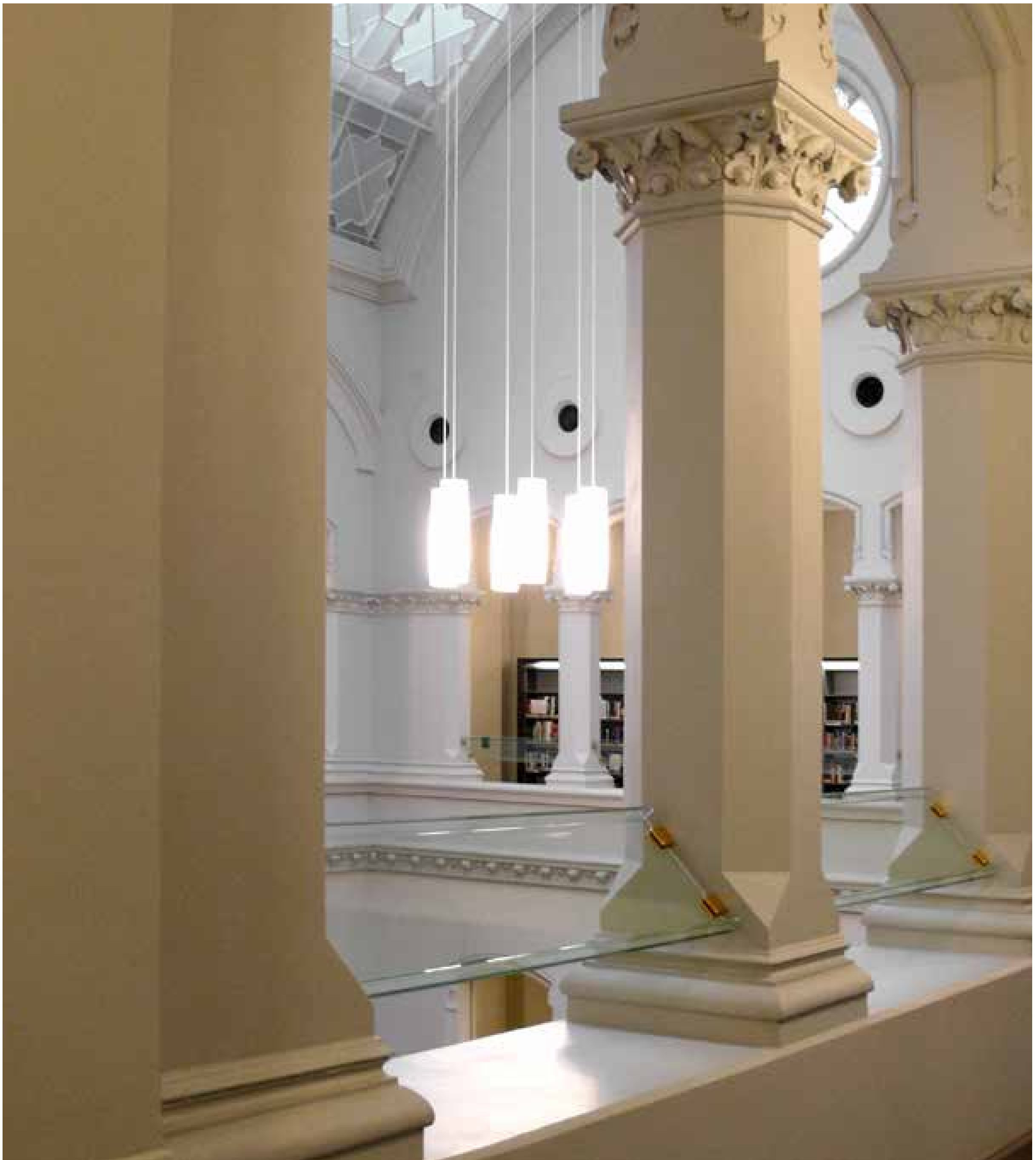
Report 2013

Prudential regulation and supervision

NationalBank
OF BELGIUM
Eurosystem



A. New European and Belgian supervision framework

1. Introduction

In the part on "Prudential regulation and supervision" of this Report, "new banking law" refers to the major project for regulatory reform in the banking sector for the purpose of transposing the European Capital Requirements Directive IV (CRD IV) and the Capital Requirements Regulation (CRR). The draft law also incorporates other key elements such as structural reforms and certain aspects of the European Directive on the recovery and resolution of credit institutions. The term "banking law" is used for simplicity even though, as the Report went to press, it was still only a draft being debated in Parliament. Some of the provisions described in the Report may therefore yet be amended.

In the aftermath of the financial crisis, the authorities radically reformed the regulatory framework of the financial system at both national and international level. These changes are designed to establish a structure which is more capable of safeguarding financial stability, and to improve governance in the financial sector. The G20 played a considerable part in outlining the main aspects of these reforms, which were subsequently considered in depth by international bodies such as the IMF, the Financial Stability Committee, the BIS and the OECD. This international coordination is vital to ensure the integration of the prudential framework and thus to avoid regulatory arbitrage in the context of financial globalisation.

Apart from the profound changes to the regulations over the past five years, the implementation of which at European and national level will be described in more detail in chapter B of the "Prudential regulation and supervision" part of this Report, it was also decided to redesign the supervision architecture in order to strengthen both the macroprudential and microprudential dimensions and to ensure the convergence of supervision practices (see chapter C). As explained in detail in the 2011 Report, the implementation of the European System of Financial Supervision (ESFS) has already contributed to a steady improvement in cooperation between the national supervisory authorities, and has also helped to establish a set of harmonised prudential procedures. In addition, cooperation between national supervisory authorities and harmonisation of supervision practices have become a reality via the operation of the colleges of national supervisors in charge of the supervision of the main entities of cross-border groups.

In the euro area, the spreading of the crisis to certain sovereign debt markets showed that a monetary union requires not only closer coordination of fiscal and economic policies but also unified supervision and, more generally, an integrated financial framework. Such a structure, called a "banking union", is essential to reduce the negative feedback between the public sector and the banking sector and to limit the fragmentation of markets. Moreover, bank supervision generally extends beyond domestic borders, in view of the existence of cross-border groups and the more general integration of markets. In that sense, the banking union is a cornerstone for the further construction of EMU, and that is the context in which, in December 2012, the Heads of State or Government agreed on the actual implementation of a first pillar of the banking union, the single supervisory

mechanism (SSM), the main characteristics of which are presented in the second section of this chapter.

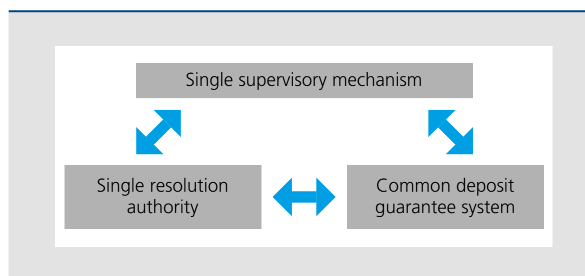
During the year under review, significant progress was made in implementing the SSM both at legislative level, with the approval of the SSM Regulation (1) on 12 September and 15 October respectively by the European Parliament and the Council, and in terms of the operational implementation of the SSM.

In regard to the second pillar, namely a single resolution mechanism, the Council reached agreement in December of the year under review. In addition, it expressed the wish to conclude an intergovernmental agreement by 1 March 2014 to govern the operation of the single resolution fund. The main points of that agreement are presented in section 3 of this chapter. It should be noted that the new banking law provides for the creation of a resolution authority at the NBB, with extensive powers of resolution for institutions in serious financial difficulty.

Progress on the third pillar, namely the harmonised deposit guarantee system, has hitherto been confined to harmonisation of the national systems.

At national level, the implementation of the "twin peaks" model on 1 April 2011 (2) brought fundamental changes to the supervision architecture. This new framework improved the coordination and integration of microprudential and macroprudential policies. Further progress was achieved in 2013 with the draft law establishing a macroprudential authority in Belgium, a role that the Bank

CHART 1 THE THREE PILLARS OF THE BANKING UNION



will take on. The authority will have to cooperate with the ECB which will also have powers relating to macroprudential policy. Section 4 sets out the framework for the exercise of macroprudential policy.

The "twin peaks" model was also reinforced by the signing of cooperation agreements between the Bank and the Financial Services and Markets Authority (FSMA) with the aim of improving the exchange of information between these two institutions. On the basis of separate reports submitted by the two institutions, the government is currently considering the possibility of further reform with the transfer of pension fund supervision from the FSMA to the Bank. Those developments are described in section 5 of this chapter.

During the year under review, this general reform of the Belgian supervision architecture and its regulatory framework was commended by the IMF in its Financial Sector Assessment Programme (FSAP).

(1) Council Regulation (EU) No. 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions.
(2) Royal Decree of 3 March 2011 implementing changes in the financial sector supervision structures.

2. Single supervisory mechanism

2.1 Context and preparation

The sovereign debt crisis in the euro area had revealed serious shortcomings in the construction of EMU. The successive responses by the European authorities over a period of almost two years have gradually lessened the vicious circle which had developed between the public sector and the banking sector, and slowed the retreat behind national boundaries on the part of market players. In that respect, the ECB's statements and actions, the report [1] by the President of the European Council in June 2012 stressing the need for close coordination in the economic, fiscal and financial spheres, the conclusions of the Council on 29 June 2012 concerning the need for a banking union and, finally, during the second half of the year under review, the adoption by the Council and the Parliament of the SSM Regulation, proved decisive in gradually restoring economic agents' confidence in the European banking system, and more generally in EMU. Chart 2 identifies the dates of announcement of the programme of outright monetary transactions by the ECB Governing Council and of the banking union. The ECB decision, reinforced by the banking union project, not only accentuated the fall in credit default swap prices for the debt of European sovereigns and financial institutions, but was also accompanied by a lasting inversion of the hierarchy between the two debtor categories, as the index of sovereign CDSs dropped below that of financial CDSs and also became much less volatile.

The SSM, which aims primarily to ensure the soundness and safeguarding of European banks and to enhance integration and financial stability in Europe, is scheduled to take effect on 4 November 2014. The implementation of this reform of the architecture of financial supervision in Europe is a major challenge, especially as the preparations will have to be completed within a very short period.

During the year under review, a number of projects have already been launched and some progress has been made at various levels, notably in regard to organisation, supervision techniques and legislation. In 2013, the ECB and the national competent authorities worked closely together on the preparations for the SSM. That cooperation was piloted by a High-Level Group comprising representatives of each of the national competent authorities concerned and the ECB, and by a smaller Project Team. The High-Level Group was supported by a Task Force, which was in turn assisted by five Work Streams.

The SSM operating procedures were set out in a draft Framework Regulation and a supervisory manual. Moreover, in accordance with the Regulation implementing the SSM, the ECB, in close collaboration with the national competent authorities, initiated the comprehensive assessment process for credit institutions which will come under the direct supervision of the ECB from 4 November 2014. That exercise, the components of which are described in Box 1, aims to determine the risk profile and identify any structural weaknesses in these institutions in order to promote the transparency and consolidation of the European banking sector with a view to the lasting restoration of market confidence in the European banking system.

2.2 Tasks

The SSM Regulation assigns to the ECB important tasks concerning prudential policy with due respect for EU law. The ECB's responsibilities relate to institutions deemed significant, i.e. those that meet one of the following criteria : (1) the total value of its assets

(1) Towards a genuine Economic and Monetary Union, 26 June 2012.

CHART 2 EFFECT OF THE BANKING UNION ON THE LINK BETWEEN BANKING SECTORS AND SOVEREIGN SECTORS
(credit default swap indices, daily data, basis points)

Sources: Bloomberg, Thomson Reuters Datastream.
(1) Index measuring the average level of premiums on five-year credit default swaps referencing the sovereign debt of 19 West European countries.
(2) Index measuring the average level of premiums on five-year credit default swaps referencing the senior debt of 25 large European financial institutions.

exceeds € 30 billion, or (2) the ratio of its total assets to the GDP of the Member State of establishment exceeds 20 % (unless the total value of its assets is below € 5 billion), or (3) in the view of the national competent authority the institution is considered to be of significant relevance to the domestic economy, and the ECB confirms that opinion, and (4) it has requested or received support from the EFSF or the ESM. In the case of institutions considered less significant, the national competent authorities remain responsible for supervision. Nonetheless, the ECB will exercise horizontal supervision in order to detect potential vulnerabilities. It will also be able to take over the direct supervision of those institutions if that proves necessary to ensure the consistent, rigorous application of the supervision rules. Nevertheless, one exception was introduced for "common" procedures: for the grant or withdrawal of credit institution authorisation and for decisions relating to qualifying holdings, the ECB will be responsible for all banks, whatever their significance. However, the national authorities will remain responsible for preparing decisions on these subjects.

The ECB will have to ensure that credit institutions respect the minimum prudential requirements set by the CRD IV and the CRR [1] notably in regard to capital, liquidity, governance and major risks. Thus, it will have to make sure that institutions hold sufficient own funds in relation to the minimum prudential rules but also considering their intrinsic risk profile. In this context, the ECB will also be responsible for the individual risk assessment under pillar 2.

In addition, the ECB will have the task of applying the qualitative requirements intended to guarantee that credit institutions have sound structures, processes and governance mechanisms. That includes the procedures for checking the integrity and expertise requirements for people in charge of managing credit institutions, but also examination of the internal control systems and remuneration policies and practices.

(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, and Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No. 648/2012.

In view of the importance of the large financial groups, the ECB will have to exercise supervision on both a consolidated and a non-consolidated basis. Thus, the ECB will participate in the colleges, without prejudice to the right of the national authorities to take part as observers. Moreover, in the case of financial conglomerates for which the banking arm is the dominant activity, the supplementary supervision will likewise be the responsibility of the ECB, which will thus take on a coordinating role.

The Framework Regulation and the supervisory manual stipulate that a Joint Supervisory Team (JST) will be associated with each significant bank or banking group and will supervise that bank or banking group.

The ECB will have to apply the European and national laws derived from the EU legislation. Some supervisory tasks are not entrusted to the ECB and remain the responsibility of the national authorities. These include consumer protection and measures to combat money-laundering. Furthermore, as explained in section 4 of this chapter, the macroprudential powers are shared between the ECB and the national competent authorities. In view of the importance of these policies for the stability of the financial system as a whole, it will be necessary to establish efficient coordination with all the authorities concerned.

If the ECB finds any shortcomings or defects, it will be able to impose appropriate measures or sanctions, as defined by the Framework Regulation which spells out the respective roles of the ECB and the national competent authorities. In addition, wherever possible, the allocation of powers to impose sanctions is aligned with the allocation of supervisory powers and therefore takes account of the distinction between significant and less significant institutions. In accordance with the SSM Regulation, the ECB's power to impose sanctions is confined to imposing fines and periodic penalty payments. The ECB may ask the competent national authorities to impose additional sanctions. Moreover, on finding a serious deterioration in the financial situation of a credit institution, the ECB will be able to take early intervention measures as defined by EU law. Those actions will have to be coordinated with the competent resolution authorities.

2.3 Governance

The Governing Council is the ECB's top decision-making body, including for the performance of the new tasks resulting from the SSM. For the preparation and performance of the ECB's tasks in the SSM, a new body called the Supervisory Board was set up at the ECB. All proposals for decisions by the Supervisory Board are subject to the approval of the Governing Council.

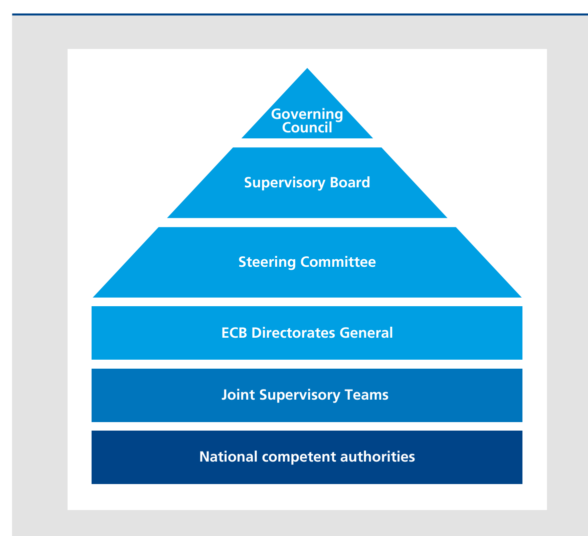
Decisions relating to the performance of the prudential tasks may take the form of individual measures or guidelines, recommendations or decisions. The ECB may also adopt Regulations, but only to the extent necessary to organise or specify the arrangements for carrying out the SSM tasks.

Supervisory Board meetings will be prepared by a Steering Committee. Its composition will be laid down in the Supervisory Board's rules of procedure, but in any case must ensure a fair balance and an rotation between the national competent authorities.

In view of its responsibilities relating to the stability of the financial system, the Supervisory Board can be expected to work closely with the Governing Council in determining macroprudential policy. The Governing Council and the Supervisory Board may arrange joint meetings in order to ensure that the microprudential and macroprudential perspectives are effectively combined. Those joint meetings should mean that proposals for decisions prepared by the Supervisory Board with a view to activation of the macroprudential tools are generally approved by the Governing Council without amendment (see section 4 of this chapter).

The ESCB Financial Stability Committee will also meet in a composition adapted to the SSM. As the macroprudential tools are still largely held by the national authorities, the

CHART 3 GOVERNANCE OF THE SINGLE SUPERVISORY MECHANISM



members of this Committee, with their experience gained at national level, will make an important contribution towards assessing the macroprudential risks. In this area, the ECB will also work with the European Systemic Risk Board (ESRB) which performs key functions in the coordination of macroprudential policies (see section 4 of this chapter)

The creation of the SSM also has implications for the European Banking Authority (EBA) whose governance and voting arrangements were adapted to ensure the smooth functioning of the Single Market and the cohesion of the European Union. Thus, the simple majority rule for certain decisions of the Supervisory Board has been changed to a double simple majority rule, applicable to members from the competent authorities of countries participating in the SSM and members representing the competent authorities of non-participating nations.

In addition, the various powers of the EBA have been clarified. Apart from the convergence of prudential rules and standards, the EBA is to contribute towards promoting best supervisory practices in the Single Market by developing, in consultation with the competent authorities, a European supervisory manual incorporating the best supervisory techniques and procedures. This manual will cover both prudential aspects, e.g. relating to credit risk or liquidity risk, and the dimensions concerning consumer protection and measures to combat money-laundering. Moreover, in connection with its powers relating to the coordination of crisis management, the EBA will be invited to participate as an observer in the meetings of the authorities concerned, particularly the resolution authorities. In addition, the EBA's tasks have been extended to include assessing the need to prohibit or restrict certain types of financial activities or making recommendations to the EC or the SSM Supervisory Board on the treatment applicable to new or innovative financial activities. All these changes were introduced by an EU Regulation dated 22 October 2013 (1).

(1) Regulation (EU) No. 1022/2013 of the European Parliament and of the Council of 22 October 2013 amending Regulation (EU) No. 1093/2010 establishing a European Supervisory Authority (European Banking Authority) as regards the conferral of specific tasks on the European Central Bank pursuant to Council Regulation (EU) No. 1024/2013.

Box 1 – Comprehensive assessment of credit institutions in preparation for the SSM

In November of the year under review, in accordance with the SSM Regulation, the ECB and the competent authorities began the comprehensive assessment of the banks for which the new European supervisory authority will take on the supervision from 4 November 2014. This exercise concerns the 128 credit institutions in the 18 participating euro area countries with an asset value in excess of € 30 billion, representing around 85 % of the banking assets of the euro area.

This exercise, which is to be completed before the SSM takes effect, aims both to foster transparency by enhancing the quality of the information available on the condition of banks and to continue the consolidation of the credit institutions' balance sheet by conducting a comprehensive assessment of their risk profile and identifying and implementing any corrective measures required.

This assessment, which should help to build confidence in the European banking sector, comprises three complementary components, the results of which will be disclosed per country and per institution on completion of the process, prior to the transfer of the supervision of these institutions to the SSM:

– Risk assessment system (RAS): using various indicators plus backward- and forward-looking information, a comprehensive quantitative and qualitative analysis will be conducted on the intrinsic risk profile of the institutions. It will cover the business model, liquidity risk, credit risk and governance aspects. This analysis will be based on a harmonised methodology developed by the ECB in collaboration with the national authorities. Initially, this new supervision tool will be used in parallel with the national systems, so as to derive benefit from bases of comparison and improve the methodology. This dual assessment, which is relatively onerous in operational terms, will facilitate the transition to the new supervision framework.

– Asset quality review: this review aims to analyse in detail the quality of banks' assets, essentially by checking their valuation in the institutions' accounts as at 31 December 2013, with due regard for the level of collateral and provisions. The analysis will cover banking and trading book exposures, on- and off-balance-sheet positions,

and exposures to domestic and foreign risks using minimum cover criteria. All categories of exposures will be considered, whether they relate to governments, financial institutions, firms or households. Special attention will focus on the valuation of more complex instruments and less liquid or higher risk assets, which tend to increase the opacity of bank balance sheets. For this exercise, a prudent interpretation of the international financial reporting standards (IFRS) will be applied and the EBA will establish a harmonised definition of non-performing loans and forbearance in order to ensure uniform treatment between countries and institutions.

– **Stress tests**: on completion of the prudential analysis and quality review, stress tests will be conducted jointly with the EBA in order to check the banks' ability to absorb various types of macroeconomic and financial shocks.

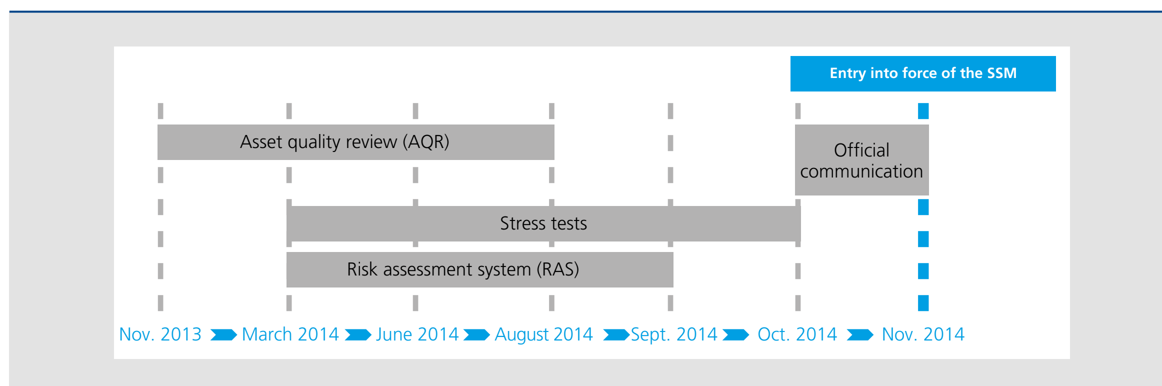
To determine any capital shortfall, the assessment will be based on a capital benchmark of 8 % Common Equity Tier 1 – CET 1 in accordance with the definition in the CRD IV and the CRR, while taking account of the transitional arrangements both for examining asset quality and for the baseline stress test scenario. For the adverse scenarios, lower capital thresholds will be notified with the details of the exercise.

In view of the scale of this exercise, the ECB and the national authorities will work together closely at all times, while enlisting the support of independent third parties. To ensure that the exercise is consistent between Member States and between banks, the ECB will take responsibility for developing and implementing a standardised methodology and a comprehensive approach while the national authorities will be responsible for the execution under the supervision of the ECB, which will ensure the quality of the exercise.

A number of Belgian credit institutions will be subject to this comprehensive assessment, namely Belfius, KBC Group, Investar (Argenta), AXA, Bank of New York Mellon and Dexia. This last institution will be subject to special treatment to take account of its specific characteristics and the resolution plan approved by the European Commission on 28 December 2012. The exercise will also include the credit institutions BNP Paribas Fortis and ING Belgium via their respective parent institutions.

Where appropriate, this comprehensive assessment of the credit institutions will be followed by a series of corrective measures, notably to adjust the provisions and equity capital of the various banks. In that context, the *ex-ante* establishment of support mechanisms is crucial to the success of the exercise. Any capital shortfalls identified must be made good primarily via private capital sources. If those sources are insufficient, it will be possible to resort to public intervention in accordance with national practices and European rules.

COMPREHENSIVE ASSESSMENT TIMETABLE



Source: ECB.

2.4 Challenges

Given the scale and importance of the reform of prudential supervision, the practical implementation of this project presents numerous challenges. The transitional period is extremely short, especially as all the preparatory work has to be completed by the end of that period, even if some key parameters will still have to be determined later.

With regard to organisation, the ECB has to develop expertise and acquire the human resources needed to establish and harmonise quality control practices. Overall, the ECB expects to employ an extra 1 000 staff over the period 2013-2014; they will be allocated among the various Directorates General and other support services to be set up when the SSM actually takes effect. The recruitment of the necessary staff, including some from the national supervisory bodies, must not be at the expense of any significant weakening of the national teams, which will themselves face a relatively heavy work load in their own preparations for the SSM and the comprehensive assessment of the large banks in their own country. These national teams will have to work closely with the ECB, both during the transition phase and in the final phase, notably via the Joint Supervisory Teams (JSTs), which will ensure the transfer of the knowledge required to guarantee high-quality supervision.

Apart from this collaboration between the ECB and the national authorities, it will also be necessary to ensure a degree of uniformity in the decisions in order to establish a level playing field between the institutions coming under ECB supervision, while taking account of both structural differences and variations in risk profile between the individual institutions. This decision-making process must be efficient, and must be conducted within a reasonable timeframe, although there needs to be full scope for interaction between the national authorities and the ECB in the preparation and implementation of decisions in the SSM. The comprehensive assessment exercise concerning large European credit institutions will be the first experience of applying this collaboration framework. It will also offer a first opportunity for harmonising supervision practices and techniques.

In regard to legislation, the harmonisation of the rules introduced by the CRD IV and the CRR is accompanied by a degree of discretion retained by the Member States and the competent supervisory authorities. Some of these national options may have significant prudential implications. That concerns in particular the treatment of banks' shareholdings in insurance companies, and the regimes applicable – during the transitional phase determined by Basel III – to unrealised losses and gains on assets recorded at fair value and to deferred taxes. Until the SSM enters into force, it is for the national authorities – namely the NBB in the case of the companies subject to its supervision – to determine these options (see chapter B, section 2.1 of the "Prudential regulation and supervision" part of the Report for more details on the Belgian options). From 4 November 2014, the ECB will take charge of harmonising these options under the SSM. Meanwhile, the prudential treatment of SSM credit institutions will remain subject to some uncertainty that could have significant accounting implications. It will be essential to quantify that impact correctly to ensure a uniform approach in the comprehensive assessment process, taking account of the potential implications of that exercise for the possible imposition of corrective recapitalisation or restructuring measures.

These harmonisation issues will not be confined to the treatment of the options under the CRD IV and the CRR, but will also concern the application of the national laws of the participating countries, whether those laws are derived from the transposition of other EU Directives or from purely national law, as those legislative provisions could interfere with the tasks conferred on the ECB. In Belgium's case, one instance is the Bank's power to veto strategic decisions taken by Belgian credit institutions.

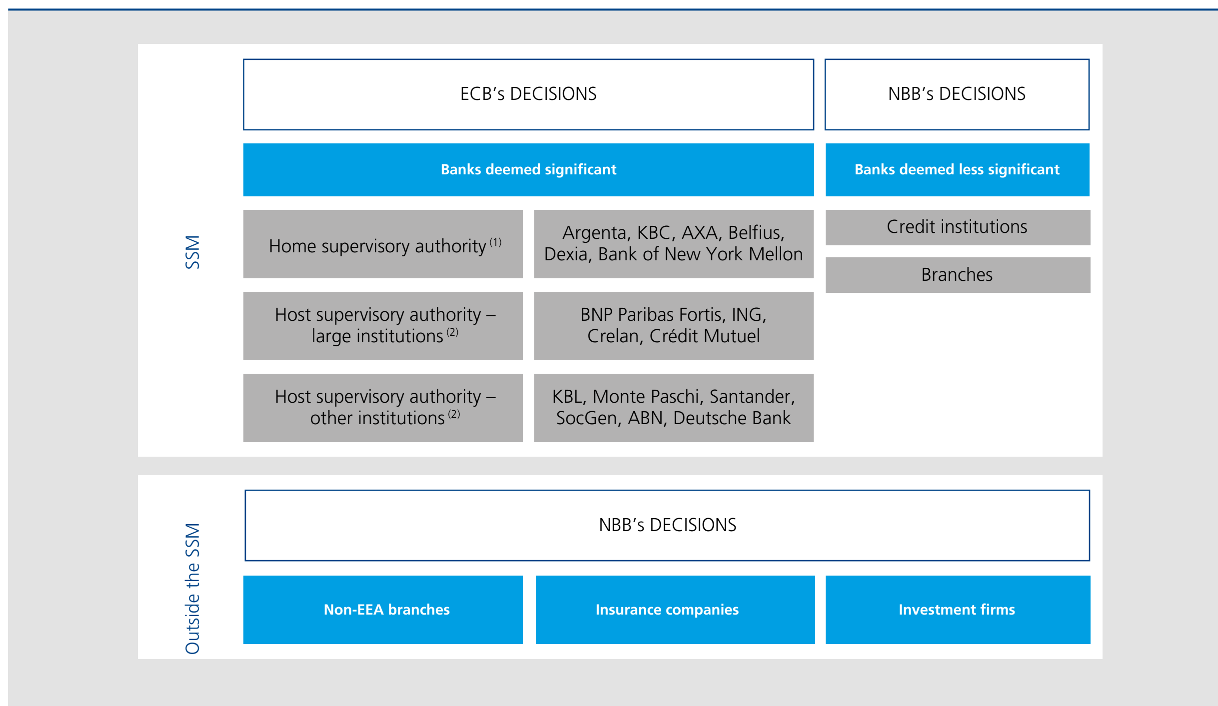
As regards regulation, the ECB will also have to coordinate its action with that of the European authorities. That will primarily concern the EBA, but will also extend to the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA). The ECB will in fact have to supervise conglomerates pursuing activities in multiple sectors and pay particular attention to preventing any risk of arbitrage that might result from divergent sectoral regulations.

2.5 Impact on the NBB's prudential supervision and on credit institutions

Owing to the substantial market share in Belgium of financial groups meeting the criteria defining significant credit institutions, the NBB will be very closely involved in the implementation of the SSM. Indeed, around 95 % of the sector's total assets are held by Belgian credit institutions deemed to be significant, and therefore falling within the competence of the ECB from 4 November 2014.

There will be a JST for each significant credit institution or banking group. For each JST, the Supervisory Board will appoint a coordinator and decide the team's size and

CHART 4 IMPLICATIONS OF THE SSM FOR THE NBB IN TERMS OF DECISION-MAKING PROCESSES CONCERNING INSTITUTIONS SUBJECT TO ITS SUPERVISION



Source: NBB.
(1) Home supervision concerns supervision in the bank's country of origin at the highest consolidation level.
(2) Host supervision concerns supervision in the host country of branches or subsidiaries of banks of foreign origin.

composition. The national competent authorities of the countries where a bank is established will appoint the staff members to form part of the JSTs. For the national authorities, they form the key resource for assisting the ECB in the preparation of its supervisory tasks. In fact, in the case of banks subject to the ECB's direct supervision, the files are to be prepared by the JSTs in accordance with clearly defined procedures harmonised at SSM level. While the final decision will now rest with the Supervisory Board and the Governing Council, the NBB will nevertheless be informed in advance of all proposals for decisions relating to significant credit institutions, both via the JST members who will report regularly to the Bank on the work of the SSM bodies, and via the national representatives on the Supervisory Board and the Governing Council.

For banks considered less significant and for institutions not subject to ECB supervision, such as branches directly subject to the law of a non-EEA Member State, the NBB retains full responsibility for the final decisions [1]. However, the supervision methods must be harmonised with those developed for banks deemed significant, with due regard for the principle of proportionality.

Entry into force of the SSM will also affect institutions subject to direct ECB supervision. Although the NBB will remain the contact point for certain specific matters such as verification of the expertise and integrity of the management, these institutions will in future contact the ECB on most matters in order to ensure uniform treatment within the SSM. Moreover, regular meetings between the supervisory authority and the institutions will from now on take place under the aegis of the ECB and the JSTs. While the national authorities will continue to take charge of the regular collection of prudential data, the ECB will conduct the necessary checks to ensure the level of quality.

(1) Except for decisions relating to "common" procedures, where the final decision rests with the SSM decision-making bodies.

3. Single resolution mechanism

On 10 July 2013, the European Commission published a proposal for a Regulation establishing rules and a procedure for the resolution of credit institutions in the framework of a single resolution mechanism (SRM)[1]. That proposal aims to establish the second pillar of the banking union, complementing the other two pillars, namely the single supervisory mechanism and the harmonised deposit guarantee system. The single resolution mechanism aims to strengthen the cohesion of the banking union by centralising resolution responsibilities at European level by analogy with the planned centralisation of responsibility for supervision. That alignment is necessary because supervision, early intervention and resolution form a continuum. It ensures that the implications of supervision responsibilities exercised at central level do not have to be borne by the national authorities in the resolution framework.

The SRM as proposed by the EC is based on the creation of a Single Resolution Board and a Single Bank Resolution Fund. The Single Resolution Board is to be composed of an Executive Director, a Deputy Executive Director, and representatives of the European Commission, the European Central Bank, and the national resolution authorities. It will be responsible for drawing up resolution plans for all banking groups established in Member States participating in the SSM, and for banks not forming part of a group. As a corollary, it will also assess resolvability and stipulate the minimum own funds requirements. In addition, it will determine the liabilities to be taken into account in the bank's bail-in, taking care not to jeopardise financial stability. Finally, the Board is to define the approach to be adopted where, in cooperation with the SSM, it finds that a group or a bank actually meets the conditions for resolution. In particular, that implies determining the use to be made of the various resolution tools, namely (i) sale of the business, (ii) use of a bridge institution, (iii) asset separation, and (iv) bail-in. The approach proposed by the Single Resolution Board will be validated by the European Commission, while it will be implemented by the national resolution authorities concerned, under the supervision of the Single Resolution Board.

The definition of a resolution approach is governed by a set of principles designed to ensure continuity of the critical functions performed by the institution but without resorting to public funding and taking care to avoid certain forms of moral hazard. The Single Resolution Board has to ensure that the shareholders are the first to bear the losses, followed if necessary by the institution's creditors, according to the order of priority for bankruptcy cases and giving equitable treatment to creditors in the same class. In particular, no creditor may incur greater losses than would have been the case if the institution had been the subject of bankruptcy proceedings. Finally, the Single Resolution Board will ensure that the institution's management is dismissed, except where retention of the management is necessary for the achievement of the resolution objectives.

The Single Resolution Fund is to be financed by credit institutions and investment firms. This Fund will replace the national resolution funds of the participating Member States and will take on their role. It will have six intervention options. First, it can guarantee the assets or components of the liabilities of an institution in resolution, one of its subsidiaries or a bridge institution or asset management vehicle. Second, it can grant a loan to these various bodies. Third, it can acquire certain assets of an institution in resolution. Fourth, it can contribute to the capital of a bridge institution or asset management vehicle. Fifth, it can also pay compensation to shareholders or creditors if

(1) Proposal for a Regulation of the European Parliament and of the Council establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund and amending Regulation (EU) No. 1093/2010.

it is established that the compensation granted to them is too little in view of the situation which would have applied to them in a bankruptcy scenario. Finally, it can contribute to the bail-in if the latter has not been applied to all creditors eligible for the bail-in.

On 18 December 2013, the EU Council of Ministers concluded an agreement on the general approach concerning the single resolution mechanism. That agreement concerns both a compromise text of the Regulation establishing rules and a procedure for the resolution of banks under a single resolution mechanism, and on the intention to conclude an intergovernmental agreement by 1 March 2014 which will govern the Single Resolution Fund. That Fund is to be financed mainly by the banking sector and provided with a back stop at the expense of the national authorities or the ESM[1], if the available funds prove insufficient. The compromise text contains adjustments in relation to the decision-making process within the SSM, the composition of the Single Resolution Board and the powers of the Single Resolution Fund. Negotiations with the European Parliament can therefore begin with a view to concluding an agreement by the end of the legislature.

The European Commission intends the SRM to take effect on 1 January 2015. However, in order to function correctly, this mechanism, which is an essential extension of the single supervisory mechanism, must be supported by a uniform body of rules within the participating Member States. The entry into force of the SRM therefore also depends on the date of entry into force of the Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions[2], scheduled for 1 January 2015[3].

That Directive will be partly transposed in Belgium via the new banking law which, among other things, gives the National Bank the role of resolution authority; for that purpose, a Resolution College will be formed at the Bank. This new resolution authority will therefore need to work with the Single Resolution Board in connection with the tasks conferred upon it[4].

(1) On 21 June in the year under review, the Eurogroup reached agreement on the direct recapitalisation of financial institutions by the EMS. That recapitalisation will be limited to € 60 billion. The operational framework will only be completed once the European Parliament has finalised the legislative proposals for recovery and resolution and the deposit guarantee system.

(2) Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC ,82/891/EC, 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No. 1093/2010.

(3) See chapter B, section 2.4 of the part on "Prudential regulation and supervision" of the Report, concerning the legislative framework for the recovery and resolution of banks.

(4) See chapter B, section 2.4 of the part on "Prudential regulation and supervision".

4. Macroprudential policy

The single supervisory mechanism, which has a microprudential task, will have to coordinate its action with that of the macroprudential authorities responsible for ensuring the stability of the financial system as a whole. Indeed, one of the great lessons of the recent crisis was that an individual approach to the institutions is not enough to contain the risks of financial fragility. In a context of global markets, the interactions between financial intermediaries can rapidly trigger contagion which will spread all the faster if the main market players have adopted similar strategies or identical positions.

This macroprudential dimension calls for specific competence, because it requires not only the development of an aggregate view of the functioning of the financial markets, but also a clear grasp of the interactions between the real and financial spheres of the economy. The causes of instability in the system are not solely linked to endogenous factors but may also come from developments in the structure of economic activities, featuring – at global level – structural imbalances in the current account balance or, at national level, abnormal growth of certain categories of expenditure and investment, notably in the real estate sector.

As a result of their position at the heart of the financial system, combined with the expertise developed in conducting one of the main components of macroeconomic policy, central banks are destined to play a leading role in defining such a macroprudential policy. The policy has to combine two major imperatives. It must be coordinated within economic regions where there is close financial integration, as in the euro area, because contagion effects are liable to be particularly virulent in such an environment. At the same time, since it is evident that financial instability may also occur within a particular market as a result of cyclical developments specific to one country, that is an argument for leaving some national autonomy. First, despite the creation of a single resolution mechanism, the domestic authorities will still carry primary responsibility for the financial implications of a systemic crisis affecting their economy. Also, those authorities will be more likely to use their freedom of action in relation to macroprudential policy if the other main components of macroeconomic policy, such as monetary and microprudential policy, are increasingly beyond their direct control.

These were the considerations behind the setting up in 2010 of the European Systemic Risk Board (ESRB), which was given the task of coordinating the conduct of macroprudential policy within the EU and, via its warnings or recommendations, prompting national or European authorities to take action in this area. So far, the ESRB has made six recommendations. Four of them concern specific topics, namely lending in foreign currencies, funding of credit institutions in dollars, monetary undertakings for collective investment, and funding risk assessment and follow-up. Two more specifically concern the establishment of appropriate structures for exercising macroprudential policy.

The first of these two recommendations calls on all EU Member States to designate a national authority specifically responsible for this policy. In Belgium, the government proposes to confer that mandate on the NBB by its draft law establishing the mechanisms of a macroprudential policy and spelling out the specific tasks devolved to the NBB in connection with its task of contributing to the stability of the financial system. For that purpose, the Bank will be authorised to collect any useful information from institutions that could generate a macroprudential risk, if appropriate via the bodies responsible for supervising those institutions. It will be able to mobilise in-house information and expertise and be supported by its regular contact with the other bodies concerned, and

its relations with the European authorities involved in the exercise of macroprudential policy.

Another ESRB recommendation asks the Member States to develop a strategy for the conduct of macroprudential policy by defining intermediate objectives, using specific instruments and periodically assessing those objectives and instruments. The draft law provides for a broad range of instruments to enable the Bank to comply with that recommendation. In that respect, a distinction should be made between the instruments which had originally been intended for microprudential aspects and certain instruments for exclusively macroprudential use. The former include the imposition of supplementary requirements regarding own funds or liquidity, either in general or geared to certain exposures, and quantitative limits in relation to counterparties or certain activities. The Bank can implement them directly so long as it first informs the competent authorities and takes account of any objections that they raise. The second set of instruments comprises measures relating to mortgage loans, concerning loan-to-value ratios and debt service ratios for borrowers ; these measures are to be implemented by the government on the recommendation of the Bank.

However, the NBB did not wait for the formal introduction of this new law before implementing measures to prevent the emergence of systemic risks. While the previous legislation had not designated an authority responsible for macroprudential policy as such, the Bank's Organic Law had long included contributing to financial stability among the Bank's tasks. This role of the Bank was greatly extended in April 2011 with the implementation of the "twin peaks" model, incorporating the macroprudential and microprudential dimensions of financial supervision and giving the Bank special powers in relation to systemic institutions.

That is the backdrop against which the Bank introduced two adjustments to its regulations on own funds at the end of 2013. In view of the recent property price rises and the economic uncertainty that could impair borrowers' future repayment capabilities, as part of a comprehensive package, it increased the weighting coefficients of mortgage loans, the levels of which were considerably lower than those prevailing in most neighbouring countries (see chapter C, section 2.1 of the part on "Prudential regulation and supervision" of the Report). Also, when considering the need for structural reform of the Belgian banking sector, the Bank decided to impose a capital surcharge on trading activities above a certain threshold, in order to reduce the scale of credit institutions' high-risk activities (see chapter B, section 3 of the "Prudential regulation and supervision" part).

The centralisation of the prudential supervision of credit institutions in the future SSM means that the Bank will coordinate its macroprudential action with the ECB to a greater extent than in the past. Up to now, that coordination was based essentially on existing interactions between financial stability and price stability, the primary objective of the ECB's monetary policy. It was based on Article 127.5 of the Treaty on the Functioning of the European Union, stipulating that the ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system. On taking direct responsibility for the individual supervision of systemic financial institutions in the euro area, the ECB will supervise the use for microprudential purposes of many instruments which could also be mobilised in the macroprudential sphere. That will not remove all need for more targeted use of these tools by the national authorities, in the event of developments threatening the financial stability of one of the Member States. The SSM Regulation stipulates that both the

TABLE 1 EUROPEAN PRUDENTIAL SUPERVISION ARCHITECTURE

	Microprudential supervision		Macroprudential supervision		Prudential regulation
	Euro area	Rest of the EU	Euro area	Rest of the EU	EU
Banks	SSM / national authorities	National authorities	SSM / national authorities / ESRB	National authorities / ESRB	EC / EBA
Other financial institutions	National authorities		National authorities / ESRB		EC / EIOPA / ESMA

Source : NBB.

national competent authorities and the ECB may, subject to prior mutual notification, impose additional solvency requirements for systemic purposes. Consequently, these respective powers will reinforce and supplement each other in order to raise the level of requirements if appropriate, but not to reduce it so as to prevent the conduct of macroprudential policy leading to a relaxation of the prudential rules.

The establishment of this new framework for the coordination of macroprudential policy between the ECB and the national central banks will have to be reconciled with the establishment within the ESCB of a governance structure which safeguards the autonomy of the exercise of the individual supervision of credit institutions and at the same time maintains the independence of monetary policy. In the macroprudential sphere, there will be a need for special arrangements reflecting the hierarchy that already prevails at the level of most Member States, where the central bank is the main player in regard to the introduction of regulations specifically designed to prevent systemic risks.

The ECB will also have to liaise with the ESRB, which will retain its own macroprudential powers. They are more limited than those of the ECB, since the ESRB only has power to issue warnings or recommendations, with no direct control over the actual use of the instruments. At the same time, those powers are more extensive in that the ESRB's mandate covers the whole of the EU and extends beyond just the credit institution segment to encompass the whole of the financial sector.

5. Belgian supervision framework

The Law of 2 July 2010 [1] laid the foundations for a radical change in the supervision of firms in the financial sector in Belgium, conferring on the King the powers necessary to transfer the prudential supervision of credit institutions, insurance companies, investment firms, reinsurance companies and institutions for occupational retirement provision (IORPs) to the National Bank of Belgium.

In accordance with this reform introduced by the "twin peaks" Royal Decree, the Bank became the main prudential supervision authority while the FSMA conducts the transverse supervision of the rules of conduct, market supervision, and consumer information and protection [2]. The report to the King preceding the "twin peaks" Decree also defined the dividing line between the powers of the two institutions: *"The prudential rules aim specifically to ensure the soundness of financial institutions by imposing requirements relating in particular to the solvency, liquidity and profitability of those institutions; the rules of conduct aim specifically to ensure the honest, fair and professional treatment of customers via requirements relating in particular to the firm's competence, the conduct of its business and the conscientious treatment of the customer or consumer under the code of conduct."*

5.1 Cooperation protocol between the Bank and the FSMA

The new "twin peaks" supervision architecture implies some interaction and consultation between the Bank and the FSMA in order to coordinate the performance of their supervisory tasks. While the banking and financial legislation amended by the "twin peaks" Royal Decree contains some provisions on coordination of the supervision by the Bank and the FSMA, it also stipulates that these two authorities are to conclude a protocol in order to lay down the practical arrangements for the cooperation specified by law, and to determine the cases where further coordination is necessary to ensure uniform application of the legislation.

The Bank and the FSMA concluded that protocol on 14 March 2013 [3]. It was intended to spell out the two authorities' mutual understanding of the cooperation which exists between them while pointing out that it is for each authority to perform the tasks assigned to it by law with full autonomy and responsibility. The cooperation takes three forms, namely the exchange of information, consultation and coordination; the latter is arranged as a dialogue after which the authority that has to decide takes sole responsibility for the decision.

Among other things, the two authorities agreed that, apart from the exchange of information specified by the banking and financial legislation, they would on their own initiative exchange all information of significance and relevance for the performance of their respective tasks so that each of them may take its decisions in full knowledge of the facts. Similarly, they agreed to consult one another in order to ensure the uniform application of the banking and financial legislation.

In addition to the regular meetings between the Governor of the Bank and the Chairman of the FSMA, the protocol establishes a liaison committee and a joint supervision policy committee. These two committees aim to ensure a continuous dialogue between the two authorities on the implementation of the protocol and the coordination of

(1) Law of 2 July 2010 amending the Law of 2 August 2002 on the supervision of the financial sector and on financial services, and the Law of 22 February 1998 establishing the Organic Statute of the National Bank of Belgium, and containing miscellaneous provisions.
(2) See Parliamentary documents, 52nd legislature, 2009-2010, No. 2408/1, p. 27.
(3) General protocol on the cooperation between the National Bank of Belgium and the Financial Services and Markets Authority to ensure the coordination of the supervision of the institutions subject to their respective supervision. This protocol is published on the respective websites of the two authorities.

their supervision policies respectively. In this context, the Bank and the FSMA consulted one another in particular on aspects relating to the fit and proper character of managers and on money-laundering.

The protocol also describes the practical arrangements for cooperation between the two authorities.

It should also be mentioned that this general protocol on cooperation conforms to the recommendations made by the IMF in the context of the FSAP and that, apart from this protocol, the Bank and the FSMA have already concluded a cooperation agreement on the supervision and monitoring of market infrastructures, while a protocol on foreign investment firms is currently being finalised.

5.2 Supervision of occupational pension and supplementary pension institutions

The powers relating to the prudential supervision of IORPs have not yet been transferred to the Bank. That transfer is enshrined in chapter 20 of the "twin peaks" Decree, but under Article 351 (2) 3rd indent of that Decree the effective date of the transfer is to be determined by a Royal Decree. In the absence of such a decree, the transfer will take place automatically on 31 December 2015. It was also stipulated that by no later than 31 December 2013 the Bank and the FSMA are to produce a report to "enable the King to take a decision on the entry into force of the provisions of this chapter". Among other things, that report is to examine any changes which have occurred in regard to the characteristics of the legislation and the IORP market, and is to ensure equivalent treatment of institutions operating in the second pillar pension sector (insurance companies and IORPs) so as to avoid prudential arbitrage. The Bank submitted its report to the government at the end of 2013.

B. Prudential regulation

1. Introduction

During the year under review, work continued on the reform of the prudential regulatory framework. The measures were transposed into Belgian and European law on the basis of the guidelines established by the international institutions.

For the banking sector, this concerned more specifically the publication of CRD IV and CRR, which apply from 1 January 2014, and the proposals for a Regulation on the single resolution mechanism and a Directive on the recovery and resolution of banks. These European provisions need to be transposed into Belgian law, hence the new banking law. Its scope is very broad: as well as transposing CRD IV, CRR and the recovery and resolution provisions, it covers structural reforms and remuneration policy. These various points are considered in more detail in section 2 of this chapter.

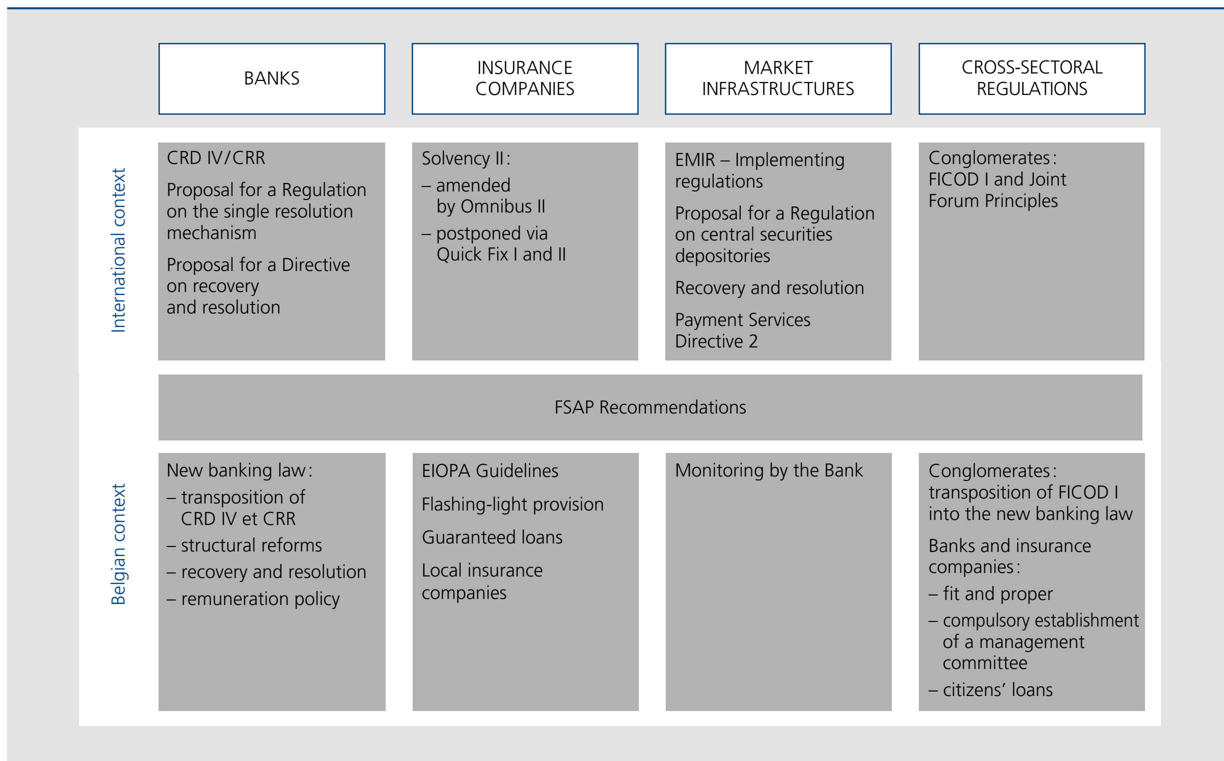
In regard to the insurance sector, the changes concerning prudential regulation stipulated in the Solvency II Directive [1] were postponed again. However, transitional measures were adopted under the Quick Fix I and II Directives, so that some provisions of the Regulation could already be implemented. In addition, the Solvency II Directive required amendment, and that was done by the Omnibus II Directive. Owing to the delay in implementing Solvency II, it was not possible to finalise a predraft Belgian law during the year under review. In order to prepare firms for the new supervision regulations, the Bank decided to comply with and supplement the EIOPA guidelines. Furthermore, measures were adopted at Belgian level concerning interest rate risk provisions (flashing-light provisions), while the Bank submitted predrafts to the government on the acceptance of publicly guaranteed loans as covering assets and the system of exemption for local insurance companies. Section 3 of this chapter looks at these subjects in more detail.

For market infrastructures, the standards for central counterparties were laid down in the European Market Infrastructure Regulation (EMIR) [2] and the Implementing Regulations. In addition, further work was done on the European legislation on central securities depositories, the recovery and resolution of market infrastructures, and payment services. The Bank kept a close watch on all these activities, as discussed in section 4 of this chapter.

Progress was also made at cross-sectoral level, starting with the transposition via the new banking law of the Financial Conglomerates Directive (FICOD I) [3] and the Joint Forum Principles. In regard to the banking and insurance sector, the Bank paid particular attention to the fit and proper character of the management of financial institutions. From now on, under the banking law and the alignment of the insurance supervision law, it is compulsory to set up a management committee. Finally, in regard to "citizens' loans", the Bank has the task of checking whether the use of the money raised by means of these contracts conforms to the legal rules. These cross-sectoral aspects are explained in section 5 of this chapter.

(1) Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of insurance and reinsurance.
(2) Regulation (EU) No. 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories.
(3) Directive 2011/89/EU of the European Parliament and of the Council of 16 November 2011 amending Directives 98/78/EC, 2002/87/EC, 2006/48/EC and 2009/138/EC as regards the supplementary supervision of financial entities in a financial conglomerate.

CHART 5 REFORMS OF THE PRUDENTIAL REGULATION FRAMEWORK IN 2013 (1)



Source : NBB

(1) The legislation mentioned in the "international context" was in many cases already finalised previously but had an impact on the "Belgian context" during the year under review.

2. Banks

2.1 Transposition of Basel III into Community law – CRD IV/CRR

The lengthy process of transposing into Community law the Basel Committee proposals known as Basel III, on which work had begun in 2011, culminated in the June 2013 publication of CRD IV and CRR. This Directive and the Regulation applied on 1 January 2014 (1).

The Directive introduces new organisational provisions which require the establishment, within the statutory board of directors, of an audit committee, an appointments committee, a risk committee and a remuneration committee. In regard to the last two, the risk committee is intended to enable the statutory board of directors to determine the institution's risk strategy and risk tolerance with full knowledge of the facts, and to keep a close watch to ensure that the effective management of the institution implements and respects these two parameters. The remuneration committee has to ensure that the incentives created by the remuneration system, including the promotion system, are not such as to lead to excessive risk-taking in the institution or behaviour motivated by interests other than those of the institution and its stakeholders. To that end, the Directive specifically defines the policy rules applicable to the variable components of remuneration. In particular, except in special cases, it limits the variable component of remuneration to 100 % of the fixed component.

The new European Regulation defines the minimum solvency and liquidity requirements to be respected by all credit institutions and investment firms in Europe. Those requirements are equivalent to the ones proposed by the Basel Committee and approved by the Group of Governors and Heads of Supervision, and later by the G20 in November 2010 (2). Long transitional periods are specified for both categories of requirements, so that the new regulations can be phased in gradually, thus moderating their economic impact.

Solvency requirements

In regard to solvency, the EU Regulation introduces a leverage ratio. That ratio defines the minimum amount of own funds in relation to the total volume of assets, in order to ensure that a rapid rise in lending to counterparties with a low risk weighting does not lead to an excessive increase in the total debt ratio or leverage. It also sets aside any inconsistencies in the calculation of risk-weighted assets. While the Basel Committee proposed a level of 3 %, the Regulation only introduced the leverage ratio as an observation ratio up to 1 January 2018. In the light of the lessons derived from this observation period regarding the impact on credit institutions' business, the Commission can then make this ratio mandatory via a legislative proposal which will have to be approved by the Council and by the European Parliament.

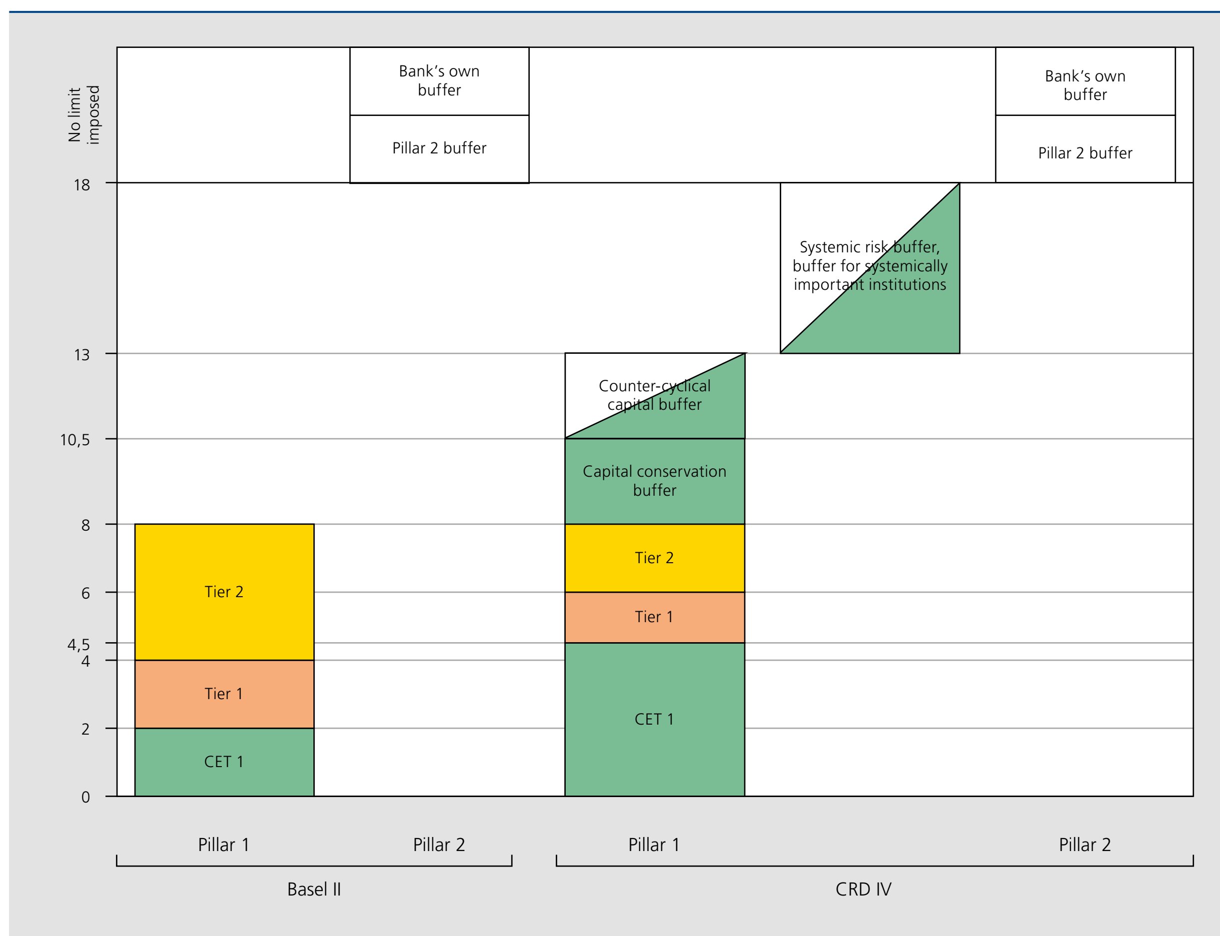
The Regulation also modifies the minimum solvency ratios expressed as percentages of the own funds to be held in relation to the weighted risk volume. Compared to the previous rules, the percentages to be respected have been raised and the definitions of both own funds and the weighted risk volume for specific risks have been tightened up. As for the percentages, the new minimum requirements raise the solvency ratio from 2 % to 4.5 % for core elements of own funds (common equity Tier 1 – CET 1), from 4 % to 6 % for Tier 1 and to 8 % in terms of total capital.

(1) CRD IV and CRR came into force on 17 July 2013 and on 28 June 2013 respectively. CRD IV had to be transposed into the national law of the Member States by 31 December 2013. CRR applies from 1 January 2014.

(2) See Report 2011, "Financial stability and prudential supervision", p. 50 to 54.

CHART 6 MINIMUM REQUIREMENTS FOR REGULATORY CAPITAL UNDER BASEL II AND CRD IV AT THE END OF THE TRANSITION PERIOD (1)

(in % of the risk-weighted assets)



Source: Basel Committee.
(1) A completed box indicates an obligation, a blank box indicates an option.

In the definition of own funds used for these ratios, the emphasis is on the core elements of own funds, which essentially comprise the capital represented by the ordinary shares and the reserves. In addition, the deductions and adjustments to own funds, e.g. in respect of goodwill or holdings in other financial institutions, were harmonised and are now applied to these core elements of the own funds. In forming their Tier 1 equity, institutions can always include hybrid debt instruments in addition to the common equity elements, so long as they are perpetual, offer total flexibility on payment and remuneration, and can be used to cover losses if necessary. Subordinated instruments with a minimum maturity of five years can continue to be taken into account as additional or Tier 2 elements in calculating the total own funds.

Turning to the risk-weighted exposure, the Regulation strengthens the capital requirements for credit risks in the case of derivatives business by imposing a capital charge for potential losses of market value resulting from downgrading of the counterparty's credit rating. Conversely, to attenuate the risk that higher solvency standards could affect lending to SMEs, the Regulation permits a 24 % reduction in the credit risk requirements for loans to SMEs, subject to certain conditions. These lower requirements will be reviewed in 2017 on the basis of a report to be drawn up by the EBA on the situation regarding lending to SMEs and the risks associated with that business.

The CRD IV Directive introduces an additional provision to lessen the pro-cyclical effect of the solvency requirements. As well as the minimum required by the Regulation, credit institutions will have to gradually build up a 2.5 % common equity buffer, known as the capital conservation buffer. In the event of a crisis, the supervisory authorities may decide to reduce the level of that buffer in order to

enable the banking sector to continue financing the economy; conversely, in the event of a credit boom, they can increase the level with an extra capital buffer known as the counter-cyclical capital buffer. If a credit institution has insufficient own funds to meet the minimum requirement and form the required buffers, the supervisory authority may impose restrictions on the payment of dividends to shareholders and on variable remuneration.

The EBA was given the task of drawing up the technical measures to ensure uniform application of these rules in Europe. In practice, that means that the Member States will have less freedom than before to impose more stringent standards on their entire banking sector. However, the Regulation and the Directive do offer the Member States some flexibility for increasing the regulatory requirements, so long as that is justified either by macroprudential risks or by structural differences between the various national financial markets.

If heightened systemic risks pose a threat to the financial sector's stability, the European regulation permits the Member States to increase the overall capital requirements, impose targeted additional requirements, e.g. on the financial sector or the real estate sector, or impose stricter rules on risk concentrations [1]. However, these measures must be justified in the light of the increased risks. In certain cases the Council may oppose a measure taken by the Member State, particularly if the ESRB, the EBA or the Commission considers that the stated justifications are not sufficiently well-founded, that the proposed measure is inappropriate, or if it has an excessively adverse impact on the functioning of the Single Market.

The Member States can also impose an extra capital buffer to take account of the structural systemic risks in their financial sector. To cater for any adverse effects of that measure on the other Member States, a notification and authorisation procedure was introduced, obliging national authorities to notify the European Commission, the EBA and the ESRB one month in advance, stating the reasons for their decision. The EBA and the ESRB are responsible for assessing whether the decision to impose such a surcharge might have excessively harmful consequences for the financial system of other Member States or for the functioning of the single market. From 2016, the Commission may also automatically oppose any systemic risk requirement in excess of 5 % of the exposure.

Finally, in accordance with the international standards, the Directive also allows the Member States to impose an extra capital buffer on institutions deemed systemically important at global or local level. That additional requirement may range between 1 % and 3.5 % of the weighted exposure and must be met by the common equity.

As regards the practical application of this new legislation to Belgian credit institutions and investment firms, the Bank prepared its own draft regulation during the year under review. This draft sets out, among other things, the rules on exercising the options left open by the European legislation and the rules on application of the transitional measures.

As far as the rules on exercising the options are concerned, the Bank decided in particular to maintain its policy on the treatment of holdings in insurance companies, accepting that these are not deducted from the own funds if they are held by a mixed financial holding company. In contrast, holdings by credit institutions or investment firms must be deducted from the own funds. The Bank also decided to maintain its policy on risk concentration by limiting the exposures of Belgian subsidiaries of foreign institutions to their group to 100 % of their own funds.

In addition, the Bank adopted a set of measures to enable credit institutions to adjust the level of their own funds gradually to the new regulations. For example, during a transitional period, it authorised them to retain in their own funds existing capital instruments which do not meet the eligibility criteria under the new regulations. If they are not redeemed in the meantime, these instruments will be gradually excluded from the own funds over a ten-year period. New deductions from the own funds, mainly those relating to unrealised losses on the investment portfolio recorded at market value and deferred taxation, will be phased in over a five-year period.

Liquidity standards

Published by the Basel Committee on Banking Supervision in December 2010, the Basel III package includes for the first time, in addition to solvency requirements, two harmonised international liquidity standards: the liquidity coverage ratio (LCR), which requires banks to hold sufficient buffers in the form of liquid assets to withstand a serious liquidity crisis independently for one month, and the net stable funding ratio (NSFR), which focuses on a robust structural liquidity position and encourages institutions to finance their illiquid assets with relatively stable sources of funding, such as long-term funds, capital and deposits of households and SMEs. At the beginning of 2013, the Basel Committee published a finalised version of the LCR

(1) See chapter A, section 4, of the part on "Prudential regulation and supervision" of the Report.

calibration. During the year under review, the Committee continued its analysis of the interactions between the LCR and monetary policy, the transparency requirements for the LCR and the final calibration of the second ratio, the NSFR.

Under the terms of the CRR, the first harmonised liquidity ratio, the LCR, is to apply to all credit institutions and financial holding companies in Europe from 1 January 2015, both in regard to individual legal entities and at the highest consolidation level in Europe. The LCR will be phased in as a regulatory standard, starting with a minimum requirement of 60 % at the beginning of 2015, raised by 10 % a year in 2016 and 2017, and by 20 % at the beginning of 2018 to bring the ratio up to 100 %. The CRR stipulates that the European Commission will specify the final details of the European LCR by no later than the end of June 2014. The EBA was also requested to devise various technical standards and guidelines defining certain aspects of the LCR. On the subject of the NSFR, the CRR states that the European Commission may prepare a legislative proposal by the end of 2016, introducing this ratio as a regulatory standard. Finally, the CRR provides for the establishment of unified liquidity reporting for all credit institutions from 2014.

With effect from 2015, liquidity regulation and reporting in Belgium must therefore be adapted or replaced in accordance with the European single rulebook specified by the CRD IV and the CRR. However, as the local supervisory authority, the National Bank retains some discretion over the transition from the national liquidity ratios to the LCR, even in the case of significant banks subject to the direct supervision of the SSM, until such time as the LCR has been fully phased in by the CRR. The Bank's liquidity rules have already been applying quantitative liquidity standards comparable to the LCR since 2011. The Bank therefore intends to make sure that credit institutions and financial holding companies under Belgian law continue to hold sufficient liquidity reserves at the time of transition from the Bank's ratio to the LCR, in order to avoid any "cliff effects" [1] due to the phased introduction. The CRR explicitly allows the national authorities to impose stricter requirements until the LCR has been introduced in full. The Bank therefore intends to phase in the European LCR 100 % from 1 January 2015. After that date, the Belgian regulations on quantitative liquidity standards and liquidity reporting will therefore cease to apply in the case of all Belgian credit institutions and financial holding companies. The Bank explained these strategic decisions in a communication to the institutions concerned. In a later phase, these plans will be put into effect via adjustments to the relevant regulations.

In preparation for the introduction of these international standards as liquidity requirements for Belgian banks, a sample of institutions are already submitting quarterly reports to the supervisory authority on their position. The EBA then uses that information to draw up various technical standards and guidelines defining certain aspects of the LCR. From 2014, the said introduction of European prudential liquidity reporting will require all credit institutions and financial holding companies to submit reports on the standards laid down by Basel III. Apart from the reporting on these two future liquidity standards, the EBA has also developed additional harmonised reporting on other aspects of the banks' liquidity position, notably the maturity of the assets and liabilities and the concentration of funding per counterparty and per product. This additional reporting will enable the supervisors to gain a fuller picture of the position of institutions and to monitor it more effectively.

2.2 Transposition of the CRD IV and the CRR into Belgian law

The CRD IV Directive and the CRR Regulation were adopted on 26 June 2013. They implement the recommendations of the Basel Committee on Banking Supervision, particularly the "Basel III" provisions [2]. In view of the extremely short time allowed for transposing the CRD IV and the CRR into Belgian law, the Bank made a major contribution to the work of transposition conducted under the direction of the Minister of Finance. That work was incorporated in a fundamental revision of the Banking Law of 22 March 1993 [3] [4]. The entry into force of the new banking law is to be accompanied by an important regulatory section designed in particular to implement various options that the CRR left to the discretion of the Member States and national competent authorities.

The transposition also affords the opportunity for clarifying the scope of certain provisions in line with the IMF's Financial Sector Assessment Programme (FSAP) [5] and the Basel Committee's recommendations.

CRD IV contains numerous provisions on governance [6]. Those provisions were reclassified in order to bring

(1) Avoidance of cliff effects when phasing in the LCR means the need to ensure that banks already respecting the 100 % standard do not temporarily reduce their liquidity buffers because the LCR is being phased in and only stipulates a ratio of 60 % in 2015.
(2) See chapter B, section 2.1, of the part on "Prudential regulation and supervision" of the Report.
(3) Law of 22 March 1993 on the status and supervision of credit institutions.
(4) The changes concerning investment firms, especially brokerage firms, will form the subject of a separate draft law.
(5) See chapter C, section 1.1, of the part on "Prudential regulation and supervision".
(6) See chapter B, section 2.1, of the part on "Prudential regulation and supervision".

together in the new law all the measures concerning the governance structure as such. Those measures are described in Box 2.

While there are no other substantial changes concerning access to the banking business, the new law includes various additional modifications derived essentially from CRD IV, intended to regulate the pursuit of the business. This mainly concerns risk management and remuneration policy [1]. A separate chapter devoted to specific operations (mergers and assignments, issuance of covered bonds, pursuit of activities abroad, etc.), groups together some subjects already covered by the Banking Law of 22 March 1993, with the addition of strategic decisions, originally introduced for systemically important institutions in the Bank's Organic Law.

The chapter of the new banking law concerning regulatory standards and obligations is supplemented by the new provisions on additional capital buffers. Those buffers must consist of top-quality own funds, as they are meant to be the first to absorb any losses that the credit institution incurs in its activities. This concerns the capital conservation buffer, the counter-cyclical capital buffer, the capital buffer for systemically important institutions and the capital buffer for macroprudential risk. These new requirements are derived directly from CRD IV.

Compliance with these additional requirements on the formation of capital buffers is assured by the innovative provisions imposing restrictions on the payment of dividends. The new banking law stipulates that so long as the institution fails to satisfy its additional CET1 requirement, it may not pay out any dividends that result in a reduction in the common equity Tier 1 or CET1. In such cases, the priority must be to rebuild the highest quality core equity.

However, in accordance with CRD IV, the new banking law does permit some derogations from this principle of a ban on any dividend payments. Those derogations, which are subject to conditions that vary according to the size of the reduction in the safety buffers, thus enable credit institutions to rebuild their capital gradually by earmarking part of the profits for restoration of the buffer first before any discretionary distribution (dividends, share repurchases and variable bonuses, etc.). CRD IV circumscribes the progressive character of the capital

(1) See chapter B, section 2.5, of the part on "Prudential regulation and supervision".

Box 2 – Provisions on governance in the new banking law

CRD IV devotes much attention to the statutory board of directors, specifying its role and responsibilities in many areas. First, the statutory board of directors is expected to define the business strategy and objectives, including the institution's risk tolerance. Next, in order to strengthen the supervisory and monitoring role of the statutory board of directors, one of the key aims of CRD IV, it is necessary to make a clear distinction within that body between the supervision and monitoring functions relating to the institution on the one side and those relating to the effective management on the other.

That is why the new banking law makes it mandatory to establish a management committee within the statutory board of directors of credit institutions [1]. This presupposes that the non-executive board members, who are therefore not members of the management committee, form the majority on the statutory board of directors, that all executive board members, and only those members, form part of the management committee, and finally, that the chairman of the statutory board of directors is not the same person as the management committee chairman.

The supervisory authority will have a power of derogation which may lead to some relaxation of the requirements in the case of smaller organisations, in accordance with the principle of proportionality for which CRD IV makes express provision.

(1) See also section 5.2 of this chapter.

In order to enhance the effectiveness of the supervision and monitoring of the activities, operation and risk profile of significant institutions by the statutory board of directors, CRD IV requires four special committees to be set up within that board. Apart from the audit committee and the remuneration committee already stipulated by the Law of 22 March 1993, the new banking law requires the creation of a risk committee and a nomination committee. These committees are responsible for preparing the decisions of the statutory board of directors on their respective subjects. Only the non-executive members of the statutory board of directors – who are not involved in the effective management of the institution – may form part of these committees, which are intended to reinforce the supervisory function of the statutory board of directors.

The establishment of a risk committee within the statutory board of directors is one of the key advances of CRD IV. That is why the latter, and hence the new banking law, stipulate that each member of the risk committee shall individually have a full understanding of the subjects handled by the said risk committee. The statutory board of directors can then act with full knowledge of the facts to determine the risk strategy and risk tolerance appropriate to the institution, notably in regard to proprietary trading activities (see section 2.3 of this chapter), and closely supervise the implementation and compliance by the effective management of the institution.

The professionalisation of the statutory management bodies is to be evident not only in the profiles of their members but also in their degree of commitment and independence in the exercise of their mandate. In this connection, the nomination committee assesses the level of knowledge, commitment, availability and independent mindedness required for the statutory board of directors as a whole and for each of its members according to the characteristics of the credit institution.

At the instigation of the European Parliament, CRD IV also includes a specific provision aimed at encouraging diversity, more particularly the representation of women on the statutory management bodies. That provision was transposed into the new banking law.

As regards the operational organisation, it should be noted that the Law of 22 March 1993 contained very few specific provisions on the operational independent control functions of internal audit, risk management and compliance, which should not be confused with the aforesaid committees dealing with some of these subjects within the statutory board of directors. The relationship between the commercial and business units and the independent control functions is sometimes defined as the three-line defence model of a credit institution :

– the commercial and business units (including the front office) form the institution's first line of defence, which has to identify the risks of each transaction and adhere to the set procedures and limits ;
– the second line of defence comprises the oversight functions (sometimes also called support functions), namely the risk management function and the compliance function, responsible for ensuring that the risks are identified and managed by the commercial and business units (and the front office) in accordance with the set rules and procedures ;
– the third line of defence is the internal audit which, among other things, ensures respect for the procedures by the first and second lines of defence.

The new banking law defines the necessary independence of these three functions, their powers and the arrangements for remuneration of the person in charge and the staff assigned to the performance of the functions. It should be noted that, in practice, the new rules have largely been anticipated.

rebuilding thus defined, and imposes the calculation rules to be applied in order to determine how much institutions must retain and how much they can pay out ; this is known as the "maximum distributable amount".

The provisions on the oversight of credit institutions incorporate a new chapter on the prudential supervision process which transposes CRD IV, while corresponding to current good practice. The section on group oversight (oversight on a consolidated basis and

supplementary supervision of conglomerates) forms a coherent whole, containing the provisions of the EU legislation on supplementary supervision of financial conglomerates[1], the provisions of the Banking Law of 22 March 1993, and those of the Royal Decrees of 12 August 1994 and 21 November 2005[2][3].

As for the recovery measures applicable in cases where an institution fails to comply with the prudential laws or regulations, the banking law adds new, binding measures to the Banking Law of 22 March 1993, formulated on the basis of CRD IV, plus the possibility of implementing a recovery plan. In line with CRD IV, the new banking law in fact provides for two innovations.

The aim of the first innovation is that measures can be taken to remedy a failure before it actually occurs. If a supervisory authority has information indicating that, within the next twelve months, a credit institution is likely to cease functioning, in accordance with the current legislation on supervision, it can thus already require certain measures to be taken within a specified period. The second innovation consists in the option for the supervisory authority to impose tougher requirements on a credit institution if it identifies a failure or a recognised risk of failure, even if the authority has already set a recovery deadline. In that situation, the credit institution may be made subject to additional or specific requirements relating to solvency, liquidity, risk concentration, valuation, reporting or disclosure. The supervisory authority may also impose more binding measures on the rebuilding of the capital, in relation to dividend distribution or any payment to shareholders and/or holders of equity instruments, or concerning variable remuneration. These binding measures will be lifted when the supervisory authority finds that the institution has rectified the situation within the specified time.

Except for the provisions resulting from the changes inherent in the transposition of CRD IV, there is nothing fundamentally new about the provisions relating to penalty payments, other coercive measures and sanctions. The new banking law distinguishes between penalty payments and administrative sanctions, in view of their differing nature and purpose.

(1) See chapter B, section 5.1, of the part on "Prudential regulation and supervision".
(2) Royal Decree of 12 August 1994 on the supervision on a consolidated basis of credit institutions, investment firms and investment fund management companies.
(3) Royal Decree of 21 November 2005 organising the supplementary supervision of credit institutions, insurance companies, reinsurance companies, investment firms and investment fund management companies forming part of a financial services group, and amending the Royal Decree of 22 February 1991 containing general rules on the supervision of insurance companies and the Royal Decree of 12 August 1994 on the supervision on a consolidated basis of credit institutions.
(4) See chapter A, section 2, of the part on "Prudential regulation and supervision".

Finally, the new banking law includes amending provisions to bring it into line with the changes in European law, particularly the ECB's new powers in the prudential supervision sphere[4].

2.3 Structural reforms

In July 2013, the Bank published its final report on structural banking reforms in Belgium, following the publication of its interim report in June 2012. When the Belgian government asked the Bank to analyse the question of structural reforms, two countries had announced their intention to implement such reforms in the banking sector, namely the United States, by means of the Volcker rule, and the United Kingdom, with the Vickers reforms. In October 2012 an ad-hoc group of experts chaired by Erkki Liikanen and appointed by the European Commission published a report containing recommendations on structural banking reforms in Europe. The above examples provided either for a ban on proprietary trading (i.e. activities which do not meet the needs of customers) or the separation of certain types of trading activities into distinct entities, in that case with a choice between total compartmentalisation or partial ring-fencing (for activities above a certain threshold).

The current emphasis on structural reforms was prompted by the significant role played by the banks' proprietary trading – very often involving complex financial products – in exacerbating the recent financial crisis. Although trading activities undeniably entail a high degree of risk, it must also be remembered that they are heterogeneous: some are riskier than others, and some are better for the real economy than others. Trading activities are varied by nature: they may concern trading for own account, financial services for customers in which the bank acts as counterparty in transactions relating, for example, to derivatives that a customer wishes to buy or sell, market-maker activities – notably on government bond markets – where the bank, as an intermediary, ensures sufficient liquidity for the market to operate smoothly, the provision of issue guarantees, and transactions intended to hedge the banks' own risk positions resulting from its "traditional" banking business.

Unfortunately, it is quite difficult in practice to distinguish between proprietary trading and other trading activities. For instance, the characteristics of proprietary trading are similar to those of market-making and certain hedging activities. In these last two cases, the banking entity acts as the counterparty in negotiating the underlying position and only maintains its position for a limited period. Moreover, these positions, even if held only temporarily,

may also generate profits or losses as a result of price fluctuations. Owing to these similarities, the characteristics of a transaction are not sufficient in themselves to determine whether or not the trading is taking place for own account. Instead, it is the purpose of the transaction and the intention of the trader that are decisive.

This problem of distinguishing between proprietary trading and other forms of dealing with similar characteristics explains some of the differences between the multiple proposals currently on the table concerning structural banking reforms. Thus, the Liikanen group opted to recommend separation of both proprietary trading and the market-making activities of deposit banks in order to avoid the lack of clarity that the separate definition of the two types of activity would create. In the United States, where the Volcker rule only requires the separation of proprietary trading, the authorities have spent over two years preparing regulations to implement that rule.

Apart from the problems relating to the distinction between proprietary trading and other trading activities, the aims of the structural banking reforms are numerous and difficult to implement. Those aims include: eliminating any implicit subsidy resulting from the deposit guarantee for trading activities, protecting retail activities from contagion by risk-trading activities, reducing risk-taking, and limiting any risk of taxpayers having to bear the cost of a bankruptcy. In view of these numerous problems, the Bank opted for an overall approach in its report, making policy recommendations in such varied spheres as recovery and resolution frameworks, trading activities proper, the tax treatment of savings, and depositor protection. This set of potential measures offers various lines of defence in relation to the challenge of achieving the stated objectives of the structural reforms.

Recommendations on proprietary trading

Two recommendations in the Bank's final report concern trading activities, and get right to the heart of the problems connected with structural banking reforms. The first recommendation, which is based on the interim report, concerns the application of capital surcharges to trading activities above a certain threshold. The aim is to discourage institutions from engaging in excessive trading activities and to ensure that these trading activities do not create a serious obstacle if the bank should require resolution. The second recommendation concerns requiring banks to transfer their proprietary trading activities above a certain threshold to a separate entity which is banned from accepting deposits. Strict limits would be imposed on intra-group positions between the deposit bank and this trading entity.

For the capital surcharges, two indicators – one based on risk and the other not – will be used to determine the thresholds beyond which the banks will be subject to a surcharge. The concept of a non-risk-based indicator is comparable to one of the Liikanen group proposals for providing a back stop in addition to the risk-weighted capital requirements, to protect against inadequate capital requirements for market risk as a result of model risks and measurement errors. The Bank's non-risk-based indicator puts the threshold for the ratio between trading assets and total assets at 15 %.

The risk-based indicator used to determine the capital surcharge will be based on the amount of the capital requirements for market risk as a percentage of the total capital requirements. Although the requirements for market risk apply to the bank's trading portfolio positions and are therefore a good risk-based indicator for trading positions, the requirements for market risk also have to be calculated for all exchange rate risks. Since in practice a large proportion of foreign exchange positions result from the hedging of exposures in the banking book, the proportion of the requirements for market risk resulting from foreign exchange positions is deducted from the risk-based indicator. Expressed as a percentage of the total capital requirements, the threshold determined by the risk-based indicator for the total amount of the capital requirements for market risk, after deduction of the requirements for market risk resulting from the foreign exchange risk, comes to 10 %.

If the non-risk-based indicator triggers a capital surcharge for trading activities, the amount of the surcharge will be equal to 100 % of the volume of trading activities above the threshold of 15 % of the total assets. If the risk-based indicator triggers a capital surcharge, the amount of the surcharge will be equal to three times the amount by which the capital requirements for market risk exceed the threshold of 10 % of the total capital requirements. If both indicators are triggered, the amount of the surcharge will be equal to the higher of the surcharges implied by either indicator.

Table 2 shows the average values of the two indicators for the four largest Belgian banks. It is evident that the average of the two indicators would have exceeded the thresholds in 2008, although there are significant differences between the individual values for the various banks. The table also shows that the values of the two indicators have fallen over time, suggesting that trading activities declined in the wake of the crisis.

Another recommendation in the Bank's final report is that proprietary trading activities above a certain capital threshold should be separated from deposit banks. The Bank proposes imposing such ring-fencing if the capital requirements for proprietary trading activities as defined exceed a specified threshold. The Bank has yet to put forward a proposed figure for that threshold, but it must not exceed a percentage to be set at between 0 % and 2.5 % of the capital. That margin offers some flexibility in determining the exact threshold ; at this stage, that is necessary in view of the problem of defining proprietary trading and distinguishing it from other trading activities. That flexibility also appears appropriate because no other country has adopted a similar rule.

Rules to be laid down in a separate regulation will define proprietary trading as all the residual activities which cannot be placed in other categories, such as market-making activities by official market-makers, transactions made at the request of customers and adequately hedged, and transactions relating to cash management or asset and liability management. Since there are no clear definitions of market-making or customer services, the exact details of the definition of these categories in the new banking law and the implementing regulations will play a significant role in determining the amounts of the banks' trading activities which will be classed as proprietary trading.

Both the measures proposed in relation to trading activities are innovative, and Belgium will be the first country to implement rules of this type. In addition, the Bank considers that these two policies are complementary. On the one hand, as trading activities are generally very risky, the surcharge should prevent banks engaging in an excessive volume of trading. Also, proprietary trading which is not clearly of benefit to the real economy should not form a significant percentage of the banks' trading activities.

TABLE 2 VALUES OF THE NON-RISK-BASED INDICATOR AND THE RISK-BASED INDICATOR FOR THE FOUR LARGEST BELGIAN BANKS

(in %)

	End		Q1
	2012	2010	2008
Non-risk-based indicator	12.3	15.3	21.4
Risk-based indicator	5.2	8.8 (1)	13.9 (1)

Source: NBB.
(1) Estimated on the basis of the Basel 2.5 rules for capital requirements for market risks.

Other recommendations

The bank recovery and resolution sphere forms the subject of three recommendations which also figured in the interim report. The first recommendation prescribes the preparation of recovery and resolution plans for all domestic systemically important banks (D-SIBs). In that respect, the Bank has already started preparing and evaluating recovery plans for eight Belgian D-SIBs (section 2.4, of this chapter).

The second recommendation advocates more effective regulatory and legal practices for launching resolution procedures in the event of credit institutions failing. For example, that recommendation suggests clarifying the NBB's role as a resolution authority. That point is now included in the new banking law which provides for the creation of an independent resolution authority at the Bank.

The third recommendation, in line with the requirement that all strategic decisions by D-SIBs must be submitted for the Bank's prior approval, concerns a broad definition of strategic decisions. That definition includes any change in the bank's operations or activities which could affect its resolvability. This recommendation has now been implemented in the Bank's prudential practices.

As for the other recommendations in the final report, the interim report had drawn attention to the high level of savings in Belgium, in conjunction with the key role – due partly to tax concessions – of bank intermediation for these savings. In view of the possible inefficiencies that could result, the Bank recommended making the subsidy for this type of savings instrument more neutral, in order to diversify the channels through which savings are allocated to investment in the real economy. The suggestion is that any extension to other instruments of the tax exemption for income from savings deposits should also apply to long-term instruments in order to alleviate the long-term funding constraints for businesses, and SMEs in particular, and to promote long-term saving [1]. However, any abolition of the tax exemption for income from savings deposits should be phased in over a sufficiently long period in order to minimise the disruption for financial institutions and the financial system.

The last subject addressed in the final report concerns depositor protection. Policies aimed at protecting depositors are designed to increase the likelihood that balance sheet

(1) In any case, the tax exemptions on savings products must conform to the European rules, which prohibit any discrimination in favour of funds invested with financial institutions based in Belgium.

assets will be sufficient to cover the liabilities relating to deposits in the event of a bankruptcy, thus reducing the need for intervention by deposit guarantee systems or taxpayers. In that respect, the report recommends introducing a rule giving depositors priority in the creditor reimbursement ranking in the event of a bank failure. The recommended rule would imply that all deposits eligible for deposit protection would be repaid before unsecured creditors. The new banking law contains such a provision. The final report also recommends that banks should maintain a minimum amount of own funds or liabilities eligible for a bail-in, so as to avoid having to use taxpayers' money in the event of a bank failure.

2.4 Recovery and resolution

Agreement was reached in December of the year under review on the proposal for a Directive establishing a framework for recovery and resolution [(1)]. The Directive covers the whole sequence of crisis management, from preparation to resolution and financing. It applies to credit institutions and to some investment firms.

In order to improve the crisis management preparations, the Directive provides for the drafting of recovery and resolution plans. The major problems confronting some financial institutions since 2008 have shown that the time factor played a key role in the management of a financial crisis. Complex solutions have to be evaluated and implemented very swiftly, both by the struggling institution and by the government. However, some solutions should be capable of being assessed before a crisis erupts, in order to speed up the response by financial institutions and the government.

Such plans make it possible to explore the various potentially available crisis management options. As a result of these preparations, the obstacles to an orderly resolution can be identified and reduced during a non-crisis phase. The recovery plan identifies in particular the measures that a credit institution can take when facing a serious crisis. The aim of those measures is to restore the financial health of the institution that implements them. Conversely, the resolution plan identifies the critical economic functions so that, in a crisis, it is possible to proceed with an orderly resolution, minimising the cost to taxpayers in the event of public intervention. Moreover, the resolution plan tests the authorities' ability to use the various resolution instruments available to them.

For the purpose of drawing up these plans, the Directive specifies that resolution authorities should be able to take measures to reduce or remove obstacles to resolvability. Those powers include the option of requiring the institution to conclude service agreements to cover the provision of critical economic functions or services, to limit its maximum individual and aggregate exposures, to divest specific assets and to change its legal or operational structures so as to reduce complexity in order to permit the separation of critical functions from other functions in the event of resolution.

The Directive also introduces a new instrument : intra-group financial support. This is a mutual agreement setting out the arrangements for liquidity support within a group in the event of a crisis. Such an agreement is voluntary in that a group is not obliged to conclude one and, if it does so, not all the group companies need necessarily be parties to the agreement.

In addition, the Directive provides for extension and harmonisation of the early intervention powers and resolution instruments. The early intervention powers include the possibility for the supervisory authority to appoint a special manager, to require the institution to implement the measures set out in its recovery plan, to convene a shareholders' meeting and to require the institution to negotiate a debt restructuring plan with its creditors.

Furthermore, the Directive requires the Member States to designate a resolution authority whose powers include the use of the resolution instruments. These must be applied once an institution faces three conditions simultaneously. First, it must be failing or likely to fail. Second, there is no reasonable prospect that any alternative private sector or supervisory action would prevent the failure of the institution within a reasonable timeframe. Third, a resolution action must be necessary in the public interest. When the first two conditions are met, and regardless of the whether the third condition is fulfilled, the resolution authority must proceed to write down the capital instruments. If the third condition is also met, the resolution authority must apply one of the resolution instruments, namely sale of the business, creation of a bridge institution, asset separation or bail-in. Finally, the Directive establishes a mechanism for financing resolution measures via the creation of a scheme financed in advance by the sector. This financing mechanism remains national in the Directive, although the intention is that all the funds of countries participating in the SSM are to be pooled in a single resolution fund under the single resolution mechanism [(2)].

The new banking law will already transpose parts of the Directive. As well as designating the NBB as the resolution authority, that law will introduce an obligation to draw up recovery and resolution plans for credit institutions under

(1) See chapter A, section 3, of the part on "Prudential regulation and supervision" of the Report.
(2) See chapter A, section 3, of the part on "Prudential regulation and supervision".

Belgian law. In accordance with the Directive, the resolution authority will be responsible for assessing the resolvability of each institution and reducing or removing any obstacles to resolution. The new banking law will define the conditions for initiating resolution and will introduce the resolution instruments specified by the Directive. However, although the bail-in principle is enshrined in the law, such an instrument can only be used subject to a Royal Decree debated by the Council of Ministers and adopted on the recommendation of the resolution authority. That Decree will have to be ratified by law within twelve months following its publication in the *Moniteur belge/Belgisch Staatsblad*.

The new banking law will also introduce the instrument for the write-down or conversion of capital instruments, conferring on the resolution authority the power to write them down or convert them into shares if an institution is no longer viable. That is also in line with the approach recommended by the European Commission in its communication on the banking sector dated 10 July 2013 [1]. In connection with the assessment of State aid, the Commission specifies that in accordance with the principle of a fair sharing of the burden, the losses must first be absorbed by the equity, hybrid securities and subordinated debt instruments. Conversely, the Commission does not yet require senior debt holders to contribute to the burden-sharing as they would in the case of a bail-in.

The obligation introduced by the new banking law to draw up a recovery plan for credit institutions formalises the approach already adopted by the Bank. Following the implementation and assessment of two pilot projects conducted and partially completed in 2012, the Bank extended this approach to all D-SIBs in 2013. In addition, the Bank set up a pilot project with an insurance company to provide it with a recovery plan [2]. These various projects also conform to the IMF's recommendation, in the context of the FSAP, on drawing up recovery and resolution plans for all systemically important financial institutions. CRD IV also makes provision for those plans.

In order to facilitate the preparation of recovery plans for the various institutions subject to that obligation, the Bank has developed guidelines detailing the type of information that the recovery plan must comprise. These guidelines are based directly on international experience in this sphere, particularly the instructions which the Bank of England issued to its own institutions, and the EBA's recommendations.

The recovery plan is to consist of various modules dealing with specific questions. The first section describes the governance of the plan and identifies the people within the institution who are responsible for developing it. This module ensures that the management and decision-making bodies of the institution are sufficiently involved in devising the plan. To that end, the institution is asked to confirm that the plan was approved by the institution's board of directors. The second module presents a two-part strategic analysis. The first part gives a full description of the institution's activities and their systemic importance. In particular, the analysis must permit identification of the legal entities that perform functions which the institution deemed critical. The second part of this second module forms the core of the recovery plan, since it identifies the institution's vulnerabilities, draws up crisis scenarios specific to each vulnerability, lists the recovery options that could be implemented and assesses their relevance in each of the stated scenarios. The third module deals with the activation of the plan. It aims to ensure that the recovery plan is integrated into the governance of the business and will be launched sufficiently early for the recovery options to be implemented if necessary. Finally, the last module lists the measures that the institution intends to take so that its plan can be implemented or updated.

2.5 Remuneration policy

There is a broad national and international consensus on the role that financial sector remuneration policies played in the eruption of the 2008-2009 financial crisis. It is clear from all the national and international reports published in the aftermath of the financial crisis that remuneration policy has to form a key element of risk management by financial institutions and prudential supervision of that risk management.

In the transposition of CRD IV, the remuneration policy requirements which, at this stage, appear mainly in the Regulation of 8 February 2011 [3], are all enshrined in the new banking law. That law also contains the limits set by CRD IV in respect of remuneration in institutions receiving exceptional financial support from the government.

The Regulation, which faithfully transposed into Belgian law the requirements of CRD III [4] on an appropriate remuneration policy and came into force on 1 January 2011, is

(1) Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis (2013/C 216/01).

(2) On this subject, it should be noted that in October 2012 the European Commission launched a consultation on the recovery and resolution framework for financial institutions other than banks, which deals in particular with the preparation of recovery plans by insurance companies. Following that consultation, the European Commission announced that it would initiate legislation on the recovery and resolution framework of financial institutions other than banks.

(3) Regulation of 8 February 2011 approved by the Royal Decree of 22 February 2011. Mention should also be made of the circular dated 14 February 2011 on the establishment of a good remuneration policy, which refers to the "Guidelines on Remuneration Policies and Practices" of the Committee of European Banking Supervisors, which form an integral part of the Belgian prudential framework on remuneration policy.

(4) Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions.

based on several pillars. First, it determines the categories of staff to be subject to the remuneration policy (the Identified Staff). Next, it lays down a number of governance principles relating to remuneration policy (notably the responsibilities of the statutory board of directors and the formation of a remuneration committee within it). It also sets out some principles to be respected regarding the link between risks and remuneration. Finally, it lists the elements of the remuneration policy which must be made public.

From the start, the Bank paid great attention to implementing these requirements concerning remuneration policy, notably by arranging horizontal analyses of remuneration practices in the sector. In 2012, on the basis of that experience, the Bank adopted a guideline that introduced a more specific, quantitative interpretation of two constant points for attention in regard to remuneration policy, namely the number of Identified Staff and the appropriate ratio between fixed and variable remuneration [1].

In principle, it was not the intention that CRD IV should rework the provisions on remuneration introduced by CRD III. The main innovation of CRD IV consists in the introduction of a maximum ratio of 1 to 1 between variable and fixed remuneration, with the option for the general meeting to grant a derogation permitting a ratio of 2 to 1. That obligation will take effect from the 2014 performance year and should create a more level playing field. In that respect, the new banking law is expected to impose stricter rules. Another point which should be mentioned is the EBA's mandate to develop regulatory technical standards, particularly on the criteria for selecting the Identified Staff and the conditions under which supplementary Tier 1 and Tier 2 capital and other instruments can be used for remuneration purposes. In regard to the criteria for selecting the Identified Staff, the regulatory technical standards aim at greater harmonisation of the selection processes, in line with the NBB's policy, and should help institutions to start listing their Identified Staff, an exercise that in fact still constitutes a risk analysis. The Bank's guidelines, whereby the Identified Staff must include at least 1 % of the total number of staff, should be viewed as a minimum to be respected after this risk analysis.

In 2013, the NBB embarked on another extensive horizontal analysis of compliance with the rules on remuneration policy by large institutions. By always using the same method to make comparisons between institutions, the Bank aims to encourage a level playing field in the Belgian financial sector. This time, six large institutions were included in the analysis, which looked at performance during 2012 for which variable remuneration was paid at the beginning of 2013. This third horizontal analysis revealed that progress has generally been made on the two points covered by the policy that the Bank adopted in the previous year, namely the number of Identified Staff and the proportion between fixed and variable remuneration.

However, the NBB notes that further progress is needed in the use of mechanisms to facilitate a link between remuneration policy and the risk management of the institutions. There are two aspects to the question of the link between risks and remuneration : an *ex-ante* aspect and an *ex-post* aspect. In the first instance, risks must be taken into account in the performance assessment phase when variable remuneration is decided (*ex-ante*). Since it is impossible to determine all the risks in advance, it may be necessary to make adjustments later ; that is the stage covered by the requirements on the actual payment of the variable remuneration (*ex post*). Thus, part of the variable remuneration can only be paid after some time has elapsed (40 % to 60 % of variable remuneration over a period of at least 3 to 5 years) and at least half of it must consist of financial instruments. This takes effective account of the institution's performance over the longer term.

Finally, on 15 July 2013 and 29 November 2013 respectively, the EBA published reports containing quantitative data on high earners (staff earning over € 1 million per annum). The first report related to performance in 2010 and 2011, and the second to performance in 2012. These reports were based on remuneration data gathered by the national supervisory authorities, including the Bank. For each Member State, the EBA listed the number of high earners in each sphere of activity and the main elements of their remuneration.

(1) For more details on this subject, see the NBB Report 2012, p 210-212.

3. Insurance undertakings

3.1 International environment

The Solvency II Directive [1] aims at radical modernisation of the European legislative framework for prudential supervision of insurance and reinsurance undertakings. The basic goals of this Directive are to ensure that the assets and liabilities of the supervised firms are valued at market prices, and to focus closer attention on the risks to which the firms are exposed and the way in which those risks are managed [2].

The original plan was that the Directive should enter into force on 1 November 2012. However, it emerged that the proposed methods for valuation at market prices could lead to great volatility in the valuations of the firms' capital ; that was incompatible with the medium- to long-term horizon of most of their liabilities. It was therefore decided to examine alternative methods aimed at reducing this excessive volatility in the capital, to attenuate the impact of low interest rates on the discounting of the long-term guarantees given by the firms, and to conduct an impact study on these new methods (Long-Term Guarantees Assessment) [3]. At the same time, the entry into force of the Directive was first postponed to 1 January 2014 by the Quick Fix I Directive [4]. The impact study which began on 28 January 2013 combines various scenarios for assessing the effects of the proposed measures on the financial situation of firms (assets, liabilities, capital, minimum capital requirements and solvency ratio), on consumer protection, on the implementation costs and effectiveness of the Solvency II Directive, and on the financial stability and the risk management of firms.

The data on the eight Belgian companies taking part in this study were analysed and validated by the national authorities and by EIOPA. In a report subsequently made public, EIOPA recommended a number of methods to be taken into account for the Long-Term Guarantees Assessment, and proposed that firms should publish the impact of these measures on their financial situation. Under the Omnibus II Directive [5], amending the Solvency II Directive, the presidency of the European Union formulated a proposal for adjustment based largely on the EIOPA report. The preparation of that proposal made it necessary to postpone once again the transposition and entry into force of the Solvency II Directive, to 31 March 2015 and 1 January 2016 respectively. That postponement was incorporated in the proposal for the Quick Fix II Directive [6].

As a result of the delayed entry into force of the Solvency II Directive, EIOPA published an opinion on its website concerning the provisional implementation of that Directive [7]. The Bank notified that opinion to the sector in order to make it aware of the issue and to encourage unremitting efforts in preparation for the implementation of the Solvency II Directive.

On 31 October 2013, following the adoption of that opinion, EIOPA published guidelines for the national authorities on how to proceed during the transitional phase in the run-up to Solvency II. Those guidelines concern four key topics : governance, forward-looking assessment of own risks (based on the principles of Own Risk and Solvency Assessment or ORSA), pre-application for the use of internal models and the periodic submission of information.

(1) Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of insurance and reinsurance.
(2) For more details, see the Report 2011, "Financial stability and prudential supervision", p. 55 to 58.
(3) See Report 2012, p. 206.
(4) Directive 2012/23/EU of the European Parliament and of the Council of 12 September 2012 amending Directive 2009/138/EC (Solvency II) as regards the date for its transposition and the date of its application, and the date of repeal of certain Directives (Quick Fix I).
(5) These proposals were to be incorporated in the proposal for a Directive of the European Parliament and of the Council amending Directives 2003/71/EC and 2009/138/EC in respect of the powers of the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority (Omnibus II).
(6) Proposal for a Directive of the European Parliament and of the Council amending Directive 2009/138/EC on the taking-up and pursuit of the business of insurance and reinsurance (Solvency II) as regards the date for its transposition and the date of its application, and the date of repeal of certain Directives (Quick Fix II).
(7) Opinion on Interim Implementation of Solvency II.

The national authorities are not required to conform to these guidelines, but if they decide not to, they must inform EIOPA and explain their reasons. EIOPA will then publish a notice stating that the competent authority does not comply with the guidelines or does not intend to do so.

With the support of the national authorities, EIOPA has also established a question-and-answer procedure concerning the preparatory guidelines in order to clarify their scope and interpretation, notably in specific cases. The responses will be published on the EIOPA website. They will not be binding, so that the national authorities retain some latitude in the application of the guidelines, e.g. to take account of specific local circumstances.

Finally, the Solvency II Directive will have to be supplemented by implementing measures at various levels, some being binding and directly applicable in the Member States by way of EU Regulations (delegated acts and implementing technical standards), others being simply guidelines for which the Bank will either have to state whether it conforms or intends to conform, or must explain the reasons why it does not wish to do so.

3.2 National legislation

Transposition of the Solvency II Directive and preparatory measures

Work on the transposition of the Solvency II Directive continued during 2013. In view of the uncertainty relating in particular to the treatment of long-term guarantees (see section 3.1), it was not possible to finalise a pre-draft law during the year under review.

In order to prepare firms as far as possible for the new supervision rules, EIOPA published guidelines which aim to anticipate the implementation of certain parts of the new supervision regime. In this respect, the Bank decided on a proactive approach, not only conforming to the EIOPA guidelines but also supplementing them in two respects. First, the obligation to submit information is extended to insurance companies below the minimum thresholds specified in the guidelines, in order to prepare all market players for the future Solvency II rules. However, the Bank intends to ask these firms for less extensive information. Second, firms and groups undergoing the process of pre-application for the use of internal risk management models will have to use the same forms for the information relating to the solvency requirements as those for the submission of information by firms adopting the standard approach. In fact, it is not at all certain that firms or groups submitting an application will actually be granted approval for the use of an internal model immediately on entry into force of the Solvency II Directive.

Circulars have been prepared to implement the content of these guidelines.

The provision for interest rate risk, known as the flashing-light provision

Life insurers and undertakings covering accidents at work still have contracts in their portfolio offering guaranteed yields well in excess of the yields currently obtainable on the financial markets. Insurance companies in such a position have to form a "supplementary" technical reserve. Income from the assets corresponding to that provision is added to that generated by the covering assets representing the life insurance provision so as to guarantee the interest rate level promised in the contract.

The principle and the detailed provisions on the formation of the supplementary reserve are set out in Article 31, § 3, of the life insurance Decree[(1)]. However, a circular exempts insurance companies from forming that reserve if they can show that the financial flows generated by their covering assets will cover the commitments given in their insurance contracts[(2)].

Nevertheless, in line with an International Monetary Fund recommendation[(3)], the NBB suspended the application of that circular during the year under review for two important reasons. The first concerns the current economic situation, which implies that the low level of interest rates will persist for a long time both on the Belgian capital market and on the euro-swap market. The second reason is the need to establish a mechanism tailored more closely to the principles of the future supervision regime to be introduced on transposition of the Solvency II Directive. The Bank is planning to implement a new exemption system to take account of the second reason for the suspension and to ensure that the technical provisions are sufficient at all times in accordance with the current prudential standards.

Acceptance of loans guaranteed by a public authority as covering assets

During the year under review, a pre-draft Royal Decree was prepared with a view to amending Article 10, § 4

(1) Royal Decree of 14 November 2003 on life insurance business.
(2) Circular CPA-2006-2-CPA. See Annual Report 2012, p. 227.
(3) "We recommend that the NBB strengthen its Flashing Light approach and put in place a sound market-consistent valuation standard for total provisions, either as a Pillar 1 or as a Pillar 2 requirement for all insurers".

of the Royal Decree of 22 February 1991, hereinafter referred to as the general regulation [1].

The proposed change relates to the treatment of loans guaranteed by States, regional and local authorities or international organisations, as covering assets, and more particularly the maximum percentage that such loans may represent in the technical provisions. Those loans are generally used to finance long-term public investment projects (infrastructure, telecommunications, hospitals, social housing, schools, prisons, etc.) which correspond fairly well to the maturity of the insurance companies' liabilities.

Since these loans are not accompanied by one of the guarantees expressly listed in the general regulation (mortgage, other real surety, a guarantee by a bank or insurance company) they could only be used as assets covering 5 % of the technical provisions for all loans together and 1 % per borrower, greatly reducing the attraction of these investments for insurance companies. That restriction was illogical since – despite the quality of the guarantor – the general regulation rated these loans as inferior to those guaranteed by a credit institution or insurance company. Conversely, there was no limit for loans granted direct to public entities.

The said pre-draft Royal Decree intends to rectify this inconsistency while keeping this type of investment within the limits set by the European Directives. Two essential changes are proposed for that purpose.

The first consists in according to loans guaranteed by a State [2], a regional or local authority, or an international organisation to which an EEA Member State belongs the same treatment as applies to loans granted direct to those same authorities. The second change concerns the individual limits applicable both to loans granted to those counterparties and to other securities (bonds, equities, etc.) that they issue. Loans guaranteed by one of the said authorities or organisations and other securities issued by the same counterparty can be included in the covering assets at 10 % of the technical provisions per counterparty, on the understanding that the total investments (loans and securities) effected with issuers and borrowers with whom the insurance company places over 5 % of its technical provisions must not exceed 40 % of those provisions.

Local insurers

Local insurers are set up in the form of mutual insurance associations or cooperative societies and confine their insurance business to the municipality where their head office is located or to neighbouring municipalities. They only insure against the risk of fire or related and ancillary risks (theft, water damage, owner's and tenant's liability, assistance in the event of a fire, etc.). The insurance covers simple risks, namely private housing (up to € 1.4 million) and some other real estate (up to € 45.4 million).

Originally, these businesses only fell within the scope of the law on the supervision of insurance companies if that was explicitly specified by a Royal Decree, which was never the case. The new Article 2, § 1 *quater* of the supervision law in force since 1 January 2010 stipulates that these businesses are now subject to all the provisions of the law unless a Royal Decree grants them total or partial exemption. In the absence of such a decree, local insurers are now therefore subject to all the provisions of the law on the supervision of insurance companies.

However, this situation does not tally with the intention of the legislature, which recognised that "the full application of the supervision legislation to these businesses would be a death sentence for them" [3] and that it was sufficient to subject them to "a 'light' supervision regime involving the imposition of a number of rules concerning good governance and compulsory reinsurance with a small retention" [4].

The Bank therefore prepared a pre-draft Royal Decree that aims to maintain much of the exemption regime which was the rule before the change in the law in 2010. This is a provisional solution enabling local insurers to continue operating perfectly legally pending the establishment of a specific supervision regime when the Solvency II Directive is transposed.

However, the pre-draft Royal Decree does provide for local insurers to be registered with the Bank. That registration, which is a requirement for exemption, is subject to a number of conditions, notably the business must have been operating since 1 January 2010, it must limit its activities in regard to both insured property and risks covered and ancillary transactions, it must be largely reinsured and it must submit documents and information enabling the Bank to monitor the maintenance of the conditions for granting registration.

(1) Royal Decree of 22 February 1991 laying down general regulations on the supervision of insurance companies.
(2) Refers only to countries which are members of the OECD or have concluded certain loan agreements with the International Monetary Fund, i.e. more specifically the countries in Zone A as referred to in Article 2 (1) of Council Directive 89/647/EEC of 18 December 1989 on a solvency ratio for credit institutions.
(3) Parliamentary documents, Chamber 52/2292/1, p.35.
(4) Parliamentary documents, Chamber 52/2292/1, p.35.

4. Financial market infrastructures

The regulations on financial market infrastructures underwent a number of changes during the period under review. At European Union level the implementation of the standards laid down by the EMIR Regulation [1] for central counterparties continued. Further work was also done on the European legislation concerning central securities depositories (CSDs). Consultations were initiated at global and European level with a view to the adoption of rules on the recovery and resolution of financial market infrastructures. Finally, work also continued on the regulations relating to payment services.

4.1 Central counterparties: EMIR Regulation

The EMIR Regulation aims to strengthen the European Union's regulatory framework on transactions in derivatives by improving the stability, transparency and efficiency of derivatives markets. It also aims to reduce the credit risk, liquidity risk and operational risk of the counterparties in the clearing of OTC derivative transactions.

The EMIR Regulation and the Implementing Regulations that came into force on 15 March 2013 govern the mandatory use of central counterparties (CCPs) for standardised OTC derivative transactions and lay down risk management requirements, including the exchange of collateral for non-standardised OTC derivative transactions. The EMIR Regulation also introduces an obligation to report derivative contracts to central registers. These rules provide an overview of the operation of the derivative markets and provide the supervisory authorities with data on the derivative contracts of institutions subject to their supervision. The entry into force of the various obligations is being staggered: the obligation to report derivative contracts takes effect in February 2014, while the clearing obligation is set to apply from mid-2014.

These regulations also govern the operation of the trade repositories, which centralise the data on transactions in derivatives concluded by market players. Finally, the EMIR Regulation also establishes the conditions and procedures for granting licences to CCPs, and governs CCP supervision. CCPs are in fact systemically important market infrastructures with a high risk concentration.

Use of a CCP reduces the systemic risk by optimising the risk management of the counterparty and increasing transparency, at least if the CCP itself ensures robust risk management. The EMIR Regulation therefore stipulates, among other obligations, that margins and haircuts must always be sufficiently conservative and that the CCP must have pre-paid financial resources at its disposal to cope with the simultaneous default of the two main clearing members.

4.2 Securities clearing: proposal for an EU Regulation

Since 2012, the NBB has been involved in the work at European level on the new Regulation concerning CSDs. The main aim of this piece of legislation is to establish a harmonised status and a common supervision framework for CSDs in accordance with the international principles of the Committee on Payments and Settlement Systems – International Organisation of Securities Commissions (CPSS-IOSCO) relating to CSDs.

The grant of European CSD status by the national authorities will enable these institutions to operate freely in the EU, including offering issuance services which were previously organised essentially on a national basis. To ensure the

(1) Regulation (EU) No. 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories.

smooth operation of the financial markets and investor protection, there will need to be cooperation agreements between the competent authorities of the countries for which the services offered by a CSD are of significant importance.

The negotiations on this new Regulation are still in progress, and should be finalised in early 2014. After that, ESMA working closely with the central banks will have to develop the technical standards based on this regulation. The Bank is also involved in the working groups set up for that purpose.

The four Belgian CSDs – Euroclear Bank, CIK, Bank of New York Mellon CSD and NBB-SSS – will need to initiate various measures in the coming months to conform to all the new rules under the CSD Regulation. Its implementation in Belgium will also entail a number of changes to the laws and regulations, which are already being prepared.

4.3 Recovery of financial market infrastructures

As a member of the CPSS, the National Bank took part in the international work on the recovery and resolution of financial market infrastructures. That work is aimed at obliging those infrastructures to devise emergency plans to cope with unexpected losses, so that they can continue their critical activities without government financial intervention. Market infrastructures must arrange for the unexpected losses resulting from counterparty default, higher operating costs or loss of income to be allocated *ex ante* among their shareholders, participants and creditors. Various bodies organised consultations on this subject during the period under review. The European Commission started the ball rolling at the end of 2012 by arranging a consultation for non-bank institutions, and the CPSS and the FSB did likewise in July and August respectively. The Regulation is expected to apply in particular to CCPs and CSDs that grant credit.

4.4 Retail payments and non-bank payment service providers

Payment institutions and certain electronic money institutions provide payment services such as payment account cash deposit and withdrawal, transactions via these payment accounts, card payment issuance and funds transfer. The NBB continued work on the implementation of the European Payment Services Directive [1] and the corresponding Belgian legislation. For instance, the Royal Decree of 19 September 2013 [2] ratifies the Bank regulation on the capital of electronic money institutions. During the period under review, the Bank also published guidelines governing the prudential status and periodic reporting of electronic money institutions, and the exemption policy relating to payment and electronic money services. At the same time, negotiations began at European level on Payment Services Directive 2, which will refine and update the regulatory framework for payment institutions.

The Bank takes part in the European Forum on the Security of Retail Payments, which aims at the exchange of expertise on the subject between the participating prudential supervisors and overseers. In January 2013 the Forum published recommendations [3] which providers of payment services and payment systems have to apply from 1 February 2015. The aim is to reduce the relatively high incidence of fraud and to create fair conditions of competition for payment service providers. The Forum also arranged a public consultation on access to payment accounts for non-bank payment service providers. The final report on that consultation is expected early in 2014. Finally, in November 2013, it launched a public consultation on the recommendations concerning the security of mobile payments.

(1) Directive 2007/64/EC of the European Parliament and of the Council of 13 November 2007 on payment services in the internal market amending Directives 97/7/EC, 2002/65/EC, 2005/60/EC and 2006/48/EC and repealing Directive 97/5/EC.

(2) Royal Decree approving the regulation of the National Bank of Belgium of 18 June 2013 on the capital of institutions for electronic money and the investment of funds received in exchange for the electronic money issued.

(3) Recommendations for the security of internet payments, ECB, January 2013.

5. Cross-sectoral regulations

5.1 Conglomerates

Financial conglomerates are groups which, with due regard for clearly defined significance thresholds set out in the Financial Conglomerates Directive (FICOD)[1], combine the activities of the banking and investment sector with those of the insurance sector. The activities of the companies belonging to such groups are deemed significant in a given financial sector if they exceed either an absolute threshold or a relative threshold (Article 3 of the Financial Conglomerates Directive). These groups are headed either by an unregulated holding company (mixed financial holding company) or a regulated undertaking such as a credit institution or insurance company.

In the new banking law, the supplementary supervision of financial conglomerates forms the subject of two substantive amendments.

First, it was a question of transposing FICOD I[2], which amends both the Financial Conglomerates Directive itself and the sectoral prudential directives for the banking and insurance sectors. FICOD I was designed as a relatively limited technical amendment, intended essentially to introduce top-level supervision.

It was also necessary to implement the Joint Forum Principles on the Supervision of Financial Conglomerates which were published on 24 September 2012, redrafting the principles of the same name dating from 1999. The Joint Forum is an international cross-sectoral consultation body operating under the aegis of three founding committees, namely the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors and the International Organisation of Securities Commissions.

This resulted in compliance with the recommendations made by the IMF in the FSAP[3].

Apart from these substantive amendments, there was a desire for a single, consistent regulatory text in the form of the new banking law, bringing together all the implementing provisions on group supervision[4] in so far as they apply to credit institutions.

Ultimately, the intention is that the changes to the supervision of credit institutions should be mirrored by similar changes for insurance companies via the implementation of the Solvency II Directive.

At European level, the main aim of FICOD I was to remedy an undesirable effect of the original Directive on financial conglomerates. It had emerged that, as a result of the supplementary supervision of the conglomerate introduced by the original text, consolidated bank supervision of the holding company disappeared or was reduced to a lower-level bank consolidation within the financial conglomerate if the group was organised as a financial holding company. To remedy this undesirable effect, the former CBFA, in common with other European supervisory authorities, had made use of the exemption option in Article 3(3) of the Financial Conglomerates Directive[5]. This article stipulates that financial conglomerates which exceed the absolute size threshold – namely a balance sheet total in excess of € 6 billion for the smallest financial sector in the group – but not the relative size threshold

(1) Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate and amending Council Directives 73/239/EEC, 79/267/EEC, 92/49/EEC, 92/96/EEC, 93/6/EEC and 93/22/EEC of the Council, and Directives 98/78/EC and 2000/12/EC of the European Parliament and of the Council.

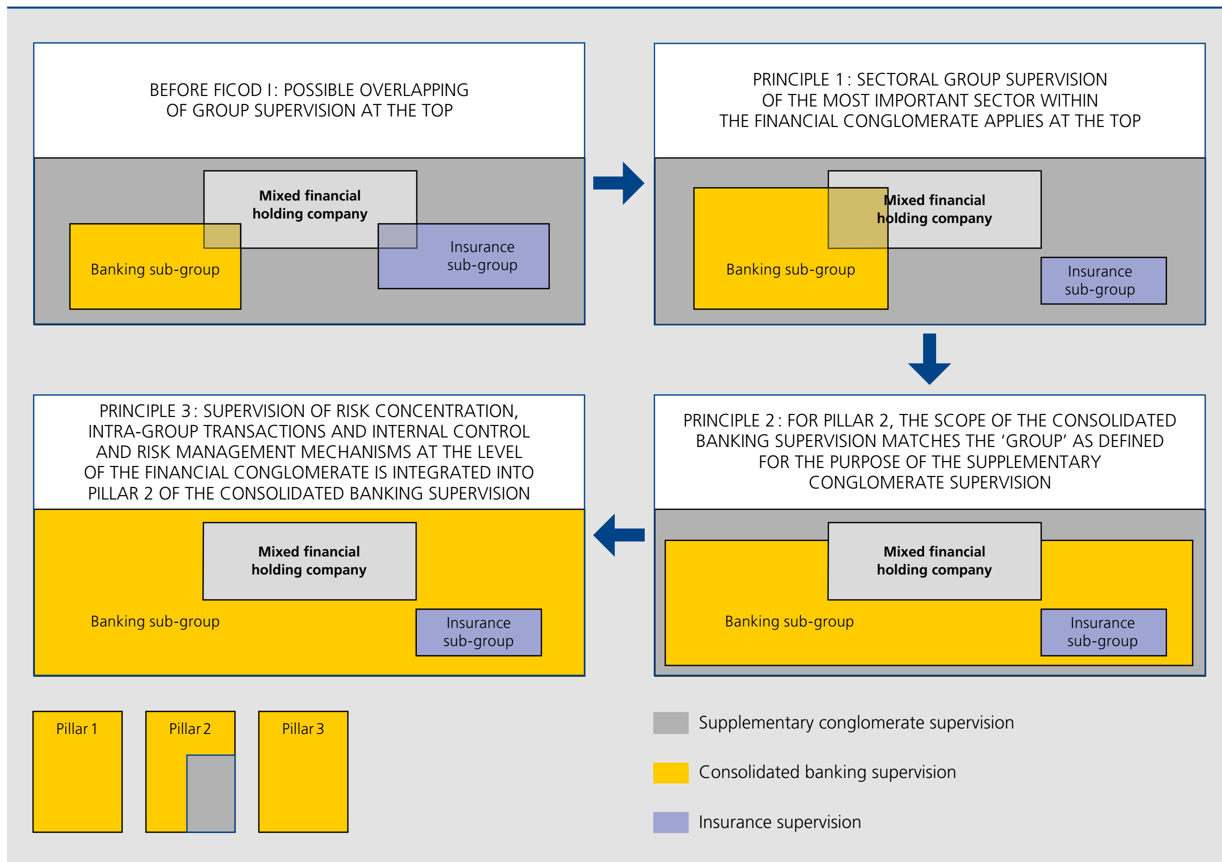
(2) Directive 2011/89/EU of the European Parliament and of the Council of 16 November 2011 amending Directives 98/78/EC, 2002/87/EC, 2006/48/EC and 2009/138/EC as regards the supplementary supervision of financial entities in a financial conglomerate.

(3) For more details, see section 1 of chapter C in the part on "Prudential regulation and supervision" of the Report.

(4) This concerns the provisions of the Royal Decree of 12 August 1994 on consolidated supervision and the Royal Decree of 21 November 2005 organising the supplementary supervision of conglomerates.

(5) Transposed at the time by Article 2 § 3, end of the first indent, of the Royal Decree of 21 November 2005.

CHART 7 INTEGRATION OF THE SUPPLEMENTARY CONGLOMERATE SUPERVISION INTO CONSOLIDATED BANKING SUPERVISION



Source: NBB.

can claim exemption from supplementary group supervision. Such exemptions made it possible to maintain consolidated bank supervision at the group's top level. (1)

In order to rectify this undesirable effect, it was decided that FICOD I would introduce a whole set of identical changes in the various sectoral Directives. In CRD III and IV, the term "financial holding company" (i.e. a holding company heading a banking group) was supplemented by the words "or mixed financial holding company") (designating a holding company heading a financial conglomerate). Thus, consolidated banking supervision can also apply at the level of a mixed financial holding company. By this technique, FICOD I reinforces the idea of top-level supervision, so that both consolidated banking supervision and supplementary banking supervision can be applied at the group's top level, regardless of its structure. As a result, group supervision can operate more effectively at the group's central decision-making level, i.e. where most of the strategies will be mapped out for the group as a whole or for the banking sub-group.

When FICOD I was transposed via the new banking law, this additional phrase "or mixed financial holding company" was inserted after "financial holding company".

In addition, the new banking law governs the relationship between consolidated banking supervision and supplementary supervision of conglomerates, an issue which has not so far been clearly resolved in the European texts on the subject. The new banking law applies three principles in order to integrate the supplementary conglomerate supervision into the consolidated banking supervision.

First, to avoid any overlap between insurance group supervision and consolidated banking supervision at the level of a mixed financial holding company, it is stipulated that if the banking sector is the most important sector of the financial conglomerate, it is always solely consolidated banking supervision that will apply at the level of the mixed financial holding company. This does

(1) See the annual report of the CBFA, DC Report 2006, pp. 34 and 35.

not mean that insurance group supervision cannot apply to a lower sub-group of insurance companies within the financial conglomerate.

Next, if a credit institution is part of a financial conglomerate, the obligations and powers relating to risk-based supervision [1] can be determined on the basis of the group as a whole – as defined pursuant to the Financial Conglomerates Directive – as the relevant scope for consolidated banking supervision. This means that the scope of this consolidated supervision – specified in Article 19 of Regulation No. 575/2013 [2] – which is normally confined to subsidiaries of those credit institutions, investment firms and financial institutions, is extended to include all possible subsidiaries and associated companies, and hence also those in the insurance sector.

Finally, in line with the second principle, it is stipulated that the group risks resulting from intra-group transactions and risk concentrations within the financial conglomerate are to be treated separately and appropriately under pillar 2 of the consolidated banking supervision, and that any stress tests at the level of the financial conglomerate [3] can be incorporated in this pillar.

These various principles mean that, for a financial conglomerate in which the banking sector is dominant, the supplementary supervision of the conglomerate can be tailored as far as possible to the consolidated banking supervision so that these groups are subject to only one supervision regime – albeit incorporating additional supervision of the conglomerate – rather than two separate supervision regimes. This also conforms to the IMF recommendations on the supervision of conglomerates in that the baseline supervision which the NBB was to exercise over credit institutions – for both solo and consolidated supervision – is directly extended to financial conglomerates. The baseline supervision of these groups comprises a set of minimum supervisory measures conducted during a specified cycle on the basis of a clear framework enshrined in law, geared specifically to the supervision of the risks inherent in conglomerates (intra-group transactions, risk concentration, complexity, conflicts of interests), and in which financial conglomerates with the same risk profile are subject to the same degree of supervision.

Apart from the capital test for financial conglomerates [4], which aims purely to detect multiple use of the same capital ("double gearing") for the banking sector and investment services and for the insurance sector, it is now also possible, under pillar 2 of the consolidated banking supervision, to make a capital adjustment whereby the risks relating to the conglomerate can be weighed against the benefits of diversification which may result from combining banking and insurance activities.

Although it is ultimately specific to Belgium, this integration between consolidated banking supervision and supplementary conglomerate supervision is supported by various provisions of the Financial Conglomerates Directive. For instance, Article 9 (6) states that the supervisory authorities can align the supplementary supervision of the internal control mechanisms and risk management processes at the level of the financial conglomerate with the sectoral provisions on the Supervisory Review and Evaluation Process (SREP).

The integration is permissible only with the approval of all the competent authorities concerned with the financial conglomerate. That is particularly important for the ECB's power in relation to the supplementary supervision of conglomerates. When this Report went to press, it was still unclear exactly how the ECB intended to implement that. Nonetheless, there are indications that it similarly wishes to conduct the supplementary supervision of conglomerates as part of the consolidated banking supervision.

5.2 Governance

Fit and proper

On 17 June 2013, the NBB published a circular [5] in which it aims to focus special attention on the fit and proper character of the people responsible at the top level of financial institutions.

This new circular, finalised following a public consultation, is addressed to all financial institutions subject to the Bank's supervision. By giving the various types of institution the same guidelines on the assessment of aptitude, the Bank can maintain its consistent treatment of the financial sector. The cross-sectoral fit and proper approach

(1) "Obligations and powers relating to risk-based supervision" (pillar 2 of the prudential supervision) means the obligations concerning the Internal Capital Adequacy Assessment Process (ICAAP), and the rules, processes and mechanisms of credit institutions (governance), and the Supervisory Review and Evaluation Process (SREP) and the associated supervision measures.

(2) Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 July 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No. 648/2012.

(3) Transposition of Article 9bis, inserted in the Financial Conglomerates Directive since entry into force of FICOD I.

(4) On the basis of the calculation methods mentioned in Article 6 of the Financial Conglomerates Directive. See also the document entitled "Joint Committee FINAL draft Regulatory Technical Standards on the consistent application of the calculation methods under Article 6(2) of the Financial Conglomerates Directive under Regulation (EU) No. 575/2013 (Capital Requirements Regulation – CRR) and Directive 2013/36/EU", published on 26 July 2013.

(5) The standards of "expertise" and "professional integrity" for members of the management committee, directors, people responsible for independent audit functions, and effective managers of financial institutions (circular NBB _2013_02 of 17 June 2013).

is also connected with the presence of large banking and insurance groups on the Belgian market.

The personnel covered by the circular are those performing or wishing to perform the following functions in a financial institution:
– member of the management committee (whether a director or not);
– director;
– person responsible for an independent audit function;
– effective manager: in institutions with no executive committee or in certain branches.

The circular spells out the responsibilities for assessing aptitude. In that regard, it draws attention to the respective roles of the financial institution, the persons concerned and the supervisory authority. The main principle is that responsibility for selecting and retaining staff with expertise and professional integrity rests with the financial institution itself.

The circular contains detailed guidelines on the assessment of expertise and professional integrity. In that connection, it stresses that fit and proper screening always implies an in-depth assessment process which, on the basis of the various relevant elements, provides the most comprehensive possible picture of a person's aptitude for a particular job. The use of a number of weighting factors, such as the reliability and age of the data, makes it possible to judge the relevance and significance of the available information.

The aspect relating to expertise ("fit") comprises three complementary components: appropriate knowledge and experience, competence, and professional behaviour. The assessment of the first two components takes account of the characteristics of the institution concerned and the (intended) job. In the case of a post within a body comprising more than one person, account must be taken of the composition and functioning of the body as a whole.

The aspect relating to integrity ("proper") extends beyond disqualification, which applies automatically and leaves the NBB no discretion. In fact, the Bank examines the entire history for anything that could affect a person's professional integrity. In some situations, however, the Bank wishes to exercise its discretion very strictly, so that its assessments are then virtually automatic. That applies, for example, if the person was convicted of an offence included in the list of offences leading to disqualification, even if the verdict is still open to appeal.

In principle, aptitude is assessed before the commencement of duties and when duties are changed. However, since the requirements concerning expertise and integrity apply at all times, a new assessment may take place while a person is in post. The circular sets out the practical details of assessments by both the financial institution and the supervisory authority, both before the commencement of duties and during performance of the function.

In regard to the assessments by the Bank, it is stated that the Bank has a wide range of information sources and will make more systematic use of the interview technique for its screenings. Deliberate withholding of information or misinformation will have a negative influence on the assessment and lead to immediate rejection.

The new "fit and proper" policy will be enshrined in law when the CRD IV and Solvency II Directives are transposed into national law.

Within the framework of the SSM, the ECB Governing Council will take the final decision in the event of a negative "fit and proper" assessment for a significant bank. The person concerned will have the opportunity to be heard first.

Obligation to establish a management committee

The ever-increasing complexity of the business of credit institutions and insurance companies, and the requirements resulting from stricter prudential supervision, have long since prompted many firms to optimise their internal organisation by setting up a management committee. The policy of the prudential supervisor on this matter is nothing new and was reflected, for example in a circular concerning good governance[(1)]. However, in the absence of any legal obligation the approach has so far been confined to recommending the establishment of an management committee.

In the case of credit institutions, the new banking law will make it compulsory to form a management committee, while that obligation will be imposed on insurance companies by the insertion in the current insurance supervision law of a specific provision from the new banking law. That will ensure parallel arrangements for the two categories of financial institution.

The obligation to form a management committee has many advantages from the prudential angle. In contrast to the exercise of effective management, the operation of the management committee is governed by the Company

(1) Circular PPB-2007-6-CPB-CPA.

Code, which guarantees a high level of legal certainty, notably in regard to the collegial aspect of the board, relations between the management committee and the board of directors, separation of the management and supervision functions, and the delegation of powers, common in financial institutions. In addition, the management committee of a financial institution must be composed of directors, which implies equality between its members and identical access to information and mutual control over decision-taking. However, that does not prevent the allocation of separate functions to the various members of the management committee.

The main drawback of this obligation to form a management committee concerns its potential extra cost for small organisations, which sometimes have difficulty in meeting this requirement owing to the shortage of appropriate candidates. If the nature, scale and complexity of the business justify it, the Bank may exempt a credit institution or insurance company from the obligation to form a management committee, or may permit this commitee to include members who are not directors.

5.3 "Citizens' loans"

Credit institutions

The draft law on "thematic citizens' loans" is intended to encourage long-term saving to facilitate lending for the purpose of funding socio-economic or ethical projects. In order to finance such projects, credit institutions will be able to raise funds in the form of savings notes or term deposits, and the income will qualify for tax concessions. These savings notes and term deposits must have a maturity of at least five years. The minimum investment is set at € 200.

Credit institutions can use the funds thus raised solely to provide direct or indirect finance (via interbank loans) for public or private sector projects meeting the conditions laid down by this law and its implementing decrees.

The law stipulates a period of one year for actually allocating the capital raised by these "thematic citizens' loans" to eligible projects. A buffer equivalent to 10 % of the funds raised can also be reserved and invested in secure liquid assets in order to ensure that the credit institution can handle savers' deposits and withdrawals.

The Bank is responsible for monitoring compliance with the rules on the allocation of the funds raised by credit institutions. For that purpose, credit institutions must meet the requirements concerning reporting, the content and frequency of which will be defined by regulation. That reporting supplements the accounting data on the funds raised and the use of the funds which must be recorded under a separate heading pursuant to the draft Royal Decree.

Insurance companies

The scope of the law on "thematic citizens' loans" has been amended to include certain insurance products. The aim is to offer life insurance policies in order to raise capital which can be used to fund socio-economic or ethical projects. The insurance policies in question are single premium class 21 contracts (life insurance with a guaranteed yield), having a minimum term of ten years and offering cover in the event of death which is at least equivalent to the inventory value, so that they are similar to insurance bonds. The right of redemption is limited to 5 % of the theoretical redemption value. In addition, the contracts must qualify for compensation from the Special Protection Fund for deposits, life insurance and capital of approved cooperative societies. The insurance company cannot impose a minimum premium of more than € 200. Finally, the contracts concerned must provide for the formation of a ring-fenced fund as referred to in Article 57 of the Life Insurance Decree.

As in the case of credit institutions, the Bank has to verify whether the allocation of the funds raised by means of these contracts meets the legal requirements.

C. Prudential supervision

1. Development of closer, more comprehensive supervision

During 2012 and 2013, the IMF conducted a full, in-depth analysis of the Belgian financial sector under the FSAP. In addition, and taking account of the resulting recommendations, the NBB set out its priorities for microprudential and macroprudential analysis in its master plan 2012-2015 and in its 2013 and 2014 risk reviews. These priorities were determined with due regard for the potential risks which could arise in the financial sector, in the current national and international macroeconomic environment. The action plans of the various prudential services have to take account of those identified as priority risks.

During the year under review, the supervision structure for banks, insurance companies and financial market infrastructures was developed further in the context of the FSAP recommendations and the 2013 annual risk review. That structure is presented in sections 2, 3 and 4 respectively of this chapter.

1.1 Financial Sector Assessment Programme

The IMF's assessment of the financial sector aims to detect the main vulnerabilities which could trigger financial crises. That assessment comprises two main pillars. The first concerns analysis of the resilience of the financial system as a whole, notably on the basis of stress tests and the detection of the principal risks facing the system. The second pillar assesses the quality of the regulation and supervision of banks, insurance companies and financial markets.

The conclusions of the Belgian financial sector assessment, published in May of the year under review, draw attention to the main progress made in restoring a sound financial sector and improving the prudential supervision framework on the basis of the lessons learnt from the financial crisis. The IMF's assessment was positive overall; it emphasises that the regulation of the banks and insurance companies conforms to international good practice. Adherence to the IMF recommendations will be further checked under the new SSM supervision framework.

While the introduction of the "twin peaks" model on 1 April 2011 generated more synergy between microprudential and macroprudential policy, the supervision method adopted by the Bank and the implementation of a supervision cycle contributed to the improvement in the analyses and the promotion of financial supervision centred on the main risk factors. Nonetheless, the IMF pointed out the need to continue the reforms in order to ensure the optimum functioning of the new supervision architecture. The IMF recommendations concerned strengthening cooperation between the FSMA and the Bank and establishing a macroprudential authority. Apart from the improvements to be made to the regulatory framework for crisis management, the IMF also recommended establishing a resolution authority in Belgium.

In regard to the supervision process, the IMF stressed the importance of tailoring the supervision of individual institutions to the risk profiles and complexity of the organisational structures, especially in the case of smaller institutions. In addition, the IMF considered that the supervisory authority should have regular meetings with the management of financial institutions in order to examine in detail the main risks facing those institutions and the measures and actions required to limit those risks. In the insurance sector, too, the prudential supervision framework should take greater account of this aspect of risk analysis so that the sector is better prepared for the implementation of Solvency II.

The IMF's main findings and recommendations concerning the supervision of conglomerates in Belgium were that prudential practice has been based in recent years on prudence and the maximum use of the powers conferred on the supervisory authority, even if that means that there is no specific regime applied to conglomerates but instead consolidated supervision at sectoral level. The IMF noted that the corollary was the current lack of a clear framework applicable to any group classed as a financial conglomerate. The IMF's main recommendation therefore concerned the need to establish baseline supervision for financial conglomerates.

Although the financial position of banks and insurance companies has gradually improved over the past few years, the stress tests revealed certain vulnerabilities, namely the sector's low profitability and the close links between the financial sector and the government. According to the IMF, the supervision of financial institutions should include more systematic stress tests at both microprudential and macroprudential level.

As already explained in various sections of this Report, most of the IMF's recommendations under the FSAP have been or will be taken into account in the various legislative proposals currently being finalised, and in the supervision techniques and procedures applied by the Bank. By way of illustration, Box 3 details the Bank's preparatory work concerning the Financial Action Task Force (FATF) on money-laundering.

Box 3 – Combating money-laundering and the financing of terrorism and proliferation : preparation of the 4th mutual evaluation of Belgium by the FATF

In February 2012, the intergovernmental Financial Action Task Force (FATF) approved the new "International Standards on Combating Money Laundering (AML) and the Financing of Terrorism & Proliferation (CFT)", constituting its forty new "Recommendations". The FATF then continued its work of defining the new methodology for assessing technical compliance with the FATF recommendations and the effectiveness of the AML/CFT systems. As a member of the Belgian delegation, the Bank played an active part in this work. Adopted in February 2013, this new methodology will form the basis of the fourth round of mutual evaluations of the organisation's member countries. Following the assessment of the Belgian financial system conducted by the IMF in 2012 and 2013, Belgium will be one of the first four countries to undergo a mutual evaluation by the FATF using the new methodology.

New FATF methodology

The new methodology takes account of the experience gained during the third round of mutual evaluations. After that round, the member countries considered that, while it had been necessary to check initially that the countries evaluated had adapted their laws, regulations and measures to combat money-laundering and terrorist financing in order to take account of the 40 FATF Recommendations, the fourth round of evaluations should be used to ensure that the control mechanisms developed by member countries are effective, though without neglecting the need for those countries to watch over the compliance of their provisions with the new international standards which remain the essential basis for the effectiveness of these systems.

The new FATF methodology therefore implies that the fourth-round evaluations are organised by a dual procedure. That procedure first evaluates the technical compliance of the national systems with the standards but also, at the same time, their effectiveness in combating money-laundering, the financing of terrorism and proliferation. The countries evaluated will thus have to demonstrate that their laws and regulations and the other measures that they apply satisfy the almost 250 criteria for assessing technical compliance, which cover all components of the FATF recommendations. In addition, they will have to demonstrate the degree to which their systems for combating money-laundering and the financing of terrorism and proliferation are suitable for attaining the aims

of an effective system. Those aims are identified and specified in detail by the methodology in the form of eleven immediate outcomes.

As in the past, the new evaluations will be organised in three main phases. First, the country assessed has to provide the evaluation team with detailed information on both the technical compliance of its provisions with the FATF recommendations and the effectiveness of its systems. That basic information is supplemented by a two-week on-site visit by the evaluation team so that the evaluators can gain a clearer understanding of the mechanisms in place. Finally, the mutual evaluation report is discussed and adopted by the FATF. However, it should be noted that, during the on-site visit, the emphasis will be on evaluating the effectiveness of the mechanisms developed by the country in question. That evaluation will focus mainly on the vulnerabilities of the country evaluated, taking account of all its specific characteristics. The aim of the evaluation is in fact to help the evaluated country to tackle those vulnerabilities in order to increase the effectiveness of the measures to combat money laundering and the financing of terrorism and proliferation.

Preparations in Belgium

In the closing weeks of 2013 and the initial weeks of 2014, the various Belgian authorities concerned, including the Bank, thus contributed to the preparation of the detailed dossier of information on the mechanisms in place in Belgium, to demonstrate that they comply with the standards and are effective.

In this connection it should be noted that, pending the fourth Directive on the prevention of money-laundering and the financing of terrorism, on which negotiations are in progress, it has not yet been possible to adapt the Belgian laws and regulations to the new FATF standards.

However, since the new standards place more emphasis on the risk-based approach to supervision, the Bank can in particular make use of the "periodic questionnaire" on AML/CTF which financial institutions subject to its supervision have to complete each year. With that questionnaire, the Bank's risk-based approach to the exercise of supervision will be based on the collection of systematic, standardised data, facilitating comparisons between financial institutions and over time. In order to enable the financial institutions to prepare their answers for the beginning of 2014, the questionnaire was sent out to them by circular in September 2013 [1]. Shortly after that, the questionnaire was also presented to them at an information meeting organised by the Bank.

The information dossier produced by the Belgian authorities will form the main basis on which, in the spring of 2014, the FATF evaluation team will determine the priorities to be given particular attention during the rest of the mutual evaluation process, and notably during the on-site visit.

During that visit scheduled for 30 June to 11 July 2014, the evaluation team will conduct a detailed examination of the AML/CFT mechanisms implemented in Belgium, taking account of the previous decision on the priority of the various topics in this field.

The draft evaluation report will be debated and approved by the FATF in February 2015. This mutual evaluation report will also form the final section of the report drawn up by the IMF on Belgium under the FSAP.

(1) See Circular NBB_2013_10 of 25 September 2013 on the periodic Questionnaire relating to the prevention of money-laundering and the financing of terrorism, and the annexes to the circular.

1.2 Annual risk review 2013

Every year, in order to define its prudential analyses and guidelines, the Bank determines its priorities for the three main financial sectors, namely banks, insurance companies and market infrastructures, taking account of their respective characteristics. Those priorities are subjected to both a transverse analysis for all these sectors and a vertical analysis at the level of the individual dossiers dealt with by the operational services. These priorities concern both the major financial risks and the supervision procedures. All these aspects, listed and illustrated in chart 8 below, are discussed in more detail in the sections that follow. Box 4 looks in more depth at the New Organisation for Valorisation of Audit (NOVA) project, a reform which had already been launched before the establishment of the annual risk review 2013, but which also forms part of the improvements to the supervision process.

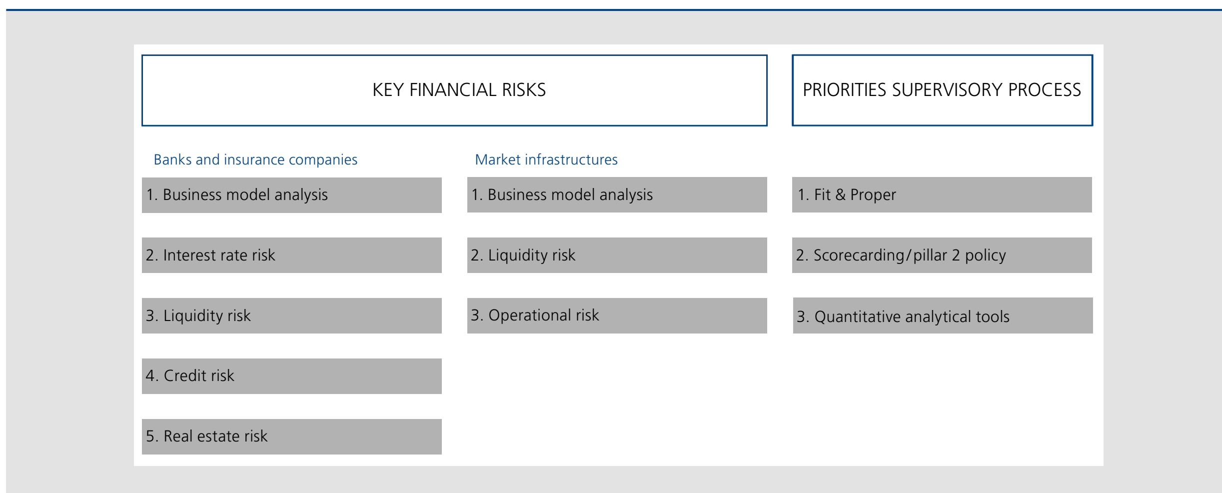
In regard to financial risks, during the year under review, particular attention focused on the business models of the individual institutions, since they are subject to stricter requirements as a result of the major changes to the law following the financial crisis. The business model risk concerns the three sectors, but the work had initially concentrated on the banking sector, where the determinants of the main sources of income and costs were identified. The interest rate risk is closely connected with the business models owing to the importance of intermediation activity, though the banks and insurance companies differ in their approach to that activity. Other risks were also accorded priority: liquidity risk which confronts the three sectors owing to financial market volatility, credit risk in a context of slackening economic growth in Belgium and in neighbouring euro area countries, and the real estate market risks in Belgium. Finally, the operational risks relating to cyber crime are of more specific concern to market infrastructures.

In regard to supervision procedures, the work concerned three priority topics. First, the publication of a new circular on expertise and professional reliability [(1)] was an important step forwards in the 'fit and proper' project launched in 2012. The uniform application of the assessment criteria set out in the circular and the extension of the experience with 'fit and proper' interviews will remain high on the agenda of all prudential departments in 2014.

On the second topic, "scorecarding" can be regarded as completed for credit institutions. The Bank reformed this risk analysis instrument in order to improve structural consistency in the supervision of the various credit institutions over which it has authority. In this connection it worked on two projects: cluster analysis and proportionality. The first project aimed to improve what is known as "peer group clustering" on a more refined and risk-oriented basis. The aim of the proportionality project was to permit adaptation of the profile of institutions in the scorecarding application on the basis of their impact/risk classification, and is therefore connected with the clustering project. The work on pillar 2 was postponed for credit institutions; future work will depend on the SSM developments concerning the SREP.

(1) See chapter B, section 5.2 of the "Prudential regulation and supervision" part of the Report.

CHART 8 RISK REVIEW 2013



Source: NBB.

Finally, the revision of the Quantitative Analytical Tools (QAT) is a project concerning the process of supervising both banks and insurance companies. In 2013 the work centred on the banking element (the B-QAT project). The existing Bank Performance Report (BPR) had to be revised following the changes to financial and prudential reporting made by CRD IV, applicable from 1 January 2014. In this project, work concerned both the content, namely the most relevant core data supporting supervision, and the form in which the data can be processed and presented in an optimal way, such as how to improve the integration of microprudential and macroprudential data. B-QAT is organised at three levels: (1) the Key Risk Indicators (KRI) are a standardised set of ratios and key figures which act as an early warning system for the teams responsible for prudential supervision, (2) the risk dashboard gives a broader and more detailed picture of the credit institution and forms a kind of financial identity card combining various topics in a clear format to give a coherent, structured picture of the credit institutions, and (3) the detailed thematic templates supply more specific information on each topic and facilitate in-depth analysis of a particular topic by combining relevant information from various sources or from various basic reports. For levels 2 and 3, the Bank had to do most of work, while the KRIs are essentially defined by the EBA or the SSM. Work on the thematic templates was completed in the autumn of 2013. The B-QAT project along with other changes to supervisory practices showed that there was a need for an updated IT environment, in the form of the Prudential Supervision Improvement and Extension Programme (PRIME). This programme aims to renovate the IT applications and tools supporting the Bank's prudential supervision activities. The programme is intended to provide institutions, the supervisory authorities, the management and the various parties involved with a modern and efficient environment for collecting, validating and managing data and for analysis and prudential reporting. That environment will also be flexible so that the expected requirements of the SSM can be respected. In PRIME, the data from the various sectors subject to supervision are collected on one and the same technological platform.

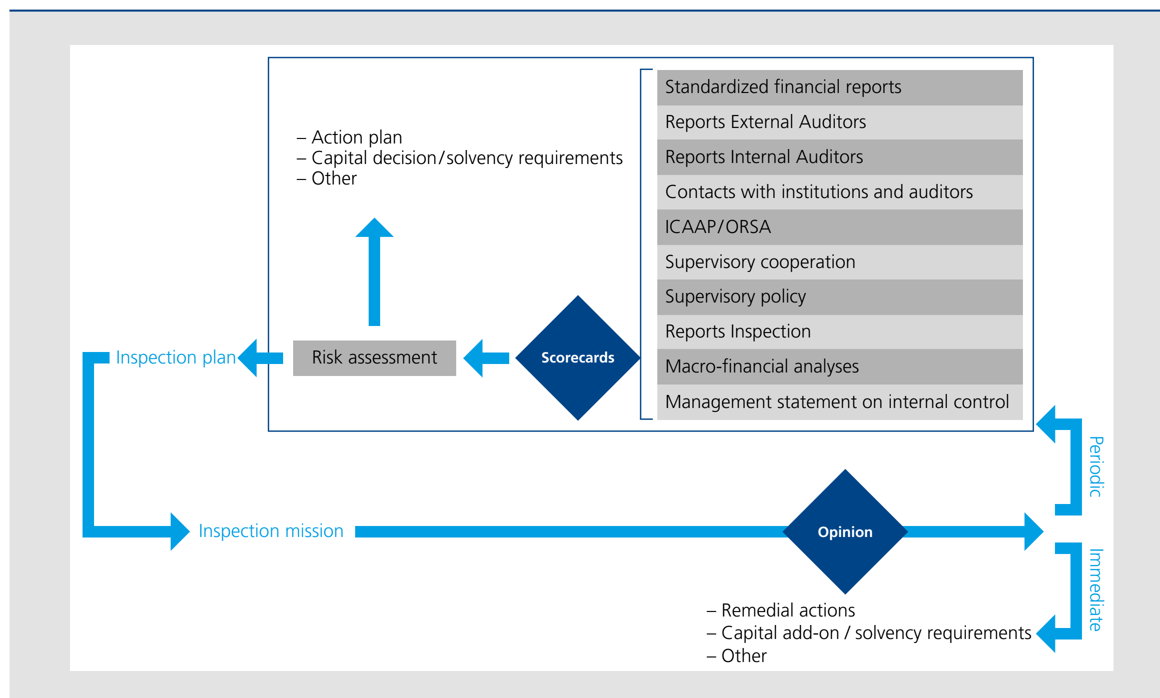
Box 4 – NOVA: the new inspection method

For the Bank, the inspections conducted by specialist inspectors on banks and insurance companies are a vital and irreplaceable supervision instrument for detecting failings in the way in which institutions organise their business and manage their risks, and for taking the necessary corrective measures. The Bank's inspections take place in the context of the risk assessment of the institutions, and lead to decisions on action plans. One of the actions that might be considered is the planning of an inspection. The Bank may also arrange an inspection at any time if specific circumstances so require. After the inspection, the Bank draws up an inspection report in which it expresses a general opinion and sets out its findings and recommendations. This inspection report enables the Bank to assess whether immediate action is needed, and to adjust the general risk profile of the institution at the time of the periodic risk assessment (see chart for more details).

During the year under review, the inspection methods were radically revised via the New Organisation for Valorisation of Audit (NOVA) project, in order to harmonise the inspections and make them more effective. Work on the NOVA project resulted in a general inspection manual, applicable since October 2013. That manual gives a clear definition of the inspection process and sets out a formal methodology. More particularly, it provides for an inspection universe, the introduction of the latest audit concepts and techniques, revision of the work programme objectives, a standardised implementation process, opinion rating, scoring of the recommendations and a modified inspection report. The NOVA project also involved work on automating the inspection process in order to maximise consistency in its execution.

The inspections conducted by the Bank are a) results-oriented: inspectors formulate opinions and recommendations for the spheres examined, giving them individual scores so that the shortcomings detected can be targeted, b) risk-oriented: the inspectors apply a methodology based on an analysis of the risk exposures and the way in which the risks are, or are not, monitored, c) intrusive: adequate information on supervision is actively sought, and d) forward-looking: the spheres analysed are related to the overall risk management system that supports future

INSPECTIONS IN CONNECTION WITH RISK ASSESSMENT



Source: Circular NBB_2013_15 of 11 December 2013 on inspections.

(financial) performance, for which purpose the Bank uses the Prudential Internal Control Standardised Model (or PRISM) as the internal reference model.

The review of the inspection methods coincides with the introduction of the SSM. The Bank decided to align the NOVA methodology as far as possible with that of the SSM, while maintaining the elements for which there is no provision as yet in the SSM, and/or those which, in the light of Belgian experience, should preferably be kept, such as the formulation and follow-up of recommendations by inspectors, and the notification of an overall rating. These additional elements will apply to all supervised institutions until the SSM comes into operation, and to all subjects for which the Bank has full and exclusive powers.

The inspection process and the expectations in relation to supervised institutions are explained in detail in the circular relating to inspections [1]. This transparent approach is designed primarily to ensure that the inspections run smoothly. The methodological revision is accompanied by adjustments to the organisational model, as the Bank decided to group the inspectors together in a single service from November 2014.

(1) Circular NBB_2013_15 of 11 December 2013 on inspections.

1.3 Annual risk review 2014

In regard to financial risks, the Bank set its supervision priorities for 2014 against the backdrop of a slight improvement in the macroeconomic and financial environment. In general, the work begun in 2013 will continue in 2014. There were no major changes to the list of priorities, though the sequence was amended and there was a shift of emphasis. In addition, a clearer distinction was made between priorities for credit institutions and those for insurance companies. While the banking sector analyses will be greatly influenced by the preparations for the SSM, especially the comprehensive assessment of credit institutions coming under direct ECB supervision from November 2014, the insurance company analyses will concentrate on examining the business models and their sustainability in the context of the very low level of interest rates in recent years and the changes to be made to the regulations under Solvency II.

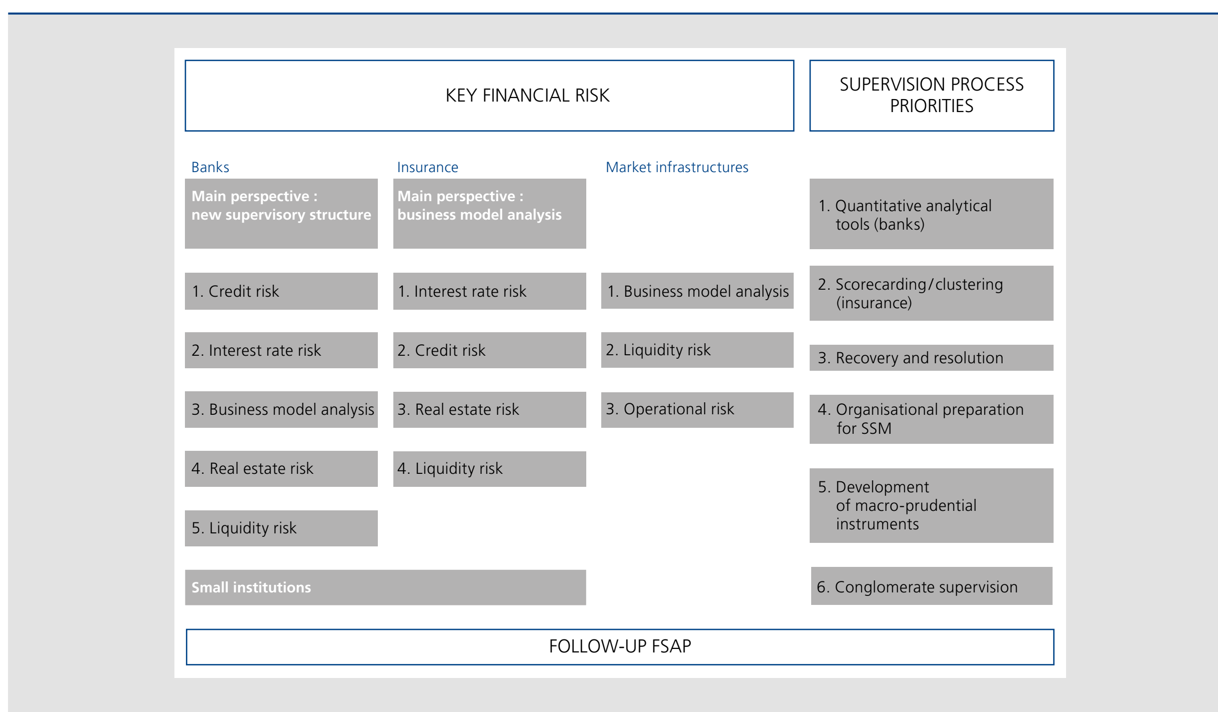
As recommended by the IMF following the FSAP, the concept of supervision tailored to the risk profile will also be extended to smaller institutions, particularly those with a high risk profile.

As regards priorities under the supervision process, the B-QAT project will first be supplemented in the near future with a second component: the risk dashboard. The first application of the new B-QAT concerning data for the first quarter of 2014 will obviously be subjected to close scrutiny, and will be followed by the final adjustments to the new analysis instrument. A similar analysis instrument is to be developed for the supervision of insurance companies as a result of Solvency II, which will introduce new reporting requirements. Now that the implementation of Solvency II has been scheduled for 1 January 2016, this will mean a tougher challenge in 2014. Other work relating to the supervision of insurance companies which needs to be done in the near future is the updating of scorecarding to permit more risk-oriented supervision. As in the case of banking supervision, this will form the basis of a cluster analysis in 2014[1].

Recovery and resolution will also be added to the list of priorities. Since the 2007-2008 crisis, the development of recovery and resolution plans has become one of the priorities of supervisory authorities throughout the world. The preparation of such plans for global systemically important banks (G-SIBs) is coordinated at G20 level by the FSB. This aspect will be developed in parallel with

(1) See chapter C, section 3.1, of the part of the Report on "Prudential regulation and supervision".

CHART 9 RISK REVIEW 2014



Source: NBB.

the European work programme on this subject, now that the Bank has gained experience from a number of pilot projects[(1)].

Creation of the SSM also presents a major organisational challenge for the Bank's supervision processes, as explained in detail in other sections of this Report[(2)]. In addition, the operational framework for the macroprudential instruments specified by CRD IV will be developed in line with what is being done at international level, as in the ESRB.

Finally, turning to the supervision of conglomerates, one of the FSAP recommendations concerned devising better baseline supervision for financial conglomerates and paying greater attention to the specific risks generated within such "bancassurance" groups. Since there are currently no clear international guidelines on this, the Bank considered it advisable to align the supervision of financial conglomerates with consolidated supervision at sectoral level. For credit institutions, that was done via the new banking law[(3)]. For insurance companies, it will be introduced via transposition of the Solvency II Directive.

(1) See chapter B, section 2.4, of the part on "Prudential regulation and supervision".
(2) See chapter A, section 2, of the part on "Prudential regulation and supervision".
(3) See chapter B, section 2.2, of the part on "Prudential regulation and supervision".

2. Banks

2.1 Components of the annual risk review 2013

During the year under review, the Bank's priorities for the supervision of the banking sector concerned business models, interest rate risk, liquidity risk, credit risk and real estate risk.

Business models and interest rate risk

In the second half of 2012, the Bank began setting up an analysis of the business models of banks. This analysis and the underlying methods were tested on a large bank. During 2013, the methodology developed was then further refined and extended to the four large banks (Belfius, BNPP Fortis, ING Belgium and KBC).

Business models are the means and methods that an institution uses to conduct its business, generate profits and continue developing. Each business model is unique, but certain characteristics are common to different banks. Business model analysis forms part of the supervision activities and, according to CRD IV, it is an essential part of the SREP, which means that the findings must be reflected in other components of the SREP and be used in the general SREP analysis. The purpose of the business model analysis is to enable the supervisory authority to form an opinion on (1) the current business model of the institution subject to its supervision and its viability, (2) the way in which the business model could change as a result of the institution's strategic decisions and/or changes in the economic and market environment, in other words the sustainability of the model. That determines the appropriate actions to be taken by the supervisory authority under the SREP.

The business model analysis offers the supervisory authority an instrument for determining at an early stage the situations and actions which could prejudice the institution's sustainability or general financial stability. The supervisory authority is thus able to adopt a more prospective and proactive approach. The development and implementation of business model analyses in Belgium is in line with a more general international trend among supervisory authorities to conduct in-depth analyses of the business models of banks in the course of their supervision.

The need for a business model analysis as part of supervision also fits into the context of the major developments and changes in the economic and market environment at national and international level, and the amendments to banking regulation, which are putting pressure on the institutions and forcing them to change. In addition, there is strong pressure of competition in the Belgian banking sector owing to a number of large banks retreating to their home market and reverting to traditional banking activities. The inclusion of the business model analysis in banking supervision and its extension to insurance companies forms part of the IMF's recommendations in connection with the FSAP[1].

In 2013, the main focus of attention was the development and implementation of the first phase of the business model analysis, which consisted in mapping the four main credit institutions in Belgium. That analysis was based on both quantitative and qualitative data. Since the aim at this stage is to determine in particular the bank's ability to generate income and profit, it was necessary to identify the profitability drivers at the most basic level – i.e. customer tariffs, the volume of business, fees, etc. Development of the analysis framework for these basic variables also permits some comparisons between institutions – e.g. in regard to volumes, tariffs

(1) See chapter C, section 1, of the part on "Prudential regulation and supervision".

and margins – and, in a second phase, projections and scenarios simulating in particular the interaction with macroeconomic variables such as the yield curve. The quantitative analysis is based partly on the internal data that the bank supplies on its activities, portfolios and sub-portfolios, and in that respect distinguishes between homogenous product groups; this produces characteristic data such as volumes, customer tariffs and maturities for all activities on and off the balance sheet. The various sources of income such as net interest income, fee income and income from market activities are included in the analysis, as is the operating cost structure and depreciation. This analysis makes it possible to produce an outline, economic representation of the activities and underlying profit generation for each institution.

The quantitative analysis is supplemented by various types of qualitative information on the institution, namely the quarterly and annual reporting, management accounting and budget reviews, market analyses, risk analyses for the various activities, etc. Interviews are also conducted with those responsible for the various operational activities within the institution. The data and the qualitative information enable a detailed bottom-up analysis, though it has to be supplemented by an analysis adopting a more top-down approach. Finally, on the basis of the quantitative and qualitative analyses, the performance of the current business model of each institution is assessed, together with its main sources of risk and vulnerability. That analysis is useful not only for the SREP but also for the analysis of the periodic financial results of the institution.

In 2014, the business model analysis will continue, with the ongoing operational implementation of the first phase and the launch of the second phase where possible. This second phase will focus more on prospective analyses and will examine the institution's strategic actions and multi-annual plans in order to arrive at an assessment of its sustainability.

In view of the low interest rate environment and the potential impact of an upturn in interest rates, particular attention has been paid to analysing interest rate risks in the banking sector. Since the impact of the low interest rate environment on bank revenues was a key aspect of the work relating to the business model analysis, the work on the interest rate risk for the banking sector was largely integrated into that on the business model analysis in 2013. In 2014, the work programme for interest rate risk will concentrate more specifically on the asset/liability management (ALM) aspect of those analyses. In addition, specific analyses were conducted in 2013 on certain ALM aspects of individual institutions and for specific activities, in connection with the modelling of the interest rate sensitivity of sight accounts and savings accounts and the impact of a sudden rise in interest rates on the market value of the Belgian government bonds in credit institutions' portfolios.

Liquidity risk

Credit institutions were able to raise funding on the financial markets under better conditions in 2013. Most large institutions also recorded steady growth of regulated savings deposits. As a result of the further expansion of this last source of funds and the limited growth of the assets, there was less need for Belgian banks to issue long-term paper. Issuance of long-term securities was relatively modest during the year under review, and mainly concerned covered bonds. These developments enabled credit institutions and financial holding companies to consolidate their already relatively comfortable short-term liquidity position, and to respect the regulatory stress test ratios for liquidity risk introduced by the supervisory authority in 2011.

Despite the steady improvement in financial market conditions from the second half of 2012, supervision of the liquidity position and liquidity management of credit institutions remains a priority, especially in the context of the preparations for the introduction of international liquidity standards. During the year under review, the Bank therefore continued to produce a quarterly report presenting an overview of financing conditions on the money and capital markets and a transverse analysis of the liquidity position of institutions on the basis of national liquidity ratios and new harmonised international standards. That report monitors the liquidity position of banks periodically, and duly informs the services concerned and the management of the NBB. Daily reporting of the liquidity of systemically important institutions continued as before.

Following a survey of the treatment of cash flows relating to derivative portfolios, the Bank also identified a number of inconsistencies in the liquidity reporting currently applicable in Belgium. The supervisory authority calculates its regulatory liquidity standards – the stress test ratios for liquidity risk – on the basis of that liquidity reporting. To ensure that the reporting tables are completed consistently, the Bank therefore decided to publish a list of frequently asked questions and the answers relating to the tables and the instructions. The Bank expects institutions to take account of these clarifications from now on in reporting their liquidity position.

The second pillar of bank supervision according to the Basel Principles is based on an analysis by the supervisory

authority of the specific characteristics of individual institutions and the need to impose individual supervision measures. In regard to this second pillar, CRD IV specifies that during the SREP the supervisory authorities should also pay explicit attention to an institution's liquidity position and liquidity management, and may impose additional, specific liquidity requirements on the basis of that analysis and other information. In addition to second-pillar decisions on capital, similar decisions on liquidity will be introduced in 2014 and will apply at least annually. During the year under review, the EBA worked on guidelines for an SREP on liquidity, and the SSM also developed a comparable methodology. The Bank is similarly devising a methodology on the basis of these international guidelines and activities.

Credit and real estate risk

During the year under review, the work relating to credit risk centred on two key topics : comparison of the various parameters that banks use to calculate their risk-weighted assets, and prospective assessment of the credit risk on the basis of adverse macroeconomic scenarios.

The credit risk parameters were compared for the business loan portfolio. This portfolio is better suited to direct comparison of the risk parameters applied by different lenders since a firm often has a relationship with more than one bank. For this purpose, use was made of new data from the central credit register supplemented by the results of an *ad-hoc* survey. The analysis attempted to distinguish between differences due to the nature of the loan (maturity, collateral obtained) and differences resulting from divergent calibration of the same risk by different banks. These data also made it possible to identify the branches of activity with a high ratio of risk-weighted assets to total assets. All these analyses which are in line with a general trend towards risk assessment benchmarking, will support the work required by the ECB in connection with the comprehensive assessment of credit institutions.

The prospective assessment of credit risk relates to the stress tests, of which it forms a key element. Thus, it was possible to model changes in the credit risk (losses and provisions) of banks according to various macroeconomic scenarios on the basis of the work done in connection with the IMF's FSAP mission. However, this approach proved to have a number of limitations. Work is currently in progress on improvements to the analysis framework with a view to the stress tests to be conducted as part of the comprehensive assessment which the ECB has launched in preparation for the SSM.

As far as credit risk on the Belgian mortgage market is concerned, in the past few years, the Bank has analysed recent developments on that market in detail, and ascertained the risk profile and quality of credit institutions' mortgage loan portfolios. This analysis was based in particular on data collected from 16 credit institutions via *ad-hoc* reporting of data on Belgian mortgage loans granted and held by each institution. During the year under review, the Bank decided to repeat this survey of credit institutions at regular intervals for the time being. The data on outstanding totals and new business will now be collected twice yearly, and the data on the corresponding minimum capital requirements will be collected annually (for the year-end position).

On the basis of the 2012 and 2013 surveys and in view of the relatively high ratio of mortgage loans in the balance sheet total of credit institutions, the Bank also considered that a potential increase in credit losses on these portfolios due to possible market shocks justified prudential measures. Similarly, the FSAP report had noted potential risks to financial stability from the Belgian property market.

These measures aim to strengthen the banks' resilience and mitigate the concentration risk. Box 5 offers a more detailed account of the reasons for these measures and their content. They are the first macroprudential measures taken by the Bank.

Box 5 – Real estate : measures adopted

Over the last few years, the Bank has analysed in depth recent developments on the mortgage market and identified the risk profile and quality of Belgian credit institutions' mortgage loan portfolios.

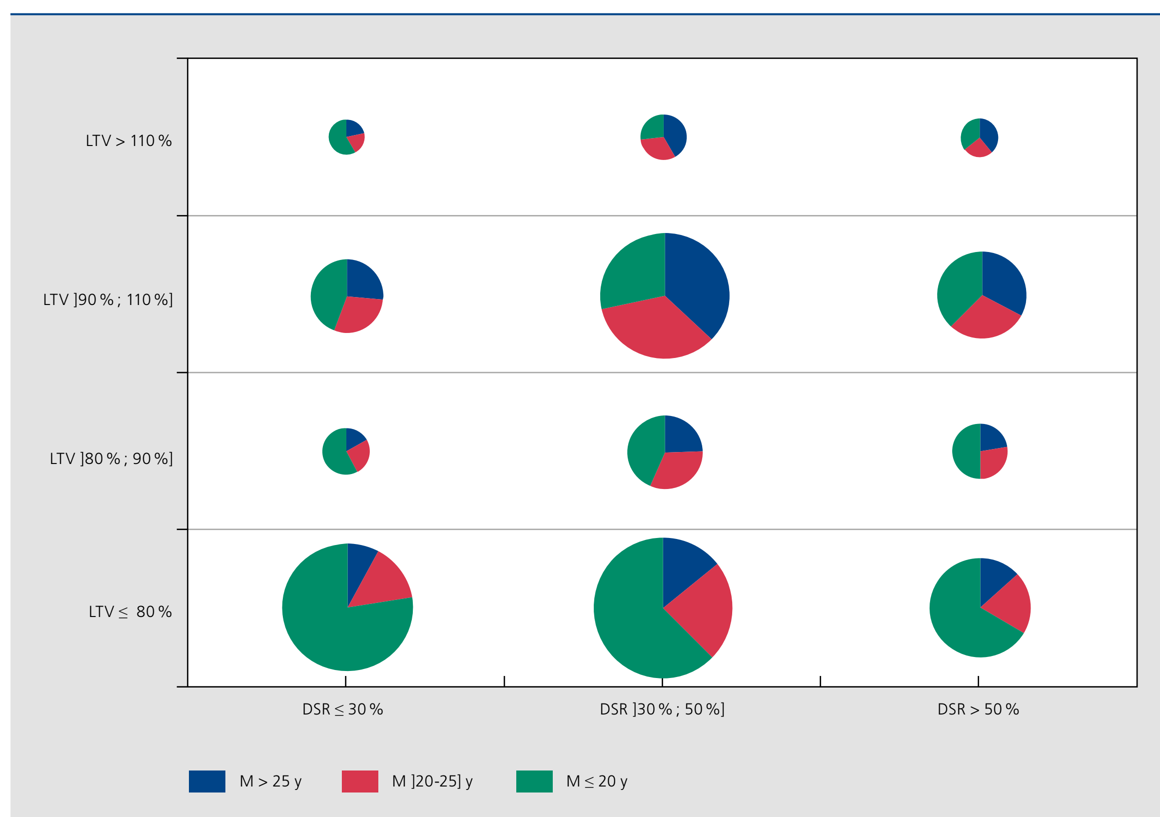
In this respect, the 2012 Financial Stability Review (FSR) stated that a substantial number of borrowers in recent vintages may have stretched their loan maturities, loan sizes and/or debt service ratios to levels that could entail

a higher risk of future credit losses for banks than in the past. To maintain the current very high asset quality of Belgian mortgage loans, the FSR therefore called for increased vigilance over current market developments, and a closer watch on the application of sufficiently conservative credit standards and the establishment of adequate risk pricing for all new mortgage loans.

The supplementary survey in 2013 focused in particular on the way in which the potential risks associated with mortgage loans are taken into account in calculating the minimum capital requirements for credit risk under the pillar 1 rules. In that regard, particular attention was paid to credit institutions which use the internal ratings-based approach (IRB) to calculate their minimum regulatory capital requirements for mortgage loans. The levels of the risk weights calculated with these internal risk models for Belgian mortgage loans (averaging around 10 %) are considerably lower than those determined by the standard approach for calculating the minimum capital requirements for credit risk (risk weighting of at least 35 %), though they vary widely between institutions. More detailed analysis confirmed that these differences between institutions are largely attributable to variations in the risk profile – and particularly the relative importance of the riskier sub-segments – of the portfolios of the different banks. However, the analysis also confirmed that the risk weights for Belgian mortgage loans were often very low in absolute terms, and lower on average than in many other European countries.

BREAKDOWN OF THE PORTFOLIO OF MORTGAGE LOANS OF IRB BANKS BY LTV, DSR AND MATURITY AT ISSUANCE [1] [2]

(non-consolidated data, end 2012)



Source: NBB.

(1) The three indicators are calculated at the time of granting the loans.

(2) The relative size of the circles reflects the relative size of the portfolios, while the level of the outstanding amount of loans in relation to the value of the property (loan-to-value, LTV) and the ratio between the debt repayments and the borrower's income at the time of granting the loan (debt service ratio, DSR) are broken down by specific intervals. In addition, each portfolio is broken down according to the initial maturity (maturity, M) of the loans expressed in years.

Although the credit quality indicators for households do not so far point to any deterioration in default rates on recent mortgage loan vintages, a number of factors could lead to a rise in credit losses in the future. In that respect, the said article in the FSR 2012 highlighted the particularly steep increase in house prices and mortgage lending over the preceding ten years, and the trend towards longer loan maturities and the relatively high (though stable) share of loan-to-value ratios of more than 80 % (including ratios higher than 100 %) in new contracts. In this connection, it is possible that a sizeable group of borrowers in recent vintages may have stretched their mortgage loan maturities, loan sizes and/or debt service ratios to levels that could entail a higher risk of future credit losses for banks than in the past. Consequently, some segments of the latest mortgage loan vintages could be more vulnerable to a deterioration in incomes and housing market conditions. Partly on the basis of criteria measuring the over- or under-valuation of property prices, the Bank and international institutions such as the ESRB, the OECD and the IMF therefore decided to draw attention recently to the potential risks associated with the Belgian housing and mortgage market.

In this context, and in view of the relatively large share of Belgian mortgage loans in the balance sheets of Belgian credit institutions, the NBB considered it justified to take some prudential measures aimed at strengthening the banks' resilience and reducing the concentration risk.

The first measure is macroprudential in nature and provides for a flat-rate 5 percentage point increase in the risk weightings calculated by the banks themselves, but only for banks calculating their minimum regulatory capital requirements for Belgian mortgage loans according to an IRB model. That measure took effect with the Royal Decree of 8 December 2013 (1). In practice, if a bank using the IRB approach calculates an internal risk weighting of 10 % for Belgian mortgage loans, this measure requires the minimum capital requirements to be calculated on the basis of a 15 % risk weighting. This add-on does not apply to banks using the standard approach mentioned earlier to calculate their capital requirements. This moderate add-on seems appropriate in view of the rather conservative policy on mortgage lending in the past, and the historically low level of losses on such loans. However, in view of the cyclical character of this measure, the Bank will keep a close eye on market developments for the purpose of continuous assessment of the appropriate level of that add-on. From 2014, the new capital requirements for Belgian mortgage loans can only be maintained pursuant to European rules permitting the EU Member States to impose specific requirements to address macroprudential risks. The Bank will do whatever is necessary to maintain the add-on with due regard for the new EU Directives applicable from 1 January 2014.

The other two measures adopted by the Bank are microprudential in nature : one concerned launching a horizontal assessment of the said IRB models on the basis of the results of the backtesting (2) to be conducted by the institutions, followed by any necessary adjustments to those approaches, and the other consisted in requesting credit institutions to carry out a self-assessment of the degree to which each bank conforms to the EBA Opinion on Good Practices for Responsible Mortgage Lending and the EBA Opinion on Good Practices for the Treatment of Borrowers in Mortgage Payment Difficulties. The results of these two exercises will be analysed in the first half of 2014.

(1) Royal Decree of 8 December 2013 approving the regulation of 22 October 2013 of the National Bank of Belgium amending the regulation of 15 November 2011 of the National Bank of Belgium on the solvency of credit institutions and investment firms.
(2) Backtesting is one of the components of the quantitative validation of a model based on comparison between predicted and actual values.

2.2 Organisation of supervision

Mapping of the banking sector

The population of banks was relatively stable in 2013. The decline in the number of credit institutions under Belgian law – which is partly technical (switch to payment institution status) – was largely offset by a rise in the number of branches under foreign law. The already significant presence of foreign banks in Belgium, in the form of Belgian branches or subsidiaries, is persisting. In the investment firm sector, consolidation has also been in progress for a number of years, and in 2013 that again led to a fall in the number of institutions.

Supervision practice – preparation for Basel III

At least once a year, the supervisory authority subjects each financial institution to a full risk assessment, and checks whether the financial institution's capital is sufficient, taking account of its financial structure and risk profile, including risks not covered by pillar 1. If the institution is part of a group, the consolidating supervisory authority and the authorities responsible for supervising subsidiaries and major branches have to agree on a common position and determine the capital needed for each entity and for the consolidated unit. The mutual decision on capital is the outcome of a long and intensive process, starting with the request by the consolidating supervisory authority to the local supervisory authorities for their assessment of the risks and their proposal regarding capital for the local entity, and culminating in a detailed risk assessment for the group as a whole and for its constituent entities followed by determination of the level of capital. That level is generally significantly higher – to a degree that depends on the specific risk profile of the group and its entities – than the minimum regulatory capital requirement.

During the period under review, the Bank paid special attention to the preparation of credit institutions for the more stringent Basel III rules, and conducted two types of analysis for that purpose. The first analysis comprised periodic simulations of the banks' capital levels according to the rules applicable from 1 January 2014. The banks not only had to respect the new minimum regulatory standards, but also had to show that their capital was sufficient to maintain the minimum set by the latest decision on capital. A second set of analyses examined the extent to which the banks were already able to comply with all the new Basel III rules from 1 January 2014 without using the transitional arrangements. Banks with an insufficient margin were asked to implement an action plan to expand their buffers in time by increasing their capital and/or reducing their risks. In a number of cases, this led to specific actions and measures to strengthen the solvency position of the institutions concerned.

TABLE 3 CHANGE IN THE NUMBER OF INSTITUTIONS SUBJECT TO THE BANK'S SUPERVISION

	31-12-2012	31-12-2013
Credit institutions	123	122
Under Belgian law	44	39
Branches governed by the law of another EEA country	53	55
Branches governed by the law of a non-EEA country	9	10
Financial holding companies	7	7
Financial services groups	4	4
Other financial institutions (1)	6	6
Investment firms	36	34
Under Belgian law	21	20
Branches governed by the law of another EEA country	13	12
Branches governed by the law of a non-EEA country	0	0
Financial holding companies	2	2
Payment institutions and electronic money institutions	18	26
Payment institutions	12	16
Electronic money institutions	6	10

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

Supervision practice – inspections and model validation

On-site inspections are an important aspect of supervision. Prudential inspectors do not form part of permanent supervision teams but make up a separate group, carrying out their inspection missions in accordance with an agreed methodology (see the box on NOVA in chapter C, section 1 of the "Prudential regulation and supervision" part of the Report). Important topics covered by the inspections include the functioning and quality of risk management, the organisation and risk management of market activities, management of credit risk and liquidity risk, supervision of the retail network, and the application of the regulations on the prevention of money-laundering and the financing of terrorism.

As regards the validation of new models and the monitoring of the performance of previously validated models, the bulk of the work again concerned credit risk, which accounts for the major part of the capital requirements for institutions. Attention also focused on fair value models owing to the gradual disappearance of the prudential filter of the AFS (available for sale) portfolio under Basel III. Some new dossiers were also dealt with under market and operational risk and the ICAAP (International Capital Adequacy Assessment Process).

Supervision practice – cyber security and IT outsourcing

The internet has rapidly become a critical external network for the provision of services to the outside world (customers, branch networks, agents, etc.) and for the internal operation of institutions subject to supervision. At the same time, the use of the internet by institutions and their dependence on this tool generate high risks for the security and continuity of internal and outsourced IT systems and for the internet services offered.

In this connection, a particular focus of attention in 2013 concerned protection against cyber risks in general, and the plans for outsourcing the IT activities of financial institutions via "cloud computing" systems[1] in particular. Close cooperation was also established with Febelfin and the Federal Computer Crime Unit, among others, in order to combat e-banking fraud. It is noteworthy that almost all the e-banking fraud committed in Belgium in 2013 was due to specific fraudulent techniques (generally 'phishing' e-mails followed by telephone contact) whereby cyber criminals deceive users of e-banking services into disclosing their personal security codes.

(1) These are IT services offered on request and on line by providers of specialist IT services. In this connection, virtualisation and internet techniques are often used to render the IT services more extensible and more flexible.

3. Insurance undertakings

3.1 Components of the annual risk review 2013

The NBB has already been taking various initiatives since the end of 2011 to identify the points for attention in the insurance sector. In so doing, it has concentrated mainly on interest rate risk and liquidity risk. Since the end of 2011, the Bank has therefore launched special reporting geared to the vulnerabilities of large insurance companies. That reporting gives the supervisory authority a better idea of some of the risks specific to the insurance sector. In 2013, the Bank continued to use the results of this special quarterly reporting combined with the regular reporting data to conduct horizontal analyses in the insurance sector. The two main initiatives of 2013 are discussed below.

Persistence of a low interest rate environment

During the year under review, the NBB launched analyses designed to study in more detail the potential implications of persistently low interest rates for the insurance sector in Belgium. Historically, the Belgian insurance sector has always featured high guaranteed yields on certain life insurance products, and that is still the case, both for individual life insurance and for group policies. The guaranteed yields offered in Belgium are among the highest in the European insurance sector.

On the basis of an initial outlier analysis, the Bank singled out 13 companies and subjected them to more detailed examination in regard to the risks relating to this persistently low interest rate environment. The results of these analyses were then incorporated in a horizontal market analysis.

The initial findings resulting from these analyses indicate very wide variations in the management of the interest rate risk in the insurance sector. Companies use highly diverse strategies to manage this risk, and some of them warrant closer monitoring by the supervisory authority. The analyses also afforded a clearer view of the various facets and consequences of this persistently low interest rate environment.

Such an environment not only leads to a reinvestment risk – investments maturing have to be reinvested at a lower yield – but low interest rates also make it more difficult for insurers to market attractive life insurance products. With low guaranteed yields, it is harder to persuade customers and that may contribute to a decline in the volume of premium income.

In a low interest rate environment, there is also a danger that insurance companies may be over-zealous in their quest for higher returns on their investment portfolio. The first signs of a change in investment strategies are emerging on the Belgian insurance market. In a context of diversified portfolio management, that may not necessarily be a problem but firms must ensure that their expertise in managing their investments and risks is sufficient to maintain control over these alternative investments, which often have a credit and liquidity risk profile different from that of their traditional investment portfolio.

Another consequence of the low interest rate environment is that the transition from Solvency I to Solvency II, bringing a more market-consistent valuation, entails additional challenges, because the market value of the technical provisions increases significantly if the risk-free interest rate is low. In order to ease this transition, Omnibus II provided for transitional measures for discounting the risk-free interest rate. That is mainly advantageous for countries offering high guaranteed yields, so the likelihood is that Belgian insurance companies will also want to make use of that.

Furthermore, a low interest rate environment implies the risk of a sharp interest rate hike. If rates increase, insurance companies are not generally in a position to respond as flexibly as banks, owing to the longer maturity of their assets. The profit-sharing that insurance companies can offer on top of the minimum guaranteed yield therefore takes longer to adapt to rising interest rates than the interest that the banking sector can offer on alternative investments such as savings accounts or savings certificates. The risk of increasing surrenders and a further decline in premiums is then all the more real.

Analysis of a low interest rate environment shows the need for constant monitoring of this problem. Moreover, since the total assets of the insurance sector consist largely of investments in bonds issued by government entities, in-depth research was conducted into the composition and characteristics of the government bond portfolio of the insurance sector.

The results of this analysis for the sector as a whole were published in the FSR 2013. By mapping the maturity profile and coupon interest rates on government bonds, this study showed that, in the coming years, if the low interest rate climate persists, Belgian insurance companies will probably have to reinvest substantial amounts of AAA and AA bonds maturing at yields below the current coupon rate. In view of the outstanding amount of life insurance contracts with a high guaranteed yield, if the reinvestment risk materialises to such a considerable degree, albeit gradually, then in a low interest rate environment that could have a very significant impact on the results of insurance companies. Against that background, the substantial unrealised capital gains that insurance companies are currently recording on their bond portfolios will need to be treated prudently; those gains should not be allocated to the payment of dividends for policy-holders or shareholders, but should instead be regarded as a buffer for the years ahead, in case the current low interest rate environment persists in the medium term.

That environment and the resulting uncertainty over the feasibility of continuing to respect long-term commitments have already led to a downward adjustment of the guaranteed interest rate in the life insurance sector, both on new policies and for existing contracts where that is contractually possible. Moreover, this same low interest rate environment means that non-life insurers can no longer count on sufficient financial income generated by their assets to offset technical losses. That situation has encouraged the sector to pay greater attention to pricing, claims management and costs, and that has benefited the combined ratio. Apart from the individual analysis of the interest rate risk, the Bank therefore also considers the business model and general strategy of insurance companies as a key element in the overall risk assessment. Two pilot projects were launched in 2013 for that purpose. In 2014, the Bank will use the experience gained from those projects to initiate a more general review of the business models of large insurance groups.

Liquidity risk

In its analysis of the potential liquidity risk in the insurance sector, the Bank focused attention on monitoring the following aspects:

– "Surrenders" and total incoming and outgoing cash flows, namely premiums, (partial) surrenders, expiring contracts, deaths, etc. in class 21 insurance portfolios.
– The respective ratios between "liquid" and "less liquid" assets/liabilities.
– The exposure to certain specific assets and derivatives with a potential liquidity risk, e.g. repo's, securities lending activities, OTC derivatives, etc.
– Projections concerning liabilities and assets sensitive to the interest rate, in order to help identify significant future cash flow shortfalls.

The reported data once again confirm that, faced with a tendency towards rising surrenders and declining premiums, the Belgian insurance sector is finding it increasingly difficult to maintain the level of new class 21 business. That is due partly to the new tax treatment of life insurance products introduced in 2013, raising the tax on new premiums from 1.1 % to 2 %. It is also exacerbated by the low interest rate environment and by the fact that some life insurance products are no longer offered. Despite these declining volumes, the pure liquidity risk relating to this trend appears to be under control in most companies. The main point to watch is that these shrinking production volumes do not have too serious an impact on the profitability of the insurance business.

These developments also demonstrate the importance of monitoring the change in liquid assets and studying in more detail the relationship between liquid assets and liabilities that can be regarded as liquid or can be readily cancelled. In that respect, the conduct of an ALM policy centred on identifying and monitoring cash deficits will become increasingly important, both for the supervisory authority and for the insurance companies themselves. In some companies, the concentration of exposure to certain assets and derivatives with a potential liquidity risk is relatively high as a percentage of the total assets. Those exposures need to be monitored more closely.

3.2 Organisation of supervision

Mapping of the insurance sector and colleges of supervisors

At the end of the period under review, the Bank was supervising a total of 106 insurers, reinsurers, mutual guarantee associations and regional public transport companies (the latter being able to insure their fleet of vehicles themselves). That is therefore fewer than at the end of 2012, when the total came to 113. This downward trend is attributable to mergers, the conversion of Belgian companies into branches under the law of other EEA countries, closures following the transfer of portfolios to run-off, or the expiry of all the insurance liabilities. Furthermore, a European group continued to centralise its business lines in Belgium during 2013. As a result, the Belgian subsidiary will operate in future via branches in most other EEA countries.

Supervisory authorities of cross-border groups cooperate in colleges coordinated by the group's consolidating supervisor (the home country authority), with the participation of the supervisory authorities of the group's subsidiaries and branches (host country authority). Recurring items on the agenda for these colleges include the examination and assessment of the financial position, organisation, strategy, and the risks to which the group and its subsidiaries are exposed. Coordination arrangements are drawn up, namely arrangements on cooperation and the exchange of information, both in a going concern situation – e.g. for approval of an internal model – and in a stress situation. In that connection, EIOPA developed an internet application to continue streamlining the exchange of information between supervisory authorities.

TABLE 4 CHANGE IN THE NUMBER OF UNDERTAKINGS SUBJECT TO SUPERVISION (1)

	31-12-2012	31-12-2013
Active insurance undertakings	87	83
Insurance undertakings in run-off	9	8
Reinsurance undertakings	1	1
Other (2)	16	14
Total	**113**	**106**

Source: NBB.
(1) In addition, at the end of 2013, the Bank exercised prudential supervision over nine branches of companies governed by the law of another EEA country, though that was confined to checking compliance with the money-laundering legislation.
(2) Mutual guarantee associations and regional public transport companies.

During the period under review, a number of colleges were organised to prepare for the introduction of Solvency II. They took the form of joint inspections, workshops and reviews. In 2013, the emphasis was on drafting and discussing a risk assessment at the level of the group and at the level of its constituent entities.

In 2012, the colleges had also launched the initial preparations for the Own Risk and Solvency Assessment (ORSA) of institutions, a pillar-2 requirement of Solvency II. An initial assessment of the ORSA ratios by the supervisory authorities took place in 2013.

Supervision practice – preparations for Solvency II

In 2013, the insurance sector was asked about the best estimate of the technical provisions. The NBB's intention here was to examine the degree to which the industry was ready for entry into force of the new prudential regime. The survey results will be used in 2014 to encourage firms which are not yet up to the required level of supervision in methodological terms to catch up and take the necessary measures for that purpose.

Some companies are already anticipating Solvency II by adjusting their technical provisions towards the best estimate. That practice is problematic because it implies only partial implementation of the new prudential regime. In 2014 the Bank will therefore pay particular attention to estimating the required level of the technical provisions under the existing rules.

Under Solvency II, as an integral part of their business strategy, companies will have to conduct a regular assessment of their total solvency needs in the light of their specific risk profile, more particularly the ORSA. At the end of 2012, insurance companies were reminded about preparing an ORSA. Seven companies responded to the Bank's request and a number of the reports received were analysed and tested for compliance with the Solvency II requirements. A qualitative assessment model was developed for that purpose. The exercise will continue in 2014 with an initial analysis for a number of companies and a second analysis for those already examined. The qualitative assessment model will be refined and an initial approach to quantitative assessment is planned. The aim is to assess all companies by 2015.

Under the future Solvency II prudential framework, firms will be able to calculate their regulatory capital requirements on the basis of an internal model. The Solvency II Directive gives the prudential authority six months to

TABLE 5 COLLEGES IN WHICH THE BANK PARTICIPATES

	The Bank is the home-country authority	The Bank is the host-country authority
Complex groups	Ageas	AXA (AXA Belgium)
	KBC Insurance	
	Belfius Insurance	
	P&V	
Local undertakings	Intégrale Ducroire TCRe	
International undertakings		Allianz (Allianz Belgium and Euler Hermes)
		Generali (Generali Belgium and Europe Assistance)
		Munich Re (ERGO Life, DAS and DKV)
		HDI (HDI Gerling)
		BNP Paribas (Cardif)
		Delta Lloyd / Aviva (Delta Lloyd Life)
		Bâloise (Baloise Belgium and Euromex)
		MetLife (MetLife Insurance)
		Nationale Suisse (Nationale Suisse Belgium and L'Européenne)
		ING (ING Life and ING Non-Life)
		Assurances du Crédit Mutuel (Partners)
		CIGNA (CIGNA Life and CIGNA Europe)

Source: NBB.

assess the model and approve its use for regulatory purposes. Since the large workload entailed is concentrated on too brief a period, it was decided to allow firms to submit the model for assessment to the supervisory authority in advance, under a pre-application procedure. It is certainly not the intention for the supervisory authority to make any formal decision on the model at this stage. The firm must demonstrate that the modelled risks are sufficiently under control to produce reliable results.

At the Bank, work on pre-applications for internal models began in 2011 for undertakings which had submitted a dossier following the communication of 18 February 2011 concerning this procedure. In all, eleven dossiers were submitted to the Bank. This procedure permits examination of the extent to which companies wishing to use internal models to calculate their capital requirements are prepared for that.

In 2013, the same team dealt with both the quantitative and the qualitative aspects of the models. The inspections were conducted at the level of the Belgian parent company, the foreign parent company of Belgian firms, and the Belgian subsidiary of the foreign parent company. The developments and adjustments made to the internal models were monitored via regular meetings with the companies and by specific inspections. For some insurance groups, the college of supervisors discussed the practical arrangements and the organisation of the decision-making process in cases where the supervisory authorities disagreed on the appropriateness of the group model for the local market. Any shortcomings in the models were notified to the companies following discussion by the college.

The NBB notes that the companies have made progress but that some major challenges remain. The inspection missions already carried out enabled the Bank to draw conclusions both on the risks covered and on problems specific to each type of risk and the methodology applied. The 2012 findings were confirmed. Credit risk is often inadequately covered, the calculation of the market risk is approximate, the mortality tables used are not forward-looking, and non-transparent Vendor models are used in the case of catastrophe risk. The conclusions on the general modelling principles are also in line with those from 2012. The chosen methodology generates simplified models with inadequate granularity. Independent validation of the models needs upgrading and local knowledge of the group models is sometimes lacking, a finding that also applies to the management's

knowledge of the model. The methods of aggregating capital requirements are often insufficiently justified. That conclusion applies equally to the risk model: the choice of model, the assumptions and the use of expert judgment need stronger support. Finally, the outcome of the assessment of the technical provisions is uncertain. This all leads to excessive volatility in the capital and uncertainty over its exact level.

In regard to the flashing-light provision discussed in chapter B, section 3.2 of the "Prudential regulation and supervision" part, the Bank notified insurance companies that from 2013 the exemption dossiers will no longer be examined on the basis of the CPA-2006-2-CPA circular but according to a new methodology, owing to the persistently low interest rate environment and developments concerning Solvency II. As a result, no exemptions were granted in 2013.

Supervision practice – risk information and risk analysis

For the large insurance groups, periodic meetings took place with the members of the executive management of the undertaking. These meetings are intended to keep a close watch on the financial health of the companies concerned. That monitoring is necessary, notably in view of the FSAP conclusions. The weaknesses identified in some companies indicate the need for recovery measures. The periodic meetings with the companies ensure that the measures taken are closely monitored.

The large insurance groups inform the Bank of the outcome of the business-specific analyses which they conduct either periodically or on an *ad-hoc* basis (IMF stress tests, survey of vulnerabilities, assessment of the impact of Solvency II). During the course of 2013, the results of the various separate surveys were collated and examined against the standard reporting submitted to the Bank by the company. This exercise led to a risk analysis for each company. On the basis of these analyses, it was possible to detect any pitfalls, prompting more detailed analyses of those potential risks. The analysis results were discussed with the companies, which were urged to take steps to reduce their exposure to the increased risks.

Pursuant to the Bank's circular of 21 December 2012[1], in the case of the large insurance groups, an interview was conducted every three months with the approved auditor to discuss the undertaking's general situation. For other companies, these interviews were held less frequently.

Supervision practice – inspections

The inspection method underwent fundamental changes in 2013 to harmonise the inspections and improve their efficiency. For more details on this, see Box 5 on NOVA in chapter C, section 1 of the "Prudential regulation and supervision" part.

The 2013 inspection plan comprised a number of assignments concerning fifteen insurance companies. The main purpose of the missions was to assess:

– the rules and principles applied in regard to governance and management structure;
– the risk management systems and transverse control functions;
– reinsurance business;
– the organisation of class 23 activities and management of the associated risks;
– the rules for allocating costs among the various branches of activity;
– the adequacy of the technical provisions calculated under Solvency I;
– the progress of the preparations for the Solvency II requirements and in particular the adoption of the best estimate for calculating the technical provisions, and the preparations for the ORSA.

Some of the inspection missions also aimed to verify respect for the measures announced by the companies following previous missions, while others aimed to compare the management practices of the various companies for certain specific classes of activity.

(1) Circular NBB_2012_16 of 21 December 2012 on the approved auditors' duty of cooperation.

4. Oversight and prudential supervision of market infrastructures

4.1 Components of the annual risk review 2013

In the year under review, the Bank's supervision priorities for financial market infrastructures concerned business models, liquidity risk and operational risk.

Business models

The various market infrastructures are adapting their business models with a view to the introduction of TARGET2-Securities (T2S) and the specific new rules designed to make the activities more robust, such as CRD IV, EMIR and the draft Regulation on CSDs. This restructuring will give these entities access to new types of activity or functions, and that could tend to increase their risk profiles. The many companies operating in the post-trading sector are able to perform different roles: they may act as central depositories, provide custody services or act as authorised representative, depository or counterparty. However, their respective business models tend to converge for certain business segments, e.g. those where collateral is mobilised and rendered fluid. The extension of the market infrastructure activities to other links in the post-trading chain, the provision of new services and the increase in geographical scope therefore require close monitoring for the potential impact on risks.

Liquidity risk

If a financial market infrastructure has insufficient liquid resources at the scheduled moment for settlement, that may lead to systemic problems, especially in illiquid or volatile markets, and solvency problems. In particular, the NBB made sure that Euroclear Bank, as a financial market infrastructure, has the necessary procedures to measure and manage liquidity risk, even in the event of simultaneous default by two of its largest participants. Central depositories have an atypical risk profile. They do not collect deposits from the public and their lending activities are generally confined to granting intraday credit, solely for the purpose of facilitating the settlement of transactions. The excess deposits by their professional customers are also reinvested at maturities that ensure balance sheet liquidity. The supervision therefore needs to be based on principles specifically tailored to these business profiles, such as the CPSS-IOSCO principles for market infrastructures.

Operational risk

In the field of operational risk, cyber security is now receiving more specific attention. The supervisory authorities must, in particular, ascertain whether the market infrastructures are able to defend themselves and respond to cyber attacks, which are becoming more numerous and more serious. The main aim is to safeguard the integrity and confidentiality of the transactions handled by these infrastructures, and to guarantee continuity of service. As a member of the CPSS, the Bank took part in the international work on the cyber risks facing financial market infrastructures. That work charted the recent developments in cyber threats and the techniques available for dealing with them. The subject currently being examined is how the financial system as a whole could protect itself better against the growing level of threat, and whether the recovery mechanisms planned in response to a successful attack need to be strengthened. In view of the close links between infrastructures in the global financial system, it is vital to prevent the spread

of any consequences of an attack. The work of the G20 central banks concerning cyber risks is still at the analysis stage, and it is too soon to state what the new oversight expectations might be for financial market infrastructures in this sphere.

During the period under review, the Bank organised a round-table conference with the Belgian financial market infrastructures on the subject of cyber risks. There was an exchange of expertise on techniques for preventing, detecting, controlling and combating cyber threats. The participants also discussed the challenge of coping with the growing cyber threats, and considered the sectoral measures that might make a positive contribution here.

4.2 Organisation of supervision / oversight

The Bank is the prudential supervisory authority and overseer of market infrastructures. In exercising prudential supervision, it monitors the operator as an institution, whereas its oversight focuses on the system used by the operator. While the prudential supervision checks whether an institution complies with the rules on capital requirements, management, organisation and operational functioning, the oversight is more concerned with the stability of the financial system as a whole. The oversight examines whether systemic infrastructures are capable of ensuring the continuity of their services even in extreme circumstances. Table 6 indicates the Belgian infrastructures subject to the Bank's authority and cooperation between the Bank and the supervisory authorities of third-country infrastructures.

SWIFT

The Bank acts as lead overseer (principal supervisory authority) of SWIFT (Society for Worldwide Interbank Financial Telecommunication). Central banks make SWIFT subject to oversight because this entity is crucial to the security and efficiency of the financial messages exchanged between financial institutions and financial market infrastructures throughout the world.

During the period under review, the SWIFT Oversight Forum set up in May 2012 became more closely involved in determining the policy on oversight in relation to SWIFT. Apart from the G10 central banks, ten other central banks are informed of the SWIFT oversight conclusions. They

TABLE 6 THE BANK'S SUPERVISION AND OVERSIGHT OF FINANCIAL MARKET INFRASTRUCTURES

	International college of supervisors / cooperative oversight agreement		The Bank acts as the sole authority
	The Bank acts as the principal authority	The Bank participates under the direction of another principal authority	
Supervision			Belgian branch of Bank of New York Mellon
			Payment and electronic money institutions
Supervision and oversight	Euroclear Belgium (CIK) – ESES	CCP colleges (1)	Euroclear Bank (2)
	Euroclear SA/NV		Atos Worldline
	Bank of New York Mellon SA/NV (3)		BNYM CSD
Oversight	SWIFT (4)	TARGET2-Securities (5)	NBB-SSS
		TARGET2	Bancontact/Mister Cash (6)
		CLS (7)	CEC (6)
			MasterCard Europe (6)

Source: NBB.
(1) These are the supervisory colleges for the central counterparties LCH Clearnet SA, LCH Clearnet Ltd, Euro CCP-NL, Eurex AG Clearing, KDPW-CCP, Keler CCP and CC&G.
(2) The Bank works on an *ad-hoc* basis with the other central banks concerned.
(3) Bank of New York Mellon SA/NV is the European headquarters of the BNYM group. The Bank is the principal authority in the college of European supervisors.
(4) Society for Worldwide Interbank Financial Telecommunication.
(5) TARGET2-Securities is the planned platform for the settlement of multiple securities settlement systems (SSS) in the euro area from mid-2015.
(6) Peer review in the Eurosystem / ESCB.
(7) Continuous Linked Settlement.

participate in determining the points for attention for future oversight activities.

The oversight activities concern all types of operating risk that may affect the SWIFT messaging services. During the period under review, special attention focused on the further development of integrated risk management and protection against cyber threats. Entry into service of a new data centre and the progress achieved with the technological renovation of the FIN application – the central application for the exchange of messages via SWIFT – were closely monitored.

Payment infrastructure

The Bank acts as lead overseer of MasterCard Europe. In 2013, it concluded a Memorandum of Understanding with the Central Bank of Russia, establishing cooperative oversight. The cooperation takes effect at the same time as the establishment of a legal supervision framework in the Russian Federation, and is justified by the growth potential of MasterCard Europe in that country. A similar agreement with the Nederlandsche Bank is being prepared, since the Dutch debit card scheme (PIN) was replaced by the MasterCard Europe debit card function (Maestro). The Bank also kept a close watch on the measures taken by Bancontact/MisterCash to conform to the standards introduced by SEPA (Single Euro Payments Area) for a payment card scheme.

The Centre for Exchange and Clearing (CEC), the Belgian clearing centre for the exchange and clearing of small interbank payments, migrated its technical platform at the end of March 2013 to the French retail payments system, *Système technologique d'échange et de traitement*. The CEC nevertheless remains a Belgian legal entity. The Bank concluded an agreement with the Banque de France on the exchange of information for the purpose of oversight.

Growing numbers of non-bank institutions have been operating under the payment institution status introduced last year (see the table in section 2.2 of chapter C). In 2013, the Bank embarked on a detailed survey of the duties of vigilance incumbent upon these payment institutions in order to prevent money-laundering and the financing of terrorism.

Central counterparties

In the final quarter of 2013, the national competent authorities launched the authorisation procedure defined in the EU's EMIR Regulation, whereby each CCP is granted a European passport. In that context, a supervisory college is set up for each CCP and has a right of consultation and escalation under the authorisation procedure. In early January 2013, the Bank took part in the supervisory college of 7 foreign CCPs, either as the supervisory authority of a CSD which the CCP uses for settlement, or as the supervisory authority of one of the three main clearing members of the central counterparty.

Securities deposit and settlement

The supervision concerning CSDs and securities settlement systems (SSS) focused on the establishment of a CSD by Bank of New York Mellon and on the activities of Euroclear Bank.

In December 2012, Bank of New York Mellon CSD and Bank of New York Mellon SA/NV were recognised respectively as a CSD and an institution equivalent to a settlement institution. That recognition entails the obligation to meet a series of basic requirements for a robust operational framework and risk management. In 2013, the Bank considered that those requirements were met and approved the operational launch of the Bank of New York Mellon CSD. The latter was also appointed as a securities settlement system. It will begin operating by early 2014 at the latest.

In November 2012, the FSB included the Bank of New York Mellon group in the list of Global Systemically Important Banks (G-SIBs). Consequently, as the supervisory authority of Bank of New York Mellon SA/NV the Bank concluded a cooperation agreement with the Federal Deposit Insurance Cooperation and the Board of the Federal Reserve, responsible for supervising the group's parent company in the United States. That agreement concerns participation in the preparation and regular monitoring of a general resolution plan under the aegis of a Crisis Management Group comprising the supervisory authorities of the main entities of Bank of New York Mellon. The work of the Crisis Management Group began in the second half of 2013.

From late 2012 to early 2013, the IMF conducted an EU-wide FSAP for the first time covering pan-European financial market infrastructures. In the process, the IMF – following in the footsteps of the Bank – also conducted an assessment of Euroclear Bank, on the basis of the CPSS-IOSCO principles applicable to financial market infrastructures. The IMF's recommendations concerned among other things the recovery plan requirements, advances on coupon payments and bond redemptions, daily reconciliation of positions in securities, and risk analysis concerning customers of participants in Euroclear Bank. As regards the organisation of the

supervision itself, the IMF recommended formalising and extending the current cooperation between the Bank and the Luxembourg authorities in respect of Euroclear Bank, in order to create a level playing field for Euroclear Bank and Clearstream Banking Luxembourg as international central securities depositories (ICSDs), and to include the ECB in that process. The Bank and the Luxembourg authorities are currently finalising an agreement. Lastly, the IMF considered it appropriate to deploy additional resources to strengthen the oversight of systemically important market infrastructures like Euroclear Bank.

In accordance with the new requirements included in the CPSS-IOSCO principles for market infrastructures, the Bank has to cooperate with the authorities of the countries for which the smooth operation of market infrastructures based in Belgium and active internationally is of major importance. At this stage, that requirement specifically concerns Euroclear Bank. The various cooperation agreements intended to give the authorities concerned access to all useful information for the exercise of their own responsibilities were finalised recently or are in progress. The structural implementation of that cooperation will take place in 2014.