

DOCUMENTATIEBLAD

STRUCTURAL EVOLUTION AND PRUDENTIAL SURVEILLANCE OF THE BELGIAN FINANCIAL MARKET IN THE EU ENVIRONMENT**Thierry TIMMERMMANS**

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Abstract

This article reviews the major recent structural changes in the Belgian financial sector and their implications for the prudential surveillance of Belgian financial institutions and markets. Those changes have been wide-ranging as the combined effects of new technologies and deregulation have removed barriers and speeded up consolidation of the sector. Financial institutions have adapted to this changing environment, relying on new techniques to master the broader risks they are taking on. Faced with those developments, authorities have to reconsider the way they are pursuing their financial stability mandate. While supervisors are adapting their approach to take into consideration both the emergence of new categories of risk and the developments of better risk management instruments, central banks are monitoring financial stability issues from a global perspective, focusing on interdependencies, the contagion process and systemic risk. At the same time, both authorities have to put in place adequate arrangements to ensure orderly management of cross-border crises in the EU.

KEYWORDS: *Supervision, Market infrastructure, Systemic risk, Financial sector, Central banks, Financial stability*

JEL CODES: *G10, G15, G21, G28*

INTRODUCTION

Financial systems around the world have undergone a major transformation in the last two decades. Some of the forces for change have been felt to a very similar degree in the various national markets. Others, while common to most countries, have taken a more specific form in the EU area as the completion of the single financial market and the switchover to the euro have shaped or speeded up several of the key developments faced by European financial institutions.

Technological change belongs to the first category. The positive effects that new techniques for the treatment, storage and transfer of data have exerted on the largely information-based financial sector have been at work worldwide. Information technologies make it possible to develop more sophisticated products, to build up better market infrastructure, to implement more accurate and reliable techniques for risk management, to reach more distant and diversified markets, and to multiply both value and volume of operations.

Deregulation has been another global trend helping to reshape the financial landscape. Artificial barriers preventing market entry or limiting competition between products and institutions have been broken down to a significant extent. In the EU, this market opening has been extended, to a much higher degree than in other parts of the world, to the removal of barriers between jurisdictions. Cross-border competition is less and less concentrated on wholesale or specialised segments of the market and is increasingly spreading to retail and traditional core business. It is also much more likely to be reflected in the establishment of transnational financial groups.

It is, however, in the process of institutional change that the EU dimension has played the most important role. The numerous EU Directives brought in by the Financial Services Action Plan (FSAP) have built up a whole new legal and regulatory environment. With the arrival of the ESCB, an entire new institutional framework has also been established, not only for the conduct of monetary policy but also for monitoring financial stability and for setting up cross-border arrangements for financial crisis management.

The first section of this article will review the impact of those major developments on the structure of the Belgian financial sector's activities. The second section will briefly analyse how supervisory authorities and central banks are adapting to those structural changes in the Belgian financial sector.

1. MAJOR STRUCTURAL CHANGES IN THE BELGIAN FINANCIAL SECTOR

1.1. GROWING CONCENTRATION IN THE SECTOR

One of the most striking developments within the Belgian banking sector is undoubtedly the concentration into a small number of very large groups. Nowadays, the 4 main institutions collect 82 p.c. of all bank deposits from Belgian residents. While Belgium is a rather extreme case in the EU, the banking sector is also becoming increasingly concentrated in the other euro-zone countries as the share of the 5 largest credit institutions in each domestic market, expressed in terms of percentage of total assets, exceeds on average 50 p.c.

The 4 main Belgian groups share two specific characteristics. First and foremost, they have a strong international dimension. The cross-border structure is the most complete in the case of Fortis and Dexia which are among the few international financial groups formed through a merger between institutions from different countries. ING Belgium is one of the main subsidiaries of a multinational Dutch financial group, while the Belgian group KBC has a strong presence abroad, too, most notably in Central and Eastern Europe.

Table 1
Market share in banking and insurance of the largest financial groups on the Belgian market at the end of 2005¹
(consolidated data, percentages)

Group	Insurance market	of wich:		Banking market
		Life insurance market	Non-life insurance market	
Dexia	7.3	8.4	4.2	14.7
Fortis	19.6	20.9	15.7	31.9
ING	5.6	6.3	3.7	14.0
KBC	18.8	22.2	9.0	21.4
Subtotal	51.3	57.8	32.6	82.0
Axa	12.5	11.0	16.8	2.6
Ethias	15.1	15.6	13.5	0.6
Total	78.9	84.4	62.9	85.2

Sources: Assuralia, CBFA, NBB.

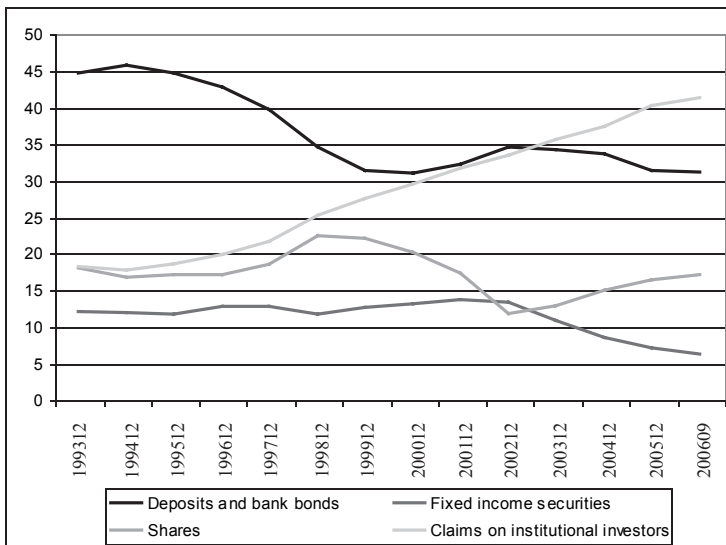
1 Market shares are calculated on the basis of deposits by Belgian residents for banking and collected premiums for insurance.

A second feature of those groups is their strong involvement in bankassurance. Together, Fortis, Dexia, KBC and ING Belgium account for about 45 p.c. of the insurance market in Belgium, measured as a percentage of collected premiums. This market share rises to almost 75 p.c. if we add to those 4 groups Axa and Ethias, which are also present on the Belgian banking market, albeit to a limited extent.

1.2. NEW PATTERNS IN HOUSEHOLD SAVING BEHAVIOUR

The development of bankassurance has enabled the main Belgian financial groups to both accompany and benefit from a major trend in the saving behaviour of Belgian households, i.e. a growing interest in institutional investment products. While Belgian households have traditionally invested the bulk of their savings with banks, the relative importance of this category of claims had declined from 46 p.c. in 1994 to 34 p.c. by 2005. The value of outstanding claims on institutional investors – the sum of financial assets invested in insurance products, mutual funds and pension funds – now largely exceeds total household investment in bank products. At the end of 2005, it accounted for 41 p.c. of total financial assets compared to just 18 p.c. in 1994.

Chart 1: Stock of Belgian households' financial assets :
(Percentage of total financial assets)



Source: NBB

The success of institutional investments can be attributed to several factors, i.e. greater household focus on long-term saving to complement the legal pension system, favourable tax treatment and, more generally, the flexibility, diversification potential and wide range of risk-return combination offered by those products. By distributing insurance products or mutual funds, the major Belgian financial groups have been able to adapt smoothly to the changing pattern of households' financial investment.

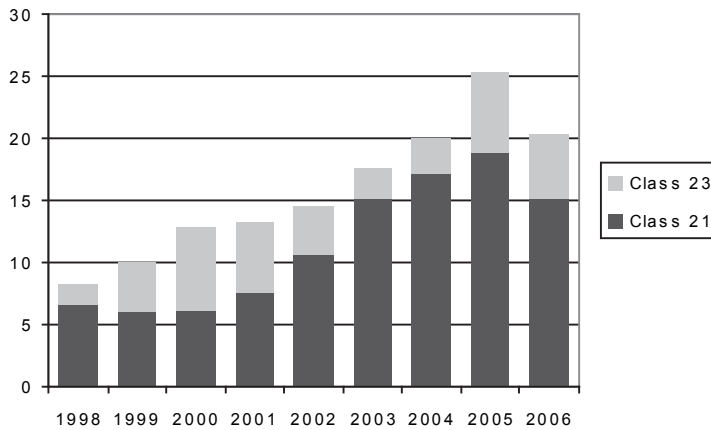
1.3. NEW ENVIRONMENT FOR INTEREST RATE RISK MANAGEMENT

The diversification into insurance products also offers potential in terms of risk management as it allows Belgian financial groups to better manage their global interest rate exposure. Indeed, the main consequence of banks' maturity transformation activities is that the duration of their liabilities is much shorter than that of their assets. This maturity mismatch is offset, at the level of bankassurance groups, by an opposite mismatch, in the insurance branch of business, between the long duration of life insurance liabilities and the shorter duration of the asset portfolio.

While this kind of compensation effect is at work in the case of an interest rate "change", a low general "level" of interest rates, as has been observed in recent years, raises issues for both types of business. In the banking sector, the intermediation business becomes less profitable as the gap between market rates and low-interest sight deposits narrows. In the insurance sector, it becomes much harder to generate the regular income needed to get the return guaranteed to the defined benefit contracts.

The specific constraints linked to the low-interest-rate environment, exacerbated by growing competition in attracting savings, have led financial institutions to transfer a proportion of those risks to other parties. In Belgium, a good example of such a shift is the gradual increase in the relative share of unit-linked life insurance contracts (defined contribution - class 23) as opposed to guaranteed-return contracts (defined benefit - class 21). While class 23 contracts only accounted for 6.7 p.c. of life insurance companies' total technical provisions in 1998, their relative share had reached 19 p.c. by the end of 2005.

**Chart 2: Premiums collected by Belgian life insurance companies
(billions of euro)**



Sources: Assuralia, CBFA, NBB

1.4. DIVERSIFICATION OF CREDIT ACTIVITIES

The constitution of large cross-border financial groups, already discussed in section 1.1, has had a very significant impact on the nature of Belgian banks' credit activities. While, at the end of 1999, almost half of Belgian banks' total assets was still on domestic counterpart, this share declined to less than 30 p.c. in 2006. It is true that interbank activities have, for many years, been largely internationalised. But this trend has now spread to other wholesale activities. In particular, the outstanding amount of loans to foreign non-financial corporations currently comes to about three times the corresponding amount for Belgian corporations. Even in the retail sector, Belgian banks have greatly enlarged their market as loans to foreign households now account for 45 p.c. of total loans to households.

Table 2
Sectoral and geographical breakdown of the counterparties of Belgian banks financial assets¹

(data at the end of June 2006², p.c. of total unless otherwise stated)

	Billion euro		p.c. of total		
			Resident in		
			Belgium	Rest of the world	
			Total	of wich other euro-zone countries	
Credit institutions	328.6	29.0	2.6	26.4	14.0
Corporations	278.9	24.6	6.2	18.4	6.8
Household	235.9	20.8	11.4	9.4	8.2
General government	208.1	18.4	6.7	11.7	9.9
Non-bank financial institutions	80.7	7.2	2.5	4.7	0.9
Total	1132.2	100.0	29.4	70.6	39.8

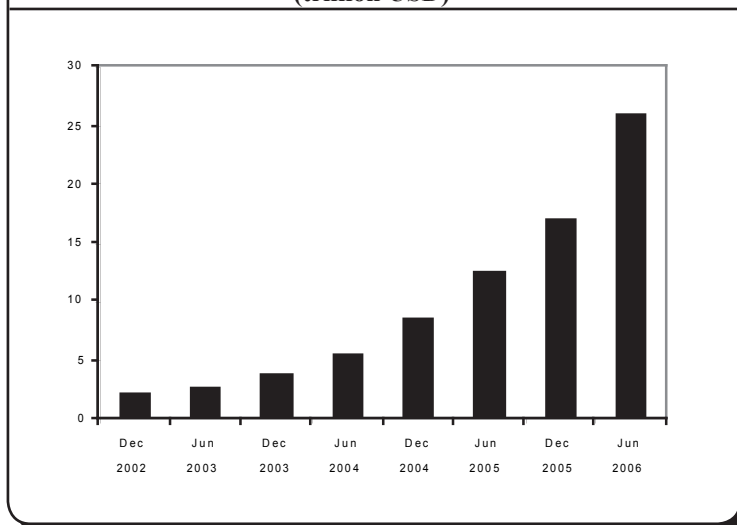
Sources: CBFA, BNB

In terms of risk, this geographical diversification implies that Belgian banks are now very active in less well-known and potentially more risky markets. At the same time, the management of those credit risks could be facilitated by the development of new derivative products. The recent development of this market has indeed been impressive, as illustrated by the strong growth in the notional amount of credit default swaps outstanding, which reached 26 billion dollars at the end of June 2006.

1 Excluding equities and derivatives.

2 These figures, established according to IAS accounting standards, relate to the six major Belgian banks, representing 92.5 p.c. of total consolidated assets of the Belgian banking sector at the end of 2005.

**Chart 3: Notional amount of credit default swaps outstanding
(trillion USD)**



Sources: Bond Market Association, ISDA.

By reducing the segmentation in the credit market, those instruments have helped achieve more consistent pricing and a wider dispersion of risks throughout the financial system. But those developments are not without danger. The increasing complexity of the financial instruments used to shift risks and the dearth of data about the new market positions resulting from those transactions have tended to make it even harder to see where the ultimate risk exposures are currently located in the financial system. In this connection, it remains uncertain how a systemic credit event could impact on market liquidity, asset prices and counterparty risks run by the major stakeholders in those markets.

1.5. RELIANCE ON KEY FINANCIAL INFRASTRUCTURE

Financial market deregulation and the introduction of the euro have put pressure on the payment and securities settlement infrastructure in Europe. On the one hand, users of this infrastructure have sharply stepped up the scale of their transactions. They are making much larger payments and trading bigger volumes, and they want lower costs and faster execution for increasingly complex deals. All this has boosted demand for safe, sound and efficient financial infrastructure. On the other hand, this infrastructure is still quite fragmented. Historically, it has developed from an essentially national basis and a lot of technical, legal or tax barriers stand in the way of the emergence of an efficient architecture for cross-border operations.

Those issues concern the Belgian financial market from both sides of the equation. On the demand side, the large Belgian financial institutions are major users of this infrastructure for themselves and for their clients. Belgium also plays host to two major transnational suppliers of such services, namely Euroclear, an important International Central Securities Depository (ICSD), and SWIFT, a company specialised in worldwide secured transmission of financial messages between credit institutions.

So, the Belgian financial market is strongly involved in the various initiatives taken to achieve full interoperability in the provision of cross-border payment and settlement services. This requires, in particular, price transparency, freedom of choice, open access to all infrastructure.

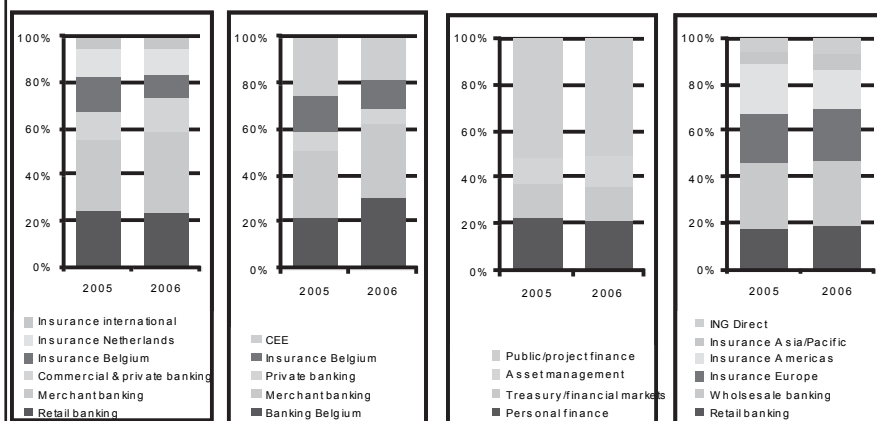
1.6. CHANGING NATURE OF BANKING ACTIVITIES

All the above-mentioned structural developments are gradually contributing to change the nature of banking. Belgian credit institutions have come a long way from the traditional collection of deposits and their intermediation through providing loans or acquiring bonds.

When it comes to client relations, banks are increasingly acting as advisers through their private banking activities. They are also offering asset management services to institutional investors, when they are not acting in that capacity themselves. In certain segments of the credit market, banks' role is increasingly moving towards one limited to origination, with exposures subsequently being offloaded onto third parties. Instead, credit institutions are turning more and more towards the provision of merger and acquisition advice or corporate finance services by setting up bond-financing programmes or private and public equity issues.

A clear indication of those major changes lies in the growing importance of fees and commission in Belgian credit institutions' total banking revenue. For the 4 major bankassurance groups, the distribution between the various sources of income is another sign of strong geographical as well as sectoral diversification.

Chart 4: Sources of profit for the major bankassurance groups on the Belgian market (p.c. of total)



Source: Published accounts of the 4 groups.

The above chart only gives a very aggregate view of the structure of income. This revenue comes from a wide range of activities performed through a web of branches and subsidiaries. It includes origination and trading of sophisticated derivative products, trade finance, hedge fund platforms, energy trading or even credit insurance and guarantees for bonds, asset-backed securities and structural finance.

2. IMPLICATIONS FOR PRUDENTIAL SURVEILLANCE OF BELGIAN FINANCIAL INSTITUTIONS AND MARKETS

2.1. SUPERVISORY AUTHORITIES

As a result of the various developments described in the first section, supervisors have come under heavy pressure to adapt their regulatory approach. In no field has this been felt more strongly than in the definition of capital requirements, traditionally considered as the primary instrument for regulating banking activities. Indeed, the very nature of risks endorsed by banks in the exercise of their core activity, i.e. the financing of mostly illiquid assets, usually held to maturity, by liquid liabilities, mainly collected from uninformed depositors, requires strong capitalisation. Yet, in response to deregulation and the ensuing competition, many banks have been inclined to increase their leverage or to undertake more risky business with an unchanged capital base.

Basel I was a first attempt to set a lower boundary to solvency which was, at the same time, sensitive to the risks assumed by banks. However, the categorisation of risk introduced by Basel I soon proved to be far too crude, calling for a more refined approach. To specify the new capital adequacy rules, supervisors have engaged in a

close dialogue with the major international banks as the latter have, for many years, been at the forefront of the development of internal models for risk management. Another compelling reason to rely more on banks' internal risk-management techniques is that the banks themselves, through their credit monitoring, have much better information than supervisors on the true risks of their clients. However, this intimate knowledge combined with the ever-widening options offered by sophisticated risk-management instruments, also allows banks to fine-tune their own risk preference much more easily than in the past. The existence of those two sources of asymmetry in information between banks and their supervisors justifies the implementation of a system whereby individual banks may use their internal risk models but with those models being subject to a strong validation process by supervisors. This new system, introduced by Basel II, will put heavy pressure on scarce supervisory resources.

The close dialogue between financial institutions and prudential authorities is not confined to the analysis and validation of internal models. It also extends to the global organisation of the risk-management function. As banks' risk profiles are changing very rapidly and the internal models used for monitoring these risks are becoming increasingly complex, supervisors are finding it more and more difficult to carry out their mandate. As a result, they have to rely more heavily on the existence of sound governance principles and good management practice within the banks themselves.

Requirements for market information are also changing. This dimension has been taken explicitly into account by Basel II through the specific role assigned to market discipline. It is probably no coincidence that the introduction of the new international accounting standard (IAS/IFRS), which requires a much greater use of market prices in accounting reports, has more or less coincided with the implementation of the Basel II rules. The objective should be that financial institutions publish what they use in their internal management systems and, conversely, use internally what they publish.

This combination of more risk-sensitive solvency rules, a dialogue between banks and supervisors and market discipline forms the three pillars of the Basel II system. Those various approaches will be needed to meet the forthcoming challenges linked to the above-mentioned changes in the nature of banks' activities.

One of the first challenges emerges from risk diversification by financial institutions through the creation of cross-sectoral conglomerates. As already discussed in section 1, the major Belgian financial institutions combine commercial banking, insurance and security services. Yet risk management is still highly fragmented as supervisors calculate separately how much capital is needed for credit risks, interest rate risks, market risks or even underwriting risks in insurance. Since the total risks are not equal to the sum of the parts, a more integrated approach is recommended. However, a lot of research is still needed to devise adequate instruments to measure the true correlations between the various categories of risk.

Another major challenge is linked to the shifting of risks. At the operational level, some key activities, such as IT or even part of the risk management, e.g. back office functions, are outsourced to other firms. It may be quite complex for supervisors to fully appreciate the extent of the control that those banks are able to keep over those outsourced activities.

Banks are also increasingly shifting some of their financial risks to third parties which makes it more difficult for authorities, as well as for markets, to track the circulation of risks. As an example, nowadays banks are transferring parts of their loan portfolios to hedge funds which, in turn, are leveraging their own position by borrowing from the banks. As a consequence, the latter could well end up financing the very elements of the portfolio that they have previously securitised in the markets.

More generally, when banks are transferring financial risks, this does not mean that they no longer have any responsibility to assume. This is especially the case when risks are sold to retail customers. Supervisors have to make sure that banks are fully aware of the potential consequences, in terms of reputation, of mis-selling products, giving bad advice or neglecting their duty of care.

2.2. CENTRAL BANKS

As long as financial markets experienced no major disruptions, as was the case for the first decades after the second world war, financial stability was not a major source of concern for central banks. Shocks and crises were rare and, when they did happen, they were mostly confined to individual institutions, thus calling for a micro-prudential approach - the traditional remit of the banking supervisory authorities.

However, in recent years, deregulation, the internationalisation of markets, the growing complexity of products and business activities and the emergence of large, global players have all contributed to change the nature of risk.

While real cycles have tended to become smoother, financial shocks have multiplied. The banking crises in Japan or in Scandinavian countries in the early nineties, the Asian crisis, the Russian and Argentinian debt defaults, the stock price bubble, the failure of large hedge funds, the corporate accounting scandals in the US are but a few examples of the potential size and diversity of sources of turbulence.

The emergence of very large and complex financial groups has gone hand in hand with the development of a web of links between those institutions. This makes it necessary to complement micro-prudential surveillance, focused on the resilience of individual financial institutions, with macro-prudential analysis, which endeavours to detect more general developments likely to weaken global financial stability.

The specificity of macro-prudential analysis is not only a question of size. It is also a question of perspective. While, for supervisors, the macro-economic environment and financial markets are considered as exogenous, they become endogenous variables in macro-prudential analysis, which is concerned by the many interactions that exist between individual financial institutions and their global impact on financial markets and the real economy. As market players are reacting much more quickly than in the past to common sources of information, this increases the risk of occurrence of collective behaviour which, however justified at an individual level, could create systemic problems once adopted simultaneously by a large number of institutions.

A lot of effort and research has gone into getting a better understanding of those dynamic effects. Several central banks, including the National Bank of Belgium, are publishing, through their "Financial Stability Review", analyses of the financial sector focusing on interdependencies, the contagion process and systemic risks. The IMF has developed its Financial Sector Assessment Program (FSAP) which carries out a systematic evaluation of the financial stability conditions in the various member countries. In the case of Belgium, the FSAP program was successfully conducted in 2005.

Close surveillance and thorough analysis are no absolute guarantee for an absence of shocks or accidents. In those situations, central banks will come to the fore through their mandate as lender of last resort. Any such intervention should be considered with the utmost caution in order to avoid the risk of moral hazard. The primacy of private-sector solutions should be stressed and the overriding principle must be for the owners, managers and, if need be, creditors of the institution in difficulty to bear the financial consequences of insolvency.

The management and resolution of financial crises are intrinsically complex. The various authorities involved have to face potential conflicts of interest resulting from the different policy objectives they have been assigned. Banks themselves are complex institutions which combine retail and wholesale funding to finance a mix of lines of business. The crisis-resolution mechanism almost always has to be implemented quickly in a very uncertain environment.

Those three dimensions have become even more intricate with the internationalisation of financial markets and the emergence of cross-border institutions. Conflicts of interest will be sharper between authorities from different countries, especially when taxpayers' money could be at stake. International banks are adopting functional or business-line approaches to their operations, which often transcend national borders. While speed will be even more of the essence for solving a cross-border crisis, it will at the same time be necessary to coordinate the action of a larger number of authorities and market players from further afield, often in the face of substantial differences in supervisory culture and legal environment.

Authorities are rising to the challenge. Several cross-border crisis simulation exercises have recently been conducted between the euro-zone central banks in the framework of the ESCB but, also, in a wider setting with the joint participation of central banks, supervisors and Treasuries under the aegis of the EU's Economic and Financial Committee.

These exercises help to develop a common understanding and contribute to raising awareness of the many issues at stake. To provide further impetus for this preparatory work, a high-level Ad-Hoc Working Group has been set up, comprising senior central bankers, supervisors and Treasury representatives of EU member countries. The objective of the Working Group is to explore the scope for developing general principles and procedures that could be applied in resolving cross-border financial crises and to compile a policy toolkit for crisis resolution.

CONCLUSION

Recent changes in the EU financial sector have been wide-ranging. The combined effects of new technologies and deregulation have helped remove barriers and have had the result of speeding up consolidation of the sector. Households and corporations have greatly benefited through the positive effects of stronger competition on prices and through wider choice. Financial institutions have adapted to this changing environment, relying on improved risk-management techniques to master the new risks they are taking on.

Faced with these multi-faceted developments, authorities have to reconsider the way they are pursuing their financial stability mandate. This is all the more necessary now that the implementation of the EU single financial market and the introduction of the euro have greatly contributed to speeding up internationalisation of European financial markets. Supervisory authorities are adapting their approach to take into consideration both the emergence of new categories of risk and the development of better risk-management instruments. Central banks are monitoring financial stability issues from a global perspective, focusing on interdependencies, the contagion process and systemic risk. At the same time, authorities have to put in place adequate arrangements to ensure orderly management of cross-border crises in the EU. This heavy schedule clearly indicates that it will remain a major challenge for central banks and supervisors alike to keep up with the increasing sophistication and complexity of EU financial markets in the years to come.