

D. Banks and stockbroking firms

Under the SSM, new initiatives were taken in parallel with those of the European Commission to address the persistently high level of non-performing loans in certain countries, and the banks underwent a new SREP assessment. New stress tests were coordinated at European level by the EBA, and in Belgium by the Bank.

At national level, horizontal analyses focused particularly on the risks associated with interest rates, financing, liquidity and the business models of Belgian banks. On-site inspection missions examined the governance, business models and main risks present in credit institutions. In particular, the missions concerning internal models formed part of the TRIM project set up at SSM level, and among other things focused on credit risk and market risk.

Developments concerning banking regulation took place mainly at the European Union level, where work continued at a steady pace to strengthen the Banking Union and the Capital Markets Union. At global level, following the conclusion of the Basel III agreement at the end of 2017, the work of the Basel Committee on Banking Supervision focused more on the implementation and assessment of the Basel III reforms and on the scope for regulatory arbitrage. At Belgian level, the Bank published a new Circular and updated its governance manual.

1. Mapping of the sector, supervision priorities and operational aspects

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

While the bank population remained stable overall at 105 institutions in 2018, the number of credit institutions governed by Belgian law was down by two units at 32. This decline concerns two banking subsidiaries which merged with their Belgian parent bank. Conversely, the population of branches of European credit institutions increased in net terms by one unit (four new approvals and three licence withdrawals).

These movements seem to bear out a number of underlying trends. First, consolidation has been steadily taking place for several years in the segment comprising Belgian banks which apply a relatively traditional business model (private customers and SMEs served by a hybrid distribution network with both physical outlets and internet access). This

consolidation often stems from the need to achieve economies of scale and rationalise costs in order to bring the existing distribution channels more into line with the digital future. It should be noted that a series of licence applications are currently being examined for new banks which intend to offer a range of almost exclusively digital services, aimed at specific niches such as private banking, or a broader public for ordinary banking transactions.

In regard to branches, some banks are reconsidering their location in the European Union and in the euro area, not only in the context of the United Kingdom's departure from the EU, but also as part of a more

The ongoing consolidation stems from the need to rationalise costs, and the desire to bring the existing distribution channels more into line with the digital future

general effort by the banks to adapt their geographical position to commercial needs.

In most cases, the branches have a small target group of professional counterparties, and their market share is modest. However, completion of the Banking Union is likely to bring a more fundamental reorganisation of the banking landscape in the euro area and in Belgium, which will probably be accompanied by an increase in the number of branches targeting the banking needs of individuals and other non-professional counterparties as regards payments, savings and investment.

In the euro area, banking supervision is exercised by the SSM, which is based on cooperation between the ECB and the national banking supervision authorities of the euro area. The ECB exercises direct supervision over all significant institutions (SIs) with the assistance of 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, 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 15 banks; that number goes up to 19 if financial holding companies and financial services groups of less significant institutions are included.

Table 20

Number of institutions subject to supervision

(end-of-period data)

	2017	2018
Credit institutions	104	105
Under Belgian law	34	32
Branches governed by the law of an EEA member country	46	47
Branches governed by the law of a non-EEA member country	8	8
Financial holding companies	5	6
Financial services groups	5	5
Other financial institutions ¹	6	7
Investment firms	32	32
Under Belgian law	19	17
Branches governed by the law of an EEA member country	11	14
Financial holding companies	2	1

Source: NBB.

¹ Specialist subsidiaries of credit institutions and credit institutions associated with a central institution with which they form a federation.



Table 21

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 –
Groupe CMNE – Beobank, Banque Transatlantique Belgium	Delen Private Bank, Bank J. Van Breda & C°
ING Belgium	Shizuoka Bank
Banca Monte Paschi Belgio	United Taiwan Bank
MeDirect Bank	Van de Put & C°
Puilaetco Dewaay Private Bankers	vdk bank
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.

BOX 11**The Bank's role in the single supervisory mechanism**

Since 2014, banking supervision in Europe has been organised via the single supervisory mechanism (SSM). The SSM comprises the ECB and the national supervisory authorities of the euro area countries, including the Bank.

The SSM's main aims are to safeguard the safety and soundness of the European banking system, to increase financial integration and stability, and to ensure consistent banking supervision.

With the SSM, the decision-making process has become longer and more complex, in that prudential decisions concerning Belgian banks are no longer taken by the National Bank in Brussels but by the ECB in Frankfurt. On the other hand, the Bank is now involved in decisions taken in Frankfurt, not only for Belgian banks but for all banks in the euro area. Those decisions are prepared under a cooperative effort





between the ECB and the national supervisory authorities concerned, including the Bank. This mechanism also avoids any national bias in the decision-making process.

The Bank's role in the SSM is therefore performed at various levels. Within the SSM, decisions are taken by the ECB Governing Council (on which the NBB's Governor has a seat) on the proposal of the SSM Supervisory Board (in which the NBB's Director in charge of banking supervision represents the Bank). Depending on their nature, the decisions are prepared by Joint Supervisory Teams (JSTs), inspection teams or SSM horizontal functions.

The JSTs conduct the day-to-day supervision of significant banks. Under the SSM, each significant bank or banking group (significant institution or SI), has its own JST composed of staff of the ECB and the national supervisory authorities. The Bank takes part not only in the JSTs of banking groups which have their (European) head office in Belgium, but also in the JSTs of Belgian banks which have their principal place of business elsewhere in the euro area. There are thus 15 JSTs in which the Bank plays an active part: seven for groups which have their (European) head office in Belgium (Argenta, AXA Bank, Belfius, Degroof Petercam, Dexia, KBC, The Bank of New York Mellon) and eight for institutions headed by a parent company established elsewhere in the euro area (BNPP Fortis and bpost banque, groupe Crédit Mutuel, ING Belgium, MeDirect, Monte Paschi Belgio, Puilaetco, Santander Consumer Bank, Société Générale Private Banking).

The allocation of tasks in a JST depends on the size and structure of the banking group subject to its supervision. The Bank's staff who are members of a JST analyse the risks incurred by the banking group concerned in Belgium but also help to monitor the risks to which the group is exposed elsewhere. In larger



JSTs, which supervise the largest and most complex banking groups, there is scope for specialisation, with the JST's Belgian members concentrating, for example, on one specific risk (such as operational risk) for the banking group as a whole.

In the SSM, the ECB exercises direct supervision over the 119 SIs in the participating Member States. Together, these banks account for almost 82 % of the total banking assets of the euro area. Banks which are not considered "significant" are classed as "less significant" institutions. This mainly concerns local and specialist banks. They remain subject to the supervision of the national supervisory authorities, in close cooperation with the ECB. The Bank is thus the supervisory authority for fifteen local banks or specialist institutions (such as Euroclear).

On-site inspections of institutions subject to SSM supervision are conducted by teams comprising inspectors from the ECB and the national supervisory authorities such as the Bank. In principle, these inspection teams are led by staff of the national supervisory authority, but an inspection team may also be led by the ECB.

The SSM is supported by the horizontal functions of the ECB and the national supervisory authorities. The methodology for risk monitoring and analysis and other aspects of supervision is drawn up by committees and networks comprising experts from the ECB and national supervisory authorities such as the Bank.

The national supervisory authorities of the SSM continue to supply the great majority of the staff responsible for prudential supervision tasks. The reason lies partly in the design and organisation of the SSM, which supplemented the existing supervisory capability of the national supervisory authorities when the SSM was launched with a well-defined central supervisory capacity at the ECB. Also, the national supervisory authorities often have to cover an area of supervision broader than that specifically entrusted to the SSM. For instance, the SSM does not cover certain categories of institutions (branches of third country banks, representative agencies, stockbroking firms), measures to tackle money-laundering and tax mechanisms, structural reform of the financial market, etc.

The Bank currently allocates around 125 staff to the microprudential supervision of credit institutions and investment firms. The allocation of these resources is broken down as follows:

- a) 50 % to ongoing (off-site) supervision over each institution. This concerns analysis of the financial situation, compliance with the regulatory ratios (solvency, liquidity, balance sheet ratios, etc.), assessment of the risks to which each institution is exposed and how they are covered, and assessment of the institution's corporate governance;
- b) 30 % to on-site supervision. This concerns the inspection function, which carries out on-site inspections at institutions according to a specified audit methodology and on the basis of a predefined mission and includes checks on the models that the banks use to calculate their capital requirements;
- c) 20 % to transversal activities, such as the collection and validation of the data that institutions must submit to the supervisory authority, and support for the teams in charge of examining new licence applications and assessing the suitability of the institutions' directors and shareholders. This also concerns monitoring the way in which individual institutions incorporate new financial sector trends



in their business model (for example, as regards FinTech or the PSD2), trends which, while offering new opportunities, may also entail risks.

As mentioned earlier, the Bank also has the task of watching over financial institutions' compliance with the legislation aimed at preventing the use of the financial system for the purpose of money-laundering and terrorist financing, and the financing of the proliferation of weapons of mass destruction. That task has not been transferred to the ECB, including as regards the SIs. Finally, the ECB has certain macroprudential powers under the SSM, but that is without prejudice to the responsibility of the national macroprudential supervisory authority.

1.2 The deliverables of microprudential supervision

Microprudential supervision is conducted by various teams of staff. Some staff analyse and assess a given institution's financial situation and the risks to which it is exposed (ongoing or off-site supervision). Others conduct on-site inspections at institutions on the basis of a specific mission, using the audit methodology (on-site supervision).

Microprudential supervision is conducted by various multidisciplinary teams of staff covering ongoing supervision (off-site role), on-site inspections (on-site supervision) and checks on internal models

Finally, there are teams responsible for checking and validating the quantitative "internal" models used by certain institutions to calculate their capital requirements. This supervision cannot achieve its intended targets and results unless all the analyses, examination and monitoring lead to deliverables resulting in operational supervision decisions and actions in regard to the institution. The activities of the various functions involved are spelt out below.

Ongoing (off-site) supervision – Decision on capital

In principle, the analyses and examinations concerning a bank's financial situation and risks lead each

year to a SREP (Supervisory Review and Evaluation Process) decision. The SREP follows a common methodology and decision-making process permitting horizontal comparisons and analyses. The harmonised SREP ensures that institutions in similar situations are treated in the same way and assessed according to the same criteria.

Periodically, each institution therefore receives an individual SREP decision aimed at making continuous improvements to its position (financial situation, organisation and governance). Thus, the supervisory authorities' decisions comprise not only additional capital requirements on top of the minimum requirements, but also supplementary measures addressing weaknesses specific to the institution concerned.

Decisions are based on a combination of quantitative and qualitative elements derived from an overall assessment of the institution's sustainability, capital and liquidity. Apart from supplementary capital and liquidity requirements, SREP decisions may include quality control measures, such as the imposition of conditions or restrictions on activities, reinforcement of the internal control environment, the obligation to reduce risks, limitation or prior approval of the payment of dividends, or the imposition of supplementary or more frequent reporting obligations.

The results of the SREP decisions applicable to Belgian banks and taken during the year under review are presented in section D.2.2 below.

On-site inspections – Inspection report

The inspections supplement the ongoing supervision of institutions and aim to provide a detailed analysis of the various risks, internal control systems, business models and governance of the supervised legal entities.

They are conducted on the premises of the supervised legal entities according to a predefined scope and timetable. The inspections must be risk-based, proportionate, intrusive, prospective and pragmatic.

Under the responsibility of a head of mission, the inspection teams act independently of the teams in charge of ongoing supervision, but in coordination with them.

Unless there are special reasons for doing otherwise, the inspection process follows various defined steps detailed in the manuals used by the inspectors:

- the preparatory phase, which comprises confirmation of the availability of the parties concerned, notification of the start of the inspection to the supervised entity, and production of a preparatory memorandum for the inspection, describing the reasons justifying it and its scope and objectives. Before the meeting at the start of the inspection, the head of mission also sends an initial request for information;
- the inspection itself takes place on the premises of the supervised legal entity. The investigation phase comprises interviews and examination of procedures, reports and files. Evidence is collected in order to ensure that an “audit trail” is in place for all the weaknesses identified by the inspection team. Various inspection techniques are used: observation, verification and analysis of information, targeted interviews, process analysis, sampling/case-by-case examination, confirmation of data, etc.;
- in the report phase, the inspection’s findings are formalised in an inspection report which contains conclusions, a schedule of findings or recommendations, and a main part. Annexes may be added. It should be noted that:
 - the findings or recommendations are ranked according to their actual or potential impact on

the financial situation of the supervised legal entity, its level of capital, internal governance, and risk control and management. The reputational risk incurred by the supervised legal entity is also taken into account;

- in addition, the report gives an overall score which reflects the general assessment on completion of the inspection¹;
- the draft report is sent to the supervised legal entity a few days before an end-of-mission meeting is held, at which the inspection team presents the inspection results;
- taking account of comments received at the end-of-mission meeting², the head of mission will then finalise the draft report, which will be sent to the supervised legal entity.

The inspection reports give rise to recommendations which will be monitored by the teams in charge of the ongoing supervision of the legal entities concerned. Those teams will be responsible for monitoring the implementation of the corrective measures under an action plan defined with the supervised legal entity.

On the date set in the action plan, the monitoring phase may be ended if the measures taken by the supervised legal entity conform entirely to the monitoring request, or additional information may be requested for the purpose of adjusting the action plan.

The inspections may also result in the application of prudential measures under the disciplinary powers assigned to the regulator.

In 2018, the inspections concerned the governance, business models and main risks in the institutions subject to supervision: credit risk, market risk, liquidity risk, interest rate risk, operational risk (including IT risk), reputational risk, etc.

The inspections covered significant and less significant credit institutions (SIs and LSIs), but also

1 Inspection reports produced under the SSM do not give an overall score.

2 In the case of inspections conducted under the SSM, the supervised legal entity has two weeks to respond in writing.

investment firms and payment institutions subject to the Bank's supervision.

The prevention of money-laundering was another subject covered in 2018 by inspections of all categories of institutions subject to supervision.

Inspections on internal models

Inspections of internal models aim to assess the quality of the models that banks use to calculate their regulatory capital requirements, in the light of the regulations in force. These models should lead to better risk management.

Since the regulations governing internal models are principles-based, their assessment relies to a large extent on judgment and benchmarking in relation to other banks and current good practice. This assessment is facilitated by use of the ECB guide to internal models, which describes the SSM's interpretation of the laws relating to models.

The scope of the models reviewed covers all Pillar 1 risks (credit risk, market risk, operational risk and counterparty risk), and the economic capital models used by the banks under Pillar 2.

The inspections concerning internal models take place mainly on site and are facilitated by files supplied by the banks; the files contain all the relevant information enabling the inspectors to understand and assess the models used by the banks.

Apart from the usual inspection techniques, inspectors often use modelling of their own to quantify errors and simplifications on the part of the banks. This quantification is important to determine the severity of the weaknesses detected.

The inspection culminates in a report containing a description of the models reviewed and the weaknesses identified.

Recommendations aimed at remedying these weaknesses and a proposal for a decision (approval or rejection) are set out in a note by the inspection team and submitted to the management of the SSM. This proposal for a decision may be accompanied by a capital penalty. Decisions are followed up by the JSTs (see box 11), possibly with the assistance of the inspectors who carried out the mission.

The on-site missions conducted in 2018 continued to form part of the TRIM (Targeted Review of Internal Models) project, set up at SSM level and intended to strengthen credibility and confirm the suitability and relevance of the internal models used by SIs to calculate their capital requirements. The missions focused mainly on models for calculating the credit risk for retail customers and SMEs, and models for calculating market risk.

A last wave of missions will take place in 2019 under the TRIM. It will cover the models that SIs use to calculate the credit risk on portfolios with a historically low default rate (large firms, financial institutions, specialised lending).

Apart from these missions forming part of the TRIM, work focused on analysing credit risk models, including the pre-application work for one bank wishing to apply the internal models approach in the near future. One operational risk model was also monitored.

Horizontal analyses

In parallel with producing these deliverables, the Bank conducted various specific horizontal analyses of the Belgian banking sector (see box 12).



Horizontal analyses of the banking sector

Interest rate risk

In a low interest rate environment and owing to the possible impact of either persistently low interest rates or a sudden, rapid rise, interest rate risk has for a number of years been among the priorities in the supervision of Belgian credit institutions. The trend in the interest income of Belgian banks and the prudential parameters concerning interest rate risk are therefore analysed in detail.

Belgian banks generally have a relatively large proportion of assets on which the interest rates are fixed for a prolonged period. These assets consist predominantly of mortgage loans, financed mainly by sight deposits and savings deposits with no contractual maturity or repricing date. Consequently, Belgian banks have a relatively large average duration gap between the assets and liabilities and have to make extensive use of derivatives to hedge the resulting interest rate risk. However, the use of derivatives entails other risks, as explained in detail in the thematic article on “Derivatives and systemic risk” in the Bank’s 2018 Financial Stability Report. In addition, the banks depend heavily on behaviour models to estimate the repricing behaviour of non-maturity deposits and prepayments of mortgage loans. That implies a significant model risk, as observed behaviour may differ from estimated behaviour. Owing to the size of the duration gap, the considerable use of derivatives, and the high model risk, the Belgian banks’ exposure to interest rate risk on non-trading activities exceeds the average for the euro area banking sector, and that is also reflected in the stress tests conducted by the SSM in 2017, which aimed to obtain additional information on interest rate sensitivity of the economic value of banks’ capital¹ and their net interest income.

As also shown by the business model analysis (see below), the low interest rate environment puts pressure on Belgian banks’ interest income, as interest rates on deposits have fallen to their lowest level while interest rates received on the assets are steadily revised downwards, further exacerbated by the prepayment of mortgage loans. That is also reflected in the periodic reports that Belgian banks submit to the Bank, in which they are asked to indicate the economic value of equity and their interest income over the next three years for their banking book on the basis of various scenarios. In these calculations, banks have to take account of various set principles, including a maximum interest rate revision period for sight deposits and savings deposits, and the assumption of a constant balance sheet, so that the figures submitted can be more readily compared between the various institutions.

The chart below shows the net interest income of the Belgian banking sector from June 2012 and the estimated future interest income for the three years from June 2018 onwards according to three scenarios: constant interest rates, a 200-basis-point increase and a 200-basis-point reduction in interest rates. The chart below shows that, while a persistently low interest rate environment would depress the banks’ profitability in the years ahead, the same could apply if interest rates were to go up. Although higher interest rates, and especially a steeper slope in the yield curve, are generally

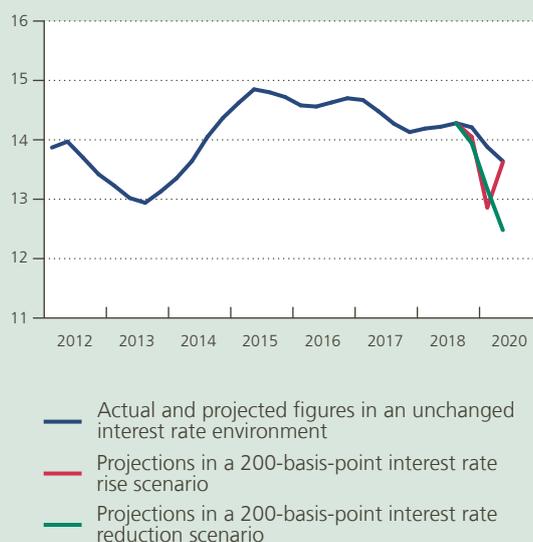
¹ The economic value of equity is the discounted value of a bank’s net assets, all cash flows being taken into account at the time of the next interest rate adjustment and discounted at a risk-free interest rate.



more favourable to the Belgian banking sector, given that their transformation margin resulting from the financing of long-term loans by short-term deposits would increase, a sudden, steep rise in interest rates could equally be disadvantageous – at least temporarily – for the banks’ interest income since the financing cost could rise sharply while interest rates on the invested assets would still remain low for some time.

Actual and projected annual net interest income of Belgian banks

(data on a consolidated basis, in € billion)



Source: NBB.

Note: The projections are derived from the Belgian banks’ periodic reporting to the Bank in which they estimate the income projected according to various scenarios defined on the basis of their internal models, taking account of certain assumptions supplied by the Bank.

In a low interest rate environment, the banks may tend to increase the duration gap, as this would widen their transformation margin and hence their net interest income if interest rates remain low. However, a bigger duration gap makes the banks more exposed to a sudden rise in interest rates.

The reporting suggests that the weighted average sensitivity of the economic value to a 200-basis-point interest rate rise¹ has increased slightly since 2014, which could indicate a slight widening of the duration gap owing to the low interest rates. However, the figures need to be interpreted with due caution.

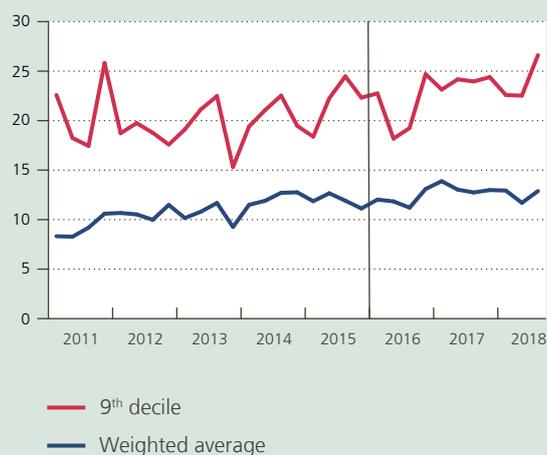
¹ In accordance with Article 98 (5) of European Directive 2013/36/EU (CRD), transposed into Belgian law by Article 143, § 1, 12°, of the Banking Law, measures must in any case be taken if a parallel change in interest rates were to reduce the institution’s economic value by more than 20% of its regulatory capital.



The banks may adopt different strategies regarding future changes in interest rates. Interest rate risk analyses aim partly to capture sectoral movements in positioning in relation to the various possible movements of the yield curve, and partly to identify banks which have excessive open positions and are therefore vulnerable to a rise in interest rates or to persistently low interest rates.

Effect of a parallel 200-basis-point increase in the yield curve on the economic value of equity

(data on a consolidated basis, in % of the regulatory capital)



Source: NBB.

Note: The projections are obtained from the Belgian banks' periodic reporting to the Bank in which they estimate the economic value of equity according to various scenarios defined on the basis of their internal models, taking account of certain assumptions supplied by the Bank. Pursuant to the Bank's circular on the interest rate risk associated with activities other than trading, adopted at the end of 2015, certain changes were made to the calculation assumptions in reporting from March 2016 onwards.

Funding and liquidity

The Bank regularly reviews the funding and liquidity of Belgian credit institutions. That review takes place annually, but the timetable and frequency may be modified during a liquidity crisis. The review of funding and liquidity is structured so as to provide information on the banks' solvency indicators (such as credit risk spreads or ratings), information on the composition of the banks' funding, and information on the banks' short-term resilience to liquidity shocks. However, the review is conducted flexibly in order to address topical subjects, too, which could potentially affect the banks' liquidity.

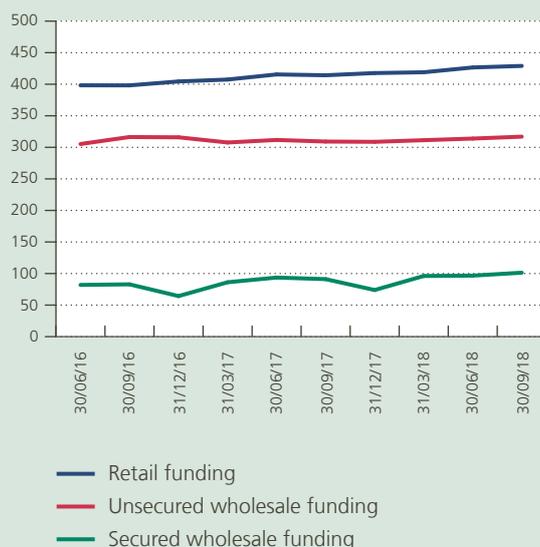
As shown by the funding and liquidity review conducted at the end of 2018, the aggregate data on all Belgian credit institutions reveal that the composition of their funding has remained relatively stable over the past two years. Retail deposits have risen by almost 8 %, constituting a stable funding source.



Unsecured wholesale funding of financial and non-financial counterparties has remained unchanged, while secured wholesale funding has risen by 22 %, starting from a lower base. This increase is due mainly to funds obtained under the targeted longer-term refinancing operations (TLTROs) and covered bonds.

Belgian banks' funding sources

(in € billion)



Source : NBB.

The stability of the composition of the assets and funding of Belgian credit institutions is also reflected in the regulatory liquidity ratios. While the short-term liquidity coverage ratio (LCR) requires a bank to hold sufficient liquid assets to withstand a liquidity stress scenario for one month, the net stable funding ratio (NSFR) requires a bank to have sufficient long-term funding to finance illiquid assets.

The NSFR is not yet a minimum regulatory requirement, but it is reported to the supervisory authorities by the SIs. The whole sample of Belgian credit institutions already has an NSFR of over 100 %, and the situation has been generally stable over the past two years.

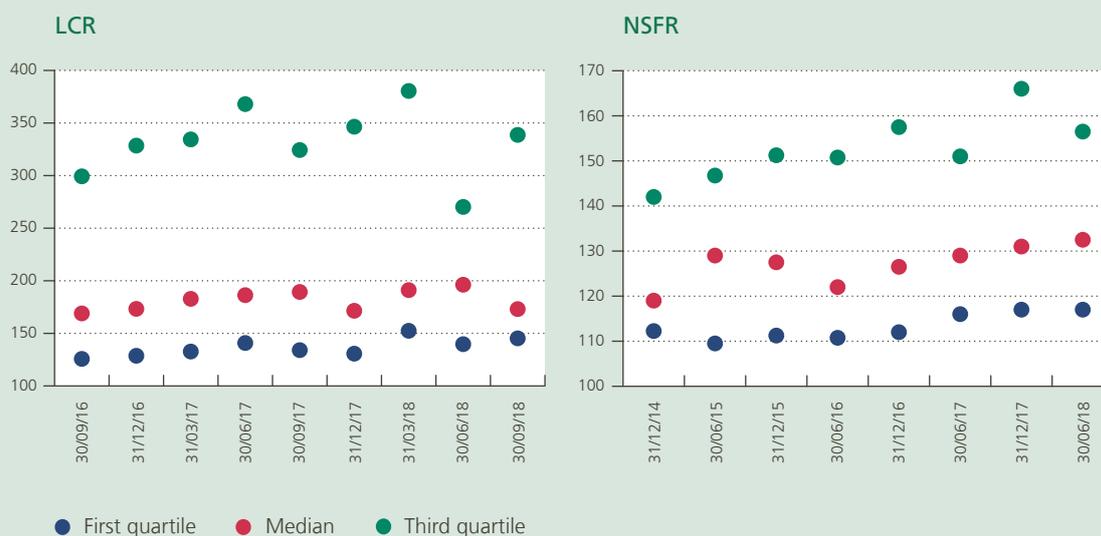
The LCR has been a minimum regulatory requirement since October 2015 and has been fully in force (minimum requirement of 100 %) since January 2018. Belgian credit institutions' LCR has also remained above 100 %. This ratio is more volatile than the NSFR owing to its short-term nature.

The 2018 review of funding and liquidity also included a liquidity crisis simulation for all Belgian credit institutions, identifying sources of pressure on liquidity which are not reflected in the LCR or the NSFR. Liquidity stress tests are becoming a standard tool in the supervisory toolbox. The SSM will also subject all SIs to a detailed liquidity stress test in 2019.



Points for attention in forthcoming reviews of funding and liquidity are the impact of the expected normalisation of central bank policy on the holding of liquid assets and funding choices, and the replacement of financing via the TLTROs expiring in June 2020.

Trend in the LCRs and NSFRs of Belgian banks



Source: NBB.

Horizontal analysis of the Belgian banks' financial plans

In 2018, the Bank continued the horizontal analysis of the leading Belgian credit institutions' strategic and financial plans. The aim of the analysis is to proactively identify significant trends in profitability, the underlying activities and potential systemic risks in the Belgian banking sector.

Previous analyses have revealed substantial and growing pressure on Belgian banks' profitability, owing to a range of factors, including low interest rates and keen competition. Analysis of the 2018 financial plans shows that this pressure is not diminishing. On the main credit markets, the banks foresee relatively strong average volume growth over the term of the financial plans, against the backdrop of declining margins. The plans show that interest income should pick up a little compared to previous forecasts, partly as a result of the upward trend in yield curves at the start of the period under review.

This raises the question whether the strong average credit expansion over the planning period – at a pace slightly exceeding that of previous years – is a realistic starting point, taking account of developments in the monetary and economic context (see box 11 in the Report 2017).

Another striking characteristic is the constant reduction in the average new loan loss provisions. This reduction in new provisions year after year is generally justified by the historically low level of the



loan provisions realised. However, this tendency, whereby credit institutions adjust their expected loss provisions according to current observations, does imply risks. In these circumstances, a change in the economic environment could rapidly exert pressure on profitability.

In a competitive environment with profitability under stress, sound and well-reasoned forward planning of the institutions' activities (including pricing) and *ex-ante* identification and close monitoring of the resulting risks within their overall balance sheet are essential to ensure their sustainability. Specific, good quality strategic, financial and corporate management plans are crucial for this prospective steering. The assumptions must be realistic, so that potential problems concerning the business model, profitability and the emergence of risks are identified, recognised and addressed as quickly as possible.

2. Prudential policy aspects

2.1 SSM and EU measures concerning non-performing loans

The year 2018 brought new European initiatives aimed at addressing the persistently high level of non-performing loans in certain European countries and avoiding a further accumulation of such loans. This work was conducted partly by the ECB, under the SSM, and by the European Commission. The measures taken should enable institutions to concentrate once again on their

core business of lending to the real economy and strengthen the resilience of the banking system as a whole.

In March 2018, the SSM published an addendum to the 2017 guidance to banks on

non-performing loans, spelling out the prudential expectations relating to the prudential provisioning of those loans. The 2017 guidance asks credit institutions to define credible strategies for dealing with their portfolio of defaulting loans, specifying quantitative targets for each portfolio and measures which need to be implemented from both an organisational and a financial point of view. The addendum adopted by the SSM aims to prevent the accumulation of new non-performing loans in the banking system, by pre-defining a target for gradually increasing coverage over time (calendar

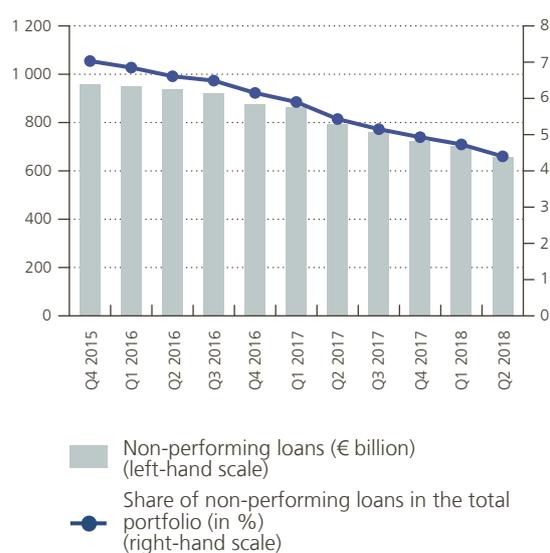
approach), which should lead to full prudential provisioning after a certain number of years. Under its SREP approach, the SSM may decide on specific prudential measures if an institution deviates from that target without justification.

In July 2018, this addendum was supplemented by the SSM's announcement of further steps in its prudential

The SSM and the European Commission took new initiatives to address the persistently high level of non-performing loans in certain countries

Chart 101

Ratio of non-performing loans of significant credit institutions in the euro area



Source: ECB.

treatment of the stock of existing non-performing loans. The SSM intends to achieve a credible reduction in the stock of such loans by defining prudential expectations specific to each institution regarding prudential provisioning. The aim is to achieve the same coverage of the stock and flow of non-performing loans over the medium term. These specific expectations are stated for each institution and are determined according to the share of non-performing loans in its total loan portfolio and its own financial characteristics, while ensuring consistency between comparable institutions.

The European Commission likewise proposed a gradual coverage approach for non-performing loans, pursuant to its mandate derived from the conclusions of the July 2017 European Council. In contrast to the SSM's approach, which advocates a target for coverage by provisions, this measure envisages a minimum compulsory level of coverage for non-performing loans by capital or provisions, applied uniformly to all credit institutions. This obligation will apply only to new loans granted by credit institutions. At the end of 2018, this proposal was still being discussed.

In 2018, the SSM continued its measures to reduce the level of non-performing loans. In particular, it made sure

that credit institutions with a high level of non-performing loans actually implement ambitious strategies to reduce those loans. Among other things, that took the form of sales of non-performing loan portfolios, renegotiation or the establishment of more efficient recovery procedures. Thus, under pressure from the prudential authorities and given the improvement in the economic environment, there was a marked acceleration in the reduction of the ratio of non-performing loans in the euro area, as the share of these loans in the loan portfolios of SIs, subject to direct SSM supervision, dropped from 7% at the end of 2015 to 4.4% at the end of June 2018. The average rate of provisioning for these loans stood at 46% at the end of June 2018.

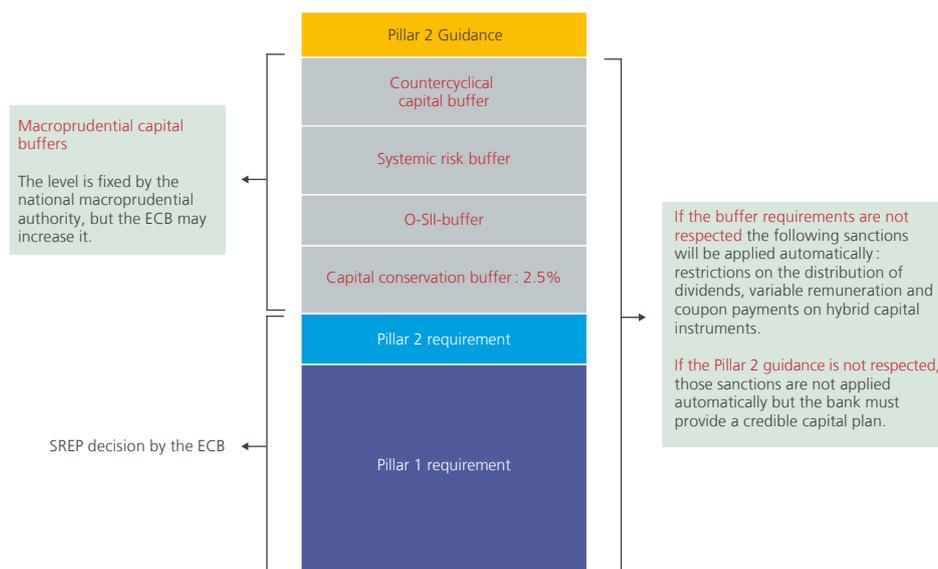
2.2 SREP methodology and results

In 2018, the banks subject to direct SSM supervision (SIs) underwent a new SREP¹ on the basis of the methodology drawn up in 2015 and the adjustments made in 2016. A complete harmonised stress test exercise was also carried out in 2018 (see box 13)

¹ Annual exercise to assess the risks and quantify the capital and liquidity needed (Supervisory Review and Evaluation Process – SREP).

Chart 102

Structure of the capital requirements in terms of CET 1



Source: NBB.

taking account of the situation of credit institutions at the end of 2017. The SSM incorporated the results of that exercise in its SREP decisions when fixing an additional target, known as Pillar 2 guidance¹, for CET1 capital. The Pillar 2 guidance was determined in order to ensure that in a severe crisis the CET1 ratio remains above 5.5% of the risk-weighted assets and the amount of the systemic capital buffer for banks classed as global systemically important groups as defined by the FSB.

Although there was no change in 2018 to the SSM methodology for quantifying the requirements under Pillar 2 or the Pillar 2 guidance, in July 2018 the EBA published a revision of its guidelines on the common procedures and methodologies for the SREP, particularly as regards taking account of the stress test results when determining the Pillar 2 guidance. That revision will imply two methodological changes which the ECB should incorporate in the 2019 SREP, whose decisions will apply in 2020. First, when determining the Pillar 2 guidance, the reduction in CET1 capital resulting from the adverse scenario in the stress test can no longer be offset by capital buffers for systemic risk. The latter are intended to cover macroeconomic risks, and not bank-specific microeconomic risks which come under the Pillar 2 requirements and the Pillar 2 guidance. Second, the Pillar 2 guidance will no longer apply only to the CET1 requirement but also to the total capital requirement. These two changes should imply, *ceteris paribus*, an increase in demand for both CET1 capital and total capital from 2020: the banks need to be prepared for that.

On 9 November 2018, the ECB also published a new version of the guides on expectations regarding the quality of the internal capital and liquidity adequacy assessment processes (ICAAPs and ILAAPs). These guides, which have been used to assess ICAAPs and ILAAPs since 1 January 2019, are meant to help credit institutions to improve their practices in this regard. The SSM expects institutions to ensure that the risks which they face are accurately assessed in accordance with a prospective approach, so that all significant risks are identified, properly managed, and covered by an adequate level of capital and liquidity.

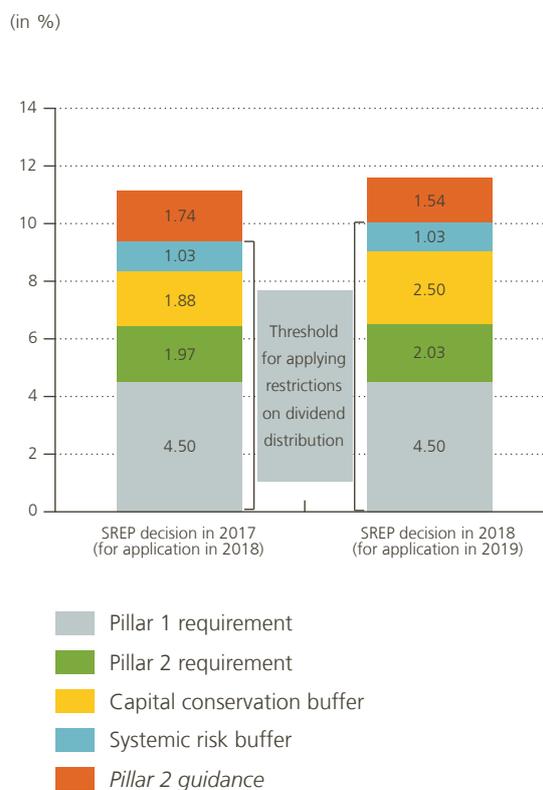
These guides should also help to reduce differences in the approaches adopted by institutions and thus ultimately strengthen the role of the ICAAPs and ILAAPs in the SREP. In this context, the SSM is continuing to draw up a methodology for determining the capital

requirements under Pillar 2 on the basis of a more granular assessment of the various risks. That work should enrich the holistic approach currently used and improve transparency concerning the nature of the factors taken into account by the SSM – notably the level of the risks, the business models, and the quality of the organisation and governance – in determining the capital requirements under Pillar 2.

In 2018, the average level of Pillar 2 requirements for the SIs came to 2.1% of the risk-weighted assets, compared to 2.0% in 2017. However, the CET1 ratio threshold

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 103
Level and structure of the CET1 capital requirements for Belgian banks



Sources: ECB, NBB.

(maximum distributable amount trigger, MDA trigger) automatically triggering prudential measures was increased further as a result of the continued phasing-in of capital conservation and systemic risk buffers.

Thus, for Belgian banks subject to SSM supervision, the average MDA trigger increased from 9.38 % to 10.06 %, while the Pillar 2 requirements remained more or less stable, at 2.03 % in 2018 compared to 1.97 % in 2017. The total CET1 capital requirement of Belgian banks increased from 11.11 % to 11.61 %, up by slightly less than the MDA trigger, reflecting the small reduction in the Pillar 2 guidance, from 1.74 % to 1.54 %, to offset the increase in the capital conservation and systemic risk buffers.

For LSIs, the Bank conducted a similar SREP exercise in accordance with a methodology aligned with the harmonised methodology developed for the SSM in 2018.

For LSIs, the method of calculating the second pillar requirement therefore changed slightly, but is still

based on the scores attributed under the SREP exercise to the various risk categories, such as interest rate risk and operational risk.

A new aspect of the methodology is the possibility of formulating Pillar 2 guidance on the basis of the stress test for LSIs (see box 13). The level of this guidance is calculated in the same way as for SIs, but the stress test in this case is conducted by the Bank. In addition, for LSIs no minimum is used for the guidance, which means that if the Pillar 2 requirement is high enough to meet the stress test requirements, no additional Pillar 2 guidance is requested.

During the year under review, a complete prudential supervision and assessment process was only conducted for top priority LSIs; in their case, it always gave rise to a new second pillar requirement. A stress test was likewise conducted for these same institutions but did not lead to Pillar 2 guidance being drawn up for any of the institutions concerned. In general, the new methodology has not led to any significant change in the capital requirements.

BOX 13

2018 stress tests by the EBA and the Bank

EBA's 2018 stress test for significant institutions

In 2018, as in 2014 and 2016, the EBA coordinated a stress test in which 48 large European banks took part, 33 of them being established in SSM Member States and subject to the direct supervision of the ECB. Two of these institutions are located in Belgium: Belfius Bank and KBC Group¹.

Like the previous ones, the 2018 exercise aimed to provide the supervisory authorities, banks and market players with a common analytical framework enabling them to compare and assess the ability of the large banks and the EU banking system to withstand adverse economic shocks. The stress test comprised a baseline scenario and an adverse scenario, both with a three-year horizon (2018-2020). The assumptions for the macroeconomic variables in the baseline scenario conformed to the December 2017 forecasts published by the ECB. The adverse scenario, designed by the ECB and the ESRB, was a hypothetical scenario reflecting the systemic risks considered to represent the most serious threats to the stability of the European Union banking sector at the start of the exercise,

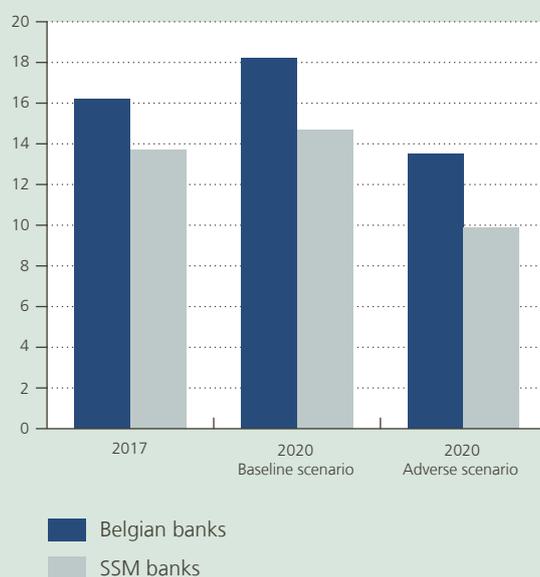
¹ ING Belgium and BNP Paribas Fortis, subsidiaries of foreign banking groups, took part in the stress test through their parent company. Their results are therefore not consolidated in the Belgian average presented in the chart in this box.



in January 2018. As the adverse stress test scenario was hypothetical, its estimated impact should not be regarded as a forecast of the banks' profitability. Moreover, the results take no account of any response to the shocks by the banks, as the test is based on the assumption of a static balance sheet. Nonetheless, the stress test results can serve as a useful analysis tool for assessing the resilience of the banks' balance sheets to the specific shocks considered.

Like the EU-wide stress test conducted in 2016, the 2018 stress test did not comprise any pass or fail threshold for the projected tier 1 capital ratio (CET1 ratio) in the adverse scenario. Instead, it was designed as a key contribution to the Supervisory Review and Evaluation Process (SREP), where mitigating management measures and the potential balance sheet dynamics may also be taken into account, primarily in order to establish Pillar 2 guidance (see section D.2.2).

Average CET 1 ratio



Sources: ECB, NBB.

The above chart compares the average CET1 ratio of the Belgian banks (Belfius and KBC) and the SSM banks at the beginning and end of the stress test horizon in the baseline scenario and in the adverse scenario.

The Belgian banks were in a better starting position compared to the sample of large SSM banks which took part in the stress test. At the beginning of the period considered, their CET 1 ratio averaged 16.2 %, contrasting favourably with the average starting value of 13.7 % for the CET 1 ratio of the sample of SSM banks.



Belgian banks also performed well in the 2018 stress test compared to other euro area banks. In the baseline scenario, the CET1 ratio for Belgian banks was up by an average of 2 percentage points between 2017 and 2020, while that of the SSM banks went up by 1 percentage point, on average, over the same period. These two increases are largely due to the favourable macroeconomic and financial forecasts published by the ECB for Belgium and the euro area, and a number of EBA methodological assumptions.

In the adverse scenario, the Belgian banks also did better than the SSM banks, as the reduction in the CET1 ratio between 2017 and 2020 averaged 2.7 percentage points for the Belgian banks and 3.9 percentage points for the SSM banks. In both cases, the sharp fall in the CET1 ratios was due to the very severe recession simulated by the ECB and the ESRB, which – for Belgium and the euro area – led among other things to a substantial contraction in GDP, a steep rise in unemployment, a marked fall in property prices and a rise in interest rates accompanied by widening spreads.

Taking account of their higher initial CET1 ratio and the smaller decline in that ratio in the adverse scenario, the CET1 ratio projected at the end of 2020 for the Belgian banks in the adverse scenario therefore averaged 13.5%, well above the average CET1 ratio of 9.9% for SSM banks.

The better starting position of the Belgian banks and their performance in the 2018 stress test are at least partly a reflection of the continuous adjustment efforts that those banks have been making since the crisis, including the strengthening of their capital, their debt reduction and the decline in the volume of legacy assets.

Overall, the results of the two largest Belgian banks which participated directly in the 2018 stress test show the steady improvement in their resilience. That is a welcome development in an environment which nonetheless remains challenging for the profitability of European banks.

The Bank's 2018 stress test for less significant institutions

In 2018, the Bank also conducted a stress test on the three main LSIs which are subject to its supervision. Since this exercise took place at the same time as the EBA stress test for SIs, both the baseline scenario and the adverse scenario were tuned to those of the EBA test. The methodology used is likewise based on that for the EBA stress test, although a number of simplifications were introduced.

The desired proportionality for this stress test was similarly ensured by asking the LSIs to supply only additional information on their starting position in December 2017. The projections for 2018-2020 were produced by the Bank, in contrast to the EBA stress test in which the SIs themselves take responsibility for the projections.

The stress test results were not published but were discussed with the LSIs and helped to determine the Pillar 2 guidance under the SREP.

3. Regulatory aspects

During the year under review, the main developments concerning banking regulation took place in the European Union, where work on strengthening the Banking Union and the Capital Markets Union continued at a steady pace. At global level, following the conclusion of the Basel III agreement finalised at the end of 2017, the Basel Committee on Banking Supervision's work focused more on the implementation and assessment of the Basel III reforms and on scope for regulatory arbitrage. At Belgian level, the Bank published a new Circular and updated its manual on governance.

3.1 International regulations

3.1.1 Strengthening of the banking union and the capital markets union

Completion of the Banking Union and further work on the Capital Markets Union in the EU continued to determine the supervisory authorities' programme in 2018. As regards completion of the Banking Union, new steps were taken to reduce the banking risks by the progress of the negotiations on a package of changes to the European banking legislation (CRR

2/CRD V/BRRD 2) and by the measures described above aimed at reducing the banks' non-performing loans, notably by the compulsory formation of provisions for those loans. This banking risk reduction is a precondition for concluding other European agreements on sharing the burden between Member States in the

event of materialisation of these risks (risk-sharing). That sharing would require the establishment of the third pillar of the Banking Union, namely a European Deposit Insurance scheme (EDIS) and adequate funding for the Single Resolution Fund. Apart from the completion of the Banking Union, other measures were taken in 2018 to establish the Capital Markets Union, intended to create deeper and better integrated capital markets in the European Union. Work on the adoption of specific prudential rules for European investment

firms and for various types of securitisation instruments are the principal elements.

The sections below deal with these topics in more detail. In this context, box 14 describes the progress achieved in the negotiations on adjustments to the banking regulations (CRR, CRD and BRRD).

European Deposit Insurance Scheme (EDIS)

One of the principal elements of the completion of the banking union concerns the switch to a European Deposit Insurance Scheme (EDIS). EDIS would be a key step towards strengthening financial stability in the euro area, by further boosting confidence in the stability of bank deposits, wherever they are located in the euro area, and severing the link between banking problems and the financial situation of the Member States concerned.

Under the initial 2015 proposal for creating EDIS, risk-sharing between the Member States would be phased in, and EDIS would be established in three automatic stages (reinsurance, coinsurance, full insurance) by 2024. Discussions in the European Parliament and the EU Council of Ministers revealed differences of opinion on that proposal. Some Member States want banks to become stronger before being ready to share the potential burden of bankruptcies in the Banking Union. Consequently, three years after the initial EDIS proposal was presented by the Commission, hardly any progress has been made.

To resolve the deadlock and facilitate political debate on EDIS, a European working group studied the continuing development of the scheme in 2018 and produced alternative proposals. Each option offers a different degree of mutual loss sharing, but first puts the emphasis on providing the essential liquidity for repaying (within 7 working days) the guaranteed deposits of a bank in difficulty. Moving on from the first stage – providing the necessary liquidity – to the second which concerns sharing the losses could be made subject to a range of conditions, such as targeted asset quality reviews and the level of the problem loans of banks whose deposits are protected by the system.

Backstop for the Single Resolution Fund

The European Resolution Fund provides adequate finance for the SRM, the second pillar of the Banking Union. From 2023 onwards, the Single Resolution

Banking risk reduction is a pre-condition for concluding European agreements on sharing the burden between Member States in the event of materialisation of these risks (risk-sharing)

Fund (SRF) will have an intervention reserve amounting to 1% of the deposits covered by guarantee systems of credit institutions in the Banking Union, equivalent to around €55 billion. In certain crisis cases, and especially in the event of a crisis affecting a significant banking group or a systemic crisis, the SRF's resources are likely to be insufficient to enable it to fulfil its mission. That is why – back in 2013, even before the SRF was created – Ministers from the Eurogroup and the Ecofin Council indicated the need to develop a public safety net, called the “backstop”. The use of that safety net is a last resort.

In its roadmap for deeper European Economic and Monetary Union, the European Commission proposed that the future European Monetary Fund should serve as a safety net for the SRF, either by providing it with guarantees or by granting it a liquidity line.

On that basis, on 4 December 2018, Finance Ministers meeting in the Ecofin Council agreed terms of reference governing the activation of a common safety net for the SRF. That common safety net is provided by intervention on the part of the European Stability Mechanism, which offers the SRF a renewable credit line the size of which is determined, during the transitional period, by the level of the SRF. This safety net covers all possible uses of the SRF, including liquidity support. The European Stability Mechanism enjoys preferential creditor status. This common safety net will be introduced by no later than the end of the transitional period, or earlier depending on the progress achieved in reducing risks.

Prudential regime for investment firms

Investment firms like Belgian stockbroking firms are now subject to European prudential regulation which had been intended more for credit institutions and is therefore less suited to the activities and risks specific to that sector. The European Commission therefore proposed a revision of the prudential framework for investment firms, in the context of the capital markets union. Under that proposal, the banking regulation (and SSM supervision) only applies to large investment firms of systemic importance, and there is a new, tailor-made regime for smaller investment firms, addressing the problems of the current regulatory framework (complexity, lack of risk sensitivity, and fragmentation). More specifically, the Commission proposes a prudential framework which is both simpler and more proportionate, as well as being more

sensitive to the specific risks of investment firms and better suited to their business models.

The capital requirements for investment firms would be fixed according to a new approach, specifically designed for the commercial services and practices most likely to generate risks for investment firms, their customers and their counterparties. This approach establishes the capital requirements according to the scale, nature and complexity of the investment services offered and/or activities pursued. The minimum starting capital required for granting a licence, namely a quarter of the firm's fixed costs for the previous year, would be the minimum amount of capital required. Very small, non-complex investment firms would be subject to an even simpler regime for capital, corporate governance and reporting obligations.

The proposal makes provision for a five-year transitional period for investment firms before they have to apply the new requirements in full. Both the European Parliament and the EU Council of Ministers negotiated intensively on this proposal during 2018 with a view to speedy production of a final version.

Prudential regulation for various types of securitisation instruments

The creation of a European Capital Markets Union also anticipates the adjustment and harmonisation of the European regulations on various types of securitisation instruments. The new Regulation on securitisation, comprising a general framework plus a specific framework for simple, transparent and standardised securitisation (STS), was adopted in December 2017 and came into force on 1 January 2019¹. In 2018, the EBA worked on various technical mandates and guidelines to render the regulations and the STS framework operational.

In March 2018, the European Commission published a proposal on a framework for covered bonds, comprising a Directive and a Regulation amending the CRR as regards exposures in the form of covered bonds. Negotiations are in progress at European level and a final agreement should be reached in 2019. The Directive's main aim is to introduce minimum standards and encourage the development of covered bond markets in the Member States where markets are

¹ Regulation (EU) No. 2017/2402 of 12 December 2017.

under-developed or lack a legal framework. The minimum standards are linked to structural characteristics (such as eligibility of the assets as collateral and requirements concerning collateral) and public supervision.

Finally, during 2018, the European Commission also presented a proposal concerning sovereign bond-backed securities (SBBS). This is a specific legal framework for securitisation operations made by private or public entities and backed by a diversified set of euro area sovereign bonds. Thanks to the principle of priority/subordinate tranches of debt instruments and appropriate calibration, the top tranche could represent a low-risk European debt instrument.

Banks make a significant contribution to the direct financing of central governments by granting loans or buying government debt instruments for their own account. Liquid sovereign bonds also play a crucial role in the liquidity and balance sheet management of financial institutions. Thus, when there are higher financial risks for a national government, reflected in lower solvency and higher risk premiums, these exposures can damage banks' solvency and liquidity. In addition, banks tend to retain a larger share of the debt of their own national government, and that concentration heightens the risk of contagion, with the national government's problems affecting the local financial sector (sovereign-bank nexus). The SBBS proposal aims to alleviate that problem.

BOX 14

Reform of the European regulations (Risk reduction package)

The NBB's Report 2017 had already examined the proposals published by the European Commission with a view to amending the European banking legislation, namely the Capital Requirements Regulation (CRR), which is directly applicable, and the Capital Requirements Directive (CRD) and the Bank Recovery and Resolution Directive (BRRD), to be transposed into national law by the Member States. These proposals aim to introduce a number of key components of the Basel III package of additional regulatory requirements such as the leverage ratio, the net stable funding ratio (NSFR), new methods of calculating the capital requirements for counterparty risk and market risk, and the arrangements for introducing the TLAC requirement in the EU (see chapter C) for global systemically important institutions. This set of measures is therefore known as the risk reduction package.

In 2018, the European Parliament and the EU Council both determined their position on these proposals, and the negotiations between those two bodies and the European Commission, known as the "trilogue", began with a view to finalising the legislation. In the context of this debate, Belgium's key points for attention concerned the proposals for replacing the capital requirements, the liquidity requirements and the MREL requirements of local subsidiaries of foreign banks with parent company guarantees, the need to make European banks subject to adequate requirements concerning subordinated debt which could facilitate the resolution of a struggling bank, and maintenance of the effectiveness of the package of measures in reducing risks. Other points for attention in the debate included the need to adjust the Basel rules to specific European characteristics and the importance of proportionality in the application of the banking regulations to smaller and less complex institutions.

At the end of 2018, the European institutions reached agreement on the broad outline of the "Risk reduction package" which will undergo technical development with the aim of publishing final texts in the first half of 2019.

However, this proposal has been criticised by many EU Member States and by the financial sector, partly because the SBBs are expected to have a negative impact on the liquidity and funding costs of the various national governments, and it is feared that – in the event of a crisis – buyers may not be found for the subordinate tranches. The Bank is prepared to continue the debate on the proposed instrument in the context of deepening the Capital Markets Union.

3.1.2 Work of the Basel Committee

After having concluded the Basel III agreement, the Basel Committee on Banking Supervision focused on the implementation and assessment of the Basel III reforms and on the measures to be taken concerning the scope for regulatory arbitrage. The implementation work concerns such matters as the organisation of regular quantitative studies of the impact of the introduction of the new standards. Box 15 briefly describes the results of the first impact study which took account of the finalised Basel III agreement. Regarding the scope for regulatory arbitrage, work is in progress for the adoption of measures aimed at curbing window dressing, i.e. temporary reductions in transaction volumes on the main financial markets around the reference dates, which have the effect of temporarily increasing on those dates the leverage ratios which the entities in question are required to report. The concerns raised by the heightened volatility on various segments of the money markets and derivatives markets



around the key reference dates were among the reasons prompting the Basel Committee to consider these measures. Finally, in 2018, the Committee agreed to step up the harmonisation of certain aspects of the minimum capital requirements for market risk. These market risk standards were published by the Basel Committee on Banking Supervision in January 2016, as part of the Basel III package, but recent adjustments are intended to address the problems identified by the Basel Committee in monitoring the implementation and impact of the new regulations. The adjustments include recalibration of certain parameters and a simplified approach for banks with lower market risks. All the components of the Basel III framework have thus been completed.

BOX 15

Impact of the Basel III reforms adopted in the wake of the crisis

The NBB's Report 2017 had already dealt with the finalisation of the Basel III reforms for the banking sector, adopted in the wake of the crisis. A final agreement on that subject had been concluded by the Basel Committee on Banking Supervision in December 2017.

That agreement provides for a significant change in the calculation of the risk-weighted assets, the denominator of the risk-based capital ratio. In particular, in the case of credit risk, this means a revision of the standardised approach and a reduction in the use of internal models for certain types



Overview of the results

(data at the end of 2017)

	Number of banks	Change in the Tier 1 MRC (in %) ¹	Combined capital shortfall (in € billion)		
			CET1	Tier 1	Total
Group 1 banks ²	111	3.6	5.2	7.3	13.3
of which: G-SIBs	30	3.0	5.2	6.3	12.2
Group 2 banks ²	95	5.9	1.0	0.8	0.7

Source: Basel Committee on Banking Supervision.

1 In % of the total basic MRC established according to the target level requirement, i.e. the combination of risk-based capital requirements and capital requirements based on the leverage ratio, plus the capital conservation buffer and, where applicable, the G-SIB buffer.

2 Group 1 = Banks operating internationally with Tier 1 capital > €3 billion;
G-SIBs = Global Systemically Important Banks, as determined by the Financial Stability Board.
Group 2 = Other banks.

of assets. For other types of assets, internal models are subject to additional restrictions. For operational risk, internal models are abolished altogether. The last part of the finalised Basel III package is the so-called "output floor". It specifies that the total risk-weighted assets calculated by using internal models must not be less than 72.5% of the risk-weighted assets calculated according to the standardised approach. The agreement provides for the introduction of these standards by 1 January 2022, the output floor being initially fixed at 50% and gradually rising to 72.5% by 2027.

Publication of the finalised "Basel III" package was accompanied by publication of the results of Quantitative Impact Studies (QIS). These studies show the change in the Minimum Required Capital (MRC) and any capital shortfalls caused by application of the finalised package.

The first QIS to be conducted on the basis of the published final text took place on the basis of data as at end of December 2017. The QIS revealed considerable regional variations. For instance, while the average increase in the minimum required capital is 3.6%, it is 20.2% for European banks in Group 1 ¹ and, on average, minimum required capital is actually lower for banks in America and in the rest of the world. The result for Europe tallies with the parallel impact study by the EBA. For a sample of 38 Group 1 banks in the EU, that study reported an impact of 18.7%.

The significant discrepancy between regions is not due to differences in business models, as the analysis shows, for example, that there is no correlation between the relative size of a bank's mortgage portfolio and the impact of Basel III, but instead is due more to the prudential framework currently applicable in those regions. While the Basel standard sets minimum required capital for the first Pillar, members are still free to impose stricter rules themselves (what is known as "super equivalence"). There are also variations between regions in the level of Pillar 2 capital requirements which are additional to the Pillar 1 capital requirements and are not taken into account in this QIS.

¹ The Basel Committee divides its members into three regions: Europe (EU Member States, Russia, Turkey, Switzerland), America (North, Central and South American members) and the rest of the world (Asia, Oceania and South Africa).



The impact also varies within the European Union and in Belgium. At EU level, the relatively high impact is distorted to some degree by the results for a few large banks. It should also be noted that the calculation of that impact does not take into account certain EU prudential specificities, even where the EU now already deviates from the Basel standards currently in force. In addition, the finalised Basel III package offers certain options for the supervisory authorities which are not currently taken into account in calculating the impact.

For Belgian banks, the average impact is less than the average for the EU. The Belgian banking sector would not experience any capital shortfall following the introduction of Basel III; consequently, the impact seems to be manageable for the Belgian banks, especially taking account of the sufficiently long transitional period.

The EBA is currently working jointly with the SSM and the national supervisory authorities on a new impact study in connection with the Call for Advice addressed to it by the European Commission on the implementation of the Basel III package in the EU. That study will provide a still more detailed picture of the impact of Basel III, taking account of the specific context of the EU.

3.2 Reporting, accounting and governance

On 26 September 2017, the EBA published new guidelines on internal governance¹. The new guidelines put more emphasis on the tasks and responsibilities of the statutory management body, notably as regards its supervisory function. They also provide details on the composition and role of advisory committees formed within the statutory management body. In the aftermath of the Panama Papers, it also reinforced the guidelines on the use of complex structures and the relationship to be maintained with those structures. In addition, issues such as the risk culture, rules of conduct, and the management of conflicts of interest were developed and the guidelines now fully reflect the “three lines of defence” model. The new EBA guidelines were transposed into the Belgian prudential framework by a Circular on internal governance² and – specifically for the credit institutions sector – by updating of the banking sector governance manual.

For instance, the manual takes account of the principle of proportionality and the proportionality criteria proposed in the EBA guidelines. The new guidelines on operations with offshore centres and complex structures were also explicitly included in the manual: the EBA guidelines now stipulate that the use of these structures and centres should be avoided in the first place. If an institution were nevertheless to set up complex structures or activities, the statutory management body must

understand them and their purpose, and the specific risks associated with them, and ensure that the internal control functions are appropriately involved.

As regards the policy on conflicts of interest, the EBA guidelines stress in particular that institutions must establish adequate procedures for transactions between related parties, and that members of the statutory management body are also required to abstain from voting on matters where they have, or could have, a potential conflict of interest, or if their objectivity would be compromised.

On the subject of the composition of the board’s main advisory committees, the EBA guidelines require these committees to comprise a majority of independent directors and to be chaired by an independent member. Where these requirements go further than the requirements of the Banking Law or any other applicable legislation, the manual and the Circular specify that these guidelines should be regarded as recommended good practice which, as stipulated by Article 21, § 1, 1°, of the Banking Law, may be taken into account in the overall assessment of the organisation and functioning of the institution’s governance arrangements.

1 EBA/GL/2017/11 Guidelines of 26 September 2017 on internal governance. These guidelines came into force on 30 June 2018 and replace the EBA GL 44 Guidelines of 27 September 2011.

2 Circular NBB_2018_28 of 23 October 2018 – EBA Guidelines of 26 September 2017 on internal governance (EBA/GL/2017/11).

