is the transitional resolution plan. It is followed by the phase 2, 3, 4 and 5 resolution plans. The transitional resolution plan defines the bases of a resolution plan and of the resolution strategy itself. Both are further developed in the phase 2 to phase 5 plans by an iterative process, each plan comprising an additional decision factor in the light of the MREL or the identification of impediments to resolvability.

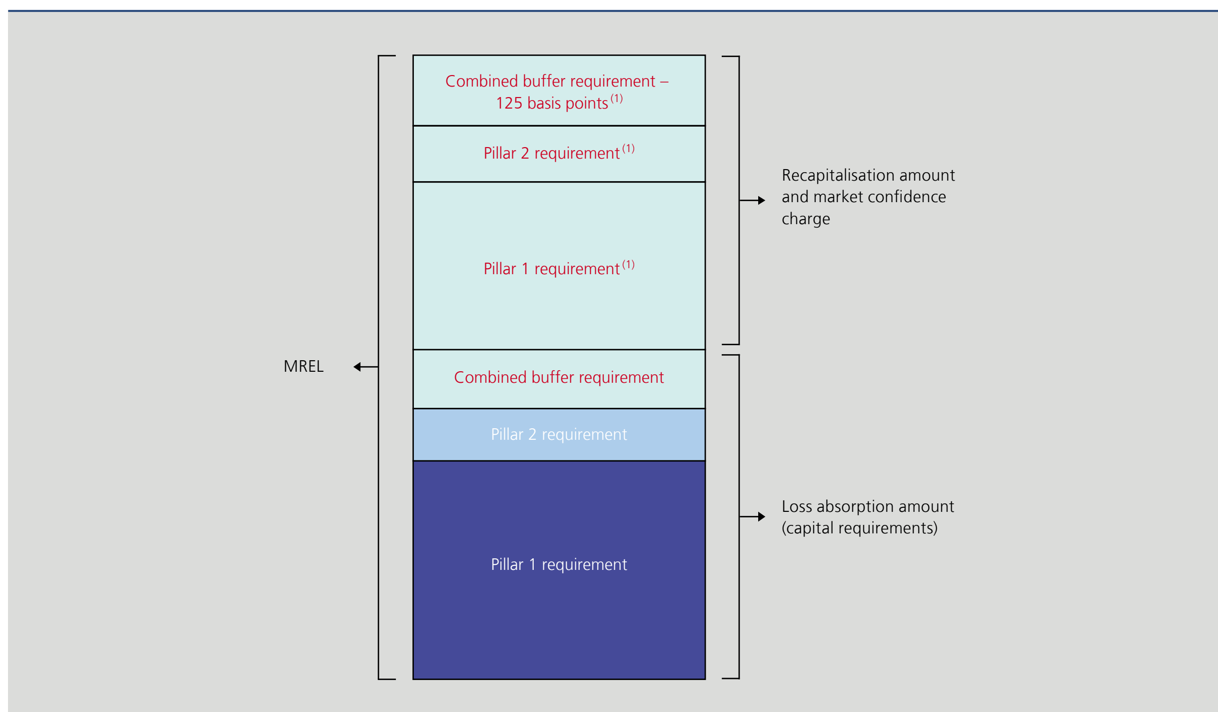
During 2017, in cooperation with the national resolution authorities, the SRB developed mainly transitional, phase 2 or phase 3 resolution plans. Unlike the phase 2 plans prepared in 2016, the phase 3 plans incorporate a binding consolidated MREL requirement.

The consolidated MREL requirement is determined in accordance with the methodology adopted by the SRB in 2017. The requirement comprises a loss absorption amount, a recapitalisation amount and a market confidence charge. The first is based on the capital requirements, namely the Pillar 1 and Pillar 2 requirements and the combined buffer requirements (see chapter D below). The recapitalisation amount is equivalent to the Pillar 1 and 2 requirements applied to the amount of the risk-weighted assets (total risk exposure) as determined after resolution. That amount may therefore recognise, within certain limits, a reduction in the risk-weighted assets resulting from the materialisation of certain risks. Finally, it is supplemented by an amount intended to ensure market confidence, equal to the combined buffer requirements less 125 basis points, again applied to the post-resolution risk-weighted assets.

A consolidated MREL is insufficient for a single point of entry resolution strategy which assumes that the bail-in, aimed at absorbing all the group's losses, is applied at a single point. That is why the consolidated requirement would need to be supplemented by a requirement at individual level to be satisfied by entities covered by the single point of entry resolution strategy.

The SRB's resolution plans are drawn up by internal resolution teams comprising members of the SRB

CHART 89 BREAKDOWN OF THE MREL REQUIREMENT




Source: NBB.
(1) Requirements applied to post-resolution risk-weighted assets.

and representatives of national resolution authorities. During 2017 the Bank, as the national resolution authority, took part in developing three phase 2 resolution plans and three phase 3 resolution plans concerning significant credit institutions established in Belgium, as well as in developing transitional resolution plans for two other credit institutions likewise established in Belgium. In addition, the Bank contributed to the development of the resolution plans of nine major banking groups with subsidiaries in Belgium.

## 1.3 Resolution financing

The BRRD requires each Member State to establish a resolution fund, financed by the levying of contributions from credit institutions and investment firms. Each resolution fund must reach a target level of at least 1 % of the total volume of covered deposits by no later than 31 December 2024.

The SRM Regulation established the Single Resolution Fund (SRF) in the Banking Union on 1 January 2016. It replaces the national resolution funds for institutions contributing to the SRF. However, national compartments are maintained within the SRF for a transitional period. The Fund must be fully constituted within eight years. Its target level is set at a minimum of 1 % of the total amount of the covered deposits for relevant institutions licensed in the Banking Union. The SRB estimates the target level of the SRF at € 55 billion in 2023.

The SRB defines the annual target level of the SRF and calculates the contributions for each institution. The national resolution authorities work with the SRB at every stage in the process. More specifically, by no later than 31 January in each year, they collect the data necessary for the calculation, and they notify the institutions of the amounts of their contributions by no later than 1 May.

The method of calculating the SRF contributions is determined by a European Commission Delegated Regulation [1]. Small institutions pay a flat-rate contribution. A risk-adjusted calculation method is used to determine the contributions of larger institutions.

(1) Commission Delegated Regulation (EU) 2015/63 of 21 October 2014 supplementing Directive 2014/59/EU of the European Parliament and of the Council with regard to *ex-ante* contributions to resolution financing arrangements.

In 2017, the SRB levied a sum of € 250 million on the Belgian institutions liable for contributions, while in 2016 the sum collected was € 277.6 million. This decline is explained by the mutualisation of resources which is being phased in by the SRF during the transitional period and which modifies the basis of calculation. The change in the basis of calculation is beneficial for Belgian institutions because they have a quantity of covered deposits which is proportionately above the European average. The institutions were able to pay 15 % of their contribution in the form of an irrevocable payment commitment guaranteed by cash collateral. The total amount of the contributions from Belgian institutions in this form came to € 34.4 million in 2017. The SRF has already collected a total of € 17.4 billion from institutions covered by the SRM Regulation.

For institutions not subject to the SRF, i.e. branches located in Belgium of credit institutions or investment undertakings of a third country, and Belgian investment firms not covered by the ECB's consolidated supervision of their parent company, the Law of 27 June 2016 introduces a national resolution fund financed by the levying of annual contributions. The Law specifies that the contribution and payment arrangements are determined by the Bank's Resolution College, and that the national resolution fund collects those contributions. In 2017, the Resolution College adopted a Circular [1] specifying the calculation method applied for that year and informed the national resolution fund of the amount of the contributions due from institutions not liable for contributions to the SRF. The annual target level for 2017 amounted to just over € 450 000.

(1) Circular NBB_2017_28 – National Bank of Belgium Resolution College Circular on the calculation and collection of contributions to the Resolution Fund due from enterprises not subject to the Single Resolution Fund.

# D. Banks and stockbroking firms

*In 2017, in a continuing low interest rate environment, the SSM focused most particularly on supervising the profitability of credit institutions and their sensitivity to interest rate movements, notably on the basis of stress tests developed specifically for that purpose. The results of those tests were also used in the annual risk assessment and quantification of the necessary capital and liquidity (Supervisory Review and Evaluation Process: SREP). In addition, the SSM finalised its guidelines on the management of non-performing loans. The implementation of the accounting standard IFRS 9 and the outsourcing of various bank services were likewise accorded priority attention. Finally, the SSM published its expectations concerning the quality of the Internal Capital Adequacy Assessment Process (ICAAP) and the Internal Liquidity Adequacy Assessment Process (ILAAP), stressing the need to improve credit institution practices in that sphere. The Bank participated in all this work via the Joint Supervisory Teams.*

*At national level, horizontal analyses focused particular attention on interest rate risks, market risks and Belgian banks' business models. The Bank also monitored the implementation of the structural reforms aimed at prohibiting or restricting certain trading activities. Finally, the Bank took note of the recommendations issued by the Optima and Panama Papers commissions and followed them up.*

*Developments concerning international banking regulations took place both at global level, with the finalisation of the "Basel III" regulations by the Basel Committee on Banking Supervision, and at European level with the continuing negotiations on updating the European banking regulations. At national level, the Bank adapted its rules on the options and discretions granted to national supervisory authorities. Other points were clarified in the debate on the allocation of powers between the ECB and the national supervisory authorities.*

## 1. Mapping of the sector and operational aspects

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

At the end of 2017, the Belgian banking population comprised 104 institutions. While the number of Belgian credit institutions has remained stable, the number of branches of credit institutions governed by the law of another member country of the EEA (European Economic Area) declined by four units.

As explained in the Report 2016 (see section C.1. under "Prudential regulation and supervision"), the ECB – via the SSM – exercises direct supervision over all euro area institutions considered significant (SIs), and is assisted in that by the national supervisory authorities. The latter continue to maintain direct supervision over less significant institutions (LSIs), although the ECB may take on the direct supervision of those institutions if that is justified for the consistent application of its supervision standards.

In the case of the SIs, under the direction of the ECB, the Bank takes part in 15 Joint Supervisory Teams (JSTs) which supervise significant Belgian institutions or groups of institutions, be they Belgian banks owned by a Belgian parent company, Belgium-based subsidiaries of a non-Belgian parent company subject to the SSM, or banks established in Belgium and owned by a non-Belgian parent company not subject to either the SSM or the law of an EEA member country. The group of Belgian LSIs comprises 16 banks (excluding financial holding companies and financial services groups).

**TABLE 23** NUMBER OF INSTITUTIONS SUBJECT TO THE BANK'S SUPERVISION
(end-of-period data)

| | 2016 | 2017 |
|---|---|---|
| Credit institutions | 108 | 104 |
| Under Belgian law | 34 | 34 |
| Branches governed by the law of an EEA member country | 50 | 46 |
| Branches governed by the law of a non-EEA member country | 8 | 8 |
| Financial holding companies | 6 | 5 |
| Financial services groups | 4 | 5 |
| Other financial institutions [1] | 6 | 6 |
| Investment firms | 33 | 32 |
| Under Belgian law | 20 | 19 |
| Branches governed by the law of an EEA member country | 11 | 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.

## 1.2 Operational aspects

### *Inspections*

The rise in the number of on-site inspections in the banking sector since 2015 continued in 2017. Those inspections mostly concerned significant institutions. In accordance with the supervision priorities defined by the SSM, the inspections mainly considered the financial risks incurred by the banks and the organisation of their control functions. The inspections conducted under the SSM are increasingly entrusted to joint teams, comprising inspectors from various supervisory authorities belonging to the SSM.

On subjects which do not fall within the ECB's competence, the inspections concerned all institutions placed under the direct prudential supervision of the Bank. There was particular emphasis on the prevention of money-laundering and terrorist financing.

### *Internal models*

The TRIM (Targeted Review of Internal Models) project aims to enhance credibility and confirm the appropriateness

**TABLE 24** BELGIAN BANKS GROUPED ACCORDING TO THE SSM CLASSIFICATION CRITERIA

| Significant institutions (SIs) | Less significant institutions (LSIs) |
|---|---|
| **Belgian parent** | Groupe Anbang – Banque Nagelmackers |
| Argenta | Byblos Bank Europe |
| AXA Bank Belgium | CPH |
| Belfius | Crelan Group (Crelan, Europabank) |
| Degroof Petercam | Datex Group – CKV group |
| Dexia (financial holding company) | Dierickx-Leys |
| KBC Group KBC Banque, CBC | ENI |
| **Non-Belgian SSM-member parent** | Euroclear |
| BNP Paribas Fortis, bpost bank | Finaxis Group – ABK group, Delen Private Bank, Bank J. Van Breda & C° |
| Groupe CMNE – Beobank, Banque Transatlantique Belgium | Shizuoka Bank |
| ING Group – ING Belgium, Record Bank | United Taiwan Bank |
| Banca Monte Paschi Belgio | Van de Put & C° |
| MeDirect Bank | VDK Spaarbank |
| Puilaetco Dewaay Private Bankers | |
| Santander Consumer Bank | |
| Société Générale Private Banking | |
| **Non-SSM member parent not governed by the law of an EEA member country** | |
| Bank of New York Mellon | |

Source: NBB.

and relevance of the internal models used by SIs to calculate capital requirements. Among other things, this project aims to ensure that the internal models conform to the regulations, to harmonise supervision practices within the SSM, and to reduce unjustified variations in the risk-weighted assets.

The first TRIM on-site missions took place in 2017. This first wave of missions concerned the models for calculating credit risk for retail customers and SMEs, and the models for calculating market risk. Eight missions were conducted in Belgium in 2017.

As a result of the preparations carried out in 2016, these missions were based on a common methodology and uniform inspection techniques which describe the work to be done on site by all inspection teams. In addition, the use of common methodologies and techniques permits comparison of the results of each mission in the SSM. The SSM produced a "Guide for the TRIM" which spells out the expectations of the supervisory authorities and determines a common interpretation of the rules in the SSM. This stage is a precondition for achieving one of the TRIM's objectives, namely the harmonisation of supervision practices. Thus, the guide will facilitate a more harmonised approach to the assessments of the models' quality and their assumptions.

A second wave of missions will take place in 2018 and 2019. As well as completing the missions concerning market risk calculation models, it will cover the models used by SIs to calculate the credit risk on portfolios with a historically low default rate (corporates, financial institutions, specialised finance).

*Belgian structural reforms*

The Bank is the competent authority responsible for ensuring compliance with the rules restricting the trading activities of credit institutions ("structural reforms"). The Banking Law and the Bank's Regulation dated 1 April 2014 [1] frame the legislation on structural reforms and establish a prohibition in principle on proprietary trading, but with a number of possible exemptions. The structural reforms are not governed by European law and therefore come under the supervision of the Bank. Meanwhile, the European Commission decided to withdraw its proposal for a Regulation on the subject at European level. Apart from Belgium, other countries such as Germany, France and the United Kingdom now have national legislation on structural reforms of the banking sector.

(1) National Bank of Belgium Regulation of 1 April 2014 on proprietary trading activities.

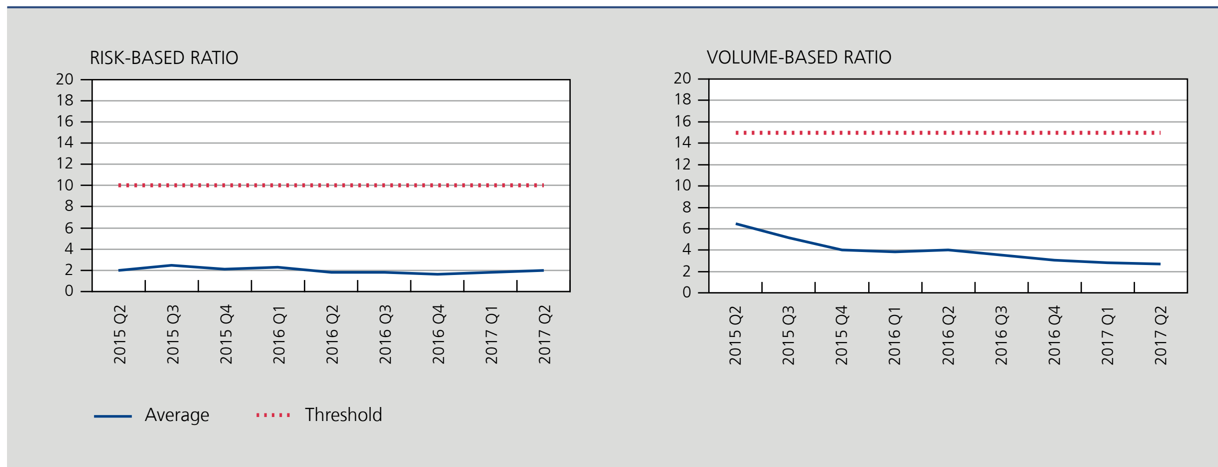
The Belgian Banking Law prohibits Belgian credit institutions which collect deposits or issue debt instruments covered by the Belgian deposit protection system from engaging in proprietary trading activities and certain very high-risk trading activities. However, five categories of trading activities are still allowed. The first two permissible trading activities are the provision of investment services and ancillary services for customers, including hedging, and the maintenance – on the basis of a contractual obligation – of a liquid market by continuously publishing buying and selling prices for a particular type of transferable security or financial instrument. Trading operations that constitute effective economic hedging of the various risks inherent in a financial institution's balance sheet are exempt from the prohibition, as are trading operations connected with sound liquidity management, and those resulting from strategic decisions relating to the management of a sustainable and liquid investment portfolio for the institution concerned, provided all these trading operations meet clearly defined criteria and standards.

The permitted trading activities are subject to both quantitative and qualitative requirements. A dissuasive capital surcharge is imposed on financial institutions if the permitted trading activities exceed one of the quantitative thresholds laid down in the Regulation. These materiality thresholds consist of a first, volume-based threshold which stipulates that the sum of the trading assets must not exceed 15 % of the total assets, and a second, risk-based threshold whereby the sum of the capital requirements for market risk must not exceed 10 % of the total capital requirements.

In order to monitor the Belgian banking sector's application of the legislation relating to the structural reforms, the Bank has conducted horizontal analyses since 2015 on the basis of quantitative and qualitative reporting tables. At the same time, the Bank conducted a number of on-site inspections in 2017 to verify compliance with Belgian law. The reporting obligation combined with targeted spot checks enable the supervisory authority to assess general compliance with the legislation on the structural reforms.

The quantitative reporting data revealed a reduction in permissible trading operations brought about by the legislation on structural reforms but also, for example, by the restrictions resulting from the leverage ratio. That ratio prompted institutions to take steps to limit derivatives portfolios, to use bilateral netting, or to settle existing derivatives transactions via a central counterparty. All these measures helped to reduce the risks for the Belgian banking sector.

**CHART 90** EVOLUTION OF TRADING ACTIVITY RATIOS OF BELGIAN BANKS
(data on a consolidated basis; in %)




Source: NBB.

However, the materiality thresholds defined in the Regulation do not in any way constrain the trading activities of Belgian banks. The quarterly reports show that the volume-based ratio has fallen significantly since 2014. All institutions respect the permitted threshold of 15 % with a very wide safety margin. The derivatives position is a key determinant of that ratio. The volume of derivatives held for trading purposes was reduced on both the assets and the liabilities side of the balance sheet in all reporting institutions between the end of 2014 and the end of 2016. Similarly, the risk-based ratio has maintained a downward trend, on average, since 2014. Here, too, all institutions respect the permitted threshold of 10 % with a very large safety margin.

Although the regulatory framework aims to prevent financial institutions from expanding their trading activities to the excessive levels prevailing before the financial crisis, thus building up certain risks, the Regulation also intends to provide an adequate margin for the trading activities necessary to support the economy and to conduct the institution's own management (asset/liability management and liquidity management).

### *Optima and Panama Papers commissions*

On 7 July 2016, the Belgian Parliament set up a parliamentary commission to inquire into the causes of Optima Bank's bankruptcy and any conflicts of interest between the Optima group, including its constituent entities, and the government. The committee of inquiry's report published on 28 June 2017 successively examines Optima Bank's business model and policy, the role of the financial supervisory authorities, evaluation of the legislation and financial supervision instruments, relations between Optima Bank and the other Optima group companies, the link between Optima Bank and public entities, and finally, the tax fraud inquiry, and particularly the fraud and money-laundering mechanisms. A key factor in the design and organisation of the committee's work was that it had to take account of the fact that some aspects of the case formed part of a current judicial investigation.

In its work, the commission of inquiry was able to use the database which the Bank made available to it in a data room opened from September 2016 to the end of June 2017, containing all the Bank's administrative documentation. The Bank also provided detailed written answers to all requests for clarification and documentation.

In assessing the Bank's role, the commission of inquiry analysed the Bank's action in the light of the information and supervision instruments available to it at the time when it had to make choices and take decisions in regard to Optima. The commission also confirmed the point of view whereby access to the financial market did not need to be tightened up to the point where the entry threshold became prohibitive for new institutions, which are generally small entities operating according to specific business models. Such an approach would mainly benefit existing, larger institutions, which would continue to expand, potentially increasing the systemic risk further within the financial sector. Moreover, in assessing the supervisory authorities' role, the commission did not assume that the purpose of prudential supervision was primarily to prevent

the failure of any financial institution, as that would favour moral hazard. If supervisors were to adapt a "no bankruptcies" policy, this could in fact send the banks a wrong signal in tempting them to consider that, whatever risks they took, the supervisory authorities and/or the government would always intervene to prevent a bankruptcy. Instead, the commission assumed that the impact of a bankruptcy had to be absorbed by the efficient functioning of the mechanisms for resolution, liquidation (possibly via bankruptcy proceedings) and depositors' compensation in accordance with the rules on the subject.

The Bank took note of parliament's conclusions and recommendations, and will cooperate fully in their implementation, in the interests of consistency with the recommendations made by parliament in the case of the Panama Papers.

Analysis of the recommendations revealed that some of them concern the practicalities of supervision. Consequently, when implementing them it is necessary to take account of the institutional context under the SSM, whereby the ECB is responsible for the supervision of not only SIs but also – indirectly – LSIs. Accordingly, the supervision of SIs and LSIs must be organised as consistently as possible.

In regard to legislation, various initiatives have already been taken in response to a range of recommendations, particularly concerning the prevention of money-laundering and terrorist financing, compliance, "fit and proper" policies and special schemes. Some recommendations had already been implemented in anticipation, or may be implemented fairly soon. Other recommendations do not require specific monitoring in the light of the existing supervision framework. Finally, the Bank also looked into a number of recommendations which will take longer to implement, e.g. in the sphere of the particular mechanisms, given that any initiative on these subjects needs the support of other interested parties.

## 2. Supervision under the single supervisory mechanism

### 2.1 Supervision priorities and risk assessment

The year under review was the third full year of operation of the SSM, which is responsible for the prudential supervision of the main banking groups operating in Belgium.

During that year, the SSM's action was essentially based on risk analysis and developments in the banking sector. Profitability was still under stress for euro area banks, owing to cyclical factors such as the low interest rates in the euro area, significantly eroding the banks' interest margin without the volume of lending expanding sufficiently to offset that, but also structural factors such as the excessive level of non-performing loans in the banking sectors of certain countries, and the failure to achieve an adequate reduction in operating costs. That is the context in which the SSM defined its priorities for 2018, focusing its action on various specific spheres.

In 2016, the SSM launched a thematic review of the banks' business models and profit sources. That analysis is based mainly on examination of the business plans and the measures aimed at adapting the business models to identified future challenges, notably concerning digitisation and outsourcing. That analysis will continue in 2018, making it easier to detect weaknesses in banks' profitability and to assess the adequacy of the measures to be taken under their strategic plan.

Assessing the sensitivity of interest margins to interest rate movements is particularly important in a low interest rate environment and in view of a potential increase in those rates. During the past year, that analysis was based partly on the results of a stress test exercise (see box 12 under "Prudential regulation and supervision").

One of the factors significantly eroding the profitability of some European banks and their ability to support the real economy is still the excessive level of non-performing loans. In that regard, the SSM finalised its guidance on the management of these loans, and asked the credit institutions to define credible strategies for gradually reducing their portfolio of non-performing loans. The strategies had to be defined by institutions with a high level of non-performing loans compared to the national average. They were submitted for the approval of the SSM, which examined whether they were sufficiently ambitious yet realistic, taking account of the financial and operational capacity of the banks concerned and the legal and judicial context in which they operate. In 2018, the SSM will keep a close eye on the implementation of these measures and their effectiveness.

To supplement its guidance, the SSM also published a consultation document spelling out its expectations regarding prudential provisions for non-performing loans. In that connection, it proposes that, to calculate the prudential capital, institutions should apply a 100 % provision to the unsecured part of any loan deemed non-performing for more than two years, and a 100 % provision to the secured part of any loan which has been non-performing for more than seven years, unless the institution can provide objective evidence that such a level of provision is not justified. The aim of this rule is to prevent any future increase in the volume of non-performing loans without adequate cover at levels which are

unsustainable for the sector. If this level of provision cannot be demonstrated in the accounts, notably under the IFRS rules, the institutions concerned will be asked to adjust their capital accordingly. This prudential provisioning rule will apply to loans classed as non-performing after 1 January 2018. The SSM will issue a proposal at a later stage concerning the stock of non-performing loans on that date.

The SSM also finalised its thematic review on the credit institutions' preparations for applying IFRS 9 which comes into force in 2018 and will have a noticeable impact on the volume of loan loss provisions (see section D.3.3).

The adequacy of risk management and of solvency and liquidity positions is another constant point for attention, especially in a period of low profitability implying limited capacity to generate capital and a potential tendency to opt for riskier strategies (search for yield).

From that point of view, it is essential for institutions to have accurate, reliable data in order to identify, measure and manage their risks properly. In that connection, the SSM continues to put constant pressure on institutions to make them respect the international standards of data quality and aggregation and internal risk reporting.

In addition, the SSM published its specific expectations regarding the quality of the Internal Capital Adequacy Assessment Process (ICAAP) and the Internal Liquidity Adequacy Assessment Process (ILAAP), emphasising the need for improvement in credit institutions' practices on this subject. As regards risk measurement, the SSM expects institutions to estimate their risks and capital needs both on an economic basis and with due regard for the regulatory capital requirements. Thus, institutions should be able – taking account of their business plans and financial plans – to ensure that they can maintain their regulatory capital at a level above the total regulatory requirements, including all the capital buffers. In the case of a severe crisis scenario (adverse stress test), institutions should also guarantee that the level of capital remains above the minimum requirements (total Pillar 1 and Pillar 2 requirements).

As institutions are also tending to resort to the outsourcing of many services on a larger scale, partly to reduce their costs, the SSM launched a thematic review on the subject aimed at identifying the associated risks, defining good practice and developing a framework for controlling these risks. As regards more particularly the developments concerning digitisation, the SSM drew up its methodology for assessing IT risks, more specifically cyber risk, and incorporated it in its process for assessing the risks and quantifying the necessary capital and liquidity (SREP).

The consequences of Brexit will also continue to influence the SSM's activities during 2018. The ECB, working with the national supervisory authorities, will continue to examine the plans of banks wishing to relocate some of their activities currently based in the United Kingdom by transferring them to the euro area. Particular attention will focus on the implementation of the policies defined by the ECB to prevent the licensing in the euro area of banking entities lacking adequate control over the risks associated with their activities. The ECB will also monitor the impact of Brexit on the activities of European banks and the measures that the banks take to limit the repercussions.

As well as participating in the various activities of the SSM, the Bank also conducted several specific horizontal analyses of the Belgian banking sector (see box 11).

## Box 11 – Horizontal analyses of the banking sector

The Bank regularly monitors the various risks confronting the banking sector. These general analyses cover subjects such as developments in credit institutions' balance sheets, profitability, and solvency and liquidity positions. For several years now, the Bank has been keeping a close eye on developments concerning the mortgage loan portfolios of major Belgian banks (see section B.1.). In 2017, the Bank also conducted horizontal analyses on various specific topics. The analyses concerning banks' business models and interest rate and market risks are presented below.

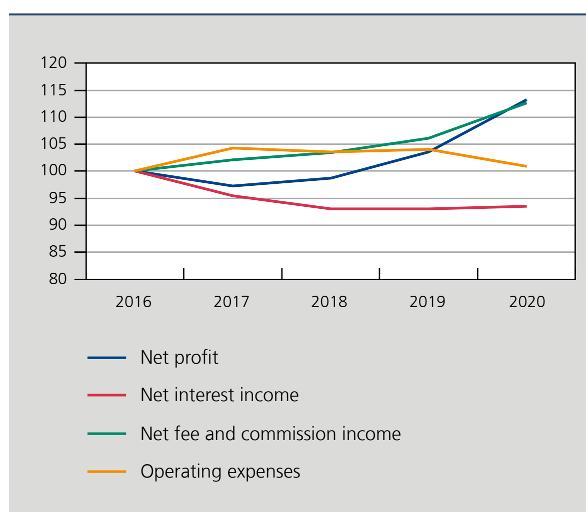
*Business models*

Every year, the Bank conducts a horizontal analysis of the strategic and financial plans of the leading Belgian credit institutions. That analysis aims to present an overview of the banks' own expectations regarding the profitability

of the banking sector, its main activities and any underlying systemic risks. If banks all adopt the same strategy, the individual measures taken by the banks can in fact lead to significant systemic risks.

As already described (see chapter 3 of the "Economic and financial developments" part of this Report), the profitability of the Belgian banking sector, though above the euro area average, is currently subject to pressure from various factors, such as the move initiated during the financial crisis whereby Belgian banks are refocusing on the domestic market, the resulting fiercer competition, and the low level of interest rates. This pressure on the underlying profitability of Belgian banks highlights the importance of prospective monitoring of developments to detect any risks. This analysis shows that the banks expect this pressure to continue for some time yet, but there are considerable differences of opinion on when they may see profits growing again.

PROFITABILITY FORECASTS IN THE STRATEGIC AND FINANCIAL PLANS OF THE LEADING BELGIAN BANKS (1)




Source: NBB on the basis of forecasts produced by the leading Belgian banks.
(1) Forecasts for 2017 to 2020, expressed in relation to actual results in 2016.

The 2017 analysis in fact shows that most institutions expect their net interest income to fall in the coming years. While the low interest rates encourage new lending, at the same time they result in increasing erosion of the transformation margin. According to the sector, this downward trend in net interest income would persist even if the banks manage to boost the expansion of their lending, as most of them expect to do.

However, such an increase in the volume of lending would put substantial pressure on loan pricing. In these market circumstances, it is therefore necessary to keep a close watch over lending conditions. In their forecasts, the banks nevertheless expect historically low loan loss provisions, similar to those seen in recent years.

All banks expect to partly offset the loss of interest income by increasing their fee and commission income, mainly by selling investment funds and services, and insurance products. However, as fee and commission income is heavily dependent on the market environment, the amount is difficult to estimate. This is why this source of income is more volatile than traditional interest income.

In view of the pressure on income and the challenge presented by the entry of new operators, most banks feel obliged to make substantial reductions in their operating costs, or at least to keep them stable to maintain their profits over time. In this situation, many banks ultimately predict a gradual – or in some cases considerable – reduction in staff costs by switching to digital sales channels and making greater use of automation. These developments need to be closely monitored in view of the risks, particularly the operational risks, that they may entail.

*Interest rate risk*

Given the low interest rates and the potential consequences either of rates persisting at that low level or of a possible turnaround, the interest rate risk has been a priority for the supervision of Belgian credit institutions for a number of years. For this reason, developments in the interest income of Belgian banks and the prudential indicators of interest rate risk in the banking book have been analysed in more detail over the past few years. In addition, a horizontal analysis of the ALM (asset and liability management) strategies of several Belgian banks was launched in 2017 to gain a better understanding of the way in which they address the challenges concerning low interest rates and the uncertainty over how interest rates will move in the coming years.

Generally speaking, Belgian banks have a relatively large volume of assets on which interest rates are fixed for a long period, financed mainly by sight deposits and savings deposits. As the broader analysis of the business models revealed, the low interest rates tend to depress the interest income of the Belgian banks, as deposit interest rates have reached their floor, while the return on the assets is progressively revised downwards, which is exacerbated by early redemption of mortgage loans.

In a low interest rate environment, banks may therefore be inclined to increase the duration gap between their assets and liabilities, boosting their transformation margin and hence their net interest income, if interest rates remain low. However, a bigger duration gap also makes the banks more vulnerable to an interest rate hike. In that context, the analysis of the Belgian banks' ALM strategies aims to gain a better understanding of the decisions taken in recent years concerning the banks' positioning in relation to various possible changes in the yield curve, and the consequences in terms of sensitivity to interest rates. The initial results indicate that Belgian banks pursue divergent strategies in relation to future interest rate movements.

*Market risks*

During the period under review, the Bank also conducted a new horizontal analysis of the market risks and credit valuation adjustment (CVA)[(1)] risks for the Belgian financial sector.

An annual horizontal analysis is necessary to monitor more accurately how this type of risk is changing. This exercise, which also serves to establish a benchmark against which the individual findings can be assessed, applies in the first place to the main banks subject to capital requirements for market risks and CVA, but also applies to ten smaller credit institutions with limited trading activities, and banks with a specific business model.

During 2016 and the first half of 2017, the financial markets remained positive and relatively calm. On average, the capital requirement applicable to major Belgian banks for market risks and CVA was only 2.2 % and 2 % respectively of the total Pillar 1 capital requirement, compared to 84.8 % for credit risk and 8.7 % for operational risk. The smaller institutions with limited trading activities have a capital requirement for market risk amounting to just 0.6 % of the total capital requirements. For most large Belgian banks, the capital requirement for market risk is calculated mainly on the basis of internal models, while smaller institutions use only the standardised approach. Total exposures reported in the trading books indicate that the largest position is in debt instruments, followed by

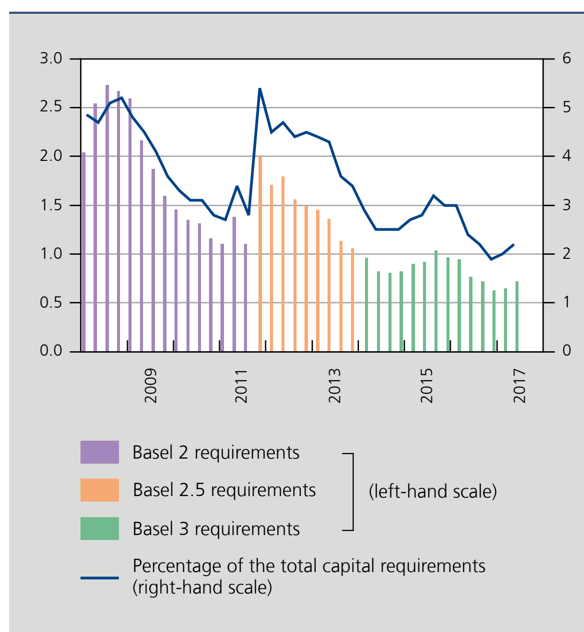
(1) Credit valuation adjustment (CVA) risk : risk of loss caused by changes in a counterparty's credit risk premium due to a change in its credit rating, or in other words in the market value of the counterparty's credit risk.

foreign exchange positions and equity positions. Commodity positions are negligible. The capital requirement for CVA risk is calculated mainly on the basis of the standardised approach.

In recent years, the scale of the Belgian banks' trading activities has been greatly reduced. Since the introduction of the Basel 2.5 methodology for market risk in the fourth quarter of 2011, almost all Belgian banks have seen a gradual reduction in their capital requirement for market risk. This period featured de-risking and deleveraging activities, and a decline in demand for more complex commercial products, at a time of relative calm on the financial markets. The capital requirements for market risk imposed on the banks currently considered significant (SIs) have fallen considerably over the long term, dropping from around € 2 billion in the first quarter of 2008 to € 690 million in the second quarter of 2017. The trend in financial assets held for trading purposes has been similar, as over the same period the proportion of the total assets represented by financial assets held for trading declined significantly, from an average of 15.3 % in the first quarter of 2007 to 5.3 % in the second quarter of 2017.

THE BELGIAN BANKING SECTOR'S CAPITAL REQUIREMENTS FOR MARKET RISK

(in € billion, unless otherwise stated)



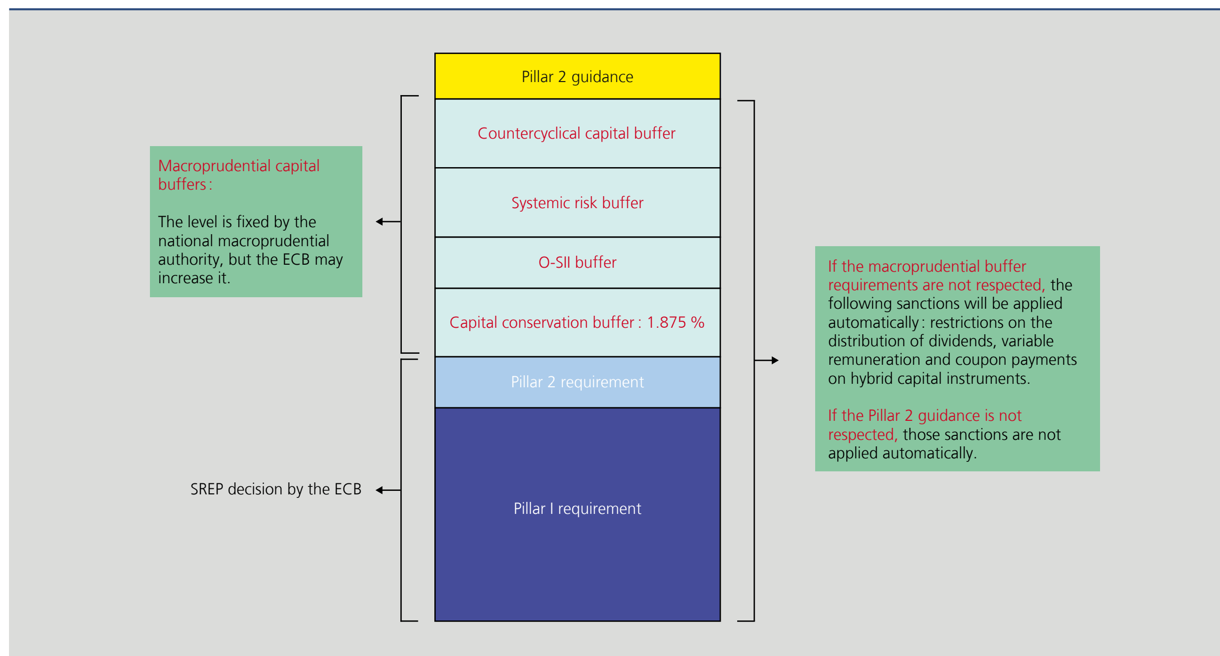

Source: NBB.

## 2.2 SREP methodology and results

In 2017, banks subject to SSM supervision (SIs) underwent a new SREP evaluation based on the methodology developed in 2015 and the adjustments made in 2016 to take account of the results of the harmonised stress tests conducted on the basis of the situation at the end of 2015. The SSM had taken account of those results in its SREP decisions when setting an additional target, called the Pillar 2 guidance [1], on CET1 capital. The Pillar 2 guidance was meant to ensure that, in a severe crisis, the CET1 ratio remains above the sum of 5.5 % of the risk-weighted

(1) Unlike the Pillar 2 requirement, the Pillar 2 guidance is fixed in addition to the amount of CET1 necessary to cover the capital buffer requirements. Failure to meet that target does not trigger automatic prudential measures such as restrictions on payment of dividends, variable remuneration or coupons on AT1 instruments, applicable in the event of failure to comply with the capital buffer requirements. If a bank does not respect the Pillar 2 guidance, it must inform the supervisory authority, and the SSM may take prudential measures, with due regard for the specific circumstances.

CHART 91 EVOLUTION OF TRADING ACTIVITY RATIOS OF BELGIAN BANKS
(data on a consolidated basis; in %)




Source: NBB.

assets plus the amount of the systemic capital buffer fixed by the FSB for banks classed as global systemically important groups.

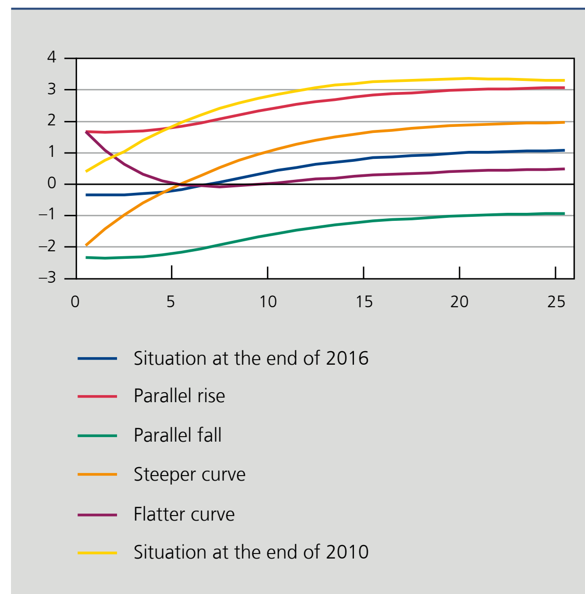
For the 2017 SREP decision, applicable in 2018, and more particularly for the Pillar 2 guidance, the SSM did not conduct a full stress test as in 2016, but conducted a detailed analysis of the interest rate risk sensitivity of the banks subject to its supervision (see box 12 below). The results of that exercise led to reductions or increases in the Pillar 2 guidance of 10 or 25 basis points compared to the level fixed under the 2016 SREP decision.

## Box 12 – Stress test on the interest rate risk for banks

In 2017, as part of its annual stress test exercise, the SSM carried out a stress test on the interest rate risk related to non-trading book activities (the banking book) of banks subject to the ECB's direct supervision.

The stress test aimed to obtain additional information on the interest rate sensitivity of the banks' economic value of equity and net interest income. The interest rate sensitivity was tested on the basis of six interest rate scenarios simulating changes in the level and shape of the yield curve: (1) a curve identical to that at the end of 2016, (2) a steeper curve, with short-term interest rates falling while long-term rates rise, (3) a flatter curve with short-term interest rates rising and long-term rates falling, (4) a return to the end-2010 curve, becoming steeper because long-term interest rates are rising more than short-term rates, (5) a parallel 2 % rise in interest rates, and (6) a parallel 2 % fall in interest rates. The shocks are intended to expose certain sensitivities, but are not a forecast of future interest rate changes in the euro area. The stress test was a bottom-up exercise, which means that the banks provided the projections for the interest rate shocks on the basis of their own models.

YIELD CURVES IN THE VARIOUS SCENARIOS



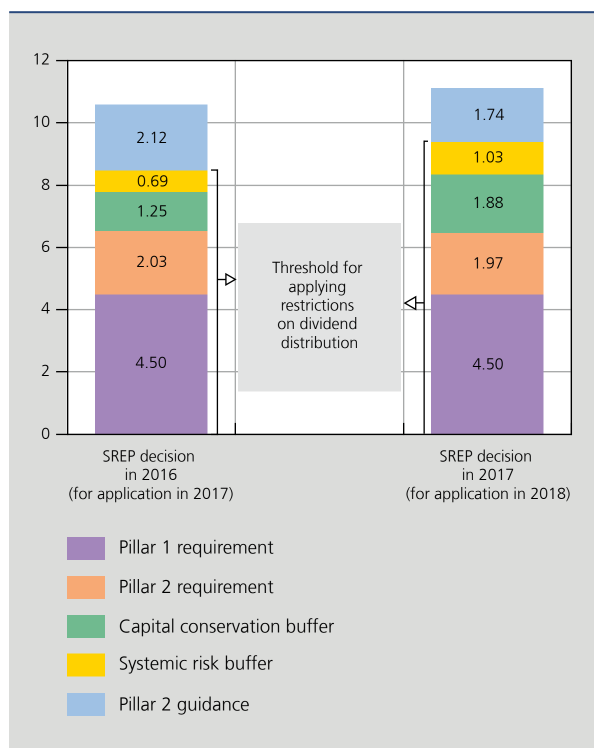

Source: ECB.

On the basis of the stress test results, the SSM concluded that most European banks were managing their interest rate risk relatively well. The stress test showed that for most banks subject to the ECB's direct supervision, rising interest rates would boost net interest income in the next three years, but would reduce the economic value of the equity. In addition, the stress test showed that most models that banks use to estimate the repricing profile of deposits with no contractual maturity are based exclusively on a period of declining interest rates and could therefore present a high model risk. Finally, the stress test confirmed that banks use interest rate derivatives to hedge interest rate risk exposures and to obtain a specific interest rate profile, and that they take varying positions in regard to future interest rate changes.

The stress test results and the additional information obtained on interest rate sensitivity are used for the Supervisory Review and Evaluation Process (SREP), more specifically in regard to the qualitative measures and for the discussion between the supervisory authority and the banks. In addition, the results are used by the SSM to adjust the Pillar 2 guidance for banks (see section D.2.).

Altogether, 111 credit institutions took part in the stress tests, including six Belgian institutions. Belgian banks generally have a specific business model featuring a relatively large percentage of assets with a long repricing maturity. The assets consist mainly of mortgage loans financed primarily by deposits with no contractual maturity or repricing date. As a result, Belgian banks have a relatively large duration gap between their assets and liabilities, and therefore resort to derivatives on a substantial scale to hedge the resulting interest rate risk. However, derivatives in turn create other risks. Also, the banks are heavily dependent on behavioural models to estimate both the repricing profile of deposits with no contractual maturity and the early redemption of mortgage loans. That implies a considerable model risk. Owing to the significant duration gap, the extensive use of derivatives and the high model risk, Belgian banks' exposure to interest rate risk in the banking book is greater than the average for the euro area banking sector, and that is also reflected in the SSM stress test.

CHART 92 AMOUNT AND STRUCTURE OF THE CET1 CAPITAL REQUIREMENTS
(in %)




Sources: ECB, NBB.

Although 2017 brought no changes in the methodology for quantifying the Pillar 2 requirements of the SSM's Pillar 2 guidance, it should be noted that the European Commission and the EBA started work on improving the harmonisation of practices on the subject. Thus, the ECB methodology could undergo further adjustments in 2018 to take account of the effects of those revisions being prepared at European level. In 2018, the SREP evaluation should also take account of the results of the new harmonised stress test exercise.

In 2016, the adjustments to the SREP methodology had led to a reduction in the average level of the Pillar 2 requirements, which then came to 2 % of the risk-weighted assets as opposed to 3.1 % in 2015. As a result, this was similar to the level imposed by other prudential supervisory authorities outside the euro area. In 2017, the average level of the Pillar 2 requirements was stable in relation to 2016. However, the CET1 ratio threshold – (maximum distributable amount trigger: MDA trigger) beyond which a bank must restrict the payment of dividends, variable remuneration or coupons on additional capital instruments in accordance with European law – increased as a result of the further phasing in of capital conservation buffers and systemic risk buffers.

Thus, for Belgian banks subject to SSM supervision, the average MDA trigger increased from 8.47 % to 9.38 %, while the Pillar 2 requirements remained more or less stable at 1.97 % in 2017 compared to 2.03 % in 2016.

The total CET1 capital requirement increased from 10.59 % to 11.11 %, smaller than the rise in the MDA trigger, reflecting the reduction of the Pillar 2 guidance from 2.12 % to 1.74 %. That reduction is due mainly to the fact that the part of the capital conservation and systemic risk buffers taking effect in 2018 can be offset by a corresponding reduction in the Pillar 2 guidance, provided the latter is maintained at a minimum of 1 %.

The Bank conducted a similar exercise for LSIs which, in contrast to SIs, are subject to the Bank's direct supervision. From 2018, that exercise will also be based on the results of the stress tests developed during the year under review (see box 13).

## Box 13 – Trial stress test exercise for LSIs

In 2017, the Bank conducted a trial stress test exercise for five LSIs, as part of the SSM project for developing a harmonised, consistent approach for the SREP of euro area LSIs. Three guiding principles were followed during this exercise. First, the stress test had to be based on a static balance sheet assumption whereby LSIs cannot take measures to reduce the impact of the shock applied, such as reducing exposures, selling assets or cutting costs. Next, the main stress factors consisted of higher loan losses, lower net interest income, and – for most LSIs – losses on the market value of their trading book. Finally, the path of the CET1 ratio had to be simulated over a three-year period (2017-2019) according to a baseline scenario and an adverse scenario supplied by the ECB. These two scenarios comprised projections of a number of macroeconomic and financial variables, such as real GDP, the unemployment rate, property prices and interest rates.

Since this was a trial exercise, the Bank decided to adopt a top-down approach without collecting prior data from the institutions. That would make it possible to judge the degree to which the prudential reporting data alone are an appropriate and sufficient input for such an exercise. In addition, this decision was guided by the fact that also smaller LSIs will be subject to this stress test in the future, and they do not necessarily have sufficient resources to devote to such an exercise. The results of the trial exercise proved insufficiently robust for use in determining the Pillar 2 guidance, both as regards the path of the CET1 ratio over the three-year period and the stress factors underlying the capital reduction.

For that reason, in preparation for the 2018 exercise, the results of the trial stress test exercise were discussed with the LSIs to identify the additional information that they could provide about their starting position, and to judge the relevance of the methodological assumptions used. In parallel with methodology improvements, that additional information will be used in 2018 in a new stress test exercise for three high-priority LSIs. The results of that exercise will be used to determine the Pillar 2 guidance in the context of the 2018 SREP.

# 3. Regulatory aspects

## 3.1 International regulations

The changes in international banking regulations at global level are marked by the finalisation of the "Basel III" regulations by the Basel Committee on Banking Supervision and at European level by the ongoing negotiations on an update of the European banking regulations. The sections below present the salient points on these two subjects.

### 3.1.1 Final Basel III agreement

The 2016 Report gave a detailed account of the work of the Basel Committee on Banking Supervision concerning completion of the Basel III package, with reforms of the regulatory standards for the banking sector. Apart from the set of Basel III standards already finalised, including the increase in the quality and level of the regulatory capital requirements and the introduction of harmonised liquidity ratios, a leverage ratio, and macroprudential buffers in addition to the minimum requirements, the Committee continued to work on strengthening the credibility of the denominator of the risk-weighted capital ratio. The revision of the calculation of this denominator, namely the risk-weighted assets, would then complete the Basel III reforms. In that context, the Committee worked on revising the standard approach for the calculation of the risk-weighted assets, an approach which does not use internal models, and restricted the use of internal models for certain types of risks. For other types of risks, the use of internal models was made subject to additional conditions. For instance, the regulations specify the use of an output floor setting a minimum level for the capital requirements calculated on the basis of internal models, a level which should be no less than a set percentage of the capital requirements as calculated according to the standard approach. That should improve the comparability of capital requirements determined on the basis of internal models, and prevent any undue use of those models. These reforms will be phased in. A final agreement on the subject, ratified in December 2017, provides for the introduction of a 72.5 % output floor from 2022. The increase in the capital requirements resulting from the new framework is capped for the first five years at 25 % for individual banks. Completion of these reforms could mark the beginning of a pause in regard to international banking regulations. For European banks, however, these standards have yet to be transposed into European legislation before they enter into force. The revision of the European banking regulations discussed in the next section therefore does not yet include that transposition.

In 2017, the Basel Committee on Banking Supervision also continued to examine the preferential treatment of sovereign exposures with regard to the calculation of capital requirements. In this context, the Committee published a discussion paper setting out a number of ideas on the subject, ranging from abolition of the national discretionary power permitting preferential treatment of these exposures, and introduction of additional capital requirements when set concentration limits are exceeded, to increased transparency on the part of banks concerning their exposure to public sector counterparties. However, in view of the impact of such treatment on the government bond markets and on government funding costs, any change in that approach must be carefully considered.

### 3.1.2 Adjustments to the European banking regulations (CRR 2 and CRD V)

At the end of 2016, the European Commission published its proposals on adjustments to the European banking regulations, comprising the directly applicable Capital Requirements Regulation (CRR), as well as the Capital Requirements Directive[1] (CRD) to be transposed into national law by the Member States. These proposals aim to implement some additional elements of the Basel III package for European banks, such as the second Basel III liquidity standard, a long-term liquidity ratio (net stable funding ratio, NSFR), and the leverage ratio imposing a minimum capital requirement based on the size of the institution's assets and some of its off-balance-sheet items. The proposals also make provision for new methods of calculating the capital requirements for market risks and counterparty risks in the risk-weighted capital ratio, and measures to increase proportionality in the application of the banking regulations by limiting the burden of reporting and disclosure for smaller institutions. The texts also include far-reaching proposals on the replacement of the capital and liquidity requirements for local subsidiaries of EU banks, substituting guarantees provided by the EU-based parent company. Finally, the proposals concern adjustments in the Pillar 2 approach of the supervisory authorities and define the details of the TLAC requirement for global systemically important institutions (see chapter 2 of the "Prudential regulation and supervision" part of the Report 2015). The European institutions will endeavour to finalise these adjustments to the Directive and the Regulation by the end of 2018.

(1) 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.

However, during the year under review, the Member States and the European Parliament have already agreed to fast-track certain elements of that proposal. First, this concerns transitional measures aimed at ensuring that the entry into force of the new international accounting standards on the treatment of expected loan losses (IFRS 9) has a gradual impact on the banks' regulatory capital. Section 3.3 of this chapter gives more details on those transitional measures. Next comes the creation of a new category of debt instrument (Non-Preferred Senior debt) in the creditor hierarchy, which ranks immediately senior to the subordinated instruments issued by banks. The issuance of these instruments is intended to strengthen the level of risk-absorbing debt (MREL) in the banking sector and to facilitate possible resolution. The new debt instrument category introduced in Belgium was explained in detail in chapter C.

The reforms of the banking regulations are a key element in the European Commission's policy development programme for the completion of the Banking Union. The adjustments to the banking regulations should lead to further risk reduction in the European banking sector, and should relaunch the associated negotiations with a view to the further deepening of the European agreements on burden-sharing in the event of certain risks materialising in European banks, via the establishment of a European deposit guarantee scheme and a mechanism providing adequate finance for the European Resolution Fund (risk-sharing). In that context, box 14 describes the elements that the European Commission listed in a recent Communication on its vision for the completion of the Banking Union, as well as the consequences of a Banking Union that is still incomplete with regard to the need for both capital and liquidity buffers at the level of Belgian subsidiaries of European banking groups and the required supervision of those Belgian subsidiaries.

## Box 14 – Completing the Banking Union

The Banking Union is still incomplete. The introduction of a single supervision and single resolution of significant credit institutions by the SSM and the SRM respectively still has to be supplemented by the adoption of a third pillar comprising a single deposit guarantee scheme, and by development of a guarantee mechanism that provides sufficient funding for the SRF.

During the year under review, the European Commission published a report on the subject[1] setting out its ambition of concluding new agreements on the completion of the Banking Union by the end of 2018. In this context, the European Commission aims via the proposed adjustments to the European banking regulations (CRR 2 and CRD V)

(1) European Commission Communication to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of Regions on completing the Banking Union, October 2017.

to unlock the discussions on the European Deposit Insurance Scheme (EDIS) by specifying that, initially, this guarantee fund can provide liquidity for national systems, and then in a second co-insurance phase, the European system progressively contributes towards covering national losses in accordance with an allocation key yet to be determined. In addition, it is necessary to design adequate funding for the SRF, preferably in the form of a credit line from the European Stability Mechanism (ESM).

At the same time and with regard to a further reduction in the risks of the European banking sector, the European Commission announced measures to reduce the volume of non-performing loans in certain banks via an action plan which includes new prudential measures by supervisory authorities, a reform of the national legislation on bankruptcy, the development of secondary markets for non-performing assets, and incentives for further restructuring in the banking sector. There are also proposals for defining a specific prudential regime for investment firms, in order to reduce risks there too. Finally, the Commission envisages proposals aimed at establishing a framework for sovereign bond-backed securities (SBBS) in order to further diversify the banks' sovereign bond portfolios and thus break the link between the potential financial problems of governments and the stability of the local banking sector.

The incomplete Banking Union and the ongoing international discussions on cost-sharing in the event of an international banking group getting into difficulties imply that sufficient attention is still needed on the supervision, at individual level, of large local subsidiaries of such groups. It is also important that those local subsidiaries have sufficient buffers (in the form of capital, liquidity or a bail-in capacity of the required quality) to cope with unexpected losses or shocks, or to permit resolution with recapitalisation. The proposals on replacing the capital, liquidity and MREL requirements applicable to local subsidiaries of EU banks with guarantees provided by the parent company, as set out in the aforesaid Commission proposals on adjustments to the European banking regulations, must therefore take due account – in the home/host debate – of the concerns of the host countries, so that systemic subsidiaries of international banking groups operating in those host countries have sufficient buffers and therefore do not constitute an excessive risk for financial stability in those countries.

## 3.2 Belgian regulations

Owing to the increasing harmonisation of the banking regulations at European level, the Belgian regulatory activities are less extensive than in the past. That being the case, apart from the Belgian initiative explained in chapter C concerning the issuance of a new category of subordinated instruments by the Belgian banking sector, the Bank made amendments to its Regulation[1] on the national options and discretions for national competent supervisors as laid down by the CRR and the CRD. In 2016, the ECB – as the competent authority for SIs – largely harmonised the national options and discretions. In 2017, it recommended a similar approach for LSIs, prompting the Bank to amend its Regulation on the subject[2].

Other relevant clarifications of the institutional framework in the context of the debate on the allocation of powers between the ECB and the national supervisory authorities were made. When implementing the prudential missions entrusted to it by the SSM Regulation, the ECB applies the European legislation and its national version. In 2016 and 2017, the ECB worked with the European Commission to clarify the allocation of powers between the ECB and the competent national authorities, taking account of the list of tasks set out in the SSM Regulation, and to determine the national legislation which can be deemed to be implementing the EU legislation. In regard to the Belgian Banking Law in the case of SIs, the clarifications concerned the authorisation to be granted for strategic decisions (Article 77), the approval of certain appointments (Article 60), the consent to be granted for the appointment of approved auditors (Article 223) and transactions with related parties (Article 72). It was established that these articles in the Banking Law come under the microprudential scope and therefore – in the case of significant institutions – fall under the jurisdiction of the SSM. An additional clarification was announced on the subject of covered bonds.

(1) National Bank of Belgium Regulation of 4 March 2014 on the implementation of Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013.
(2) National Bank of Belgium Regulation of 12 December 2017 amending the National Bank of Belgium Regulation of 4 March 2014 on the implementation of Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013.

The national competent authorities retain exclusive responsibility for tasks which are not included in the list of tasks given in the SSM Regulation and which are not essential to the ECB's prudential function. Examples include macroprudential supervision tasks, regulations on structural reforms, and the supervision of external auditors.

## 3.3 Accounting and governance

### 3.3.1 Implementation of IFRS 9 "Financial instruments"

Since 1 January 2018, IFRS 9 (International Financial Reporting Standard 9) has replaced IAS 39, in force up to that date. The new standard introduces significant changes in regard to loan loss provisions (impairments), which from now on must be valued on the basis of an expected loss model, while IAS 39 prescribed an incurred loss model. To assess the effect of this new standard and the implementation difficulties that it could cause, the EBA conducted two impact studies, the second having ended with publication of a report in July 2017. The ECB also conducted a thematic analysis on the implementation of the IFRS 9 by SIs and, in collaboration with the national authorities, by LSIs. The EBA and ECB analyses highlight the importance of good preparation for the entry into force of this new accounting standard.

One of the main conclusions of these analyses was that the banks had made progress in implementing IFRS 9, but that small banks were still lagging behind in their preparations, compared to large banks. In addition, it seems that many banks have lowered their ambitions regarding parallel runs for IFRS 9 and IAS 39, which could – depending on the case – prove worrying for the transition. The banks will use varying data, processes and models to estimate the expected credit losses, and that could impair comparability between banks, hence the importance of the information to be supplied in the notes to the annual accounts (disclosures). The internal implementation and validation of the modelled methods of valuing the provisions remain major points for attention with a view to rigorous application of the standard. In quantitative terms, it seems that the main effect of IFRS 9 will be to increase the provisions compared to the current level under IAS 39 (by 13 % on average, according to the EBA study). The effect on the common equity Tier 1 (CET1) ratio should on average range between 40 (ECB analysis) and 45 basis points (EBA analysis). Smaller banks which mainly use the standardised approach to measure credit risk at prudential level estimated a bigger impact on their capital ratios than the large banks.

In view of the introduction of IFRS 9, the EBA adopted guidelines on credit risk management practices and on the recording of expected credit losses. These guidelines are based on recommendations on the same subject, published by the Basel Committee in December 2015, but adapt them to the European context. The EBA guidelines recommend establishing appropriate and prudent practices, both in credit risk management and in the implementation and continuing application of the expected credit loss methods of accounting.

The Bank played an active part in the aforesaid work of the EBA and the ECB on monitoring the implementation of IFRS 9. Also, to follow up the EBA guidelines on credit risk management practices and accounting for expected credit losses, the Bank published a Circular [1] making these guidelines applicable in Belgium.

Finally, it should be noted that measures have been adopted at European level giving institutions the option of spreading over a five-year period the negative impact on the regulatory capital resulting from the transition to IFRS 9 rules on provisioning.

### 3.3.2 Remuneration policy: horizontal analysis

The Bank traditionally conducts an annual horizontal analysis on the remuneration policies of significant institutions. In the analysis conducted during the year under review, the main focus was on the subjects mentioned in the Bank's Circular dated 10 November 2016 [2], and on monitoring the Bank's recommendations issued in the course of previous analyses.

The findings can be divided into bank-specific conclusions and more general conclusions or tendencies. In view of the SSM's competence in regard to the supervision of individual significant institutions, the results for the banks concerned were shared with the JSTs to ensure appropriate monitoring. The general conclusions are presented below.

As regards "Identified Staff", the banks made an effort to improve the documentation on their identification process. However, they need to demonstrate greater transparency about the participation of the remuneration committee, the risk and control functions, the functions supporting operational activities, and the committees of the statutory governing body concerned in the identification process.

(1) Circular NBB_2017_26 of 11 October 2017 concerning the EBA Guidelines of 12 May 2017 on credit institutions' credit risk management practices and accounting for expected credit losses.
(2) Circular NBB_2016_44 of 10 November 2016 concerning the EBA Guidelines of 27 June 2016 on sound remuneration policies (EBA/GL/2015/22).

In the case of the ratio between fixed and variable pay, all the Belgian banks respect the 50 % maximum specified by the Banking Law. Some banks use "functional" allowances which lead to a (substantial) real increase in fixed remuneration. The EBA guidelines of 27 June 2016 on sound remuneration policies set out clear criteria for the allowances which can be classed as fixed remuneration. The banks need to improve their remuneration policy in order to increase the transparency of the terms describing their allowances.

In general, it appears that the banks grant financial instruments within the legally permitted limits. Banks tend to pay 50 % of the variable remuneration in the form of financial instruments in the case of both the immediate part and the deferred part.

The banks are encouraged to apply more varied percentages and deferral periods. In accordance with the EBA guidelines, significant institutions should in any case apply, at least for members of the management body and senior management effectively running the business, deferral periods of at least five years. This last rule has not yet been implemented by all the banks.

In some cases, the role of the risk committee and control functions concerning remuneration could be improved. In that connection, the banks should ensure that the risk committee examines, documents and justifies its assessment of the remuneration system. The assessment and discussions should be a recurring annual item on the risk committee's agenda.

The same applies to the participation of the control functions in determining the Identified Staff and in decisions on the allocation of variable remuneration.

In the light of the results of this horizontal analysis, the Bank will review the frequency of this exercise.

# E. Insurance undertakings

*During the year under review, the Bank continued to exercise closer supervision over insurance undertakings with the highest risk profile. In some cases, the Bank imposed measures which occasionally led to cessation of all or part of an undertaking's business. The Bank's operational supervision over insurance undertakings also focused in particular on the adequacy of the "best estimates" of future flows of technical provisions in the life insurance portfolios, in view of the importance and the difficulty of modelling customer behaviour in a changing interest rate environment. The quarterly reports which undertakings submitted to the Bank under the new Solvency II prudential regime also formed the subject of a transversal analysis.*

*Furthermore, the legal framework for insurance and reinsurance undertakings was completed. Supervision regimes tailored to small institutions were set up, and Communications on licensing and cross-border activities were published. In addition, Circulars clarified the Bank's expectations concerning the internal risk management of insurance undertakings, the identification of preferential claims in the event of liquidation, the loss-absorbing capacity of deferred taxes, and the definition of infrastructure investment and the associated prudential eligibility criteria.*

*Brexit and its implications for the Belgian and European insurance market constituted a key point for attention. The year under review also brought EIOPA's generally positive assessment of the way in which the Bank exercises prudential supervision over insurers and insurance groups. In addition, various field tests were conducted in connection with the preparation of a common prudential framework for internationally active insurance groups.*

*Finally, the Bank also conducted various horizontal analyses on such subjects as liquidity risks and spread risks, and carried out stress tests on the interest rate risk.*

## 1. Mapping of the sector and supervision priorities

### 1.1 Insurance undertakings

At the end of 2017, the Bank exercised supervision over 82 insurers, reinsurers, surety companies and regional public transport companies which insure their fleet of vehicles themselves. The steady decline in the number of undertakings evident in previous years continued, owing to mergers and the cessation of business following the transfer of portfolios. These operations are dictated partly by the need to continue streamlining the structure of the insurance groups operating on the Belgian market, and partly by new, tougher capital requirements in a low interest rate environment.

There was a notable rise in the number of reinsurers subject to supervision, but that was due simply to a technical adjustment to the regulations. With the entry into force of the new prudential supervision regime, direct insurers that also operated as reinsurers before 2016 were additionally registered as reinsurers.

### 1.2 Insurance groups

At the end of 2017, 11 Belgian insurance groups were subject to the Bank's supervision, three fewer than in 2016. Further rationalisation of the groups' structure is dictated by the Solvency II framework. Seven of these groups only have holdings in Belgian insurance undertakings (national groups), while four groups have holdings in at least one foreign insurance undertaking (international groups).

**TABLE 25** NUMBER OF INSTITUTIONS SUBJECT TO SUPERVISION[1]
(end-of-period data)

| | 2013 | 2014 | 2015 | 2016 | 2017 |
|---|---|---|---|---|---|
| Active insurance undertakings | 83 | 80 | 75 | 72 | 67 |
| Insurance undertakings in run-off | 8 | 4 | 3 | 2 | 2 |
| Reinsurance undertakings | 1 | 1 | 1 | 1 | 29 |
| of which: undertakings also operating as insurers | – | – | – | – | 28 |
| Other[2] | 14 | 12 | 12 | 12 | 12 |
| **Total**[3] | **106** | **97** | **91** | **87** | **82** |

Source: NBB.
(1) At the end of 2017, the Bank also exercised prudential supervision over twelve branches of undertakings governed by the law of another EEA member country, but that prudential supervision was confined to verifying compliance with the money-laundering legislation.
(2) Surety companies and regional public transport companies.
(3) For 2017, the total only takes account once of undertakings active as both insurers and reinsurers..

Under Solvency II, the Bank is the group supervisory authority for each of those groups, and in that capacity, it receives specific reports which form the basis of prudential supervision at group level.

The supervisory authorities of cross-border groups facilitate group supervision by working together in colleges of supervisors. These colleges ensure that the collaboration, exchange of information, and mutual consultation between the supervisory authorities of the EEA member countries actually takes place in order to promote decision-making and the convergence of supervisory activities. The establishment and operation of the colleges are based on coordination arrangements between the supervisory authorities concerned, for which the principles are laid down in the regulations.

**TABLE 26** BELGIAN INSURANCE GROUPS SUBJECT TO THE BANK'S SUPERVISION

| Belgian national groups | Belgian international groups |
|---|---|
| Belfius Assurances | Ageas SA/NV |
| Cigna Elmwood Holdings | ASCO |
| Credimo Holding | KBC Assurances |
| Fédérale Assurance | PSH |
| Fork Capital | |
| Securex | |
| Vitrufin | |

Source: NBB.

## 1.3 Points for attention concerning operational supervision

During 2017, the problems identified in the past relating to the financial situation of certain undertakings were not all resolved. Undertakings with a high risk profile remained subject to closer supervision by the Bank. In parallel with initiatives taken by the institutions themselves, the Bank imposed measures which, in certain cases, led to cessation of some or all of the institution's activities.

In addition, the supervision of insurers again featured the entry into force of new prudential rules. The problems concerning the correct application of the new rules have not been totally resolved at this stage, but some progress was apparent. Owing to the scale and complexity of the reporting, its quality gave rise to questions, but a notable improvement was achieved during the period under review.

In 2016, work and surveys had been conducted on large insurance undertakings. In 2017, the resulting information was subjected to a transversal analysis on three specific subjects.

***Best estimate***

A first sphere concerned the work on the adequacy of the "best estimate"[1] of the technical provisions for the portfolio of life insurance products. Workshops arranged

(1) The best estimate corresponds to the average future cash flows weighted according to their probability, taking account of the current expected value of those flows, estimated on the basis of the relevant risk-free yield curves.

**TABLE 27** COLLEGES FOR INSURANCE UNDERTAKINGS SUBJECT TO THE BANK'S SUPERVISION

| The Bank is the group supervisory authority | The Bank is one of the supervisory authorities involved | |
|---|---|---|
| Ageas SA/NV | Allianz | Allianz Benelux |
| ASCO | | Euler Hermes |
| KBC Assurances | | |
| PSH | AXA | AXA Belgium |
| | | Touring Assurances |
| | Assurances du Crédit Mutuel | Partners Assurances |
| | Delta Lloyd | Delta Lloyd Life |
| | Generali | Generali Belgium |
| | | Europ Assistance Belgium |
| | Munich Re | D.A.S. |
| | | Ergo Insurance |
| | | DKV Belgium |
| | NN | NN Insurance Belgium |
| | | NN Insurance Services Belgium |
| | Baloise Group | Baloise Belgium |
| | | Euromex |

Source: NBB.

with large undertakings examined the calculation of the best estimates at granular level. There were discussions on the functioning of profit-sharing at segment and product level. In the current low interest rate environment, the undertaking's profit-sharing policy has only a limited impact on the calculation of the best estimate for life insurance products. However, that profit-sharing will be more significant if interest rates rise, especially for more recent products with a low guaranteed yield, as the average maturity and cash flows of the undertakings' assets are largely aligned with those of the liabilities, and that currently reduces the portfolio's interest rate risk. If interest rates rise, that alignment could limit the undertaking's scope to keep profit-sharing in line with market interest rate levels (capacity to pay). If the undertaking cannot meet its customers' expectations, those customers will be inclined to drop the product (redemption risk or lapse risk) and invest in other products which do keep to market interest rates. It is no easy task to model customers' behaviour in a changing interest rate environment for the purpose of calculating the best estimate, as there are few time series available on the subject. These analyses lead to further interactions with the undertakings to gain a better understanding of the modelling of best estimates at product and portfolio level.

### *Cost projections in the best estimate*

A second sphere of the transversal analysis concerned the cost projection in the best estimates. This analysis was based on a questionnaire sent to seven large insurers in 2016. The comparative analysis of the responses resulted in general findings and clarifications regarding the current regulations, and they were presented to the sector for consultation.

The Bank wants to see more consistent cost allocation and cost projections in the best estimates, as it found that there were differences in the way in which undertakings allocate and project costs, and that situation was not always entirely in accordance with all the regulations. The Bank also drew up instructions and issued clarifications concerning reporting models. However, the information provided by that reporting does not enable the Bank to conduct a full analysis. The Bank therefore attaches

great importance to the production of adequate documentation by the undertakings. This work resulted in a Communication to the undertakings[1].

*Analysis of the periodic reporting*

The quarterly reports that undertakings submit to the Bank under the new prudential regime were analysed in depth. The data thus supplied were subjected to plausibility checks in regard to the key elements of the undertakings' financial situation. In 2017, the Bank received for the first time reports on a complete financial year, in this case the year 2016. The information in these annual reports is particularly extensive, and new supervision instruments are being developed for conducting the necessary analyses on these data. The action of the Bank in systematically asking the undertakings to remedy the defects found is leading to a notable improvement in reporting quality.

Priority was accorded to analysis of insurers with a low solvency ratio. The solvency calculations are based on a multitude of technical specifications and require a good interpretation of the regulations to ensure correct application. In addition, correct calculation of the parameters used is equally essential to ensure the quality of the solvency figures reported. The analysis includes a detailed examination of the valuations in the balance sheet, and of the calculation of the required and available capital. This exercise is conducted according to the principle of proportionality.

In 2017, undertakings submitted a Regular Supervisory Reporting (RSR) to the Bank for the first time. This document forms part of the information which must be submitted for supervision purposes. The RSR information is used to establish the undertaking's overall risk profile. It is examined together with the information obtained from the ORSA (Own Risk and Solvency Assessment)[2], the Solvency and Financial Condition Report and the governance memorandum. The RSR of the large undertakings was analysed, then shared and discussed in the colleges of supervisors. Meetings were arranged with the large undertakings to examine the consistency of the various documents mentioned above. The RSR is a particularly useful instrument for the supervisory authority as it permits the correct interpretation of the large volume of figures submitted in the periodic reports.

(1) Communication NBB_2017_32 of 29 December 2017 on the results of the horizontal analysis of the costs used in valuing the technical provisions.
(2) The ORSA enables the insurer to assess its risks and solvency internally. In that connection, it pays particular attention to the overall solvency need, continuous conformity with the set capital requirements and technical provision requirements, and evaluation of the degree to which the insurer's risk profile deviates from the assumptions underlying the calculation of the solvency capital requirement ("adequacy of the standard formula").

## 1.4 Points for attention concerning thematic inspections

*Investment management*

The persistent low interest rate environment makes it difficult for insurers to find suitable investments with a yield sufficient to cover the contractually guaranteed interest rates without taking excessive risks. A number of insurers are refocusing their investments, notably in favour of (mortgage) loans (see section 3.4 under "Economic and financial developments" in this Report). In 2017, being concerned about appropriate management of the risks of these investments, the Bank carried out inspections on the investment strategies and the associated risk management. Those inspections yielded some findings. The executive board often receives insufficient information on the implementation of the investment strategy and the risk management. The ALM policy and the investment policy (including as regards outsourcing) are not always sufficiently developed and/or do not conform to the Solvency II regulations, and the ALM risk is not always monitored continuously. The functions associated with these tasks need to be more clearly defined, and the risk management needs to be independent of the operational tasks. Finally, it is evident that the internal audit does not always pay the necessary attention to the investment policy, usually owing to a lack of resources.

*Prevention of money-laundering and terrorist financing*

The inspections carried out in this sphere highlighted some shortcomings in the analysis of the risks confronting the undertakings, which may lead to organisational inadequacies in terms of both the resources allocated to the prevention function and the procedures established for detecting and reporting suspicious transactions. The on-site checks also revealed a lack of knowledge and proper organisation in relation to financial sanctions and embargoes.

*Other themes*

The calculation of the best estimate of the technical provisions (see section E.1.3) also formed the subject of specific inspections which concerned in particular the account taken of profit-sharing and the difficulties that small undertakings experience in calibrating their assumptions.

Inspections on the valuation of mortgage loans also generated some points for attention, notably as regards the discounting assumptions, the failure to take account of interest on arrears in the cash flows, and the absence of back-testing.

## 2. Legal framework and horizontal analyses

### 2.1 Undertakings subject to a special regime on account of their size

Article 4 of the Solvency II Directive states that the provisions of the Directive do not apply to undertakings whose business does not exceed certain thresholds concerning premium income or technical provisions, or does not involve certain complex risks such as liability, credit and suretyship insurance risks, or cross-border activities. Belgium made use of this option by making provision, in Articles 272 to 302 of the Solvency II Law, for three regimes geared to small undertakings.

The first of these regimes concerns undertakings which fall below the thresholds defined by the Directive, which are reiterated in the Solvency II Law, though the latter specifies that reinsurance activities are not eligible for this particular regime. The undertakings in question are subject to a supervisory regime similar to the one that existed under the Law of 9 July 1975 on the supervision of insurance undertakings, particularly as regards the requirements concerning own funds and technical provisions.

The second regime concerns undertakings whose business does not exceed the thresholds in the Directive and which have also concluded an agreement whereby they systematically reinsure or transfer all their insurance liabilities. In view of this transfer of risks, these undertakings are exempt from all supervision, except for the obligation to register with the Bank and prove that they still meet the conditions to qualify for that exemption.

Finally, the third regime concerns local insurance undertakings, i.e. those which confine their business to covering certain fire risks in the municipality where their head office is located or in neighbouring municipalities. The thresholds applicable to these undertakings are lower than for the preceding categories, the permitted activities are more limited, and a high reinsurance transfer percentage is required. If these conditions are met, the supervision regime is confined to registration, verification of compliance with the said conditions, and the requirement concerning an effective management team comprising at least two persons. It should also be noted that this regime is available only to undertakings pursuing activities which met the aforesaid conditions on 1 January 2016.

The supervision regimes described above are described in more detail in two specific Circulars [1], [2].

### 2.2 Preferential rights and running inventories

The Solvency II Law set up a system of protection for policy-holders, insured persons and beneficiaries of insurance contracts or commitments in the event of liquidation of the insurance undertaking. This system comprises a preferential right to the assets corresponding to the technical provisions of the various separately managed activities, and a preferential right to the whole of the assets of the insurance undertaking. It should be noted that these preferential rights do not concern reinsurance claims.

These provisions formed the subject of a Circular [3] specifying which claims are preferential and the rules on their valuation, and the conditions governing whether an asset can be included in those subject to the preferential rights corresponding to the various separately managed activities.

The Circular also points out that insurance undertakings must maintain a special register, called the running inventory, which identifies the assets forming the basis of each of the preferential rights corresponding to the separately managed activities. These registers must be constantly updated, but since the preferential rights will only be asserted in the context of a liquidation in which the insurance contracts are terminated, it is only necessary to submit an annual summary to the Bank. It is therefore only necessary to submit the complete registers to the Bank if the risk of liquidation is imminent or if a check is being carried out.

### 2.3 Communications on authorisation and cross-border activities

***Communication on the authorisation of undertakings governed by Belgian law***

The Solvency II Law maintained the principle of prior authorisation for the pursuit of insurance or reinsurance activities. Authorisation is granted per branch in the case of insurance and per activity in the case of reinsurance. An undertaking authorised in an insurance branch or a reinsurance activity cannot extend its operations to another branch or activity for which it does not have authorisation until after obtaining an extension of its authorisation.

(1) Circular NBB_2017_11 of 27 March 2017 on insurance undertakings subject to a special regime on account of their size.
(2) Circular NBB_2017_12 of 27 March 2017 on local insurance undertakings.
(3) Circular NBB_2017_10 of 22 March 2017 on preferential rights of insurance creditors, running inventories and the summary statement of the running inventories.

The Bank published a Communication[1] which sets out the conditions and describes the procedure for applying for authorisation as an insurance or reinsurance undertaking governed by Belgian law, or for requesting an extension of an existing authorisation. It is accompanied by the memorandum on the obtaining of authorisation by an insurance or reinsurance undertaking governed by Belgian law, detailing the procedure to be followed. These documents essentially constitute an update of Communication D.146 of 19 April 1996 and the previous authorisation memorandum, which are cancelled.

*Communications on cross-border activities*

The Solvency II Directive upheld the principle whereby authorisation obtained in one Member State is valid throughout the European Union. However, that does not mean that there are no formalities governing the commencement of activities in another Member State, be it via a branch or via freedom to provide services. In reality, both the Directive and the Solvency II Law provide for a notification procedure between the authorities of the Member States concerned by the start of cross-border activities. Belgian law also makes provision for a prior notification regime for the acquisition of a subsidiary abroad and the commencement of an activity in a non-EEA country. Those procedures are set out in two Communications[2],[3] which update the Bank's guidelines on the subject.

## 2.4 Circular on the Own Risk and Solvency Assessment (ORSA)

The Own Risk and Solvency Assessment (ORSA) forms the foundation of the risk management of insurance undertakings under Solvency II.

It is essential for an undertaking's executive committee and board of directors to be aware of all the significant risks to which the undertaking is exposed, whether or not they are included in the calculation of the regulatory solvency capital requirements and whether or not they are quantifiable. It is vital for the undertaking to assess for itself, in its risk management, the amount of own funds that it should hold in view of the risk exposure and commercial objectives specific to the undertaking. It is essential for the solvency and risk assessment to be incorporated in the undertaking's management policy, and more particularly in its strategic decisions.

An initial Circular on the subject had been adopted pursuant to the EIOPA guidelines. A new Circular[4] was drawn up during the period under review to strengthen the risk management.

A chapter was added concerning good practices for stress tests. In the ORSA, undertakings have to make a prospective assessment of the risks which they expect to face. Stress tests are one of the tools that they must use to facilitate that prospective approach to risk management. The aim of the good practices is to give undertakings better information on how to devise a sound framework for stress tests, sensitivity analyses and scenario-based analyses. These good practices describe both the quantitative and the qualitative aspects of the stress tests while drawing attention to the principle of proportionality: small undertakings can focus more on qualitative aspects while larger undertakings have to use more sophisticated stress-testing techniques.

Undertakings are also required to attach a table to their ORSA report, presenting an overview of the five principal current or future risks confronting the undertaking, taking account of the business plan and its risk tolerance limits. The summary table gives the Bank an accurate idea of the risk analysis conducted by undertakings and an overview of the stress tests and scenarios devised.

## 2.5 Loss-absorbing capacity of deferred taxes

Article 153 of the Solvency II Law, which transposes Article 103 of the Directive, provides for an adjustment to the calculation of the solvency capital requirement (SCR) corresponding to the loss-absorbing capacity of deferred taxes.

Under Solvency II, the assets and liabilities are recorded at the value at which they could be transferred or exchanged in a transaction concluded under normal market conditions. That results in a figure which differs from their book value or their tax value. Deferred tax assets (DTAs) and deferred tax liabilities (DTLs) represent the tax impact of these valuation differences known as "temporary differences". However, it should be noted that, as in the case of the IFRS, part of the DTAs may also result from unused tax credits and unused tax losses.

Thus, in the Solvency II balance sheet, an insurer or reinsurer will record a DTL or a DTA according to whether an asset will produce a gain or a loss not currently

(1) Communication NBB_2017_17 of 2 June 2017 on the procedures for obtaining authorisation as an insurance or reinsurance undertaking governed by Belgian law, and for obtaining an authorisation extension.
(2) Communication NBB_2017_18 of 2 June 2017 on the procedures to be followed by insurance or reinsurance undertakings governed by Belgian law for pursuing an insurance or reinsurance activity abroad.
(3) Communication NBB_2017_19 of 2 June 2017 on the procedures to be followed by insurance or reinsurance undertakings governed by foreign law for pursuing an insurance or reinsurance activity in Belgium.
(4) Circular NBB_2017_13 of 19 April 2017 on the Own Risk and Solvency Assessment (ORSA).

expressed in its balance sheet. In other words, the undertaking will immediately record either the tax on the profit resulting from the capital gain, or the tax credit resulting from the capital loss. However, the recording of a (net) deferred tax asset is subject to a recoverability test in which the undertaking has to demonstrate that it will make a future taxable profit to which this DTA can be imputed.

Deferred tax assets may result either from a negative valuation difference between the value according to Solvency II and the tax value of the assets, which is the case if there is an unrealised net loss on the securities portfolio, or from a positive valuation difference in the liabilities if the Solvency II technical provisions exceed the statutory technical provisions.

The adjustment concerning the loss-absorbing capacity of deferred taxes (LAC DT) consists in taking account of changes in the deferred tax assets and liabilities when calculating the SCR, as the SCR is an own funds requirement intended to cater for either a reduction in the value of the assets or an increase in the liabilities. Such fluctuations also imply a change in the amount of the deferred tax assets and liabilities. The adjustment in question consists in taking that change into account in calculating the SCR.

In an initial Circular [1] on the subject, only the amount of the net deferred tax liabilities could be taken into account in the adjustment concerning the loss-absorbing capacity of deferred taxes. The Circular [2] discussed here abolished that restriction in order to bring the Bank's practices more into line with those developed on this subject in the other Member States.

It is evident from an EIOPA study that the restriction applied by the Bank could be considered a strict rule compared to the methods developed in the other Member States, which aim primarily to impose restrictive assumptions, should the occasion arise, in connection with the demonstration of the existence of future profits which can justify the part of the LAC DT exceeding the net DTL.

With effect from 2016, Belgian undertakings were therefore authorised to reduce their SCR by an amount in excess of the net DTL, known as the notional DTLs. However, the Circular specifies that these notional DTLs must not exceed whichever is the smaller of either, on the one hand, the amount resulting from the recoverability test or, on the other hand, the estimated taxable profits according to the undertaking's business plan, which are cumulated over a maximum of five years and multiplied by the tax rate, then by the SCR coverage rate before application of the adjustment, the latter rate being reduced by 100 %.

The new Circular was to apply for the first time to the calculation of the SCR relating to the situation as at 31 December 2016. However, an analysis revealed that few undertakings used the option offered by the new Circular.

EIOPA also carried out work to reduce the differences between Member States in application of the LAC DT.

## 2.6 Infrastructure Circular

Economic research has shown that the investment rate in the European Union is still below the long-term average prevailing before the 2008-2009 financial crisis. It is government investment that is particularly low, mainly on account of the need to restore sound budgets in the Member States following the European debt crisis.

As investment is a highly cyclical component of demand, it largely explains the seriousness of the recession and the struggle to restore growth in the euro area. In addition, the low investment rate also erodes an economy's long-term growth potential.

The European Commission, under the presidency of Jean-Claude Juncker, therefore put forward an "Investment Plan for Europe" when he took office. One aim of the plan was to eliminate unjustified barriers in the legislation concerning the funding of infrastructure projects by insurers. In fact, insurers – and particularly life insurers – are essentially long-term investors often seeking to acquire assets with a maturity that matches their liabilities.

That is why Delegated Regulation 2015/35, which – among other things – sets out the capital requirements for insurance undertakings, creates a separate infrastructure asset class that takes account of the specific characteristics of this investment. The new asset class has to meet criteria concerning resistance to stress and the predictability of cash flows, and must form the subject of an appropriate contractual framework. Fulfilment of these criteria should ensure that the prudential policy is tailored to the risk profile of infrastructure investment.

(1) Circular NBB_2016_21 of 25 April 2016 on the loss-absorbing capacity of technical provisions and deferred taxes.
(2) Circular NBB_2017_14 of 19 April 2017 on the loss-absorbing capacity of deferred taxes.

In February 2017, the Bank published a Circular[(1)] providing additional clarification on the definition of infrastructure investment and the associated eligibility criteria, to enable insurers to assess the corresponding risks. In some cases, that risk assessment will require adjustment of the risk management systems of insurance undertakings in view of the potentially new character of the investments concerned.

## 2.7 Brexit

The United Kingdom's withdrawal from the European Union – commonly known as "Brexit" – planned for the first quarter of 2019 raises a series of questions concerning the activity of British undertakings in the European Union, particularly if it is assumed that, after Brexit, the United Kingdom will have to be considered as a third country under EU legislation on insurance and reinsurance. In that scenario, British undertakings will no longer be able to pursue their activities either via freedom to provide services or via a European branch which would not be supervised by the Member State in which it is established.

In view of this uncertainty, some British insurers and reinsurers are already examining the possibility of establishing a subsidiary in the European Union and transferring to that subsidiary the activities that they have hitherto carried out via freedom to provide services or via a branch. Such a subsidiary would offer parent companies in the United Kingdom the advantages of the single licence throughout the European Union. Some insurance and reinsurance undertakings (Lloyd's, MS Amlin and QBE) have publicly announced their intention to establish such a subsidiary in Belgium. Another institution (The Navigators Group) has announced its intention to acquire shares in a Belgian insurer (ASCO). Contact is currently ongoing with the Bank's services in connection with the preparation of an authorisation application for these undertakings.

At this stage, several points remain unclear, such as the post-Brexit fate of insurance or reinsurance contracts concluded prior to that date with a company based in the United Kingdom and the arrangements for transferring European activities currently managed from the United Kingdom to a subsidiary located in the European Union.

The same applies to the activities that companies governed by the law of a European Union Member State pursue via freedom to provide services or via a branch in the United Kingdom. In their case, the uncertainty lies in whether "post-Brexit" British law will still authorise such activities, and under what conditions. At EIOPA level, discussions are in progress, in which the Bank is participating, for the purpose of examining the prudential issues associated with the United Kingdom's departure from the European Union.

(1) Circular NBB_2017_04 of 16 February 2017 on infrastructure investment under the Solvency II regime.

## 2.8 EIOPA visit

Among its various tasks, EIOPA is responsible for promoting a common culture of consistent, high-quality supervision of insurance and reinsurance companies. In that connection, EIOPA assesses supervisory authorities' implementation of national projects such as balance sheet inspections, stress tests, or the application of the rules on internal models for calculating solvency requirements, and the efficient operation of the colleges of supervisors.

In April 2017, EIOPA thus assessed how the Bank exercised prudential supervision over insurers and insurance groups. For that purpose, it gathered information on all the applicable legislation, and the Circulars, internal policies and various transversal analyses developed by the Bank. That information was supplemented by presentations on the Bank's own tools and procedures, and their deployment for the purposes of operational supervision, and by question and answer sessions. EIOPA's conclusions were generally reassuring as regards the quality of supervision exercised by the Bank, which has already prepared a plan in response to EIOPA's comments.

## 2.9 ICS field test

In connection with the global convergence of capital standards and the promotion of financial stability, the International Association of Insurance Supervisors (IAIS) is currently developing a common prudential framework for internationally active insurance groups (IAIGs). That framework includes the development of an International Capital Standard (ICS) comprising a number of elements : the provision concerning the consolidation scope, the valuation of assets and liabilities, the own funds components and the own funds requirements.

In the past three years, there have been various field tests on the subject to obtain input from experts, both from the sector concerned and from the supervisory authorities. The field testing serves to refine the capital standards mentioned above and to continue developing the qualitative aspects of the framework. During the period under review, field testing was carried out specifically to develop an initial, concrete version of the capital standards according

to a standard method. A new field test will permit further refinement of these standards, including as regards undertaking-specific parameters and the internal models used to determine the capital requirements. The expectation is that the international capital standard can be introduced by the end of 2019, and will be applied on a consolidated basis to all internationally active insurance groups.

## 2.10 Horizontal analyses and stress tests

During the year under review, the Bank also conducted various horizontal analyses of the Belgian insurance sector (see box 15), and carried out stress tests to ensure that the interest rate risk is still low for insurance undertakings (see box 16).

### Box 15 – Horizontal analyses of the Belgian insurance sector

This year, as part of its risk analysis, the Bank again carried out a series of horizontal analyses on the main risks for the insurance sector. This work included a more detailed examination of the interest rate, liquidity and spread risks faced by Belgian insurers.

*Interest rate risk*

The potential consequences of persistently low interest rates have been the most significant financial risk for insurers for several years now, and remain an attention point for the Bank.

In 2014, in order to obtain a more complete and detailed view of the insurance sector's exposure to interest rate risk, the Bank had decided to develop standard annual reporting specifically for monitoring that risk. This report comprises four sections, each designed to shed light on a specific aspect of the interest rate risk: the current composition of the guaranteed yields on insurance contracts, the duration of the technical provisions and their covering assets, detailed projections of cash flows concerning the technical provisions and assets, and projections relating to yields on the assets and liabilities.

With the aid of these data, an assessment framework was devised on the basis of a set of risk indicators. The Bank has been applying this assessment framework for three years, and has refined it each year. In particular, it uses the framework to examine the average level of the guaranteed yields and their residual term, the proportion of the technical provisions accompanied by guaranteed yields on future premiums, the level of the duration gaps, the matching of the underlying asset and liability cash flows, and the difference between the projection of the expected yields on the assets, on the one hand, and the guaranteed yields on the liabilities on the other hand. These parameters make it easier for the Bank to identify the undertakings which are (more) vulnerable to a low interest rate environment.

Undertakings for which the risk was deemed significant were subjected to a more detailed examination. In a limited number of cases, this led the Bank to request an action plan from the undertaking, or to analyse possible measures to limit its interest rate risk. That approach will continue to be followed in the longer term.

In this connection, the Bank proposed an amendment to the prudential regulations on life insurance intended to avert the risks of large-scale policy redemptions, particularly in the event of an increase in interest rates. The measure aims to discourage early redemptions, or at least to ensure that the costs associated with speculative redemptions are shared between the insurer and the policy-holder. In practice, this measure would consist in making the redemption value depend on both the residual term of the policy and the difference between the guaranteed contractual yield and an interest rate representing financial market yields at the time of redemption.

*Liquidity risk*

Back in 2014, taking account of the downward trend in the volume of traditional life insurance premiums and the increased share of illiquid assets on the Belgian insurance market, the Bank had already decided to keep a close watch on liquidity risk in the insurance sector.

The Bank provides for separate quarterly liquidity reporting by all life insurance undertakings. An insurer generally faces a less significant liquidity risk than a bank, and that risk is more difficult to measure.

To permit integrated monitoring of the liquidity risk, the Bank developed an assessment framework based on a set of risk indicators. Those indicators focus on the trend in incoming and outgoing cash flows, the trend in the liquid assets and liabilities, and finally, the trend in exposures to instruments and derivatives presenting a potential liquidity risk. These three groups of indicators permit more systematic monitoring of the liquidity risks of individual insurers and of the sector as a whole.

For a small number of undertakings, the liquidity reporting results led the Bank to adopt follow-up measures or to carry out inspections. More specifically, the findings which emerged from these analyses regarding the reduction in premium volumes and the growing number of individual life insurance contract surrenders also gave rise to a strategic review on the future of the individual life insurance sector in Belgium, and recommendations by the Bank on the subject.

*Spread risk*

Fixed-interest-rate assets – which make up the bulk of the insurers' investment portfolio – are subject to spread risk. The spread corresponds to the risk premium, i.e. the difference between the asset's yield and the risk-free interest rate. If an asset's risk premium increases, its yield increases and its market value falls. The spread risk is therefore the risk that the asset's market value may vary according to fluctuations in the risk premium, due to a change in the (perceived) risk of the asset.

Quantitative studies and stress tests previously conducted for the insurance sector revealed that variations in spreads often had a very significant impact on the insurer's balance sheet. That may be due partly to the large proportion of government and corporate bonds in the investment portfolios of Belgian insurers, and partly to the principle of marking to market enshrined in the Solvency II regime. Since all variations in spreads are reflected in the market value of these bonds, they have a direct (positive or negative) impact on the own funds of insurance undertakings.

To take account of the often long-term character of an insurer's investment portfolio, the Solvency II regulatory framework provides for long-term guarantee (LTG) measures, which moderate the said impact by offsetting part of the increase in the spread with an increase in the discount rate for the technical provisions. In that regard, the level of the offsetting depends on the type of LTG measure which can be applied.

In order to obtain a more integrated and complete view of the spread risk for insurers, beyond the possible effect on capital requirements and valuation, an assessment framework was developed in the year under review for monitoring the spread risk of Belgian insurers. That assessment framework mainly concerns the indicators relating to credit quality, duration and interest rate sensitivity of fixed-interest-rate assets. During the year under review, the extent to which that risk is covered by the capital buffer stipulated by the Solvency II framework was also examined. That risk will be monitored with the aid of the insurers' annual reporting on the subject to the Bank.

Undertakings identified as outliers will be monitored in future quantitative analyses, e.g. via stress tests. The Bank also analyses how insurers themselves assess the risk in their ORSA report. In that connection, particular attention will focus on the spread risk of government bonds, as the Solvency II framework does not impose any capital buffer in that respect.

## Box 16 – "Flashing-light" policy and national stress test framework

***"Flashing-light" reserve***

Under the Solvency I regime, insurers had to form additional statutory provisions (commonly known as the flashing-light reserve) to cover the interest rate risk that they incurred on certain types of contract. Following the entry into force of the new Solvency II prudential regime, the prudential rules on additional reserves were retained in the accounting framework. That reserve must therefore be maintained for as long as the interest rate risk persists. However, as the Solvency II regime also makes provision for specific regulatory requirements to cover the interest rate risk, new rules were introduced in the accounting framework, thus simplifying the mechanism for waiving the obligation to form additional reserves.

As a general rule, that waiver is conditional upon fulfilment of all the regulatory capital requirements under Solvency II without making use of the transitional measures concerning technical provisions. Apart from checking fulfilment of this condition, the Bank analyses the situation of the undertakings concerned and the market conditions in order to ensure that the interest rate risk is still low. In that assessment, it uses the most relevant tools at its disposal, including the stress test results relating to the interest rate risk exposure.

*Stress tests*

The Bank considered it useful to issue a Communication to the sector explaining its policy and expectations concerning stress tests for insurance. In that regard, a distinction is made between firms' own stress tests, e.g. those developed for the ORSA, and stress tests imposed by the Bank. The latter tests may be both microprudential (focusing attention on specific exposures in a small number of undertakings) and macroprudential. The Bank's stress test policy is flexible and provides substantial scope for achieving objectives specific to each exercise. The insurance sector undergoes a stress test at least once a year, and if there is a European stress test the Bank adjusts its own stress test accordingly.

This new framework was first applied in practice in 2017. To reduce the workload for firms, the stress test methodology was adapted as far as possible to that for the 2016 EIOPA stress test. That test puts the emphasis on the most relevant risks for insurers, namely market risks, including the interest rate risk, and excluding technical underwriting risks, and consists of two quantitative scenarios supplemented by a brief qualitative questionnaire.

The main aim of the first – low for long – scenario is to detect and assess the Belgian insurance sector's potential vulnerabilities relating to the interest rate risk. That scenario tries to simulate a structural stagnation situation in which a shortage of profitable long-term investment and persistently weak growth (and low growth expectations) lead to a continuing decline in the risk-free yield curve, particularly for the longest maturities. This exercise forms part of a macroprudential risk assessment and by that token supplements the risk assessments conducted for individual undertakings (see box 15). The main aim of the stress test is to detect the sector's vulnerabilities. However, weaknesses found at individual level must not be ignored. This implies that the results of the low for long scenario are taken into account in the assessment of the waiver application mentioned above.

The second scenario was developed by the IMF in collaboration with the Bank, in the context of the FSAP conducted in Belgium (see chapter A under "Prudential regulation and supervision"). To test the insurance sector's resilience, an adverse macrofinancial scenario was developed, simulating a recession caused by a sudden increase in risk aversion worldwide, a reappraisal of the sovereign risk in the euro area, a credit cycle crash in emerging market economies, and a significant correction on Belgian property markets. That scenario combines an increase in the risk-free yield curve with substantial shocks affecting key asset classes in the investment portfolio (government and corporate bonds, mortgages and other loans, equities, real estate, etc.). The results of these stress tests were not yet final when this Report went to press.

# F. Financial market infrastructures

*During the year under review, in regard to financial market infrastructures (FMIs), particular attention focused on changes in the regulations and their implementation by the systems and institutions subject to the Bank's prudential supervision and oversight activities. The possible implications of Brexit for this sector were also considered in detail. As in the case of other financial sectors, developments concerning FinTech (see section G.3. below) and cyber risks (see section G.4) were likewise closely monitored.*

*The Bank also published for the first time the Report on Financial Market Infrastructures and Payment Services[1], offering a detailed picture of the activities of those systems and institutions, changes in the regulatory environment, the Bank's approaches to oversight and prudential supervision, and its main objectives for 2017.*

## 1. Mapping of the sector

Belgium hosts a number of FMIs, securities depositories, payment service providers such as payment institutions and electronic money institutions, and critical service providers. Some of these entities, such as SWIFT, Euroclear, Bank of New York Mellon, Mastercard Europe and Worldline, are of international systemic importance. As the lead authority, the Bank set up international cooperation agreements for some of these systems and institutions.

The Bank's oversight is concentrated both on the security and efficiency of all FMI operations such as payment, clearing and settlement systems, and on their connections with other financial market players. At microeconomic level, the prudential supervision authorities watch over the financial health of institutions in this sector, thus helping to maintain confidence among their counterparties and users. These two supervision approaches are aimed at promoting financial stability. In cases where the Bank exercises both oversight and prudential supervision, the supervisory activities can be considered complementary.

The systems and institutions can be grouped according to the type of services that they offer their participants or customers : clearing, settlement and custody of securities, payments and the provision of critical services.

(1) See https ://www.nbb.be/doc/ts/publications/fmi-and-paymentservices/2017/fmi-report2017.pdf.

## 2. Priorities for oversight and supervision

In 2017, the Bank devoted a major part of its prudential supervision and oversight activities to changes in the legislation affecting most categories of FMIs and payment service providers, and to analysis of the impact of those changes. As the FMIs act as nodal points in the processing of payments and securities transfers, IT risks – and more particularly cyber risks – also continue to require the necessary attention. Cyber risks and FinTech are discussed in chapter G below.

***Securities clearing, settlement and custody***

Although there is no Belgium-based central counterparty (CCP) involved in securities clearing, the Bank participates in various CCP supervision colleges, either because those institutions settle transactions on the books of a Belgian Central Securities Depository (CSD), or because of the importance of a Belgian financial institution as a CCP participant. Since the euro-denominated activities of CCPs currently operating from the United Kingdom may be significant, the impact of Brexit is being closely monitored.

TABLE 28 MAPPING OF THE FINANCIAL MARKET INFRASTRUCTURES AND PAYMENT SERVICES SECTOR

| | International cooperation | | The Bank acts as the sole authority |
|---|---|---|---|
| | The Bank acts as lead authority | That Bank participates under the direction of another authority | |
| Prudential supervision | | Securities depository<br>Bank of New York Mellon SA (BNYM SA/NV) | Securities depository<br>BNYM Brussels branch |
| | | | Payment service providers (PSP) [1]<br>Payment institutions (PI)<br>Electronic money institutions (ELMI) |
| Prudential supervision and oversight | Securities settlement systems<br>Securities depository (CSD)<br>Euroclear Belgium (ESES)<br>International securities depository (ICSD)<br>Euroclear Bank SA/NV<br>Equivalent settlement institution<br>Euroclear SA/NV (ESA) | Securities clearing systems (CCP)<br>LCH.Clearnet Ltd (UK), ICE Clear Europe (UK), LCH.Clearnet SA (FR), Eurex Clearing AG (DE), EuroCCP (NL), Keler CCP (HU), CC&G (IT) | Payment processors<br>Worldline SA/NV |
| Oversight | Critical service provider<br>SWIFT | Critical service provider<br>TARGET2-Securities (T2S) | Securities settlement systems<br>Securities depository<br>NBB-SSS |
| | | Payment system<br>TARGET2 (T2)<br>CLS Bank | Card payment schemes<br>Bancontact<br>MasterCard Europe |
| | | | Payment system<br>Centre for Exchange and Clearing (CEC) |

| | | | |
|---|---|---|---|
| Post-trade infrastructuren | Securities clearing | Payments | Payment systems |
| | Securities settlement | | Payment institutions and electronic money institutions |
| | Custody of securities | | Payment processors |
| Critical service providers | TARGET2-Securities | | Card payment schemes |
| | SWIFT | | |

Source: NBB.
(1) For a list of payment service providers, see https://www.nbb.be/doc/ts/publications/fmi-and-paymentservices/2017/2017-chapter-3-2-payment-institutions-electronic-money-institutions.pdf.

In the CSD sector, the implementing and regulatory technical standards of the CSD Regulation [1] came into force on 30 March 2017. The Regulation defines the common rules on settlement in the EU, regulates the activities performed by CSDs, organises the provision of banking services related to CSD activities, and deals with sanctions and the deadlines for obtaining authorisation to perform the functions of a CSD. Every CSD in the EU must apply to its competent authority for authorisation.

As the competent authority in Belgium, the Bank authorises and supervises CSDs established in Belgium. The Bank seeks the FSMA's advice for aspects that fall under the latter's limited competence for CSDs as part of its tasks of ensuring compliance with rules guaranteeing the sound operation, integrity and transparency of financial instruments markets, as well as its work on ensuring

(1) Regulation (EU) No. 909/2014 on improving securities settlement in the European Union and on central securities depositories.

compliance with the rules for protecting the interests of investors in financial instrument transactions [1]. A protocol setting out the cooperation arrangements was concluded between the two institutions in 2017.

Under the Regulation, the competent authority has to decide on the completeness of the application for authorisation. Applications for authorisation submitted by CSDs based in Belgium and forming part of the Euroclear group – notably Euroclear Belgium and Euroclear Bank – were considered incomplete for various reasons, such as the non-exhaustive character of the application, ongoing IT changes, and the incomplete implementation of new control processes and procedures. Euroclear Belgium and Euroclear Bank must provide all the additional information for assessing their compliance with the Regulation's requirements by no later than the end of September and the end of December 2018 respectively. From the moment the application is considered complete, the Bank, as the competent authority, will transmit all the necessary information to the other authorities which, pursuant to the Regulation, have to be consulted on the conformity of the application. BNY-Mellon CSD decided not to submit an application for authorisation.

The Regulation exempts NBB-SSS, like other public CSDs, from certain obligations, such as obtaining an authorisation. However, these CSDs must comply with all other obligations applicable to them by no later than one year from the date of entry into force of the technical standards, i.e. by 30 March 2018 at the latest.

In view of the importance of the entities located in Belgium internationally active in securities settlement, custody and related services on behalf of professional clients, the prudential supervision approach applied to this sector in Belgium was adapted to the specific character of those activities long ago. In order to optimise this approach, it was considered appropriate to introduce an additional supervision status specifically geared to banking entities operating exclusively in the custody and servicing of securities.

The main activity of these entities in fact consists in holding financial instruments off the balance sheet for their clients. However, the banking regulations do not address prudential supervision aspects relating to such activity; it is therefore justifiable and necessary to apply a special prudential supervision approach to these institutions for the relevant aspects which are not covered by the banking regulations.

Technically, the current definition of "assimilated settlement institutions" is divided into two sub-categories in order to include credit institutions based in Belgium whose activity consists solely in providing their clients with securities custody services, accounting and settlement of financial instruments, and ancillary services.

These institutions are in fact very similar to existing assimilated settlement institutions, defined as entities which deal with all or part of the operational management of services provided by settlement entities. Those similarities are in particular as follows: the type of activities pursued, the absence of retail deposits and other retail customer services, such as retail lending, and the maintenance of the risk profile at a low level. The Law introducing this new type of authorisation came into force on 21 August 2017 [2].

*Payments*

The Bank bears wide responsibility for payments and – depending on the system or the institution – acts as the overseer or the prudential supervision authority. As the overseer, the Bank covers payment systems, payment instrument processors and card payment schemes, while, as the prudential supervisory authority, it supervises payment service providers.

The proper, secure processing of card payments in Belgium is a key aim of the Bank's oversight, in view of the role of such payments in the economy. Although payment processors are not necessarily payment systems, the Belgian economy is heavily dependent on their smooth operation, and hence on the stability and continuity of card payments. The Law of 24 March 2017 on the supervision of payment transaction processors makes systemically important payment processors subject to the direct legal supervision of the Bank, and lays down certain conditions for pursuit of the activity [3].

At the end of 2017, 19 payment institutions and 5 electronic money institutions were subject to the Bank's supervision. The Bank also exercised supervision over eight exempt legal entities and three branches of foreign institutions. During the year under review, four Belgian payment institutions were authorised, including MoneyGram and Ebury Partners which, in view of Brexit, decided to establish a subsidiary in Belgium, while one authorisation was withdrawn. All these institutions

(1) The rules on conflicts of interest, record-keeping, the requirements concerning participation, transparency, procedures for communicating with participants and other market infrastructures, the protection of the assets of participants and of their clients, freedom to issue securities via any CSD authorised in the EU, and access between a CSD and another market infrastructure.
(2) Law of 31 July 2017 concerning miscellaneous financial and fiscal provisions and measures relating to concession contracts.
(3) Law of 24 March 2017 on the supervision of payment transaction processors.

**TABLE 29** NUMBER OF PAYMENT AND ELECTRONIC MONEY INSTITUTIONS SUBJECT TO SUPERVISION
(end-of-period data)

| | 2014 | 2015 | 2016 | 2017 |
|---|---|---|---|---|
| Payment institutions | 18 | 20 | 24 | 26 |
| Under Belgian law | 11 | 12 | 16 | 19 |
| Exempt institutions [1] | 4 | 5 | 5 | 5 |
| Branches governed by the law of an EEA member country | 3 | 3 | 3 | 2 |
| Electronic money institutions | 11 | 11 | 9 | 9 |
| Under Belgian law | 5 | 5 | 5 | 5 |
| Exempt institutions [1] | 5 | 5 | 3 | 3 |
| Branches governed by the law of an EEA member country | 1 | 1 | 1 | 1 |

Source : NBB.
(1) "Exempt institutions" are subject to a lighter supervision regime in accordance with Circular NBB_2015_12 on the Bank's exemption policy on the basis of Article 48 of the Law of 21 December 2009.

endeavour to offer their services in totally digital form by taking advantage of innovations in financial technology (see also chapter G.3 on FinTech).

During the period under review, one of the priorities of the prudential supervision of payment institutions and electronic money institutions concerned the transposition of the second European Payment Services Directive (PSD2) [1]. That Directive, which concerns recent innovations in payment services and for which the Belgian transposition law came into force at the beginning of 2018, adds two new categories of payment services providers to the regulatory framework : payment initiation service providers and account aggregation service providers. These two types of service providers will be entitled, in the same way as other institutions authorised for that purpose, to gain access to the payment accounts of a payment services user provided the user has explicitly given consent. One of the possible applications of this change in the legal framework is the option for an account aggregation service provider to set up a single application containing the balance of the various accounts that an individual holds with multiple financial institutions. As regards payment initiation service providers, the new regime enables them to initiate payments directly from a user's payment account to a payee. The supervision regime applicable to each type of payment service provider is proportionate to the scale of the providers' activities and the associated risks.

Another key element of the PSD2 is the application of "strong authentication" of the customer with a view to the totally secure initiation and execution of payments. This type of authentication requires the use of at least two of the following three elements, which must be independent and confidential : an element known only to the user (e.g. a PIN code), an element held only by the user (e.g. a payment card) and an element specific to the user (e.g. biometric data, such as a fingerprint).

With a view to uniform application of the new regulations in the EEA, the EBA is to draw up technical standards on the subject.

*Provision of critical services*

SWIFT (Society for Worldwide Interbank Financial Telecommunication) is a limited liability cooperative society based in Belgium and specialising in the exchange of financial messages between financial institutions and financial market infrastructures.

SWIFT is neither a financial institution nor a financial market infrastructure, but operates as a critical service provider for each of those parties, and is therefore itself systemic. That is why SWIFT is subject to international cooperative oversight exercised by various central banks. The Bank takes on the role of lead overseer for SWIFT and, in that capacity, cooperates with the G10 central banks [2]. The conclusions of these oversight activities are also

(1) Directive (EU) 2015/2366 of the European Parliament and of the Council. of 25 November 2015 on payment services in the internal market, amending Directives 2002/65/EC, 2009/110/EC and 2013/36/EU and Regulation (EU) No. 1093/2010, and repealing Directive 2007/64/EC.
(2) Bank of Canada, Deutsche Bundesbank, European Central Bank, Banque de France, Banca d'Italia, Bank of Japan, De Nederlandsche Bank, Sveriges Riksbank, Swiss National Bank, Bank of England and the Federal Reserve System, represented by the Federal Reserve Bank of New York and the Board of Governors of the Federal Reserve System.

shared with a wider group of central banks in the SWIFT Oversight Forum [1]. The Bank keeps a particularly close eye on developments in SWIFT and maintains continuous relations with the institution. As the lead overseer, the Bank acts as the central contact point for the cooperative oversight, and chairs the groups in charge of technical activities and the high-level groups responsible for defining the oversight policy. The Bank also provides the supporting secretariat for these activities.

The cooperative oversight is essentially organised around five main themes (a) risk detection and management, (b) data security, (c) the system's reliability and resilience (d) technological developments and planning, and (e) communication with users. For each of these themes, there are high-level expectations in relation to SWIFT.

(1) For the composition of the Forum, see the description at: https://www.nbb.be/en/financial-oversight/oversight/critical-service-providers.

(2) CPMI-IOSCO (2016), *Guidance on cyber resilience for financial market infrastructures*, BIS (http://www.bis.org/cpmi/publ/d146.pdf).

In 2017, apart from a series of recurring subjects such as monitoring of the effectiveness of SWIFT's internal control system (collaboration between the institution's line managers, risk management and internal audit) or strategic decisions concerning expected technological developments, the Bank devoted due attention to cyber risk (see chapter G.4) and SWIFT's strategic stance on that challenge. A first specific theme examined in the year under review concerned the roll-out of the Customer Security Programme (CSP) and the accompanying SWIFT communication to its users on sound management practices and responsibilities concerning security. In the years ahead, the further development of the CSP will most likely remain a priority for the oversight of SWIFT. A second key aspect of cyber risk concerns the assessment of SWIFT's internal resilience to cyber threats and the associated investment. In that connection, the cyber strategy that SWIFT devises and the procedures which it develops pursuant to that strategy are also analysed in the light of the CPMI-IOSCO guidance on the subject [2].

# G. Cross-sectoral aspects of prudential regulation and supervision

*As a prudential supervisory authority, the Bank is competent for a range of spheres which cover multiple sectors and are therefore not discussed in the sections of this Annual Report on banking, insurance and financial market infrastructures.*

*In 2017, one of the main developments was the completion of the work on transposing into Belgian law the Fourth EU Directive on the prevention of money-laundering and terrorist financing, which will demand a major effort on the part of both financial institutions and the competent authorities, including the Bank.*

*The Quality Assurance Unit, intended to ensure that the Bank's prudential supervision and resolution activities satisfy a number of quality requirements, continued working on the definition of its framework in order to progress gradually towards a definitive method of operation.*

*During the year under review, the Bank also set up a single point of contact for FinTech, in collaboration with the FSMA, which acts as the supervisory authority's access channel for questions concerning the legislative framework for the provision of financial services in Belgium, notably in the context of the European Payment Services Directive (PSD2). The Bank also kept a close watch on developments relating to private digital currencies.*

*In view of the growing cyber threats, the Bank actively contributed to the further development, at European level, of a regulatory framework for the management of cyber risks and recommendations on the subject. During the year under review, it also carried out a number of inspection assignments concerning cyber risk. Finally, in collaboration with other players, the Bank continued its work aimed at mapping e-banking fraud and raising consumers' awareness of the issue.*

*As regards governance, reporting and the collaboration of auditors in prudential supervision, the year under review brought the adoption and publication by the Bank of several new normative documents on such matters as the quality of prudential and financial data, the cooperation of accredited auditors in prudential supervision, reporting on loans to related persons, qualifying holdings, the "fit and proper" framework and the compliance function.*

## 1. Measures to combat money-laundering and terrorist financing

The year 2017 brought the final touches to the work on transposing into Belgian law – via the Law of 18 September 2017 [1] – the Fourth EU Directive on the prevention of money-laundering and terrorist financing (ML/TF) [2]. This new Law makes a transition to mechanisms resolutely aimed at the general adoption of a risk-based approach, as regards both the preventive obligations of financial institutions and the supervision by the competent authorities, including the Bank, over compliance with those obligations. This development requires both parties to make significant efforts to adapt the arrangements that they had defined and implemented under the previous Law.

(1) Law of 18 September 2017 on the prevention of money-laundering and terrorist financing and limits on the use of cash.

(2) Directive (EU) 2015/849 of the European Parliament and of the Council of 20 May 2015 on the prevention of the use of the financial system for the purposes of money-laundering or terrorist financing, amending Regulation (EU) No. 648/2012 of the European Parliament and of the Council, and repealing Directive 2005/60/EC of the European Parliament and of the Council and Commission Directive 2006/70/EC.

## 1.1 Law of 18 September 2017

The structure of the new Law was radically revised compared to that of the Law of 11 January 1993, which it abolishes and replaces. In particular, all the obligations imposed on the entities in question were regrouped in a special book of the new Law. The book intentionally begins with a list of the obligations relating to the organisation and internal controls which those entities must establish. The legislation thus clearly indicates that these are essential conditions which these entities must first meet if they are to satisfy the legal obligations concerning vigilance over business relationships and transactions. These vigilance obligations, which include the identification and verification of the identity of the persons involved, knowledge of the customer, and of the purpose and nature of the business relationship or transaction, and constant vigilance in that regard, are now entirely governed by the principles of the risk-based approach. That approach permits less stringent preventive measures if the ML/TF risks are low, but stipulates tougher measures if those risks are high. The general adoption of this approach is intended to permit the optimum allocation of the prevention resources. In addition, the characteristics of this approach are now spelt out more clearly than before. In particular, the Law specifies that this approach must lead to a global risk assessment the results of which must be reflected in the internal policies and procedures of the entity concerned, combined with an individual assessment of the risks associated with each customer and intended to ensure that the vigilance measures applied are in keeping with the level and nature of those risks.

Similarly, the Law requires the supervisory authorities, including the Bank, to modulate the frequency and intensity of their supervisory functions according to the risk profile of each entity subject to supervision. That profile has to be ascertained by an assessment of the inherent risks confronting each entity on account of its own characteristics, combined with a risk management assessment taking account of the measures aimed at risk reduction and the degree to which those measures conform to the legal and regulatory obligations.

## 1.2 Bank Regulation of 21 November 2017

On 21 November 2017, to supplement this new legislative framework as required by the new Law, the Bank adopted a new Regulation [1] specifying the requirements to be met by the internal organisational arrangements of financial institutions under its jurisdiction, their general risk assessment process and their internal control measures and procedures. Unlike the Regulation that it replaces, this new Regulation no longer contains provisions on the duty of vigilance, as the obligations on that subject are now set out in full by the Law.

## 1.3 Implementation of the new legal and regulatory framework

As stated above, the overall risk assessment which the entities concerned must carry out and the adaptation of their internal prevention systems according to the risks identified are crucial elements of the new legal and regulatory framework. The Bank therefore decided to carry out checks without delay on all financial institutions under its jurisdiction. Accordingly, it requested all financial institutions to submit summaries of the results of their overall risk analyses, the weaknesses detected in their preventive systems, and the measures taken to remedy those weaknesses within a reasonable timescale [2].

## 1.4 Operationalisation of risk-based supervision

At the same time, without waiting for publication of the new Law, the Bank refined the tools at its disposal to base its checks on its risk assessment. Thus, to supplement the annual questionnaire concerning measures to combat ML/TF, hitherto focusing mainly on the level of conformity with the Laws and Regulations, the Bank requested financial institutions to supply relevant information on the inherent ML/TF risks that they face, taking account of sectoral differences [3]. The Bank also developed a tool enabling it to ascertain the risk profile of each of these financial institutions on the basis of all the available information. In accordance with the new Law, this approach has already enabled the Bank to determine its supervision priorities from 2017 onwards. On the basis of its experience, it thus produced a new periodic questionnaire including both questions on the inherent risks and on conformity with the new legal and regulatory framework, and questions designed to assess the effectiveness of the preventive measures applied by each supervised financial institution [4]. This new questionnaire, together with diversification of the

(1) National Bank of Belgium Regulation of 21 November 2017 on the prevention of money-laundering and terrorist financing, approved by the Royal Decree of 10 December 2017.
(2) Circular NBB_2018_02 of 24 January 2018 on the overall risk assessment of money-laundering and terrorist financing risks.
(3) Circular NBB_2017_15 of 24 April 2017 – Reporting on inherent risks related to money-laundering and terrorist financing to which financial institutions are exposed.
(4) Circular NBB_2018_01 of 15 January 2018 – Periodic questionnaire on combating money-laundering and terrorist financing.

information sources and additional improvements to the analysis tools, will enable the Bank to further enhance the quality of its risk-based approach.

## 2. Quality assurance

The Quality Assurance Unit set up in 2016 aims to give the Bank the assurance that its prudential supervision and resolution activities (in both the national and the international context) meet the quality requirements in terms of homogeneity and consistency, timeliness, accuracy, and conformity with the regulatory framework and best practices, which promote effective, efficient and rigorous supervision.

The strategic priorities, the intervention scope and the tools available to the Quality Assurance Unit, which reflect in operational terms the aims described above, and which were described in the Report 2016 [1], continue to apply. The Quality Assurance Unit is currently continuing to work on the definition of its framework in order to progress towards a definitive operating method. In that connection, the intention is to define, in consultation with the various services concerned, a QA universe which will clearly specify the processes and activities of the various services operating in prudential supervision and resolution, but also to finalise in the near future a QA framework, which will structure the activities directly carried out by the Quality Assurance Unit and will also aim to provide methodological support for all the players concerned, whether their work is aimed primarily at improving the quality of their operation, or whether they act in the context of their day-to-day supervision activities.

The quality assurance work in the field of bank supervision, conducted as a priority in response to the ECB's expectations on the subject in the context of the SSM, continued in 2017 and focused in particular on the processes, procedures and checks applied in the operational services responsible for the supervision of less significant institutions (LSIs). A key development area which will become still more important in 2018 concerns managing and coordinating a network of quality assurance correspondents from the Bank's operational supervision and resolution services. A new platform was thus established for the regular, structured exchange of information concerning quality, but also for the purpose of determining, in consultation with the services concerned, any measures needed to improve quality in order to ensure that these services can work as effectively and efficiently as possible to achieve the four objectives stated above.

## 3. FinTech

### 3.1 Fintech contact point

Given the market's increased interest in innovation in financial technology, in 2017, the Bank established a single point of contact for FinTech on its website [2], in collaboration with the FSMA. The establishment of this contact point is in line with the strategy of the Minister of Finance and the HLEG on the future of the Belgian financial sector, which aims to promote Brussels as a financial centre. The contact point operates as an access channel to the supervisory authority for questions on the legislation governing the provision of financial services in Belgium. The target group comprises institutions that have exploratory questions on the provision of new and innovative financial products or services and which may require an authorisation by the regulator. The purpose of the contact point is therefore to function as a single, convenient point of contact for dealing with the various questions raised; the questions are either answered directly or forwarded to the appropriate contact persons. In that regard, the contact point acts as a facilitating entity and should not be considered a mandatory route for questions on FinTech.

Since the contact point was set up on 25 April 2017, there have been meetings on a regular basis with external parties who had questions on the legislative framework. Some of the enquiring parties were considering setting up a business, whereas other parties, including existing firms, were examining whether they should offer new financial services. The contact point staff found that the majority of the questions asked concerned the provision of payment services and, to a lesser extent, the creation of on-line exchange platforms for virtual and digital currencies. The main factor driving this trend is the second European Payment Services Directive (PSD2), which came into force at the beginning of 2018. Among other things, the Directive introduces new payment services and opens access to payment accounts for institutions approved for that purpose (see section F.2.). Most parties also had questions on the legal qualification of the services that they are considering offering, and the legal requirements related to the provision of those services in Belgium.

The contact moments with FinTech firms revealed that start-ups need to invest heavily and need to have substantial capital available to attain the necessary size on

(1) See section F.2. under "Prudential regulation and supervision" in the Report 2016.
(2) The central point of contact for FinTech has its own web page on the Bank's website: https://www.nbb.be/en/financial-oversight/general/contact-point-fintech.

their market. One of the key reasons for this is that a sufficient volume of users needs to be attracted for the firm to become profitable from the provided services.

In consultation with the organisations representing start-ups in the financial sector, an analysis was also conducted to identify the main obstacles that those firms encounter in expanding their activities. This analysis showed that the requirements concerning appropriate internal control systems were seen as a stumbling block by firms that have a limited number of full-time equivalents employed. Furthermore, although the necessary injections of capital are deemed to be significant, the sector does not perceive them as a constraint. Next, the analysis highlighted that a large part of the sector was unfamiliar with the various regulatory frameworks applicable to the financial sector. The single point of contact therefore often needs to provide regulatory guidance, thereby clearly explaining the authorisation procedure and qualifying the envisaged services. The Bank will continue to work on improving the visibility of the contact point in order to foster a dialogue between the supervisory authority and the sector. For that reason, in view of the potential influence of the new technologies on the Belgian financial market, a questionnaire was sent out during the year under review to the various players on the market, including the banking and insurance sector and payment institutions, to obtain additional information on the impact of FinTech and the digital transformation. This horizontal survey was aimed to gain a better understanding of the attitudes of the various players towards FinTech, the potential impact of these developments on their business model, and the measures they envisage for keeping up with developments.

### 3.2 Digital currencies

Digital currencies issued by the private sector (such as bitcoin) are different from regulated electronic money [1] in that they are not issued against a deposit of funds, and they have no fixed value in relation to a currency which is legal tender, such as the euro. Their issuers are not subject to the surveillance of the supervisory authorities and do not need authorisation to pursue their activities. Transactions in private digital currencies, both purchases of such currencies on exchange platforms and the transactions in which they are used as a means of payment, therefore take place outside the regulated financial system. They are called "currencies" because in some cases they can be used as a means of payment, but they do not have all the economic and legal characteristics of money. They are not genuine units of account, as it is only in very exceptional cases that prices are expressed directly in a private digital currency, and they cannot be regarded as a store of value, particularly on account of their price fluctuations. Moreover, they are not legal tender, nor do they have any discharging power. Creditors are therefore not required to accept them in settlement of debts (see box 1 under "Economic and financial developments" in this Report).

The escalating price of the bitcoin in 2017 once again attracted the attention of the media and the public to this phenomenon. The Bank, which had already stressed the risks that holders of these currencies incur in a warning published in 2014 and reiterated in 2015, continues to keep a close watch on developments in this sphere. The use of these currencies as a means of payment still appears marginal in Belgium. However, their use for criminal purposes or for terrorist financing has prompted the Belgian and European authorities to consider imposing rules on intermediaries who facilitate the conversion of private digital currencies into official currencies, the aim being to combat money-laundering and terrorist financing.

## 4. Cyber risks

### 4.1 Continuing rise in cyber threats

During the year under review, the already strongly computerised financial sector continued to digitalise its business processes. The degree of interconnection between the operational processes of the various financial players also remained very high. Furthermore, financial institutions increasingly opt for business models in which IT services are outsourced, according to operational or functional specialisation. Customers' access channels to financial institutions and FMIs are becoming increasingly digitalised and more diverse, yet another factor rendering the financial landscape more complex and leading to a higher operational risk level.

Cyber attacks directed at financial sector targets are becoming increasingly sophisticated and causing ever more damage (see box 17). The number of attacks compromising the integrity or confidentiality of IT systems and data is also on the rise. Cyber attacks may originate within or outside the institution, and the attackers may have various motives, such as financial theft, geostrategic espionage, and sabotage inspired by terrorist or militant ideas. This diversity makes it very difficult for financial institutions and FMIs to ensure that their IT systems, data and services are

(1) As defined in European Directive 2009/110/EC on the taking up, pursuit and prudential supervision of the business of electronic money institutions.

adequately protected against all types of attacks. Since cyber threats are evolving very rapidly, defensive capabilities of institutions and FMIs must be more flexible than ever in responding to changing patterns of attacks. It is vital to have solutions for collecting information on potential threats, attackers, and types of attack. One example of such a solution is the electronic portal installed by Febelfin in 2016 to facilitate the exchange of information on cyber security between all parties concerned.

It is also useful for financial institutions to know the risk profile of the customer and/or counterparty when it comes to determining the fraud risk for specific transactions. In retail banking, this is being achieved for example by integrating security mechanisms in the internet or mobile banking applications. In the context of correspondent banking activities, the Customer Security Programme (CSP) currently being implemented by SWIFT is an important example of a development aimed at facilitating risk assessment.

### Box 17 – Some examples of cyber security incidents in 2017

*Lloyds Banking Group:* in January, a number of major banks in the United Kingdom experienced a wave of Distributed Denial of Service (DDoS) attacks lasting for three days. These attacks caused partial non-availability of digital channels, but did not result in any fraud or data leaks.

*Operation Cloud Hopper:* in April, PwC conducted a study on Operation Cloud Hopper which shows how providers of IT services (such as cloud services) were hacked in order to spy on their customers and steal confidential documents. There are no direct indications that financial institutions were targeted, but the *modus operandi*, namely attacking indirectly via the IT service supply chain, is worrying.

*Wannacry/Petya/NotPetya/Nyetya/Goldeneye:* from May, a series of large-scale ransomware incidents have been observed. Ransomware is malware which digitally encrypts a user's data until the victim pays a ransom (generally in bitcoin). The various versions of ransomware are probably based on a source code previously stolen from the US National Security Agency. Belgian financial institutions proved adequately protected against this wave of attacks, but a number of foreign institutions suffered serious difficulties.

*Equifax:* in July, the personal data of 143 million American residents were stolen from Equifax, a credit-rating company. The data leak caused a significant fall in the company's stock market value.

*Silence Trojan:* in November, Kaspersky Lab discovered the malware Silence Trojan, which targets financial institutions and is similar to Carbanak. According to Kaspersky, in 2015, up to 100 financial institutions (particularly in Eastern Europe and Russia) were infected with the Carbanak malware which, they claim, may have resulted in fraud amounting to $ 1 billion. In this type of attack, fraudsters attempt to penetrate financial institutions directly, to then accumulate knowledge of the victim's internal systems over prolonged periods (several months) before proceeding to act and stealing substantial sums. At this stage, it is not known whether Silence Trojan has already claimed any victims.

During the year under review, as in previous years, cyber risks formed the subject of ever closer attention in the financial sector. Assessing cyber risks and promoting control of those risks are also top priorities for the prudential supervision and oversight of financial institutions and FMIs. At individual level, institutions are being strongly encouraged to continue stepping up their measures and efforts to protect against cyber risks. Cross-sectoral cyber risk management strategies under development in Belgium and abroad also remain a focus of attention.

### 4.2 Recommendations on cyber resilience

On 1 January 2016, the Circular[1] on the Bank's expectations concerning the operational continuity and security of systemically important institutions came into force. Cyber resilience is a major theme addressed in

(1) Circular NBB_2015_32 of 18 December 2015 on additional prudential expectations concerning the operational continuity and security of systemic financial institutions.

this Circular. The Bank also made an active contribution to establishing a European regulatory framework for the management of IT risks and cyber risks under the aegis of the EBA. That work culminated in the EBA's publication of guidance for supervisory authorities on the assessment of the ICT risk in the SREP of credit institutions and investment firms [1] and recommendations on outsourcing by financial institutions to cloud service providers [2]. Finally, the EBA published technical standards, guidance and recommendations in the context of the second European Payment Services Directive (PSD2), where cyber-security-related risks are being addressed.

In June 2016, the CPMI and IOSCO had published guidance [3] on cyber resilience for FMIs that entered into force immediately. In September 2017, the CPMI published a discussion note [4] presenting a strategy aimed at reducing the fraud risk in wholesale payments, and developing measures to prevent, detect and remedy fraud, by providing for proper communication on the subject by all public and private sector players concerned. As co-chair of this CMI working group, the Bank made a significant contribution to that note. In the near future, the CPMI will draw up recommendations spelling out the proposed strategy.

One of the main attention points in prudential regulation and oversight recommendations is the need for the management of cyber risks by the financial players. Controlling cyber risks not only depends on implementing technology solutions, but also entails sufficient attention to address threats that originate from within the organisation, either by employees or management. Financial players must make their staff aware of cyber risks so that they know how the risk can arise and how they should respond. Likewise, the management bodies must have the necessary expertise and information to be able to monitor cyber threats effectively and keep them within acceptable limits.

The publications mentioned above likewise recommend that financial players conduct tests to assess their degree of resilience against cyber threats. Those tests are becoming increasingly sophisticated and in some jurisdictions they are based on specific frameworks comprising a harmonised test methodology. The Bank is actively monitoring developments in this area to ensure that sound management practices in this regard are also being established in Belgium, taking into account any relevant European or international initiatives on the subject.

(1) EBA Guidelines on ICT Risk Assessment under the Supervisory Review and Evaluation Process (SREP).
(2) EBA Recommendations on outsourcing to cloud service providers.
(3) CPMI-IOSCO guidance on cyber resilience for financial market infrastructures.
(4) BIS, Discussion note – Reducing the risk of wholesale payments fraud related to endpoint security – consultative document, September 2017.

## 4.3 Operational activities

The Bank devotes specific attention to cyber risks as part of its prudential supervision and oversight work, on the one hand focusing on the security posture of individual financial institutions and FMIs and the confidence that they inspire, and, on the other hand, on the situation of the sector as a whole.

The approach to address cyber risk management at individual institutions is two-pronged. First, institutions are required to hold capital to cover their exposure to operational risks, including cyber risks. Second, the operational security and robustness of the critical processes of financial institutions and FMIs are subject to close monitoring. The availability, integrity and confidentiality of the IT systems and data play a central role here. In 2017, the Bank conducted a number of inspections to check the supervised entities' compliance with the regulatory framework and the proper management of their IT systems in relation to cyber risks. In addition, the Bank also monitors cyber risks at financial institutions and FMIs on an ongoing basis as part of its continuous and recurrent supervisory activities.

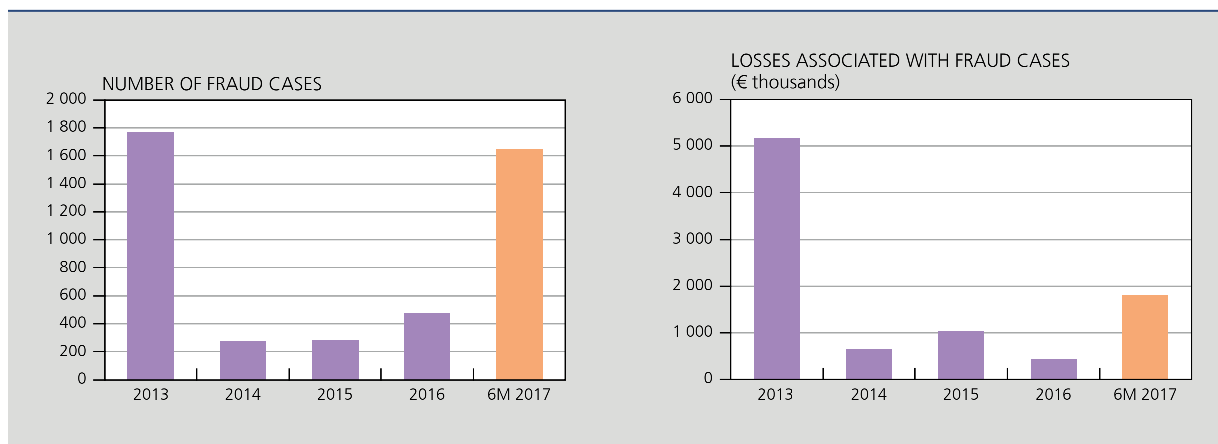
The Bank also devotes the necessary attention to sector-wide initiatives concerning cyber risks. An important example in this regard is its contribution to the development of a framework for ethical hacking (red teaming), an initiative linked to the objectives of both the Belgian Financial Sector Cyber Advisory Council and the ECB's FMI Cyber Security Strategy. In the SSM, a framework for reporting cyber risk incidents was set up in 2016, and sector-wide surveys and analyses on cyber themes are being conducted on a regular basis.

## 4.4 E-banking fraud

In 2017, the Bank continued its close cooperation with Febelfin and other parties to jointly follow up on e-banking fraud and to continue raising consumers' awareness on the subject. Despite these efforts, it was noted that the number of e-banking fraud cases and the associated financial losses increased considerably in the first half of 2017.

As in previous years, reported cases of e-banking fraud among consumers in 2017 were due almost exclusively to fraud techniques whereby cyber criminals deceive users of e-banking into disclosing their personal security codes (usually after a telephone call or via a malicious website). The rise in fraud cases in 2017 is therefore attributable to an increase in the number of attacks rather than the use

**CHART 93** E-BANKING FRAUD




Source: Febelfin.

of innovative fraud techniques. Here, too, the Bank keeps a very close watch on recent developments concerning authentication techniques for payments.

## 5. Developments in governance, reporting and auditors' cooperation in prudential supervision

The year under review saw the Bank adopt and publish a number of new normative documents on governance, reporting and auditors' cooperation in prudential supervision. In a first Circular, supervised undertakings are asked to implement a number of recommendations concerning their internal organisation to ensure that the supervisory authorities are sent prudential and financial data that meet high-quality criteria. The second Circular defines the auditors' duty to cooperate in prudential supervision. There are some major changes here in regard to the auditor's obligations concerning periodic reporting to the supervisory authority, both for the planning of its supervisory tasks and for their execution. A third Circular concerns the updating of credit institutions' and insurers' reporting obligations to the supervisory authority on loans to senior management, shareholders and/or related persons. Finally, the Bank also adopted a new version of the Circular and the Communication on the prudential assessment of acquisitions and increases in qualifying holdings in financial sector entities, in accordance with the common guidelines drawn up by the EBA, EIOPA and the European Securities and Markets Authority (ESMA). Mention should also be made of the legislative work aimed at strengthening the "fit and proper" framework and in relation to the conditions on performance of the compliance function.

### 5.1 Data quality Circular

In connection with their prudential supervision work, the supervisory authorities (the Bank, the ECB and – depending on the case – the EBA or EIOPA) periodically collect prudential and financial data from all institutions subject to their supervision. This reporting takes place at both national and European level.

For prudential supervision, good-quality reporting is essential: it ensures that the supervisory authority can conduct a solid, comparable analysis of the reported data and maintain a soundly-based dialogue with the institutions.

As the institutions are responsible for the quality of the data reported for prudential supervision purposes, the Bank deemed it useful to issue a set of recommendations to the institutions under its supervision, stating its expectations as regards prudential reporting quality.

For that purpose, a Circular [1] was adopted, setting out the criteria for assessing reporting quality. Those expectations concern not only the submission of the reports but also their content. They also include the various quality rules on reporting, drawn up by the supervisory authorities.

In addition, this Circular specified the prudential expectations regarding the internal organisation of institutions for the preparation and submission of prudential reports. Implementation of the principles of this Circular will at least ensure conformity with the quality requirements defined in

(1) Circular NBB_2017_27 of 12 October 2017 on the Bank's expectations as regards quality of reported prudential and financial data.

the regulatory framework on reporting. Accredited auditors are asked to examine compliance with these prudential expectations in the six-monthly reporting checks.

## 5.2 Duty of cooperation of accredited auditors

In view of the societal importance of financial institutions and insurance companies, auditing duties can only be entrusted to auditors approved for that purpose by the Bank. In addition, the sectoral laws stipulate that accredited auditors must, on their own exclusive responsibility, cooperate in prudential supervision. That obligation implies that they perform certain specific tasks, which are spelt out in a new Bank Circular[1].

That Circular replaces an earlier Bank Circular dating from 2012, although the latter's structure has been largely retained. First, the Circular takes account of the new legislation which has entered into force since the publication of the previous Circular and which applies to credit institutions, investment firms and insurers/reinsurers respectively. The Circular now also includes the details of the duty of cooperation in the case of accredited auditors of electronic money institutions.

In addition to the necessary regulatory updates, a number of changes were made in order to augment the value added of the accredited auditor's role in the confirmation of periodic financial reporting. Thus, in the course of their activities, auditors are asked to focus particularly on a number of sector-specific prudential points for attention. The importance of the accredited auditor's role in ensuring the quality of the figures is also emphasised (see also section G.5.1). Furthermore, accredited auditors of general interest entities (credit institutions, insurers and reinsurers, settlement institutions and entities equivalent to settlement institutions) are required to submit their audit plans systematically to the supervisory authority and to produce supplementary reports, notably on important subjects which attracted their attention in the course of their work.

The new Circular also takes account of the changes resulting from the entry into force of Solvency II. The accredited auditor's duties regarding periodic statements are complicated by the fact that the Solvency II legal framework is no longer based on the accounting framework (BE GAAP/IFRS), the traditional point of reference for this work. Only the parts of the Solvency II reporting that permit a better understanding of the institution's financial situation are included in the external audit, unlike the parts prepared primarily for statistical purposes. From now on, accredited auditors must take account of the reporting introduced under Solvency II for the work of assessing internal control measures.

Finally, the Circular conforms to the guidelines published by both the EBA[2] and EIPOA[3] on communication and dialogue between the supervisory authority and statutory auditors.

## 5.3 Loans, credit and guarantees to managers, shareholders and related persons

Article 72 of the Banking Law and Article 93 of the Solvency II Law define the legal framework for loans, credit and guarantees granted to managers, shareholders and related persons. These legal provisions prescribe reporting to the supervisory authority.

The adoption of the Banking Law in 2014 and the Solvency II Law in 2016 fundamentally changed the legal regime. In view of these and subsequent changes, it was necessary to replace the old 1994 Circular[4] on the subject.

The new Circular[5], aimed at both the banking sector and the insurance sector, sets out the legal provisions and clarifies the way in which institutions must fulfil their annual reporting obligations to the supervisory authority. In the annex to the Circular, tables provide the supervisory authority with a complete picture of the total outstanding amount in relation to a particular person or institution.

Credit institutions must submit their report to the supervisory authority before the end of February in the following year. Insurance undertakings must submit these tables in conjunction with the updated governance memorandum, with due regard for the deadlines stated in the eCorporate 2016/40 Circular.

## 5.4 Supervision of qualifying shareholders

On 5 May 2017, the EBA, EIOPA and ESMA published new joint guidelines on the prudential assessment of acquisitions and increases of qualifying holdings in the financial sector entities.

(1) Circular NBB_2017_20 of 9 June 2017 on the duty of cooperation of accredited statutory auditors.
(2) EBA Guidelines of 7 November 2016 on communication between competent authorities supervising credit institutions and the statutory auditor(s) and the audit firm(s) carrying out the statutory audit of credit institutions.
(3) EIOPA Guidelines of 2 February 2017 on facilitating an effective dialogue between competent authorities supervising insurance undertakings and statutory auditor(s) and the audit firm(s) carrying out the statutory audit of those undertakings.
(4) Circular D1 94/5 of 28 November 1994 on loans, credit and guarantees to managers, shareholders and related persons.
(5) Circular NBB_2017_21 of 7 July 2017 on loans, credit and guarantees to managers, shareholders and related persons.

Following that publication, the Bank revised its regulatory framework on shareholder supervision for (a) credit institutions under Belgian law, (b) insurance and reinsurance undertakings under Belgian law, (c) investment firms under Belgian law, (d) financial holding companies under Belgian law, (e) insurance holding companies under Belgian law, and (f) mixed financial holding companies under Belgian law.

The Communication[1] published by the Bank in September 2017 replaces the 2009 Communication[2] and forms the new reference framework for acquisitions, increases, reductions or transfers of qualifying holdings in the capital of one of the aforesaid financial entities. It provides all persons concerned with the necessary information for submitting their plans to the supervisory authority (the Bank or the ECB, depending on the case), and clarifications concerning the rules of procedure and assessment criteria that the supervisory authority will apply.

The main changes compared to the 2009 version concern (a) extension of the scope of the Circular, (b) redefinition of the concept of an indirect shareholding, (c) updating of the information required to assess the integrity of candidate shareholders who are natural persons and the effective management of shareholders who are legal persons, and (d) reinforcement of the requirements concerning continuous shareholder monitoring.

To supplement this Communication, the Bank published on the same day a new Circular[3] for the attention of financial entities in which it specifies the arrangements for implementing the occasional and periodic notification obligations that these financial entities are required to fulfil concerning their shareholders. That Circular replaces the 2009 Circular[4] on the same subject.

## 5.5 HLEG recommendations on fit and proper and compliance

The 2016 report of the High-Level Expert Group (HLEG) on the future of the Belgian financial sector (see also chapter B above) contains a set of recommendations on strengthening governance in financial institutions. Subsequently, proposals were drawn up in consultation with the various stakeholders concerning the fit and proper assessment of senior management and the compliance function in financial institutions. That process resulted in changes to various sectoral laws.

In regard to "fit and proper", members of the statutory governing body, persons who effectively run the undertaking, and those responsible for independent control functions must at all times have the necessary professional integrity and sufficient expertise to perform their function. The legislative changes aim to reinforce the permanence of those requirements.

On the one hand, they introduce the obligation to inform the supervisory authority immediately of anything implying a change in the information supplied at the time of the appointment which could affect compliance with the fit and proper requirements. This list is not exhaustive, but it may include new, relevant facts or information such as investigations initiated by the administrative or judicial authorities in the broad sense (including investigations into facts which could give rise to disqualification), information which could lead to disciplinary sanctions, etc.

They also enable the supervisory authority to decide to reassess the fit and proper character of those concerned on the basis of findings or analyses conducted during the exercise of its supervisory mission, or if it has new information relevant for the assessment of them. That reassessment may, for example, result in reports or findings demonstrating a negative or hostile attitude towards generally accepted good practices (e.g. regarding the transparent and complete disclosure of information to the statutory governing body), recurrent or deliberate disregard of supervisory authority recommendations, a proven non-availability for attending meetings, the supply of incomplete or incorrect information to the supervisory authority or shareholders, an uncooperative attitude towards the supervisory authority, etc. This incorporation of the fit and proper policy into the continuous supervision of institutions is in line with the international and European trend towards making the top management more responsible for its actions or omissions. For instance, in its guide to fit and proper assessments, the ECB stresses the importance of new facts relating to performance of the function which may generate doubts about the staff member's ability to ensure the sound and prudent management of the institution.

The legislative changes concerning compliance aim to provide a stronger framework for this function in order

(1) Communication NBB_2017_22 to candidate shareholders and assigning shareholders.
(2) Communication CBFA_2009-31 of 18 November 2009 to persons intending to acquire, increase, reduce or sell a qualifying shareholding in the capital of financial institutions.
(3) Circular NBB_2017_23 of 22 September 2017/Circular to financial institutions concerning acquisitions, increases, reductions and transfers of qualifying holdings.
(4) Circular CBFA_2009_32 of 18 November 2009 to financial institutions concerning acquisitions, increases, reductions and transfers of qualifying holdings.

to promote the integrity of institutions and confidence in the financial sector in general. More specifically, they concern :

– specifying the responsibility of the statutory governing body in drafting the integrity policy ;
– stipulating that the statutory governing body must submit an annual report to the supervisory authority on the assessment of the proper functioning of the compliance function ;
– in cooperation with the FSMA, enabling the Bank to make those in charge of the compliance function subject to the same minimum criteria concerning expertise as those already implemented by the FSMA.

On this last point, the Bank and the FSMA have developed a joint approach to encourage harmonisation of the requirements of the two supervisory authorities for the assessment of the expertise of those in charge of the compliance function. The Bank set out that approach in a draft Regulation. The FSMA also drew up a Regulation amending its previous Regulation of 27 October 2011 on the approval of compliance officers.

The Bank's draft Regulation begins by listing the requirements for the assessment of the expertise of the person responsible for the compliance function, the main new requirement being that the person must pass an examination at a training centre approved by the Bank and the FSMA. Next, it describes the rules on approval of the examination, which will form the subject of a protocol of collaboration between the two supervisory authorities to ensure the effective and consistent implementation of the Regulation. Finally, it contains a number of essential transitional measures.