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.

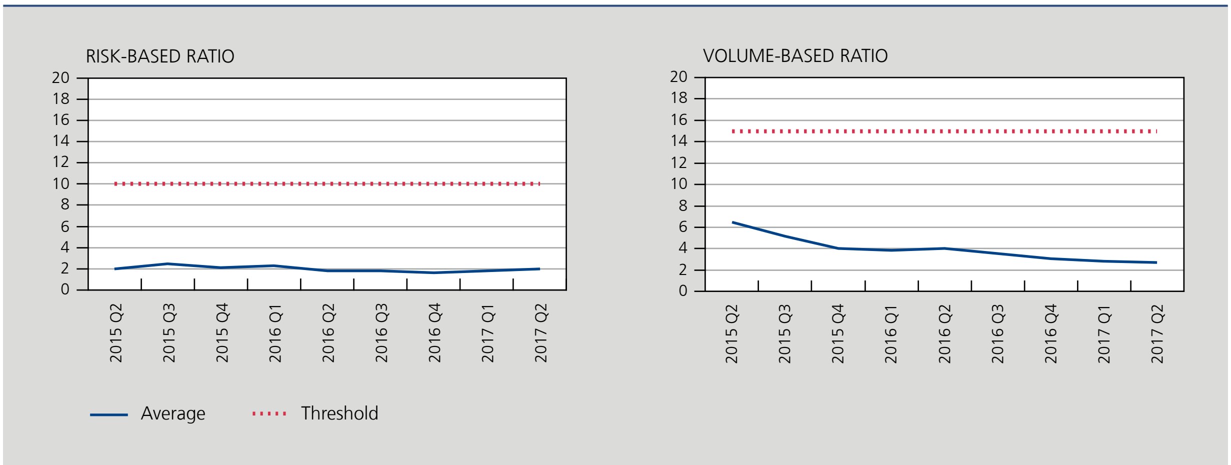
The Belgian Banking Law prohibits Belgian credit institutions which collect deposits or issue debt instruments covered by the Belgian deposit protection system from engaging in proprietary trading activities and certain very high-risk trading activities. However, five categories of trading activities 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

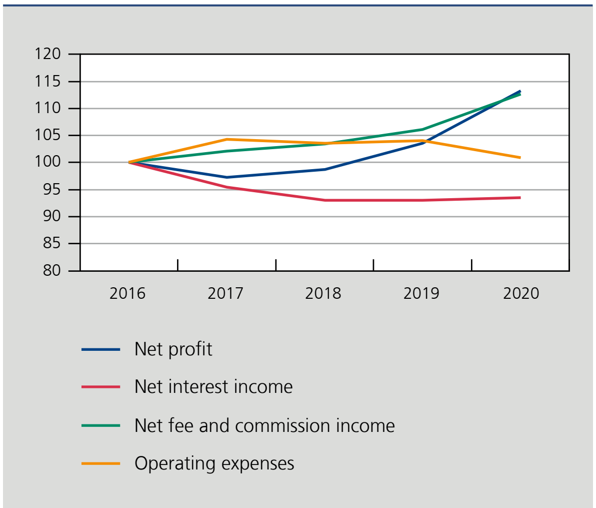
The Bank regularly monitors the various risks confronting the banking sector. These general analyses cover subjects such as developments in credit institutions' balance sheets, profitability, and solvency and liquidity positions. For several years now, the Bank has been keeping a close eye on developments 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

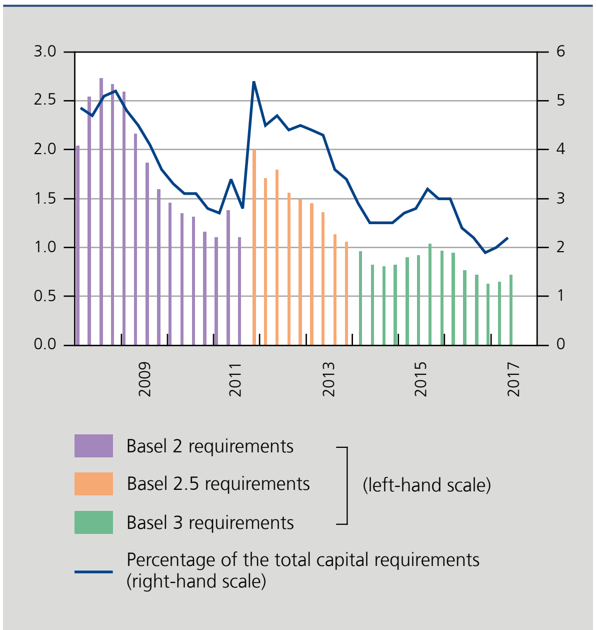
(1) Credit valuation adjustment (CVA) risk : risk of loss caused by changes in a counterparty's credit risk premium due to a change in its credit rating, or in other words in the market value of the counterparty's credit risk.

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.

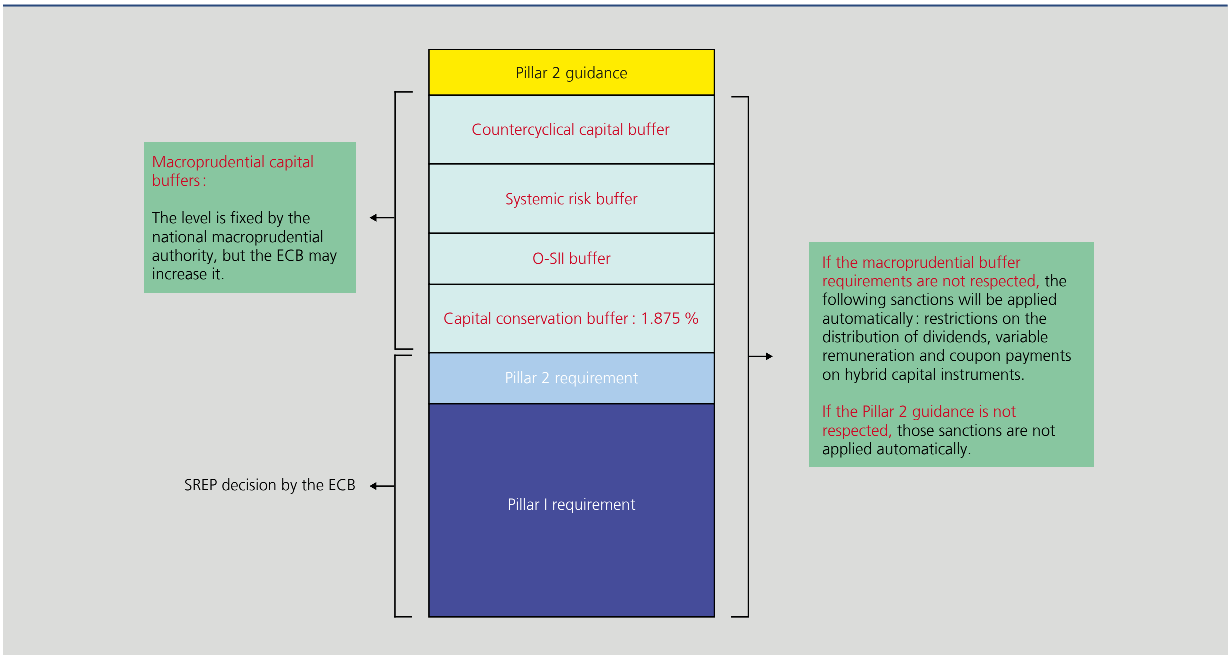
2.2 SREP methodology and results

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.

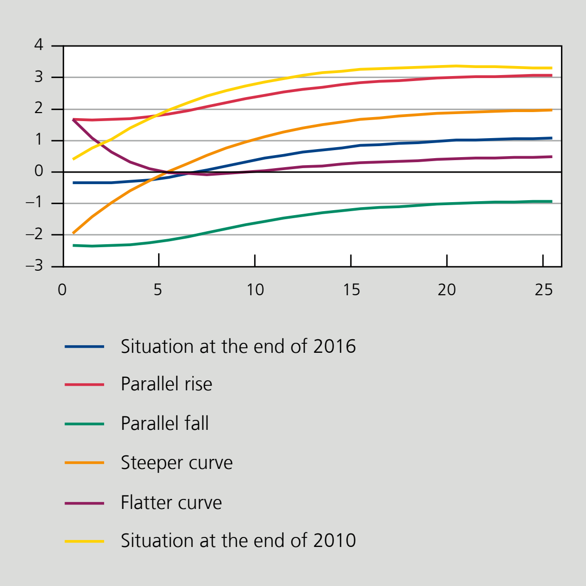
For the 2017 SREP decision, applicable in 2018, and more particularly for the Pillar 2 guidance, the SSM did not conduct a full stress test as in 2016, but conducted a detailed analysis of the interest rate risk sensitivity of the banks subject to its supervision (see box 12 below). The results of that 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



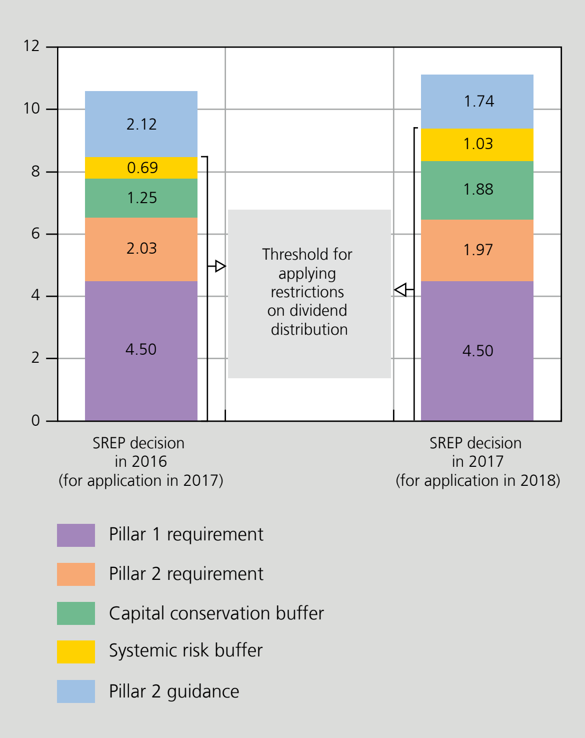
Source : ECB.

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.