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March 2018

TECHNICAL NOTE—BANKING, INSURANCE AND FINANCIAL CONGLOMERATE SUPERVISION

This Technical Note on Banking, Insurance, and Financial Conglomerate Supervision for Belgium prepared by a staff team of the International Monetary Fund. It is based on the information available at the time it was completed on February 26, 2018.

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TECHNICAL NOTE

BANKING, INSURANCE AND FINANCIAL CONGLOMERATE SUPERVISION

Prepared By
Monetary and Capital Markets Department

This Technical Note was prepared by IMF staff in the context of the Financial Sector Assessment Program in Belgium. It contains technical analysis and detailed information underpinning the FSAP's findings and recommendations. Further information on the FSAP can be found at http://www.imf.org/external/np/fsap/fssa.aspx

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Glossary

ALM	Asset and Liability Management
BCP	Basel Core Principles for Effective Banking Supervision
BGAAP	Belgian Generally Accepted Accounting Principles
BL	Banking Law
BRRD	Bank Recovery and Resolution Directive (Directive 2014/59/EU)
BU	Banking Union
CBFA	Banking, Finance and Insurance Commission
CCB	Capital Conservation Buffer
CCyB	Countercyclical Capital Buffer
CET1	Common Equity Tier 1
CRD IV	Capital Requirements Directive (Directive 2013/36/EU)
CRO	Chief Risk Officer
CRR	Capital Requirements Regulation (Regulation (EU) No. 575/2013)
CVA	Credit Valuation Adjustment
DTL	Deferred tax liabilities
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
EIOPA	European Insurance and Occupational Pensions Authority
FC	Financial Conglomerate
FHC	Financial Holding Company
FICOD	Financial Conglomerate Directive (Directive 2002/87/EC, as amended by Directive 2011/89/EU)
FINREP	Financial Reporting
FSAP	Financial Sector Assessment Program
FSMA	Financial Services and Markets Authority
FSB	Financial Stability Board
FTE	Full-Time-Equivalent
G-SIB	Global Systemically Important Bank
G-SII	Global Systemically Important Institution/Insurer
IAIS	International Association of Insurance Supervisors
ICAAP	Internal Capital Adequacy Assessment Process
ILAAP	Internal Liquidity Adequacy Assessment Process
ICP	Insurance Core Principle
IFRS	International Financial Reporting Standards
IMI	Internal Model Investigation
IRB	Internal Ratings Based
JFP	Joint Forum Principles for Supervision of Financial Conglomerates
JST	Joint Supervisory Team
LAC_DT	Loss Absorption Capacity of Deferred Taxes

LCR	Liquidity Coverage Ratio
LSI	Less Significant Institution
MAHC	Mixed Activity Holding Company
MEL	Minimum Engagement Levels
MFHC	Mixed Financial Holding Company
MOCE	Margin Over Current Estimate
NBB	National Bank of Belgium
NCA	National Competent Authority
NSFR	Net Stable Funding Ratio
ORSA	Own Risk and Solvency Assessment
O-SII	Other Systemically Important Institution
PPP	Prudent Person Principle
RWAs	Risk weighted assets
SCR	Solvency Capital Requirement
SEP	Supervisory Examination Program
SI	Significant Institution
SIFI	Significantly Important Financial Institution
SME	Small and Medium Sized Enterprise
SPE	Special Purpose Entity
SREP	Supervisory Review and Evaluation Process
SSM	Single Supervisory Mechanism
UCITS	Undertaking for Collective Investment in Transferable Securities
VA	Volatility Adjustment

EXECUTIVE SUMMARY

The regulatory framework for Belgian financial institutions has been strengthened substantially since the 2013 FSAP. Notably, new national banking and insurance laws have been issued, the Bank Recovery and Resolution Directive (BRRD) and amendments to Financial Conglomerate Directive (FICOD) have been transposed, Solvency II has been implemented, and the National Bank of Belgium (NBB) has been designated as the macroprudential authority. This has improved significantly the regulatory framework and broadened its scope to better address the challenges posed by financial conglomerates (FC).

Financial sector supervision has also been upgraded markedly. The Single Supervisory Mechanism (SSM), responsible for over 90 percent of the Belgian banking sector assets, has made the supervision of banks more intrusive, forward looking, and effective. NBB has enhanced supervision of the less significant institutions (LSIs) by aligning its practices with those applied to significant banks, with due consideration of proportionality issues.

The FSAP team commends the authorities for these improvements and urges them to continue with their efforts to further strengthen the policy framework for financial stability. The team recommends improvements in the three areas assessed in the current FSAP.

In banking, the recommendations focus on the need for a careful transition to the banking union and strong oversight of internal models, loan classification and provisioning, and related party transactions.

- *Transition to the banking union*. While fully supportive of the single market, the FSAP team recommends maintaining sufficient capital in cross-border subsidiaries until a common deposit insurance scheme and a common fiscal backstop for systemic events are in place. Any changes to current prudential requirements and supervision focus should be mindful of financial stability in member states and be made gradually, to minimize the risk of unintended consequences.
- *Internal models.* The targeted review of internal models launched by the SSM has entered the execution phase in 2017. Continuing to improve model monitoring will be key to reducing unwarranted variability of risk weighted assets. Supervisors should continue to demand greater involvement of bank boards in the oversight of the models.
- *Loan classification and provisioning.* Loan valuation and provisioning have traditionally been driven by accounting norms in Belgium. Guidelines issued recently by the European Central Bank (ECB) introduce prudential considerations for loan classification, but their impact is bound to be limited. Supervisors should play a more proactive role in assessing banks' treatment of assets to ensure sound classification and provisioning standards.
- *Related party transactions.* There is no EU-wide regulation on transactions with related parties and the legal definition of related party transaction in the Belgian framework is too narrow. The definition of related parties and transactions should be broadened, and banks should be required to establish sounder policies and processes to identify them.

- *Off balance sheet activities.* Special purpose entities (SPE) should be brought within the scope of supervision. Supervisors should be able to develop a process for determining whether an SPE is to be fully or proportionally consolidated for regulatory purposes. The overall nature of the relationship between SPEs and the financial institutions should be contemplated, going beyond traditional control and influence criteria. Stress tests and scenario analyses should consider all relevant off-balance sheet activities

On the insurance front, NBB faces important challenges. Some of these relate to the changing risk profile of the industry, while others pertain to the industry's partial reliance on relatively low-quality forms of capital, which might fail to provide adequate loss absorption in the event of a crisis.

- *Evolving risk profiles*. In response to low interest rates, several insurers have moved from traditional insurance products to asset management-type products, which reduces their exposure to interest rate risk but renders them vulnerable to liquidity risk—for which a robust regulatory framework is not yet in place. In addition, Brexit has prompted the reallocation of reinsurance business to Belgium, which will pose additional challenges. NBB should stand ready to deploy prudential measures to mitigate liquidity risk, strive to retain its highly-qualified staff, and enhance its resources as the size and complexity of the industry increases.

- *Quality of capital*. Although the industry already meets Solvency II requirements, reliance on lower quality forms of capital is a concern. This includes subordinated loans from parent banks and unrecognized gains on new insurance products with flexibility of surrender which are thus vulnerable to redemption risk. Further, it is possible that the use of volatility adjustments (VA) may have led to an overstatement of insurers' solvency. Proactive engagement with the industry to gradually improve the quality of capital is strongly recommended.

As for FCs, supervisory expectations on governance should be heightened and oversight of key prudential requirements strengthened.

- *Policies for governance, risk management, and capital and liquidity requirements.* The SSM Supervisory Manual provides supervisors with limited insight beyond the regulatory requirements. Defining best practices and providing further guidance is critical for effective FC supervision.

- *Intra-group transactions and concentration risk.* Supervisory practices for collecting data and analyzing intra-group transactions and concentration risk are limited and not harmonized. SSM/NBB should develop guidance on the evaluation of FC intragroup transactions to determine their economic purpose and identify any transfer of sub-quality assets at book value between affiliates to avoid loss recognition. For FCs where supplementary supervision has been waived, supervisory guidance should emphasize that channels of risk transmission such as reputational risk remain and must be monitored.

Table 1. Belgium: Recommendations on Banking, Insurance and Financial Conglomerate Supervision

Recommendations and Responsible Authorities	Timing*	Priority**
Banking supervision		
Continue enhancing the reliability and consistency of internal models used to calculate regulatory capital. (NBB/SSM)	C	H
Play a more active role in assessing loan classifications to ensure prudent provisioning practices. (NBB/SSM)	C	H
Seek to strengthen the regulation and monitoring of transactions with related parties. (NBB/SSM)	ST	H
Continue efforts to enhance the risk management and control functions by strengthening the role of the board in its supervisory function. (NBB/SSM).	I	M
Continue efforts to enhance banks' and FCs' data quality and reporting. (NBB/SSM)	C	M
Ensure that off-balance sheet activities, including SPEs, are brought within the scope of group-wide supervision. (NBB/SSM)	MT	H
Insurance supervision		
Engage with the insurance industry to gradually improve the quality of capital. (NBB)	ST	M
Seek to impose appropriate measures to address increasing liquidity risk of the sector, with due consideration of policyholders' protection and benefits. (NBB)	ST	H
Consider imposing more detailed reporting requirements on insurers with large exposures to mortgage loans. (NBB)	ST	M
Continue analyzing the business growth of reinsurance operations and enhance supervisory resources as needed. (NBB)	C	H
Strive to retain staff with high expertise in the implementation of Solvency II. (NBB)	C	H
Financial conglomerate supervision		
Seek legislative changes to enhance supervisory authority over holding companies and flexibility in defining the supervisory perimeter. (NBB/SSM)	MT	M
Set supervisory expectations for FC governance and integrated risk management. (NBB/SSM)	ST	H
Enhance data collection to monitor risk concentration and intra-group transactions by implementing Regulation 2015/2303. (NBB/SSM)	ST	H
Provide additional guidance in the SSM Supervisory Manual concerning supplementary supervision. (SSM)	ST	H
Enhance disclosure by the FCs that do not deduct participations in insurance subsidiaries. (NBB/SSM).	I	M

Table 1. Belgium: Recommendations on Banking, Insurance and Financial Conglomerate Supervision (concluded)		
Establish a supervisory approach to monitor liquidity risk at FC level, reflecting differences in banking and insurance. (NBB/SSM)	MT	M
Monitor risk of regulatory arbitrage between insurance and banking sectors. (NBB/SSM)	I	H

* C = continuous; I = Immediate (within one year); ST = Short Term (within 1- 2 years); MT = Medium Term (within 3-5 years)

** H= High; M= Medium; L=Low.

INTRODUCTION

A. Scope and Approach

1. The framework for the supervision of banks, insurance companies and FCs in Belgium has been fundamentally revamped since the 2013 FSAP. The establishment of the SSM has made the ECB directly responsible for the supervision of over 90 percent of the Belgian banking sector assets. In addition, the twin peaks supervisory model implemented in 2011 has been streamlined and new banking and insurance laws have been issued. These new laws and changes to the NBB Organic Law have redesigned the supervisory framework, including by implementing the Solvency II Directive and BRRD, designating the NBB as the macroprudential authority, and enhancing the legislation for the supervision of FCs.

2. This technical note analyzes the key aspects of the regulatory and supervisory regime of banks, insurance companies and FCs in Belgium. The analysis was part of the 2018 Financial Sector Assessment Program (FSAP) and was based on the regulatory framework in place and the supervisory practices employed as of September 2017.[1] The analysis was based on a review of regulations, meetings with the NBB and ECB and review of their joint self-assessments and responses to other questionnaires. The assessment team also met with representatives from banks, insurers, audit firms, and industry associations.

3. The issues discussed in this note were selected on the basis of their macrofinancial relevance and previously identified deficiencies in the Belgian regulatory and supervisory framework. The banking supervision evaluation included organization and resources of the supervisory authorities; independence and governance; supervisory approach; risk management; capital adequacy; credit risk; problem assets, provisioning and reserves; and internal controls and audit. Despite basing the evaluation on the 2012 Basel Core Principles (BCPs), the mission has not assessed compliance with the individual BCPs, which will be assessed in the upcoming euro area FSAP. The insurance evaluation has focused on selected Insurance Core Principles (ICPs) in the context of a wider discussion of key issues in regulation and supervision. The note does not include a detailed assessment of observance of the ICPs. The focus of the note is on i) key vulnerabilities identified in the previous FSAP regarding supervisory resources; ii) the implementation of the Solvency II requirements, and iii) resolution and crisis management of large and complex insurance groups.

4. Considering the prevalence of FCs in the Belgian financial sector, special attention has been devoted to their regulation and supervision. The authorities completed self-assessments on compliance with the Joint Forum Principles for the Supervision of Financial Conglomerates (JFP). FCs challenge individual sector supervisors to evaluate group wide capital adequacy, conflicts of interest, contagion, concentration and other risks, making it necessary to complement individual sector supervision with supplementary supervision. The mission analyzed current supervisory practices and contrasted them with the JFP.

[1] The authors of this technical note are Caio Ferreira and Nobuyasu Sugimoto (IMF) and José Tuya (external expert).

5. The IMF mission thanks the authorities and private sector participants for their excellent cooperation. The FSAP team benefitted greatly from the inputs received and exchanges of views during meetings with supervisors and market participants. The team sincerely thanks the NBB and ECB staff for their professionalism, spirit of cooperation, and for making enormous efforts to respond to the team's requests and overcome logistical challenges.

MARKET STRUCTURE

6. The Belgian financial system is relatively large, concentrated, and interconnected with the rest of the world. Although the banking sector has contracted in size since the global financial crisis, it remains large relative to the economy with total assets at around 250 percent of GDP in 2016. There is a strong presence of foreign owned institutions and the insurance sector is embedded in the predominant bancassurance model dominated by a few FCs.

A. Banking Sector

7. The banking system is dominated by four banking groups representing over 80 percent of the consolidated system assets. In 2016 there were 90 credit institutions operating in Belgium (Table 2) but the system is highly concentrated. The largest and the fourth largest banks in Belgium are subsidiaries of other euro area banks, making the presence of foreign-owned banks a characteristic that defines the system (Figure 1).

Table 2. Belgium: Credit Institutions in Belgium

Institutions	2011	2016
Credit institutions governed by Belgian law with Belgium majority shareholding	20	15
Credit institutions governed by Belgian law with foreign majority shareholding	27	19
EU member states	20	11
Other States	7	8
Belgian branches of foreign credit institutions	61	56
EU member states	52	48
Other States	9	8
Total	108	90

Source: NBB Financial Stability Report 2017.

8. Loans account for approximately 60 percent of banking system assets. Mortgage loans increased about 5.5 percent from end-2015 to end-2016 and comprise approximately 18 percent of the total assets. Banks have increased their domestic focus during recent years but foreign loans continue to be comparatively high. On the liability side, household deposits have been increasing and accounted for about 36 percent of the total liabilities at the end of 2016.

9. The health of Belgian banks has improved in recent years. Profitability has recovered and the banks' migration to the new Basel III standards is well under way. Non-performing loans have declined to 3.5 percent of total loans at 2016: Q3 and the liquid assets to short-term liabilities ratio stands at a healthy 57.8 (Table 3).

Table 3. Belgium: Financial Soundness Indicators

	2010	2011	2012	2013	2014	2015	2016Q3
Regulatory Capital to Risk-Weighted Assets	19.3	18.5	18.2	18.7	17.6	18.7	18.5
Regulatory Tier 1 Capital to Risk-Weighted Assets	15.5	15.1	15.9	16.4	15.3	16.0	15.9
Non-performing Loans Net of Provisions to Capital	14.2	17.3	19.9	23.8	26.0	21.9	19.9
Non-performing Loans to Total Gross Loans	2.8	3.3	3.7	4.2	4.2	3.8	3.5
Sectoral Distribution of Total Loans: Residents	47.6	52.9	57.1	57.3	61.3	61.8	62.6
Sectoral Distribution of Total Loans: Deposit-takers	1.3	1.0	1.0	0.7	0.8	0.4	0.6
Sectoral Distribution of Total Loans: Central bank	-	-	-	-	0.3	0.7	1.4
Sectoral Distribution of Total Loans: Other financial corporations	4.8	6.5	6.8	6.7	3.2	2.2	2.5
Sectoral Distribution of Total Loans: General government	0.5	0.9	0.8	0.6	7.0	5.9	5.8
Sectoral Distribution of Total Loans: Nonfinancial corporations	13.2	14.9	15.7	15.7	18.7	19.4	19.2
Sectoral Distribution of Total Loans: Other domestic sectors	27.8	29.6	32.8	33.6	31.4	33.1	33.2
Sectoral Distribution of Total Loans: Nonresidents	52.4	47.1	42.9	42.7	38.7	38.2	37.4
Return on Assets	0.5	0.1	0.2	1.0	0.5	0.7	0.7
Return on Equity	10.6	1.2	3.4	16.0	7.9	10.2	10.2
Interest Margin to Gross Income	58.7	67.1	64.2	44.7	60.7	58.5	65.7
Non-interest Expenses to Gross Income	65.4	75.4	81.9	53.8	65.8	63.9	63.0
Liquid Assets to Total Assets (Liquid Asset Ratio)	32.5	34.3	36.4	36.8	32.8	32.2	33.2
Liquid Assets to Short Term Liabilities	75.7	82.1	77.3	68.5	61.3	56.8	57.8
Net Open Position in Foreign Exchange to Capital	3.3	1.4	2.1	2.1	3.3	2.6	1.9

Source: IMF Financial Soundness Indicators Database.

B. Insurance Sector

10. The Belgian insurance industry is characterized by the presence of a few FCs and is concentrated. Three large insurers (KBC, Belfius and Argenta) belong to FCs led by banks, and account for 20 percent of the total assets of the insurance industry. Insurance policies are distributed mainly through brokers and bancassurance, the latter being an important sales channel of insurance products, offering saving type products. 92 percent of the industry assets are held by composite insurers, while the asset shares of pure life and non-life companies are 3 percent and 5 percent, respectively, as of end 2016. Given the significant market share of composite insurers, all data on the insurance sector below are those of composite insurers, unless specifically mentioned otherwise.

Figure 1. Belgian Banking Sector

Source: NBB, FSI database, Banks' Annual reports and IMF staff calculations.

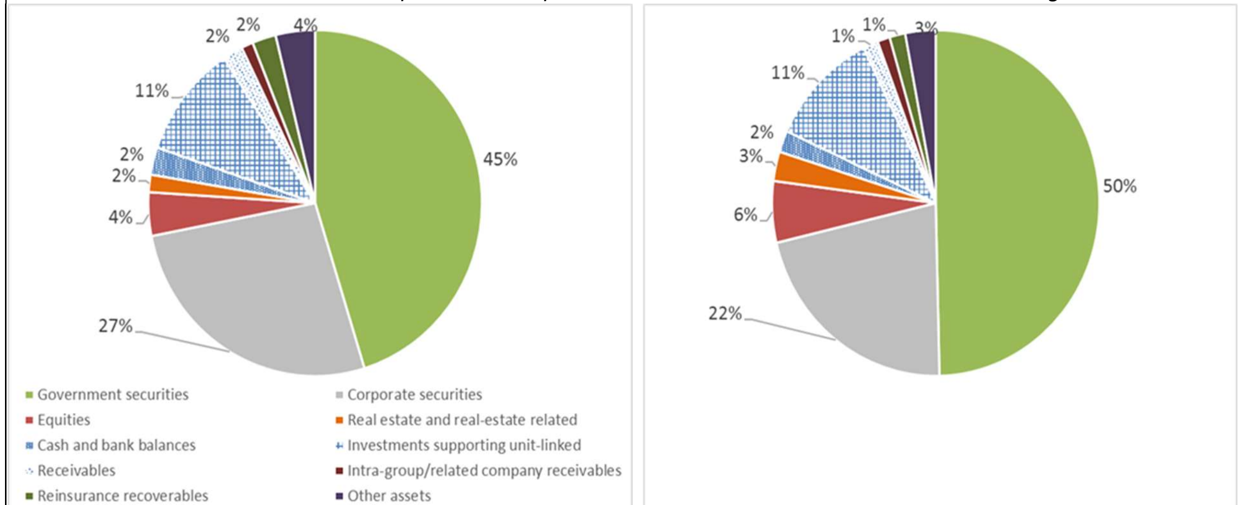
11. While no sign of searching for yield has been observed on an industry wide basis, some groups are increasing their investments in illiquid assets such as mortgage loan portfolios. The majority of life and non-life investments consists of government securities, with about 69 percent of the total assets of the life sector, 59 percent of the non-life sector and 50 percent of composite insurers' assets. However, some groups are increasing their allocations to less liquid assets, in particular mortgage loans, typically acquired from banks within the same FC.

12. Belgian insurers have high allocations of Belgian government bonds. Belgian insurers have a material home bias. Belgium and France account for about 60 percent and 10 percent of the

sovereign portfolio, respectively, and there is no clear trend of asset allocation changes towards euro area periphery countries and lower credit corporate bonds in the last five years, which has been observed in neighboring countries (such as France and Germany).

Figure 2. Belgium: Asset Allocation of Composite Insurers in 2014 and 2016

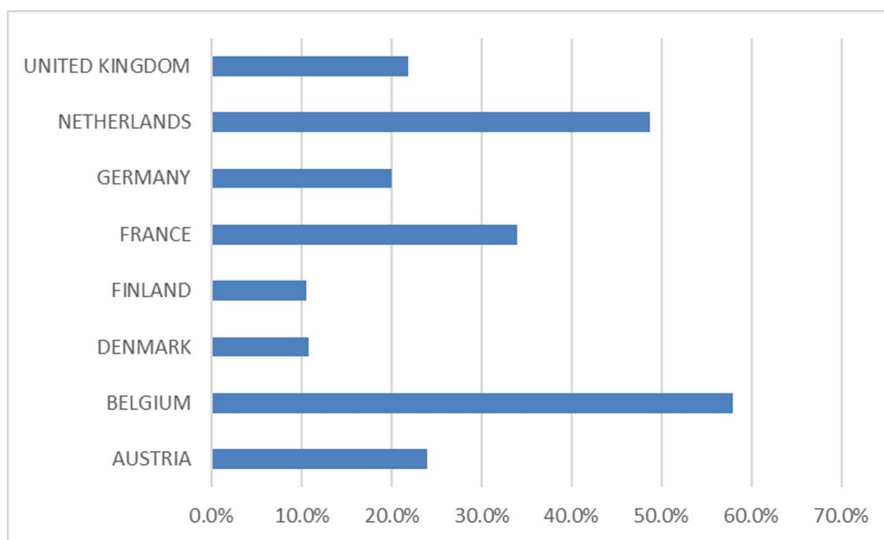
There is no sign of search for yield in the insurers' asset allocation. The left chart is the allocation as of end 2014 based on book value and the right chart is that of end 2016 based on market value. Allocation in government bonds (safest assets) has increased from 45 percent to 50 percent (some increase is due to mark to market gains).



Source: NBB.

Figure 3. Belgium Peer Comparison of Sovereign Concentration as of Third Quarter 2016

Belgian insurers have the highest share of asset allocation to sovereigns. Most investments are in Belgian government bonds.



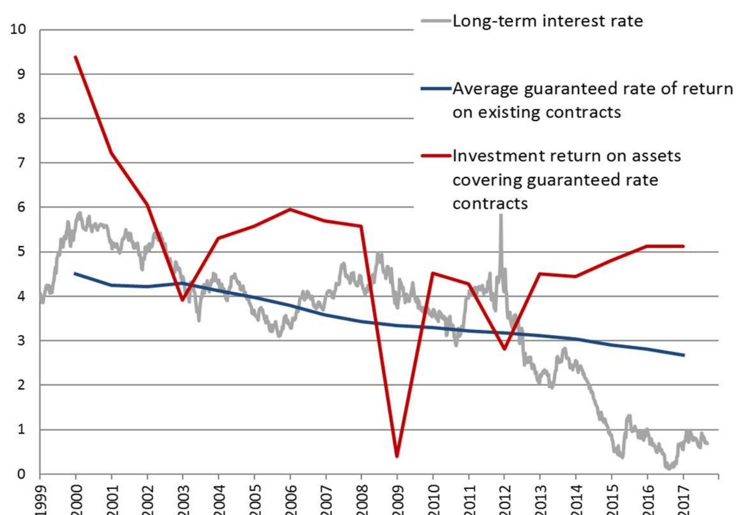
Source: EIOPA.

13. Life insurers have made efforts to lower guaranteed rates, but long-term interest rates have fallen faster. Some insurers have decided to stop selling saving type products to shift toward

more protection type products. Others have proposed to policyholders to decrease the guaranteed rates in order to invest more in equities so as to increase the potential future profit sharing. They are also encouraging policyholders to shift to unit-linked products. Those efforts have helped the industry to lower the average guaranteed rate only gradually. In fact, the average rate is still around 3 percent while the long-term interest rate is less than 1 percent.

Figure 4. Belgium: Guaranteed Rate and Investment Return

Guaranteed rate has decreased, but only gradually and more slowly than long-term interest rate (yield of 10 year Belgium government bond) and investment return)



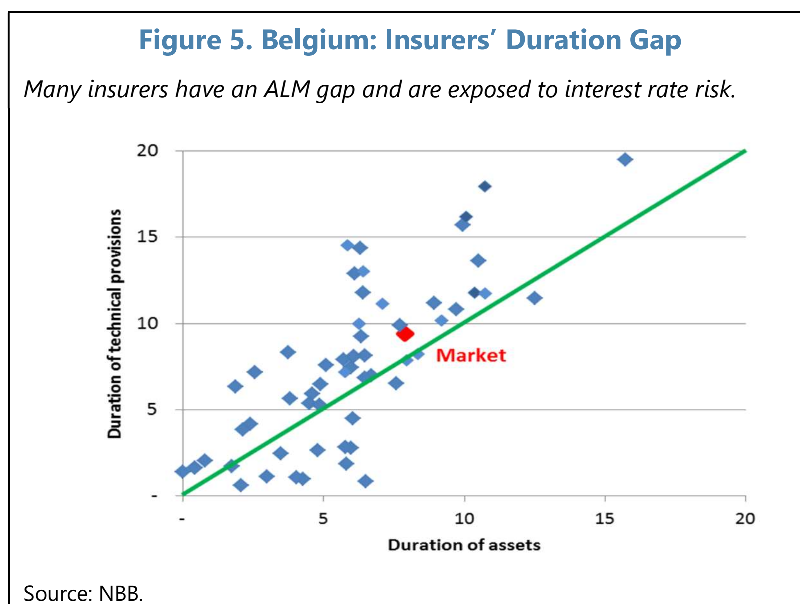
Source: NBB.

14. Small and medium-sized Belgian insurers still have a sizable duration mismatch and they are exposed to interest rate risk. While large insurers have reduced the asset and liability management (ALM) gap significantly in the last few years, small and medium sized insurers are left behind and the gap has not narrowed in the last few years. As a result, there are still many insurers with a large ALM gap which exposes them to interest rate risk; they will ultimately suffer from a prolonged low interest rate scenario.

15. Large insurers have successfully reduced their ALM gap and improved their resiliency to further decreases in long-term interest rates, but they are exposed to liquidity risk. New policies (typically universal life products) provide greater flexibility to both insurers and policyholders, which shortens the duration of insurance liabilities significantly. Some insurers are actively using derivatives (interest rate swaps). Those efforts have helped the industry to reduce the ALM gap. While the ALM gap of the industry averaged more than 4 years in 2015, it has now reduced to less than 1 year, and the sensitivity to the lower interest rate is significantly smaller. However, because of those efforts, the industry is being increasingly exposed to liquidity risk, as the new policies also provide greater flexibility for policyholders to surrender their policies without any penalty; additionally, derivative transactions require providing immediate cash margins and high-quality collateral to the counterparties.

Figure 5. Belgium: Insurers' Duration Gap

Many insurers have an ALM gap and are exposed to interest rate risk.



Source: NBB.

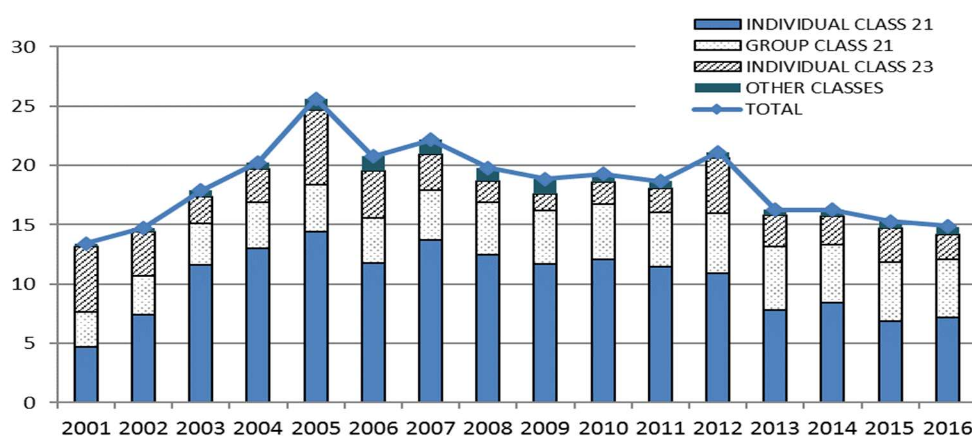
16. The life insurance sector is still affected by low interest rates, but NBB has managed to introduce Solvency II requirements successfully. Economic valuation and capital requirements under Solvency II lowered the solvency capital requirements (SCR) compared to the Solvency I regime, in particular those of life insurers. In fact, some insurance companies, typically smaller ones, were undercapitalized in 2014 based on Solvency II SCR specifications at that time. However, the NBB's efforts improved the weak companies' solvency condition successfully and now the average SCR ratio is 134 percent for life and 177 percent for composite insurers. Only one insurer is using the Solvency II transitional measure for technical provisions. However, many insurers (19) are using the VA, and this is one of the issues that the NBB still needs to address.

17. Declining premiums pose an additional challenge to the profitability and liquidity of the life insurance sector. Life insurance premiums have been declining since 2005, from EUR 25 billion to EUR 15 billion. The declining trend has accelerated from 2012, by 7 percent annually. This trend reflects the overall drop in the attractiveness of life insurance products, combined with a tax reform targeting products designed for retail policyholders.[2] As over the last few years some insurance companies have stopped selling savings-type products, the trend is unlikely to reverse in the near future. The sector's net profit also dropped from EUR 2.4 billion to EUR 1 billion from 2012 to 2016.

[2] The tax on life insurance premiums was introduced in 2005 (1.1 percent) and increased to 2 percent in 2015. The tax on other financial products (such as deposits and securities) will be increased in 2017, which could have a positive impact to the insurance sector.

Figure 6. Belgium: Premiums of Life Insurance Products

Life insurance premiums (especially those of traditional retail products) have continuously declined for more than 10 years.



Source: NBB.

Note: Class 21 products are life insurance products with minimum guarantees (typically for the first 8 years since the initial contract). Class 23 products are unit-linked products without minimum guarantees from the underwriting insurers.

C. Financial Conglomerates

18. FCs play an important role in the Belgian financial system. There are three large FCs, all of which are led by banks and with asset management and insurance subsidiaries, which are typically engaged in both life and non-life activities. Belgian FCs were hit hard during the 2008 global financial crisis from the shortage of funding and capital. The crisis revealed that regulatory requirements and oversight could not fully capture all the activities of the FCs.

19. Belgian FCs have a large market share in the banking sector and a significant market share in the insurance sector. Banking entities of the three FCs account for 42 percent of the banking sector assets and 20 percent of the insurance sector assets. Cross selling of banking and insurance products to the same clients is an important feature of the Belgian financial groups, and other non-conglomerate groups have strategic partnerships between banking and insurance entities for the bancassurance business.

20. FCs have important synergies in terms of marketing and distribution. The diversification of business lines and risk profiles helps FCs reduce profit volatility and capital fluctuations. For insurance companies, the FC model provides an important distribution channel, and banks are also benefitting from the fee incomes from sales of insurance products, which usually generate higher fees than other financial and savings products, such as investment funds.

21. FCs have complex group structures, which makes risk management, supervision, and resolution challenging. The legal structures of FCs tend to be very complex, partially due to the long history of lack of regulatory powers at the ultimate holding company level. FCs are enhancing business integration for improving group efficiency and profitability, and consequently conducting larger and more frequent intra-group transactions between banking and insurance entities.

22. Risk management within the FCs has developed in line with each sector's regulation and supervision. While the business integration between banking and insurance entities has progressed, that of control functions seems to lag. Industry practices in risk management tend to differ between each sector. Each sector has different risk characteristics with complex correlations, which makes it difficult for the group risk management to integrate the necessary risk assessments into one coherent framework. Full integration at the FC level has not yet been achieved even in the groups with advanced practices. Similarly, supervisory assessment tends to be conducted separately for each sector. Proper coordination and integration of supervisory assessments across different sectors are difficult to achieve. Belgian banking and insurance laws provide comprehensive powers to the NBB and ECB, which allows them to streamline the group structures for effective group supervision. However, FCs pose challenges to proper supervision.

23. Fragmented regulatory frameworks could trigger regulatory arbitrage through intragroup transactions, which makes proper regulation and supervision even more difficult. While Solvency II implementation improved the consistency between bank and insurance capital requirements, uneven regulatory treatment of banking, securities and insurance business provides regulatory arbitrage opportunities. While the main motivation of intragroup transactions should not be regulatory arbitrage, fragmented regulation makes it difficult for the supervisors to capture the risks of the FC appropriately.

INSTITUTIONAL SETTING

A. Supervisory Responsibilities, Objectives, and Powers

24. On April 1, 2011, a twin peaks approach to financial sector supervision was adopted. The NBB and the Financial Services and Markets Authority (FSMA) assumed the supervisory responsibilities of the former Banking, Finance and Insurance Commission (CBFA). The NBB has been attributed the responsibility for the micro- and macro-prudential supervision of banks, insurance companies, and stock-broking firms. The FSMA is responsible for the supervision of management companies for Undertakings for Collective Investment in Transferable Securities (UCITS), asset management companies and companies rendering investment advice and for market supervision (including issuance of public financial instruments) and rules of conduct.

25. With implementation of the SSM, the direct supervision of credit institutions is performed by the ECB for significant institutions (SIs) and the NBB for LSIs as defined in the SSM Regulation, as well as Articles 3 and 134 of the Banking Law (BL). Supervising compliance with the rules of conduct applicable to all financial institutions is the responsibility of the FSMA. Together the ECB, NBB (as the Belgian National Competent Authority (NCA)) and the other euro area NCAs, form the SSM. A cooperation protocol between the NBB and FSMA was concluded on March 14, 2013. Through the issuance of circulars, the NBB describes supervisory objectives, its interpretation of the legal framework and its expectations in that regard. The NBB discloses on its website, in addition to the applicable legislation, information on its supervisory tasks and objectives as well as a description of the SSM.

26. Member states and EU authorities share responsibilities for banking supervision and regulation. Article 4 of the Capital Requirements Directive (CRD) IV[3] requires member states to ensure that competent authorities assess compliance with CRD IV and the Capital Requirements Regulation (CRR)[4]. CRD IV, and to a lesser extent the BRRD and EBA guidelines, provide a broad framework for supervisory powers. CRD IV delegates authority to member states to ensure that national laws and regulations provide a framework for the supervisor to set and enforce prudential standards, including compliance with CRD IV.

27. The BL implements and sets the framework for compliance with EU laws and regulations and the coordination with the ECB through the SSM. Articles 15 and 134 (2) of the BL stipulate that the supervisory authority shall duly take into account, in the exercise of its tasks, (i) in licensing credit institutions, their capacity to achieve developmental objectives under the conditions necessary for the proper functioning of the banking and financial system and for the safety of depositors, and (ii) in performing its supervisory responsibilities, the potential effects of the decisions it takes on the stability of the financial system of all other member states concerned.

28. The 2014 revisions to BL introduced a new chapter on consolidated and supplementary supervision (Articles 164–219) reflecting FICOD. The new chapter integrates references to CRR that address Pillar 1 and 3 requirements and CRD IV addressing Pillar 2. The amendments eliminate the differentiated supervisory treatment between groups headed by a financial holding company (FHC)[5] or a credit institution which are subject to consolidated supervision and groups headed by a mixed financial holding company (MFHC) which are only subject to supplementary supervision under FICOD. Under the revisions, consolidated supervision may be applied at the top level whether the FC is headed by a MFHC, FHC, credit institution or insurance company. The revisions also address the ability of the supervisory authority to request from mixed activity holding companies (MAHCs) data and information necessary to exercise its supervisory role.[6]

29. Article 170 of BL extends application of all provisions based on the consolidated position of the FHC to the level of a MFHC. Article 170 applies when: i) banking sector is the most important of the FC, ii) at least one of the subsidiaries is a credit institution, and iii) the supervisory authority exercises both the consolidated supervision and the supplementary conglomerate supervision. This eliminates the need for supervisory authorities to choose between consolidated supervision or supplementary supervision at the MFHC level enabling them now to implement both, broadening the supervisory scope.

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[3] Directive 2013/36/EU.

[4] Regulation (EU) No. 575/2013.

[5] FHC is defined in CRR as a financial institution the subsidiaries of which are mainly financial. A MAHC is defined as a parent undertaking holding financial activities but whose business is mainly nonfinancial. FICOD defines a MFHC as a holding which along with its subsidiaries meets the definition of FC.

[6] BL, Article 183.

B. Independence, Accountability, Legal Protection

30. The 2012 BCP assessment recommended that the reason for the dismissal of the NBB Governor be publicly disclosed. The Governor is appointed by the King for a five-year term and can only be dismissed if he/she no longer fulfils the conditions required for the performance of his/her duties or if he/she has been guilty of serious misconduct (Article 23 of the NBB Organic Law). The Royal Decree issued when removing the Governor is a public document and states the reasons for removal, therefore, reasons for dismissal are disclosed.

31. The 2012 BCP assessment also recommended a review of the adequacy of NBB staffing. NBB currently considers its staffing levels and salary scale adequate. In 2015 the ECB requested that the NBB increase its joint supervisory team (JST) contribution to 37, a level that the NBB has met. Demand for onsite inspections and internal model investigations (IMI) has required a strengthening of NBB resources. Turnover is very low and an additional number of staff positions will be filled.

32. The NBB has the required operational and financial independence to carry out its supervisory tasks without political interference. It has transparent processes and a sound governance structure. The NBB is an autonomous public authority; Article 22 of the NBB Organic Law states that the Minister of Finance does not have the right to supervise the NBB transactions nor to oppose the implementation of any measure which is contrary to the law, the Statutes or the interests of the State. Oversight is provided by the Chamber of Representatives and the Governor sends an annual report to that body. An additional layer of independence is provided by the integration of banking supervision with the ECB in the SSM.

33. The NBB Organic Law provides protection for supervisory staff. Article 12bis, § 3 provides a limitation of liability: "the NBB, the members of its bodies and the members of its staff shall not bear civil liability for their decisions, acts and conduct in the exercise of the legal tasks of the NBB, save in the event of fraud or gross negligence".

C. Interaction with ECB/SSM and Other Agencies

34. The SSM has been in operation since November 2014. In the SSM, credit institutions are categorized as significant (SI) and directly supervised by the ECB or LSI and directly supervised by the NCAs under the oversight of the ECB, which is responsible for the effective and consistent functioning of the SSM. Factors to be considered for designation as SI or LSI are based on the criteria contained in the SSM Regulation[7] and the SSM Framework Regulation[8]. Factors include, inter alia: size, importance to the economy of the Union or any member state of the euro area and significance of cross-border activities.

35. The supervisory powers of the ECB are clearly defined. The ECB is empowered to, interalia: (i) carry out off-site supervision in accordance with Article 4 of SSM Regulation; (ii) adopt

[7] Council Regulation (EU) No 1024/2013.

[8] Regulation (EU) No 468/2014 of the ECB.

supervisory measures in accordance with Articles 16 and 18 of SSM Regulation; and (iii) conduct on-site inspections and general investigations in accordance with Articles 11 and 12 of the SSM Regulation and Articles 143 to 146 of the SSM Framework Regulation.

36. The day-to-day supervision of each supervised group is performed by a JST comprising staff from the ECB and the NBB under an ECB coordinator. Supervision at the consolidated level is performed by the JST with a high degree of involvement by the ECB and NCA staff. Solo/sub-consolidated supervision of SSM parent companies, banking subsidiaries and significant branches follows the same supervisory model as consolidated supervision. LSI supervision can be influenced by the ECB by the means listed in Article 6(5) of SSM Regulation, e.g., by issuing regulations, guidelines and general instructions to NCAs.

37. The legal framework grants the necessary powers for supervisors to perform effective cooperation, coordination, and information sharing to facilitate group-wide supervision. Cross-sector supervision requires specific institutional arrangements (including at the national level when there is distinct sector supervision). Within the EU, cooperation among sector supervisors is governed by the Directive on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a FC (FICOD).

BANKING SUPERVISION

A. Supervisory Approach and Techniques

38. The ECB, as the competent authority for the direct supervision of SIs, carries-out the supervisory review and evaluation process (SREP). Within a group, this applies at the consolidated, sub-consolidated and single-entity levels unless an entity has been waived from supervision on an individual basis in accordance with Articles 7, 8, and 10 of the CRR.

39. The SSM SREP is based on a harmonized methodology consistent with EBA guidelines (GL) on SREP (EBA/GL/2014/13). It is applied by the ECB in a proportionate manner to significant institutions depending on the nature, scale, and complexity of their activities, and, when relevant, on their situation within a group, overseas and interbank ties, significance for the overall market or a relevant sub-segment of the market, and their overall risk situation

40. The SSM SREP rests on four pillars: (i) business model and profitability assessment; (ii) internal governance and risk management assessment; (iii) risks to capital; (iv) risks to liquidity and funding. The assessments result in an overall SREP assessment that underpins a wide range of possible supervisory actions, including decisions on the institution's capital or liquidity adequacy or other qualitative or quantitative measures. There is a direct link between the supervisory assessment, the necessary supervisory measures, and the supervisory examination program (SEP). The SREP score drives the level of engagement.

41. For LSIs, the ECB carries out its oversight tasks over the NCAs in line with Article 6 of the SSM Regulation and Part VII of the SSM Framework Regulation, following a proportionate, risk-based approach. Institutional oversight activities focus especially on riskier

and larger LSIs and harmonization of practices among NCAs, while sectoral oversight captures the interconnections within a specific LSI sector. The relevant Union legislation pertaining to the mix of on-site and off-site supervision is contained within articles 97, 98 and 99 of CRD IV. In addition, the EBA guidelines on common procedures and methodologies for SREP provide detailed instructions on the risk assessment process.

42. Article 99 of CRD IV sets out the minimum expectations for competent authorities to, at least annually, adopt a supervisory assessment program. The program must include a plan for the activities and resources (paragraph 1(a)), identification of institutions for enhanced supervision (paragraph 1(b)) and a plan for onsite examinations (paragraph 1 (c)). Furthermore, the requirements of CRD IV provide for supervisors to adjust the intensity of supervision depending upon the risks identified, including a permanent onsite presence of the NCA (paragraph 3(b)), more frequent reporting (paragraph 3c)), and thematic inspections (paragraph 3(e)).

43. The SSM supervisory process starts with the planning of the regular supervisory activities. SEP covers the tasks and activities related to off-site ongoing supervision and on-site missions, in line with available resources. Off-site ongoing supervision entails routine activities or, on an ad-hoc basis, activities aimed at reviewing compliance with prudential regulation, assessing the risk profile through SREP and adopting capital, liquidity or qualitative measures as appropriate. For significant institutions within the SSM, these tasks fall under the responsibility of the JSTs.

44. In addition to ongoing supervision, in-depth reviews on certain topics are conducted through on-site reviews (inspection or IMI). The on-site reviews are typically carried out by an inspection team, that, while organizationally independent, works in close cooperation with the JST.

45. The various supervisory activities typically result in supervisory measures (e.g., recommendations or requirements). Final decisions are taken at the level of the Supervisory Board and the Governing Council of the ECB. Supervisory activities and decisions are typically followed by routine steps including communication to the credit institution, the hearing of the credit institution, the monitoring of compliance and, if necessary and applicable, enforcement and sanctioning.

46. SIs are grouped into five different categories and a different level of supervisory engagement applies to each of them. The grouping of an institution reflects both the potential impact of its resolution on financial stability (first step of the categorization) and its intrinsic riskiness (second step of the categorization). The categorization is updated annually or whenever there are new developments changing the assessment of the impact, supervisory complexity or riskiness (e.g., the purchase of another bank). Impact is assessed in the same way as in the Financial Stability Board (FSB) context for Systemically Important Financial Institutions (SIFIs): size, complexity and geographical diversification, substitutability, interconnectedness, and implicit groups. A different level of supervisory engagement applies to each of these categories in terms of (i) supervisory expectations, and (ii) resources allocated (especially JST resources), with both dimensions being interrelated. In practice, the final supervisory engagement may differ from the ex-ante required supervisory engagement reflecting unforeseen developments.

47. NBB defines every year domestic priorities for LSI supervision over the following 12 to 18 months. NBB adopts minimum engagement levels (MELs) for a set of standard activities and defines individual SEPs at least for high priority LSIs and aggregated SEPs for non-high priority LSIs to ensure full implementation of the principle of proportionality. Furthermore, NBB plans on-site missions for LSIs under its supervision.

48. Through SREP for LSIs, the NBB identifies the weaknesses and failures that require a prudential action. In addition, SREP fosters dialogue between the NBB and credit institutions. Essential SREP components are quantitative and qualitative assessments of risks as well as their management by institutions. The capacity to collect and verify relevant information is a key element to ensure the quality and consistency of risk assessments. The *scorecarding* system is a supervisory tool that provides the necessary operational structure to the determination of an institution's risk profile as well as the preparation of the control plan (prioritization).

49. Monitoring within the NBB is organized under the responsibility of multidisciplinary supervision teams. Each team member oversees an aspect of the institution: supervision of the financial situation of the institution by the financial analyst (mainly off-site) and supervision of the risk areas by the institutional specialist (mainly off-site). The review of the functioning of the institution is performed by inspection teams (mainly on-site). Within each supervision team, a coordinator ensures that the risk assessment is executed. The NBB categorizes and prioritizes the LSIs to define the intensity of the supervision. As the SSM is also responsible for the general oversight of LSIs within the SSM, final decisions for the prioritization of LSIs are taken in dialogue with the SSM.

50. The NBB methodology for categorizing LSIs focuses on the risk score of the institution and its importance in terms of total assets. The criteria used to define the different categories are a merger between concepts from the BL and the SSM Regulation. Based on the categories, NBB defines high priority LSIs (category 4), medium priority LSIs (category 3), and low priority LSIs (categories 1 and 2) which will then have an impact on the supervisory planning actions whereby high priority LSIs will have a higher frequency of supervisory actions.

51. Minimum engagement levels for on-site inspections are based on the categorization of the LSI and minimums established by the SSM. The SSM provides oversight of LSI supervision and final decisions on prioritization are taken by the NBB in dialogue with the SSM. This results in the following minimum frequency for the conduct of on-site inspections:

- High priority LSIs: 1 inspection / year
- Medium priority LSIs: 1 inspection / 4 years
- Low priority LSIs: 1 inspection / 7 years
- EU (non SSM) branches: no minimum frequency, event driven.

This leads to approximately 5-6 inspections for LSIs per year. Anti-money laundering inspections are not included in these MELs for on-site inspections as they are based on a separate risk analysis and planning.

52. Ongoing monitoring for all LSIs includes active interaction with bank management and offsite reviews. The MEL includes: annual reviews of financial information and audit reports, analysis of internal risk management reports, recovery plans, Internal Capital Adequacy Assessment Process (ICAAP), meetings with senior management, directors, internal and external auditors, risk assessment updates and SREP. Also, the early warning system (Quick Look Tool) identifies outliers based on financial ratios and trend analysis.

B. Capital Adequacy

Capital Requirements Framework

53. All Belgian banks must comply with capital requirements broadly aligned with Basel III. The implementation of Basel III[9] has significantly raised the capital base of Belgian banks, even before the phase-in of all the requirements was complete. Belgian banks' end 2016 average Tier 1 and total capital ratios of 15.7 and 18.8 percent are slightly above the EU average capital ratios (15.5 and 18.5, respectively). The full implementation of Basel III that is currently being phased in until 2019 is not expected to substantially lower these figures.

54. Capital requirements are imposed on solo and consolidated bases. The CRR requires each individual institution to meet the capital adequacy requirements on an individual basis, even if it is part of a group. Although the CRR allows the NBB to waive the capital adequacy requirements on a solo basis for cases where the parent and subsidiaries are established in Belgium[10], the NBB has never applied this option.

55. The implementation of Basel III in the EU contains some discrepancies from the international standards that are relevant in Belgium. The Basel Committee on Banking Supervision (BCBS) performed a detailed assessment of EU capital regulation as part of the Regulatory Consistency Assessment Program (RCAP) and found some deviations from the Basel standards that were considered material.[11] Main deviations include:

- Investment in insurance subsidiaries. Basel III requires significant investments in the capital of non-consolidated financial institutions (above a threshold) to be deducted from the corresponding tier of capital. Instead, if certain conditions are met, the Belgian regulation allows, in line with the EU rules, those investments to be risk-weighted at 370 percent.[12] Considering

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[9] Basel III was implemented mainly through Regulation (EU) No 575/2013 (CRR) that establishes the requirements to calculate and consistently observe minimum capital requirements. These provisions are supplemented and further specified by Delegated Regulations (EU) No. 241/2014, 2015/850 and 2015/923 and by other delegated or implementing acts of the EC. Directive 2013/36/EU (CRD), as transposed into national legislation of the respective EU Member State, determines minimum requirements for capital buffers. National options and discretions specified in ECB's regulation N°2016/445 were implemented in Belgium through NBB Regulation of 4 March 2014 implementing the CRR.

[10] CRR, Article 7.

[11] See https://www.bis.org/bcbs/publ/d300.pdf.

[12] Article 49, paragraph 1 and Article 471 of the CRR.

that some Belgian financial groups have relatively large insurance subsidiaries, the deviation might materially overstate the capital ratio of the group compared to international standards.

- Exposures to small and medium sized enterprises (SMEs). Under the transitional provisions in the CRR, capital requirements for credit risk on exposures to SMEs, both in the EU and abroad, are multiplied by a factor of 0.7619 corresponding to the ratio between 8 percent (minimum under Basel II) and 10.5 percent (minimum total capital ratio + capital conservation buffer in Basel III). The adjustment is meant to 'neutralize' the impact of the Capital Conservation Buffer (CCB), so that the capital requirement of an SME exposure under Basel III is the same as it was under Basel II. This provision, applicable to SME exposures under both the standardized and internal ratings based (IRB) approach, can be material even though Belgian banks have a relatively low exposure to SMEs.
- Credit valuation adjustment (CVA) risk. The CRR allows an exemption from the CVA risk capital charge transactions between EU banks and "CVA exempted entities".[13] This constitutes a material departure from the Basel framework.

56. NBB capital regulation has strengthened some elements of the CRR. The regulation gradually eliminates the possibility of IRB banks using the standardized approach for sovereign exposures, further aligning the regulation with international standards and increasing capital requirements.[14] The Belgian regulation also incorporates some immediate implementation options (no phase-in) foreseen by the CRR for the application of the new capital definition, such as goodwill and negative results for the current year that are fully deducted from own funds,[15] although other items use the full phase-in flexibility of the regulation.

57. Belgium also requires banks to comply with a non-risk based capital limit. Until a harmonized EU leverage ratio is in place, EU member states are free to impose additional leverage requirements. In this regard, Belgium has decided to maintain a long-standing gearing ratio that requires a minimum proportion of liabilities to be held as own funds.[16] Notwithstanding the fact that the average risk weight density of IRB exposures in Belgium is relatively low, the ratio is more constraining than the fully-loaded risk based capital requirements (including buffers) only for a limited number of banks.

[13] Banks subject to the CRR can exclude exposures to pension funds, member state central governments, regional governments and local bodies wherever they qualify for a 0 percent risk weight under the standardized approach for credit risk as well as to qualifying non-financial end-users.

[14] The implementation has been phased in from 2014 to 2018. Banks have applied 20 percent of the IRB RWA for those exposures in 2014, 40 percent in 2015 and 60 percent in 2016. In 2017 they should apply 80 percent and in 2018100 percent.

[15] Article 22 of the NBB Regulation of March 4, 2014 implementing the CRR.

[16] Article 38 of the NBB Regulation of March 4, 2014 implementing CRR options. Minimum own funds requirement is calculated as 6 percent of liabilities ≤ €25 million, plus 4 percent of liabilities > €25 million and ≤ €125 million, plus 3 percent of liabilities > €125 million and ≤ €250 million, plus 2.5 percent of liabilities >€250 million and ≤ €1.250 million plus 2 percent of liabilities > €1.250 million.

58. The NBB requires banks to voluntarily maintain higher capital requirements for mortgage loans aiming to mitigate the systemic risk posed by the real estate sector. Until May 27, 2017 the regulatory framework imposed a 5-percentage point add-on to the risk weights for mortgages backed by real estate calculated by banks using the IRB approach. The measure was imposed under the macroprudential framework[17] and meaningfully increased capital requirements, considering that the average risk weight calculated by the IRB banks is around 10 percent. The add-on aimed to mitigate potential risks arising from the Belgian real estate sector in view of the sustained housing price increases combined with a progressive build-up of households' debt. At the end of May, the regulation imposing the additional requirement expired. While new proposals are being discussed, with a view to tightening the requirement beyond the 5-percentage point add-on, banks have been advised to continue using the former requirement to calculate their risk weighted assets.

Capital Buffers

59. The CRD establishes five different types of capital buffers.[18] These are:

- CCB. The CCB is currently set at 1.25 percent of risk-weighted assets (until end 2017). It is being phased in according to the international timeline and applies to all SIs and LSIs.
- Countercyclical Capital Buffer (CCyB). The CCyB is currently set at zero percent for exposures in Belgium, but its final value depends on the CCyB ratios established in the jurisdictions where the bank operates. The CCyB applies to all SIs and LSIs.
- Global Systemically Important Institution (G-SII) buffer. The G-SII follows the Basel methodology for the Global Systemically Important Banks (G-SIBs). Some banks operating in Belgium such as BNP Paribas, ING Bank and The Bank of NY Mellon are classified as G-SIIs and are subjected to the applicable capital surcharge.
- Other Systemically Important Institution (O-SII) buffer. Banks are identified as O-SIIs according to their size, importance for the economy of the EU and Belgium, significance of cross-border operations and interconnectedness.[19] Each O-SII is allocated into one of two buckets according to their degree of systemic importance. The CRD allows authorities to require an O-SII buffer of up to 2 percent. The actual levels of the Common Equity Tier 1 (CET1) capital surcharges are presented in Table 4.
- Systemic risk buffer. It is designed to mitigate long term non-cyclical systemic or macroprudential risks not covered by the CRR. It is currently not applied in Belgium.

[17] CRR Article 458.

[18] Articles 128-135.

[19] EBA guidelines the criteria to determine the conditions of application of Article 131(3) of Directive 2013/36/EU (CRD) in relation to the assessment of other systemically important institutions (O-SIIs).

Table 4. Belgium: O-SII Capital Buffer[1]

O-SII	Bucket	O-SII buffer rate, percent
BNPP Fortis	2	1.5
KBC Group	2	1.5
Belfius Bank	2	1.5
ING Belgium	2	1.5
Euroclear	1	0.75
The Bank of New York Mellon	1	0.75
Axa Bank Europe	1	0.75
Argenta	1	0.75

[1] From January 1, 2018. Current values are 1 percent for institutions in the highest bucket and 0.5 percent for the lower bucket.

60. The capital buffers should be met with CET1. The CCyB, G-SII, O-SII and systemic risk buffer extend the CCB. Only the highest buffer among the G-SII, O-SII and systemic risk buffer are applied (Figure 8) at a consolidated, sub-consolidated and solo basis.

Internal Models

61. Major banks in Belgium make extensive use of internal models to calculate capital requirements. Internal models tend to require substantially less capital than the standardized approaches. In Belgium, the low default rate reflected in the databases of banks generates particularly low risk weights in comparison with other European countries (Figure 7). Internal models for credit risk are the most used, including by seven SIs and two LSIs (Table 5).[20] After the establishment of the SSM the responsibility for model approval is split between the SSM and the NBB, depending on the bank, but no bank has been authorized to use advanced approaches recently. The last authorization to use the advanced IRB approach was granted in 2013. Any material change to an approved internal model needs prior permission by the competent authority.

Pillar 2 Add-ons

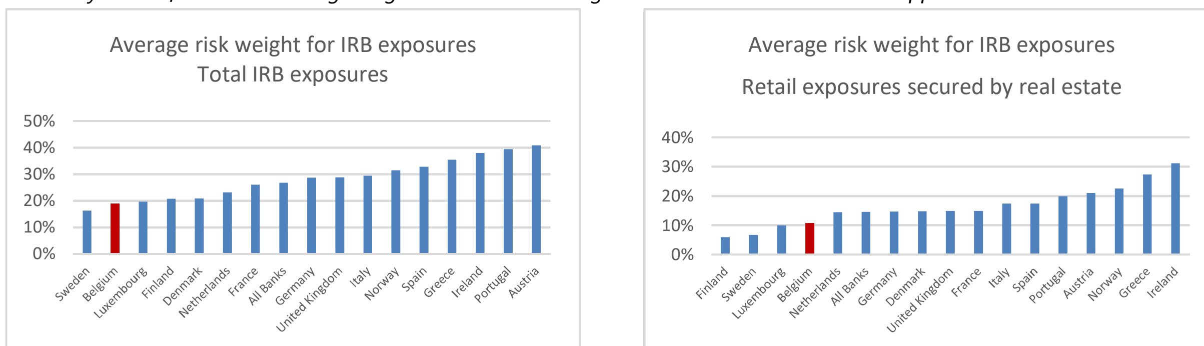
62. The capital framework allows for the consideration of the risk profile of banks and a forward-looking approach to capital management through the SREP. The ECB has the power to require institutions to hold capital in excess of the Pillar 1 requirements set out in CRR.[21] In practice, these requirements are defined once a year in the context of the SREP. The SREP is composed of the risk assessments, ICAAP and Internal Liquidity Adequacy Assessment Process (ILAAP) reviews and Pillar 2 quantifications, which include stress tests. The final conclusions can include corrective measures and additional capital and/or liquidity requirements. The powers and procedures of the NBB in relation to LSIs are similar.

[20] Five SI banks used models for market risk. Two SI banks and one LSI bank use models for operational risk.

[21] Article 16(2)(a) of the SSMR

Figure 7. Average Risk Weight for IRB Exposures

Relatively low default rates in Belgium generate low risk weights under the internal models approach.



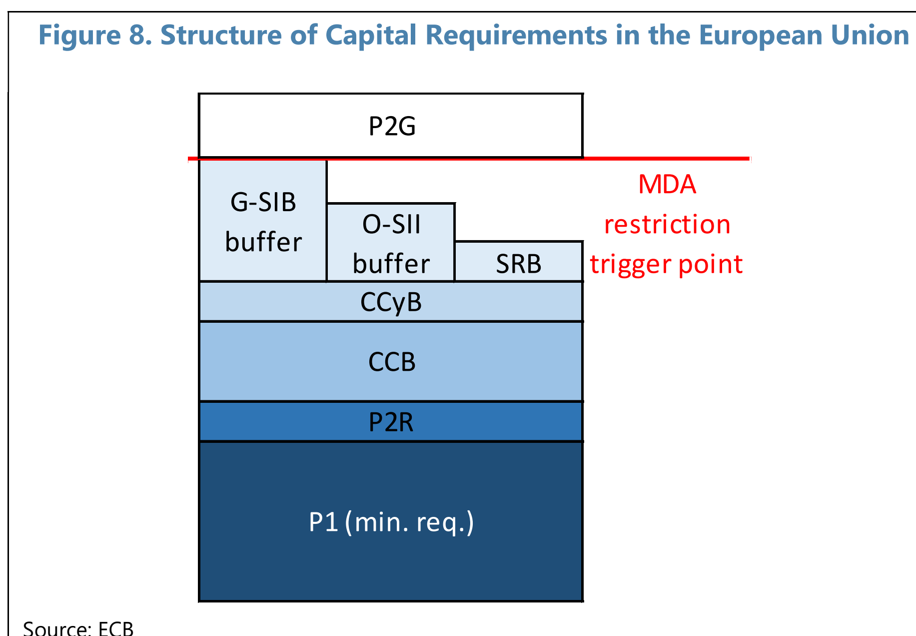
Source: EBA 2016 EU-wide transparency exercise results. IMF Staff calculations. Average risk weight calculated as the ratio between risk exposure amount and exposure value.

Table 5. Belgium: Use of Internal Model Approaches by Belgian Banks

	Internal Models for Credit Risk (IRB)	Internal Models for Market Risk	Internal Models for Operational Risk (AMA)
	Systemic Institutions (SIs)		
KBC Group	Yes	Yes	No
Belfius Banque	Yes	Yes	No
Dexia Group	Yes	Yes	No
Investar	Yes	No	No
Axa Bank Europe	Yes	No	No
BNP Paribas Fortis	Yes	Yes	Yes
ING Belgium	Yes	Yes	Yes
	Less Systemic Institutions (LSIs)		
Euroclear	Yes	No	Yes
Crelan	Yes	No	No

Source: NBB.

Figure 8. Structure of Capital Requirements in the European Union



Source: ECB

63. The capital decision takes the form of a Pillar 2 capital add-on. The amount, in terms of CET1 capital, is added to the Pillar 1 minimum requirements and to the capital buffers envisaged in the Basel framework and regulated by the CRD. The Pillar 2 add-on is composed of a Pillar 2 requirement and a Pillar 2 guidance. A Pillar 2 requirement is binding and expected to be observed at all times. Its breach affects the maximum distribution of a bank's profits. The Pillar 2 guidance is nonbinding, does not affect profit distributions and is based on the results of the supervisory stress tests.

64. Independent Pillar 2 assessments and decisions are taken for material subsidiaries. The SREP is applied according to the prudential requirements set out in the CRR.[22] Supervisors can, as a result of the SREP assessments, impose the same or differentiated Pillar 2 requirements on consolidated, sub-consolidated and individual levels. Although the SREP process for subsidiaries is simpler and does not include independent stress tests, the large Belgian subsidiaries of SSM banking groups (BNPP Fortis, ING Belgium) are subject to a SREP decision including a Pillar 2 requirement and a Pillar 2 guidance. This is not the case for small subsidiaries due to their lack of materiality within the group.

Prudential Requirements for Bank Subsidiaries

65. The European Commission (EC) has proposed changes to the CRR that would make the application of capital requirements on an individual bank basis more flexible. The EC published on November 23, 2016 a legislative proposal that would expand waivers from capital and liquidity

[22] Supervisory procedures for the SREP at subsidiary level are usually simpler than the ones used at consolidated level and do not include supervisory stress tests.

requirements to subsidiaries located in a different member state than the parent entity.[23] The proposal considers that requiring subsidiaries to comply with capital and liquidity requirements on an individual basis may prevent groups from managing their resources efficiently at the level of the group. The proposal argues that the establishment of the SSM has strengthened group supervision, especially where group entities are situated in member states participating in the SSM, allowing cross-border banking groups to benefit more from the single market potential without threatening financial stability. By facilitating the pooling of capital and liquidity at the group level, the proposal would thus further the goal of the single market.

66. In practice, the proposed waivers mean that the individual banks within the group may not have to meet minimum capital and liquidity requirements. The competent authority supervising parents established in a member state within the banking union (the ECB) would be able to waive the application of own funds and liquidity requirements for subsidiaries located in other member states than the parent if they are included in the consolidated requirements.[24] To safeguard host countries, the capital waiver would only be granted if the parent commits to supporting its subsidiaries for the whole amount of the waived requirement and the guarantee is collateralized for at least half of the guaranteed amount. The same waivers would be made available, as an option and only if the competent authority of both the parent company and the subsidiary agree, for banking groups that include EU parent companies and/or subsidiaries outside the banking union.

67. The FSAP team supports the single market, but—during the transition to a full banking union—considers that prudential requirements and adequate supervision at the national level remain important for financial stability. As long as the banking union is incomplete, especially regarding a common deposit insurance scheme and a common fiscal backstop for systemic events, insufficient liquidity or capital or inadequate governance, risk management and supervision at the level of subsidiaries could have substantial financial, economic, and fiscal impacts in host member states if these subsidiaries are exposed to a severe shock. Any changes to capital, liquidity or governance requirements or the intensity of supervision should be mindful of financial stability in individual member states and be made gradually, to minimize the risk of unintended consequences. The concern about financial stability is particularly relevant for systemically important subsidiaries.[25]

68. While international standards do not require the establishment of capital and liquidity requirements at the subsidiary level within a given jurisdiction, they do require appropriate consideration of individual entities. The BCPs require the supervision of each bank on a stand-

[23] The proposals are part of the Risk Reduction Measures (RRM) Legislative Proposals (https://ec.europa.eu/transparency/regdoc/rep/1/2016/EN/COM-2016-850-F1-EN-MAIN.PDF). The proposals are currently discussed at the Council of the EU and the European Parliament.

[24] Cross border waivers for liquidity requirements are already allowed by Article 8 (3) of the CRR. As the competent authority responsible for granting this waiver, the ECB has issued a guideline where it establishes a minimum Liquidity Coverage Ratio of 75 percent for systemically important subsidiaries.

[25] The ECB is currently working on a recommendation to the EC for additional prudential safeguards and technical modifications in order to address any potential financial stability concerns resulting from the application of this waiver mechanism. This is particularly relevant in case the waiver application relates to a systemically important subsidiary.

alone basis and appropriate distribution of capital and liquidity within the different entities of the group. While the EC proposal is not inconsistent with the Basel standard, the quality of monitoring and supervisory intervention at the subsidiary level will be important to ensure that the EU supervisory framework meets these standards.

69. The proposed waivers will be discussed further as part of the upcoming euro area FSAP.

Recommendations

70. The relatively heavy reliance on internal models for regulatory capital requires strong oversight by banks' boards and supervisors. The targeted review of internal models launched by the SSM is assessing banks' compliance with regulatory requirements and the reliability of the models currently authorized for capital requirements calculation. The project has entered the execution phase in 2017. It is planned to be completed by 2019. Its sound execution and continued efforts to improve ongoing model monitoring is key to reducing unwarranted variability of risk weighted assets (RWAs) that undermines the confidence in capital ratios. Supervisors should also continue to enforce strong oversight of the models by banks' boards. The proliferation and variety of models within financial institutions demands extensive involvement of the board in the oversight of the models as well as an appropriate model risk management framework, which includes an effective model governance, a risk control function, a validation function and internal audit as a third line of defense.

C. Credit Risk, Problem Loans, Asset Classification, Provisions and Reserves

Credit Risk

71. The supervisory framework requires banks to maintain sound credit risk management processes. The BL (Annex I) requires institutions to have internal procedures to assess the credit risk associated with risk positions on different debtors, securitizations, securities and the entire portfolio. These procedures should consider all relevant information on debtors and should not rely solely on external ratings. The BL also requires, among others:

- Clear procedures for approval, amendment, extension and refinancing of credits and sound and clearly defined criteria for granting credit;
- Appropriate systems for the management and continuous monitoring of the loan portfolios and risk positions to which credit risk is linked; and
- Appropriate diversification of credit portfolios, considering the overall credit strategy.

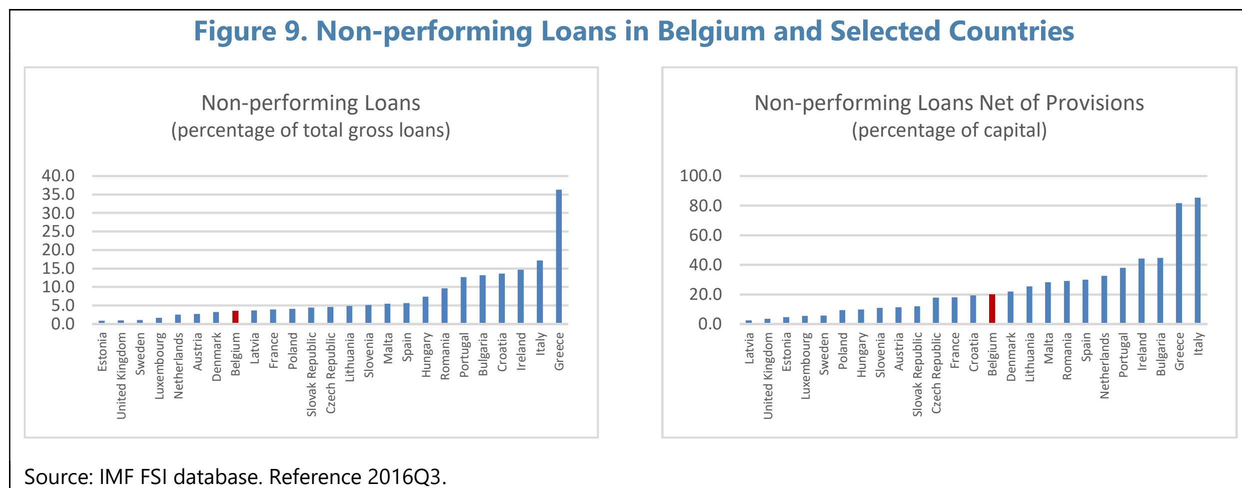
72. The requirements for credit risk management are verified through on-site inspections and reports from the management and from accredited auditors in the context of SREP. The BL grants authorities full access to information in the credit and investment portfolio and to bank

officers. The law also requires institutions to conduct stress tests that are considered during the SREP evaluation.[26]

Problem Assets, Provisions and Reserves

73. NPLs in Belgium are relatively low. NPLs have declined during the last two years and accounted for 3.4 percent of the total loans at the end of 2016. The result of the 2014 SSM asset quality review has not had a significant impact on the general level of provisions of most Belgian banks.

Figure 9. Non-performing Loans in Belgium and Selected Countries



Source: IMF FSI database. Reference 2016Q3.

74. The regulatory framework for problem assets, provisions, and reserves consists of two layers covering accounting and prudential standards. The accounting framework contains the requirements on the valuation and presentation of assets and liabilities for both general purpose financial statements and prudential returns. The prudential layer contains additional provisions on the management of credit risk and the solvency treatment of problem assets, provisions, and reserves.

75. Both SIs and LSIs should report in accordance with the Belgian Generally Accepted Accounting Principles (BGAAP)[27] on an individual basis and International Financial Reporting Standards (IFRS) on consolidated terms. The European financial reporting (Finrep) follows, on an individual basis, the national accounting rules (BGAAP) unless the institution has requested and obtained a special agreement from the ECB (SI) or the NBB (LSI) to prepare its Finrep solo reporting based on IFRS.

76. Loan-loss provisions are established in accordance with accounting standards. IAS 39, and after January 1, 2018, IFRS 9, lays down the principles for impairment recognition for banks under a consolidation obligation, which prepare their consolidated financial statements in

[26] BL, Article 148.

[27] Royal Decree (RD) of 23 September 1992 on the annual accounts of credit institutions. This RD implements the European Directive 86/635/EEC of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions.

accordance with IFRS. The BGAAP sets general standards and definitions for banks to identify impaired loans and distinguishes two classes of problem assets: "loans with uncertain outcome" and "doubtful loans". It also requires credit institutions to apply a forward-looking approach and reflect realistic repayment and recovery expectations. Loans classified as "doubtful" require individual (specific) provisions in the expectation that there will not be full payment of the outstanding principal and interest. Loans classified as "uncertain" are assigned provisions for the part considered uncertain.

77. The prudential framework sets additional requirements for problem assets aiming to reinforce governance mechanisms, information systems, and procedures. The BL requires banks to have appropriate systems that include the detection and management of problem loans. Further, the SREP guidelines require the management body to approve the policies for managing, measuring and controlling credit risk; and that these policies are clearly formalized, communicated and applied consistently across the institutions.

78. Review of loan classification and provisioning is entrusted to external auditors. Accredited external auditors are required to provide an opinion to the supervisor on the correctness of the annual accounts and the prudential reporting of the banks on a semiannual basis. Nevertheless, the maximum period for engagement of auditors before mandatory rotation can be relatively long. Article 17 of the EU Audit Regulation aims at ensuring independence by imposing a maximum term of ten years for auditors of public interest entities (among others, banks). However, exceptions are foreseen, notably an extension to 24 years when after the expiry of the maximum term more than one external auditor is simultaneously engaged (i.e., to form a college). The latter is considered an additional safeguard for the auditor's independence. Article 133 of the Belgian Companies Code is in line with EU legislation: auditors are appointed for renewable terms of 3 years, with a maximum of nine years, extendable to 24 years in case a college is established after the initial nine years.

79. Belgian authorities have issued limited supervisory guidance on asset classification and provisioning beyond the accounting standards. As most European countries with low NPL ratios, Belgium has not issued substantial guidance to banks on issues such as NPL recognition and classification, classification of forborne exposures, impairment triggers, provisioning, write-offs or accrued interest. Banks are mostly expected to follow accounting standards.

80. The ECB took an important step forward by publishing guidance on NPLs detailing supervisory expectations for the treatment of NPLs. The guidance on NPLs is applicable to all SIs supervised directly under the SSM.[28] It includes supervisory expectations regarding banks' policies, systems and procedures for the recognition of NPLs and the impairment measures including provisions and all the elements of the management of problem assets. The guidance is applicable considering the principle of proportionality and respecting accounting differences across countries. It provides authorities with important elements to harmonize definitions and supervisory reports across countries and gives some best practice examples to reduce the diversity in implementation.

[28] https://www.bankingsupervision.europa.eu/ecb/pub/pdf/guidance_on_npl.en.pdf

The guidance does not have a prescriptive nature and, therefore, does not provide accounting requirements, but describes practices that may be applied within existing accounting frameworks.

81. Supervisors review the overall framework for problem assets and provisions within the SREP. The SREP guidelines require the competent authorities to ensure that the credit risk framework enables the institution to differentiate between different levels of borrowers and to determine the level of provisions and credit valuation adjustments required to cover expected and incurred losses. External auditor reports are considered in this process.

82. Nevertheless, supervisors face important limitations when requiring banks to hold appropriate amounts of provisions. Asset classification and provisioning are mainly driven by accounting standards and the NBB and the SSM cannot directly instruct Belgian banks to adjust their classifications of individual assets, nor to increase their levels of provisions and reserves. However, supervisory powers allow the ECB to influence the provisioning policy of a bank within the limits of accounting standards. Furthermore, they allow the ECB to require credit institutions to apply specific adjustments (deductions, filters or similar measures) to own funds calculations where the accounting treatment applied by the bank is considered not prudent from a supervisory perspective.

Recommendations

83. Supervisors should play a more active role in assessing loan classification to ensure prudent provisioning practices. Belgian supervisors have traditionally viewed loan valuation as an accounting function and have relied heavily on external auditors to assess the correctness of the provisioning amounts. The "Guidance to banks on non-performing loans" published by the ECB helps introduce prudential considerations and narrow bank management's judgement but its non-rule nature has limits. It is important to continue the regulatory efforts to ensure an appropriate prudential treatment of problem assets. In addition, these initiatives need to be complemented by more intrusive supervisory reviews. EBA Guidelines on SREP require competent authorities to pay particular attention to the adequacy of the classification of credit exposures and assess the impact of potential misclassification. In practice, despite some recent initiatives, cases where the supervisor directly tests a bank's treatment of assets with a view to identifying independently any material circumvention of the classification and provisioning standards are not common.

84. The credit risk framework could be further enhanced by introducing more granular regulatory requirements. The framework for credit risk is sound but would benefit from more granular requirements that would increase the adherence to the BCPs. More specifically, supervisors could be more explicit on the requirement that credit risk exposures that are especially risky or otherwise not in line with the mainstream of the bank's activities be decided by the bank's board or senior management (BCP17.6). Banks should also be more explicitly required to have policies and processes to monitor the total indebtedness of entities to which they extend credit (BCP 17.4).

85. Authorities could consider reducing the maximum period of engagement of external auditors before mandatory rotation. The periods defined in the Companies Code, with a

maximum of 9 years, extendable to 24 years in case a college is established after the initial 9 years might be excessively long to ensure the independence of the auditors.

D. Concentration Risk, Large Exposures, and Transactions with Related Parties

Concentration Risk and Large Exposures Limits

86. The regulatory framework focuses on concentration risk from exposures to individual counterparties or groups of connected counterparties. Banks are required to have adequate procedures and internal control mechanisms for identifying, managing, monitoring, reporting and recording large exposures (i.e., exposures equal to or in excess of 10 percent of the institutions' eligible capital).[29] The SSM Supervisory Manual also requires institutions under its direct supervision to have a concise and practical definition of what constitutes a credit concentration and the SREP guidelines require the supervisors to identify and measure credit concentration risk including single name, sectoral, geographical, product and collateral concentrations. Nevertheless, the framework does not explicitly require banks to have policies and processes that provide a bank wide view of the sources of concentration risk, including in markets, asset classes, collateral and currencies (CP 19.1). In addition, there is no specific requirement that all material concentrations should be reviewed and reported to the bank's supervisory board (CP 19.3); and the law does not provide supervisors discretion in applying the definition of a "group of connected counterparties" on a case by case basis (CP 19.5).

87. Large exposure limits are broadly aligned with international standards.[30] The definition of large exposures includes both on- and off-balance-sheet items. Exposure to a counterparty or a group of connected counterparties must be considered as a large exposure where its value is equal to or exceeds 10 percent of the institution's eligible capital. A bank may not incur an exposure to a client or group of connected clients higher than 25 percent of its eligible capital. Nevertheless, some exceptions may weaken the limit. If the counterparty is a credit institution or investment firm, the limit is 100 percent of the bank's eligible capital or EUR 150 million, whichever is higher, when the reporting institution's eligible capital is lower than EUR 600 million. Other relevant exceptions apply, such as for some off-balance sheet facilities. In addition, some exemptions under national discretion are not compliant with the international standard.[31] The ECB opted to exercise a number of these exemptions.

88. Exposures of Belgian banks to parent undertakings and sister institutions are limited. The NBB has implemented CRR options maintaining a system of intra-group concentration limits for SIs and LSIs.[32] The rules essentially limit the up-and-sideways intra-group exposures from Belgian

[29] CRR, Article 393.

[30] CRR, Articles 389, 395 and 403.

[31] CRR, Article 400(2).

[32] This discretion is foreseen in CRR Article 493(3)(c).

banks to foreign parent companies and their subsidiaries to 100 percent of eligible regulatory capital. Exposures to subsidiaries of Belgian banks are not limited.

Transactions with Related Parties

89. Banks are required to make credit decisions free of conflicts of interest. There is no directly applicable EU wide framework for exposures to related parties. Nevertheless, the Belgian BL requires credit institutions to have sound structures for the organization of the business and effective procedures for the prevention of conflicts of interest. In this regard, the NBB Governance Manual requires credit institutions to maintain a comprehensive policy, including organizational and administrative arrangements as well as adequate procedures, to identify and prevent conflicts of interest. Finally, the BL also provides the rules for loans to managers, shareholders and related persons to avoid conflicts of interest.[33]

90. Nevertheless, the legal provisions are insufficient to establish a comprehensive prudential framework for transactions with related parties. Specific provisions (Article 72 of the BL) are limited to loans, credits and guarantees and do not include other transactions such as service contracts, asset purchases and sales, construction contracts, lease agreements, derivative transactions and write-offs. The definition of related party is narrow and does not include, for instance, other institutions of the broad economic group (only the parent undertaking) and does not allow supervisors to exercise discretion in applying the definition. There is no requirement that related party exposures be monitored and controlled separately and in aggregate by the bank.

Recommendations

91. The related-party transactions framework needs substantial improvement. There is no EU wide regulation on transactions with related parties. The Belgian framework establishes some provisions but the legal definition of related party transaction is excessively narrow and does not cover common cases where conflicts of interest can arise, such as many intra-group transactions. Supervisors need to reinforce the framework by widening the definition of related parties and covered transactions, requiring banks to establish sounder policies and processes to identify them, and more actively monitoring these transactions.

E. Risk Management, Internal Controls and Audit

92. Belgium follows the traditional three-lines-of-defense model. The relationship between the commercial and business units and the independent control functions is required to be organized following the “three lines of defense”:

- The commercial and business units (including the front office) are the first line of defense of the institution. They are responsible for identifying the risks associated with each operation and must observe established procedures and limits;

[33] BL, Article 72.

- The control functions, i.e., the risk management function and the compliance function, form the second line of defense. They must ensure that the risks are identified and managed by the commercial and business units (and the front office) according to established policies and procedures;
- The internal audit is the third line of defense. It monitors compliance by the first and second lines of defense with the established policies and procedures.

93. The control functions of a credit institution are required to have sufficient authority, status and resources and be independent from the operational functions. The persons responsible for the control functions (risk management and compliance) may report directly—if necessary through the risk committee—to the board. This direct access is designed to enable the board to exercise its supervisory function more strictly. The head of control functions may only be removed from office by the board after previous notification to the supervisory authority. Regulation also requires the management committee to provide to the board, the accredited statutory auditor and the supervisory authority a report on the evaluation of the effectiveness of the organizational structure and on the measures, that, where applicable, are taken to tackle any non-conformity.

Risk Management

94. The Belgian regulatory framework sets the basis for sound risk management practices. The CRD and EBA guidelines require banks to have in place an appropriate risk management framework commensurate with their risk profile. The risk management framework should include a clear organizational structure with well-defined, transparent and consistent lines of responsibility; and effective processes to identify, manage, monitor and report all relevant risks. Belgium has transposed the EU directives into national law and the NBB has issued circulars which apply to all relevant institutions (SIs and LSIs) transposing EBA guidelines into Belgian legislation.

95. The legislation requires the board to determine the risk tolerance of the credit institution and closely monitor its risk profile. The board is responsible for approving and regularly reviewing the strategies and policies on taking, managing, monitoring, and mitigating risks.[34] The board is also required to devote a great proportion of its activity to the supervision of the management of all significant risks, including those related to the valuation of assets and use of external ratings and internal models. Finally, it is also the responsibility of the board to ensure that sufficient resources are allocated to risk management activities. In order to achieve these goals, each credit institution should establish a risk committee within the board with the necessary professional or academic experience. Regulation[35] also requires the establishment of reporting mechanisms that provide the board and all relevant units timely and appropriate information about the risks faced by the credit institution.

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[34] BL, Article 57.

[35] NBB Governance Manual.

Box 1. The Responsibilities and Structure of the Board (Management Body)

The management body (board) has the overall responsibility for the credit institution. Its activities can be categorized in three different functions:

- The policy function sets the strategy and orientation of the activities of the credit institution, e.g., commercial policy and structures, risk profile, risk policy and risk management, and capital adequacy.
- The management function proposes the direction for the institution, ensures the effective implementation of the strategies, manages the credit institution's activity and develops the governance structure.
- The supervisory function oversees the management function and provides advice to it, including by providing constructive challenges when developing the strategy of an institution; monitoring the performance of the management function; ensuring the integrity of financial information and effective risk management and internal controls.

Although the board is responsible for these three functions, the BL requires a clear division between the activities of the senior management of the institution and the supervision of this management. In order to achieve this rule, the management function is entrusted to the executive members of the board, who sit on the management committee, while the supervisory function is entrusted to the non-executive members. The general policy function is entrusted to the governing body as a whole (executive and non-executive members).

Where necessary, the board should set up specialized advisory committees to analyze specific issues and advise the management body on these issues. Four specialized committees should be set up within the board: an audit committee, a risk committee, a remuneration committee, and a nomination committee. These committees should be composed of non-executive members and be responsible for preparing the decisions of the management body in their respective areas of competence.

Non-executive members should form the majority of the board and the chairman of the board cannot chair the management committee.

96. The Chief Risk Officer (CRO) must be an executive member of the management committee. To minimize conflicts of interest the head of the risk management function cannot exercise any other function except, subject to supervisory approval, the compliance function.

97. The adequacy of internal governance and risk management is assessed during the SREP. The methodology serves as an overall review of the institution’s operational and organizational structure. The assessment covers three main aspects of the institution: i) internal governance framework (including key control functions such as risk management, internal auditing, compliance); ii) risk management framework and risk culture; iii) risk infrastructure, internal data and reporting. The assessment includes how institutions monitor their risk exposures; identify the need for risk mitigating measures; and assess the adequacy of their internal policies, organization and

limits. Supervisors are also expected to assess whether the senior management and the board have both the knowledge and the information necessary to understand the nature and level of the risks that are being taken by the institution.

98. An important step of the supervisory review is the assessment of the risk appetite framework. Supervisory reviews aim to assess whether there are appropriate mechanisms in place to ensure that the risk appetite, risk management strategy, and business strategy are effectively aligned and embedded in decision-making and operations at all appropriate levels of the institution. The board is required to establish structures to ensure the translation of the risk appetite into clear incentives and constraints for business lines. The risk appetite should also cover activities, operations and systems that fall within the risk landscape of the institution but are outside its direct control, including subsidiaries and third-party outsourcing suppliers.

99. Supervisors also review annually the board's and senior management's role in approving the ICAAP/ILAAP. The ICAAP/ILAAP are expected to play a meaningful role in the board's decision making and capital planning, strategy and risk appetite setting. Furthermore, the ICAAP/ILAAP assumptions and methodology are expected to be reasonably understood and discussed.

100. Work is ongoing to improve banks' risk data quality and reporting. The NBB is currently finalizing a new circular establishing a framework for risk data aggregation and reporting. The circular is expected to incorporate in the Belgian regulatory framework the "Principles for effective risk aggregation and risk reporting" recommended by the BCBS as well as developments within the ECB. In parallel, as part of the SSM priorities for 2016–17, the ECB is currently conducting a thematic review which aims to assess compliance with the BCBS principles on data aggregation and reporting. Supervisors have also tested the capability of banks to aggregate risk data rapidly and produce risk reports by making occasional requests for information on selected risk issues with short deadlines.

101. Banks are required to develop and maintain recovery and contingency plans. Recovery plans should include a range of recovery options, as well as the conditions and procedures to ensure their timely implementation. Recovery plans should also contemplate a range of scenarios of severe macroeconomic and financial stress relevant to the institutions' specific conditions; and include a framework of indicators which identify the trigger levels for a decision-making process on whether to take appropriate recovery actions. The ECB and the NBB assess these plans focusing on whether the implementation of the proposed arrangements is likely to restore the viability and financial position of the institution; and if the conditions for implementation are reasonable. All banks need to maintain recovery plans but the obligations of small non-complex firms are simplified. Banks should also keep in place contingency and business continuity plans that ensure that an institution can operate on an on-going basis and limit losses in the event of severe business disruption.

102. Supervisors require banks to have a stress-testing program and demonstrate how they use its outcomes for risk management and internal capital and liquidity assessment. Banks are supposed to follow the EBA guidelines on stress testing. Supervisors periodically assess the frequency of the tests, their integration with the overall risk management framework and if the results are reported to the board. Supervisors also assess if assumptions and scenarios are regularly

reviewed and updated, if different horizons are implemented (institution specific, market wide and possible combinations) and if the stress testing has an impact on individual level as well as on the group wide position. The NBB also expects LSIs to develop, in the course of their ICAAP/ILAAP, rigorous stress testing exercises.

Compliance and Internal Audit Function

103. The BL requires all banks to establish an independent compliance function in accordance with international standards. The compliance function is responsible for monitoring compliance with the legal and regulatory rules on integrity and conduct applicable to credit institutions. The compliance function is expected to prevent the credit institution from suffering the consequences—in particular, a loss of reputation or credibility—of non-compliance with the legal and regulatory provisions or with the ethical rules applicable to banks. The legal provisions are complemented by a circular[36] postulating several principles detailing supervisors' expectations in relation to the function, including governance, reporting and resources. The principles are applied proportionally, with due account for the type of institution and for the nature of the services which are provided. Supervisors assess compliance with the legal provisions via on-site and off-site examinations.

104. The NBB and EBA have proposed regulatory changes to further strengthen control functions. The NBB, together with the FSMA, is further developing the "fit and proper" criteria for compliance officers, which includes an examination for candidate compliance officers; mandating the board to define an appropriate integrity policy; and requiring a specific yearly reporting by the board to the supervisor on the evaluation of the compliance function. The EBA launched in October 2016 a public consultation on its revised guidelines on internal governance. The draft guidelines put more emphasis on the duties and responsibilities of the board in its supervisory function on risk oversight. The aim is to improve the status of the risk management function, enhancing the information flow between the risk management function and the board and ensuring effective monitoring of risk governance by supervisors.

105. Internal audit requirements are aligned with international standards. The BL requires credit institutions to establish an independent audit function covering all the institution's operations and entities, including in the case of outsourcing. The framework builds on EU directives and BCBS recommendations.[37] The internal audit function should report directly to the board, where applicable through the audit committee, and should keep the management committee or the senior management informed about its findings. Supervisors assess compliance with legal and regulatory requirements within the framework of their duties and responsibilities. The management body takes any steps necessary to ensure that the institution always has an adequate internal audit function. These requirements are assessed on an on-going base within the Internal Governance and Risk Management Assessment part of the SREP.

[36] NBB-FSMA circular of December 4, 2012 regarding the compliance function.

[37] See the BL (Article 39); NBB Regulation of May 19, 2015; and NBB circular of July 13, 2015 on the internal audit function.

Recommendations

106. Efforts to strengthen the risk management and control functions should continue. Since the global financial crisis authorities have worked to enhance internal governance and the risk management and control functions. While the standards are generally sound and improvements are evident, results of the inspections on Belgian banks show that there is still room to further enhance the standards by strengthening the role of the board in its supervisory function. Although the board in its supervisory function already has broad responsibilities to monitor that the strategy, policies and risk appetite of the banks are implemented consistently, guidelines such as the ones on internal governance proposed by the EBA could further strengthen the control functions.

107. Regular meetings with the full board should form an integral component of supervision practices. Consistently with the regulatory framework that places significant responsibility on the board, the ECB has increased its engagement with the board. Meetings with key individual members of the board (CEO, CRO) are now frequent, but meetings with the full board are not part of the standard supervisory practice. Annual meetings with the full board (including non-executive independent directors) would help the supervisor assess the role of the board in overseeing management to ensure that the policies, processes and systems are implemented effectively at all decision levels.

108. Risk data aggregation and reporting need continued attention. Supervisors have found weaknesses in data quality across the Belgian banks and FCs. Data issues result in part from aging IT infrastructure and legacy systems and lack of harmonized IT policies across multiple legal entities of the group that might result in incompatible IT systems. Standards for data aggregation and the need for a bank-wide view of risk are essential and should continue to be enforced by supervisors.

INSURANCE SUPERVISION

A. Supervisory Approach

109. The 2013 FSAP highlighted the importance of having adequate resources to effectively discharge the supervisory mandates. There are ongoing resource implications arising from the implementation of Solvency II and the supervision of complex cross-border insurance groups/conglomerates. In 2012, staff allocated to the Insurance Supervisory Resources comprised around 50 full-time-equivalents (FTE), who were handling important tasks, in particular i) close monitoring of distressed insurers; ii) enhanced supervision of nine insurance groups, of which six are complex groups, and iii) resource-intensive implementation of Solvency II.

110. Early adoption of key Solvency II requirements enabled the industry to meet the higher capital requirements without relying on the 16-year transitional measures. The NBB implemented several elements of Solvency II even before the official launch (January 2016), which helped strengthen the effectiveness of on-going supervision. The NBB identified troubled insurers in an early stage and applied intrusive supervision to improve the solvency position of these companies. The industry made efforts by lowering the guaranteed rates of saving products, shortening the period of guarantees (to eight years or even shorter for the majority of products),

reducing the ALM gap, and encouraging the policyholders to surrender contracts with the highest guaranteed interest rates. Thanks to those efforts, most of the industry meets the Solvency II capital standards without relying on transitional measures.

111. The NBB has managed to improve its resources and build up expertise by the early adoption and well-prepared implementation of Solvency II. The NBB prepared well for the implementation by adopting some key requirements early. Resources were expanded gradually with effective training programs, supported by sufficient training budgets. The staff has also improved its expertise during the implementation process. The NBB successfully retained its highly-trained staff. According to industry representatives, the NBB is able to hire and retain highly trained experts from the industry with interesting assignments, reasonable compensation and strong commitment by the senior management to improve the quality of the insurance supervision further.

Box 2. Impact of Brexit

European insurers, in particular internationally active insurance groups, are benefitting from a consistent regulatory framework and diversification ability. Insurers within EU have free access to policyholders in all member states without having to set up a physical presence. Solvency II allows geographical diversification of assets and liabilities within the EU, which is very important for internationally active insurance groups. The consistent application of the regulatory framework makes complex processes, such as the joint approval process of internal models, smooth and practicable.

Uncertainties around the consequences of Brexit are pushing internationally active insurance groups to relocate to EU member states. Brexit has triggered significant regulatory uncertainties under the Solvency II regime, especially regarding the access to EU policyholders and the amount of capital requirements. In particular, the uncertainty raises serious concerns among internationally active reinsurance groups, such as Lloyds, on questions such as whether reinsurance contracts with them would be treated as equivalent to those with EU reinsurers after Brexit, and whether they can continue using their internal models and apply them to the entire group.

Large players in the reinsurance market, such as Lloyds and some syndicates, are planning to establish subsidiaries in Brussels. In March 2017, Lloyds announced that it will establish a new EU subsidiary in Brussels to secure current business with EU counterparties. Based on its press release and statement, it chose Brussels because of "the robust regulatory framework" in Belgium, amongst other reasons, such as the central location within Europe and access to a large international talent pool. Given the uncertainty of the consequences of Brexit, it is hard to estimate how much business will eventually be relocated to Brussels. UK media has estimated that 100 – 600 (out of 900) global staff of Lloyds will be relocated. After the announcement, some large syndicates (such as MS Amlin) also decided to follow Lloyds to Belgium.

The NBB would be responsible for supervising a number of new subsidiaries with complex reinsurance risks. The NBB is fully aware of the new challenges, as there is currently no large re-insurance group located in Belgium and thus no experts employed by the NBB. The NBB decided to hire four new experts in addition to four experts who will be transferred internally to insurance supervision and is enhancing its expertise by closely coordinating with the current home supervisor of Lloyds, the UK Prudential Regulation Authority (PRA).

Recommendations

112. The NBB should continue to analyze the business growth of reinsurance operations and enhance its resources as needed. The uncertainty about the consequences of Brexit makes it difficult to figure out the size and complexity of the reinsurance business to be relocated to Belgium. Reinsurance companies are more interconnected with other financial market participants and exposed to complex risks. Depending on the outcome of Brexit, Belgian operations could become significant and systemically important. The NBB is encouraged to continue analyzing the business growth of reinsurance. If needed, the NBB should enhance its resources promptly to ensure proper supervision of the complex reinsurance operations.

113. The NBB should strive to retain the current staff with substantial knowledge of Solvency II. Solvency II is one of the most complex prudential frameworks and requires enough experts for continuous model validation, improvement of data submission, and further guidance for proper implementation (including calculation of best estimate loss absorption capacity of deferred taxes (LAC_DT)). The current NBB staff obtained deep knowledge during the implementation process, and those professional staff would be difficult to replace with others. Strong engagement from senior management and reasonable compensation seem to help the NBB retain those staff. The NBB is encouraged to monitor the retention of the staff carefully.

B. Solvency Requirements

Valuation of Assets and Liabilities

114. Insurance assets and liabilities are valued consistently with observable market data for solvency purposes. Assets are generally valued at mark to market. Technical provisions are valued with the best estimate (probability-weighted average of future cash flows taking account of the time value of money), plus Margin Over Current Estimate (MOCE) derived from the cost of capital method with 6 percent as the cost of capital. The best estimate is discounted by the relevant risk-free interest rate term structure derived from the European Insurance and Occupational Pensions Authority (EIOPA). NBB clearly communicated to the industry not to rely on the transitional arrangements under Solvency II and encouraged the insurers to improve their solvency positions before the implementation of Solvency II. Upon NBB's approval, the use of the transitional measures is allowed for the existing insurance liabilities at the end of 2016, but there is only one company which is permitted to use the transitional measures to soften the negative impact of the Solvency II ratio.

115. For general-purpose accounting, assets and liabilities are still valued mainly at amortized cost. Under the Belgium GAAP (BGAAP), most assets are valued at amortized or historical cost. Insurance liabilities are also discounted by using the guaranteed rates granted to the existing contracts. Assets backing technical provisions are valued at mark to market, except for sovereign bonds. The NBB has introduced the Flashing Light provision (see Box 4). While the NBB can provide an exemption from the Flashing Light provision upon an insurer's request, no exemptions have been granted in 2013, 2014 and 2015, which resulted in EUR 4.6 billion additional

provisions. The total amount of Flashing Light provisions at the end of 2016 amounted to EUR 7.6 billion. Although future accounting changes (such as IFRS 17 and 9) may have some financial and operational impact, the implementation of Solvency II has helped the industry to accommodate the negative impact of those accounting changes to the balance sheets.

116. The determination of the value of some assets and liabilities needs to consider the complex interactions between Solvency II valuation, BGAAP valuation, and tax treatment. Insurance companies need to consider the value of financial guarantees and contractual options, including the right to the reduction of benefits and the right of redemption. Belgian insurers also have material tax related components, such as deferred tax assets, deferred tax liabilities (DTL) and LAC_DT. This makes the calculations quite complex. The discretionary character of clear policy holder profit sharing makes it quite difficult for the NBB to validate the models for the calculation of insurance liabilities. To improve the situation, the NBB issued additional guidelines which cap the LAC_DT[38] to the net DTL in 2016. In 2017, a new circular was issued that allowed to go beyond the cap of net DTL. A new cap was defined, taking into account the financial position of the undertaking (the better the financial position, the higher the probability to survive and make profits under a 1/200 scenario) and limiting the projections of future profits to maximum five years. The NBB continues to monitor the situation closely, has identified a few outliers, and is actively contributing to the EU level discussions.

Capital Resources and Capital Requirements

117. The NBB has approved only a few insurance groups to use internal models for solvency purposes. The NBB has one centralized and dedicated unit (Internal Models Supervision) for internal model validation which is responsible for model validation of all sectors (banks, investment firms and insurers). The unit has imposed rigid requirements (including statistical quality test, calibrating test and use test) by leveraging on their experience in the model validation in banking supervision. The EU wide framework of joint model validations with home and host supervisors has also helped improve the robustness of the validation. The NBB has required even some Belgian subsidiaries of large insurance groups whose internal models were approved by their respective home authorities to use the standard formula.

118. Belgian insurers depend on lower quality capital instruments. Subordinated loans and other lower quality financial instruments were issued before the introduction of Solvency II and some insurance firms (including large groups) use the 10-year transition period[39] provided in Solvency II. While the NBB and industry are aware of the possible material increase of the insurers' financing cost after the 10-year period, they have not yet taken any concrete action on how to address the impact in the future. Part of their unrestricted Tier I capital relies on unrecognized gains

[38] There is merit in the simplicity of this conservative approach. Any inclusion of future potential deferred tax assets needs very careful validation. EIOPA provides high level guidance, however there are no established practices to recognize such future assets reliably.

[39] Solvency II grandfathers the capital instruments issued before January 2016 that meet the requirements under Solvency I.

from future premiums of the existing policies (so called Value in Force).[40] Low quality of capital instruments may trigger a possible reputational risk to the industry's overall loss absorption capacity in the next market turmoil.

119. Insurers using long-term guarantee (LTG) measures are subject to close oversight by the NBB. To soften the impact of the implementation of Solvency II, adjustment measures for LTG business and transitional measures (phasing in the requirements over 16 years from January 2016 to January 2032) have been allowed upon NBB approval. The NBB has imposed stringent conditions on the transitional measures and only one small insurer is using them. However, many insurers (19) use the VA. The impact of LTG measures is significant among insurers. The average SCR ratio with LTG measures was 175 percent as of the end 2016. However, the ratio would fall to 149 percent without LTG measures.

120. The application of VA may have led to an overstatement of insurers' solvency. The VA aims at avoiding pro-cyclical investment behavior of insurers when bond prices deteriorate owing to low liquidity of bond markets or exceptional expansion of credit spreads. The adjustment has the effect of stabilizing the capital resources of insurers and is set by EIOPA. The application of VA has increased the unrestricted Tier I. As a result, it had improved SCR ratios by 25 percent as of the end of 2016, when the market was stable and the VA was supposed to be immaterial. The capital resources resulting from the application of the VA do not meet the quality and suitability criteria (such as availability and permanence) described in the ICP.

121. The implementation of Solvency II required significant improvement of enterprise risk management. ICP16 requires a framework for the identification and measurement of all material risks, documentation of policies, feedback loops and an annual Own Risk and Solvency Assessment (ORSA), with clear commitment by the board and senior management. The NBB reviews the process and financial condition, including ORSA report, of each insurer and the outcome of the review is linked to a scorecard.

122. The requirements of Solvency II are based on the Prudent Person Principle (PPP) and do not prescribe quantitative limits on investments. Insurers can only invest in assets and instruments for which the insurer can properly identify, measure, monitor, manage, control and report the underlying risks. The use of derivative instruments is allowed only as long as they contribute to a reduction of risks or facilitate efficient portfolio management. Most insurers are not actively using derivatives, although a few groups use them not only for hedging purpose but also for yield enhancing purpose. Some insurers in FCs have made intragroup transactions with the parent banks not only through deposits but also through repos, securities lending and participations in mortgage loans.

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[40] The NBB does not have concrete figures of how much of the unrestricted Tier I is composed of Value in Force. Rough estimation based on B-GAAP figure is that it could reach more than 10 percent of the insurance liabilities, which suggests that a significant portion of Tier I relies on future unrealized gain from existing policies. As Belgian insurers are exposed to high redemption risk, the Value in Force is exposed to higher risk.

Box 3. Interlinkage Between Insurers and Other Financial Sectors

The contribution of the insurance sector to systemic risk has increased since the financial crisis. The extensive analysis of the insurance sector in the IMF April 2016 Global Financial Stability Report identified increased commonalities in the exposure to aggregate risk within the insurance sector and other financial sectors. The changing nature of insurance activities (shifting to more asset management type business models) may contribute to higher commonalities with other financial sectors. The Belgian insurance sector has improved its resiliency against the prolonged low interest rate scenario by ceasing the selling of life products, encouraging the buy-back of contracts with high guaranteed interest rates, and shifting from its traditional business model to non-traditional alternatives, such as unit linked products and short term saving products.

The business model shift of the insurance sector might increase interconnectedness of the insurance sector with banks and the asset management industry. The value of unit linked products (so called "class 23"; effectively asset management products with small insurance protection) has reached over EUR 30 billion, which is about 10 percent of the overall insurance sector assets and 14 percent of the premiums. Premiums received from policyholders are invested into asset management products, which are typically offered from the group's asset management entities or deposited with the parent bank.

The investments of unit linked products are partially exempted from Solvency II capital charges and thus have relatively higher allocation to risky assets. The majority of investments is made into collective investment schemes, mainly equity or mixed funds. Those tend to be internal funds and thus may not be subject to UCITS regulatory requirements, and would thus be exempted from investment, leverage, liquidity, concentration, use of derivatives and other requirements. Instead, insurers need to provide clear investment mandates and limits to protect policyholders of those products.

In case of a FC, the insurer tends to use group entities for various purposes, which results in a large concentration within the group. Excess cash tends to be deposited with banks or money market funds operated by the group asset management company. Derivative transactions needed for the internal funds tend to be conducted with the group bank. Structured notes that those products are invested in tend to be issued by a special purpose vehicle or financing company sponsored by the parent bank.

Some Belgian insurers offer "structured class 23 contracts" with synthetic guarantees, which may cause reputational risk. Typically, those products have automatic rebalancing orders of the asset allocation depending on the past investment return. The program aims at keeping the net asset value above a certain floor (specified in the contract), and frequently rebalances the allocation of risky and safe assets. However, in case of a sudden market crash, the rebalancing may not be able to execute on time and the policyholders may suffer losses. While there is no explicit legal obligation of the insurance company to protect policyholders from losses, possible reputational and legal risks exist as policyholders expect the insurers to compensate for the losses from such incidents. While the size of such funds does not seem to be material, the automatic allocation may exaggerate the volatility of the market, as asset allocation is always following the market directions (buy when markets move up and sell when markets move down).

The NBB is working jointly with the FSMA to analyze the risk arising from such interconnectedness with banks and asset management activities. The NBB and FSMA have analyzed the interlinkages among banks, insurers and asset management activities with close coordination and information exchange. Some of the findings imply the need for further enhancement of regulation, such as the introduction of concentration limits for the assets of unit linked products.

Recommendations

123. The NBB should enhance the dialogue with the insurers with higher reliance on lower quality capital instruments to improve the quality of capital. Some insurers are relying on lower quality capital instruments (such as subordinated loans from the parent banks). The industry as a whole is also relying on future unrealized gains from existing policies with higher redemption risk. To mitigate reputational risk to the industry, the NBB should enhance the dialogue with the insurers with higher reliance on lower quality capital instruments to establish a plan to improve the quality gradually.

124. The NBB is encouraged to enhance monitoring of intragroup transactions and seek the introduction of quantitative limits to intragroup exposures. Solvency II relies on a high-level, principle based PPP, which may not work appropriately to limit intragroup exposures within the group. The NBB is encouraged to enhance monitoring of intragroup transactions and consider the introduction of quantitative limits if the principle based approach cannot prevent excessive concentration through large intragroup transactions.

C. Macroprudential Regulation and Surveillance

125. The NBB has established a methodology to identify systemically important insurance groups and three insurance groups have been designated as such. Inspired by the FSB and International Association of Insurance Supervisors (IAIS) assessment methodology for Global Systemically Important Insurers (G-SIIs), the NBB has established its own methodology to identify domestic important insurance groups. Three insurance groups (which belong to bank-led conglomerates) are designated as D-SIFIs[41] and are subject to enhanced supervision with higher allocation of staff, additional reporting requirements, and close monitoring of their risks.

126. The NBB has the power to impose macroprudential measures on the entire financial sector, including the insurance sector. The NBB is currently analyzing sector wide risks by conducting several horizontal reviews. On the banking side, it has imposed macroprudential measures to address excessive mortgage loan lending by increasing the risk weight for mortgage loans by IRB banks by 5 percent. The current measure only applies to banking groups and insurers are exempted even if they are part of the banking group. The NBB is aware of the possibility for regulatory arbitrage as banking groups could potentially circumvent the measure by shifting mortgage portfolios to their insurance subsidiaries. Thus, monitoring intragroup transactions is essential.

[41] Most insurers designated as D-SIFIs belong to banking groups which are also designated as D-SIFIs.

Box 4. Measures Against Prolonged Low Interest Rate Environment

The NBB has imposed sector wide measures to mitigate system wide risk from the prolonged low interest rate environment. The NBB has actively coordinated with the relevant ministries to reduce maximum guaranteed interest rates. There are two relevant rates: i) maximum guaranteed rates applicable to life insurance products and ii) minimum guaranteed rates applicable to the second pillar pension system. The maximum guaranteed rate used to be up to 4.75 percent in the late 1990s. It was reduced to 3.75 percent in July 1999 and to 2 percent only in February 2016. The 2003 law on the supplementary pension system set a minimum interest rate which does not directly apply to insurance companies but required pension providers of the supplementary pension system (second pillar) to provide the guaranteed rate to the employees. It was set at 3.25 percent to employers and 3.75 percent to employees until January 2016, when it was reduced to 1.75 percent.

The Flashing Light Provision has encouraged life insurers to reduce the guaranteed rates of both new policies and existing policies. The Flashing Light Provision, introduced in 2011 under the BGAAP, requires the gradual buildup of additional technical provisions.[1] The discount rate for the Flashing Light provision is calibrated at 80 percent of the average yield over the last five years of the ten-year Belgian sovereign bonds. The total reserved amount in the provision reached EUR 7.6 billion as of end-2016. The provision has a direct impact on profits. While the NBB can provide an exemption from the provision, no exemptions have been granted in 2013, 2014 and 2015. This has also given a strong incentive for life insurers to reduce the guaranteed rates of existing policies.

Life insurers have made continuous efforts not only to lower the guaranteed rates but also to shorten the length of minimum guarantees. Belgian life insurers used to provide minimum guarantees to the entire period of life policies, which could be over 50 years for annuities in the 1990s. Insurers have shortened the length of the guarantees to 8 years from the premium payment. While there are still legacy portfolios which promise long term high guarantees, the current insurance liabilities do not provide any guarantees for future premium payments, which has helped insurers to reduce their interest rate risk significantly.

The NBB's conservative stance against transitional measures encouraged life insurers to improve their ALM gap before the implementation of Solvency II. The transitional measures of Solvency II allow insurers to continue to use Solvency I discounting rates over 16 years, upon the NBB's approval. However, the NBB has imposed stringent conditions for the approval, which has effectively discouraged insurers from relying on the measure. The NBB is also introducing other measures, such as early warning indicators linked to the SCR ratio without transitional measures. The NBB also prohibits insurers that rely on transitional measures to meet the SCR ratio from paying policyholders' bonus.[2]

Some insurers have taken unconventional measures (buy back of legacy products), which have helped them to meet their Solvency II requirements. Several insurers, including large insurers (such as Axa and Ethias), provided incentives (10 to 25 percent) to policyholders with high and permanent guaranteed rates and bought back those liabilities. In the case of Ethias, the buy-back program successfully reduced the legacy portfolio to less than 5 percent of its original size. The program was executed with close contact with the NBB and FSMA from 2014 to 2016, without material impact to the liquidity of the insurer. The buy-back amount has reached EUR 7 billion.

[1] The additional provision is required to be built up over 10 years.

[2] Consideration could also be given to treating dividends to equity holders similarly to the bonus to policyholders.

127. The NBB has conducted extensive horizontal reviews of material risks and addressed those risks effectively. In the last several years, the NBB has conducted industry wide reviews on major risks of life insurers, such as search for yield behavior and interest rate risk, by imposing additional reporting requirements on the industry. The analysis has identified outliers which are excessively exposed to those risks. In particular, for interest rate risk, the NBB has imposed recovery measures on some outliers and has successfully reduced their ALM gaps in the last three years.

Box 5. Horizontal Reviews

ICP 24 (Macroprudential Surveillance and Insurance Supervision) encourages insurance supervisors to perform horizontal reviews. A horizontal review is performed across many insurers around a common subject to reveal sector level vulnerabilities. It is also used to analyze whether industry practices are robust enough to address certain risks.

The NBB's horizontal reviews include ad-hoc reporting requirements, Financial Soundness Indicators (FSIs), and intensive supervisory reviews of outliers. The NBB has actively conducted reviews of major risk components, such as investment risk, interest rate risk, and spread risk. The reviews identify outliers, which are subject to supervisory reviews and inspections to improve their risk profile.

The NBB's interest rate review used four indicators, which effectively identified troubled insurers. The NBB used the average guaranteed rate, the share of insurance liabilities with guaranteed rates above 80 percent of the 10-year Belgium government bond yield, the average remaining maturity of insurance liabilities, and the share of technical provisions with a guarantee of future premiums. The NBB identified one large insurance group with high interest rate risk and actively imposed a recovery measure, which improved the group's financial position remarkably.

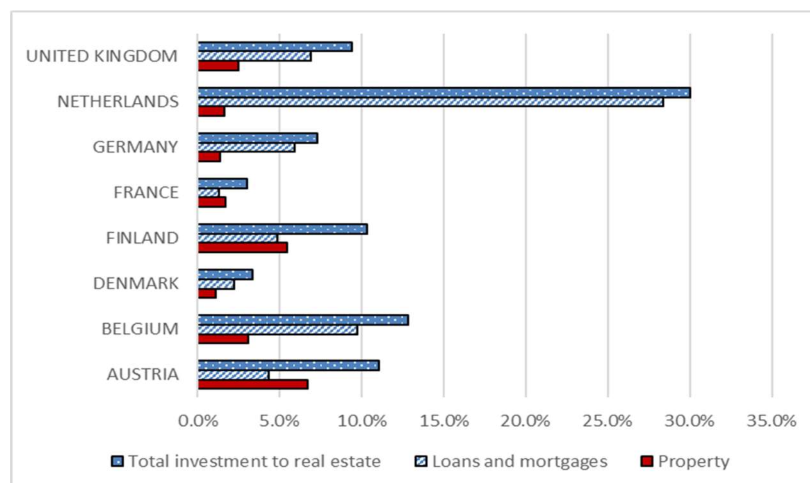
The review of investment activities identified increasing investments into mortgage loans by some insurers. The investment behavior of the Belgian insurance sector remains conservative overall. However, at an individual company level, some insurers are actively increasing their illiquid investments, such as mortgage loan portfolios (one small insurer has invested more than 50 percent of its total portfolio into mortgage loans). The investments in mortgage loans have been increased from EUR 8 billion to EUR 13 billion from the end of 2014 to 2016. The outliers have been identified and currently supervisors are discussing actions with the firms' management. The NBB is also considering additional reporting requirements to understand the risk profile of those investments, such as average Loan to Value (LTV) and Debt to Income (DTI) of the mortgage loan portfolios.

The review of liquidity risk covers the risk from surrenders and a comparison of illiquid assets/liabilities and off-balance sheet instruments, such as repos and securities lending. The indicator of surrenders identified that many Belgian insurers are suffering from negative cash flows. However, the analysis of illiquid assets and liabilities shows that most insurers have liquid assets of more than three times their liquid liabilities and for all insurers liquid assets exceed liquid liabilities. The NBB identified only a small number of companies relying on derivatives and repo transactions extensively.

NBB's horizontal reviews have helped in risk identification. While the methods applied are rather simple, the NBB has identified industry trends and outliers very effectively. In addition, because of the straightforwardness of the analysis, it is relatively easy for line supervisors to understand the identified vulnerabilities.

Figure 10. Peer Comparison of Mortgage Loan Investments

Belgian insurers' investments in mortgage loans are one of the highest among the peer countries, as of third quarter of 2016.



Source: EIOPA.

128. The NBB has identified that the liquidity risk of the insurance sector has increased and is considering macroprudential measures to mitigate it. Responding to intrusive supervision by the NBB, the life insurance sector has shifted its business model from traditional long term products to more asset management type products. While this helps improve the sector's resiliency to a prolonged low interest rate environment, the industry is being exposed to possible liquidity risk in the future due to higher redemptions, especially in case of a spike in interest rates. The NBB is considering and proposing a new measure to address the liquidity risk by imposing minimum requirements on the surrender value calculation (such as charges and market value adjustment) to be applied to new policies.

129. To limit excessive volatility of the capital ratio, Solvency II introduces a stability mechanism, the VA, which may not work properly for Belgian insurers. Due to the wide use of mark to market valuation, Solvency II figures are quite volatile, corresponding to market fluctuations. To avoid procyclical investment behavior of insurers, insurers are allowed to use VAs, which aim to stabilize solvency figures by partially offsetting the asset side loss with additional capital resources. However, the adjustment is calculated by EIOPA based on a euro area wide reference portfolio, which is quite different from the average investment portfolio of Belgian insurers, so the adjustment does not fully reflect the economic features of the Belgian insurance sector. This means that Solvency II figures would be volatile even with the VA, and insurers would need to keep a higher safety margin above the target solvency ratio. In addition, the SCR ratio with VA of Belgian insurers may increase in case of credit spread increase in euro area periphery countries, when the ratio is

supposed to decrease.[42] This kind of unreasonable movement of Solvency II figures may provide wrong signals to the market and trigger distrust of the Solvency II regime.

Recommendations

130. The NBB is encouraged to seek to impose appropriate measures to address increasing liquidity risk of the insurance sector. The measures might have side effects on the industry as possible measures to restrict redemptions may reduce the convenience of the policyholders, which may have a negative impact on the reputation and future profitability of the insurance industry. Therefore, due consideration of policyholders' protection, also upon advice from the FSMA and other agencies in charge of consumer protection, and communication to the policyholders would be important.

131. The NBB should consider imposing more detailed reporting requirements on insurers with large exposures to mortgage loans. Currently, the NBB does not have granular data and information about the quality of mortgage loan portfolios. To monitor the quality of the portfolios, it is important for the NBB to collect key risk indicators, such as LTV, DTI, PD, LGD and prepayment rate.[43] The NBB insurance supervisors are encouraged to coordinate with the banking regulators to identify the best risk indicators for mortgage loans and collect such information from the insurers with large exposure to mortgage loans.

D. Crisis Management and Resolution

132. The NBB has a wide range of measures to recover and resolve troubled insurance companies. The Insurance Supervisory Law provides a number of recovery measures, such as suspension of redemptions, prohibition of dividends, requiring additional reserves, requiring insurers to reduce risks, imposing additional liquidity rules, etc. In addition, the NBB can suspend parts of or all businesses, order the replacement of the management, and order insurers to transfer their assets and liabilities (including related reinsurance contracts). Insurance law provides that the policyholders are the highest class of creditors in case of insolvency. In addition, although the sizes are small, there are three guarantee funds, which would benefit the policyholders in case of an idiosyncratic failure of a small insurer.

133. The establishment of effective recovery and resolution plans for large insurance groups is still at an early stage. The NBB has conducted a pilot exercise of solo level pre-emptive recovery plans, involved the crisis management group of a G-SII as a key host supervisor, and developed actual recovery plans for a large insurer facing financial distress. Currently the

[42] Especially when the credit spread increases in euro area periphery countries and not in core and Belgian government bonds. VA is designed to stabilize industry's overall solvency ratio to offset investment losses from higher credit spreads. Therefore, the benefits are likely to exceed the losses of insurers with conservative asset allocations, such as Belgian insurers.

[43] The majority of mortgage loans in Belgium are fixed rate without material penalty for prepayment. Prepayment rate of Belgian mortgage loans increased in 2014 and 2015, when long term interest rates decreased. This makes the effective duration of the portfolio shorter while that of insurance liabilities becomes longer due to the change of policyholders' behavior.

establishment of formal recovery and resolution plans is not required for the insurance groups, however many groups are part of D-SIFI bank-led FCs. The banking groups are required to have recovery and resolution plans. Currently, insurance operations are not yet fully incorporated into the plans at the FC level.

Recommendations

134. The NBB should ensure that systemically important insurance groups have robust recovery or contingency plans. For systemically important insurance groups which belong to systemically important banking groups, the competent authorities should ensure that the groups' recovery plans are developed with due consideration of the insurance subsidiaries. Further, it is important that other insurance groups, which do not belong to systemically important banking groups, develop contingency plans based on ORSA and reverse stress testing.[44]

FINANCIAL CONGLOMERATE SUPERVISION

135. There are currently three banking-led FCs operating in Belgium. One of them is headed by a credit institution (Belfius), the other two are headed by a mixed financial holding company (KBC group and Argenta group). All three are SIs as defined by the SSM Regulation. There are no insurance-led FCs or mixed-activity groups.

136. The Belgian legal framework for FC supervision has been substantially enhanced. Supplementary supervision of FCs is governed by the new BL and the new Insurance Law that contain chapters dedicated to group supervision, providing symmetric regimes for bank and insurance led FCs. The BL transposed the provisions of FICOD and CRD to the Belgian legal framework and aimed to anticipate future changes to FICOD to better reflect the JFP and recommendations of the 2013 IMF FSAP. The BL goes beyond FICOD by clearly including mixed activity financial holding companies within the scope of FC supervision and determining that parent companies are responsible for compliance with the obligations resulting from supplementary conglomerate supervision.

137. But supervisory practices for FCs can be further developed. All Belgian FCs are led by banks. Supervisory procedures consider the FC dimension in the SREP and assess capital adequacy, risk concentration, intra-group transactions, and risk management and internal control mechanisms at the FC level as part of the supplementary supervision determined by FICOD and the BL. Nevertheless, supervisory expectations and best practices for FCs need to be further developed to increase the effectiveness of FC supervision.

A. Powers and Authority

138. FICOD, initially adopted in 2002, establishes the regulatory framework for the definition of FCs and their supplementary supervision in the EU. It incorporates some elements

[44]ICP requires contingency plans and procedures on their specific risks for both going and gone-concern situation.

of the JFP issued in 2012. The principles can be considered as preconditions for effective group-wide supervision of FCs.

139. FICOD introduces a layer of supplementary supervision over the regulated entities in the FC. Supplementary supervision enables supervisors to look across sectors and review group risks such as double-gearing, transparency of structure, contagion, concentrations, and conflicts of interest. Supervisors involved in the monitoring of the various sectors and institutions in the FC appoint a coordinator to exchange information and plan supervisory activities.

140. However, certain shortcomings of FICOD have been identified. They include the following issues raised in an EC staff working document published in July 2017:[45]

- FICOD defines a MFHC as the parent company of a FC, which is not a regulated entity. There are limited powers defined in FICOD over these companies.
- FICOD does not designate a single point of entry for supervisory intervention, where policies, strategies and decisions relevant for the whole group are effectively taken and with clear assignment of responsibility for compliance in respect of supplementary supervision.
- Definition of FC is prescriptive, static and not risk-based.
- There is no recovery and resolution framework directly applicable to FCs.
- There are no harmonized templates for the reporting of significant intra-group transactions, risk concentrations or capital calculation.

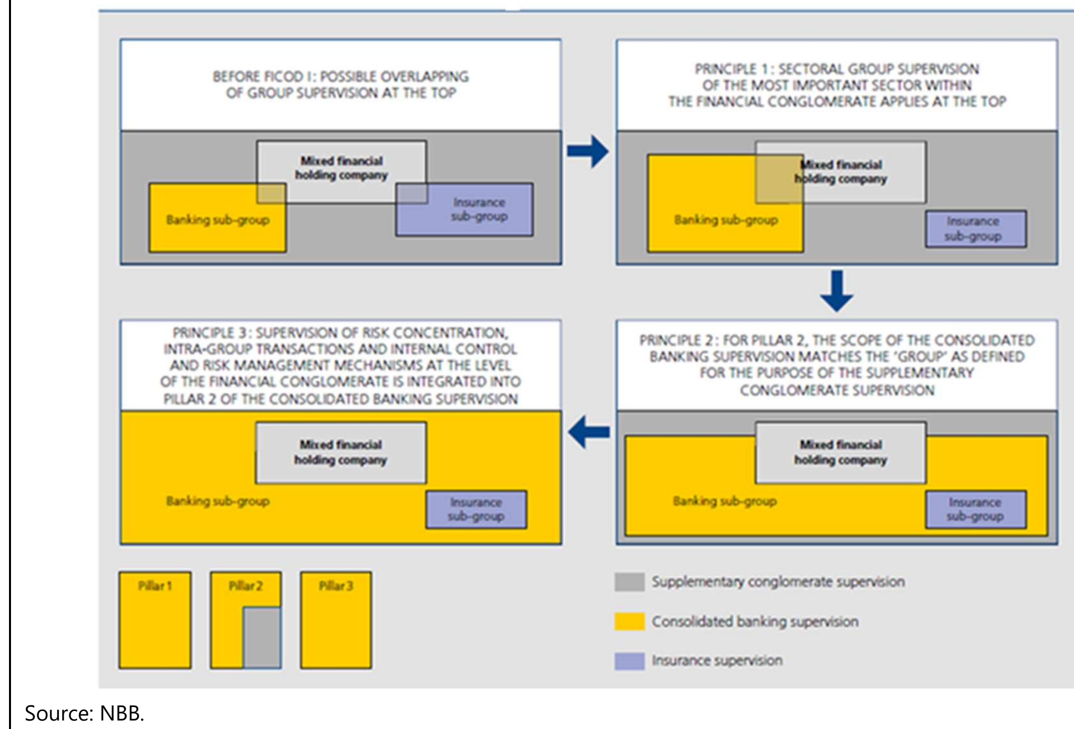
141. Important amendments to CRD IV have been implemented since the last FSAP that enhance applicability of consolidated supervision to bank-led FCs. To address lessons-learned from the global financial crisis, amendments to FICOD and CRD have been applicable since June 2013. The changes eliminated the need for supervisors to choose between applying sectoral directives or supplementary supervision as defined in FICOD. The definition of supervisory parameters in CRD includes FHCs and MFHCs. However, the amendments do not place FHCs or MFHCs under full direct supervision on individual level. Additional amendments, reflected in FICOD, include transparency requirements for the legal and operational structure at the FC level. And, finally, supervisors are required to align the application of FC supplementary supervision of internal control mechanisms and risk management processes with the SREP review as provided in CRD IV.

142. Under BL, consolidated supervision as well as supplementary supervision can be exercised at the top level of the group. As Figure 11 illustrates, top-down sectoral supervision (Principle 1) would not include the insurance subsidiary. Under supplementary supervision (Principle 2), the insurance subsidiary is brought under the supervisory parameter and the definition of group is now the same as in CRD IV for consolidated supervision. Article 170 BL specifies that intragroup transactions and risk concentration are treated as supplementary risk categories for the application

[45] Commission Staff Working Document on Directive 2002/87/EU on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate (FICOD), available at http://ec.europa.eu/transparency/regdoc/rep/10102/2017/EN/SWD-2017-272-F1-EN-MAIN-PART-1.PDF.

of all supervisory measures. Therefore, the rules integrate supplementary conglomerate supervision with sectoral consolidated supervision, which applies to the larger perimeter of the FC (Principle 3).

Figure 11. Consolidated Banking Supervision and Supplementary Conglomerate Supervision Under the Belgian Regulatory Framework



Source: NBB.

143. The Belgian regulatory framework enables, in relation to the wider group, an assessment of the risks and support provided by the wider group to the FC. Article 188 of the BL defines the scope of the supplementary FC supervision to include all undertakings, whether regulated or unregulated, that form part of the group defined in BL (Article 164) as a set of undertakings formed by a parent undertaking, its subsidiaries, the undertakings in which the parent undertaking or its subsidiaries have a direct or indirect participation and the undertakings forming a consortium and undertakings controlled by the latter undertakings or in which the latter undertakings hold a participation. Article 170 includes supervision on a consolidated basis at FHC and MFHC level, provided that the banking sector is the most relevant sector in the FC.

144. To execute its authority for FC supervision and undertake its responsibilities under the SSM Regulation, the ECB applies relevant EU legislation and where that is composed of directives, the national legislation transposing those directives. Article 185 BL transposes from FICOD the principle of supplementary supervision for credit institutions that head a FC or that have as their parent undertaking a MFHC with headquarters in a member state.

145. FICOD sets the parameters for the identification of a FC and the entities within the scope of supplementary supervision, particularly those entities that could pose risks to regulated entities or the broader financial system. An FC is defined as a group with a regulated entity as the head or as part of the group, where the group's activities mainly occur within the

financial sector and at least one of the entities operates in the insurance sector and another in banking or securities. FICOD does not include the MFHC as a regulated entity; however, the BL provides the supervisory authority power to request information and apply sanctions on the MFHC. Article 183 of the BL addresses MAHCs and the ability of the supervisory authority to request information from the MAHC. Insurance entities are excluded from consolidation under CRR but are subject to supplementary supervision under FICOD.

146. BL establishes standards for significant owners of FCs. Standards of suitability for significant owners of FCs are referenced under the general conditions applying to ultimate shareholders of credit institutions (Articles 9 and 18 BL, which transpose CRD IV). Suitability evaluation of the shareholders (Article 18 BL) covers the following aspects:

- Integrity of the concerned persons;
- Financial soundness of the concerned persons especially considering their proposed duties and responsibilities within the credit institution;
- Whether the credit institution can comply and continue to comply with the prudential provisions of the BL and its implementing decrees and of CRR, whether the group of which it will be part is structured in such a way as to permit effective supervision and effective sharing of information between the competent authorities and to determine the distribution of responsibilities between the competent authorities; and
- Whether there are grounds to suspect that money is being or has been laundered or terrorism is being or has been financed or an attempt is being made or has been made to launder money or finance terrorism on the account of the concerned persons, or that their capacity of shareholder of the credit institution would increase the risk thereof.

147. Requirements for FCs promote a sufficiently transparent group structure so as not to impede effective supervision and ensure that recovery or resolution plans have been established. Article 9(4) of FICOD was amended to include a requirement that regulated entities at the level of the FC regularly provide the supervisory authority details on their legal structure, governance and organizational structure, including all regulated entities, non-regulated entities and significant branches. Article 21, §3 BL requires every credit institution to draw up a governance memorandum that includes, for the institution in question and, where applicable, for the group or subgroup of which it is the final parent undertaking, the entire internal organizational structure. Article 194, §4 BL requires that credit institutions ensure a transparent group structure. To this end, the credit institution, the MFHC or the regulated undertaking belonging to the FC designated by the supervisory authority (in its capacity of coordinator, after consultation with the other relevant competent authorities and with the FC) must regularly communicate to the supervisory authority distinctive features of the group's legal structure, policy for business organization and management structure applicable to all regulated undertakings, unregulated subsidiaries and significant branches.

148. The ECB and NBB have access to the board and senior management of the FC and of other material and relevant entities related to the FC to assess the risks and support available to the FC. Article 213 BL provides the supervisory authority with access to the credit institutions,

FCs, MFHCs, their subsidiaries and all other undertakings included in the consolidated whole or in the FC, to obtain directly or indirectly all information that is useful for the consolidated supervision or supplementary FC supervision. Management of the FC is responsible for the accuracy and reliability of information submitted to the supervisory authority. Article 183 BL extends information access to MAHCs that own credit institutions.

149. A comprehensive range of supervisory tools to be used to ensure timely corrective actions is in place. They include but are not limited to actions necessary to address deficiencies in corporate governance or risk management, capital and liquidity shortfalls, large exposure concentration limits, and inappropriate group transactions. Article 234 BL empowers the supervisory authority, when it finds that a credit institution, a FHC or a MFHC is not operating in accordance with applicable regulatory provisions, to fix a deadline by which the situation should be remedied.

150. Until the credit institution, the FHC or the MFHC has remedied the situation, the supervisory authority may, at any time:[46]

- Impose more stringent or additional own funds requirements;
- Impose the application of specific rules governing the valuation or adjustment of value for the purposes of the own funds requirements;
- Require that all or part of the distributable profits be placed in a reserve;
- Limit or prohibit any distribution of dividends or any payment, particularly of interest, to shareholders or to the holders of additional Tier 1 capital instruments, insofar as the suspension of the resulting payments does not result in the commencement of winding-up proceedings;
- Limit the amount of variable remuneration to a percentage of the profits;
- Impose specific liquidity rules, stricter than those stipulated by applicable standards, including limitations on mismatches between the institution's assets and liabilities;
- Require the institution to reduce the risks of certain activities or products or of its organization, where applicable, by requiring the sale of all or part of its business or network;
- Impose rules on the concentration of risks or the limitation of exposure, stricter than those defined in CRR;
- Impose additional reporting obligations or higher reporting frequencies, regarding risks, own funds or liquidity positions;
- impose the publication of more detailed, frequent information. This provision is also applicable if the supervisory authority receives information indicating that the institution runs the risk of no longer operating in accordance with applicable regulatory provisions over the next 12 months.

[46] Following Article 212 BL, which refers to Article 234, §1 BL, the request to remedy may be addressed directly to the credit institution, the FHC or to the MFHC. As Article 212 BL refers solely to Article 234, §1 BL, the binding measures that are foreseen in Article 234, §2 BL can only be addressed to the credit institution, provided that the FHC or the MFHC are responsible for compliance with such measures by their subsidiary (Article 205 BL).

- In extreme cases, the supervisory authority may appoint a special commissioner, order the replacement of all or part of the members of the governing body by a deadline it determines, appoint one or more provisional managers, order to call a general meeting of shareholders, with a well determined agenda, suspend the exercise of all or part of the business or prohibit such business or order the company to sell any shares it holds (Article 236 BL).

151. There is no EU-wide recovery and resolution framework applicable to deteriorating situations in FCs. Consequently, the framework relies on the existing frameworks for banks and insurers. Recovery plans are considered as governance tools and are important for the supervisory monitoring of the governance and risk management framework of every regulated entity. This is explicitly recognized by Article 9(2)(d) of FICOD where it is said that the risk management processes must include, among others, arrangements in place to contribute to and develop, if required, adequate recovery and resolution arrangements and plans. Beside the requirement for, among others, FHCs and MFHCs to draw up recovery plans under the BRRD, as transposed into each member state's national legislation, FCs that have been designated as globally systemically important firms by the FSB (i.e., G-SIBs and G-SIIs) are also requested to draw up and maintain recovery and resolution plans under the FSB Key Attributes for effective resolution.

Recommendations

152. It is recommended that the authorities seek amendments to FICOD to ensure their ability to address risks arising from FC-level activities. FHCs and MFHCs are unregulated entities and do not require authorization from supervisory authorities for establishment. The BL strengthens the supervisory authority over holding companies and makes them de-facto regulated. However, the lack of direct supervisory authority limits the flexibility to identify and include in the supervisory perimeter affiliates that are not specifically identified in Union laws or regulations. Amendments to FICOD should enhance supervisory authority over holding companies, harmonized reporting, and flexibility in defining the supervisory perimeter and/or require authorization of holding companies.

B. Supplementary Supervision

153. The ECB is the supervisory authority and designated coordinator for the three Belgian FCs. For a FC, the SREP includes the potential impact of non-banking activities on the banking activities of the group, the group's risk profile, profitability, and capital and liquidity position, and assesses the financial situation at the FC level. During the assessment, JSTs identify and monitor the risks from non-banking activities and the transmission mechanisms through which these activities may affect the banking element of the FC. This assessment, and the issuance of any recommendations arising from it, takes place at the end of the process. The conglomerate approach considers the different sector regulations.

154. To carry out its role of coordinator, the ECB may receive the FC's data from the supervised banking entity. If banking, non-banking and other risks are managed in a fully integrated manner by the supervised institution, the information provided may be used in the assessment. The ECB may also receive information from the competent insurance supervisors. FICOD provides that the competent authorities responsible for the supervision of regulated entities in a FC

and the competent authority appointed as the coordinator should provide one another with any information which is essential or relevant for the exercise of the other authorities' supervisory tasks under the sectoral rules and FICOD.

155. Supplementary supervision does not substitute sectorial supervision but builds on it and addresses those risks that stem from the activities of a group in the other financial sectors. Supplementary supervision addresses: (i) capital adequacy at group level; (i.e., avoidance of "double gearing" across the sectors); (ii) contagion (i.e., supervising intra-group transactions); (iii) concentration (i.e., supervising risk concentration across business lines); (iv) conflicts of interest (i.e., issues with respect to corporate governance); and (v) complexity.

156. The SSM Supervisory Manual provides guidance for conducting supplementary supervision of FCs. The guidance establishes a twofold approach. First, determine possible spill-over risks, whether the risks are incorporated into ICAAP at FC level and banking group level and, if parent undertaking is a FHC, whether ICAAP is performed at FHC level. Second, identify possible channels of contagion that may impact the capital of the banking group. Possible channels listed include: intragroup liquidity arrangements, intragroup guarantees, whether the bank will be able to operate standalone if the insurance company fails, and reputational risk from asset management business.

157. The manual is presently under review for update and inclusion of additional guidance. Currently the guidance is high level but, given the compendium of EU directives and regulations and national laws and regulations that must be threaded to accomplish seamless supervision, compounded by the unregulated status of FHCs, more detailed guidance may be needed. Although for some FCs application of supplementary supervision has been waived, by common agreement of the relevant competent authorities when the thresholds established in Article 3 of FICOD for considering the activities in different sectors as significant are not reached, possible transmission of risks remains and should be addressed, when relevant. The same applies to possible reputational risks from areas not directly under SSM competence, such as money laundering and asset management.

C. Corporate Governance

158. Holding companies are expected to implement appropriate governance arrangements throughout the whole group, without prejudice of individual entities. For FCs where banking is the dominant sector, the legal framework enables the supervisor to assign responsibility for capital adequacy, risk management and governance to the parent undertaking thus making FHCs and MFHCs de facto regulated entities. In this capacity, parent companies should issue guidelines to the undertakings belonging to the FC to ensure that FC-wide policies and procedures comply with the prudential requirements.[47] These guidelines need to respect the Companies Code, that balances the interests of the individual entities.

[47] BL, Article 205.

159. The governance arrangements for credit institutions need to be applied at the FC level when banking is the most important sector of the FC.[48] Parents' compliance obligations include: ensuring appropriate structure for the organization of the group; appropriate internal control and risk management systems; and independent audit function.[49] The governance arrangements should also include appropriate integrity policy, remuneration policy that penalizes risk taking beyond the level tolerated by the FC, and measures for business continuity. The fit and proper criteria for board members, senior management and control persons that apply to credit institutions also apply to FHCs and MAHCs that head FCs.[50] Finally, the responsibilities of board members of the parent company are aligned with banking sector requirements.

160. The BL also requires the head of the FC to ensure appropriate internal control and administrative and accounting procedures to manage specific FC risks. These procedures should be available at the consolidated and sub-consolidated level and include: appropriate procedures for monitoring the solvency at a group level so that all major risks are correctly identified and monitored and the own funds are sufficient in light of the risks incurred; and the adequacy of the procedures and systems for the identification, measurement, monitoring and control of intra-group transactions and risk concentrations.[51]

161. FCs are required to ensure a transparent group structure.[52] To this end, parents should communicate to supervisors their policy for business organization and their management structure applicable to all regulated and unregulated subsidiaries and significant branches. Further, every credit institution must draw up a governance memorandum which includes the entire internal organizational structure of the group or sub-group for which it is the final parent undertaking.[53] A description of the legal structure of the FC should also be published annually and material changes to the structure of the group should be communicated and approved by supervisors.

162. The adequacy of FC governance is assessed in the SREP. The SREP contains an additional FC dimension that assesses how the FC perspective reflects on the business model, governance, risks to capital, liquidity and funding of the banking group.[54] In particular, the group-wide governance approach is expected to cascade down to the sub-structures in banking and insurance in a way that does not require the differentiation between these sectors. JSTs are expected to be able to highlight any shortcoming from insurance or other non-banking sectors that could have an impact on the banking group and to focus on the interaction between the sectors. To this end, supervisory

[48] BL, Article 170.

[49] BL, Article 168.

[50] BL, Article 212.

[51] BL, Articles 190-194.

[52] BL, Article 194, §4.

[53] BL, Articles 21 and 168.

[54] BL, Article 170, §2.

authorities have access to the credit institutions, FHCs and MFHCs and their subsidiaries and all other undertakings included in the FC.[55]

Recommendations

163. Supervisory procedures to ensure the adequacy of the FC-wide structure and governance could be further developed. While governance practices are well established for banking groups, the inherited complexity of FCs and the delicate balance between interests of the ultimate parent and the other entities of the group often challenge supervisors. The SSM Supervisory Manual identifies which kind of risks should be considered but provides limited insight beyond the regulatory requirements. Defining best practices for a governance model at FC level is challenging but important to enhance the effectiveness of FC supervision.

D. Capital Adequacy and Liquidity

164. Bank-led FCs are subject to two calculations of capital adequacy based on FICOD and CRD/CRR. All Belgian FCs are bank-led and therefore subject to two requirements: one is group based capital requirement based on CRD/CRR and the other FC level capital requirement based on FICOD supplementary supervision. Due to a deviation of CRD/CRR from the Basel Framework (so called Danish Compromise, explained below), the requirement based on CRD/CRR tends to be less conservative than that based on FICOD. FCs that use the Danish Compromise are not waived from supplementary supervision under FICOD, as in order to benefit from the Danish Compromise in CRR, the group needs to be a recognized FC. Therefore, all three Belgian FCs are subject to supplementary supervision.

165. Capital adequacy calculation under FICOD (Article 6) is based on the aggregation of each sector's requirements. Where a banking group has an insurance undertaking within the group or vice versa, the group can choose a method for the calculation of its capital from the following three options: (i) accounting consolidation method; (ii) deduction and aggregation method, and (iii) combination method (combination of methods i and ii). Method i is based on the consolidated balance sheet of the group entities. Method ii is based on the aggregation of the solo accounts of each sector within the group, with the bank participation in its insurance undertakings deducted from its capital. The eligibility of the capital instruments also depends on the sectorial rules. In both methods, the solvency requirements are derived from the sum of those calculated for each sector.

166. However, supervisory analysis is mainly carried out by referring to the group-level capital ratio under the CRD/CRR, calculated according to the Danish Compromise. Bank-led FCs are subject to group level capital requirements under the CRD/CRR and both the regulators and market participants pay attention to the group level ratio. The group level capital ratio is also subject to disclosure requirements (Pillar 3). While capital adequacy ratio at the FC level is also subject to disclosure for the groups benefitting from the Danish compromise, the emphasis is put more on the

[55] BL, Article 213.

capital ratio under CRD/CRR, which creates a strong incentive for FCs to improve the ratio based on CRD/CRR.

167. Deviating from the Basel framework, the CRR (Articles 49 and 471) grants the option to allow, under certain conditions, bank-led FCs to apply low risk weights to their participations in insurance companies. In practice, IRB banking groups can apply a risk weight of 370 percent instead of deducting the investment from regulatory capital.[56] This approach tends to result in a significantly lower capital requirement than the deduction of the participation. However, other approaches, such as PD/LGD approach or internal model approaches, are allowed, which could lead to even lower risk weights.[57]

168. Several Belgian FCs with material insurance operations have been authorized to use the Danish Compromise, which might result in some cases in a sizable increase of capital ratios at the parent banking group and holding company levels. Depending on the methods applied, by switching equity investment to sub-ordinated debt, banks may reduce the required capital invested in the insurance subsidiaries and improve their capital ratio under CRD/CRR.[58] Currently, three banking-led FCs apply the 370 percent risk weight to all capital instruments of the subsidiaries regardless of their quality.

169. Different regulatory requirements for banks and insurers enable regulatory arbitrage. The definition of and requirements for the capital instruments are different between banks and insurers; for example, Solvency II Tier 2 allows some unpaid instruments. The treatment of banks' investments in insurers is also different from insurers' investments in banks. Although the implementation of Solvency II reduced such arbitrage opportunities significantly, there are still material differences. For a more detailed analysis, see Box 6.

170. There is no FC level regulatory requirement on liquidity or leverage. Banking groups are subject to liquidity requirements (such as Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR)) and leverage ratio, while Solvency II does not have such requirements in Pillar 1. As a result, there is no Pillar 1 requirement on liquidity or leverage at the FC level. Industry practice for liquidity risk management has developed differently between banking and insurance groups. Therefore, comprehensive liquidity risk assessment has not in practice been achieved at the FC level.

171. Intragroup transactions might underestimate true liquidity risk, which is not incorporated in either Pillar 1 or Pillar 2 capital requirements. Insurance subsidiaries provide a sizable amount of liquidity to the banking entities, partly due to the lack of regulatory limits on intragroup transactions. For example, an insurance subsidiary can provide deposits and margins for derivative transactions to its parent or group bank. The above mentioned asymmetric regulatory.

[56] Before entry into force of CRR, NBB regulation foresaw an effective risk weight of 400 percent, including 30 percent for expected loss on equity. This specificity was not retained in the CRR.

[57] In principle, investments in the insurance subsidiaries should be deducted from the parent's capital. The impact of the deduction is similar to imposing a 1,250 percent risk weight on the investment.

[58] The risk weight of subordinated loans would be lower than that of equities, in particular if the bank uses the IRB approach.

regime for liquidity risk, where insurance entities are excluded from the application of LCR and NSFR even if they belong to the banking group, might be behind such transactions

Box 6. Sources of Regulatory Arbitrage

The introduction of Solvency II significantly improves the consistency of banking and insurance sector prudential requirements. In Solvency I, the asset side credit and market risk was not incorporated in the capital charges, while Solvency II covers the risk of both assets and liabilities in a comprehensive manner. Capital instruments are categorized as Tier 1 and 2 with similar conditions as under the banking capital regime. Both generally apply to consolidated banking and insurance groups. However, there are still differences between the banking capital regime (CRD/CRR) and Solvency II.

The biggest difference is the valuation standard. The banking regime allows cost basis accounting in a wide variety of assets, while Solvency II requires market consistent valuation for the entire balance sheet. Capital requirements of banks are generally based on the GAAP figures, where amortized cost is available for loans and the held-to-maturity (HTM) bond portfolio. On the other hand, Solvency II requires more mark to market valuation even for such portfolios. This could be an incentive for intragroup transactions of high quality mortgage loan portfolios from banks to insurers, where the group might be able to generate gains and improve the group capital position.

Requirements for capital instruments are generally weaker in Solvency II. Solvency II allows lower quality capital instruments, such as un-committed credit lines with certain conditions. Unrealized gains from insurance liabilities (so called Value in Force) are widely recognized as core Tier I without any limit. Deferred tax assets (both pre-stress and post-stress) are more generously allowed in Solvency II. In addition, CRD/CRR allows a parent bank to not deduct its investment in insurance subsidiaries and thus allows it to use normal risk weights on those investments, as if they were investments in third parties. In fact, the quality of capital of insurance subsidiaries tends to be lower than the quality of capital at the parent bank or FC level.

Solvency II allows more comprehensive use of internal models, while banks' use of internal models is limited and likely to be restricted more in the future. The banking capital regime has more restrictions on the use of internal models in the risk weight calculations, such as the correlation assumptions in the IRB formula. It is expected that the use and output of internal models by the banking sector will be restricted and adjusted in the future, such as through exclusion of the internal model option for certain portfolios and the introduction of a floor for the IRB. On the other hand, Solvency II allows full internal models upon supervisors' approval, which could recognize more diversification and hedging. The NBB is aware of possible weaknesses in the insurers' models (such as correlation assumptions among risk categories, treatment of future deferred tax assets, and recognition of future Volatility Adjustments in stressed scenarios). The difference of the standards and practices might give an incentive for banks to transfer low risk weighted assets (such as mortgage loans) to their insurance affiliates.

Banking groups are subject to liquidity (LCR and NSFR) and leverage ratio requirements, while Solvency II does not have such requirements in Pillar 1. Solvency II also requires risk management to cover material risks, including liquidity risk, whereas the Pillar 1 capital charge for liquidity risk under Solvency II focuses on potential losses from asset fire sales, which is narrower than the risks that the LCR and NSFR are trying to capture. Therefore, the industry practice for liquidity risk management in the insurance sector has not yet been fully established. This might give a strong incentive for banks to transfer their illiquid assets (such as high risk corporate bonds, loans, and infrastructure financing) to insurers. However, BL allows the competent authority to apply a Pillar 2 liquidity measure at the FC level.

Box 6. Sources of Regulatory Arbitrage (concluded)

Solvency II requires much higher capital for spread risk, especially for long term corporate bonds. Solvency II requires covering the mark to market risk of the bond portfolio (including spread risk), while the bank capital requirements for the bond portfolio in the banking book cover only the default risk for banks using the standardized approach and the default and migration risk for IRB banks. The difference is significant for long term corporate bonds. Therefore, insurers are less likely to increase low quality long term corporate bond portfolios, as a result of this conservative approach.

The NBB and SSM are encouraged to review intragroup transactions more carefully to analyze the motivations behind the transactions. The NBB is aware of active intragroup transactions between banking and insurance entities within the Belgian FCs. While intragroup transactions are subject to reporting to the NBB, the analysis of the transactions and discussion with the industry about the motivation behind them may not have been sufficient. The NBB and SSM are encouraged to review the transactions more carefully. Also, they are recommended to address any material side effects from regulatory arbitrage transactions and take appropriate actions (such as the imposition of Pillar 2 and/or Pillar 3 requirements).

Recommendations

172. The SSM and NBB should impose more robust requirements for the integration of risk management by the groups that rely on the Danish Compromise. Article 49 of the CRR requires the competent authorities to be satisfied with the level of integrated management, risk management and internal controls both as a condition for approving the use of the Danish Compromise and on a continuous basis. However, the integration of risk management and internal controls does not yet seem to be sufficient even in the groups that rely on the approach. The SSM and NBB should impose more robust requirements for the integration of risk management in the bank led conglomerates that use the Danish Compromise.

173. The SSM and NBB should incorporate sector-level analysis into the FC level supervision more actively. Solvency II implementation for insurance subsidiaries provides good information about the more economic based measurement of risks. The FC supervisors should also coordinate more closely with the insurance supervisors with regard to the quality of insurance subsidiaries' capital instruments. Supervisors should use the information from supplementary supervision more actively. Consideration of public disclosure would also be an important step forward to ensure that bank-led conglomerates explain to the public their capital position more actively with due consideration of the risks in the insurance sector.

174. The SSM and NBB should monitor liquidity risk and establish a supervisory approach on FC level liquidity risk management. Belgian insurers are exposed to liquidity risk more than before. This implies that banks may not be able to rely on the excessive liquidity which used to be available in the previous crises. Therefore, it is extremely important for the SSM and NBB to develop a robust supervisory approach for FC level liquidity risk (such as more thorough analysis of liquidity risk from intragroup transactions, with potential inclusion of limits).

175. The SSM and NBB should analyze the nature of intragroup transactions. It is important to understand the motivations behind the transactions. Such analysis will help the authorities address any side effects from regulatory arbitrage transactions promptly.

E. Risk Management

176. Article 9 of FICOD requires regulated entities to have in place adequate risk management processes and internal control mechanisms at the FC level.[59] The risk management processes should include: i) sound governance and management with the approval and periodical review of the strategies and policies by the appropriate governing body; ii) adequate capital adequacy policies; iii) procedures to ensure that the risk monitoring systems are well integrated into the FCs' organization; and iv) arrangements to contribute to and develop, if required, adequate recovery and resolution plans. Internal control mechanisms should include: adequate mechanisms as regards capital adequacy to identify and measure all material risks incurred; and sound reporting and accounting procedures to identify, measure, monitor and control the intra-group transactions and risk concentration.

177. The BL implemented FICOD and provides the option to consider the whole group identified as a FC as the relevant scope for risk management requirements.[60] As a result, FCs led by banks are required to comply with the risk management requirements applicable to banking groups, including the maintenance of an independent, comprehensive and effective risk management framework, accompanied by a robust system of internal controls, effective internal audit and compliance functions.[61]

Risk Concentration and Intra-group Transactions and Exposures

178. Article 7 of FICOD requires supervised entities to report significant risk concentrations at the FC level arising from exposures towards counterparties.[62] The coordinating supervisor, after consultation with the other relevant competent authorities, is responsible for identifying the type of risks that must be reported as well as the form and content of the report. The competent authority must also establish thresholds for identifying and reporting each significant risk concentration within the FC. If no thresholds are laid down, risk concentrations are regarded as significant if they are greater than 10 percent of the solvency requirements. Quarterly information on concentrations is provided in regulatory reports (ad hoc adapted version of the FINREP-COREP reporting covering FC specific risks).

[59] FICOD, Article 9.

[60] BL, Article 188.

[61] BL, Articles 167 to 170.

[62] BL, Article 188 and 191; FICOD, Articles 7 and Annex II; and Delegated Regulation (EU) 2015/2303 on risk concentration and intragroup transactions.

179. Article 8 of FICOD requires FCs to have adequate risk management and internal control procedures to identify and report significant intra-group transactions.[63] If no thresholds are laid down by the competent authority, intra-group transactions are defined as significant if they are greater than 5 percent of the solvency requirements of the FC concerned. The law requires supervisors to consider the risk of contagion in the group, the existence of conflicts of interest, circumvention of sectoral legislation, as well as the level of the transactions**.** The SSM Supervisory Manual addresses risk concentration and intra-group transaction reports to build a comprehensive view of the FC risks and complement the analysis of the FC's business model.

180. Supervisors can impose restrictions to control risk concentration and intra-group transactions at the FC level. To prevent circumvention of the sectoral legislation, the BL allows supervisors to impose the sectoral provisions on risk concentration and intra-group exposures at the FC level.[64]

181. Currently information collected and analyzed on FCs may not provide sufficient detail to monitor risk concentrations and intragroup transactions. Regulation 2015/2303 supplements FICOD and expands Article 7 and 8 requirements by establishing more detailed definitions of intragroup transactions and risk concentration. The regulation also establishes reporting requirements to monitor both risks. The regulation has not been fully implemented into supervisory practice.

Off Balance Sheet Activities

182. The legal framework imposes challenges for supervisory authorities to include off-balance sheet activities within the scope of group-wide supervision. The definition of the group of institutions that forms the FC is based on holdings of participations and common management. Where an institution does not fall within the legal definition, the supervisory authority cannot exercise discretion in determining whether particular entities will be considered part of the group. As a result, off-balance sheet activities, including special purpose entities (SPE) tend to remain outside the scope of group-wide supervision.

Recommendations

183. Expectations for the integrated risk management framework in FCs should be more clearly defined. Supervisory procedures (SREP and supplementary supervision) include an analysis of the FC's risk management framework, broadly expanding the procedures used for the banking group. Nevertheless, there seems to be less clarity on supervisory expectations for integrated risk management at the FC level on a number of issues, including risk appetite, governance arrangements, appropriate FC-wide stress test procedures, risk data aggregation and recognition of risk diversification. Thematic reviews and other inspections could be used to define best practices and provide more detailed guidance on supervision manuals.

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[63] BL, Article 192 and FICOD Article 6

[64] BL, Article 170.

184. Supervisory guidance should include evaluation of FC intragroup transactions to determine the economic purpose and provide "red flags" for transactions that may transfer sub-quality assets at book value between affiliates to avoid loss recognition. It should establish scope of coverage such as: investments and inter-company balances, real estate transfers, debt instruments and deposits as well as define supervisory measures and requirements. Transactions should be made at arm's length or the supervisory authority should be notified when they are not.

185. Off-balance sheet activities, including SPEs, should be brought within the scope of group-wide supervision of the FC. Regulation should be amended to allow supervisors to develop a process for determining whether the nature of the relationship between the FC and a SPE requires the SPE to be fully or proportionally consolidated for regulatory purposes. The overall nature of the relationship between SPEs and the FC should be fully considered, going beyond traditional control and influence criteria. Finally, FC stress tests and scenario analyses should take into account all relevant off-balance sheet activities.[65]

186. Guidance in Regulation 2015/2303 concerning intragroup transactions and concentration risk should be incorporated into FC supervision. The regulation provides guidance on defining significant intragroup transactions within an FC, risks that such transactions may pose, concentration risk arising from risk exposures to counterparties that are not part of the FC including off balance sheet items. Also addressed are supervisory measures that may be imposed on FCs to address concentration and intragroup transaction risks.

[65] The mission did not assess the materiality of the risk from off-balance sheet activities.