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Belgium: Financial System Stability Assessment, including Reports on the Observance of Standards and Codes on the following topics: Banking Supervision, Securities Regulation, Insurance Supervision and Regulation, and Securities Settlement Systems

This Financial System Stability Assessment on **Belgium** was prepared by a staff team of the International Monetary Fund and the World Bank as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on **February 1, 2006.** The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of Belgium or the Executive Board of the IMF.

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BELGIUM

Financial System Stability Assessment

Prepared by the Monetary and Financial Systems and European Departments

Approved by Ulrich Baumgartner and Michael Deppler

February 1, 2006

This Financial System Stability Assessment (FSSA) is based on the work of two Financial Sector Assessment Program (FSAP) missions that visited Brussels in December 2004 and March 2005. It also incorporates the FATF AML/CFT assessment undertaken in January 2005, and work done in September 2005 on Security Settlement Systems. The FSAP findings were discussed further with the authorities during the Article IV Consultation mission in November 2005.

The FSAP team comprised Messrs. Abdessatar Ouanès (mission chief), Roger Kronenberg (deputy chief), Richard Podpiera, Alexander Tieman, Elias Kazarian, and Mmes. Jennifer Elliot, Srobona Mitra, Rita Babihuga and Marcia Bailey (assistant), all from MFD; Ms. Magdalena Polan (EUR), Messrs. François Haas (ICM), Wil Dullemond (insurance sector expert, DNB, The Netherlands), Jeffrey Mooney (payments and settlements expert, U.S. SEC), Michael Andrews (banking expert, Canada), and Toby Fiennes (banking supervision expert, U.K. FSA). The FSAP team received excellent cooperation from the authorities and market participants.

- Overall, the financial system is generally sound, resilient to potential adverse shocks, and well supervised. Risks both on the international level and domestically appear well within the banks' capacity to manage them and are well understood by the supervisor and overseer of the system.

- Assessment of Belgium's compliance with internationally accepted standards and codes shows that Belgian supervisors meet the challenges of supervising a large, internationally active financial system, although there were some weaknesses in the insurance and pension areas.

- Preserving Belgium's enviable track record of financial stability would benefit from: (i) addressing, as a priority, identified weaknesses in insurance sector supervision; (ii) establishing an effective mechanism for consolidated supervision of the *bancassurance* groups; (iii) devoting adequate resources and capacity to the oversight and supervisio-n of the Euroclear Group/Euroclear Bank and considerably strengthening coordination between the NBB and the CBFA in this area; and (iv) placing special focus on the monitoring of interest rate risks, internal controls, and liquidity management.

- Over the medium term, the main challenges for the authorities will be to: (i) ensure that their capacity to identify and address risks in the financial system keeps pace with the rapidly evolving market and increased complexity of financial groups against the backdrop of European integration; (ii) overhaul the supervision of the pension industry; and (iii) meet the challenges of the European integration.

The main author of this report is Mr. Abdessatar Ouanès, with contributions from the rest of the team.

FSAPs are designed to assess the stability of the financial system as a whole and not that of individual institutions. They have been developed to help countries identify and remedy weaknesses in their financial sector structure, thereby enhancing resilience to macroeconomic shocks and cross-border contagion. FSAPs do not cover risks specific to individual institutions, such as asset quality, operational or legal risks, or fraud.

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GLOSSARY

ABO	Accumulated Benefit Obligations
AML/CFT	Anti-Money Laundering/Combating the Financing of Terrorism
ATS	Automated Trading Systems
BCP	Basel Core Principles
BPF	Belgian Protection Fund
bps	basis points. A basis point is 1/100 of a percentage point.
BPR	Banking Performance Report
BTBs	Belgian Treasury Bills
CAR(s)	Capital Adequacy Requirement(s)
CBFA	Banking, Finance, and Insurance Commission
CEBS	Committee of European Bank Supervisors
CEEC	Central and Eastern Europe Countries
CESR	Committee of European Securities Regulators
CIK	Caisse Interprofessionnelle de Depôts et de Virements de Titres/Interprofessional Securities Depository Organization
CPSS	Committee on Payment and Settlement Systems
CSD	Central Securities Depositories
DVP	Delivery Versus Payment
EB	Euroclear Bank
ECB	European Central Bank
EMU	Economic and Monetary Union
ES	Euroclear System
ESA	Euroclear SA/NV
EU	European Union
EU–13	Non-Euro EU members—10 new members, U.K, Denmark, and Sweden
EU–15	15 EU members before the 2004 enlargement.
EU–25	All EU members
Euro Area:	12 EU members using the euro
FATF	Financial Action Task Force
FIF	Protection of Deposits and Financial Instruments
FIU	Financial Intelligence Unit
FSAP	Financial Sector Assessment Program
FSASB	Financial Services Authority Supervisory Board
FSC	Financial Stability Committee
FSR	Financial Stability Report
FSIs	Financial Soundness Indicators
GDP	Gross Domestic Product
IAIS	International Association of Insurance Supervisors
IFRS	International Financial Reporting Standards
ICSD	International Central Securities Depository
IOSCO	International Organization of Securities Commission
IT	Information Technology
LCFIs	Large complex financial institutions

LGD	Loss Given Default
LOLR	Lender-of-Last-Resort
MOUs	Memoranda of Understanding
NBB	National Bank of Belgium
NIMs	Net Interest Margins
NPL(s)	Non-Performing Loan(s)
OCA	Insurance Supervision Office
PD	Probability of Default
RTGS	Real time gross settlement
ROA	Return On Assets
ROE	Return On Equity
RSSS	Recommendations for Securities Settlement Systems
SME(s)	Small- and Medium-Sized Enterprise(s)
SSS	Securities Settlement System

I. Executive Summary

Belgium's financial system is large and dominated by a few internationally active *bancassurance* conglomerates. Following a series of mergers and acquisitions, the *bancassurance* model has become a well-developed feature of the Belgian financial landscape and a potential anchor for stability.

The financial system is resilient and benefits from a number of Belgium-specific features that help stability. These include a traditionally cautious attitude toward risk by banks, large holdings of government securities, extremely low holdings of equity by banks, a stable source of funding benefiting from generous tax incentives, a high standard of banking supervision, and a stable macroeconomic policy framework.

Stress tests confirm the system's robustness. Indeed, financial institutions withstood an adverse macroeconomic stress scenario well, helped in part by the compensating impacts of interest rate shocks on banking and insurance businesses within the group level, a major benefit of diversification in the *bancassurance* model. At the same time, the heavy exposure abroad, the open nature of the economy, and the importance of the Euroclear Group globally, make the domestic financial system potentially vulnerable to global economic developments and financial contagion. That said, Belgium's financial sector has never experienced a systemic crisis and has weathered past business cycles well, although not without some strains in the insurance sector.

Near-term vulnerability appears low. This is mainly the reflection of the soundness of the dominant banking system, the generally benign international financial environment, the strong financial condition of the corporate sector, and the relatively healthy financial position of the household sector. Nevertheless, risks still remain and may increase with a downturn in the business cycle, increased cross-border operations, and deeper links to the global money centers.

While the financial position of the insurance industry has improved, serious challenges remain. The very high exposure to guaranteed rate contracts on life insurers' books and the low long-term interest rates will keep profitability and solvency margins under pressure for some time to come.

Overall the Belgian supervisor showed a high degree of compliance with international standards, although there were some major weaknesses identified in the insurance and pension fund areas, which are being addressed. The high quality of supervision is manifested in Belgium's enviable record of financial stability, in the face of a continually changing financial landscape, and real and financial shocks.

The move toward a unified supervisor, while initially posing special challenges, which are being overcome, has helped strengthen overall supervision. Looking ahead, the Banking, Finance, and Insurance Commission (CBFA) needs to build on the recent progress made, take fuller advantage of the synergies with the National Bank of Belgium (NBB), and further enhance its effectiveness. This will help the CBFA position itself to meet new challenges stemming from: (i) the dominant role of *bancassurance* conglomerates in the domestic market and their increasingly international character; (ii) the demands of Basel II and Solvency II; (iii) the implementation of the Financial Services Action Plan and the ongoing integration within the European market; and (iv) the changes in, and special requirements of, new cross-border financial market infrastructures, such as Euronext and Euroclear.

Maintaining the soundness of the financial system and safeguarding financial stability would, in the short run, call for actions aimd at: (i) addressing identified weaknesses in the supervision of the insurance sector; (ii) establishing an effective mechanism for consolidated supervision of the *bancassurance* groups; (iii) devoting adequate resources and capacity to the oversight and supervision of the Euroclear Group/Euroclear Bank; (iv) putting in place an overarching corporate governance framework applicable to the financial sector; (v) continuing to place emphasis on liquidity management; and (vi) further enhancing the existing crisis management arrangements.

Over the medium term, the main challenges are to: (i) ensure that the authorities' capacity to identify and address risks in the financial system keeps pace with the rapidly evolving markets and increased complexity of financial groups against the backdrop of European and global integration; (ii) maintain vigilance over the financial sector's expansion abroad to prevent such a beneficial move from threatening the stability of the financial system; and (iii) overhaul the supervision of the pension industry.

Box 1 summarizes the main recommendations stemming from the FSAP. More technical recommendations are discussed in the main body of the report and in the Annex on summary assessments, and the companion paper on Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) prepared by the Financial Action Task Force (FATF).

Since the end of the second FSAP mission (March 2005), many of the FSAP recommendations have either been implemented or are in the process of being implemented.

Box 1. Prioritized Recommendations

Soundness, short-term vulnerabilities, and supervisory issues

- Establish an effective mechanism for consolidated supervision and organize the supervisory structure and approach so as to meet the special challenges posed by the *bancassurance* conglomerates, given their systemic importance.

- Address, as a priority, identified weaknesses in the supervision of the insurance sector by expeditiously upgrading insurance supervision and regulation, and intensifying the monitoring of insurance companies.

- Establish an overarching corporate governance framework for the financial sector.

- Perform stress tests in a more systematic and regular way and use the results to inform the Financial Stability Committee (FSC) discussions.

- Continue to place emphasis on liquidity management at the bank and group level for *bancassurance* conglomerates, and provide explicit guidelines for banks on liquidity management to complement the current informal discussions.

- Enhance the resources and capacity focused on the oversight and prudential supervision of the systemically important Euroclear System (ES) and further strengthen cooperation in this area between the NBB and the CBFA.

- Build on the progress made so far to take fuller advantage of the synergies between the NBB and the CBFA, and make the CBFA work more efficiently and effectively within the existing legal structure.

- Further refine the existing crisis management arrangements to ensure that there is an effective and tested crisis management mechanism in place.

- Introduce more flexibility in setting the maximum guaranteed rate in life insurance and de-link the guaranteed rates in insurance and pensions to prevent a further build-up of vulnerabilities.

- Begin strengthening substantially the prudential supervision of pension funds.

Medium-term challenges

- Ensure that the capacity to identify and address financial system risks keeps pace with market developments, innovations, and increasing complexity of financial conglomerates.

- Overhaul the supervision of the pension industry.

- Revisit a number of features in the supervisory institutional arrangements in light of the experience gained, with the view to further enhancing synergies with the NBB and strengthening the effectiveness of the management boards of the CBFA and the Financial Stability Committee.

- Streamline and harmonize laws and regulations applicable to the mandate of the CBFA.

- Meet the challenges of the implementation of the Financial Services Action Plan and reap the benefits of European integration.

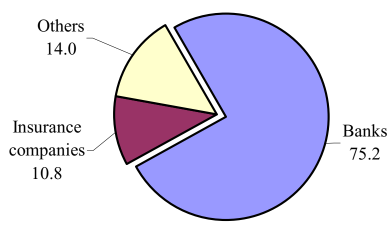
II. Financial Environment

1. **Belgium has emerged from the slowdown of 2001–02 with a stronger economic performance than many of its European partners.** Following two years of lackluster growth, economic activity picked up modestly in 2003 and strengthened in 2004, supported by prudent macroeconomic policies and a more favorable global environment. With weak domestic demand in trading partners, growth slowed down in early 2005 but the recovery has since resumed and is expected to strengthen in 2006.

2. **Belgium's large financial system is dominated by a few internationally active *bancassurance* conglomerates, which account for over 80 percent of bank assets and nearly 50 percent of total insurance premia (Figure 1, Box 2, and Table 1)**. Banking is by far the largest component of the financial sector, with assets of over EUR 1.3 trillion in 2005 (over 440 percent of GDP), making the banking sector much larger, in relative terms, than that of the U.S. or the Euro area. The insurance sector, which plays an important role through the *bancassurance* groups, is somewhat smaller, with assets equivalent to less than 60 percent of GDP. The Belgian stock exchange is relatively small, but it is hoped that its recent integration in Euronext will boost its visibility and potential growth. On the regulatory front, as many other EU countries, Belgium has recently adopted a system of consolidated supervision under the newly established CBFA.

Financial Sector Composition, 2004

(percent share of total assets)



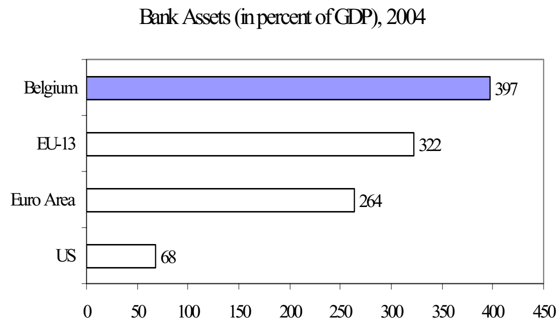
Source: NBB

3. **Belgium's financial sector has never experienced a systemic crisis, and it has weathered past business cycles well, although not without some strains in the insurance sector.** Belgian banks showed great resilience in the face of adverse market conditions and economic developments during the downturn of 2001–02, and have since improved the quality of their loan portfolios, and brought operating costs down. In contrast, insurance companies, which experienced a serious erosion in their safety margins during the slowdown, have continued to perform less satisfactorily in the current low interest rate environment. In part, this is due to the legacy of old contracts with high guaranteed returns and to a lesser extent to the inability of insurers to take full advantage of the recovery in equity prices because of a shift of their assets into fixed income securities.[1]

[1] Following the stock market downturn in 2001–02, Belgian insurers, as a group, reduced the share of equity by half (from 25 percent in 2000 to 13 percent in 2004) and increased their investment in corporate and government bonds. At end-2004 as much as 56 percent of their portfolio was in fixed income securities.

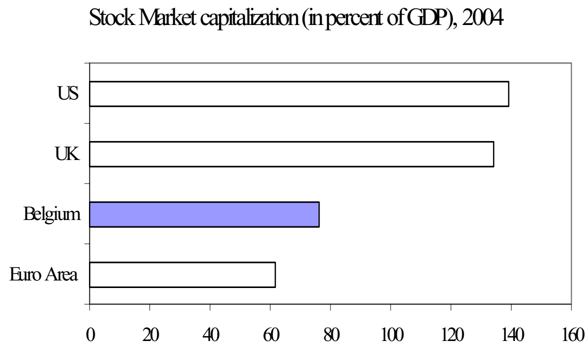
Figure 1. Belgian Banking Structures Compared

The Belgian banking sector is relatively large.



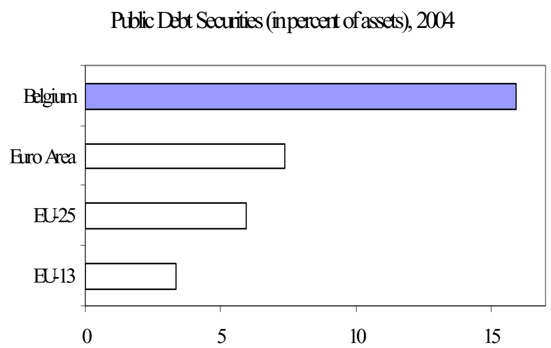
Source: The NBB, the ECB, the Federal Reserve Board, staff estimates.

But its stock market capitalization is comparable to the Euro area.



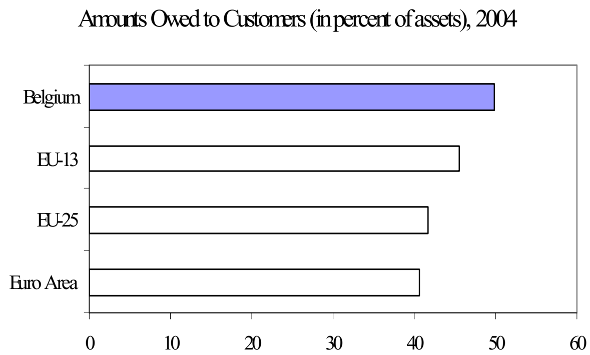
Source: The Global Financial Stability Report (IMF).

A large share of bank assets comprise debt securities from public bodies,...



Source: The ECB.

...which is funded by a large base of customer deposits.



Source: The ECB.

Box 2. Belgian Bancassurance Conglomerates

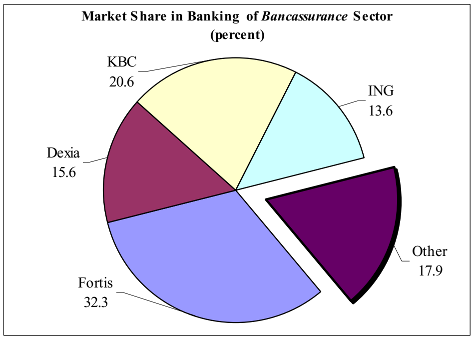
***Bancassurance* conglomerates dominate the Belgian financial system.** The major banks and insurance companies in Belgium are part of cross-border *bancassurance* groups. In 2004, the four largest *bancassurance* groups accounted for 82 percent of deposits and 44 percent of total insurance premia.

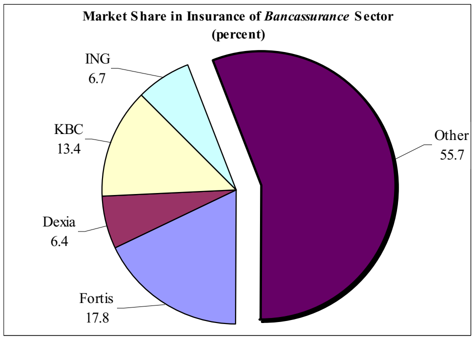
Main Bancassurance Conglomerates (2004, in percent)

	Market Share in Belgium 1/		Contribution to Group Profit 2/	
	Banking	Insurance	Banking	Insurance
Fortis	32.3	17.8	59.1	40.8
Dexia	15.6	6.4	88.5	11.5
KBC	20.6	13.4	85.8	16.2
ING Belgium	13.6	6.7	91.4	8.6
Total	82.1	44.3	...	...

Sources: The NBB and companies' reports.

1/ Measured by deposits for banks and premia for insurance companies for Belgian banking and insurance activities only.
2/ Shares may not add to 100 percent; a portion of profit/loss may be attributed to holding company.





Source: The NBB and companies' reports.

The cross-border *bancassurance* model poses a challenge to supervision. Various Memoranda of Understanding (MOUs) have been concluded between home and host supervisors to facilitate the consolidated supervision of the banking activities of the *bancassurance* groups, as well as the consolidated supervision of these groups at the holding level.

The *bancassurance* model has both benefits and risks. On the positive side, the conglomerates are able to offer a full range of financial products—traditional banking, mutual funds, and insurance products—which helps them respond to changes in market conditions, tax rules, as well as client preferences, and stabilizes the funding base. There is also a potential to diversify risk, as confirmed by the stress test exercise. Due to the differences in duration of asset and liabilities in banking and insurance, interest rate risk is likely to have an opposite impact on the economic capital of the banks and insurance subsidiaries. Revenue and cost synergies may be feasible as well. Nevertheless, more complex structures are likely to be less transparent, and the close relationship between two businesses with substantially different regulations creates room for regulatory arbitrage, particularly if the supervision in the two sectors is uneven.

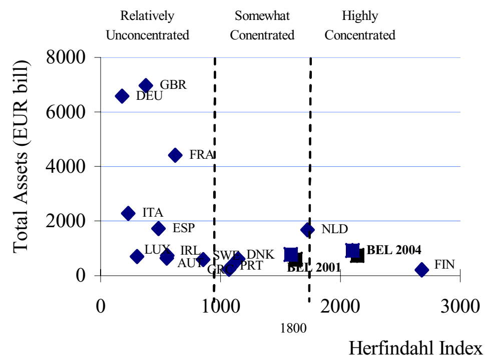
Table 1. Supervision of Belgium's Major *Bancassurance* Conglomerates 1/

Area	Fortis	Dexia	KBC	ING Belgium
Legal Structure	Belgo-Dutch group with banking and insurance arms. The banking is headed by the Fortis Bank with important banking subsidiaries in The Netherlands and Luxemburg. The insurance arm is headed by a Dutch company with important insurance subsidiaries in Belgium and The Netherlands.	Belgo-French group with predominantly banking activities organized via its subsidiaries in Belgium, France, and Luxembourg and an important U.S.-based insurance company (FSA), specialized in credit enhancement.	Belgian group with banking (predominantly) and insurance subsidiaries.	ING Bank Belgium and ING Insurance Belgium are distinct Belgian subsidiaries of the Dutch ING Group.
Banking	The CBFA consolidating supervisor of Fortis' banking arm. Given the importance of Fortis Banque Luxembourg and Fortis Bank Nederland Holding, a specific MOU for the supervision of Fortis Bank exits between the Dutch Supervisory Authority (DNB), the Luxembourg Supervisory Authority , and the CBFA.	The CBFA is the consolidating supervisor of the Belgian subsidiary Dexia Bank Belgium. The French supervisor (CB) and the Luxembourg supervisor (CSSF) ensure the consolidated supervision of Dexia Crédit Local and Banque Internationale du Luxembourg respectively.	The CBFA is the consolidating supervisor of the banking activities. Specific MOU's have been concluded with the supervisory authorities in Poland, the Czech Republic, Hungary, and Slovenia.	The CBFA is the consolidating supervisor of ING Belgium, covering ING's banking activities in South-West-Europe. Regular contacts and collaboration are maintained with DNB, responsible for the consolidated supervision of the entire ING Group.
Insurance	The CBFA supervises the Belgian insurance companies. As such, there is no consolidated supervision for the Fortis insurance pool. However, conforming to the Helsinki protocol, a coordination committee of the relevant insurance supervisors has been established under the lead of the DNB.	The CBFA supervises the Belgian insurance companies. There is no "consolidated" supervision of the insurance pool.	The CBFA supervises the Belgian companies. As such, no consolidated supervision is exercised over the insurance activities.	The CBFA supervises the Belgian insurance companies on a company basis. As such, no consolidated supervision is exercised over the insurance activities.
Holding	The CBFA coordinates the supervision of Fortis group under the terms of the framework for the exercise of the supplementary supervision at Fortis' group level, signed with the DNB in 2002.	The CBFA is the consolidating supervisor of Dexia SA (financial holding) in close collaboration with CB and CSSF. A specific MOU has been signed with these two banking supervisory authorities in 2000.	The CBFA is the consolidating supervisor of KBC group financial holding company.	No CBFA supervision at holding level as bank and insurance activities are kept separately in ING. Nevertheless, recently a joint CBFA on-site examination of the internal audit function (banking and insurance) has been undertaken jointly by the Banking and Insurance Departments in collaboration with the DNB.

Source: CBFA and NBB's *Financial Stability Review* 2005.
1/ Banking activities also include investment services (securities and asset management).

4. **Belgium has one of the most concentrated banking sectors in Europe, and a high degree of openness to outward investment, particularly with the rest of Europe.** The four largest *bancassurance* groups together account for 88 percent of banking assets compared with an average of 55 percent for the EU-15, and the Herfindahl Index now exceeds 2,000.[2] Despite the high concentration, low overall net interest margins suggest that the system could still be competitive in some segments of the loan and deposit markets. The large number of small and medium-sized banks provide competition in savings deposits and the mortgage market. The markets for savings products and private banking are exposed to foreign competition. However, with its large network of retail branches, the big banks have an advantage over new entrants in retail banking. This does not, however, preclude foreign banks' entry through mergers and acquisitions.

Market Size and Concentration in Belgium Compared to EU, 2004



Source: ECB

A. Banking Sector

5. **Financial soundness indicators point to a healthy, profitable, and relatively efficient banking system.** Belgian banks enjoy high ratings. Profitability, as measured by return on assets (ROA), is on the low side in EU-13 comparison. However, Belgium ranks higher when profitability is measured by return on equity (ROE), reflecting the fact that Belgian banks are more leveraged than many of their EU-13 counterparts. *Bancassurance* groups have tended to follow a low-risk-low-return implicit strategy, with a large portfolio of securities holdings, low-spread interbank positions, and emphasis on relationship lending to small and medium-size enterprises (SMEs). Net interest margins have, therefore, been comparatively low, despite being the main income source for banks. Fee and commission income has been gradually rising due to a shift from bank deposits to bank-based mutual funds (Figure 2). While a great deal of progress has been made in containing operating costs, the large network of retail branches will continue to constrain cost reduction efforts.

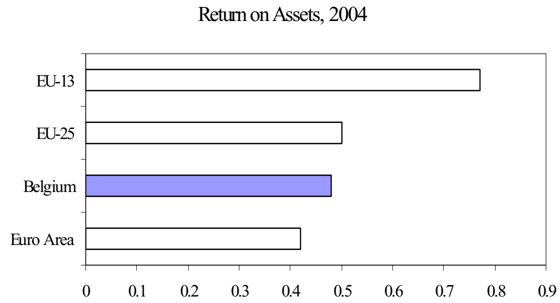
Long-term local currency ratings of Belgian banks

	Fitch	S&P
Fortis	AA-	AA-
Dexia	AA+	AA
KBC	AA-	A+
ING Belgium	AA-	AA

[2] The Herfindahl index is defined as the sum of the squared market shares (in percent) of all market participants. Hence, the index varies nonlinearly with markets shares and can attain values between 0 (no concentration) and 10,000 (complete concentration, monopoly). Values higher than 1,800 are generally considered as reflective of a highly concentrated sector.

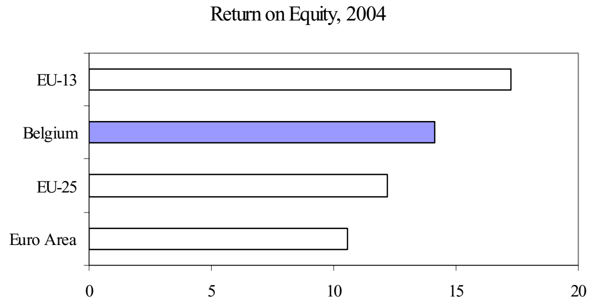
Figure 2. Belgian Banking Soundness Compared

Return on Assets (ROA) of Belgian banks is comparable to the Euro Area.1/



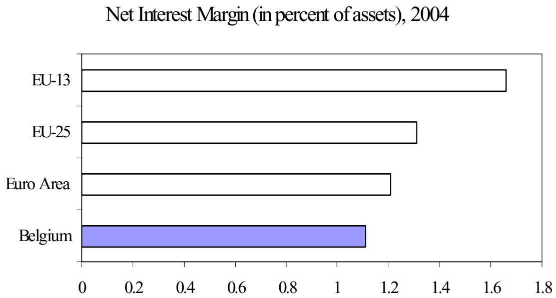
1/ After tax, percent of total assets.

...but their Return on Equity (ROE) ranks higher. 2/

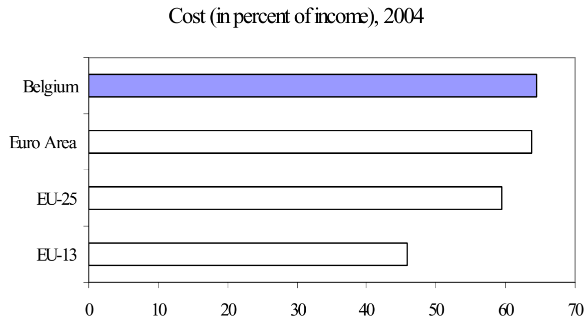


2/ After tax, percent of Tier I.

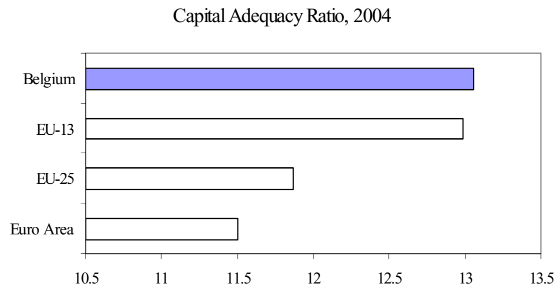
The low ROA is partly due to very low net interest margins...



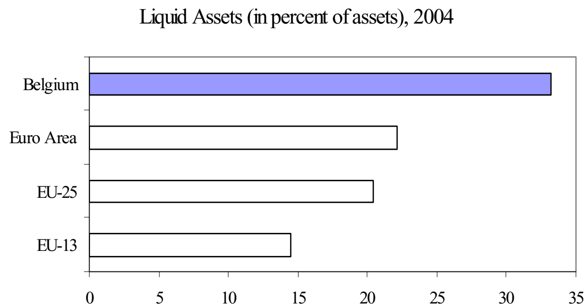
...and a high cost structure.



But Belgian banks are well capitalized...



...and highly liquid. 3/



3/ Liquid assets include cash, short term government debt, loans to credit institutions, debt securities by public bodies.

Source: The ECB.

B. Insurance

6. **The insurance industry, which is of moderate size (9 percent of GDP in annual premia) has been facing a number of serious challenges since the downturn in economic activity in 2001–02.** The Belgian insurance market is less concentrated than the banking sector. The *bancassurance* network is the most important distribution channel for life insurance, while independent agents account for the majority of nonlife premium collected in Belgium. As in many other countries, the insurance industry in Belgium has had to contend in recent years with pressures arising from a major adjustment in equity prices, depressed level of insurance premia in the late 1990s, historically low interest rates, and rising reinsurance costs. These developments led to a substantial erosion in the solvency of many insurers and exposed the risk associated with liability contracts offering guaranteed returns. While the financial position of the insurance industry has markedly improved, serious challenges remain, as the high proportion of guaranteed rate contracts on life insurers' books and the low long-term interest rates will keep profitability and solvency margins under pressure for some time to come.

C. Pension Funds

7. **The Belgian private pension fund industry is relatively small, but it is growing in response to generous tax incentives.** The second pension pillar includes all collective private pension plans—organized on a company, sectoral, or occupational level—both in the form of pension funds and group insurance. Total reserves are still modest (EUR 42 billion) and are held mostly in the form of group insurance (75 percent), with only about EUR 11 billion held in the form of pension funds. However, the importance of pension funds is likely to grow over time as a result of recent reforms. Pension funds are heavily exposed to equities, both directly and through investments in mutual funds. Overall, equities account for nearly half of total pension fund investments, but sufficient information about pension fund liabilities is not available to assess whether such exposure is prudent. There are also major weaknesses in the supervision of pension funds, including: (i) the virtual lack of onsite inspections and analysis of offsite reports; (ii) absence of a risk-based supervision system; and (iii) lack of a uniform system for assessing risk exposures, funding levels, and investment strategies.

D. Capital Markets

8. **The dominance of small and medium-size companies and a history of high public debt have shaped the features of the Belgian capital market.** The importance of SMEs has not been conducive to the development of an active corporate bond market. A tradition of strong ownership concentration has also limited the attractiveness of the stock market for issuers and investors. The Belgian stock market capitalization, at close to 77 percent of GDP, is in line with the Euro area average. Reflecting the importance of the financial system, close to half of market capitalization consists of *bancassurance* listings. The integration in 2001 of the Brussels stock exchange into a pan-European structure (Euronext), has offered potential benefits (an increased visibility vis-à-vis institutional and international investors, and the benefit of a large pool of liquidity), which have helped revive it. However, the risk of a marginalization of the bulk of Belgian listed companies remains, given the relatively small size of these enterprises.

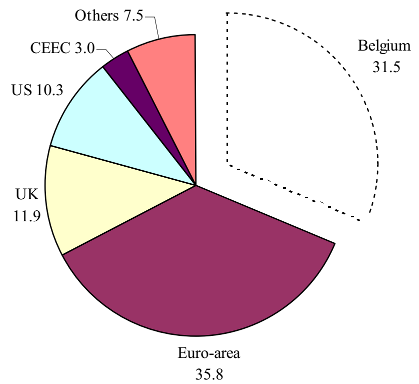
III. Sources of Strength and Potential Risk

9. **In addition to systemic macroeconomic risks, which are explored more fully in the stress testing scenarios, there are a number of sources of strength and potential risk.** These include the large international exposure of the financial system, the financial health of the counterparties, the role played by a global securities and settlement system located in Belgium, and the dominance of guaranteed rates in past insurance contracts.

A. International Exposure

10. **Belgian banks are increasingly foreign oriented.** Total foreign exposure (including all financial assets) of the banking system nearly doubled since 1999 and at end-June 2005 exceeded EUR 850 billion (over sixteen times system-wide own funds). Major *bancassurance* groups accounted for the lion's share (95 percent) of this exposure. Foreign exposure is, however, mostly concentrated in Western Europe and the U.S. (85 percent). In particular, the U.K., The Netherlands, and the U.S. are the largest exposures, accounting for close to 50 percent of total foreign exposure. Exposure to Central and Eastern Europe Countries (CEEC), mostly the Czech Republic, Hungary, and Poland, has been growing very rapidly and currently accounts for 5 percent of total foreign exposure (equivalent to about 61 percent of own funds). Virtually all the exposure in CEEC is concentrated in one major Belgian group. This banking group, draws a quarter of its income from CEEC countries, making it vulnerable to major disturbances in that region.

Euro Area has the largest share of regional exposures of Belgian banks



Source: The NBB.

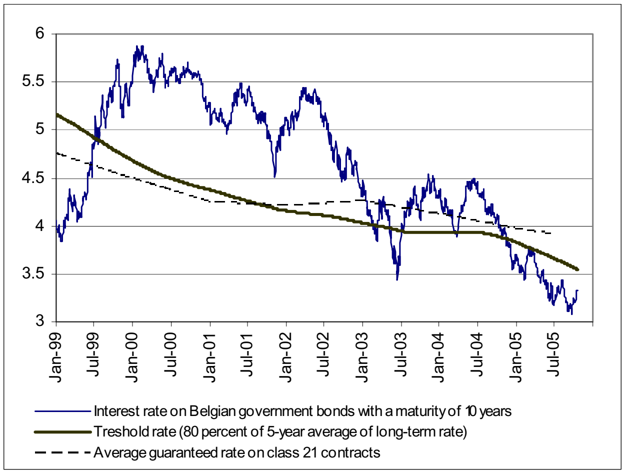
B. Counterparties: Corporate and Household Sectors

11. **The financial condition of the corporate sector is strengthening on the back of the world economic performance and benign financial conditions.** The recovery of profits, which started in 2003, gained momentum in 2004, with the median return on equity of large and medium-sized nonfinancial enterprises reaching 9.1 and 7.0 percent, respectively. This translated into higher solvency ratios (own funds as a ratio of the balance sheet total), which increased to a peak of about 30 percent for all companies. While the number of bankruptcies increased in 2004, the number of assets involved fell and both of these indicators were down in early 2005, suggesting a more resilient and credit-worthy corporate sector. Moreover, corporate sector balance sheets are not particularly vulnerable in Belgium since Belgian firms are less leveraged than their Euro area counterparts and the sector's debt/equity ratio is now 63 percent. Also, banks have lowered their risk profile through relationship lending to SMEs who dominate the corporate sector.

12. **Household financial position remains strong, with financial assets hovering around 400 percent of disposable income, and a stable debt/GDP ratio at around 42 percent.** Substantial household financial assets reflect the strong savings ratio of Belgian households (12.3 percent of gross disposable income). The aggregate level of indebtedness of Belgian households remains low at 66 percent of disposable income, even as growth of outstanding mortgage loans accelerated. Household loans, comprising 49 percent of the banks' loan portfolio, have sharply risen in the last few years even as corporate lending decreased, but nearly 75 percent of household borrowing is secured by mortgages. While residential real estate prices have been increasing strongly with some of the pick-up prompted by fiscal measures, the increases have been less than in some neighboring countries.

C. Insurance Industry's High Exposure to Guaranteed Rates

13. **Insurance products with guaranteed minimum returns are popular in Belgium, but the relatively high level of guaranteed returns creates a challenge for insurers in a low interest rate environment.** Life insurance policies with guaranteed returns remain the most popular type of contract in Belgium, accounting for over 80 percent of life insurance premium in 2003. Driven by competition, insurance companies offered the maximum allowed guaranteed return of 4.75 percent until 1999 and 3.75 percent thereafter, one of the highest in Europe.[3] Long-term interest rates have traditionally been much higher than the average guaranteed rates, but the difference between these has narrowed since 1998 and even became negative at some point. This makes it difficult for insurers to obtain a sufficient investment income to cover their obligations.



D. Global Center for Securities Settlement

14. **Belgium has growing importance in the region as a center for securities settlement.** Belgium is the home country for a major global securities settlement system (Euroclear Group) that provides settlement and custody services for both international and European domestic securities, and offers associated banking services (Box 3).

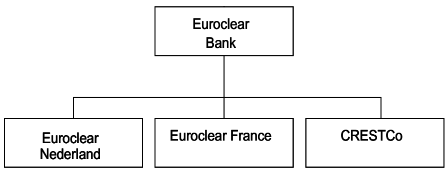
[3] Guaranteed rate insurance products are a major feature of European life insurance not only in Belgium. More recently, based on market developments, Belgian insurers lowered the guaranteed returns of new contracts to the proximity of 3 percent.

Box 3. Euroclear System: a Major International Central Securities Depository

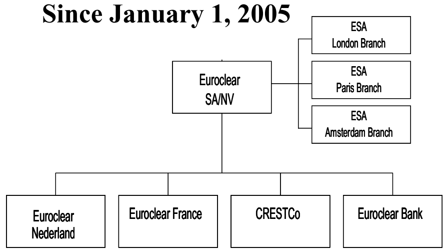
Importance of the ES. The ES has a network covering 31 domestic markets worldwide and plays the role of investors' settlement system for many domestic securities. For some of them (e.g., the German bonds market), a significant part of the secondary market is internalized in the ES. Eurobonds and other international securities constitute the core market of the ES. The turnover on a consolidated basis for the Euroclear Group averaged EUR 307 trillion in 2004 and the total value of securities held on behalf of customers hovered around EUR 5.9 trillion at end-2004. (The corresponding figures for the Euroclear Bank are EUR 132 trillion and EUR 3.5 trillion, respectively).

Corporate Structure of the ES. The Euroclear Group has recently undergone a major corporate restructuring that altered the current structure, roles and responsibilities of different entities within Euroclear Group including that of the Euroclear Bank (EB). A new holding company, Euroclear SA/NV (ESA), was set up and it owns directly the EB and the national central securities depositories (CSDs). As a result of the restructuring, EB has relinquished its ownership of the group's three CSDs—Euroclear France, CrestCo, and Euroclear Nederland—and instead has become a sister company, under the ownership of the ESA.

Until December 31, 2004



Since January 1, 2005



Supervision and oversight. A cooperation framework was laid down in a new multilateral MOU, signed in the beginning of 2005 by the Belgian authorities and the authorities of the countries where the domestic CSD is part of the ES (France, The Netherlands, and the United Kingdom). The NBB and the CBFA cooperate on the basis of their respective responsibilities and have recently enhanced and intensified their coordination of the oversight and prudential supervision of the ES.

Systemic Risk and Stability Issues. Given the size of the operations in this financial infrastructure, its global reach, and the potential for a number of known risks (settlement, operational, credit, and custodian risks), it can have major implications for the stability of the financial system.

- Systemic risk that could impact the CSDs if the EB becomes insolvent has been reduced with the corporate restructuring.

- The FSAP has analyzed the risks posed by the ES in the context of the CPSS-IOSCO recommendations for settlement systems. The assessment demonstrated that the ES is a safe, sound, efficient, and reliable system. Furthermore, the ES observes almost all CPSS/IOSCO Recommendations for Securities Clearing and Settlement Systems. Nevertheless, it was recommended that: (i) the EB enhance its risk management procedures to establish and manage links to other markets and the ESA put in place procedures to identify and solve potential conflicts between different interests of the users and shareholders; (ii) the authorities in Belgium amend the regulation on settlement finality in order to abolish the zero-hour rule for nonfinancial participants in the ES; and (iii) the CBFA and the NBB increase the effectiveness of their cooperation and strengthen their overall capacity for supervision and oversight.

IV. Soundness and Short-Term Vulnerability

15. **Overall, the financial system in Belgium is resilient and appears to benefit from a number of Belgium-specific features that help anchor its stability (Table 2).** Nevertheless, the increased complexity and evolving strategies of the *bancassurance* groups, the system's openness and related large cross-border activities, the pressure for growth and performance, and the special role played by the Euroclear Group will pose a particular challenge to the authorities as they seek to maintain and strengthen stability.

16. **The banking sector in Belgium has an impressive record of uninterrupted systemic stability.** This is largely due to a number of factors, including:

- **A generally cautious attitude toward risk:** Banks have generally tended to follow a low-risk, low-yield approach. Their loan portfolio is heavily weighted toward higher-grade corporate borrowers, while risks in the SME and the household sector have been mitigated by their close relationship-lending approach, supplemented, when needed, by appropriate collateral (e.g., mortgage lending).

- **Large holding of government securities:** The high level of government securities in banks' portfolio supports stable returns and systemic liquidity, as these assets can be used as collateral with the NBB. While on a declining trend, these holdings are still quite significant at 17 percent of assets, and higher than the EU average.

- **Extremely low holding of equity:** Banks' holdings of equities have been extremely low (currently less than two percent of their balance sheet). This has partially been the result of legal restrictions that were lifted relatively recently, and the subsequent prudential rules in place. However, it should be noted that the more liberal treatment of equity holdings in insurance companies could lead to regulatory arbitrage within the *bancassurance* groups.

- **Stable sources of funding:** The banks have experienced, and are still experiencing, a steady inflow of large, stable, and relatively inexpensive financial savings, due to the high Belgian savings rate, benefiting from tax incentives (Box 4).

- **A high standard of banking supervision and a stable macroeconomic policy framework.**

- **Diversification benefits, cost savings, and other synergies associated with the *bancassurance* model** (although, as noted in Box 2, the *bancassurance* model could also entail certain risks).

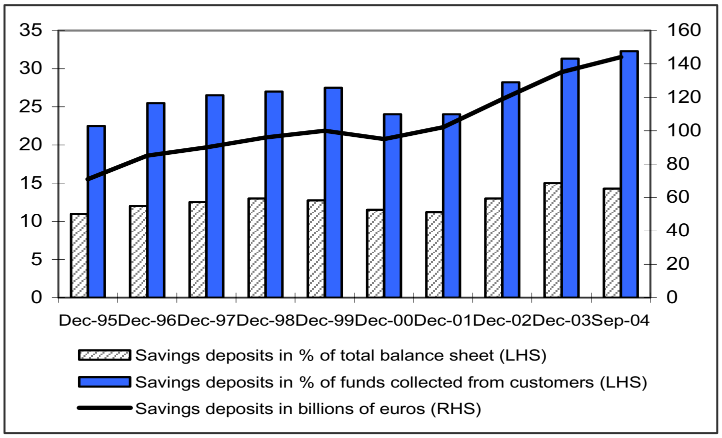
17. **The stress tests provided further confirmation of the resilience and stability of the Belgian banking system (Box 5 and Tables 3–5).** They showed that the Belgian banks exhibit considerable resilience against shocks but are vulnerable to interest rate and credit risks.

Box 4. Fiscal Incentives and Stability of Banks' Funding Source

Belgian banks have long enjoyed a very stable funding source in the form of savings deposits. Belgian households have traditionally had a high savings rate, in part due to Ricardian effects of a historically high government debt, precautionary savings for old age, and various fiscal incentives. These deposits are subject to important regulations affecting their pricing, remuneration structure, and their fiscal treatment. They represent a significant proportion of banks' liabilities on an unconsolidated basis and raise important stability issues.

Importance of regulated savings deposits

Regulated savings deposits have more than doubled in the last decade and at end-2004 amounted to EUR150 billion, equivalent to over 50 percent of GDP. Reflecting this, the share of savings deposits represents over 15 percent of banks' liabilities and a third of funds collected from customers on an unconsolidated basis. The major bancassurance groups attract the lion's share of these deposits (70 percent), but the smaller banks' share is increasing in response to their more aggressive stance on pricing.



Fiscal treatment

These deposits are free from the regular 15 percent withholding tax, up to the maximum annual limit of EUR 1,520, if the basic conditions outlined in the law are met. These conditions include the requirement of a tiered remuneration structure, consisting of a base rate and premia, whereby the limits for the base rate and the various premia are set at 4 and 2 percent respectively. The noncumulative premia consist of an *accrual* premium and a *loyalty* premium, with the former applying to new inflows into savings books that remain on the account for at least six months, and the latter applying to outstanding savings account balances that remain on the account for at least 12 months. Since banks apply the tax exemption per savings account, and there are no requirements for banks to report taxes on a consolidated basis, taxpayers can completely evade taxes by opening multiple savings accounts. So far, there has been no significant attempt to trace tax evaders.

Stability Implications

Regulated deposits have been fairly stable over time and provided a large pool of stable funding for banks, including for their longer term mortgage financing operation. That said, an accurate assessment of their effective duration will be important in the banks' risk management models. The use of regulated savings deposits, with a priori an indeterminate maturity to finance long duration assets, including mortgages, creates a significant mismatch making the banks vulnerable to an upward change in the yield curve. The stress tests undertaken in the context of the FSAP indicated that a parallel upward shift in the yield curve of 200 basis points would lead to a large market value loss, equivalent to about 9 percent of regulatory capital in the four major banks. This loss is, however, cushioned when looking at the *bancassurance* group level, as the insurance component benefits from such a shift. Nevertheless, to mitigate these risks, the duration of the savings book is prudently estimated and a great deal of attention is being paid by both banks and supervisors to liquidity management. The recent joint exercise conducted by the NBB and the CBFA underscores, in this context, the importance increasingly being attached to liquidity management in the system.

A removal of incentives to save in regulated accounts could have significant consequences for banks. Despite continuing popularity of saving books, households are turning toward other instruments, mostly those that offer tax incentives. Banks are quick to offer such products in order to preserve their funding, and to replace the lost interest income by fee income.

Box 5. Stress Tests

Coverage and scope: The stress tests covered the four *bancassurance* conglomerates and two stand-alone large insurance companies, which together account for 82 percent in banking and 76 percent in insurance. The stress tests were run by the financial institutions using their internal risk models, based on September 2004 data. The NBB also performed various top-down tests using supervisory data. These latter tests were updated on the basis of June 2005 data and the NBB reports no major changes in the initial FSAP findings.

The stress tests: The tests consisted of a macroeconomic scenario and a series of single factor shocks agreed with the authorities. *The macroeconomic scenario* envisages a global economic shock which results in low growth combined with shocks to exchange rates, equity prices, and the yield curve. *The single factor shocks* were run for interest rates, equities, exchange rates, real estate prices, credit risk, and for insurance companies only in underwriting and natural disaster risk. They were complemented with analyses of liquidity risks, concentration risk (large exposures), and contagion risk.

Main findings: Overall the stress scenarios presented no major strain on the financial institutions, confirming their general resiliency and robustness.

- **The *bancassurance* conglomerates are able to withstand the macroeconomic scenario relatively well**. Most experience the largest negative shock in the first year, with impact quickly tailing off. Disaggregating the results, the insurance companies tested seem more vulnerable than the banks, particularly to the negative developments in the equities market. On the other hand, the insurance companies stand to gain from higher interest rates in the scenario which counters the price level shock.

- **Banks' sensitivity to interest rate risk and credit risks is considerable**. A 200 bps upward parallel shift in the yield curve results in average losses of 9 percent of capital. A 50 bps upward shift in credit spread results in losses of 3 percent of capital on average. However, in the case of some banks, the size of the credit spread shock seems very large in relation to the quality of their portfolios, and, moreover, for banking book activities, the increase of the credit spread will have a positive impact on the return of credit activity and thus on profitability and solvency.

- **The impact of other market risks on bank capital is small.** Banks' mortgage exposure does not result in large real estate price risks. In addition, the banks are liquid and the risk of contagion from a domestic source through the interbank credit market seems low, as a shift towards cross-border exposure has taken place, and the structure of the interbank market has evolved into a multiple money center network. However, the failure of a major foreign counterpart might still have significant effects on the Belgian banking system. Exchange rate tests were also conducted but had not major impacts.

- **Insurance companies are most vulnerable to a downward shock to equity prices and a downward shift in the yield curve.** A 30 percent price drop results in average losses equal to 30 percent of regulatory own funds (not including hidden buffers, which in some cases are substantial). Meanwhile, a 200bps downward shift in the yield curve results in losses of 35 percent of regulatory own funds at one insurance company. In addition, two insurance companies seem somewhat vulnerable to a large price decline in real estate. The impacts of other market risks, and of stressing underwriting results, are moderate.

- **Compensating impacts of interest rate shocks on banks and insurance companies lead to diversification benefits at the conglomerate level.** Diversification benefits also accrue from exposure to different types of risks by the different entities, such as credit risks in banks and equities risks in insurance companies, and exposure originating from different product lines.

Table 2. Belgium: Bottom-Up Stress Testing Results
(Impact in percent of regulatory own funds)

		Worst Impact	Best Impact	Average 1/
			Market Risks	
			200 bps parallel upward shift of yield curve	
Conglomerate	Total	-8.3	-4.4	-5.6 2/
Bank	Total	-11.2	-5.0	-9.2
Insurance	Total	4.5	20.8	15.4 2/
			30 percent downward equity shock	
Conglomerate	Total	-10.5	-3.4	-7.2
Bank	Total	-2.6	-0.9	-1.8
Insurance	Total	-35.9	-15.7	-26.0
			20 percent decline in real estate prices	
Conglomerate	Total	-4.4	-0.9	-2.6 3/
Bank	Total	-0.8	-0.1	-0.4 3/
Insurance	Total	-12.1	-1.7	-8.6
			50 bps rise in credit spreads	
Conglomerate	Total	-6.8	-0.3	-4.6
Bank	Total	-5.7	0.2	-3.4
Insurance	Total	-19.3	-2.8	-6.7
			Credit Risks	
			60 percent increase PD, 20 percent increase LGD, Portfolio Banks Only 4/	
Total	Provisions	1.5	4.8	3.4
	Expected loss 5/	1.3	5.1	3.0
	Unexpected loss 6/	8.1	20.4	15.5
			Underwriting Results, Insurance Companies Only	
			Natural disaster risk	
Before reinsurance	operating profit	-19.4	0.0	-10.2
	available solvency margin	-7.7	0.0	-2.7 7/
After reinsurance	operating profit	-3.8	0.0	-1.9
	available solvency margin	-0.7	0.0	-0.3
			50 percent worsening technical result	
	operating profit	-24.7	-3.0	-10.2
	available solvency margin	-19.6	0.0	-6.1
			50 percent increase operating costs	
	operating profit	-8.9	-1.0	-5.2
	available solvency margin	-6.2	0.0	-2.0
			Macroeconomic Scenario 8/ 9/	
Total 10/	First year	-7.0	-2.2	-5.1
	Cumulative 3 years	-9.3	-6.8	-8.2
Credit risk 11/	First year	-2.2	0.0	-1.5
	Cumulative 3 years	-5.3	-2.9	-3.7
Interest rate risk	First year	-2.0	3.8	0.9
	Cumulative 3 years	-4.4	4.1	-0.7
Other market risk	First year	-8.6	0.0	-4.6
	Cumulative 3 years	-9.4	0.4	-3.8

Sources: The NBB, the CBFA, and participating financial institutions.

1/ Weighted average of participating bancassurance conglomerates for market and credit risk and the macroeconomic scenario, and weighted average of all participating institutions for underwriting results. Weighting by regulatory own funds.
2/ One banassurance did not report results for its insurance subsidiary. However, this impact is suggested to be small and assumed to be zero for the purpose of aggregation.
3/ Weighted average of three of the four participating bancassurances.
4/ PD=probability of default, LGD=loss given default.
5/ Expected losses are defined as PD times LGD times exposures.
6/ Unexpected losses are defined as capital requirements times exposures.
7/ Weighted average excluding one financial institution.
8/ Cumulative impact.
9/ Best, worst and average results are for three reporting bancassurance conglomerates only. One reporting insurance company is not included for reasons of comparability of the results.
10/ Impact of market value for interest rate and other market risk plus impact on operating profit for credit risk.
11/ Impact on operating profit.

Insurance companies proved vulnerable to a downward equity price shock and fall in interest rates, in particular, and displayed moderate vulnerability to a shock in underwriting results. However, financial institutions withstood an adverse macroeconomic scenario relatively well.

18. **Operational risk poses an additional concern, which was not addressed in the stress tests.** Operational losses have had a significant impact in the recent past. These risks have stemmed from acquisitions (especially from abroad and those that fell outside of banks' main business lines), from the remoteness of some operations abroad, and from simple fraud. To mitigate operational risk, financial institutions should strengthen their internal controls and supervisors should continue to pay sufficient attention to these issues. The implementation of Basel II, including pillar 2 by the CBFA will also help mitigate concerns in this area.

19. **Liquidity management by *bancassurance* groups deserves the full attention of the supervisor.** The development of *bancassurance* groups and the growth of cross-border activities are leading the banking groups to organize their liquidity management on a more integrated basis and on a pan-European scale. Complex banking groups with both banking and insurance activities now tend to include insurance exposures in their global liquidity risk management. The CBFA and the NBB have, since the FSAP, conducted a survey and interacted with major Belgian financial groups on liquidity and collateral management practices. The CBFA also took a number of measures including: (i) stepping up its supervisory activities with respect to liquidity risks, with the major banking groups having already undergone a formal screening of the group-wide liquidity risk management; (ii) exploring various approaches aimed at reorienting CBFA's current prudential approach to liquidity risk; and (iii) working out a revised liquidity reporting framework and quantitative guidelines on liquidity risk management, balancing between the need to improve its current scheme and to prevent excessively burdening the banks.

V. The Supervisory Framework

20. **Belgium introduced a system of consolidated financial sector supervision in January 2004.** Under the new framework, the former Banking and Finance Commission merged with the Insurance Supervision Office (OCA) to create the Banking, Finance, and Insurance Commission (CBFA). The merger was intended to strengthen the supervision of the large financial conglomerates that have come to dominate the Belgian financial landscape.

21. **Effective cooperation between the NBB and the CBFA is, by design, a cornerstone of the new institutional framework.** To facilitate collaboration, two joint bodies were established: the Financial Services Authority Supervisory Board (FSASB), which consists of the supervisory boards of the two institutions; and the Financial Stability Committee (FSC), which is also chaired by the NBB governor and consists of the management boards of the two institutions. Cooperation is also "institutionalized" at the level of the CBFA's Management Committee level (through the inclusion of the three members of the NBB's Board of Directors. In addition, significant synergies were to be exploited between the two institutions, notably in the areas of human resources and IT-related tasks. The NBB continues to have oversight responsibility for the payments systems and has a broad responsibility to promote financial stability.

22. **Dealing with the challenges of integration while coping with the intensive preparation for Basel II and the implementation of many EU directives has not been an easy task.** The significant and tangible progress made to date in the integration process and the strong desire on the part of the authorities to make the current supervisory arrangement more effective are welcome. The authorities have already embarked on a number of important initiatives, including sharpening CBFA's mandate and key priorities; aligning resources with well-established priorities; enhancing accountability; developing and putting in place strategic multi-year action plans; and establishing an internal audit function. The CBFA and the NBB have also endeavored to enhance their cooperation on a number of fronts, including most notably in the development of prudential policy, in dealing with Euroclear Group, and in addressing financial stability issues within the context of the FSC. The recent cooperation on liquidity issues is a good illustration of the success of these efforts in ensuring effective safeguards for the stability of the financial system. Building on this progress will be essential in ensuring an efficient and effective supervision and reinforcing the soundness of the system.

23. **The importance for the CBFA to move expeditiously in upgrading insurance supervision and establishing an effective mechanism for consolidated supervision of the *bancassurance* groups cannot be over-emphasized.** The increasingly complex nature of these cross-sector, cross-border conglomerates and their systemic nature, as well as the challenges posed by the guaranteed rate in life insurance contracts, call for an enhanced and more sophisticated supervisory approach, at both the solo and the group levels, so as to limit the room for regulatory arbitrage, which may have an adverse impact on financial soundness and stability. The CBFA has reacted swiftly by taking decisive actions in a number of areas. The CBFA has already restructured the Insurance Supervision Department and put in place a "Prudential Committee" in charge of prudential policies for banking and insurance, which should enhance exchange of information and collaboration regarding the supervision of complex financial institutions with cross-sectoral dimensions. Measures are being put in place to strengthen insurers' asset liability management. The CBFA is also reinforcing its monitoring of insurance companies, and has recently launched an exercise aimed at stress testing the scenario of a persisting low long-term interest rate. These are important first steps that need to be continued and built upon.

24. **Insurance regulation also needs to be upgraded, particularly with regards to solvency.** While the implementation of the Solvency II project will be helpful, the CBFA should, in the interim, consider further work on enhancing its solvency model. The insurance solvency system in place today is outdated, mainly because it does not take into account the asset-side and mismatch risks. In fact, risk-based capital models suggest that the true capital requirements in the insurance sector are considerably higher.

25. **Other issues that deserve attention include:**

- **Streamlining and harmonizing various laws and regulations applicable to the mandate of the CBFA**. This would enhance supervision and allow for more transparency. It would also provide an opportunity to consolidate and harmonize regulations across sectors (e.g., on fit and proper testing, corporate governance, market conduct, etc.).

- **Establishing an overarching corporate governance framework applicable to the financial sector.** The current system of corporate governance applicable to financial institutions (the so-called *protocol* system) was an innovative instrument of corporate governance at the time of its introduction in Belgium. However, recent developments have prompted the CBFA to review the system in order to: (i) develop a modern framework that will replace the "protocol"; (ii) broaden the scope of application to include all relevant financial institutions; and (iii) establish a flexible framework that, while empowering financial institutions to put in place their own corporate governance structure, sets a regulatory minimum, that provides the CBFA with adequate enforcement tools.

- **Strengthening the prudential supervision of pension funds.** The size of the pension fund industry is likely to grow and so will the risks. Sufficient resources are, therefore, needed and the CBFA should explore the synergies that exists with insurance and mutual fund supervision. The implementation into Belgian Law of the EU Directive (Directive 2003/41/EC of June 3, 2003) should provide a good opportunity to effect the necessary changes in this area.

- **Further enhancing the capacity for prudential supervision and oversight of Euroclear and strengthening NBB and CBFA cooperation.** Given the importance of Euroclear in the system and the increased complexity involved, upgrading the oversight and supervision of the Euroclear Group/Euroclear Bank is important.

- **Stress testing and stability.** Given the insights provided by the FSAP stress tests, the FSC is encouraged to make this exercise a regular feature that informs its discussion of financial stability issues and functions as a tool to ensure a systematic dialogue between the NBB, the CBFA, and the financial sector.

- **Revisiting over the medium term, a number of features in the institutional arrangements.** These include streamlining the CBFA's Management Committee and the FSC Board and reconsidering the joint chairmanship of the CBFA's Management Committee and Supervisory Board. Since a number of these institutional features are embedded in the legislation and associated Royal decrees, a more thorough review and debate would be desirable in light of the gained experience, international best practices in these areas, and the need for balancing Belgian-specific considerations.

26. **Preparations for the introduction of Basel II are on track.** Belgium's major banking groups will adopt the internal ratings based on advanced measurement approaches for credit and operational risk. In fact, institutions representing over 98 percent of the total assets will be opting for the more complex approaches. In the run-up to Basel II, cooperation between the banks and supervisory authorities is intense and frequent. Due to the high quality of assets and the important role played by SMEs, the implementation is not likely to have a negative impact on capital ratios. In addition, as banks have already been using advanced risk assessment tools for individual borrowers for several years, credit extension is unlikely to be influenced in a major way. In terms of resources, the CBFA is aware that the Basel II implementation constitutes a challenge.

27. **The assessments of Belgium's compliance with internationally accepted standards and codes show that Belgian supervisors meet the challenges of supervising a large, internationally active financial system.** While supervision in the banking and securities areas were of high standards, a number of weaknesses were identified in the insurance area (Annex). Looking ahead, however, the CBFA, as a new institution, needs to position itself to meet the new challenges posed by the increasingly international character of the *bancassurance* groups, including their important links to global money centers.

28. **Belgium has a sound legislative AML/CFT framework in place.**[4] It has ratified the relevant international conventions and criminalized money laundering and terrorist financing in line with international standards. The Belgian financial intelligence unit (FIU) is highly effective and professional in carrying out its functions. Belgian mechanisms for responding to mutual legal assistance and extradition requests largely correspond to international standards.

29. **The CBFA has generally adequate powers of supervision and inspection for the financial entities under its regulatory authority and the phasing out of bearer shares will align AML/CFT with international standards.** It is important, however, that the insurance sector be subject to compliance supervision regarding AML/CFT obligations.

VI. Systemic Liquidity, Safety Nets, and Crisis Management

A. Systemic Liquidity Arrangements

30. **Belgian banks enjoy a comfortable liquidity position.** This is due to: (i) a large, and stable savings deposit base; (ii) a broad range of eligible collateral, including large portfolios of government bonds; (iii) access to deep markets, and (iv) the Eurosystem's policy of allowing banks to use required cash reserves for intraday payments. The NBB outlines three main principles under which emergency liquidity assistance can be provided.[5] First, assistance can only be provided as a last resort, after having considered and disqualified all other options, including market options and the ability of the deposit insurance scheme to intervene preventively. Second, emergency liquidity assistance should in principle be fully collaterized, although the central bank organic law does not prohibit uncollaterized assistance in "emergency situations." Finally, it should only be provided in the event of liquidity and not solvency problems, but this distinction is sometimes difficult to make in times of crises.

B. Deposit Insurance and Crisis Management

31. **The deposit guarantee scheme provided by the Belgian Protection Fund (BPF) is a core component of the financial safety net.** Given the rise in cross-border banking activities

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[4] The Report on the Observance of Standards and Codes for the *FATF 40 Recommendations for Anti-Money Laundering and 9 Special Recommendations for Combating the Financing of Terrorism* was prepared by the Financial Action Task Force. These summary findings are drawn from the report.

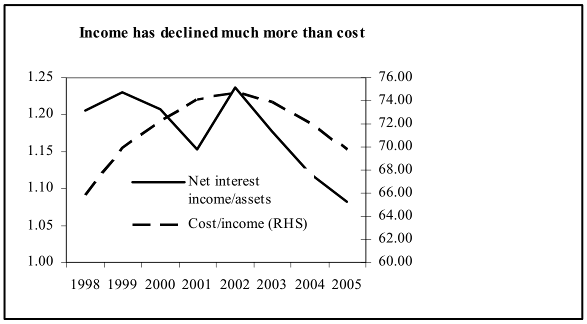
[5] Under the Eurosystem emergency liquidity assistance remains a national responsibility.

and the diversity of national depositor protection systems operated by the EU member states, there is some uncertainty about how well home/host coordination would operate in an actual crisis situation. The review of the EU directive on deposit guarantee schemes that is currently underway should provide an important opportunity to clarify questions.

32. **Despite an enviable track record in financial stability, further strengthening of crisis prevention and management tools is warranted.** The NBB has assembled a broad-based crisis team and established detailed procedures for financial crisis management, which are regularly tested. Given the cross border structure of the *bancassurance* groups, the effective management of a crisis would likely require an ex-ante greater coordination among authorities in several countries. The challenge for the NBB and the CBFA going forward is to identify potential sources of systemic risk, appreciate the cross-border dimension, and fine tune their arrangements in light of tests conducted in this area.

VII. Medium-Term Challenges

33. **The generation of income growth and further improvements in the cost-income ratio remain two of the main challenges facing Belgian banks.** As in nearly all EU banks, net interest margins (NIMs) have continued to remain under pressure. In spite of the growth of interest-bearing assets and liabilities, net interest income for Belgian banks has fallen, reflecting mainly the clear downward trend in NIMs. The NIMs fell from a peak of 1.23 percent to nearly 1.10 percent in 2005 in the context of persistently low interest rates, a flattening of the yield curve, and downward pressures on commercial interest margins (e.g., on mortgage loans and savings deposits, where competition among banks remained strong). At the same time, despite major improvements over the past several years, operating costs have remained relatively high and further significant cuts will be challenging in the Belgian environment. Cost-to-income ratios, while on a declining trend, are high even by European standards, which will pose a challenge, especially with the increasing competitive environment in the European market.



34. **The regulated savings deposits, which form a part of the large and stable funding base for banks, are sensitive to changes in the withholding tax.** Moreover, the deposit rate cap can create distortions in the deposit market in times of high interest rates, while the withholding tax exemption provides opportunities for tax evasion. Should the authorities decide to rationalize the tax system to eliminate distortions, any change in tax policy should take into account its impact on the stability of the banking sector.

35. **Given the inherent risk involved in guaranteed returns, a new build-up of associated vulnerabilities needs to be prevented.** As seen in the stress tests and made clear in the most recent downturn, a further downward shift of interest rates would be very costly for insurers, given the existing stock of contracts. The industry has already adapted by lowering the guaranteed return and guaranteeing a given return only for the current premium. From the

supervisory point of view, there is a need to exercise more flexibility in setting the maximum guaranteed rate, which plays an important prudential role. However, the rate tends to be sticky due to political considerations, mainly because it is linked to the minimum guaranteed rate in pension arrangements and as such, is not determined with prudential, but rather with social considerations in mind. As these two rates have fundamentally different functions and objectives, they should be de-linked to allow the setting of the maximum guaranteed rate to be adjusted to prudential requirements in the insurance industry.

36. **Minimum funding requirements for pension funds are low and a number of funds are underfunded, even compared with these minimum requirements**. While these weaknesses need to be addressed, a significant strengthening of prudential supervision of pension funds is important. The authorities should take advantage of the current benign financial environment to: (i) overhaul the supervision of pension funds; (ii) introduce a risk-based approach and focus supervision on core activities; (iii) revisit the issue of externalization of pension obligations with a view to increasing the minimum funding requirements to a more realistic level; and (iv) review governance of pension funds.

Table 3. Belgium: Structure of the Financial System

	1999	2000	2001	2002	2003	2004	2005 1/
Number							
Banks	119	119	113	111	109	104	102
Domestic 2/	75	72	67	65	61	59	56
Branches of foreign banks	44	47	46	46	48	45	46
Insurance companies	222	209	202	202	189	181	169
Life	31	29	28	30	31	31	30
Mixed	37	35	34	32	31	28	25
Non-life	154	145	140	140	127	122	114
Collective investment institutions 3/	120	128	134	134	132	138	137
Financial holding corporations	26	22	23	26	27	24	21
Securities dealers	49	46	43	40	37	36	32
Real estate investment funds with fixed capital	13	13	12	11	11	11	11
Private closed end equity funds	1	1	2	2	2	2	2
Mortgage companies and regional social housing corporations	6	6	7	7	7	7	7
Financial system assets (in billions of euro) *	1189	1265	1387	1356	1394	1519	1731
Banks	927	971	1064	1025	1033	1143	1331
o/w large banks	798	841	941	908	913	1011	1188
Insurance sector	99	108	118	126	143	164	178
Collective investment institutions 3/	71	83	87	78	85	95	108
Financial holding corporations	72	79	91	99	99	94	89
Securities dealers	7	7	10	10	15	3	4
Real estate investment funds with fixed capital	3	4	4	5	5	6	6
Private closed end equity funds	0	0	0	0	0	0	0
Mortgage companies and regional social housing corporations	11	11	12	13	14	14	14
Assets as percent of GDP *	499	502	536	507	508	527	580
Banks	389	386	411	383	376	397	446
Insurance companies	41	43	46	47	52	57	60
Other institutions	69	73	79	77	79	74	74

Sources: The CBFA and the NBB.

1/ Data for end September 2005.

2/ Credit institutions governed by Belgian law, including those with Belgian-majority and foreign-majority shareholdings.

3/ Includes corporated funds (SICAV), uncorporated funds, and saving pension funds.

* Encouraged set of indicators.

Table 4. Belgium: Financial Soundness Indicators of the Banking Sector 1/

	1999	2000	2001	2002	2003			2004			2005 2/		
					Total	BIG 3/	Others	Total	BIG 3/	Others	Total	BIG 3/	Others
Banking sector			(in percent, unless otherwise stated)										
Capital adequacy													
Regulatory capital as percent of risk-weighted assets *	12.0	12.0	12.9	13.2	12.9	12.4	17.9	12.9	12.6	16.5	11.8	11.4	16.8
Regulatory Tier I capital to risk-weighted assets *	7.7	7.5	8.2	8.6	8.8	8.3	13.7	9.4	9.0	13.0	8.5	8.1	12.6
Capital as percent of assets 4/ *	2.5	2.8	2.7	3.0	3.1	2.8	5.1	3.1	2.8	5.1	2.8	2.6	4.1
Asset composition and quality													
*Sectoral distribution of bank credit to the private sector (as percent of total credit to private sector) 5/ **													
Other financial intermediaries §	5.8	6.1	8.3	8.0	8.8	10.8	2.3	7.9	9.8	1.9	7.5	9.4	1.8
Financial auxiliaries §§	0.5	0.4	0.8	1.5	2.0	2.4	0.5	0.3	0.2	0.6	0.3	0.2	0.5
Insurance corporations and pension funds	0.9	0.8	0.6	1.1	1.3	1.7	0.0	1.6	2.1	0.0	1.8	2.5	0.1
Non-financial enterprises	47.5	48.0	46.7	44.6	41.5	44.1	33.0	40.2	43.5	30.3	37.8	40.8	29.0
Households	45.3	44.8	43.7	44.8	46.4	41.0	64.1	50.1	44.4	67.2	52.6	47.1	68.7
*Sectoral distribution of bank credit to corporations (as percent of total loan exposure) 6/ **													
Construction	4.8	5.1	4.9	5.1	4.9			4.4			4.3		
Real estate	5.3	5.8	6.2	6.6	7.5			7.1			6.9		
Industry	37.7	37.7	38.5	37.2	34.0			35.5			34.6		
Transport, tourism & horeca	13.6	14.1	13.9	13.3	12.1			12.4			12.8		
Energy and utilities	5.2	5.4	5.3	5.7	4.8			5.1			6.0		
TMT	3.1	3.3	3.1	3.0	2.4			2.4			2.6		
Financial	16.5	15.7	16.0	15.9	22.3			23.4			24.1		
Other	13.7	12.9	12.1	13.2	12.0			9.7			8.7		
*Geographical distribution of bank credit (as percent of total bank credit) **													
Belgium	47.2	42.0	38.3	37.1	37.5	35.4	56.7	35.7	33.4	56.3	30.6	28.8	53.6
Other EMU countries	30.0	30.4	33.5	33.7	33.8	34.7	26.0	33.7	34.7	24.9	35.4	35.6	32.6
Other developed countries	17.3	20.4	20.9	22.4	21.5	22.5	12.7	23.7	25.0	12.2	25.5	26.7	9.5
Central and eastern European countries	1.2	2.1	2.9	3.0	3.1	3.4	0.1	3.2	3.5	0.2	3.4	3.6	0.2
Emerging markets and developing countries	2.1	2.5	1.9	1.6	1.4	1.4	1.5	1.3	1.2	2.0	2.1	2.2	0.8
Off-shore centers	2.3	2.5	2.6	2.2	2.6	2.6	3.0	2.3	2.1	4.4	3.0	3.0	3.3
Asset quality													
Non-performing loans (NPL) as percent of gross loans 7/ 8/ *	2.8	2.8	2.9	3.0	2.6	2.4	4.4	2.3	2.2	3.9	2.2	2.0	3.4
Provisions + write-offs as percent of NPL 8/	58.3	57.0	57.0	51.8	52.8	51.6	58.9	54.2	53.6	56.9	51.5	50.2	57.7
NPL net of provisions as percent of tier I capital 8/ *	14.1	15.0	14.4	15.2	15.7	17.7	9.3	12.8	12.8	12.5	13.9	13.6	15.7
Foreign exchange loans as percent of total loans	19.2	22.3	24.9	22.3	22.6	23.9	11.7	26.4	28.1	12.3	32.0	33.6	18.2
Large exposures as percent of tier I capital 8/ *	57.0	51.0	67.0	61.0	46.0	48.0	42.0	40.0	38.0	48.0	38.6	35.6	57.8
10-largest credit to net credits													
Earnings and profitability													
Gross profits as percent of average assets (ROAA) *	0.6	0.8	0.5	0.5	0.5	0.5	0.5	0.6	0.6	0.7	0.7	0.6	1.4
Gross profits as percent of average equity capital (ROAE) *	23.5	29.6	19.2	17.1	17.1	17.8	13.2	21.1	22.2	15.6	24.7	24.5	26.1
Net interest margin (net interest income as percent of interest bearing assets) *	1.5	1.3	1.4	1.5	1.4	1.4	1.4	1.4	1.4	1.4	1.2	1.2	1.5
Gross income as percent of average assets	2.6	2.6	2.5	2.5	2.3	2.2	3.1	2.2	2.0	3.1	2.0	1.9	3.2
Net interest income as percent of gross income	51.6	46.0	47.5	51.4	53.1	55.7	40.3	52.9	55.1	41.8	50.0	51.3	43.5
Non-interest income as percent of gross income	48.4	54.0	52.5	48.6	46.9	44.3	59.7	47.1	44.9	58.2	50.0	48.7	56.5
Trading income as a percent of gross income *	3.2	7.8	7.0	4.4	4.5	5.1	1.5	4.8	5.6	1.4	6.6	7.3	3.6
Non-interest expenses as percent of gross income *	69.9	72.2	74.1	74.7	73.9	72.8	79.5	72.0	70.6	79.0	69.8	69.5	71.6
Personnel expenses as percent of non-interest expenses *	44.5	41.8	42.8	44.3	45.5	47.6	36.1	44.7	47.3	33.4	43.4	46.2	30.5
Spread between reference loan and deposit rates 9/ *	1.6	1.6	1.6	1.5	1.5	*N.A*	*N.A*						
Spread between reference loan and deposit rates 10/ *					1.9	*N.A*	*N.A*	1.9	*N.A*	*N.A*	1.8	*N.A*	*N.A*
Liquidity													
Liquid assets as percent of total assets 11/ *	36.1	35.3	35.3	33.3	33.2	32.0	42.3	32.7	31.5	42.1	31.0	34.7	41.6
Liquid assets as percent of short-term liabilities 12/ *	112.7	100.3	103.2	91.1	86.0	88.1	76.0	86.3	88.9	74.0	81.6	83.5	71.8
Foreign currency liabilities as percent of total liabilities *	25.2	29.8	30.0	26.9	25.1	25.8	20.3	27.1	28.1	19.2	30.8	31.7	23.9
Deposits as percent of assets	51.5	51.9	51.2	52.3	51.5	49.7	65.2	49.9	47.7	66.4	45.5	43.4	63.3
Loans as percent of deposits *	71.8	77.8	76.4	79.7	80.6	84.8	56.2	84.7	89.9	56.5	92.6	97.7	63.6
Sensitivity to market risk													
Off-balance sheet operations as percent of assets	271	269	304	419	448	491	112	535	594	89	425	467	72
of which foreign exchange operations	43	37	35	42	45	49	6	44	48	17	39	41	14
of which interest rate operations	216	213	248	354	379	416	104	474	527	67	363	400	52
other	11	19	22	23	24	26	2	17	19	5	23	25	6
Gross asset position in derivatives as a percentage of tier I capital *	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*
Gross liability position in derivatives as a percentage of tier I capital *	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*
Duration of assets	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*
Duration of liabilities	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*
Net long position in foreign exchange as a percentage of tier I capital *	6.5	7.5	6.8	8.5	7.0	6.3	9.1	5.3	4.5	7.1	5.8	5.3	3.2
Net open position in equities as a percentage of tier I capital *	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*

Sources : The CBFA and the NBB.

1/ Data on a consolidated basis, unless otherwise stated.
2/ September 2005 data
3/ BIG covers the four main banking groups.
4/ Simple ratio of capital to total assets, without risk weighting.
5/ Territorial data. Excluding government, interbank and non-resident loans.
6/ Unconsolidated (solo/company) data from the Corporate Credit Register.
7/ Non-performing loans refer to loans classified as substandard, doubtful, or loss.
8/ Unconsolidated (solo/company) data.
9/ RIR-survey. Difference between lending rate on loans <= 1 year and deposit rate on term deposits >= 1 month and <= 1 year.
10/ MIR-Survey. Difference between lending rate on loans <= 1 year and deposit rate <= 1 year.
11/ Liquid assets consist of cash, short-term interbank claims (maturity < 1 month) and the total securities portfolio.
12/ Short term liabilities consist of short term interbank debt (< 1 month) and sight, savings and short term deposits (< 1 month) of non-bank clients
* Core and encouraged set of indicators

§ Financial auxiliaries include all resident corporations and quasi-corporations engaged primarily in activities closely related to financial intermediation but which do not themselves perform an intermediation role.

§§ Financial intermediaries are units that incur liabilities on their own account on financial markets by borrowing funds, which they lend on different terms and conditions to other institutional units.

Table 5. Belgium: Financial Soundness Indicators of the Nonbanking Sectors

	1999	2000	2001	2002	2003	2004	2005 1/
	(in percent, unless otherwise stated)						
Insurance sector							
Coverage ratio 2/	267.0	265.0	276.0	254.1	248.4	252.1	
Profitability (return on average equity)	26.9	21.5	12.1	-10.4	7.3	18.0	
Life	15.3	12.4	9.4	-3.0	5.6	8.4	
Non-life	10.9	7.6	0.0	-3.7	9.1	13.0	
Corporate sector 3/							
Total debt as a percentage of equity *	95.8	88.6	83.0	79.5	78.2	62.7	
Profitability (Return on equity) *	13.0	11.6	9.8	11.7	12.9	10.3	
Debt service coverage 4/ *	180.7	179.7	113.6	176.7	195.6	185.9	
Net foreign exchange exposure as a percentage of equity *	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	
Number of applications for protection from creditors *	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	
Household sector							
Debt as a precentage of GDP *	41.3	40.3	38.7	39.4	40.3	40.6	41.9
Debt service burden as a percentage of total disposable income *	3.9	3.8	3.6	3.5	3.4	3.2	*N.A*
Financial savings ratio as a percentage of GDP	8.1	7.2	7.7	6.7	6.0	5.4	4.1
Savings rate	17.2	15.4	16.4	15.8	14.3	12.8	12.3
Real estate sector							
House price inflation 5/ *							
Small and medium-sized houses	6.7	4.1	5.3	7.8	7.6	6.8	
Apartments	4.7	7.2	4.4	8.4	8.5	14.5	
Mortgage loans as percent of total loans 6/	21.8	20.3	20.5	22.3	27.6	27.4	26.2
o/w Domestic	15.3	14.2	14.1	14.9	16.1	15.9	15.0
o/w Domestic households *	14.6	13.8	13.3	14.2	15.6	15.5	14.8
o/w Commercial real estate *	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*	*N.A*

Sources : The CBFA, the NBB, and Stadim.

1/ Projection for the year or latest available (June/September 2005).
2/ Available solvency marging over required solvency margin.
3/ Data for 2004 based on a sample of already available annual accounts in the Central Balance Sheet Register.
4/ Earnings before interest and tax as a percentage of interest and principal expenses
5/ Percent change in house price index (1953=100).
6/ Mortgage loans after deduction of deposits related to mortgage loans; consolidated basis.

* Encouraged set of indicators.

OBSERVANCE OF FINANCIAL SECTOR STANDARDS AND CODES—SUMMARY ASSESSMENTS

The annex contains summary assessments of seven international standards and codes relevant for the financial sector. The assessments have helped to identify the extent to which the supervisory and regulatory framework is adequate to address the potential risks in the financial system.

The following detailed assessments of financial sector standards were undertaken:

- The Basel Core Principles for Effective Banking Supervision (BCP),by Michael Andrews (banking expert from Canada) and Toby Fiennes (banking supervision expert, U.K. FSA)
- The International Association of Insurance Supervisors (IAIS) Insurance Core Principles (ICP), by Wil Dullemond (insurance sector expert, The Netherlands FSA);
- The Internaltional Organization of Securities Commission (IOSCO) Objectives and Principles for Securities Regulation, by Jennifer Elliot (IMF, MFD);
- The Securities Settlement Systems CPSS-IOSCO (RSSS): Euroclear System by Elias Kazarian (IMF-MFD); CIK and NBB-SSS by Jeffrey Mooney (payments and settlements expert, U.S. SEC).

The Euroclear Assessment was updated in September 2005 to reflect the corporate restructuring of Euroclear.

The assessments were based on several sources, including:

- Self-assessments by the supervisory authorities;
- Reviews of relevant legislation, regulations, policy statements and other documentation;
- Discussions with the supervisory authorities; and
- Meetings with financial market participants, users of settlement infrastructures, and financial sector associations.

The FATF 40 Recommendations for Anti-Money Laundering and 9 Special Recommendations Combating the Financing of Terrorism were assessed by the Financial Action Task Force. The Associated Report on the Observance of Standards and Codes (ROSC) is distributed separately.

REPORT ON OBSERVANCE OF STANDARDS AND CODES: BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

General

37. The assessment of implementation of the Basel Core Principles (BCP) for Effective Banking Supervision has been completed as part of a Financial Sector Assessment Program (FSAP) in December 2004. It requires a review of the legal framework, both generally and as specifically related to the financial sector, and a detailed examination of the policies and practices of the institution responsible for banking supervision. The assessment team enjoyed excellent cooperation with its counterparts and received all information required.[6] As discussed with the authorities, the assessment was completed against the essential and additional criteria, which were viewed as appropriate for a highly developed country even though the FSAP minimum standard is evaluation against the essential criteria only.

Institutional setting

38. The Banking Finance and Insurance Commission (*Commission Bancaire, Financière et des Assurances*, CBFA) is expressly charged with the oversight of credit institutions. In carrying out its functions, the CBFA cooperates and shares resources with the National Bank of Belgium (NBB) in a number of key areas, including prudential reporting by credit institutions. The NBB has oversight responsibilities for the payment system, and the NBB and the CBFA jointly constitute the Committee for Financial Stability.

General preconditions for effective banking supervision

39. The well developed financial sector in Belgium has benefited from a sound domestic economy which has in recent years enjoyed somewhat higher growth than the Euro area averaged overall. The budget has been in balance or small surplus, but low growth, albeit higher than the European average, has meant that gross public debt has declined only slowly and is still equivalent to nearly 100 percent of GDP.

40. Government infrastructure is well developed, with a substantial body of commercial law and a well respected judiciary. Accounting standards are in transition, with all publicly traded Belgian companies, including banks and insurance companies, required to adopt International Financial Reporting Standards for the fiscal year beginning in 2005.

41. Overall responsibility for the public safety-net lies with the Committee for Financial Stability, which is charged, among other things, with coordination of crisis management, oversight of deposit insurance, and the protection of investors. Liquidity support, if required,

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[6] Toby Fiennes (The Financial Services Authority, U.K.) and Michael Andrews (banking expert, Canada).

may be provided by the NBB in its capacity of lender-of-last-resort, within the broader European Central Bank system.

42. Deposit insurance to a limit of EUR 20,000 is provided by the Fund for the Protection of Deposits and Financial Instruments (FIF), which has broad powers to participate in the winding-up, reorganization, or take-over of a credit institution likely to become insolvent. Participation in the FIF is mandatory for Belgian institutions and foreign institutions from non-EU member states, and optional for institutions from other EU states that participate in their home country's fund. The CBFA has a wide range of remedial powers, and these have been generally used as required, with supervisory action matching the seriousness of the problems detected.

Main findings

43. Belgium has a high overall level of compliance with the essential and additional criteria of the Core Principles. The legal framework is well developed, and practical implementation is strong. The bank supervision staff of the CBFA enjoy a strong reputation for professional skill and integrity, and various projects already underway at the CBFA would address almost all issues noted by the assessment team.

Objectives, autonomy, powers, and resources (CP 1)

44. The CBFA has appropriate autonomy and powers for banking supervision. However, in the context of managing banking supervision within an integrated supervisory agency, it could be helpful to establish a clear, broader mandate for the CBFA to reflect its responsibility to contribute to financial stability and protect consumers through its oversight of banking, capital markets activity, and insurance. This could facilitate assessing risk arising from each area of activity, which could be helpful in dealing with the allocation of resources within the CBFA, and if required, in making a case to increase the total resources of the CBFA.

45. The overall effectiveness of bank supervision has not yet been compromised, but the assessment team is concerned that the need to upgrade capacity in the nonbank areas of the CBFA and to invest in upgrading systems and staff to keep current with evolving best practices such as Basel II, could lead to diversion of resources from the existing sound risk-focused system of bank supervision. While recognizing the need to balance autonomy with accountability and to minimize the costs borne by the industry for the CBFA's operating expenses, there may be a need to revisit the constraints placed on the total resource envelope of the CBFA to ensure that bank supervision is not weakened.

46. The assessment team also notes that the management structure of the CBFA, with three members of the management committee also having senior responsibilities at the NBB, may present some challenges as well as the benefits of ensuring close working relationships between the two organizations. The authorities will find it useful to assess its practical

success in meeting the various supervision mandates of the CBFA after some initial experience is gained with this new management structure.

Licensing and structure (CPs 2–5)

47. Belgium has a high level of compliance with this group of principles. One area for strengthening relates to initial licensing. Consistent with recommendations made for on-going supervision, there is a need to ensure there are sufficiently knowledgeable and skilled non-executive directors to effectively oversee management. This is achieved in practice for the large banking groups, but should be extended more uniformly to smaller banks. Consideration should be given to vetting directors not only for their probity, as is currently done, but also to more formally consider their skills and experience, and the balance of the board as a whole.

Prudential regulations and requirements (CPs 6–15)

48. The body of prudential regulations and requirements is generally appropriate and well enforced in practice. It would be beneficial, and the CBFA has already begun work in this regard, to expand on the provisions of Article 20 of the banking law to provide more explicit legal foundation for the various areas of internal governance and control. A number of these important areas are addressed in the "protocols" signed by most banks or in circular letters of the CBFA, but it would be better to have these governance principles more firmly rooted in the law or regulations. The common practice of issuance of bearer shares by Belgian companies could undermine an otherwise comprehensive approach to anti-money laundering and countering the financing of terrorism, as it is possible for the beneficial owners of accounts held by such companies to change without the knowledge of the bank.

Methods of ongoing supervision (CPs16–21)

49. Belgium has a well developed and effective system of supervision incorporating onsite and offsite work by integrated teams. There is a good risk-focused approach, with larger amounts of supervisory resources devoted to the institutions presenting the greatest systemic risk. Consolidated supervision is effective in practice for the large conglomerate groups due to the existence of specific memoranda of understanding (MOUs) with the other supervisory authorities and the established practices of the bank supervision function. However, there is a need to establish a more formal process within the CBFA to ensure a consistent level of coordination and cooperation between banking and insurance supervision.

Formal powers of supervisors (CP 22)

50. The broad provisions of Article 57 of the banking law permit the CBFA to act quickly, without the need for possibly time-consuming legal proceedings. A wide range of remedial measures is available, and although the CBFA has preferred to use moral suasion backed by the threat of action under the sweeping powers of Article 57, there have been three

instances over the last ten years when a special inspector has been appointed to supersede the control of management and directors of a bank.

Home-host supervision (CPs 23–25)

51. Belgium has a strong home-host regime, particularly with respect to the largest banking groups where specific MOUs are in place. There are also MOUs in place or in the final stages of negotiation with the supervisory authorities in most countries where Belgian banks have significant foreign establishments. CBFA staff routinely conduct onsite work in the significant foreign establishments of their banks, and there is evidence in practice of good information exchange and coordination with foreign supervisory authorities.

Recommendations

52. The recommendations to further enhance the practice of supervision build on a very strong foundation. Most of the recommendations in Table 6 are intended to further strengthen practices which currently meet the minimum standard of the Core Principles, and in most cases, work is already in progress to address the outstanding issues.

Table 6. Recommended Action Plan

Reference Principle	Recommended Action
1.1 Objectives	Consider establishing a broader mandate for the CBFA, which could help in addressing internal allocation of resources, and as required support the case for an increase in total resources.
1.2 Independence	Ensure the quality of banking supervision is not weakened by the need to strengthen the CBFA nonbank supervision functions and to invest in meeting the demands of evolving best practice such as Basel II. Review the effectiveness of the management board structure in achieving its intended objectives.
3. Licensing criteria	Explicitly consider the skills and experience of directors with a view to ensuring that boards of all banks are able to properly oversee management.
5. Investment criteria	Consider linking the power to object to the required notification by amending Article 33bis regarding subsidiaries to parallel the wording of Article 34 (which addresses branches).
13. Other risks	Introduce formal liquidity guidelines for banks.
14. Internal control and audit	Formally assess whether banks' boards have the skills, experience, and understanding of risks to effectively oversee the business.

Reference Principle	Recommended Action
15. Money laundering	Abolish bearer shares or develop an alternative to preclude changes in beneficial ownership without the knowledge of the financial institution. Ensure all key elements of the AML/CFT framework have the force of law.
20. Consolidated supervision	Introduce a more formal and standardized process for coordination and liaison between insurance and banking supervision.
22. Remedial measures	Consider more aggressive use of power to sanction in light of the possible deterrent effect.
23. Globally consolidated supervision	Consider formalizing the process for assessing the quality of home country supervision, likely in conjunction with the proposed EU approach to mutual recognition for third-country supervisory regime.

Authorities' response

53. The CBFA can globally subscribe to the main findings laid down in the report. The CBFA is satisfied with the overall conclusion of the assessment team that banking supervision has a high overall level of compliance with the Basel Core Principles and that the CBFA's bank supervision team enjoys a strong reputation for professional skill and integrity.

54. As stated by the assessment team, work is already underway to address almost all issues raised, either at the CBFA's own initiative or within the context of the EU-supervisory framework (Committee of European Bank Supervisors—CEBS).

Objectives, autonomy, powers and resources (CP1)

55. As an introductory remark, we would like to point out that the current governance structure of the CBFA has been laid down in the law of August 2, 2002. As a result of the integration of the Insurance Supervisory Authority into the Banking and Finance Commission, the CBFA is since January 2004 the single supervisory authority for the Belgian financial sector. The integration of the different supervisory activities constitutes an important challenge for this new organization. The move into one building at the end of September 2004 contributed to a more in-depth collaboration.

56. Various steps have been taken in the meantime in order to enhance the effectiveness of the CBFA: the internal rules regarding the functioning of the Management Committee have been completed, an internal audit function has been set up, and the public communication policy has been enhanced. The CBFA is aware of the importance of an integrated methodology for the supervision of complex groups and, with regard to financial stability, of close collaboration with the central bank (NBB).

57. Within the constraints of the CBFA's budget, new staff is being recruited in order to upgrade the capacity in nonbank supervisory functions. The CBFA is aware that the Basel II implementation constitutes a challenge in terms of appropriate supervisory resources.

Licensing and structure (CPs 2–5)

58. Concerning the skills and experience of non-executive directors of supervised firms to effectively oversee management (BCP 3—licensing criteria), the CBFA is currently undertaking a thorough review of its internal governance framework applicable to institutions under prudential supervision. The CBFA intends to build upon the work undertaken at the level of the Basel Committee (consultation paper of July 2005) and the CEBS. The CBFA intends to better delineate the responsibility for the annual accounts and the prudential reporting of the bank's governing bodies and its internal control mechanism in conjunction with the responsibility of the external auditors. In this context, the CBFA launched in October 2005 a consultation regarding the review of the role and tasks of the bank's external auditors.

59. The alignment of the legal provisions for objecting notifications (BCP 5—investment criteria) for investment in a subsidiary with those for the refusal of the establishment of branches will be addressed together with modifications required by the forthcoming changes in the EU-solvency regulation.

Prudential regulations and requirements (CPs 6–15)

60. The above-mentioned overhaul of the internal governance framework of supervised firms will be used for rooting a number of governance principles in the law or in regulations (BCP 14—internal control and audit).

61. With regard to the use of bearer shares (BCP 15—money laundering), a new law has recently been approved by the Belgian Parliament. In essence, as from January 1, 2008, all new shares will be issued in either registered or dematerialized form. For existing bearer securities various transitional measures will be applied up to December 2013. The other recommendations with regard to AML/CFT will be implemented with the transposition of the EU-regulation (i.e., the implementation of Special Recommendation VII of the FATF before the end of 2005 and of the 3rd EU-Directive on money laundering by December 2007).

62. Formal guidelines for liquidity management (BCP 13—other risks) will be introduced as part of the implementation of the European Capital Requirements Directive (CRD), more specifically with respect to the second pillar of the New Capital Framework of the Basel Committee. The target date is January 1, 2007 and the reoriented approach would result in a revised liquidity reporting framework and more explicit qualitative guidelines with regard to liquidity risk management.

Methods of ongoing supervision (CPs 16–21)

63. In order to develop a common approach between banking and insurance supervision (BCP 20—consolidated supervision) various initiatives have already been taken in the day-to-day supervision such as exchange of information, joint team meetings, common approach in individual cases, joint on-site examination and supervisory review, and integration of IT-systems.

64. A specific committee has been set up which consists of the heads of departments, members of the management committee of the CBFA, in charge of Prudential Policy (banking and insurance), Banking supervision and Insurance supervision. The purpose of this committee is to enhance exchange of information, consultation and discussion regarding the supervision of complex financial institutions with cross-sectoral dimensions and preliminary discussions of policy issues of common interest.

65. As noted by the assessment team, a specific project has been set up at the end of 2004 within the Banking supervision department in order to update and review its procedures (including job descriptions for the different supervisory functions and on-site examination work programs) with a view to ensuring a more efficient application of the existing methodology. Working groups are also reviewing the overall approach for on-site examinations, the information flow within the department and the management tools (including risk assessment tools).

Formal powers of supervisors (CP 22)

66. The CBFA will inquire into the potential benefits and consequences of a more aggressive use of the supervisory power to sanction (BCP 22—remedial measures).

Home-host supervision (CPs 23–25)

67. As regards the issue of assessing the quality of home country supervision, the CBFA will follow the proposed EU-approach for mutual recognition of third-country supervisory regimes (BCP 23—globally consolidated supervision).

REPORT ON OBSERVANCE OF STANDARDS AND CODES: IAIS

General

68. This is a summary report on the assessment of the observance of the Insurance Core Principles of the International Association of Insurance Supervisors (IAIS) in Belgium. Belgian insurance is supervised by the Banking, Finance, and Insurance Commission (CBFA). This assessment relates to the jurisdiction as a whole and, for the most part, focuses on the responsibilities and powers of the CBFA in relation to insurance supervision. This assessment was done in the context of the IMF and World Bank Financial Sector Assessment

Program (FSAP). It includes recommendations for strengthening the supervision of insurance in Belgium.

69. This assessment was conducted during a mission to Belgium from November 30 to December 13, 2004, and is based on the circumstances in place and the practices used at that time. Prospective changes have not been considered in the assessment.

70. This assessment was conducted by Mr. Wil Dullemond, a Senior Policy Advisor on Strategic Issues in Insurance Supervision at the Dutch Central Bank and Chairman of the IAIS Solvency Subcommittee. He was assisted by IMF staff members.

Institutional and macroprudential setting—overview

71. Belgium's financial system is large, with assets of over 500 percent of GDP, and it is dominated by a few large, complex financial institutions (LCFIs). Capitalization of the stock market is relatively modest, and the insurance sector, while playing an important role through the *bancassurance* groups, is relatively small, with assets equivalent to less than 50 percent of GDP. On the regulatory front, as in many other EU countries, Belgium has recently adopted a system of consolidated supervision under the auspices of the newly established CBFA.

72. The Belgian insurance market is smaller, relative to GDP, than the OECD and EU 15 average, with total premium close to 8 percent of GDP in recent years. While there are many stand-alone insurers, most of the largest insurers are part of *bancassurance* groups. Overall, the insurance market is less concentrated than the banking sector—the top four banking groups account for over 80 percent of both loans and deposits, while the top four insurance groups collect 64 percent of the life premium and 52 percent of the nonlife insurance premium. Insurance forms a major part of some *bancassurance* groups; for instance it contributed to 30–40 percent of total profits of Fortis and KBC in 2003.

73. Improvements in life insurance results have been recorded recently, but the low level of long-term interest rates relative to the guaranteed rates of return on liabilities continues to pose problems. Guaranteed returns offered by insurers were close to the maximum of 4.75 percent until 1999, after which the maximum was lowered to 3.75 percent and insurers have been offering guaranteed rates for new contracts of around 3 percent recently. However, the estimated guaranteed return on all outstanding contracts remains close to 4 percent, which is approximately equal to long-term interest rates. Losses due to the steep decline in equity prices made insurers increase the weight of fixed income securities in their portfolios. In 2003, fixed income securities accounted for 72 percent of the investment portfolio, with only 15 percent of the portfolio invested in equities. The net impact of a rise in interest rates on insurers' financial position is unclear—higher interest rates would help alleviate the burden of guaranteed returns, but would also negatively affect the value of their fixed income securities.

Main findings

74. A relatively low level of compliance is surprising for a jurisdiction with a well developed insurance market. The authorities are actively pursuing a number of supervisory initiatives that hold the potential to materially improve the level of observance in the coming years.

75. Both supervisory guidance and professional standards, (e.g., for the actuarial profession) are in some cases either absent or are at a fairly high level rather than being operational. Accordingly, the level of observance for these principles can be improved through the issuance of more complete and explicit guidance to industry regarding supervisory expectations, e.g., in the areas of governance, risk management, and internal controls.

Conditions for effective insurance supervision (ICP1)

76. Belgium mainly meets the conditions necessary for effective insurance supervision.

The supervisory system (ICP 2-5)

77. The assessment of the supervisory system indicates a broad observance of the international criteria. Some improvements in the legislation would be beneficial for the supervisor. The CBFA adopted a project leading to a risk-based approach to supervision. Making use of both insurance and banking expertise within the newly merged entity would surely enhance the quality of the supervisory system.

The supervised entity (ICP 6-10)

78. The assessment of the principles regarding the supervised entity show room for future improvements. These especially concern the assessments of the suitability of persons, corporate governance, and internal control. Within the CBFA, a unit has already been formed to address the corporate governance aspects of insurance supervision.

Ongoing supervision (ICP 11-17)

79. In this area, the principles are mainly met. Only the on-site inspections require improvement, both in number and in scope.

Prudential requirements (ICP 18-23)

80. The most important improvements are needed in this area. Until recently, supervision focused on technical provisions, profitability of products, and solvency requirements. Analyses of assets and derivatives, especially in relation to liabilities (ALM issues), would help supervision follow the developments in the insurance industry more closely.

Markets and consumers (ICP 24-27)

81. Though the Belgian regulation on intermediaries is in the process of transposing the EU directive, in the present situation the principle on intermediaries is already largely observed. The other principles in this area are partly observed. The requirements on public information provided by insurers should be upgraded to international standards.

Anti-money laundering, combating the financing of terrorism (ICP 28)

82. Belgium has extensive anti-money laundering regulations. Sufficient resources need to be allocated to AML/CFT supervision in insurance.

Table 7. Recommended Action Plan to Improve Observance of IAIS Insurance Core Principles

Reference Principle	Recommended Action
Conditions for effective insurance supervision i.e., CP 1	Keep regulations in line with best practices (e.g., corporate governance, solvency). Better regulate the role of the accredited actuary and its competencies.
Supervisory objectives i.e., CP 2	The overall objectives of the CBFA should be clarified to enable it to develop strategic and business plans. Consideration should be given to combining all insurance regulations into one document, or even harmonizing all regulations of financial institutions (cross sector), given the international and conglomerate dimension of the major Belgian financial institutions.
Supervisory authority i.e., CP 3	Provide for a situation, in which a smooth transfer of knowledge between banking and insurance supervisors becomes possible. The development of the budget should timely foresee the needs arising from Basel II and Solvency II. In any case, a strengthening of one supervision area should not cause a weakening of another. Establish an internal audit function for the CBFA.
Supervisory process i.e., CP 4	The supervisory process should be explicitly risk based (according the aims of the approved "Projet Méthodologie Prudentielle"). This should create an equilibrium between quantitative control (of assets, liabilities, ALM, solvency) and qualitative assessment (of risk management, corporate governance, internal control).
Supervisory cooperation and information sharing i.e., CP 5	Find practical room for exchange of information in special cases. Share relevant information with host supervisors, enhancing reciprocity of information sharing.
Licensing i.e., CP 6	Mutual companies and cooperative societies that limit their activities to the city where their head offices are located (or to that city and the surrounding cities) should be registered.

Reference Principle	Recommended Action
Suitability of persons i.e., CP 7	Consideration should be given to the CBFA obtaining a (legal) right to request a fit and proper test for statutory auditors and accredited actuaries. Insurers should be required to test the fitness and propriety of senior management, who are not among the mentioned key officials (to be further defined by the supervisor)..
Corporate governance i.e., CP 9	This important issue needs considerable improvement. The newly created unit "Internal Control and Internal Audit" should utilize the knowledge and experience in banking supervision. If the requirement of a strong corporate governance structure needs legal provisions, ways should be found to provide for these provisions.
Internal control i.e., CP 10	Significantly improve supervision in cooperation with auditors, actuaries and banking colleagues. The actuary should be required to submit his/her report to the Board of Directors and also send it to the CBFA.
Market analysis i.e., CP 11	Analysis should be more timely and frequent. Macroeconomic analysis relevant for the insurance industry might be prepared by the Financial Stability Committee.
Reporting to supervisors and off-site monitoring i.e., CP 12	The CBFA should reconsider every few years all the information that it receives from insurers to ensure that it is all necessary. Information not in regular use is usually best not collected and only called for as occasion demands.
On-site inspection i.e., CP 13	On-site inspections should be used much more frequently and in a more comprehensive manner. Supervision staff should be an appropriate counterpart to the management of insurers when discussing issues like corporate governance, internal control, risk analysis, etc. Regular meetings with auditors and actuaries, both individually and at the level of their professional bodies, could enhance the effectiveness of supervision.
Group-wide supervision i.e., CP 17	There is a strong need—given the structure of the Belgian market—for all Belgian groups (whether insurance groups, financial conglomerates, or other financial institution under supervision) to be subject to consolidated supervision by the CBFA.

Reference Principle	Recommended Action
Risk assessment and management i.e., CP 18	Extend the supervision of the insurance companies' internal control and internal audit as planned by the new unit. A better balance between "data" (automatically gathered from all insurers) and "information" (specifically requested) could increase the effectiveness of supervision. In this regard, the policy choice on which level the supervision of profitability should focus (product level versus branch or company level) could be reconsidered.
Insurance activity i.e., CP 19	The CBFA should require insurers to document their policies on underwriting, premium setting, and reinsurance.
Liabilities i.e., CP 20	The determination of the maximum interest rate for setting life provisions should be delegated to the CBFA and no longer be used for other purposes.
Investments i.e., CP 21	The CBFA should require insurers to document their investment policy and verify whether insurers check the application of this policy by adequate internal controls. The CBFA should also formulate other requirements in line with this core principle, e.g., on skills of personnel, on audit procedures, and on contingency plans.
Derivatives and similar commitments i.e., CP 22	The expertise available in banking supervision should be utilized in the assessment of insurers' use of derivatives. This could be a quick win as insurance supervision has insufficient skills in this area.
Capital adequacy and solvency i.e., CP 23	Structurally improve the follow-up of the resistance test, especially when insurers are identified that should strengthen solvency or adjust their asset risks.
Intermediaries i.e., CP 24	The transposition of the European Directive 2002/92/EC will deal with several aspects in this area.
Consumer protection i.e., CP 25	See ICP 24. The directive also deals with enhanced information to prospective policyholders.
Information, disclosure & transparency towards the market i.e., CP 26	The disclosure requirements are less of a qualitative nature and do not specifically mention information on risk exposures and how they are managed. This could be improved. Clarify who has the responsibility to monitor actively the information disclosed by insurers, as the CBFA does not currently perform this task.
Fraud i.e., CP 27	The CBFA should require that insurers and intermediaries allocate appropriate resources and implement effective procedures and control to deter, defect, record and, as required, promptly report fraud to appropriate authorities. If needed, additional regulation should be considered.
Anti-money laundering i.e., CP 28	Ensure that sufficient resources are allocated to AML/CFT supervision.

Authorities' response

83. The CBFA globally supports the conclusions drawn by the IMF at the date of the FSAP. Those conclusions have been very useful in order to initiate and elaborate significant improvements of the insurance sector supervision. Indeed, taking into account the limitations placed on the available human resources, most of the recommendations are being met, especially by a reorganization of the department that started end 2004 and will end beginning 2006. Substantive efforts have already been made to integrate the banking supervision know-how and to develop and improve the prudential insurance supervision, in particular for conglomerates. Moreover, on-site supervision, including joint on-site supervision of conglomerates, is being strongly developed, on an audit level as well as on a technical and financial level. We consider that the measures taken will significantly and rapidly improve the global assessment of this FSAP.

REPORT ON THE OBSERVANCE OF STANDARDS AND CODES: IMPLEMENTATION OF THE IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION

General

84. An assessment of implementation of the International Organization of Securities Commission (IOSCO) Principles was carried out as part of the first FSAP mission, from November 30 to December 13, 2004 by Jennifer Elliott. The assessment was updated in November 2005.

85. The assessment was carried out using the IOSCO Assessment Methodology (the Methodology), adopted by IOSCO in October 2003. The assessment relied on a detailed self-assessment completed by the Banking, Finance, and Insurance Commission (CBFA), in-depth interviews with CBFA staff, interviews with market participants and industry associations, and a review of key pieces of legislation and CBFA rules.

86. The assessment was made possible by the generosity and diligence of the CBFA staff who were at all times very open and informative. The assessor would like to extend her thanks in appreciation for all of the hard work and support given by CBFA staff. The assessor would also like to thank market participants and the industry associations for their time and contribution to the report.

Institutional setting and market structure

87. The Belgian market is fully integrated into the European market. The financial sector is dominated by four large banks, all of whom carry out direct investment services and have investment fund affiliates. There are 66 licensed investment firms, including portfolio managers, derivatives specialists, order execution firms and full service firms. 37 of these firms are members of the exchange. There are also 65 credit institutions, many of which carry out investment services, but without a separate license. There are three licensed

investment advisers. There are 138 separate (open-ended) investment fund companies in Belgium, with a total of 1,462 subfunds and EUR 96.2 billion in assets under management.[7] This sector is dominated by bank affiliated collective investment schemes.

88. Euronext Brussels is the only regulated stock exchange in Belgium. Euronext Brussels is 100 percent owned by Euronext BV, a Dutch company listed on the Euronext exchange. Euronext Brussels has a total market capitalization of EUR 232 billion with 227 listed companies.[8] There are another 200 unlisted issuers in Belgium.

89. In 2003, a total of EUR 385 million in equities were issued on the Belgian market (EUR 33 million representing Belgian companies and 352 foreign companies); and a total of EUR 1.57 billion in fixed income securities (EUR 50 million representing Belgian companies).[9] The total for 2004 will be greater as a result of the privatization and offer of Belgacom, a very large telecommunications company on the market in early 2004.

90. One unique feature of the Belgian financial markets is the use of "bearer shares." Bearer shares are those not registered on the share registry of a company, being fully transferable without a need to record the transfer. Bearer shares are held in certificate form or in electronic form in investment firm or bank accounts and in the central depositary, from which they may be transferred by wire. There is a tradition of the use of bearer shares. They appear to be popular as a means of avoiding tax on transfer (e.g., inheritance tax).

Description of regulatory structure and practices

91. The CBFA is an integrated regulator with a mandate to regulate and supervise credit institutions, investment firms, regulated secondary markets, collective investment schemes, issuers and insurance companies. The CBFA was formed in 2004 (incorporating banking, securities and insurance regulation). In addition the CBFA's mandate has significantly expanded since the privatization of Euronext.

92. The majority of legislative change implemented over the past several years and included in the current work program is as a result of European level initiatives. The CBFA participates at the European level through the Committee of European Securities Regulators (CESR) which develops detailed policy under each EU Directive. The CBFA has approximately 400 staff employed directly by the CBFA and subject to an independent salary scale.

[7] CBFA statistics, as of August 31, 2005.

[8] Euronext statistics, September 30, 2005.

[9] The NBB Annual Report, 2003.

General preconditions for effective securities regulation

93. The IOSCO Principles list a number of pre-conditions to effective securities regulation. These include the appropriateness of legal, tax, and accounting framework within which the securities markets operate, and the effectiveness of procedures for the efficient resolution of problems in the securities market; and the soundness of macroeconomic policies (those aspects that could affect the operations of the securities market). These preconditions appear to be in place in Belgium.

Summary of the principle-by-principle assessment

Principles related to the regulator

94. The CBFA is an independent regulator with a full mandate to regulate and supervise securities markets activities; although it does not have absolute budgetary independence, at this time it operates within an appropriate budget and has sufficient resources. The agency is subject to accountability provisions, including annual reporting and a strict code of conduct. The agency has expanded its mandate considerably over recent years but has nevertheless been able to attract skilled staff and to establish effective processes in all areas.

95. There is currently no investor education program; the CBFA should take steps to develop one, in keeping with its investor protection mandate. The principles require that "like" products be treated equally in a financial sector. While collective investment schemes in Belgium are subject to considerable regulation, there appear to be competing products developed by insurance companies that are not subject to equivalent regulation. It is, however, recognized that this situation is largely governed by EU-level directives.

Principles related to compliance and enforcement

96. The CBFA has all necessary powers to carry out inspections and investigations, as well as a range of sanctioning powers. The inspection program for investment firms and collective investment schemes is thorough and well-planned. The investigations and administrative sanctioning function of the CBFA is relatively new and only a few cases have been undertaken. The CBFA should increase the transparency of the rules administrative proceedings and, more importantly, the transparency of decisions to levy a sanction.

Principles related to information sharing and cooperation

97. The CBFA has the ability to share confidential information with foreign counterparties under a formal agreement. The agency is part of the Council of European Securities Regulators (CESR) information sharing agreement, among others, and is active in its response to requests for cooperation and information. It has become a signatory to the IOSCO Multilateral MOU for information sharing.

Principles related to issuers

98. The CBFA sets and enforces detailed prospectus and on-going disclosure requirements. Accounting and auditing standards are of an internationally acceptable quality; The International Financial Reporting Standards (IFRS) were introduced for listed issuers on January 1, 2005. Material event (or price sensitive information) disclosure requirements are monitored by the CBFA's market surveillance function. The CBFA requires additional authority over unlisted issuers (a very tiny group in the Belgian market) and should impose material event disclosure requirements on these companies. Transaction reporting requirements for large shareholders are in place but this requirement should be extended to officer, directors and related parties and transactions should be made public. The use of bearer shares may undermine the rights of investors by creating obstacles to the dissemination of disclosure information.

Principles related to collective investment schemes

99. Collective investment scheme regulation is well developed—prospectuses and marketing material are reviewed prior to an offering. There are rules in place to deal with delegations, changes to unit holder rights and net asset value calculation. The inspection program encompasses all facets of the operation of a fund, including accounting and administration and custody of assets.

Principles related to market intermediaries

100. Investment firms are subject to internal control, risk management, and capital adequacy rules. There is a process in place for winding up a firm and an investor compensation fund. Investment firms are subject to examinations by the CBFA (on a risk-assessed basis), and semi annual external audits. Some additional rules are required, including the requirement that firm's keep a registry of client complaints. These will be introduced as part of the implementation of the new EU Investment Services Directive.

Principles related to secondary markets

101. The CBFA has full power to supervise Euronext Brussels and, although it does not directly license the exchange, it must be consulted in the granting of a license. The CBFA has focused over the past two years in developing a coordination program with the other Euronext regulators and on approving the Euronext rule book in conjunction with the Euronext group. It will now focus on coordinating operational supervision of the exchange, including risk management. The coordination effort is an effective response to the need to both carry out its regulatory responsibilities and, at the same, prevent overburdening the exchange with regulation by five separate regulators.

Table 8. Recommended Actions

Reference Principle	Recommended Action
Principles Relating to the Regulator (P 1–5)	A review of “like product” regulation should be conducted with a view to leveling the playing field for UCITs. An investor education program should be developed by the CBFA.
Principles for the Enforcement of Securities Regulation (P 8–10)	Enforcement procedures should be more transparent. Application of administrative sanctions should be published as a matter of course (subject to exemptions where the public interest may be damaged).
Principles for Issuers (P 14–16)	The CBFA should be granted direct authority over on going supervision of unlisted issuers. Unlisted issuers should be subject to a material event (price sensitive information) disclosure requirement. The concept of “insider” (large shareholders, directors, officers and related parties) should be brought into transaction reporting requirements. An insider transaction reporting system should be developed and reports made publicly available. The above-market price requirement should be removed from takeover bid rules. The use of bearer shares should be eliminated to remove intransparency of ownership which per proposed legislation, may undermine the CBFA’s ability to effect enforcement as well as, investor protection mechanisms including dissemination of annual reports and share holder voting materials.
Principles for Collective Investment Schemes (P 17–20)	The use of bearer shares should be eliminated, per proposed legislation..
Principles for Market Intermediaries (P 21–24)	Written customer account agreements should be mandatory. Firms should be required to keep a registry of all client complaints.
Principles for the Secondary Market (P 25–30)	The CBFA should continue to pursue coordination of Euronext oversight.

Authorities' response

102. We welcome this assessment report, which gives a comprehensive review of Belgian securities regulation and supervision. As an external and objective screening, this assessment provides us with useful insights in our own system.

103. We have no fundamental remarks on the assessment report. As for the recommendations contained therein, we generally agree with them and we will, insofar as possible, strive to implement them. However, we want to emphasize that the issue of "unlisted issuers" should be brought in its right perspective. The greater part of those unlisted issuers are actually regulated entities (such as collective investment schemes or credit institutions), that are subject to adequate supervision. This refines the possible impression that a large group of issuers would escape from the CBFA's supervision and the disclosure requirements.

104. Finally, we want to thank the IMF-team for the interactive and dynamic way of conducting this assessment, which made it not only an instructive, but also a fruitful experience for us.

REPORT ON OBSERVANCE OF STANDARDS AND CODES: CPSS/IOSCO RECOMMENDATIONS FOR SECURITIES SETTLEMENT SYSTEMS (EUROCLEAR)

A. Introduction

General

105. 1.This assessment of the Belgium securities clearing and settlement systems against the CPSS/IOSCO Recommendations for Security Settlement Systems was undertaken in the context of the IMF FSAP exercise for Belgium in December 2004. It covers the Euroclear System (ES) operated by the Euroclear Bank (EB).

106. Prior to the mission, the Belgium authorities—the National Bank of Belgium (NBB) and the Banking, Finance, and Insurance Commission (CBFA)—conducted a comprehensive and very clear self-assessment. It was professionally done and the results were made available to the mission in advance. The Belgium authorities were fully cooperative and all relevant documentation to fulfil the assessment of the securities settlement systems was provided on time and without difficulties. The mission benefited also from meetings with service providers and some market participants arranged by the Belgian authorities.

Scope of the assessment

107. The assessment covers the ES that includes the settlement and custody activities as well as the customers network and business model of the International Central Securities Depository (ICSD) for the Eurobonds, other international securities. The Euroclear Group has recently undergone a major corporate restructuring that altered the current structure, roles

and responsibilities of different entities within Euroclear Group including that of the EB. A new holding company, Euroclear SA/NV (ESA), was set up and it owns directly the EB and the National Central Securities Depositories (CSD). As a result of the restructuring, the EB has relinquished its ownership of the group's three CSDs—Euroclear France, CrestCo, and Euroclear Nederland—and instead has become a sister company, under the ownership of the ESA. The functionalities and service to be provided by the ESA are still at the stage of development. Consequently, this assessment focuses on the structure and governance of the ES as on the end of September 2005. Some services currently provided by the ESA to the EB are also covered in this assessment.

Institutional and market structure

108. The Eurobonds and other international securities constitute the core market of the ES for which it acts as one of the ICSDs in the European Union (the second ICSD is Clearstream Banking Luxembourg). This market, which originally was an off-shore U.S. dollar market, is mostly unregulated. International securities are a heterogeneous set of financial instruments including mostly fixed income securities of various maturities (Eurobonds, Euro-MTN2, Euro-CP, Euro-CD, and Euro-Notes) but also equities and equity related products such as warrants. International securities can be defined as securities underwritten and distributed by an international syndicate team and/or offered at issuance on a significant scale simultaneously to investors in more than one country. They can be issued in any currency (euros and U.S. dollars are the most dominated currencies) and governed by any law (generally New York or English laws) independently of their place of issuance. International securities are not traded on a specific market. Some of them are listed on exchanges or traded on Automated Trading Systems (ATS) such as SWX, ECMTS, TLX, and New EuroMTS.

109. In April 2002, the EB concluded an agreement with Euronext NV, which makes the ES a preferred partner for the settlement of the trades executed on the Euronext markets of Paris, Amsterdam and Brussels. Participants to these three markets will have the choice to settle their trades in the domestic system or in the ES.

110. The ES has a network with 31 domestic markets worldwide and plays the role of investors' settlement system for many domestic securities. For some of them (e.g., the German bonds market), a significant part of the secondary market is internalized in the ES. The settlement of Irish bonds issued by the National Treasury Management Agency (government bonds), the Housing Finance Agency, the European Investment Bank and Ulysses Securitization Plc was transferred from the Central Bank of Ireland (CBFSAI) to the ES in December 2000.

Table 9. Key Statistics on the Euroclear Bank

		2002	2003	2004
Turnover (in EUR trillions)		103.5	114	132.6
Of which	*Internal settlement*	78%	78%	88%
	Bridge settlement	11%	11%	6%
	External settlement	11%	11%	6%
Instructions processed (in millions)		18	22	24
Of which	*Internal settlement*	67%	70%	84%
	Bridge settlement	23%	21%	11%
	External settlement	10%	9%	5%
Total value of securities held (in EUR trillions, as of Dec. 31)		4.8	5.2	5.9
Of which	*International Bonds*	*3.3*	*3.5*	*3.5*
	Domestic bonds	*1.3*	*1.4*	*1.6*
	Equities	*0.1*	*0.1*	*0.3*
	Other securities	*0.1*	*0.2*	*0.5*
Number of issues accepted		139,293	159,095	126,415
New issues (in € billions)		n.a.	2047	1596
Number of participants		1634	1538	1491
Overnight credit (Daily average in EUR billions)		1.4	1.4	1.5
Securities lending outstanding (Daily average in EUR billions)		8.5	8.6	8.3
Collateral provision outstanding (Daily average of triparty repo in EUR billions)		103	128	162

Source: Euroclear Bank.

B. Main Findings

111. The assessment demonstrates that the ES is a safe, sound, efficient, and reliable system. Furthermore, the ES observes almost all CPSS/IOSCO Recommendations for Securities Clearing and Settlement Systems.

Legal risk (Recommendation 1)

112. The settlement and custody activities of the ES are governed by consistent and solid set of laws, regulations and rules. In particular, this legal framework supports the enforcement of transactions, protection of customer assets, immobilization and dematerialization, securities lending and delivery versus payment with finality. There are adequate rules for addressing the event of a participant default, including the effective use of collateral, and these rules can legally be enforced. However, non-financial participants in the ES, which account for less than 0.5 percent of total settlement activities, are not protected against the zero hour rule. A legislative project is already underway that would address this residual risk.

Pre-settlement risk (Recommendations 2–5)

113. The ES does not have any influence over the trade confirmation or settlement cycles as it settles trades executed over-the-counter as well as on trading platforms located outside Belgium. Furthermore, the ES settles transactions in international and domestic securities that are cleared by CCPs introduced in the local markets, if any. This facility is designed and used as a method to expedite settlement of securities transactions and, thereby, reducing settlement failure.

Settlement risk (Recommendations 6–10)

114. The ES has adequate measures in place aimed at reducing settlement risks substantially. In particular, the system operates on a real time gross settlement (RTGS) basis. It settles on a delivery versus payment (DVP) with intraday settlement finality. In addition, the system provides automated collateralization mechanism and securities lending facility aimed at reducing settlement failure.

115. The EB provides securities lending and cash credit in connection with settlement aimed at allowing efficient settlement. The EB advances also payments in connection with securities issuances and corporate events. As an overall assessment the EB has adequate risk control mechanisms in order to mitigate the risks related to its credit activities. In particular, the EB uses a mixture of collateralization, credit limits, financial commitment from third parties and rating. However, the EB needs to enhance its risk management by enlarging its credit limit system to all activities and improving its tools to monitor and manage its total credit exposures resulting from different activities for individual and interrelated participants on a systematic way.

Operational risk (Recommendation 11)

116. The ES has adequate procedures and process to monitoring, identifying, and managing operational risk. The Board of Directors of the EB has the overall responsibility for setting adequate operational management, approves operational risk policies developments and changes, and reviews on a regular basis reports on the nature and level of operational risk exposure. The ESA provides support services to the EB among other in the field of risk management. Second, written documentation is in place in order to handle different contingency scenarios. Third, a "live" secondary data center and a dual office structure are in place in order to allow the continuity of the operation within a short period of time in the event of malfunctioning of the primary data center or of the unavailability of the main office site. Furthermore, the ES carries out external audit of its procedures and arrangements for disaster recovery and business continuity. However, the EB may consider improving the communication with its participants in the field of business continuity, in particular regarding the transparency of various contingency procedures and the possibilities to include the participants in the testing procedures.

Custody risk (Recommendation 12)

117. Several technical and institutional arrangements are in place in order to ensure the protection of the customers' securities. First, almost all securities are immobilized. Secondly, the Law of August 2, 2002 provides for the obligation for depositories established in Belgium to hold their own securities and the securities of their clients on separate accounts with their depositories. Custodians located in Belgium are required to reconcile their holdings on a regular basis within their own systems and with their accounts held at the ES. The EB monitors on a daily basis all the securities movements with the depositories or local CSDs. The EB requests its depositories to carry external audits and have access to the audit reports.

Other issues (Recommendations 13–19)

118. In general, the governance arrangements of the ES are designed in order to fulfill public interest requirements and to promote the objectives of owners and users. The EB consults its participants on a regular basis inviting them to express their views on any major changes prior to be introduced to the system. In addition, the EB interacts with its users community through different industry group such as the IPMA, the ISMA and the European Repo Council. Although the financial objectives of the Euroclear Group have been published in the 2004 Annual report of the group, Euroclear may still increase the transparency on these objectives by communicating more clearly to its users. It is also important to have in place procedures to identify and solve potential conflicts between different interests of the users and shareholders.

119. The roles and responsibilities of the NBB and the CBFA with respect to securities clearing and settlement activities are clearly defined in the Royal Decree. Their organization structures are based on experienced staff to carry out their respective regulatory functions in an efficient manner. The cooperation between the NBB and the CBFA in the field of clearing and settlement has been more transparent to the supervised entities and general public. Although the cooperation agreement between the NBB and the CBFA has already been published in the Financial Stability Review 2005 of the NBB, it might be useful to publish this agreement in a more readily accessible form on the Internet sites of both institutions. Furthermore, in order to increase the effectiveness of their cooperation, improve their communication and strengthen their overall supervision and oversight roles, the NBB and the CBFA still need to further increase their mutual understandings of respective regulatory objectives and needs. This is particular essential in the case of the EB which has dual statute as a bank and a settlement system.

120. Following the corporate restructuring of the Euroclear Group, the NBB and the CBFA have set up an international cooperation framework with the French, the English, and Dutch authorities. The agreement covers the joint assessment of the common services provided by the ESA to the other entities of the Euroclear Group as well as the exchange of

information relevant for the coordination and the cooperation between the authorities in the area of supervision/oversight.

121. Recently, the CBFA and the NBB have set up a high level Steering Group for the oversight and supervision of Euroclear. The role of this group should further be strengthened and formalized in order to enhance the coordination between the NBB and the CBFA.

122. Finally, the EB needs to enhance its risk management procedures to establish and manage links to other markets by: (i) developing standardized risk assessment methodology; (ii) abolishing the procedure of booking securities on the account of the participants before finality is achieved in the local markets; and (iii) fully secure and establish clear limit for credits granted to the Clearstream Banking Luxembourg through the Bridge.

Table 10. Summary Observance of CPSS/IOSCO Recommendations

Reference Recommendation	Recommended Action
Observed	1, 2, 3, 4, 5, 6, 7, 8, 10, 11, 12, 13, 14, 15, 16, 17, 18, 19 (Free of payment links in the EU markets).
Broadly Observed	9, 19 (DVP links, except the links to the U.S., France, Spain, and Germany).
Partly observed	19 (the Bridge between Euroclear and Clearstream Banking Luxembourg).
Non-observed	19 (Links to the U.S., France, Spain, and Germany).

Table 11. Actions to Improve Observance of the Recommendations

Reference Recommendation	Recommended Action
Recommendation 1: Legal Framework	The Belgium regulation on settlement finality should be amended in order to abolish the zero hour rule for non-financial participants in the ES.
Recommendation 9: Risk Controls	The EB needs to enhance its risk management by enlarging its credit limit system to all performed activities and improving its tools to monitor and manage its total credit exposures resulting from different activities for individual and interrelated participants on a systematic way. Furthermore, the EB should abolish the procedure of debit balances in securities.
Recommendation 11: Operational reliability	The EB may consider to better inform its participants on the business continuity issues and in particular on the transparence of various contingency procedures and the test facilities provided to the users.
Recommendation 12: Protection of Customers' securities	The CBFA may accelerate the implementation of Article 26 of the Law of August 2, 2002 that obliges the depositories established in Belgium to separate between their own securities and the securities of their clients. Regarding the network of foreign depositories, the EB may consider amending its rules in order to make the regulation and supervision of the depositories as a prerequisite to select them.

Recommendation 13: Governance	Although the financial objectives of Euroclear are published in the 2004 Annual Report of the group, the Board of Euroclear plc may consider to increase the transparency of its financial objectives by communicating it more clearly to its users. It is also important to have in place procedures to identify and solve potential conflicts between different interests of the users and shareholders.
Recommendation 18: Regulation and oversight	Although it has already been published in the Financial Stability Review 2005 of the NBB and communicated to the EB, the CBFA and the NBB may consider to make public in a more permanent form either the entire Royal Decree Article 118 of the August 2, 2002 or the part of it dealing with clearing and settlement issues. The human resources of the CBFA need to be strengthened so as to increase the number of the staff specialized in the field of securities clearing and settlement activities.
Recommendation 19: Cross-border links	**Overall assessment of market links** For the observance of this recommendation, the EB should a standardized assessment methodology for links which should be transparent and discussed with the relevant public authorities. Furthermore, the assessment of the links should be updated on a regular basis. **The bridge** For the observance of this recommendation, the EB should fully secure and establish clear limit for the credits granted to Clearstream Banking Luxembourg. **Provisional links to the U.S., France, Spain, and Germany** For the observance of this recommendation, the EB should avoid to book the securities on the account of the participants before finality is achieved in the local market or, at the minimum, prohibit their retransfer until the first transfer is final.

Authorities' response

123. In 2004, the NBB had conducted a first assessment of the ES against CPSS-IOSCO RSSS which was subsequently updated to take into account the recent restructuring of the Euroclear Group. This assessment concluded to a high level of compliance of the ES with the CPSS-IOSCO standards. The NBB welcomes the IMF assessment which confirms this compliance and which provides recommendations that are mostly in line with those already formulated by the NBB. Following the 2004 assessment, the NBB and Euroclear have drawn up an action plan in order to reach full compliance. The implementation of this action plan is followed-up by the NBB. Cooperation between the NBB and the CBFA regarding the supervision and oversight of the Euroclear has already been strongly intensified in the last years. Recent initiatives taken by both institutions should still enhance the synergy.

Report on Observance of Standards and Codes: CPSS/IOSCO Recommendations for Securities Settlement Systems (CIK/NBB)

A. Introduction

General

124. This assessment of the Belgium securities clearing and settlement systems against the CPSS/IOSCO Recommendations for Securities Settlement Systems was undertaken in the context of the IMF FSAP exercise for Belgium in December 2004. It covers the NBB SSS and the *Caisse Interprofessionnelle de Depôts et de Virements de Titres/*Interprofessional Securities Depository Organization (CIK).

125. Prior to the mission, the National Bank of Belgium (NBB) and the Banking Finance and Insurance Commission (CBFA) made a thorough self-assessment of the CIK based on the CPSS-IOSCO Methodology, which was used as the basis of the assessment. The NBB made a similar self-assessment for the NBB SSS, for which it acts as the sole supervising authority.

Scope of the assessment

126. The CIK, a limited liability company which settles a broad range of securities, including, Belgian shares, warrants, bonds and investment funds. The settlements are exclusively in euros and the cash leg of the transaction is settled on the books of the NBB. The CIK operates the following two systems to settle transactions in these instruments:

- The Forward Market Settlement (FMS) system that settles the Euronext Brussels on-exchange cash market transactions. The Paris based clearing house LCH.Clearnet SA intervenes as a central counter party for virtually all of these transactions; and
- The Electronic Matching and Securities Settlement (EMSS) system that settles over-the-counter (OTC) transactions.

127. The NBB SSS is the central securities depository and securities settlement operator for a broad range of instruments denominated in euros. These instruments are as follows:

- Government securities: linear bonds (OLOs), stripped bonds, treasury certificates,
- Belgian Treasury Bills (BTBs), *Staatsbons/Bons d'Etat*, other government loans; and
- Commercial paper: treasury bills, securization of private emissions, other nongovernment loans.

Institutional and market structure

128. Since September 2000, the operator of the stock exchange in Brussels has been Euronext Brussels SA/NV, a wholly owned subsidiary of Euronext NV. Euronext NV also is the holding company for Euronext Paris S.A., Euronext Lisbon. S.A., Euronext Amsterdam N.V., and Euronext UK plc. Euronext Brussels operates a cash and derivatives market. As of

July 2004, Euronext Brussels stock market capitalization amounted to approximately EUR 164 billion.

129. Except for minor exceptions, all trades on Euronext Brussels are cleared by LCH.Clearnet, which serves the central counter party. Currently the Euronext Brussels cash trades represent less than five percent of the overall volume of all Euronext cash market trades cleared by LCH.Clearnet. After LCH.Clearnet clears the trade, the positions are settled in FMS. The CIK uses the EMSS system to settle trades in the over-the-counter market.

130. Belgian state debt mainly consists of OLOs, split OLOs (strips) and treasury certificates. Virtually, all Belgian state debt securities are dematerialized and deposited in the NBB SSS. These instruments are traded in the over-the counter market. However, a small number of OLOs, mainly on behalf of private investors, are traded on Euronext Brussels. MTS Belgium, a division of MTS associated markets, operates an electronic trading platform for OLOs, strips and treasury certificates.

131. The OTC trading volume in OLOs (excluding repo transactions) decreased from EUR 662.8 billion in 2003 to EUR 557 billion in 2004. The trading volumes in treasury certificates also decreased from EUR 245.6 billion in 2003 to EUR 201 billion in 2004. During the same period, the percentage of the trading volume in OLOs on MTS Belgium slightly increased from 19 percent in 2003 to 21 percent in 2004. The percentage of trading volume in treasury certificates on MTS Belgium, however, decreased from 22 percent in 2003 to 20 percent in 2004.

132. OTC and stock exchange trades in Belgian government debt and commercial paper are settled at the NBB SSS. The NBB SSS operates through several real-time batch cycles during settlement date, usually T+3. Transactions in the system are settled on a gross basis (i.e., trade by trade) according to DVP model 1. Any cash credit or debit and any securities credit or debit for the settlement of a transaction is recorded individually and finally in the current accounts and securities accounts of the system.

Description of regulatory structure and practices

133. In Belgium, the CBFA and the NBB are the competent authorities for the regulation and oversight of securities clearing and settlement systems. According to the law of the August 2, 2002 on the control of the financial markets defining the statute of clearing and settlement institutions, the CBFA exercises prudential supervision of the CIK as a settlement institution, and the NBB is in charge of the oversight of the CIK and the NBB SSS as settlement systems. The CBFA does not supervise the NBB SSS.

134. Practical modalities of the oversight on the securities settlement systems involved are agreed on in a protocol between the overseer and the operator of the securities settlement system. To avoid potential conflict of interests within the NBB when exercising the oversight function, so-called Chinese Walls have been put in place; i.e., the operation of payment systems and securities settlement systems on the one hand and their oversight on the other hand are managed by two different departments. Each of these departments reports to a

different Board member. Between the NBB SSS and the NBB's Oversight Group, a Working Methodology, approved by NBB's Board, has been concluded to arrange practical modalities.

B. Main Findings

Legal risk (Recommendation 1)

135. There is a consistent set of laws, regulation and contracts that forms the legal foundation for custody and clearing and settlement of securities. All relevant laws and regulations are publicly available. Customer assets are protected by law against a bankruptcy of a custodian. Also, other key issues as netting, securities lending arrangements and the establishment of collateral interest are well regulated. All laws, regulations, and contractual arrangements are fully enforceable.

136. By October 2005, the CIK had already revised the most relevant parts of its contractual framework and published new versions of the CIK By-Laws and the CIK circular letters on its web site. It is anticipated that the relevant technical documentation will be completed by the end of 2005. As a result of the initiative, CIK's rules should be more accessible to the public and its participants, and the moment of irrevocability of transfer orders and settlement finality should be clearly defined.

Pre-settlement risk (Recommendation 2–5)

137. The CIK settles 96 percent of the trades from Euronext Brussels on their intended T+3 settlement date. Transactions involving Belgian debt securities that are settled at the NBB SSS also enjoy a low fail rate. Conversely, 12 percent of the transactions executed in the OTC equity market fail to settle on time.

Settlement risk (Recommendations 6–10)

138. The DVP arrangements of CIK's FMS system do not always link the transfer of securities to the payment of cash so that DVP is achieved. Specifically, the FMS system allows Clearnet to re-use the securities received from the selling clearing members in order to deliver them to buying clearing members before paying the seller. During this period, the seller could be at risk to the CCP because the securities are debited from the seller's account before the seller receives payment.

Other issues (Recommendations 11–19)

139. For the issuance and safekeeping of print-on-demand securities, the CIK uses electronic book-entry procedures, which are not compliant by the Belgian Law or regulations. These procedures certainly increase the custody risk for the participants. For this reason, the CIK should stop using such procedures awaiting a new legislation that protects dematerialization and book-entry safekeeping.

140. There are no formal mechanisms for NBB SSS's users to interact with management. The NBB SSS does not employ user committees or engage in participant surveys. However, the NBB SSS informally interacts with their participants regularly and is responsive to participant requests. Nevertheless, it may be advisable to consider the establishment of permanent user groups and other formal methods of communication that allow a more structured and formulized communication process between the NBB as service provider and its participants.

Table 12. Summary of CIK's Observance of CPSS/IOSCO Recommendations

Reference Recommendation	Recommendation
Observed	2, 3[1], 4, 5[1], 6, 7 (EMSS), 9, 10, 11, 13, 14, 15,16,18
Broadly Observed	1,3[2], 5[2], 19
Partly observed	8, 17
Non-Observed	7 (FMS), 12

1/exc: Exchange transactions.
2/otc: Over-the-counter transactions.

Table 13. Actions to Improve CIK's Observance of Recommendations

Reference Recommendation	Recommended Action
Recommendation 1: Legal Framework	For observance of this recommendation, the CIK should update all relevant contractual documentation. The CIK is currently updating its technical documentation. It is anticipated that CIK's relevant technical documentation containing aspects of contractual clauses
Recommendation 3: Settlement Cycles	For the observance of this recommendation, the CIK should develop procedures to mitigate the risks that result from failed trades in the OTC market. For example, the CIK may consider requiring trades match through the EMSS system to be binding on counter parties. This could reduce the likelihood that a counter party will revoke a trade. The CIK may also consider establishing a fine or fee schedule for failed trades.
Recommendation 5: Securities Lending	None.
Recommendation 7: Delivery versus payment	For observance of the recommendation, revise CIK's DVP procedures for the FMS so that the transfer of securities is linked to the payment of cash in a manner that eliminates principal risk. In particular, when participants deliver securities to the central counter party.
Recommendation 8: Settlement Finality	For observance of this recommendation the CIK should amend the appropriate documents and procedures to clearly stipulate the moment of irrevocability and finality

Reference Recommendation	Recommended Action
	of the transfer orders
Recommendation 12: Custody risk	The CIK should stop using the electronic book-entry procedures for the issuance and safekeeping of securities as they are not compliant with the current Belgian legislation.
Recommendation 17: Transparency	For observance of this recommendation, CIK needs to ensure that it discloses the answers to the CPSS-IOSCO disclosure framework or to the CPSS-IOSCO Recommendations for securities settlement systems assessment framework.
Recommendation 19: Cross-Border Links	The CIK should develop a risk methodology for the design of their links.

Table 14. Summary of NBB SSS's Observance of CPSS/IOSCO Recommendations

Reference Recommendation	Recommendation
Observed	1, 2, 3, 4, 5, 6, 7, 8, 9, 10, 11, 12, 14, 16, 17, 18, 19
Broadly Observed	13, 15
Partly observed	
Non-Observed	

Table 15. Actions to Improve the NBB SSS's Observance of Recommendations

Reference Recommendation	Recommendation
Recommendation 13: Governance	For the observance of this recommendation, the NBB SSS should consider forming user groups or other formal methods to enable structured and formalized communication between the NBB SSS and its participants.
Recommendation 15: Efficiency	The NBB SSS should regularly organize client surveys to review its service levels.

C. Authorities' Response

141. The authorities are in broad agreement with this IMF assessment report. With regard to the CIK, the action plan to remedy the non-compliance with the CPSS-IOSCO standards is in the process of being implemented. The CIK already adapted its contractual framework. Furthermore, the NBB will, in its oversight of the CIK, request the CIK to give priority to remedy the absence of DvP in the context of the CIK FMS System and to remedy the issuance and safekeeping of print-on-demand securities without the presence of a necessary

legal base. Concerning the NBB SSS, the NBB-Oversight Unit will monitor the initiatives already taken by the NBB SSS to launch a clients survey to assess its service levels and the system's intention to organize a formal user meeting during Q4 2005.