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FACULTY OF BUSINESS ECONOMICS
Master of Management: Corporate Finance

Masterproef

Corporate social responsibility and the financial crisis

Promotor :
Prof. dr. Lode VEREECK

Supervisor :
De heer Wim MARNEFFE

Vicky Lenssen

*Master Thesis nominated to obtain the degree of Master of Management , specialization
Corporate Finance*

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Foreword

In order to take opportunity of the foreword, I would like to express my thanks to certain people who have contributed to the realization of this Master's Thesis. First, I would like to thank my promoter prof.dr.Lode Vereeck and co-promoter drs.Wim Marneffe for their indispensable help and advice during the development of the Thesis.

Furthermore, gratitude also goes to my parents for their endless support, not only during the development of the Thesis, but during the entire course of Applied Economics to Master of Corporate Finances.

Summary

In the first chapter II. INTRODUCTION TO THE FINANCIAL CRISIS we discussed the housing related *government-sponsored enterprises* (GSEs) Fannie Mae and Freddie Mac that dominated the U.S. secondary mortgage market. These companies facilitated the flow of mortgage credit, which was important especially in times of economic distress like it happened due to September 2001 attacks on the WTCs. They were created by Congress with the purpose to provide funding to mortgage lenders. They would do this by purchasing their mortgages and then holding them or selling them to investors (banks) in the form of securities that they guarantee. Fannie Mae and Freddy Mac held some of the mortgages they purchased in a portfolio, but most of the mortgages were packaged into mortgage-backed securities (MBSs) that were sold to investors in the U.S. secondary mortgage market. However, mortgages and mortgage-backed securities (MBSs), might be highly creditworthy in themselves but remain one of the most risky investments from the view of interest rate risk.

Although senior management of Fannie Mae promoted its image of the enterprise as one of the lowest-risk financial institutions in the world and as 'best in class' in terms of risk management, financial reporting, internal control and corporate governance, some reports showed that this image was false. Fannie Mae's senior management was able to maximize their bonuses and other executive compensations at the expense of the shareholders, by intentionally manipulating accounting. This contributed to a risky behavior of the senior management.

In the United States, almost everyone was able to receive a loan, even those people from which was not sure they could pay back the loan completely or partly. If the borrower couldn't pay his payment, the bank had his house as collateral and simply sold the house at an auction in order to receive its money. When this wasn't sufficient, the government would act as guarantor via Fannie Mae & Freddie Mac. This introduced the concept of 'moral hazard', because banks began to allow loans to the poorer Americans while the potential returns were high and the potential losses were almost nonexistent.

In the aftermath of the WTC attack in September 2001, the president G.W. Bush asked the Federal Reserve System (Federal Reserve) to keep the interest rate a low level in order to boost the consumption. As a result, the rapid rate of growth increased the values of equities, commodities and real estate. But over time, consumer's budget became smaller due to higher commodity prices and rising housing prices. The decline in housing prices had led to a massive downgrade in the ratings of mortgage-backed securities. Banks that invested in the mortgage-backed securities were relatively safe for a while, until on September 6, 2008, Fannie Mae together with Freddie Mac crashed entirely. Because the repackaged securities of the credit agencies were spread to financial institutions across many countries, mainly due its popularity and high credit rating that the rating agencies assigned to, some financial institutions had thousands of these securities in their portfolios. This way, the problem of the U.S. garbage mortgages was dispersed to Dutch, Belgian and English banks. As a result, these banks were dragged into financial problems and had to be rescued by the government.

The crisis started with the failure of Lehman Brothers. In Belgium, life insurances with capital guarantee are popular. Banks like Fortis and Ethias, had sold TAK 23 life insurances. But for some of these financial products, the American financial institutions like Morgan Stanley and Lehman Brothers acted a guarantor. However, Lehman Brothers was dragged into the credit crisis and became a victim itself. The Belgian investments, for which Lehman Brothers acted as a guarantor, were frozen.

One of the supervisory authorities include the European Central Bank (ECB), the Banking Finance and Insurance Commission (BFIC) and the International Monetary Fund (IMF). The ECB attempted to mitigate the prevailing financial crisis, in what the President of the ECB Jean-Claude Trichet¹ called, two phases. Also protective measures are briefly summarized, for instance Markets in Financial Instruments Directive (MiFID) and Protection-fund for Deposits and Financial Instruments (BDFI), in favor of the deposits of savers or investors.

In a subsection in which some lessons from the financial crisis are described, more central supervisory responsibilities are considered. Although the Banking Finance and Insurance Commission (BFIC) argued that the current arrangement were working well, supervisory authorities should consider a banking and insurance supervision under a single structure. More central supervisory responsibilities have the advantage of reducing the chance of certain complex financial markets and transactions to be unregulated.

In the second chapter III. THE HEALTH OF FINANCIAL INSTITUTIONS DURING AND AFTER THE FINANCIAL CRISIS, the background and its government intervention is described of 4 so-called 'systems banks' KBC, Fortis, Dexia and Ethias, that suffered severe losses during the financial crisis.

The first attempts of the Eurosystem to mitigate the prevailing crisis wasn't sufficient. The European Central Bank (ECB) and the national central banks provided large amounts of liquidities but couldn't restore the financial turbulence and thus additional measure should be taken.

Therefore, the Belgian government went on to take interventions by providing guarantees and capital injections. This way, they aimed at strengthening the capital base of the banks and to reinforce the solvability. These government support measure were approved by the European Commission. The 'system banks' KBC, Fortis, Dexia and Ethias were rescued by both federal and regional government support measures. Fortunately, the Belgian government is not alone to support the banks in case of a banking crisis. Alongside France, Belgium invested €2bn in Dexia, and injected €5.5bn into KBC. In a second collaborative cash injection, Belgium invested €4.7bn into Fortis alongside Holland and Luxembourg. In exchange for the provided capital, the Belgian government was able to acquire shares of the same value. The plan is to work off these shares when time shows that the concerning banks are returned into a healthy financial condition.

¹ The ECB's response to the crisis, Statement by Jean-Claude Trichet, President of the ECB at the European American Press Club, 20 February 2009, Paris, www.ecb.int;

The billions of euros invested to rescue these financial institutions, caused the federal government debt to increase proportionally with the amount being borrowed. As a result, the Belgian government debt increased significantly in comparison with other countries. An article in the journal *De Tijd* (July 2011) stated that Belgium belongs to the countries with the highest outstanding government debt-ratio.

In the third chapter IV. INTRODUCTION TO CORPORATE SOCIAL RESPONSIBILITY, the concept of corporate responsibility is being explained and its application in the banking sector, in particular executive compensations.

The period of economic growth and stability in the global financial markets contributed to an excess of liquidities and excessive risky decision-making of executives. The international trade in structured products was popular and lucrative. Top-management were given high bonuses for achieving profit targets and balance totals were heightened. However, no attention was paid to signals concerning potential losses.

Executive compensation is being thought of as a complex and controversial topic. Since the last years, many critics have risen from public opinions, regulators, politicians and investors whether the high levels of payments awarded to Chief Executive Officers (CEOs) are consistent with shareholder's interests. Some academics such as Lucian Bebchuck, Jesse Fried and Martin Conyon, argue that deficiencies in CEO remuneration arrangements and deviations from shareholder's interests are widespread and notable. Some theories, such as the Agency theory and the Contract theory, predict that shareholders use remuneration arrangements to provide incentives for aligning CEO interests with the focus on maximizing long-term firm value. It is possible that CEOs will behave in an opportunistic behavior since they have relatively low ownership of firm shares. Alternative theories, namely the managerial power view, predicts that CEOs with managerial power control the pay-setting process and thus are able to set their own pay.

Also, one can conclude that some large banks are willing to take the step of making changes, as their own initiative, for instance KBC and Dexia. These seem to have taken into account the trade-off between aligning executives' incentives and the incentives of risk-taking. These banks have been trying to change the remuneration schemes, because it is important for an organization to adapt to pressures from outside such as public opinion and critics from regulators. Clearly, they understand that organizational legitimacy can be achieved by appearing trustworthy or by incorporating institutional strategies. However, institutional processes can bring about resistance to change. This means that usually organizations have such strong structures or rules that an introduction of new changes in the organization's culture will take several years to be accepted in the culture of the social organization. So institutionalization reduces the flexibility of an organization to adapt to changes in organization's culture, which may be needed to remain competitive in the market. It already has been a couple of years since the last financial crisis has occurred and executive payments have been dealing with a lot of criticisms. Nowadays, alternative remuneration schemes are still not yet fully integrated in all financial companies because it still needs some time to be accepted by executives and society. Top executives are not easily willing to lower their salaries just because of public opinions.

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I. INTRODUCTION

This Thesis deals with the financial crisis and corporate social responsibility. The causes of the financial crisis can be found in the United States, for instance the 'housing bubble', low interest rate policy and Fannie Mae and Freddie Mac's transfer of debtor-risk via new financial instruments from credit agencies to other financial institutions across countries. Due to the worldwide dispersion of these new financial instruments, that appeared to be 'poisoned', and the international entanglement of financial markets, financial institutions across countries began to face difficulties. In Belgium, governments had to rescue several banks in order to prevent them from failure, for instance KBC, Fortis, Dexia and Ethias. Also, corporate social responsibility will be linked to the financial crisis. In some cases, it already appeared that high executive pays, especially those linked to profit target, contribute to risky behavior of executive management. For instance in the case of Fannie Mae's senior management this will appear.

The structure in this Thesis is divided in 3 chapters. In the first chapter, named II. INTRODUCTION TO THE FINANCIAL CRISIS, we start with discussing Fannie Mae and Freddie Mac's inappropriate senior management, two government-sponsored enterprises that dominated the U.S. secondary mortgage market. They are large and complex financial institutions that played a key role in the financial system. Their role in the financial crisis and the final financial assistance is also being discussed. Then we go further with explaining the causes of the global financial crisis and summing up the financial supervisory authorities and protective measures. The chapter ends with some lessons from the financial crisis.

The emerging financial turbulence in the United States was being reinforced by the failure of the American bank Lehman Brothers medio-2007. The consequences were enormous and were widespread. The problem of the U.S. 'garbage mortgages' was dispersed to Dutch, Belgian and English banks. This because of the international entanglement of financial markets. As a result, banks across many countries experienced financial distress or even financial failures, due to the difficulties in the American real estate market.

The second chapter, named III. THE HEALTH OF FINANCIAL INSTITUTIONS DURING AND AFTER THE FINANCIAL CRISIS deals with the Belgian banks KBC, Fortis, Dexia and Ethias. They experienced financial distress and eventually were provided support measures from domestic and foreign governments.

The banks KBC, Fortis, Dexia and Ethias are also called 'system banks'. System relevant banks are banks which are important to the country's economy and therefore require government support to prevent them from going bankrupt. That is why the government intervened by providing these banks capital injections and guarantees in order to strengthen the capital base of the financial institutions. The government support measures also allowed the concerning banks to secure their access to the interbank money market. Then we give an overview of the system banks' financial health and a summary of the government support measures. Also, the impact of the government intervention is being mentioned.

Finally, in the third chapter, named IV. INTRODUCTION TO CORPORATE SOCIAL RESPONSIBILITY, the concept corporate social responsibility will be explained. It will deal with executive's pays. Remuneration is an important corporate governance issue because its structure has an impact on long-term performance. It also sets out the values of a company and abuses which can cause reputational damage. Two theories in particular will be discussed, namely the Agency theory, Stewardship theory and the Institutional theory. Also, there will be some financial institutions discussed that serve as examples of banks that are willing to make efforts concerning the excessive level of remuneration at large banks and the remuneration structure.

As a current example of high executive's pay, we can use an article published in May 2011 in the financial news of the Wall Street Journal, in which was stated that the U.S. CEO pay jumped with 11% in 2010. The Chief Executive Officers at the biggest U.S. companies were paid with bigger bonuses and stock grants, as boards rewarded them for strong profit and share-price growth. This shows that that the CEO pay in the biggest U.S. companies had not come down at a time the economy was weakening.

Some theories about executive compensation provide good theoretical reasons to conclude that in fact managerial power has a significant affect on the design of executive's pay arrangements. Therefore, executive compensation can be seen and analyzed as both an instrument to address the agency problem and as part of the agency problem. The agency problem arises from the separation of ownership and control in management. This means that when managerial power plays an important role in executive compensation, this also will have its implications for corporate governance. However, the magnitude of these implications depend to the extent to which, the companies involved, recognize these issues. Compensation arrangements can be enhanced by comparing the suggested optimal contracting with the current practices. In this chapter, 'Does the power of top executives substantially affect the design of executive compensation in companies with a separation of ownership and control?', will be the main question throughout this chapter.

Abbreviations

ABS: Asset-Backed Securities

BDFI: Protection-fund for Deposits and Financial Instruments

BFIC: Banking Finance and Insurance Commission or CBFA (in Belgium)

CDO: Collateral Debt Obligations

CEO: Chief Executive Officer

Christian workers movement: 'christelijke arbeidersbeweging'

Derivatives: Financial instruments as options, financial futures and warrants are so-called derivatives of an underlying value, such as shares, indices, currencies or commodities.

EBA: the European Banking Authority has officially come into being as of 1 January 2011. Since then it has taken over all existing and ongoing tasks and responsibilities from the Committee of European Banking Supervisors (CEBS)

ECB: European Central Bank

Endorsed: 'onderschreven'

Equity capital: 'eigen vermogen'

FPIM: In case of the government interventions, in which banks injected for instance capital to banks in Financial distress, the Belgian government was being represented by the 'Federal Investment and Participation agency'. This is an entity controlled by the Belgian government. While the Flemish region is being represented by the Flemish government.

FHLBs: Federal Home Loan Banks (in the United States)

FSA: American subsidiary of Dexia Bank

FSMA: Financial Services and Market Authority

GDP: 'BBP' or Gross Domestic Product

GSEs: government- sponsored enterprises (Fannie Mae and Freddy Mac)

IFRS: International Financing Reporting Standards

IMF: International Monetary Fund

Impairments: 'waardeverminderingen'

MBIA (KBC): MBIA, Inc. is a financial services company, founded in 1973 as the Municipal Bond Insurance Association. It is headquartered in New York and is the largest bond insurer.

MBS: Mortgage Backed Securities

MiFID: Markets in Financial Instruments Directive

NBB: National Bank of Belgium

Ratings: for instance, A+ or BBB-. Different tranches of securities get different credit ratings due to different risk profiles. The 'tranching' is realized through the prioritization of payments. For instance the most senior tranches (class A claims) will receive the cash flows from the underlying asset pool first, the class B and C (mezzanine tranches) after, and the class D (equity tranche) last.

RMBS portfolio: Residential Mortgage Backed Securities (Dexia bank)

Secured loans: 'gewaarborgde kredieten' or 'mortgages'

SME's: KMO's

Structured products: structured products are issued in the Financial markets and are being traded as securities. The 'capital guaranteed funds' are for instance courant structured products. They namely guarantee that at expiration date the amount of capital paid back is at least equal to the original amount of investment. The return of the fund paid at expiration date, is related to the evolution of the underlying assets, such as indices or a bundle of stocks. There are also some products called 'click-funds' that fix the return using 'clicks'. This means, when the underlying index reaches a pre-determined level, de resulting profit is added permanently to the fund.

Tier 1 capital: The Tier 1 capital or 'core' capital is basically book equity capital. It is permanent and provides a high level of protection against losses.

Towns: 'gemeenten'

II. INTRODUCTION TO THE FINANCIAL CRISIS

To begin with, this first chapter concisely describes the financial crisis, how it started in the United States. Two companies active in the U.S. secondary mortgage market, namely Fannie Mae and Freddie Mac, are first being described. Then, the problems its senior management faced and how these two companies played a role in the financial crisis, are explained. Finally, financial assistance to Fannie Mae and Freddie Mac provided by the Treasury department and the Board of Governors of the Federal Reserve System is briefly summarized.

1. Fannie Mae and Freddie Mac

Fannie Mae and Freddie Mac are two government-sponsored enterprises that dominated the U.S. secondary mortgage market. They are large and complex financial institutions that played a key role in the financial system. Fannie Mae and Freddie Mac are called housing related *government-sponsored enterprises* (GSEs) because they have government charters and important links to the government. Also, they are able to enjoy various privileges and immunities, that other ordinary private companies do not enjoy. Furthermore, the GSE's policy is specifically in charge of a government mission, which is providing liquidity to the secondary market in mortgages. The government takes its responsibility with regard to the financial condition of these companies by letting them regulated and supervised for financial health by a government agency².

As we just mentioned, the companies Fannie Mae and Freddie Mac shared a primary mission to stabilize and assist the U.S. secondary mortgage market. A common primary mission, along with facilitating the flow of mortgage credit, including in periods of economic distress like it happened due to September 2001 attacks on the WTCs. To accomplish this mission, the companies issued debt and stock whereby they used the proceeds to purchase conventional mortgages. And then holding them or selling them to investors (banks) in the form of securities that they guarantee. Fannie Mae and Freddie Mac held some of the mortgages they purchased in a portfolio, but most of the mortgages were packaged into mortgage-backed securities (MBSs) that were sold to investors in the U.S. secondary mortgage market. Additionally, the companies guaranteed the timely interest payment and principal payment on the MBSs that they issued, but charged a fee for this³.

Mortgages and mortgage-backed securities (MBSs), might be highly creditworthy in themselves but remain one of the most risky investments from the view of interest rate risk. This because U.S. homeowners have the option to refinance the mortgages they have in case interest rates decline.

² Privatizing Fannie Mae, Freddie Mac, and the federal home loan banks: why and how p.2, Peter J. Wallison, Thomas H. Stanton, Bert Ely (2004), the American Enterprise Institute for Public Policy Research, Washington D.C.;

³ Fannie Mae and Freddie Mac: Analysis of Options for Revising the Housing Enterprises' Long-term Structures p.2, William Shear (2009), United States Government Accountability Office (GAO-10-144T);

In another case, U.S. homeowners generally will not refinance their mortgages when interest rates increase. The U.S. homeowners have the ability to prepay their mortgages without any penalty. When this is combined with the interest rate volatility, it means that the cash flows of Fannie Mae and Freddie Mac through mortgage debt or mortgage-backed securities is highly uncertain, even if a default probability is low. In order to address these risks, Fannie Mae and Freddie Mac purchased various sorts of derivatives like interest rate swaps. The problem with these derivatives is that they carry risks of their own.

Also, it is not possible for them to protect themselves completely against interest rate risk because this is very costly and a perfect hedge doesn't exist. As a result, Fannie Mae and Freddie Mac remained facing partly *interest rate risk* by hedging only a portion of the risk they incurred⁴.

Systemic risk is mostly discussed in the context of banks. But over the years, new requirements for minimum capital, deposit insurance and correct actions when financial weakness is occurring or developing, have reduced the likelihood that either large and small banks will create systemic events. With systemic risk, economists are referring to the danger that an event in the financial systems will affect the wider economy. For example, the failure of a large bank causing to slow down economic activities or causing losses to other banks. The regulatory safeguards to prevent this from happening exist for banks but do not exist for housing related GSEs like Fannie Mae and Freddie Mac, here the regulation is rather weak. Because they are able to enjoy implicit government backing, it increases the incentive to take risky decisions. If a potential systemic event would occur, it will be directly transmitted to the housing market and from there to the wider economy. Also, the financial conditions of banks will be negatively influenced, which are holding the debt securities of Fannie Mae and Freddie Mac, and their ability to further lending will be reduced⁵.

1.1. Fannie Mae's inappropriate senior management

Although senior management of Fannie Mae promoted its image of the enterprise as one of the lowest-risk financial institutions in the world and as 'best in class' in terms of risk management, financial reporting, internal control and corporate governance, the report of 'Fannie Mae and Freddie Mac: Scandal in U.S. housing, James R. Cristie (2007)' showed that this image was false. Fannie Mae reported extremely smooth profit growth and hit announced targets for earnings per share (EPS) each quarter during the period of 1998 to mid-2004. The report stated that those achievements were only illusions created deliberately and systematically by the senior management along with the aid of inappropriate accounting and earnings management.

⁴ Privatizing Fannie Mae, Freddie Mac, and the federal home loan banks: why and how p.4-5, Peter J. Wallison, Thomas H. Stanton, Bert Ely (2004), the American Enterprise Institute for Public Policy Research, Washington D.C.;

⁵ Privatizing Fannie Mae, Freddie Mac, and the federal home loan banks: why and how p.6-7, Peter J. Wallison, Thomas H. Stanton, Bert Ely (2004), the American Enterprise Institute for Public Policy Research, Washington D.C.;

Concerning the accounting policies of Fannie Mae, a large number of its policies and practices did not comply with the accounting standards, Generally Accepted Accounting Principles (GAAP). With regard to internal control, financial reporting and corporate governance, it showed that the company had to deal with several problems also. Errors caused an overstated reported income and capital. It engaged in improper earnings management in order to achieve earnings targets that led to increased annual bonuses and other executive compensations linked to EPS. Fannie Mae's senior management was able to maximize their bonuses and other executive compensations at the expense of the shareholders, by intentionally manipulating accounting⁶.

The company had an enormous financial resources and political influence, senior management received financial rewards tied to a measure of profits that management could easily manipulate and senior executives didn't show much interest in adhering to standards of prudent or safe business operations. The combination of all these factors caused Fannie Mae senior management to engage in a wide variety of risky and unsound practices and conditions⁷.

1.2. The role of Fannie Mae and Freddie Mac in the financial crisis⁸

The housing related GSEs Fannie Mae and Freddie Mac were created by Congress with the purpose to provide funding to mortgage lenders. They would do this by purchasing their mortgages and then holding them or selling them to investors (banks) in the form of securities that they guarantee.

In the United States, almost everyone was able to receive a loan, even those people from which was not sure they could pay back the loan completely or partly. People used to borrow money for a house while they expected that the house-prices would rise. In case of a rise in the house-prices, they either took a larger mortgage on their house in order to be able to consume more, or they sold their houses short afterwards in order to buy a larger house. Even the poorest people were able to buy their own houses. The reason for this can be found in the so-called 'Community Reinvestment' in 1977 which had the purpose to enable every American to accomplish 'the American dream', namely to buy their own house or promote homeownership. This regulation was enhanced by president Bush and banks faced the risk to receive penalties when they would not cooperate with this regulation. Thus, it seemed banks were almost obligated to issue loans to the poorer Americans. However, banks were guaranteed that Fannie Mae & Freddie Mac was charged with the financial risks they would face. This gave rise to the concept of 'moral hazard'. This because banks began to allow loans to the poorer Americans while the potential returns were high and the potential losses were almost nonexistent.

⁶ Fannie Mae and Freddie Mac: Scandal in U.S. housing p.1-2, James R. Cristie, Mark Jickling, Eric Weiss (2007), Nova Science Publishers Inc;

⁷ Fannie Mae and Freddie Mac: Scandal in U.S. housing p.3, James R. Cristie, Mark Jickling, Eric Weiss (2007), Nova Science Publishers Inc;

⁸ Een bundel samengesteld door het politiek secretariaat LVSV Gent & Andreas Tirez, woordvoerder Liberales, 9th December 2010, <http://lvsvgent.be/file/CexhsVXohg1Wv3JOz0Q0Kw.pdf>;

If the borrower couldn't pay his payment, the bank had his house as collateral and simply sold the house at an auction in order to receive its money. When this wasn't sufficient, the government would provide its aid via Fannie Mae & Freddie Mac.

In the aftermath of the WTC attack in September 2001, the president G.W. Bush asked the Federal Reserve System (Federal Reserve) to keep the interest rate a low level in order to boost the consumption, for electoral reasons. One of these reasons was to mask the huge expenditures made by the government in favor of the war in Iran. To boost a broad expansion in credit and economic growth, interest rates were kept at a low level and mortgage securitization became more complex. As a result, the rapid rate of growth increased the values of equities, commodities and real estate. But over time, consumer's budget became smaller due to higher commodity prices and rising housing prices. Consumers started to reduce their expenditures.

Consequently, economic activity began to slow down and eventually housing prices started to decline. This decline in housing prices had led to a massive downgrade in the ratings of mortgage-backed securities⁹.

The Collateralized Debt Obligations (CDOs) can be viewed as packages of securities of loans on houses (mortgages). The banks sold the risk of a non-repayment to other banks. Because the government guaranteed the repayment of these loans via Fannie Mae, these financial products received the highest credit ratings which also increased the popularity of CDOs. The return on CDOs were much higher than comparable financial products and apparently with almost no risk, given the fact that the government acted as guarantor (via Fannie Mae & Freddie Mac). There was almost no risk, as long as the house prices wouldn't decline. In 2007, the American house prices started to decline and the whole structure didn't seem to hold. This because people weren't able anymore to make their payments, that caused higher sales of houses on auctions. But due to decreased demand of houses, the auctions didn't yield sufficient money to banks whereby the help of Fannie Mae was more and more required. The banks were relatively safe for a while, until on September 6, 2008, Fannie Mae together with Freddie Mac crashed entirely¹⁰. The CDOs were worthless and all the banks that invested in these CDOs were dragged into the problems and had to be rescued by the government. Those banks that didn't invested in the CDOs, also were hit by the overall panic. The overall panic caused the banks to pay suddenly a higher interest rate at the interbank money market or caused their stocks to decline in value only because the fact that they are banks.

⁹ The Financial Crisis: Impact on and Response by The European Union p.9, James K. Jackson (2009), CRS Report for Congress;

¹⁰ Dossier Redding Fannie en Freddie, 6th September 2008, De Tijd (tijd.be);

1.3. Financial assistance to Fannie Mae and Freddie Mac¹¹

On September 6, 2008, as a precaution to avoid that the deteriorating financial condition of Fannie Mae and Freddie Mac will threaten the stability of financial markets, the Federal Housing Finance Agency (FHFA) placed the two companies in conservatorship. Also out of concern that their potential default of 5.4 trillion dollar in financial obligations will affect the financial markets. The Treasury department had provided since then almost 100 billion dollar to the companies. The Congressional Budget Office (CBO) assessed the total cost of the Treasury financial assistance would amount to 400 billion dollar.

Furthermore, the Board of Governors of the Federal Reserve System also had committed to purchase up 1.45 trillion dollar in the debt and other securities. The goal was to support housing finance, as well as the housing markets and financial markets. The FHFA mentioned the conservatorship of the two companies would not be permanent but while efforts are being taken to stabilize the companies and restore the confidence in the financial markets, the conservatorship will remain in place.

With regard to the future, the Congress acknowledged it will face difficulties deciding how to restructure both companies and how to promote housing opportunities, while limiting risks to taxpayers and without threatening the financial market stability

2. Causes of the global financial crisis

The global financial crisis is often referred to as the subprime crisis that lies at its core. The U.S. speculative bubble in the housing market, which began to burst in 2006, created the subprime crisis¹². The housing bubble was arisen because the United States promoted homeownership and therefore, especially credit agencies, issued mortgage loans to enable all Americans to lend money for buying their own house. These credit agencies financed themselves via credits but didn't collect deposits. Then they repackage the credits they issued in securities and sell these to other financial institutions. This is known as 'securitization'. When credit agencies face repayment risk, which means that clients are not able to pay back their loans, this risk is transferred to the other financial institutions.

Therefore, because of the low risk the credit agencies faced, they issued mortgage loans to almost everyone. This seemed to be justified by the increasing housing prices. Normally, only the solvent clients would be given this loan, also referred to as 'prime'. Loans allowed to less solvent people, with no job or no income, are of less quality and are therefore referred to as 'subprimes'. These are also called high-risk mortgages or garbage mortgages. Often these 'subprimes' were with a variable interest rate.

¹¹ Fannie Mae and Freddie Mac: Analysis of Options for Revising the Housing Enterprises' Long-term Structures p.1, William Shear (2009), United States Government Accountability Office (GAO-10-144T);

¹² The subprime solution: How Today's Global Financial Crisis Happened and What to Do about It p.1-2, Robert J. Shiller (2008), Princeton University Press New Jersey;

When the interest rate started to increase, many families weren't able anymore to make their payments and consequently had to sell their houses. At the real estate market, due the suddenly high offer of houses, housing prices started to decline. Also, as over time, the commodity prices and housing prices increased, the consumers diminished their expenditures. Because the repackaged securities of the credit agencies were spread to financial institutions across many countries, mainly due its popularity and high credit rating that the rating agencies assigned to, some financial institutions had thousands of these securities in their portfolios. This way, the problem of the U.S. garbage mortgages was dispersed to Dutch, Belgian and English banks. As a result, financial failures occurred across many countries¹³.

More suspicion existed between financial institutions to lend each other money at the interbank money market. They are afraid that the banks they are lending money, would fail and then face the risk of not being repaid. The banks were aware of each other they had invested in these garbage mortgages, but they didn't know to what extent. In case of liquidity problems, the banks can ask the European Central Bank (ECB) for help. The ECB acted as the 'lender of last resort', but had also its conditions and its limits. The lending must not be too high because it could threaten inflation problems. Also, in order to pay back the amount of money the banks lend from the ECB, some banks were forced to sell shares or collect new capital. Accounting principles became more rigid and caused some banks to restructure their balance sheets and were obliged to sell many shares from their equity capital. So what started as a credit crisis, became a financial crisis and developed into a worldwide stock market crisis¹⁴.

The investors are also hurt by the credit crisis. Stock markets crashed and various financial products are being threatened. This because several financial institutions like Fortis and Ethias, had sold TAK 23 life insurances. These TAK 23 life insurances may or may not include full or partial capital guarantee. In Belgium, life insurances with capital guarantee are popular. For some of these financial products, the American financial institutions like Morgan Stanley and Lehman Brothers acted a guarantor. Until recently, these guarantors were given high credit ratings and risk was fairly low. But Lehman Brothers was dragged into the credit crisis and became a victim itself. The Belgian investments, for which Lehman Brothers acted as a guarantor, were frozen¹⁵. A financial crisis and economic crisis can damage the trust of people for each other and for economic institutions. They see the economic institutions they once trusted collapse around them. Also, they feel they were lied to and being encouraged to take excessive risks by overly optimistic stories. This can be translated in slower economic growth for years to come¹⁶.

¹³ Bank en beurs binnenstebuiten p.53, Karin Bellon (2009), Uitgeverij De Boeck nv, Antwerpen;

¹⁴ Bank en beurs binnenstebuiten p.54, Karin Bellon (2009), Uitgeverij De Boeck nv, Antwerpen;

¹⁵ Bank en beurs binnenstebuiten p.55, Karin Bellon (2009), Uitgeverij De Boeck nv, Antwerpen;

¹⁶ The subprime solution: How Today's Global Financial Crisis Happened and What to Do about It p.3, Robert J. Shiller (2008), Princeton University Press New Jersey;

So we can conclude the main causes of the arise of the credit crisis¹⁷:

- A too long-lasting broad monetary policy in the United States;
- The sale of houses to Americans from who could be expected in advance that they can't bear the housing costs;
- The transfer of debtor-risk via new financial instruments from credit agencies to other financial institutions across countries. It also contributed to distrust between parties active in financial markets;
- Some evidence shows that there were U.S. supervisory authorities who didn't do their tasks properly. For instance, they have been watching to 'asset bubble' or 'housing bubble' to grow, without adjusting or sharpening monetary policy. The monetary authorities were mainly paying attention to the moderate development of producers and consumers prices, and didn't consider the 'asset bubble'. In the United States, there should have been taken measures to reduce credit lending to doubtful borrowers.

In a report of James K. Jackson (2009), the author views the crisis as a series of policy events proceeding through four periods. In these various periods the policy responses differed. It is possible that these periods can overlap and thus are not necessarily discretely identifiable. Or it may be that the policy responses have been repeated¹⁸.

1. The early build-up represents the first period of the crisis. Here policymakers responded in ad hoc manner to provide assistance to banks and financial institutions in financial distress. Like Belgium, France and Luxembourg governments and shareholders provided capital to Dexia bank, and Belgian, Dutch and Luxembourg governments injected also capital into Fortis to avert the first major bank crisis in the Euro area;
2. In the second period, national governments (primarily through central banks) made efforts to address issues of liquidity that were caused by the concerns over the viability of the financial system. Central banks intervened to lower interest rates in order to provide liquidity;
3. In the third period, government finance ministries adopted policies to address issues of solvency as either credit markets essentially shut down and as banks attempted deleveraging their positions. Deleveraging can occur by reducing the holdings of troubled assets on their balance sheets;
4. In the fourth period, governments via the finance ministries and legislative bodies, focused more on the growing concerns over the economic downturn that has made the financial crisis worse. Government intervention responded by adopting macroeconomic stimulus to reduce the effects of the economic recession;

¹⁷ CA De Kam (2009), "Van financiële crisis naar depressie?", *Tijdschrift voor Openbare Financiën*, jaargang 41, 2009, nummer 2, p. 85;

¹⁸ The Financial Crisis: Impact on and Response by The European Union p.8, James K. Jackson (2009), CRS Report for Congress;

3. Financial supervision

A. Supervisory authorities

a) ECB

The European Central Bank (ECB) is known as the central bank for the euro area. The ECB has been since 1 January 1999 responsible for conducting the monetary policy. Its main task is to maintain the euro's purchasing power and thus the price stability of the euro system. At the moment, the euro area comprises 17 member countries, that have introduced the euro since its introduction in 1999. The ECB has played an important role in the long and complex process of the European integration. The introduction of the euro was a result of the monetary policy transfer from national central banks (of 11 EU member countries) to the ECB in January 1999. The ECB acted as a supranational institution¹⁹.

When we have a look at the ways in which the European Central Bank has responded to the financial crisis, the President of the ECB Jean-Claude Trichet (2009) made a distinction in his press release between the first phase of the financial market turbulence during the financial crisis, and a second phase²⁰.

The first phase started in August 2007 and lasted to mid-September 2008. This period was characterized by systemic shortage of liquidity:

- As the first respond, over the reserve maintenance period, the Eurosystem provided liquidity earlier than in normal times;
- As the second, liquidity was also provided by the operation of 'open market procedures'. These procedures had been rarely used before the turbulence. The Eurosystem extended the average maturity of its lending to euro area banks, because banks experienced an urgent increased demand for longer-term financing;
- Additionally, the international cooperation between central banks was strengthened very early. This could be done by increasing the exchanges of the information flow and monitoring the market developments in a collective manner. In mid-December 2007 the ECB provided the euro area banks with liquidity in U.S. dollars²¹;

"These measures allowed the Eurosystem to manage the tensions observed in short-term interest rates, as well as having a positive effect on conditions in longer-term markets²²."

¹⁹ Tasks of the ECB, www.ecb.int;

ECB, ESCB and the Eurosystem, www.ecb.int;

²⁰ The ECB's response to the crisis, Statement by Jean-Claude Trichet, President of the ECB at the European American Press Club, 20 February 2009, Paris, www.ecb.int;

²¹ The Financial Crisis: Impact on and Response by The European Union p.16-17, James K. Jackson (2009), CRS Report for Congress;

²² The ECB's response to the crisis, Statement by Jean-Claude Trichet, President of the ECB at the European American Press Club, 20 February 2009, Paris, www.ecb.int;

The second phase of financial market turbulence started mid-September 2008. This period was characterized by credit risk concerns that was spread from the United States to the euro area and caused money market to dysfunction. The Eurosystem responded in additional measures, allowing solvent banks to carry out their activities:

- In mid-October the ECB responded in a measure of adopting a fixed rate tender procedure with full assignment for all of its (i) weekly main refinancing operations (ii) and its longer-term refinancing operations with maturities of up to six months (which is both quite exceptional). This will continue for as long as is necessary, given the situation in the markets;
- Then the ECB also increased the number and frequency of longer-term refinancing operations. This was done by (i) conducting three additional refinancing operations per month (two with a maturity of 3 months and one with a maturity of 6 months) and (ii) introducing a special-term refinancing operation with a maturity corresponding to the duration of the reserve maintenance period;
- Furthermore, the ECB also responded in new measures as seeking to temporarily extend the list of assets eligible for use as collateral in Eurosystem credit operations;
- Finally, the ECB increased the U.S. dollar financing provided to its counterparties by (i) adopting again a fixed rate tender procedures with full assignment and (ii) maturities ranging from one week to three months through swap agreements concluded with the U.S. Federal Reserve System²³. Since December 2007, the ECB, thanks to a swap agreement with the U.S. Federal Reserve System, has been providing euro area banks with liquidity in U.S. dollars in exchange for eligible collateral.

"These measures, which reflect the very significant strengthening of the Eurosystem's intermediation role during this period of turbulence, have allowed solvent banks continued access to liquidity despite the dysfunctional nature of the money market²⁴." These ECB measures of providing weekly operations or our longer-term refinancing operations, have proved effective in overcoming the liquidity shortage in the interbank market. "However, they cannot eliminate the increased concerns regarding credit risk. In this regard, the conditions in the money market have not yet normalized and remain strongly affected by an elevated degree of risk aversion²⁵."

The President of the ECB Jean-Claude Trichet (2009) emphasized that although the increase in the Eurosystem's intermediation role appeared to be necessary, it is only a temporary measure. As conclusion he also stated that if we can draw lessons from the financial turbulence, it is that the turbulence has shown that, by stimulating confidence, particularly in periods of considerable uncertainty, cooperation between central banks in various areas can prove an effective response to both national and global challenges.

²³ The Financial Crisis: Impact on and Response by The European Union p.16-17, James K. Jackson (2009), CRS Report for Congress;

²⁴ The ECB's response to the crisis, Statement by Jean-Claude Trichet, President of the ECB at the European American Press Club, 20 February 2009, Paris, www.ecb.int;

²⁵ The ECB's response to the crisis, Statement by Jean-Claude Trichet, President of the ECB at the European American Press Club, 20 February 2009, Paris, www.ecb.int;

The European Central Bank and its Governing Council do everything which is possible to preserve, enhance, strengthen confidence as there was a lack of confidence in the financial system during the crisis. They want to convince euro the 329 million fellow citizens of the euro area that they can count on the ECB and that the Eurosystem will take the necessary decisions while having always in mind monetary and financial stability as an aim in the medium and long term.

When addressing the financial architecture and the financial supervision, it is most likely policymakers will weigh the cost and benefits of a centralizing supervision tasks into a few entities or dispersing the tasks across a number of different entities. For instance, the Federal Reserve in the United States and the European Central Bank in the euro area. The more central supervisory responsibilities have the advantage of reducing the chance of certain complex financial markets and transactions to be unregulated. However, having various dispersed supervision entities has the advantage of a more specialized approach to market supervision²⁶.

James K. Jackson (2009), compared the EU-system and the U.S.-system in his book 'The Financial Crisis: Impact on and Response by The European Union'. Each member in the EU system is characterized by its own institutional and legal regulations of the banking market. Also, the national supervisory authorities in the EU-system are organized differently by each member country.

On the other hand, in the United States, the Federal Reserve is characterized as a monopoly over the conduct of monetary policy. One of its purposes is to keep monetary policy independent of political interests. The Federal Reserve doesn't act alone, but shares its regulatory and supervisory responsibilities with a number of different entities, which are more directly accountable to elected officials and also are more subject to change²⁷.

b) CBFA

The 'Commissie voor het Bank-, Financie- en Assurantiewezen (CBFA) or the 'Banking Finance and Insurance Commission' (BFIC), was until March 31, 2011, responsible for the supervision of the Belgian financial sector. It included the integration of the 'Control-service for Insurances' (CDV) and the 'Commission for Banking Finance' (CBF). In November 2011, the CBFA changed its name, and the abbreviation now is in Dutch, French and English the 'FSMA' or Financial Services and Markets Authority²⁸.

The CBFA used to be responsible for recognition, suspension and deletion of publicly traded companies and their supervision. Besides the supervision of the stock market Euronext and Nasdaq Europe, the CBFA is also engaged in the control of Treasury bills like linear obligations.

²⁶ The Financial Crisis: Impact on and Response by The European Union p.3, James K. Jackson (2009), CRS Report for Congress;

²⁷ The Financial Crisis: Impact on and Response by The European Union p.4, James K. Jackson (2009), CRS Report for Congress;

²⁸ CBFA verandert van naam: FSMA bevoegd voor gedragstoezicht alle financiële instellingen, 6th November 2011, De Tijd (tijd.be);

Here, the CBFA is assisted by the 'Rentefonds'. The 'Rentefonds' was founded in 1945 and is managed by both the Ministry of Finances and the National Bank of Belgium. It is in charge of the liquidity, administrative functions and the supervision in the stock market of government securities or Treasury bills. It acts as the counterparts of those individuals willing to buy or sell government securities. When there is a high demand for government securities, the 'Rentefonds' will offer more of those and vice versa.

The new supervision structure includes:

- The 'National Bank of Belgium' (NBB) is entrusted both the micro-prudential and systemic control, and the macro-prudential control;
- The successor of the CBFA, the 'Financial Services and Market Authority' (FSMA) is entrusted the supervision of compliance regarding the rules of conduct of monetary policy. The financial intermediaries are bounded to these rules of conduct, in order to guarantee a loyal and professional treatment to their clients. The FSMA is also responsible for the commercialization of financial products and the protection of the consumers of financial services²⁹.

c) *IMF*³⁰

The International Monetary Fund (IMF) is an organization founded in 1944, together with the World-bank and became official by 29 national governments since 1945. It is a specialized organization of the United States. Nowadays, the IMF is an organization of 187 countries. Its work includes enhancing global monetary cooperation, facilitating international trade and promoting high employment and sustainable economic growth. Another important role of the IFM is securing financial stability in the international system. It does this by:

1. Keeping track of the global economy and the economies of member countries;
2. Lending to countries with balance of payments difficulties;
3. Giving practical help to members;

Furthermore, the work of the IMF can be subdivided in surveillance, technical assistance and lending. First, the surveillance includes overseeing the international monetary system developments on both national and global basis, and providing them with macroeconomic and financial policy advice. Second, technical assistance includes assisting mainly low- and middle-income countries in effectively managing their economies. Again, here they provide also practical guidance and training. Finally, lending comprises that the IMF provides loans to countries that have trouble meeting their international payments and cannot otherwise find sufficient financing on affordable terms. It also provides concessional loans to low-income countries to help them develop their economies and reduce poverty.

²⁹ Notification of the CBFA, The new supervision architecture for the financial sector p.2, 23rd March 2011, http://www.cbfa.be/nl/press/pdf/cbfa_2011_15.pdf;

³⁰ About the IMF, <http://www.imf.org/external/about.htm>;

B. Protective measures³¹

a) *MiFID*

The 'Markets in Financial Instruments Directive' is part of the Lissabon-agenda (2000) which purpose is to impose rigid rules to investment agencies in the trading of investment-products. Its regulations and directives are valid since November 2007 in Europe, but also Iceland, Norway and Liechtenstein. Its regulations account for almost all financial instruments, except the savings-accounts and insurance-products. Due to the MiFID, banks have some kind of duty towards their clients because they have to serve the client's interest while making transactions. It even obliges financial institutions to set up a 'investor's profile' according to a specific scheme.

b) *BDFI*

The 'Protection-fund for Deposits and Financial Instruments' was founded in 1998 in favor of the application of European guidelines. It takes responsibility concerning the deposits of savers or investors. Each individual person that is the titular of savings-accounts or securities by an institution, is able to enjoy protection of the fund. Every bank in Belgium, publicly traded company or asset-managers in charge of the issuing of orders in financial instruments, is obliged to join the BDFI. Consequently, they have to pay an annual contribution. The reserves are used in case of a failure. Until recently, the compensation of the BDFI was limited to 20 000 euro (since 1st January 2000)³². But due to the distrust during the credit crisis, Europe upgraded the compensation amount to minimum 50 000 euro in 2008. It only deals with financial instruments that doesn't belong to the institution and of which the investor cannot be used anymore.

³¹ Bank en beurs binnenstebuiten p.46-47, Karin Bellon (2009), Uitgeverij De Boeck nv, Antwerpen;

³² Bank- en Beurswezen in België p.46, H. De Muynck (2008), Academia Press Gent;

4. Lessons from the financial crisis and possible government measures

Although government intervention during the financial crisis were well-handled, it is important to realize that certain risks were not corrected and therefore remain in place and that a new or further intervention framework should be elaborated for future actions³³:

- The financial supervisory authorities should ensure that banks (i) appropriately manage indirect credit risk resulting from foreign currency loans, and (ii) promote borrowers' awareness of risk—both domestically and abroad;
- Also, adopting an unifying macro-financial risk analysis should be considered, with banking and insurance supervision under a single structure, while leaving supervision of financial markets in a separate institution;

Supervision under a single structure could foster a culture of mutual trust, open communication, and common objectives. Like was mentioned before, more central supervisory responsibilities have the advantage of reducing the chance of certain complex financial markets and transactions to be unregulated. However, arguments of the BFIC (or CBFA) stated that the current arrangements were working well.

- The confidence between financial institutions has been damaged and therefore it will take some time before financial markets return to function normal;
- It even could be a better approach to prevent banks from growing too large, this in order to avoid them from failure in times of financial distress;
- Also, government interventions standing ready to bail out banks in distress are creating incentives to moral hazard. This can induce risky and unsound practices;
- When savers or investors are being assured to be compensated their deposits, to a high amount (100 000 euro BDFI), their concerns might be appeased. Therefore, authorities like the BDFI should consider to lower the deposits-guarantee regulation back to the level of before the financial crisis (20 000 euro);
- The big shareholders might also play a role, in checking the reward-system. They could check whether the reward-system induces incentives for risky and unsound decisions;
- Some other points should also be considered, like the management of banks should be less focused on the achievements of high returns, to serve the shareholder's interest. Not linking executive compensation schemes to returns could be helpful here.

³³ Lessons from the Financial Crisis: Concluding Statement of the Mission p. 2, Article IV Consultations, 15th December 2008, Belgium, http://www.nbb.be/doc/TS/Other/imf_Belgium_2008.pdf;

III. THE HEALTH OF FINANCIAL INSTITUTIONS DURING AND AFTER THE FINANCIAL CRISIS

In this section, the background is described of 4 so called 'systems banks' that suffered severe losses during the financial crisis. System relevant banks are banks which are important to the country's economy and therefore require government support to prevent them from going bankrupt. These banks are large and mostly have been widely branched so that in times of financial distress, they can influence the financial system across national borders³⁴. Fortunately, the Belgian government is not alone to support the banks in case of a banking crisis. Belgium can be seen as a small EU country with large banking sectors (along with the Netherlands and Luxembourg) that has been engaged in joint interventions in order to support banks in financial distress. Alongside France, Belgium invested €2bn in Dexia, and injected €5.5bn into KBC. In a second collaborative cash injection, Belgium invested €4.7bn into Fortis alongside Holland and Luxembourg³⁵.

Furthermore, in the summary follows a short overview of the credit rating and rating agencies in which the Special Purpose Vehicle is being explained. Also, the measures are being summed up that both the federal and regional government have taken in order to rescue these banks during the 2008 financial crisis. These government intervention measures can take the form of either 'capital injections' or 'credit loans' and 'securities'³⁶. Additionally, some is described of benefits to the government when undertaking the rescue operations of banks in financial distress and the criterion they use when considering a bank its bailout.

Since the financial crisis, the Belgian banks pursue strategies for moving towards tightened capital standards. These strategies rely in part on sustained profit generation in order to reach common equity levels. As will appear, common equity level of banks is important for their trustworthiness and facilitates interbank lending. Some of the Belgian banks will also need to sustain sufficiently high levels of income generation in order to free enough capital resources so they will be able to repay the capital injected by the government. It also seems the Belgian banks refocused their business activities on their domestic and certain foreign core customers³⁷. This will also appear in the interview of a local KBC bank manager.

³⁴ Studie naar strengere vereisten voor kleinere banken, 18th July 2011, tijd.be;
Wetsvoorstel houdende verplichting voor financiële instellingen om een financieel noodplan op te stellen p.1, Wetgevingsstuk nr. 4-1461/1, 15th October 2009, Hugo Vandenberghe;

³⁵ European banks move to pay back state cash, 6th October 2009, Wall Street Journal;

³⁶ Financial Stability Review 2011 p.7, Nationale bank van België, nbb.be;

³⁷ Financial Stability Review 2011 p.14, Nationale bank van België, nbb.be;

1. KBC

a) Background

KBC group, also known as KBC bank and insurer, is a publicly traded financial holding. It came into being on the 3rd June 1998 as a result of a merger between the Kredietbank, the CERA and ABB Insurances³⁸. During the years, it has developed a good record of cross-sales with insurance and asset management and also engaged in the acquisition of franchises in Central and East Europe. KBC operates as an independent but multichannel bank -insurance meant for individuals and SME's in Belgium and Central of Europe. Its main activities are spread over KBC's 2 important markets, namely Belgium and Central & East of Europe. Here it focuses on retail and bank-insurance activities like asset management, activities concerning services to enterprises and also the selection of market activities³⁹. It is rather selective to its activities when it comes to markets in other regions.

Table 1.1 Structure of KBC

KBC Bank & Insurance Holding	
KBC Bank:	Kredietbank
	CERA
	ABB Insurances

Source: *Belgische Vereniging van Banken; Bank -en beurswezen in België p. 11, H. De Muyneck (2008); Bedrijfsgechiedenis, kbc.com;*

Moreover, since 2nd March 2005 KBC nv operates as one juridical entity that has control over 3 underlying partnerships of KBC Bank (100%), KBC Insurances (100%) and KBL European Private Bankers(99.9%)⁴⁰. Since 2007, KBC has also a presence in the Russian market, which appeared to be profitable after these years⁴¹. As they mainly focus on Belgian bank-insurance (50%), they also aim at the Central & East European market (30%) and markets in West Europe, Southeast Asia and the United States. The main goal of the activities is intermediation rather than investing, unlike Fortis, Dexia and Ethias.

³⁸ Financial information, ABB history, kbc.com;

Canal front: urban renewal in Brussels p.22, Charlotte Mikolajczak, Michael J. Crosbie, Laure Eggericx, Atelier d'art urbain (2004), The Images Publishing Group Pty Ltd, Australia;

³⁹ Bedrijfsgechiedenis, kbc.com

Strategie, kbc.com;

⁴⁰ Groepsstructuur, kbc.com;

⁴¹ Interview with Natalie Vanderheyden, KBC bank manager in Dilsen-Stokkem, 25th July 2011;

The use of products such as Asset Backed Securities and Collateralized Debt Obligations started in 2001 together with the funding of 'Structured Credit Products Group'. KBC Group was able to act via its subsidiary KBC Financial Products as an originator by structuring CDO-transactions in its own interest or the in the interest of a third party investors⁴². KBC Financial Products was in charge of the 'Structured Credit Products Group' and developed its CDOs by themselves, as also appeared in the interview with Natalie Vanderheyden local bank manager of KBC.

She explained that these CDOs can be compared with credit-packages transformed into obligations. They were developed by KBC and sold to its top-clients⁴³. Also, rating agencies had given these CDOs a triple A rating, which is perceived as a creditworthy rating. Then 6 years later, the investments in these structured products was being limited. In 2007, a reduction of trading activities in accordance with KBC's strategy was mentioned in the annual report. This contributed to a fall in the net (not) realized profit coming from financial instruments (-35 million euro in comparison to 2006). This item also involved the negative influence of the market value adjustments of its CDO portfolio (-18 million euro in 2007)⁴⁴. The portfolio CDOs, consisting of CDOs with some Asset-Backed Securities (ABSs) as underlying assets, did not suffer from losses per 31st December 2007, but experienced a negative influence on the net profit in part because of the 'marking-to-market' of the portfolio CDOs with underlying Asset-Backed Securities (ABSs)⁴⁵. The mark-to-market approach of accounting is used for the management of any financial portfolio. It is a way of accounting for financial products in which an inventory of financial products is revalued a pre-set interval (usually at the end-of-business on a daily basis) at the current market rates. The combination of realized and unrealized profit and loss is booked to the profit-and-loss account⁴⁶.

Finally, one year later, the direction committee of KBC group brought the investments in products based on mortgage loans from the United States to an end in 2008. On the 6th November 2008, the journal 'De Tijd' had published an article in which was stated that KBC confirmed writedowns on its exposure to collateralized debt obligations⁴⁷.

In February 2009, more than 90% of the CDOs (repackaged securities) issued by KBC, have received the rating 'garbage' of the rating agency Moody's. This reflects 4.5 billion euro of the total issue 4.9 billion euro. Originally, the rating agency gave its highest Aaa-credit rating to 40% of the CDOs a few years before, due to not taking into account possible crisis scenarios. But in 2009, numerous clients had to face the unforeseen difficulties⁴⁸.

⁴² Waarde-en risicobeheer in 2009 p.56, multimediafiles.kbcgroup.eu

⁴³ Interview with Natalie Vanderheyden, KBC bank manager in Dilsen-Stokkem, 25th July 2011;

⁴⁴ Annual report 2007 KBC p. 56,
http://bib.kuleuven.be/ebib/data/jaarverslagen/KBC_2007nl.pdf

⁴⁵ Annual report 2007 KBC p. 75 ,
http://bib.kuleuven.be/ebib/data/jaarverslagen/KBC_2007nl.pdf;

⁴⁶ Guide to Fair Value Under IFRS p.9, James P. Catty (2010), John Wiley & Sons Inc. Hoboken New Jersey;

⁴⁷ CDO exposure drags KBC to loss, 6th November 2008, Wall Street Journal (wsj.com);

⁴⁸ 180° bocht van Moody's treft KBC klanten, 25th February 2009, tijd.be;

Table 1.2 Key figures of KBC⁴⁹

KBC	2005	2006	2007	2008	2009	2010
Balance total	325,801	325,400	355,597	355,317	324,231	320,823
Equity	17,466	18,453	18,487	14,210	16,662	18,147
Profit (IFRS)	2,249	3,430	3,281	-2,484	-2,466	1,860
Profit (underlying)	2,306	2,548	3,143	2,270	1,724	1,710
ROE	18,00%	24,00%	21,00%	-18,00%	-23,00%	12,00%

The Return On Equity in 2007 is about 21%, which is a high result for KBC, but then drops the following year to negative 18% due to the impact of the financial crisis. When we have a further look at the table above, we are also able to see the other consequences of the financial crisis. It is noticeable that the profit results differs between IFRS and the underlying value. The application of the underlying value means that it experiences no direct influence of the financial crisis. The application of IFRS takes into account the profits or losses directly associated with the financial crisis. This method takes into account writedowns of shares and credits.

The IFRS method is obligated to publicly traded companies according to a new regulation, which requires the recording of the assets' market value (or fair value) in the book keeping, as well as the liabilities⁵⁰. As you can see, profits are higher when not taking into account the writedowns of assets during the financial crisis.

Also, the balance total slightly decreases because of deleveraging of both assets and liabilities. This in order to meet capital standards. Although the government authorized an amount of 3.5 billion euro and the second time also an amount of 3.5 billion euro, the stock market plummeted. This process is known as deleveraging. On the one hand, deleveraging was partly driven by higher costs of debt during the crisis. Credit became scarce and interest rates increased with regard to short-term debt. Especially large banks became unwilling to lend, while investors didn't want to buy short-term commercial papers anymore.

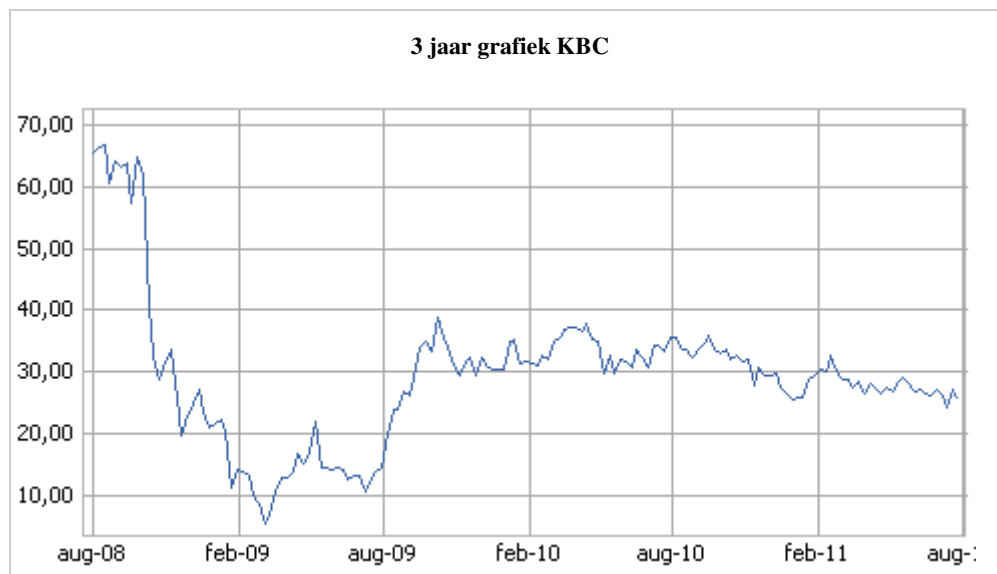
On the other hand, deleveraging was also driven by losses that financial institutions experienced on their MBS portfolios. Because of these losses, financial institutions were forced to sell assets in order to maintain the required leverage ratio, which is the ratio of average assets to capital⁵¹. The fluctuations of the balance total are less volatile in comparison with Fortis or Dexia. This can be attributed to its main goal of its activities which is intermediation rather than investing, like we already mentioned in the previous subsection.

⁴⁹ Annual report 2010 KBC p.18-19;

⁵⁰ International financial reporting standards: a practical guide p.49, Hennie van Greuning, World Bank (2006), Washington DC;

⁵¹ Too big to save?: how to fix the U.S. financial system p. 122-123, Robert C. Pozen (2010), John Wiley & Sons Inc. Hoboken New Jersey;

Graph 1.1 KBC stock quotes from the last 3 years



Source: <http://www.beursduivel.be/koersen.php?page=bkoersen&naam=KBC&type=3j>

b) During the financial crisis & Government support

Due to the low margins of the intermediation function (ask/bid spread), banks like KBC, Fortis and Dexia began to develop more complex products based on mortgage loans from the United States. KBC developed a complex hybrid synthetic CDO of ABS and corporate securities, which was closed in October 2006 and managed by KBC Financial Products⁵². The transaction had a weighted average credit rating of BBB that included some BB-rated assets. However, the development of CDO portfolios caused KBC a high risk to face, without even being aware of it. In 2007, investments in ABSs and CDOs were reduced and a year later investments in structured products based on mortgage loans from the United States were ended. Due to the financial crisis, it was typically many CDO portfolios that suffered significant losses⁵³.

Luckily, it could last the financial difficulties until September 2008 by making use of their liquid means. But the failure of the Lehman Brothers caused exchange rate depreciations, for which KBC wasn't matched up to. Also, the government support to Fortis negatively influenced KBC's difficulties because the expectation concerning the Tier 1 -ratio increased. The 'Tier 1-ratio' is a solvability ratio that has the norm of 8%, based on risky weighted assets and is comprised in the Basel 2 agreement. It is also referred to as a safety margin of the bank's capital. In order to achieve this norm, the capital has to be sufficient. Sometimes the level of capital can be too low in order to fulfill the Tier 1 ratio and therefore the liquidity position could be at stake⁵⁴.

⁵² Interview with Natalie Vanderheyden, KBC bank manager in Dilsen-Stokkem, 25th July 2011;

⁵³ Structured Credit Products: Credit Derivatives and Synthetic Securitisation p.565, Moorad Choudhry (2004, 2010), John Wiley & Sons (Asia) Pte. Ltd.;

⁵⁴ Bank and Insurance Capital Management p.108, Frans de Weert (2011), John Wiley & Sons Ltd., West Sussex United Kingdom;

Since the advent of the financial crisis, the financial market considered higher solvability ratios more and more as the norm. Such a higher norm had led to pressure with regard to financial institutions to increase their capital buffers above the required regulatory minima. Before the beginning of the financial crisis, KBC its solvability position was considered to be very strong. However, the demand of the market to maintain a higher capital buffer combined with significant impairments on its structured products portfolios (like CDOs), led to the need of capital-strengthening instruments.

Because of the disadvantageous events just mentioned, the earlier favorable liquidity position of KBC Groep was at stake. Fortunately, the government rushed to help KBC with capital injections, while KBC experienced pressure due to competitive disadvantage of those banks which already received government support⁵⁵. In order to maintain its capital base at a sufficient level, capital-strengthening instruments were issued which were indorsed by the Belgian federal and regional government. It dealt about a total amount of 7 billion euro of equity securities, endorsed by the Belgian government (3.5 billion euro) and also by the Flemish government (3.5 billion euro)⁵⁶.

In 2009 KBC had to deal with a first quarterly loss of 3.6 billion euro, largely due to writedowns on assets insured by the New York bond insurer MBIA and impairments on the remaining super senior CDO-tranches⁵⁷. Because the government's first rescue wasn't enough to ease shock over the bank's large and unexpected exposure to the bond insurer MBIA, an additional asset protection plan was set up by the concerning 20 billion euro to CDO and MBIA related risk⁵⁸.

Since end 2008, KBC Groep issued 7 billion euro to core-capital securities subscribed by the Belgian government (the FPIM) and the Flemish region (Flemish government) each 3.5 billion euro. The transaction by the Belgian government was completed in December 2008 while the transaction by the Flemish region was completed in July 2009. The returns of these transactions was being used by KBC Groep to strengthen its core-capital by 5.5 billion euro via a standard capital raise of KBC Bank and to increase its solvability margin of its insurance activities by 1.5 billion euro via a standard capital raise of KBC Insurances⁵⁹.

⁵⁵ Bank en beurs binnenstebuiten p. 55, Karin Bellon (2009), Uitgeverij De Boeck nv, Antwerpen;

⁵⁶ KBC bailout, 7th November 2008, Wall Street Journal (wsj.com);

⁵⁷ Annual report KBC 2009 p. 1-2;

⁵⁸ KBC gets new bailout after €3.8bn loss, 14th May 2009, Wall Street Journal (wsj.com);

⁵⁹ Overzicht van de kapitaalversterkende transacties met de Belgische Staat en het Vlaamse Gewest, 6th August 2009,

https://multimediafiles.kbcgroup.eu/ng/published/KBCCOM/PDF/COM_RVG_pdf_FAQ_kapitaalversterkende_maatregelen_NL.pdf;

KBC Groep NV:

- KBL EPB (99,9% subsidiary of KBC Groep);
- KBC Bank (100% subsidiary of KBC Groep): Subscription of new (ordinary) shares of KBC Bank by the Belgian government and the Flemish region for a total amount of 5.5 billion euro;
- KBC Insurances (100% subsidiary of KBC Groep): Subscription of new (ordinary) shares of KBC Insurances by the Belgian government and the Flemish region for a total amount of 1.5 billion euro;

The first government rescue was an 'hybrid capital injection' of 3.5 billion euro based on subordinated loans exchanged for preferential (but not qualified for voting) securities. This way, the Tier 1-ratio could increase up to 11% in December 2009, coming from 9% in December 2008⁶⁰.

A Collateralized Debt Obligation is a financial instrument based on a bundle of hypothetical loans. If in this bundle a higher than expected amount of problems occurs, this means a higher number of individuals cannot fulfill their duties. This causes a loss for the investor and a reduction in the rating for debtor's risk. So CDOs are very sensitive to interest rates, house prices and economic problems in general. KBC had like other banks, CDO-investments in a number of portfolios. In 2008, a reduction in the rating negatively influenced the so-called 'mark-to-model'-value of CDO investments with an amount of 0.3 billion euro.

A reduction in the profit accounts resulted and difficulties had risen back. Therefore, in the beginning of 2009, KBC needed government support again with a second capital injection of 2 billion and an additional stand-by option of 1.5 billion euro⁶¹.

Characteristics of the government rescue transactions⁶²:

- The issue price is 29.50 euro per security;
- The option of KBC to buy back all or a part of the securities at 150% of the issue price (44.25 euro) in cash, with the approval of the financial supervisor;
- The option of KBC to exchange its securities for ordinary shares on a one-on-one basis, is only valid for the transaction concerning the Belgian government after 3 years, thus starting from December 2011. If KBC chooses to exercise this option, the Belgian government has the right to choose for a repayment in cash. The repayment in cash will amount 115% of the issue price starting from the fourth year and will increase each following year with 5 percent points with a maximum of 150%;

⁶⁰ Annual report 2009 KBC p. 1 <https://www.kbc.com/MISC/D9e01/~N/~KBCCOM/~/-BZIZTPN/BZJ07U9/~-BZL19JQ>;

⁶¹ KBC Groep Jaaroverzicht 2008, https://multimediafiles.kbcgroup.eu/ng/published/KBCCOM/PDF/COM_RVG_pdf_Corp_broch_2008_nl.pdf;

⁶² KBC Groep Jaaroverzicht 2008, https://multimediafiles.kbcgroup.eu/ng/published/KBCCOM/PDF/COM_RVG_pdf_Corp_broch_2008_nl.pdf;

c) *After the financial crisis*

A recent credit development is that the ratings on KBC's hybrid securities is upgraded since the 16th February 2010. On the 16th February 2010, Moody's Investors Service upgraded its ratings on certain KBC Bank NV's hybrid securities. The upgrade reflects Moody's view that KBC Bank NV's publicly-stated intention to pay coupons and the agreement of the European Commission to do so lowers the expected loss on these instruments⁶³.

In July 2011, the Belgian journal announced that the Belgian banks KBC and Dexia succeeded the second stress test organized by the European supervisor EBA. It is the second stress test that Europe organizes since the financial crisis. Although was expected that the EBA would be stricter in its testing in comparison with the first stress test last year, it was foreseen that Dexia and KBC were in a safe zone. In Europe 91 banks had to prove their ability to sustain a new crisis. There were 7 banks who didn't succeed the test, they will have to ask the financial help of their shareholders⁶⁴. KBC had a position above that of Fortis, but below that of Dexia. In the first stress test, KBC stated it would have a buffer of 4.6 billion euro in the worst case scenario, which was a good reserve⁶⁵.

The aim of this test was to restore the confidence in the financial system and banks. Since the financial crisis, it happened sometimes that financial institution are reluctant to lend money to their collegian financial institutions because they are not sure whether or not they will be repaid. Some banks suffered severe losses due to the banking crisis, which negatively influenced their perception of credit worthy (or solvency). With the publication of the test results, the European governments hoped that the distrust in the financial institutions will disappear and banks will lend to each other in an easy manner. That will allow them to also issue loans to corporations and individuals in an easier manner, which in turn is a good business to stimulate economic activities.

In an interview with a KBC bank manager in Dilsen-Stokkem, she explained the consequences of the financial crisis in its intern policy. Intern there is a firm focus on credit-policy and profitability. When discussing the credit-policy, there are different levels of authorities or people assigned to this who have the power to make decision related to the credit-activities. When discussing the profitability, a consideration is made between risk and profitability. When clients ask for credit and investment-opportunities, KBC views the total client relationship and operates with client-related pricing.

⁶³ Credit Opinion: KBC Bank N.V. Global Credit Research 9th March 2010
https://multimediafiles.kbcgroup.eu/ng/published/KBCCOM/PDF/COM_RVG_pdf_rapport_Moodys_maart_2010.pdf;

⁶⁴ KBC en Dexia slagen in tweede stresstest EU, 7th July 2011, tijd.be,
[http://www.tijd.be/nieuws/ondernemingen_financien/KBC_en_Dexia_slagen_in_tweede_stresstest_EU.907923_2-3095.art?highlight=dexia](http://www.tijd.be/nieuws/ondernemingen_financien/KBC_en_Dexia_slagen_in_tweede_stresstest_EU.907923_2-3095.art?highlight=dexia;);

⁶⁵ Zeven banken zakken voor stresstest, 23rd July 2010, Het Belang van Limburg (hbvl.be);

Furthermore, she also explained that KBC has been doing and will keep on doing efforts in order to be able to pay back the state cash during the KBC bailout. For this, it attempts to balance its 'in-balance' products (like savings-accounts) and 'off-balance' products (like asset-management). So far, KBC is on scheme and expects to remain on scheme. They also noticed that more questions are asked concerning banks going bankrupt and that both clients and bank colleagues have become more critical.

2. Fortis

a) Background

Fortis Bank started in June 1999 with the fusion of multiple banks, these are the Bank Generale and ASLK in Belgium, MeesPierson and VSB Bank in the Netherlands⁶⁶.

Table 2.1 Structure of Fortis

Fortis Group	
Fortis Bank:	Generale Bank (Belgium)
	ASLK Bank (Belgium)
	MeesPierson (the Netherlands)
	VSB Bank (the Netherlands)

Source: Belgische Vereniging van Banken; Bank -en beurswezen in België p. 11, H. De Muynck (2008)

Up to 2008, the Fortis group originally was composed of Fortis SA/NV (Belgian) and Fortis NV (Dutch). It used to be a Belgium – Dutch bank that handled in bank and insurance activities. It was composed of 2 sub-companies, namely the Dutch Fortis NV and the Belgian Fortis NV/SA. But at the end of September and the beginning of October 2008, it followed to a sale of various parts of Fortis to the Dutch government. The Dutch government acquired the Fortis NV (Dutch), including the share of Fortis in ABN AMRO and the Dutch insurance activities⁶⁷. Also, the Belgian government acquired the Belgian Fortis SA/NV, which it in turn passed to BNP Paribas for 75%. The Belgian bank Fortis NV/SA is since then in hands of BNP Paribas. Besides this, BNP Paribas also operates for 25% in the capital of Belgian Insurance agency (which has become AG Insurance). The remaining components that Fortis had still left was 75% of AG Insurance (this used to be Fortis Insurance Belgium), then Fortis Insurance International for 100% and finally Royal Park Investments which is a structured credit portfolio. But it has nothing to do anymore with the banking activities of the company.

⁶⁶ Voorgeschiedenis, ageas.com;

⁶⁷ Fortis en ABN AMRO, ageas.com;

This means the Fortis company is from then on subject of multiple owners. The various sub-companies of the main Fortis holding remained 'Fortis' in their names. Because Fortis holding now only engages in only a few insurance activities, it changed the name to 'Ageas' on the 30th April 2010⁶⁸.

Today, BNP Paribas Fortis is organized around 4 core activities⁶⁹:

- Retail & Private Banking;
- Corporate & Public Banking;
- Corporate & Investment Banking;
- Investment Solutions;

As we mentioned before, Fortis bank was internationally active when we talk about structured credit products. Like the former ASLK bank invested in a portfolio of Asset-Backed Securities, Collateralized-Debt Obligations and Credit Default Swaps, Fortis bank also invested in such portfolios. Moreover, 95% of its ABS-portfolio had an AAA-rating which is a relative high rating. However, because the portfolio of the ASLK bank sustained the minor 2001-2002 financial crisis, it elaborated its trading to positions in the American dollar⁷⁰.

Before the financial difficulties started, Fortis bank had a Return On Equity between the 23% and 17%, which were promising results. The Belgian-Dutch bank and insurer reported a 41% decline in the first half of 2008, according to Wall Street Journal. They also stated that Fortis could face a more volatile second half as a result of an expected negative charge from the sale of parts of its Dutch commercial banking operations⁷¹. Thus the table shows clearly the impact of the financial crisis with a negative profit of 28 billion euro and a significant decrease in the balance total.

Table 2.2 Key figures of Fortis⁷²

Fortis	2005	2006	2007	2008	2009	2010
Balance total	728,994.0	775,229.0	871,179.0	92,870.0	93,243.0	99,166.7
Equity	19,656.0	21,551.0	34,194.0	7,310.0	10,004.0	9,869.2
Profit (IFRS)	3,941.0	4,352.0	3,994.0	(-28,022.0)	1,192.0	223.1
in millions of euros						

Furthermore, in September 2008 rating agencies Moody's and Standard&Poor lowered the Fortis ratings. Moody's claimed that the lowering of the financial strength of the bank-insurer Fortis, is a consequence of additional writedowns (depreciations) that it had to make on its portfolio of structured credit products. Hereby, it had lost its position in the Dow Jones Euro Stoxx 50 which is a very influential reference of the 50 most important European shares.

⁶⁸ Geschiedenis van Ageas, ageas.com;

⁶⁹ About us, bnpparibasfortis.com;

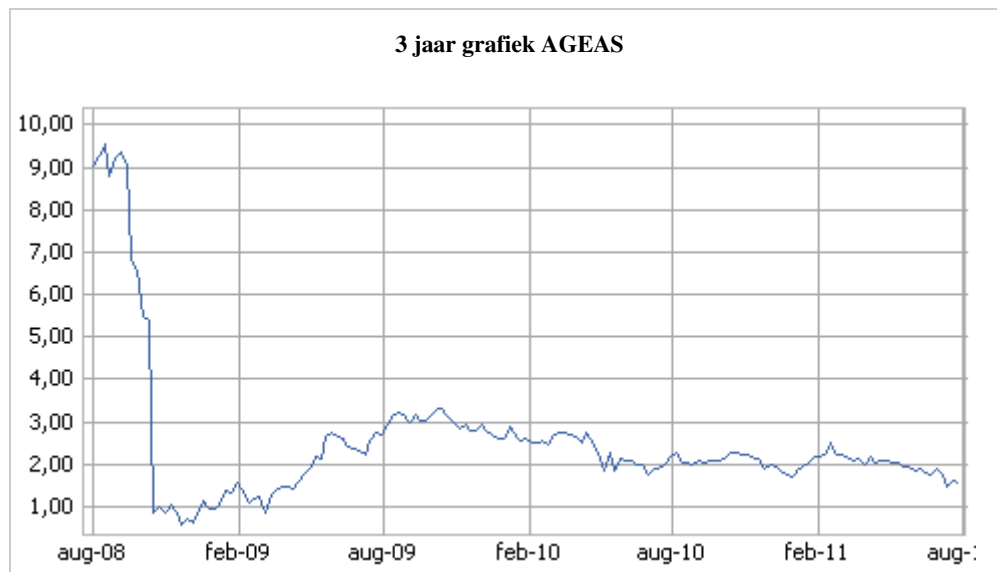
⁷⁰ Fortis Investments Strengthens its US Fixed Income / Structured Credit Capability, Business Wire, 26th July 2004;

⁷¹ Fortis forecasts more volatile second half, 4th August 2008, Wall Street Journal (wsj.com);

⁷² Financial information, <http://www.bnpparibas.be/nl/news/news.asp?Code=JLAU-8F3DM2>; AGEAS Annual report 2010 and financial statements, www.ageas.com;

In the end of September the quotation plummeted to below 5.50 euro and keeps on falling to below 1 euro euro at the end of 2008⁷³.

Graph 1.1 KBC stock quotes from the last 3 years



Source: <http://www.beursduivel.be/koersen.php?page=bkoersen&naam=AGEAS&type=3j>

There are 3 important rating agencies, namely Moody's, S&P and Fitch. Lately, they have been perceived negatively in the news regularly. During the banking crisis, they have played an important role. When the rating agencies lower the rating of the financial strength of a country, due to difficulties with repayments and the size of the debt, the interest rate increases consequently. This makes it harder for that country to fulfill its obligations. Frank Vranken, Chief Investment Advisor of BNP Paribas Fortis Private Banking stated, "S&P and Moody's were heavily occupied with competing each other in order to acquire market share. They issued accordingly an AAA-rating to almost every emission"⁷⁴. Some policymakers demand for a public rating agency as an alternative. However, it is mostly thanks to the government that these 3 players have this power. The supervising authorities namely have delegated their control activities. They daily use the work of these rating agencies⁷⁵.

In the top 10 list of countries with the largest outstanding government debt measured as a percentage of their Gross Domestic Product is Belgium at the tenth position. This gives a clear view that Belgium belongs to the countries with the highest debt-ratio.

⁷³ Moody's verlaagt financial strength rating voor Fortis, 1st September 2008, De Tijd (tijd.be);

⁷⁴ Zijn ratingbureaus verantwoordelijk voor de crisis, 8th August 2011, Netto (tijd.be);

⁷⁵ Zijn ratingbureaus verantwoordelijk voor de crisis, 8th August 2011, Netto (tijd.be);

Countries with the largest government debt (in percentage of GDP):

1. Japan 226%
2. Saint Kitts and Nevis 185%
3. Greece 152%
4. Lebanon 150%
5. Zimbabwe 149%
6. Iceland 124%
7. Jamaica 123%
8. Italy 120%
9. Singapore 102%
10. Belgium 98%

Source: CIA Factbook – World bank 2010

A good alternative to measure the debt-ratio of a country is to express its debt as a percentage of the gross domestic product. A percentage of 90% is often considered as critical. When it is above the 90%, countries face the risk of becoming followed closely by the rating agencies. This can lead to countries being pressured to implement savings. The financial crisis caused the total government debt to increase. It is remarkable that the United States isn't in the list, but with a debt-ratio of 95% it is very close.

Also, it is possible to range countries dealing with debt-amounts on the basis of extern debt. This figure only takes into account the debt which is in foreign hands. Not only the government debt is comprised but also private debts like mortgage loans. It is remarkable that the list includes mostly western countries. In the top 11 list of countries with the largest outstanding extern debt measured in billion dollar, Belgium follows on the eleventh position. Also, this gives a clear view that Belgium belongs to the countries with a high extern debt-ratio that is in foreign hands⁷⁶.

Countries with the largest extern debt in billion dollar (per capita in dollar):

1. United States 14.825 (47.650)
2. United Kingdom 8.981 (143.737)
3. Germany 5.442 (65.566)
4. France 5.366 (85.081)
5. Japan 2.640 (20.848)
6. Italy 2.601 (43.197)
7. Netherlands 2.547 (153.434)
8. Spain 2.456 (53.376)
9. Ireland 2.382 (574.868)
10. Luxembourg 2.076 (4.152.000*)
11. Belgium 1.324 (124.906)

*Source: World Bank, figures per 31st March 2011, with the exception of UK (2010), *Luxembourg as a financial centre;*

⁷⁶ Welke landen torsen de hoogste schuldenberg, 28th July 2011, Netto (tijd.be);

b) During the financial crisis & Government support

Obviously, Fortis bank suffered the most losses during the financial crisis in the summer and autumn 2008 and ended up in a negative spiral. It announced in the autumn 2008 it needed an amount of 8.3 billion euro in order to prevent it from going down. Also, dividend payments were cancelled despite earlier approvals. Fortis its ratings were lowered by a few credit assessors like Moody's and Standard & Poor. Moreover, in the end of August 2009 Fortis had lost its position unfortunately since 1998 in the Dow Jones Euro Stoxx 50, which is a very prominent index of the 50 most important European stocks⁷⁷.

Out of necessity, the federal government had supported Fortis in order to prevent it from going bankrupt and to prevent other banks from failing also. If not, this would lead to economical depression and national unemployment like it happened during the 1930's. So the government had been taking supportive measures to guard the intermediation function.

On the 29th September 2008 it was announced that Belgium, Luxembourg and the Netherlands will engage together in a participation of Fortis bank as a support measure⁷⁸. While the Dutch government invested about 4 billion euro in the Dutch Fortis division, Belgium participated in the main covering Fortis Bank NV/SA bank-holding via a Federal Participation and Investment Society (FPIM) inclusive the Fortis bank Belgium, which amounted to *4.7 billion euro*. Meanwhile, Luxembourg took a 49% participation in the Fortis Banque Luxembourg for an amount of *2.5 billion euro*. The three national governments acquired 49% in each of the 3 Fortis divisions. This would be the first capital injection. But soon was realized that the first attempt of this partial nationalization to prevent the bank from failure wasn't sufficient. This because the more influential clients recalled their deposits very early, the first capital injection wasn't effective. Then in the beginning of October 2008, the Dutch government paid an amount of *16.8 billion euro* for a full acquisition of the Dutch components of Fortis Bank with the remaining part of ABN AMRO.

Also on the 6th October 2008, a new rescue-plan was elaborated and a second capital injection was able to take place. The federal government purchased the remaining shares of Fortis Bank Belgium for an amount of *4.72 billion euro* in order to fully nationalize the Belgian division of Fortis Groep. Short after, 75% of the Belgian Bank Fortis was sold to the French BNP Paribas and chose to keep the remaining 25%. By transferring respectively 4.70 billion euro and 4.72 billion euro from the 'Treasury' to the FPIM, it enabled FPIM to acquire 99.93% of the shares of Fortis Bank⁷⁹.

Furthermore, on the 4th December 2008, another capital injection of 598.72 million euro and a total 5 billion euro loan was made available by the 'Treasury' to the FPIM for the foundation of a Special Purpose Vehicle. This Special Purpose Vehicle was being discussed to take over a part of the problematic or 'toxic' assets of the Fortis Bank. Later the name was changed to Royal Park Investments. This was financed for 43.5% by the Belgian government and the remains were financed by BNP Paribas and Fortis holding.

⁷⁷ AB InBev in, Fortis uit Euro Stoxx50, 31st August 2009, De Tijd (tijd.be);

⁷⁸ Fortis gets €11.2bn rescue, 29th September 2008, Wall Street Journal (wsj.com);

⁷⁹ Bank en beurs binnenstebuiten p. 55, Karin Bellon (2009), Uitgeverij De Boeck nv, Antwerpen;

The Special Purpose Vehicle hereafter was able to benefit from a 2 billion euro loan (part of the total 5 billion euro loan), put available by the government. Also, a remaining 3 billion euro loan for the Fortis holding was made available. The loans were being remitted back to the Belgian government in 2009⁸⁰. Additionally, a second capital injection in the Special Purpose Vehicle of Fortis by the government took place on the 27th April 2009, which amounted to 137.387 million euro⁸¹.

New structure of Fortis Groep⁸²:

- Dutch part: Fortis Bank Netherlands + ABN AMRO; Fortis Insurance Netherlands + Corporate;
- Belgian part: 25% Fortis Bank Belgium;
- Luxembourg part: Fortis Bank Luxembourg;
- French part: BNP Paribas purchased Fortis Insurance Belgium and also has a partial participation in Fortis Bank Belgium and Fortis Bank Luxembourg;

The Belgian government support measures in short are (in billion euro):

2008	First capital injection	4,7
	Second capital injection	4,72
	First capital injection in SPV	0,6
	Loans to SPV	2
	Loans to Fortis Holding	3
2009	Repayment loan to SPV	-2
	Repayment loan to Fortis Holding	-3
	Second capital injection in SPV	0,14

c) *After the financial crisis*

After the intervention of the government in the beginning of October, the trade of Fortis shares was being shut down on the 18th November 2008 for a verdict of the law court concerning the sale of Fortis activities to BNP Paribas⁸³. The day after, the trade was being restarted again on the Euronext Brussel. After only 20 minutes being started, the share was 2% lower at 0.69 euro⁸⁴. The biggest fall took place in the end of November 2008 with a share-value of only 0.57 euro. This meant a negative return of -89.94%. The most shareholders were feeling betrayed and were convinced they were being informed incorrectly. Almost a year later on the 10th March 2010, the Authority of Financial Markets (AFM) accused Fortis concerning market-manipulation and the act of not publishing exchange rate sensitive information. Fortis SA/NV in Brussels and Fortis NV in Utrecht both had to pay a fine of a total amount of 576,000 euro⁸⁵.

⁸⁰ Federale Overheidsdienst Financiën (Federale Staatsschuld) p.38 , Jaarverslag 2008, June 2009;

⁸¹ Impact van de financiële crisis en de genomen steunmaatregelen op het beheer van de staatsschuld en de evolutie van de staatsfinanciën p.32-33 ,Rekenhof, 9th December 2009;

⁸² Bank en beurs binnenstebuiten p.28, Karin Bellon (2009) Uitgeverij De Boeck nv, Antwerpen;

⁸³ Analisten verwachten herstel van aandelenkoers Fortis, 19th November 2008, De Tijd (tijd.be);

⁸⁴ Aandeel Fortis zakt bij hervatting, 19th November 2008, De Tijd (tijd.be);

⁸⁵ Fortis krijgt boete voor misleiding beleggers, 10th March 2010, De Tijd (tijd.be);

3. Dexia

a) Background

Dexia is a private banking arm and is known as a Belgian-French financial holding. It was founded in 1996 by a fusion of Gemeentekrediet of Belgium and Crédit Local of France. These 2 important actors of the local Public Finance in France and Belgium were united together with Banque Internationale of Luxembourg in 1999, under the name Dexia. Its American subsidiary FSA existed via Crédit Local and was responsible for the insurance of Asset Backed Securities (ABS). In 2001, Arcofin CVBA invested its shares of Artesia BC in Dexia, in exchange for new shares of Dexia. Its main activities are the granting of credit to all levels of the government, therefore it is internationally active in markets of governmental funds. Then also financial services are provided to individuals and enterprises by acting as a retail and commercial bank. In comparison with other banks, it belongs to one of the greatest in financing to government. Furthermore, it also operates as a retail bank in Belgium, French and Turkey, by operating in insurances to individuals. And in Luxembourg as Dexia Banque Internationale which provides also services like asset management⁸⁶.

Table 3.1: Structure of Dexia

Dexia Group (Gemeentekrediet + Crédit Local France + ARCOFIN)	
Dexia Bank:	Dexia Bank
	Artesia BC

Source: Belgische Vereniging van Banken; Bank -en beurswezen in België p. 11, H. De Muynck (2008)

In the ranking of the top 500 corporations worldwide measured revenues, Dexia is being ranked as the first Belgium company on the 49th position⁸⁷. Also, it takes the 30rd position of the largest European banks listed according to their equity capital⁸⁸.

The publicly traded corporation Dexia has participations in multiple banks like Dexia Crédit Local in French, Dexia Bank in Belgium, Dexia Banque Internationale in Luxembourg and also in Denizbank in Turkey acquired in 2006⁸⁹.

Furthermore, thanks to the acquisition of métier 'Thesauri and Financial markets' it was able to have a strong presence on the capital markets for both refinancing and balance-management of Dexia group and the elaboration of structured financial products. This undertaking had excellent results up till 2007 but the banking crisis in 2008 did have a significant interference. This caused the risk aversion of Dexia group to increase and activities in trading being reduced to the absolute minimum.

⁸⁶ <http://www.groeparco.be/index/be-nl/1979/navigationcats/551/>;
www.dexia.be;

⁸⁷ Fortune list 2010

⁸⁸ Kerncijfers p. 72, Febelfin (2007);

Bank-en beurswezen in België p. 11, H. De Muynck (2008), Academia Press, Gent;

Bank en beurs binnenstebuiten p.28, Karin Bellon (2009) Uitgeverij De Boeck nv, Antwerpen;

⁸⁹ Effecten van steunmaatregelen p.23, Saskia De Leeuw (2010), Universiteit Gent;

Table 3.2 Key figures of Dexia⁹⁰

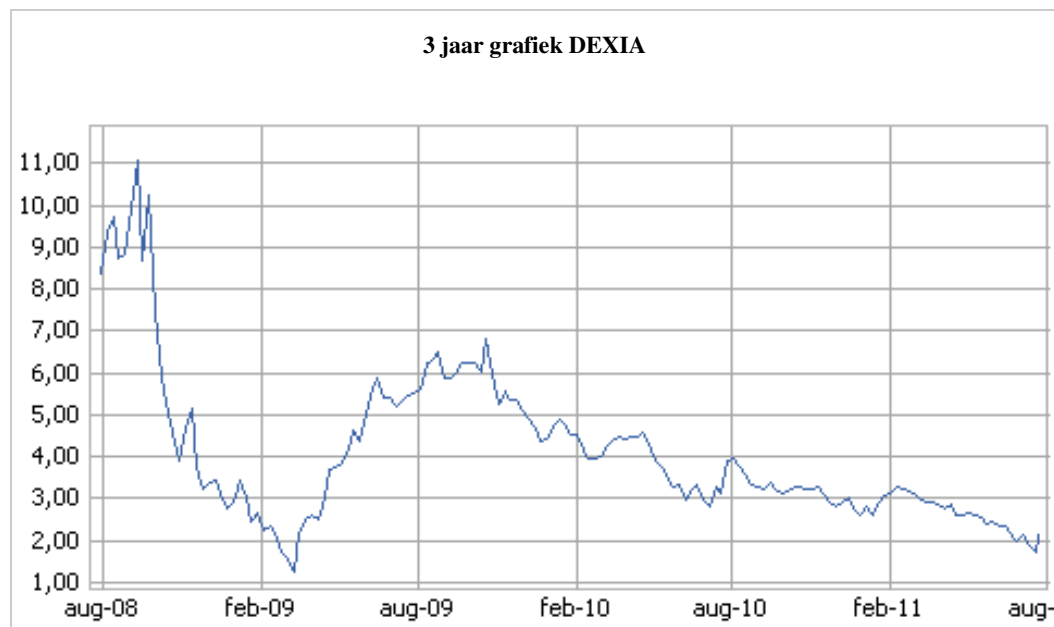
Dexia	2005	2006	2007	2008	2009	2010
Balance total	508,761.0	566,743.0	604,564.0	651,006.0	253,771.0	247,902.0
Equity	15.7	18.435	16.394	5.618	5.675	5.452
Profit (IFRS)	2,038.0	2,750.0	2,533.0	(-3,326.0)	421.5	678.3
ROE	20.0%	23.1%	17.8%	(-22.6%)	6.0%	9.3%
<i>in million euro</i>						

The first assessment of the net profit in 2008 was -3 billion euro due to the crisis. As the table shows, the actual net profit in 2008 was negative amount of -3.326 billion euro. But after these losses, it was able to make progress in 2009. Also, the high results of the Return On Equity changed in negative percentages. And the equity reduced a one third. The American subsidiary FSA contributed to most of the losses. This caused an increased risk aversion in the American financial market and a loss in confidence. Therefore by way of precautions, reductions in the value of Residential Mortgage Backed Securities (RMBS) portfolios were made that amounted for 300 million euro causing the net loss to be even higher than what was expected.

The Dexia annual report of 2008 announced the 3 losses:

- 1.6 billion euro due to the sale of FSA;
- 600 million euro on investment portfolios;
- 800 million euro of opposed to financial institutions (including Lehman Brothers, Iceland Banks and Washington Mutual);

Graph 3.1 Dexia stock quotes from the last 3 years



Source: <http://www.beursduivel.be/aandeel-DEXIA.koersen>

⁹⁰ Key figures can be found at www.dexia.com;
<http://www.groeparco.be/index/be-nl/1979/navigationcats/551/>;
https://www.dexia.be/info/NL/Media/050411_dex_RA_n_DEF_tcm_11-19273.pdf;

On the 5th March 2009 Dexia experienced the lowest level of its DEXB quotation of about 1.21 euro coming from above 2 euro. As a reaction Dexia announced a remediation plan in which it would focus on its main activities and avoid risky positions in financial markets. In Belgium about 750 jobs were cancelled and in the rest of the world also 750 jobs in total were cancelled. However, during the 2nd half of 2009 the quotation would increase again between €4 and €7.0⁹¹.

Confidence in Dexia started to increase little because it showed that unsecured loans were possible via commercial papers and obligations. It became clear in the end of 2009 when the amount of covered guarantees in function of Dexia's loans lowered by almost 50%.

b) During the financial crisis & Government support

The financial crisis in 2008 caused a disturbance in financial markets, market liquidity and also in the credit risks of certain RMBS (Residual Mortgage Backed Securities).

Furthermore, during the banking crisis Dexia also had to deal with enormous pressure because other financial institutions refused to grant credit. The other banks experienced namely difficulties having confidence in Dexia due to potential losses concerning its American subsidiary, the FSA. When the Moody's rating agency in September 2008 lowered the quotation of Dexia long term credits and deposits and after its stock plummeted 30%, Dexia group realized they needed government support very urgent. Thus there was a high need for French, Belgian and Luxembourg government support, along with existing shareholders support. Within a few days, support measures of capital injections and government guarantees were available. Namely, a capital raise of approximately 6.4 billion EUR with additional government guarantees for certain assets and liabilities⁹².

- A capital injection of almost 6.4 billion euro:

- 1 billion euro invested by the Belgian federal government;
- 500 million euro invested by the Flemish government;
- 350 million euro invested by the Walloon government;
- 150 million euro invested by the Brussels government;
- 3 billion euro invested by the French government;
- 376 million euro invested by the Luxembourg government;
- 1 billion euro invested by the 3 most important institutional shareholders, namely Gemeentelijke Holding, Arcofin and Ethias;

⁹¹ <http://www.beursduivel.be/aandeel-DEXIA.koersen>

⁹² Dexia CEO and board chairman step down, Wall Street Journal, 30rd September 2008; Bank en beurs binnenstebuiten p. 55, Karin Bellon (2009), Uitgeverij De Boeck nv, Antwerpen; <http://www.groeparco.be/index/be-nl/1979/navigationcats/551/>;

- From the 31st of October 2008 effectively, government guarantees in order to safeguard the commitment of Dexia with regard to opposed financial institutions. This amounted to a total of maximum 150 billion euro. It originally was planned to expire in November 2010:

- the Belgian government takes 60.5% for its account;
- the French government takes 36.5% for its account;
- the Luxembourg government takes 3% for its account;

Remarkably, these supportive measure did have a purpose of interest because the 3 governments were able to benefit from:

- the right to additional shares at 9.9 euro per due to the additional capital;
- a monthly fine paid by Dexia to the 3 governments proportional to their contributions. These fine could amount in 2009 to 0.5% on the secured loans with a lifetime of less than one year and 0.865% on the credits of longer than 1 year;

As a result of the capital raise, the shareholders-structure was being mixed up. The several Belgian and French governments had then control over the majority of Dexia's capital⁹³:

- The Belgian Communities (Gemeenten) have 14% participation;
- The Belgian Government has 5.7% participation;
- The Belgian Regions (Gewesten) have 5.7% participation;
- The French Caisse des Depots et Consignations (CDC) has a blockings means of 25%;

Besides those mentioned above, other banks already had participations in Dexia⁹⁴:

- Ethias now has a control of 5%;
- The French insurer CNP has a control of 1.3%;
- Arcofin has a control of 14%;
- Gemeentelijke Holding has a control of over the 14% and is now the second most largest shareholder;

It has been widely discussed that Dexia seemed to have received a preferential treatment⁹⁵ of the government with regard to the financial crisis. Dexia is the main bank of several towns, which are also shareholders of Dexia via the Gemeentelijke Holding. Also, Arcofin is an important shareholder, which is the financial part of the Christian workers movement. So, it was not a surprise that ex-premier Jean-Luc Dehaene with a political ACW-background became the new chairman of Dexia in the beginning of October 2008. But will he be able to save Dexia? Professor Paul De Grauwe⁹⁶ is rather pessimistic and points out Dexia's American subsidiary FSA still has this sub-prime 'garbage' and the question is who will be held responsible?

⁹³ Dexia krijgt 6,4 miljard euro vers kapitaal tegen 9,90 euro per aandeel, 30rd September 2008, trends.be <http://economie-nl.trends.rnews.be>;

⁹⁴ Vrtnieuws, 29th June 2011, deredactie.be;

⁹⁵ Banken zitten op een berg geld, Ewald Pironet (2008) in Knack p. 16;

⁹⁶ Banken zitten op een berg geld, Ewald Pironet (2008) in Knack p. 16;

In the end of 2008, a sale of the FSA's healthy shares followed and Dexia was no longer active in financial market for insurance of MBS and CDO.

The underlying distrust on the financial markets lasted, merely because of the lowering of Dexia's quotation from A1 to A3. This was foreseen in the annual report in 2008, in which was stated that Dexia had a Moody's Rating A1 with a negative outlook⁹⁷.

c) After the financial crisis

On the 6th February 2010, the European Commission agreed with the proposed restructuring. The restructuring was necessary to justify the government support to Dexia ⁹⁸:

- the acquisitions of Dexia Crediop, Dexia Sabadell and Dexia Banka Slovensko had to be undone;
- early termination of state guarantees in the middle of 2010;
- by 2014, Dexia has to be slimmed by one third in total;

Dexia had high hopes of its banking activities in Turkey while the traditional retail activities realized a higher proportion in the earnings. Along with Turkey, Belgium and France became promising. It was even predicted that half of the personnel would work in Turkey by 2014⁹⁹.

An increasing inflow of funds through savings accounts of private customers and a decreasing outflow of capital via obligations and loans to the public sector, meant it was on the right way having sufficient funding in the short term. Additionally, because of the early termination Dexia appeared to regain its confidence¹⁰⁰.

In January 2011, Dexia and La Banque Postale came to an agreement with regard to the finance of Dexia worth 3 billion euro. It has taken the form of covered bonds (obligations with collateral). Through the cooperation with La Banque Postale, Dexia has been able to solve a large part of its finance problems. The French part of Dexia has not been able to make use of savings, in comparison with the Belgian part of Dexia. Thus it has to appeal to the financial markets, but this is rather expensive while the financial markets are still turbulent since the financial crisis¹⁰¹.

In June 2011, the journal De Tijd has calculated that the support of the governments to Dexia almost 3 years ago, is evaporated for nearly four fifth. This means the investment of the federal government, the 3 regional governments and the shareholder Gemeentelijke Holding in 2008, is worth 80% less¹⁰².

⁹⁷ Annual report Dexia Bank 2008, dexia.be;

⁹⁸ Dexia redt kroonjuwelen uit klauwen van Europa, 6th February 2010, standaard.be;

⁹⁹ Helft Dexia-personeel Turks in 2014, 12th October 2010, standaard.be;

¹⁰⁰ Dexia ziet volledig af van staatswaarborg voor toekomstige financieringen

<http://nieuws.be.msn.com/financieel/artikel.aspx?cp-documentid=153978733>;

<http://www.groeparco.be/news/be-nl/145/detail/item/4616/navigationcats/510/>;

Dexia ziet voor zijn toekomstige financieringen volledig af van de staatswaarborg, Dexia.be;

¹⁰¹ Dexia krijgt 3 miljard van La Banque Postale, 20th January 2011, tijd.be;

¹⁰² Overheidssteun Dexia voor 80% verdampt, 17th June 2011, analist.nl;

In the beginning of June 2011, the Moody's rating agency lowered the quotation of Dexia long term credits and deposits from the high rating A1 to a lower rating of A3. It is applied to Dexia Bank Belgium, Dexia Crédit Local and Dexia Banque Internationale. This means they are being perceived at a lower solvency. The shares are heavily undermined as a consequence ¹⁰³. This will have an impact on banks like Ethias who have participations.

In July 2011, the journal De Tijd announces that Dexia succeeded the stresstest organized by the European supervisor EBA¹⁰⁴. Dexia had a position above that of KBC and Fortis. Most likely it had its position thanks to a higher buffer by which the government support measures have played an important role¹⁰⁵. Dexia stated last year during the first stresstest of which it also succeeded, it had a buffer of 7.4 billion euro in a crisis scenario¹⁰⁶.

4. Ethias

a) Background

Ethias is a Belgian Insurance Group for SME's but is also a bank offering standardized investment products. It was founded in 1919 by a group of town and province directors, in order to insure explosions, fire, lightning and thunder. It concerned an association of persons agreed to insure one another. Their contributions were part of a fund which was used to cover the damages of members. So every member participated as an insurer and also as the insured one. Furthermore, there was neither capital nor shareholders that had to be compensated. It used to focus on the public sector and public companies, but since January 2000 it expanded its focus to also private companies¹⁰⁷.

In December 2003 the company changed its name while one of the reasons was to have uniformity between the 3 language-areas of Belgium. It used to have the name SMAP (Société Mutuelle des Administrations Publiques) in the French-speaking part, while in the Dutch-speaking part it used to name OMOB (Onderlinge Maatschappij der Openbare Besturen).

At that time, Ethias was the third largest insurer in Belgium, with 1 million customers¹⁰⁸. In June 2007, Steve Stevaert was appointed as the new chairman of insurance company Ethias¹⁰⁹.

Before restructuring in June 2008, Ethias was a group of four mutual insurance associations as shown in the table following.

¹⁰³ Dexia onderuit na ratingverlaging Moody's, 8th June 2011, hbvl.be;

¹⁰⁴ KBC en Dexia slagen in tweede stresstest EU, 7th July 2011, tijd.be;

¹⁰⁵ Interview with Natalie Vanderheyden, KBC bank manager in Dilsen-Stokkem, 25th July 2011;

¹⁰⁶ Zeven banken zakken voor stresstest, 23rd July 2010, hbvl.be;

¹⁰⁷ Waar staan we, ethias.be;

¹⁰⁸ Van waar komen we, ethias.be;

¹⁰⁹ Steve Stevaert is nieuwe voorzitter van verzekeraar Ethias, 23rd June 2007, tijd.be;

Table 4.1 Structure of Ethias Group

Ethias Group (OMOB)	
Ethias Bank	Ethias Fire
	Ethias Life
	Ethias Work Accidents
	Ethias Common Law

Source: Belgische Vereniging van Banken; Bank -en beurswezen in België p. 11, H. De Muynck (2008)

It was in Ethias Life where the consequences of the financial crisis were most visible. It had to deal with a deficient solvency due to the force decrease of stock quotes and value decrease of both financial obligations and structured products. The loss of confidence in the solvency caused liquidity problems because there were a lot of First-deposits called in¹¹⁰. Ethias had a gamma of First-products like for example First-insurance account (2001), First-Invest (2005), First-Junior (2006) etcetera, these are TAK 21 investment-products with a higher guaranteed return and less risk involved¹¹¹. Because of the rapid growth of Ethias, the First-products were part of the majority of the Ethias-portfolio. But the First-formula has led to some problems because, due to bad economic circumstances in the capital markets, the guaranteed high return could not be accomplished. When clients began to extract their deposits from their First-accounts, while the underlying investments heavily depreciated, problems quickly raised.

Furthermore, on the 10th December 2009, the European Commission strongly demands Ethias to cut back its insurance activities, primarily its First-products¹¹².

Also important to notice, because Ethias is not stock market listed, it is not required to have a bookkeeping according to the IFRS standards. Investments were entered in the bookkeeping at their cost price and depreciations were entered in the bookkeeping in case of 20% depreciation for at least 3 years¹¹³.

Due to the continuously learning and aggregative know-how, the number of members also increased during these years. Among its members, include the following¹¹⁴:

- The Federal Government, the Regions (Gewesten) and the Communities (Gemeenschappen);
- The actors like the Senate, parliaments of the Regions and Communities;
- The 10 provinces;
- More than 540 cities and towns;
- Hundreds of social welfare institutions (OCMW);
- Thousands of associations like school committee, personnel associations and youth houses;

¹¹⁰ Ethias ends the year 2009 with a positive results, Press release 12th February 2010, ethias.be;

¹¹¹ Waar staan we, ethias.be;

¹¹² http://www.onafhankelijkadvies.be/index.php?option=com_content&task=view&id=131&Itemid=1;

¹¹³ Annual report 2008 Ethias nv p. 50

http://www.ethias.be/upload/corporate/nl/rapport/Rapport_annuel_Ethias_sa_NL.pdf;

¹¹⁴ Tot wie richten we ons, ethias.be;

Table 4.2 Key figures of Ethias¹¹⁵

Ethias	2005	2006	2007	2008	2009	2010
Balance total	23,985.641	26,391.190	28,657.997	28,642.019	24,867.080	24,071.751
Equity	1,433.970	1,556.329	1,709.217	1,101.577	1,149.301	1,093.353
Profit (IFRS)	86.643	138.771	149.332	(-2,071.480)	37.717	(-198.712)
<i>in million euro</i>						

Subsidiary Ethias Bank has suffered the most during the financial crisis and also contributed most to the losses of Ethias Group. The loss of Ethias Bank was primarily due to depreciations on the securities portfolio¹¹⁶, which consisted of CDO's, ABS and MBS¹¹⁷. After the period of October 2008 to March 2009, with an instable financial market and the loss of confidence of clients, Ethias seemed to regain the loyalty of its clients. It ends the year 2009 with a positive results while they expected in the beginning of the year to end with a loss of 9.2 million euro¹¹⁸. In 2010, Ethias accomplished an operational result of 225 million euro but an exceptional element includes the depreciation of 424 million euro of the portfolio Dexia shares. The shares of Dexia were valued at €3.85 coming from €8.41. Ethias owns 5.04% of Dexia's capital. The valuation of the Dexia-shares at €3.85 comes from the assumed market value in May 2012. In May 2012 is the deadline between Ethias and the European Commission by which Ethias has to eliminate 90% of the portfolio Dexia-shares because the EU is convinced that Ethias is too much depended on and exposed to one company, namely Dexia¹¹⁹.

b) During the financial crisis & Government support

There are several financial institutions like Fortis and Ethias that have sold popular TAK-23 life insurances, provided with or without partial capital protection. For a number of these products, American financial institutions were involved like Morgan Stanley and Lehman Brothers that acted as a guarantor. These guarantors used to have high ratings and therefore low risks. But Lehman Brothers (from 1850), which is the oldest and second largest bank in the United States, became a victim itself of the financial crisis. It will appear that the lack of support Lehman Brothers has received, was a big mistake with regard to banks who were associated with Lehman Brothers¹²⁰.

¹¹⁵ Key figures can be found at:

corporate annual report 2008 p.25, ethias.be;

corporate annual report 2007 p.96, ethias.be;

corporate annual report 2010 p.56, ethias.be;

Annual report 2008 Ethias nv p. 28 - 30

[http://www.ethias.be/upload/corporate/nl/rapport/Rapport annuel Ethias sa NL.pdf](http://www.ethias.be/upload/corporate/nl/rapport/Rapport%20annuel%20Ethias%20sa%20NL.pdf);

¹¹⁶ Annual report 2008 Ethias nv p. 63

[http://www.ethias.be/upload/corporate/nl/rapport/Rapport annuel Ethias sa NL.pdf](http://www.ethias.be/upload/corporate/nl/rapport/Rapport%20annuel%20Ethias%20sa%20NL.pdf);

¹¹⁷ De'subprime' crisis en het auditverslag p.69, Bosch Kenny (2009), Thesis U Hasselt Diepenbeek;

¹¹⁸ Ethias ends the year 2009 with a positive results, Press release 12th February 2010, ethias.be

¹¹⁹ Results 2010 of Ethias nv, Press release, 4th May 2011, ethias.be;

¹²⁰ Bank en beurs binnenstebuiten p. 55, Karin Bellon (2009), Uitgeverij De Boeck nv, Antwerpen;

In the end of 2007, Ethias received a warning of the European supervisor CBFA concerning its participation of 5.04% in Dexia's total capital via its life insurance branch. Thereafter, during the first 7 months of 2008, Dexia's quotation declined with approximately 50%.

At 23rd September 2008, the Fitch rating agency lowered the ratings of Ethias Life and Common Law from A+ to A-, because Ethias had an exposure of 120 million euro to the American Lehman Brothers. This was derived from both the annual report of Ethias and the report of the rating agency Fitch¹²¹. The solvency of Ethias Group appeared to be negatively influenced caused by the distrust in the financial markets and led to a loss on both structured products and derivatives.

On the 21st October 2008 it announced a finance plan that was set up to improve the liquidity and solvency of the group. The plan included a capital injection from the federal and regional government for a total amount of 1.5 billion euro¹²².

They each received in exchange preferential shares of Ethias. The capital raise was effective on the 13th February 2009¹²³ and was like KBC a reinforcing solvency intervention¹²⁴:

- Capital injection of 500 million euro invested by the federal government;
- Capital injection of 500 million euro invested by the Flemish government;
- Capital injection of 500 million euro invested by the Walloon government;

One of the measures of the European Central Bank on the 15th October 2008 was that the Eurosystem lowered the credit threshold for marketable and non-marketable assets from A- to BBB-, with the exception of asset-backed securities (ABS)¹²⁵. It was at the 16th February that the Fitch rating agency affirmed the BBB- rating of Ethias its Insurer Financial Strength Rating and Issuer Default Rating. They also added that the future prospects are rather stable.

After the government intervention, the structure of Ethias and its shareholder structure is the following¹²⁶:

- Ethias Common Law has a participation of 25% -3 shares;
- The Federal Government has a participation via FPIM (Federal Participation and Investment company) of 25% +1 share;
- The Walloon region has a participation via FIWAPAC nv (Société Régionale d'Investissement de Wallonie) of 25% +1 share;
- And the Flemish region also has a participation of 25% +1 share;

¹²¹ Ethias voor 120 miljoen blootgesteld aan Lehman, 23rd September 2008, tijd.be

¹²² Verslag van het Rekenhof, Rekeningenboek over 2008, 17th June 2010;

FPIM, Jaarverslag 2008 p. 7 http://www.sfpi-fpim.be/Data/FPIM_jaarverslag_2008.pdf;

¹²³ FPIM, Jaarverslag 2008 p. 16 http://www.sfpi-fpim.be/Data/FPIM_jaarverslag_2008.pdf;

¹²⁴ FPIM, Jaarverslag 2008 p. 7 http://www.sfpi-fpim.be/Data/FPIM_jaarverslag_2008.pdf;

¹²⁵ A Proposal Of a New Approach to Financial Supervision After the 2007-2008 Financial Crisis p.18, Luiss Guido Carli (2006-2008), Doctoral Thesis Phd, Libera Università Internazionale degli Studi Sociali, Roma;

¹²⁶ Annual report 2008 Ethias nv p. 14

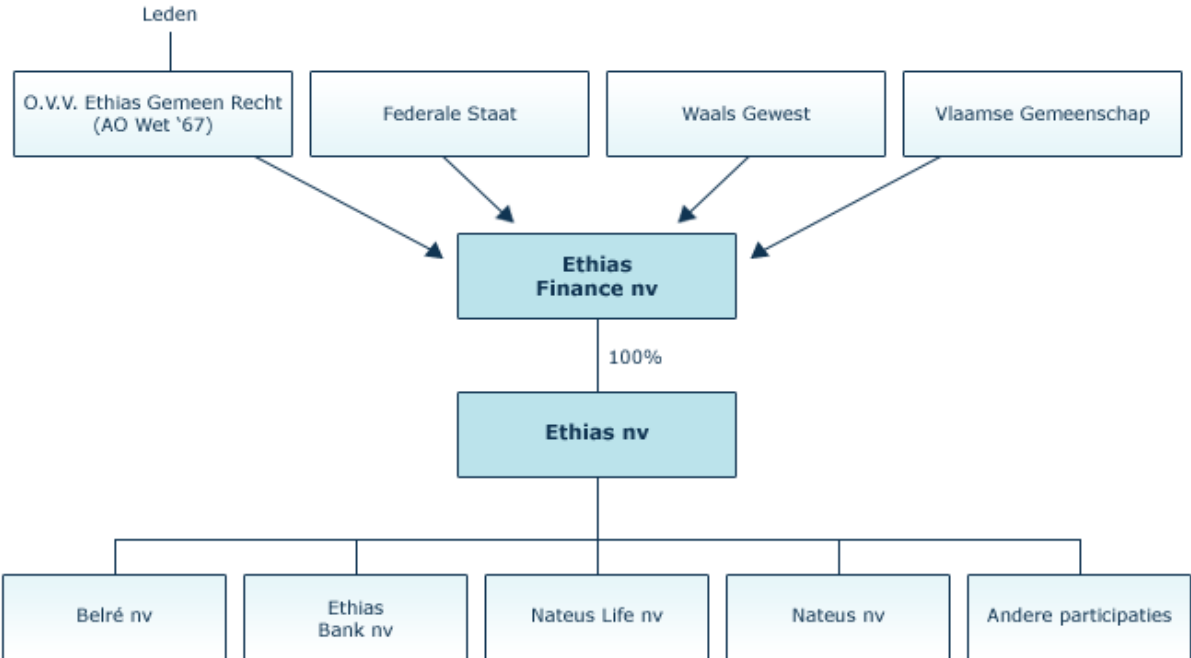
http://www.ethias.be/upload/corporate/nl/rapport/Rapport_annuel_Ethias_sa_NL.pdf;

Ethias nv draagt haar Dexia-aandelen over aan Ethias Finance nv, Press release, 1st June 2011, ethias.be;

Furthermore, Ethias Group consisted of several levels¹²⁷:

- Ethias Common Law is responsible for activities in the branch of 'Accidents' and 'Illnesses'. Along with the Belgian government, Walloon region and the Flemish community, it is shareholder of the holding 'Ethias Finance nv';
- 'Ethias Finance nv' also has 100% participation in shares of 'Ethias nv';
- 'Ethias nv' is an insurance-company and has all the remaining participations in the other partnerships of Ethias Group;

Figure 4.1 Shareholder structure Ethias



Source: Ethias een mutualistisch geïnspireerde verzekeringsgroep, ethias.be

¹²⁷ Onze structuur, ethias.be;

c) *After the financial crisis*

At August 2010, Ethias is still not out of trouble with its participation in Dexia of 5.04%. Ethias is the 6th most important shareholder of Dexia. The 88.8 million shares had a cost price of 1.36 billion euro, with an average of 15.25 euro per share. At the end of 2008, most of the shares were depreciated to 9.90 euro per share. Since then, Dexia has lost some of its value, but nevertheless Ethias didn't list a depreciation with the argument that the participation in Dexia was a long term view.

Meanwhile, the European Commission and the international auditor PricewaterhouseCoopers insisted Ethias to push off 90% of its Dexia's shares before May 2012. According to the rules, this must lead to a depreciation but Ethias has other expectations. The auditor is even convinced that Ethias should pass through a loss of 400 million euro in its bookkeeping. This because it strongly believes that Ethias will experience difficulties in 2010 while avoiding depreciation. The majority of the Dexia shares are valued at 9.90 euro in the bookkeeping of Ethias, while the real market value is much lower. This can eventually lead to loss in the equity capital¹²⁸.

On the 30th June, the Boards of Ethias nv and Ethias Finance nv approved the transfer of all Dexia-shares held by Ethias nv to Ethias Finance nv. This way the insurance company holds its promise to the European Commission to remove the majority of the Dexia-shares from its financial balance, without selling the shares to an external party. The internal solution means that the Dexia-shares are being sold to the holding of the group, Ethias Finance nv¹²⁹. It also is able to meet the deadline, set up by the European Commission, with a lead of more than one year. To remind, the European Commission obligated Ethias nv to remove at least 90% of its Dexia-portfolio before May 2012.

The transfer concerns its participation of 5.04% in Dexia-capital. The share was being valorized at €2.81 each, a value that matches the value of the share at the time of the decision to transfer. It will yield a depreciation of about 82.5 million euro to Ethias nv. Taking into account the transfer of the Luxembourg subsidiary Belré and the already accomplished operational result of 2011, the allocation of the depreciation will not affect the solvency of the Ethias Group¹³⁰.

To be able to finance this operation, Ethias Finance nv will collect about 280 million euro by issuing obligations at the market¹³¹.

This operation also received approval of the European Commission¹³².

¹²⁸ Ethias in de penarie door Dexia-belang, 19th August 2010, tijd.be;

¹²⁹ Ethias houdt Dexia's binnen de groep, 1st July 2011, tijd.be;

¹³⁰ Ethias nv draagt haar Dexia-aandelen over aan Ethias Finance nv, Press release, 1st June 2011, ethias.be;

¹³¹ Ethias haalt circa 280 miljoen euro op, 30th June 2011, tijd.be;

¹³² Ethias nv draagt haar Dexia-aandelen over aan Ethias Finance nv, Press release, 1st June 2011, ethias.be;

5. Summary

a. The credit ratings and rating agencies

Table 5.1 The ratings of the banks according to rating agencies

	Rating agencies		
	Moody's	S&P	Fitch
KBC	Aa3	A	A
BNP Fortis	A1	AA	A+
Dexia	A3	A	A+
Ethias	-	-	BBB-

Source: <http://www.bankshopper.be/nl/sparen/vergelijk-ratings-waarborgfondsen.html>

"Special Purpose Vehicles are legal entities such as limited liability company, a trust or a corporation. They can be public or private and appear in many varieties. Of interest for credit ratings are financial SPVs that are set up to transform existing financial assets that generate cash flows, into new securities to be reimbursed by these cash flows. These SPVs are designed so they cannot go bankrupt and to live a predetermined lifetime, setting them thereby apart from regular business corporations as ongoing concerns that can go bankrupt. Financial SPVs tend to have common characteristics. One of the common characteristics is that they are created by a sponsor to carry out a specific purpose or a series of specific transactions, such as managing a determined pool of financial assets purchased with money raised in the securities markets. SPVs have assets purchased from the asset originator, liabilities issued to pay for these assets and a portion of economic equity. The originator sells a pool of assets to the SPV. The SPV issues several classes or 'tranches' of securities with different priorities of claims on the cash flows of the SPV and the pool of assets that backs them. Having different risk profiles, different tranches of securities get different credit ratings. The assets in the pool can range from cash instruments such as mortgages, credit card receivables, loans, corporate bonds, notes, or previously structured instruments such as CDO's, to synthetic instruments such as credit default swaps (CDSs). The tranching is realized through the prioritization of payments. For instance the most senior tranches (class A claims) will receive the cash flows from the underlying asset pool first, the class B and C (mezzanine tranches) after, and the class D (equity tranche) last. Hence the most junior tranches (mezzanine tranches) are the ones that absorb first credit losses and thereby insulate the most senior claims from default risk. The original purpose of the SPV is to protect its creditors from the default and potential bankruptcy of the originator, or previous owner of its assets. Hence, the SPV is segregated from other entities and acquires the assets from the originator via a true sale. It is in this sense that an SPV is said to be bankruptcy-remote from the originator. This allows originating firms to finance themselves off-balance sheet via such SPV at a lower cost of capital than otherwise. The 3 dominant players among the credit rating agencies (CRAs) are S&P, Moody's and Fitch. By and large, the 3 agencies are comparable in the most important dimensions. In terms of performance, investors generally perceive all 3 agencies as equivalent¹³³."

¹³³ The rating agencies and their credit ratings: what they are, how they work and why they are relevant p. 32-33, 388, Herwig M. Langohr, Patricia T. Langohr (2008), John Wiley & Sons Ltd, West Sussex England;

b. *The government interventions and the Tier 1 ratios*

The following table summarizes the loans and capital transfers of both the federal and regional government:

Table 5.2 Federal and regional government interventions 2008-2009

	2008		2009		Total
	Federal	Regional	Federal	Regional	
KBC	3.50	0.00	0.00	3.50	7.00
Fortis	15.02	0.00	(-4.86)	0.00	10.16
Dexia	1.00	1.00	0.00	0.00	2.00
Ethias	0.50	1.00	0.00	0.00	1.50
<i>in billion euro</i>					20.66

The total support of the federal and regional government to the banks KBC, Fortis, Dexia and Ethias amounted 20.66 billion euro.

"Under the Basel Accord, banks must maintain risk capital of at least 8% of the total 'risk-weighted assets' (RWAs) of the bank. In addition, banks must maintain a Tier 1 ratio of 4%. These numbers are absolute minimums. A 'well-capitalized bank' must maintain a Tier 1 ratio of 6% and a total capital ratio of 10%.

The Tier 1 capital or 'core' capital is basically book equity capital, less goodwill because goodwill cannot serve as a buffer against losses. Tier 1 capital is permanent and provides a high level of protection against losses. It includes proceeds from stock issues plus disclosed reserves.

Tier 2 capital or 'supplementary' capital is deemed of lower quality than Tier 1 capital because it might be redeemed eventually. It includes undisclosed reserves, asset-revaluation reserves, and general provisions or loan-loss reserves, hybrid debt capital instruments and subordinated debt with maturity greater than 5 years. Since such debt has junior status relative to deposits, it acts as a buffer to protect depositors (and the deposit insurer). A maximum of 50% of bank's capital could consist of Tier 2 capital¹³⁴."

Thus the Tier-1 ratio of a bank is the ratio of capital (provided by the shareholders) plus the long term subordinated loans on the one hand, and the 'risk weighted assets' (total liabilities) on the other hand¹³⁵.

While supervisors demand a Tier 1 ratio of at least 4%, some banks strive for a higher percentage for themselves. Between banks, the Tier 1 ratio serves as an important measure for the confidence they have in each other to lend them money. Especially in times of uncertainty, the Tier 1 ratio can serve as an important measure. A high Tier 1 ratio indicates the bank has a relative high equity capital stand-by and this will protect it against losses.

¹³⁴ Value at risk: the new benchmark for managing financial risk p. 54, Philippe Jorion (2007), The McGraw-Hill Companies Inc, United States of America;

¹³⁵ Bank- en Beurswezen in België p.40, H. De Mynck (2008), Academia Press Gent;

Banks tend to lend money far more easier to other banks with a high Tier 1 ratio, which in turn facilitates this bank to provide mortgages and other credits.

The definition is agreed in a mutual agreement between banks, but is also well-known in the Basel 1 and Basel 2, in which the international norms of capital and liquidity are summarized¹³⁶.

The government interventions with regard to banks during the financial crisis have improved the capital base of these banks significantly. For banks to have rather easy access to the interbank market, these banks should attempt to approach the average Tier 1 ratio of 10%. This way, they prove each other they have sufficient capital and thus are a reliable opponent. In the following table, you can see that the government interventions have lead to an increasing Tier 1 ratio during 2008 and 2009 for the 4 banks discussed, and thus improved consequently the banks their capital buffer. The Tier 1 ratios in 2009 all go beyond the 10%.

Table 5.3 Tier 1 ratios

	Tier 1 ratio	
	2008	2009
Fortis	9.4%	12.3%
KBC	9.0%	11.0%
Dexia	10.6%	12.3%
Ethias	10.53%	11.16%
<i>According to Basel 2</i>		

Sources: Annual report 2009 KBC p. 1 <https://www.kbc.com/MISC/D9e01/~N/~KBCCOM/~/-BZIZTPN/BZJ07U9/~-BZL19JQ>;
 Press release Dexia, dexia.com www.dexia.com/NL/aandeelhouder_belegger/.../20090226_CP_NL.pdf;
 Press release Ethias, ethias.com www.ethias.be/upload/pdf/.../2009_0106_ethiasbank_certificaat2009.pdf;
 Press release Fortis, bnpparibas.be <http://www.bnpparibas.be/nl/news/news.asp?Code=JLAU-8F3DM2>;

Basel 3, in which the new international norms concerning capital and liquidity are stated, will be entered in phases from the first January 2013. By 2019 the introduction should be completed. The purpose of Basel 3 is to create an uniform level playing field for all banks worldwide. Basel III is an international accord trying to standardize some banking safety requirements in a worldwide economy. The failure of Lehman Brothers and Northern Rock and the troubles in Greece, Spain, Italy, Ireland, and Portugal show how one nation's problems are felt around the world. Basel III will not prevent another global financial crisis, in some opinions, but it will require banks to hold more capital and, hopefully, be better prepared for the next crisis.

Some countries are reserved to the introduction of Basel 3. They argue that several countries are already started to notice the use of higher standards in comparison with the standards of Basel 3. Other countries believe that the norms are too strict. An equal and uniform base is difficult to accomplish with regard to accounting differences between GAAP and IFRS. Moreover, not all rules are yet final. Still there could be changes made concerning liquidity ratios and stable financing ratios before they are actually implemented.

¹³⁶ KBC receives €2bn cash injection, 22nd January 2009, Financial Times (FT.com);
 Dexia to take €3.6bn asset sale hit, 27th May 2011, Financial Times (FT.com);

However, by and large it seems to be worthwhile to follow any developments in the situation. There could be a chance that banks move to areas where regulations are most flexible¹³⁷.

c. Government interventions and benefits to the government

The government could benefit from the capital injections because it is able to refinance itself in a cheap manner and the share market might benefit when investors search for returns that they cannot find anymore with the fixed interest investments¹³⁸.

Another perspective is that the banking supervision regulations does not provide capital injections as a supervision instrument. For the capital injections granted by the government, the taxpayer acts as a guarantor. The money obtained to finance the capital injections is partially borrowed by governments operating on the capital market. When those banks rescued by government measures eventually do fail, the taxpayer will have to bear the mistaken acts of the Minister of Finances¹³⁹. The consequence is thus that the so-called 'system relevant' banks supported by the government during the financial crisis, are not owned by the shareholders of these banks but the taxpayer (via the government) as 'lender of last resort'. It is obvious economic model of market regulation cannot last long time in which private risks are being passed to the public finances¹⁴⁰.

d. Selective bailouts

To what extent is the choice of government intervention related to the nature of the banking sector or legal structure of banks in distress? The financial crisis has shown that the 3 'traditional' financial sectors, namely the depository banks (like Dexia), investments banks and insurance companies (like Ethias), were rescued by government intervention (KBC and Fortis are a combination of bank and insurer). The rescue of Ethias (insurance company) can be seen as prove that the insurance sector can be a source of systematic risk. In contrary to the more traditional view to which the specific balance sheet structure of these insurance companies would make the systematically not relevant.

A too-big-to fail approach is an approach in which the financial institution in distress is too important for the economy to fail and government support is thus important. This approach is likely to be followed on a national base, because the cost of bailouts are ultimately passed on to the taxpayers. The financial institutions in distress are being evaluated by the criterion whether the bank is too-big-to-fail for its domestic financial and economic system. So even when a financial institution doesn't belong to the largest financial companies worldwide, they still can be evaluated as too-big-to-fail when considering the national borders.

¹³⁷ De impact van Bazel III op Europese banken, 16th June 2011, morningstar.be;

¹³⁸ Interessante waardering zet aan tot rechtstreeks beleggen in groeilanden (emerging markets), Frank Lierman, 6th November 2010, De Tijd;

¹³⁹ A Proposal Of a New Approach to Financial Supervision After the 2007-2008 Financial Crisis p.46, Luiss Guido Carli (2006-2008), Doctoral Thesis Phd, Libera Università Internazionale degli Studi Sociali, Roma;

¹⁴⁰ Vba jaarnaal, nr.1 voorjaar 2009, p.11

http://www.vbabeleggingsprofessionals.nl/data_o/docs/1_197_4853.pdf#page=10;

But the failure of Lehman Brothers in the United States doesn't correspond to the too-big-to-fail approach because it used to have a total balance sheet much higher than other banks that were provided government support. However, a too-interconnected-to-fail approach might better explain the US policy choice not to rescue Lehman Brothers, although this approach is not sufficient to prevent systematic risk.

So one might conclude that a more effective choice of government intervention should not solely be based on size, but should rather be based on systematic risk and systematic relevance (systematic interconnections) of the financial institution¹⁴¹.

¹⁴¹ A Proposal Of a New Approach to Financial Supervision After the 2007-2008 Financial Crisis p.44-48, Luiss Guido Carli (2006-2008), Doctoral Thesis Phd, Libera Università Internazionale degli Studi Sociali, Roma;

IV. INTRODUCTION TO CORPORATE SOCIAL RESPONSIBILITY

1. Introduction

Corporate social responsibility (CSR) is often defined as a long-term process which requires a continuous improvement in the way a company conducts its business, not only for the purpose of making a financial profit, but also in response to the increasing demands for transparency placed on the company by its stakeholders (employees, customers, shareholders, suppliers, etc.)¹⁴². A lot of literature is concerning corporate social responsibility. The scientific culture dealing with corporate social responsibility is growing. Topics differ from , corporate social responsiveness, corporate citizenship and corporate social performance to corporate responsibility and sustainable business. Also many applications are available in the banking sector, especially concerning executive pays¹⁴³. In the first chapter we discussed the financial crisis, however in this chapter we would like to link corporate social responsibility to the financial crisis. In some cases, it already appeared that high executive pays linked to profit target, contribute to risky behavior of executive management. For instance in the case of Fannie Mae's senior management we discussed in the first chapter.

Public opinions can vary whether high executive pays are justified or not. The article of L.A. Bebchuk & J.M Fried¹⁴⁴ considers whether high executive compensations are justified or not. They pose several arguments in favor of high compensation and also in opposition to high payments.

Arguments in favor of justified high executive compensations:

- Alleviating the agency problems by providing incentives for CEO's;
- Business become more complex and demand for capable top executives increases which allow higher compensations;
- Risky and uncertain environments also allow for a higher pay;
- Risk to get fired because of more diligent boards;
- Relative highly changeable environments require different levels of effort, the risky strategies that executives have to take demand for more effort and so allow a higher pay;

¹⁴² Philip Kotler, Nancy Lee (2005), *Corporate social responsibility: doing the most good for your company and Your Cause* p.3, John Wiley & Sons Inc., New Jersey;

¹⁴³ (Maatschappelijk) verantwoord ondernemen p.107-108, Aimé Heene, Nikolay Dentchev (2005), Academia Press Gent;

¹⁴⁴ Lucian Arye Bebchuk & Jesse M. Fried (2005), Executive Compensation as an Agency Problem, *Journal of Economic Perspectives*, Volume 17, Number 3, Pages 71-92;

The arguments opposed to high executive compensations:

- Executives are less motivated to follow interests of shareholders;
- Executives are mostly not paid for performance;
- It causes executives to focus too much on short-term compensation while it is better for the firm value to adopt a long-term value;
- It leads to a wide gap between CEO's and average workers: is there still trust & respect in their relationship? Are the averaged workers still motivated?
- The shareholders play only a little role in setting executive pay;

It is true that business become more and more complex and dynamic. It does justify a higher CEO compensation but it is the same for average workers, so in that point of view they should also get a higher pay.

Furthermore, it is the inclusion of stock options plans that increase the wealth of executives primarily and not the base salary. These options are not based on performance measures in many cases, which is problematic as will be discussed later on in this chapter.

Possible solutions¹⁴⁵ to these organizational problems could be:

- Even more transparency about the executive's stock options plans (there is already some degree of transparency);
- New rules of board positions;
- Regulations concerning shareholder structure in order to reduce the possibility that CEO's can act in their own interest;

We will address this discussion from the perspective of 'Social Responsibility'. Concerning the regulations, they will be linked to the 'Institutional theory'. To what extent do the financial markets take the public opinion into account? Or do the firms make changes out of their own initiative? If so, to what extent will they be prepared to make a change?

The main question throughout this chapter will be: 'Does the power of top executives substantially affect the design of executive compensation in companies with a separation of ownership and control?'

Remuneration is an important corporate governance issue because its structure has an impact on long-term performance. It also sets out the values of a company and abuses which can cause reputational damage.

There will be some financial institutions discussed that serve as examples of banks that are willing to make efforts concerning the excessive level of remuneration at large banks and the remuneration structure.

¹⁴⁵ Martin J. Conyon (2006). Executive Compensation and Incentives. *Academy of Management Perspectives*, Pages 25-40;

Sub-prime crisis in the banking industry

The last financial crisis intensified in the third quarter of 2008 with a number of collapses and a generalized loss of confidence that hit all financial institutions. As a result, several banks failed in Belgium like UBS, while others received government recapitalization towards the end of 2008 like Fortis, Dexia, KBC and Ethias.

The financial crisis has put the banking industry's compensation policies and incentive systems under severe criticism from investors, regulators, politicians and the public. According to the critics, there are two main problems with bankers' pay: the excessive level of remuneration at large banks and the remuneration structure, which may induce excessively high risk-taking and encourage short term focusing¹⁴⁶.

With regard to executive directors, many theories, for instance the Agency theory, stress that executive directors should have a meaningful shareholding in their companies in order to align incentives with those of the shareholders. But only a few European banks had such formalized policies in 2006. However, the actual amount of stock owned by the top executive in each the bank was well above 100% of annual fixed salary. Then with respect to non-executive directors, it is often argued that they should acquire a meaningful shareholding but not so large as to compromise the independence of the non-executive directors. Again, only a few European banks disclosed such policies¹⁴⁷.

According to the 'Agency theory', the role of the governing board can be described as a controlling role. This is, controlling the relationship between a principal and an agent. The agents are the executive directors, those that are hired by the shareholders in an organization in order to execute activities or services. Also, the shareholders delegate decision-making authority to the executives. This raises problems concerning self-interested behavior.

The shareholders acting as the principals pursue interests as long-term profit maximization and shareholder return maximization. These may not be served by the top executives, however, they may serve their own personal interest like for example short term profit maximization.

So there may be conflicts of interest between the shareholders and the executives. Fama and Jensen explain in their article '*separation of ownership and control*'¹⁴⁸ that in order to preserve the shareholder's interests they make use of opportunistic behavior and thus show controlling behavior towards executives/managers when hiring those.

¹⁴⁶ Corporate Governance Lessons from the Financial crisis p. 1-19, Grant Kirkpatrick, OECD Steering Group, 11 February 2009, France;

¹⁴⁷ Corporate Governance Lessons from the Financial crisis p. 12, Grant Kirkpatrick, OECD Steering Group, 11 February 2009, France;

¹⁴⁸ Eugene F. Fama and Michael C. Jensen 1983. Separation of ownership and control. *The Journal of Law and Economics*, Vol.26;

Reverse causality of the agency theory states that executives have to be controlled in order to shape behavior. But this creates the type of undesired behavior. Because the shareholders control these top managers, they will become more de-motivated and it might cause self-serving behavior. As we will see later on, KBC bank strives for a long-lasting relationship with its employees by providing them new career opportunities and training. By giving these executives some autonomy and opportunities for self-development, the shareholders create the right conditions where executives might find their motivation.

Opposed to the Agency theory, is the 'Stewardship theory' which is also linked to the 'reverse causality', which we mentioned in the previous paragraph. According to the Stewardship theory, the role of the governing board can be described as a strategic role, instead of a controlling role in case of the Agency theory. This is, designing executive as good stewards of the organization and let them be responsible for attaining high organizational profit and shareholder returns.

The executives acting as the stewards are free from the control of the shareholders (principal), this is in contradiction with the Agency theory. Here the basis assumption is that the executives are mainly motivated by responsibility, achievement and self-directed work. The article '*toward a stewardship theory of management*' of Davis J.H.¹⁴⁹ mainly mentioned that self-directed behavior is seen as an effective motivation and is an important factor to increase organizational success. Moreover, organizations value a transcendent-purpose very highly and executives are seen purpose-maximizers rather than profit-maximizers. So according to this theory, if you find a job which is perceived as your hobby, money isn't important anymore as long as you are being paid sufficiently. But if bonuses doesn't work to motivate people, then why organizations are doing this worldwide? In theory the Stewardship theory works but in practice it is hard to find a job that is perceived as your hobby, which the Stewardship theory namely implies. That could be a possible explanation of why we cannot find such incentive schemes, but rather a combination of both incorporating the controlling component of the shareholders towards the executives and the component of partitioning decision rights to executives.

¹⁴⁹ Davis J.H. (1997) Toward a stewardship theory of management. *Academy of Management Review*, Vol. 22, No.1, Pages 20-47;

'The Corporate Governance Lessons from the Financial Crisis' of Grant Kirkpatrick (2009)¹⁵⁰ is a report that analyses the impact of failures and weaknesses in corporate governance on the financial crisis. Our focus is on the executives' salaries. In general, the report concludes that the financial crisis can, to an important extent, be attributed to remuneration systems which are not closely related to the organization's strategy and its longer term interests.

Remuneration and incentive systems: strong incentives to take risk

It has been often argued that remuneration and incentive systems have played a significant role in influencing the sensitivity of financial institutions towards unfavorable economic conditions, such as the real estate downturn. Also, CEO remuneration has not closely followed company performance. The speed to which bankers adopt back their old habits by paying them high bonuses, has surprised many people. This was published in an article of the journal 'De Tijd' in April 2007¹⁵¹. The surprise is even greater because the good financial results of the banks have in fact nothing to do with good management of top executives, but are the result of the cheap lending tariffs of the central banks available to the banks, since the last 2 years. Furthermore, in May 2011 the financial news in Wall Street Journal published an article in which was stated that the U.S. CEO pay jumped with 11% in 2010. The Chief Executive Officers at the biggest U.S. companies were paid with bigger bonuses and stock grants, as boards rewarded them for strong profit and share-price growth¹⁵². This shows that that the CEO pay in the biggest U.S. companies had not come down at a time the economy was weakening. This confirms what has been said during the lessons of Corporate Governance, that executives in the financial market adopt a perspective similar like that of 'they are always able to win, even in cases of failure'. Or in other words, they receive 'rewards for failure'.

Board and executive remuneration

One of the proposed principles of conduct for compensations policies, which is added to the conclusion, recommends often that the board should fulfill certain key functions including "*aligning key executive and board remuneration with the longer term interests of the company and its shareholders*"¹⁵³ (principle VI.D.4). This also implies that it is regarded as good practice for shareholders to develop and disclose a remuneration policy statement covering key executives. Such policy statements specify the relationship between remuneration and performance, and include measurable standards that emphasize the long run interests of the company over short term considerations. Implementation has been patchy. However, remuneration systems lower down the management chain might have been an even more important issue.

¹⁵⁰ Grant Kirkpatrick (2009). The Corporate Governance Lessons from the Financial Crisis p.1-12. *Financial Market Trends*;

¹⁵¹ Geen economische argumenten voor hoge bonussen, 27 April 2011, De Tijd (tijd.be);

¹⁵² US CEO pay in 2010 jumped 11%, 09 May 2011, The Wall Street Journal (wsj.com);

¹⁵³ Corporate Governance Board Practices: Incentives and Governing Risks p.53, OECD Publishing (2011); Corporate Governance Lessons from the Financial crisis p. 1-13, Grant Kirkpatrick, OECD Steering Group, 11 February 2009, France;

The Basel Committee guidance is more general extending to senior managers: the board should ensure that compensation policies and practices are consistent with the bank's corporate culture, long term objectives and strategy, and control environment (principle 6). The board of KBC bank applies this very well to their executives because the remunerations of its employees occurs on the basis of each individual's merits (knowledge and skill), development potential, added value and the responsibilities.

It has been strongly argued that incentive systems might face to risk to encourage excessive risk. Reward-systems linked to returns in the financial systems encourage the decisions that include not-justified risks and encourage the pursue of short term profits¹⁵⁴. It is usual in most banks that the equity component in compensation (either in shares or options) increases with seniority. Because of a great emphasis of measuring/evaluating executives' performance, the executives tend to show dysfunctional behavior in order to obtain targets and thus receive high bonuses. Cases where there is embezzlement, financial misrepresentation and choosing ex ante targets that are easily obtained in order to get rewards, can explain some of the losses that the bank could face.

2. Dexia¹⁵⁵

Dexia AM believes that companies need to be able to attract and retain high-skilled individuals and motivate executives. However, an adequate remuneration structure should be set up to prevent unnecessary risk-taking.

Therefore, Dexia AM's policy on director compensation is based on the 'pay-for-performance' principle. Dexia AM focuses to enable transparency on basic salary, short term/long term incentives, pension arrangements, excessiveness, recruitment incentives, other non-performance related cash award (such as relocation awards or school fees), termination provision and compensation recovery policies. All this in order to balance performance and risk-taking!

Dexia AM believes that the remuneration of directors should be clearly set out. Executive payments should ideally be composed of a fixed and a variable element according to Dexia:

- the fixed remuneration should be in line with national and sector standards;
- the variable element should be linked to the performance of the company (disclosed performance targets). Variable remuneration components should be intended to reward performance.

Furthermore, performance should be compared against a disclosed peer group benchmark in order to evaluate performance on the basis of the right measures.

Their objective is that no executive director should be able to set their own remuneration and also the remuneration of the CEO should be set out separately. This means there is no influential executive's power on the compensations' schemes of Dexia.

¹⁵⁴ Kansen na de crisis: de succesalmanak 2009 p.22, M. Meijer, Adviesbureau Meijnik BV, Hilversum;

¹⁵⁵ Asset management Dexia, Proxy Voting, *Annual Review 2010*;

3. KBC¹⁵⁶

KBC's specific commitments of Social Responsibility are set out in its Principles for Socially Responsible Business, in order to enter into a proactive commitment towards its stakeholders.

In recent years, the group has also published an annual Corporate Social Responsibility Report, which deals with its vision and achievements in this area. This report provides group-wide information on CSR, including quantitative data on KBC staff. It is set up in accordance with the reporting requirements set out in the Global Reporting Initiative G3 Guidelines and the United Nations Global Compact principles.

An equal opportunity policy is what KBC wants to pursue an equal opportunity policy, along with eliminating any form of discrimination in dealing with its employees. The remuneration of its employees occurs on the basis of each individual's merits, such as his or her knowledge and skill, development potential, added value and the responsibilities. Their objective also is that no executive director should be able to set their own remuneration and also the remuneration of the CEO should be set out separately.

Furthermore, KBC strives for a lasting working relationship with its employees. In order to achieve these goals:

- KBC enables offering a competitive pay package, providing employees with a *fair* pay for their work and their contribution to the company's results;
- KBC also makes it possible to provide its employees with a sound career guidance and top-quality training, so that they are given adequate opportunities further along their careers and when developing their skills;
- Furthermore, KBC encourages its employees to become socially involved, which will contribute to what is called 'sustainable commitment';

4. Fortis

The Executive Management is being explained in an annual review of 2007¹⁵⁷. It was comprised of a Chief Executive Officer (CEO) and the Group Executive Committee. They are in charge of managing Fortis in accordance with the values, strategies, policies and budgets determined by the Board of Directors. The Executive Committee includes the CEO, the Deputy CEO and other management members with an executive function within Fortis.

¹⁵⁶ Annual Corporate Social Responsibility Report of KBC, https://www.kbc.com/MISC/D9e01?t=~social_responsibility;

¹⁵⁷ Fortis Jaaroverzicht 2007 p 73-74. , Corporate Governance bij Fortis (reports.fortis.com/2007/nl);

The remunerations of management members with an executive function consists of a fixed base-salary, a variable annual bonus and a variable longer term bonus. This salary was paid in 2007 in a combination of options, cash and restricted shares. The level of the variable reward is dependent on the individual performances of the business in relation to in advance determined target, and the performance of Fortis in comparison to comparable companies in the financial sector.

With regard to shares and options, in 2007 Fortis has allowed selected senior managers to acquire options on shares. This as acknowledgment of confidence in their personal contributions to the development and growth of Fortis. The number of options available to inscribe, was determined individually and was related with the level and the extent of the individual its responsibilities. Fortis used previously repurchased shares or issued new shares when these options were being exercised.

Because Fortis has an international structure, namely is a holding of a Dutch and a Belgian publicly traded company, it was considered to comply to two systems of corporate governance. This was based on the separate corporate governance codes. The underlying principles of the two separate codes did indeed correspond, but there were also certain differences. Because of the Belgian-Dutch context, Fortis had developed its own 'tier 1' ratio, which meets both the Belgian and Dutch requirements¹⁵⁸.

5. Ethias

When discussing Corporate Social Responsibility, Ethias as a mutual insurer, has always practiced CSR, even without being aware of it or communicating it. This claims Philippe Lallemand, Chairman of the Ethics Committee, at an AMICE seminar in 2008¹⁵⁹. Ethias is committed to engage in a social responsible manner towards its activities. With this in mind, Ethias adopted the multi-annual plan in 2003, in order to coordinate its CSR practices. The 'Ethics Committee' is in charge of its implementation and follow-up. The following activities include¹⁶⁰:

- Acquisition of the first social label by Ethias Home Insurance (2003) and in 2006 followed an extension of the label for a further three-year period;
- The development of a social ethics code;
- The creation of social ethics code;
- The development of an ethical and solidarity-based fund 'Ethico Invest Mundo';
- The creation of a code of practice and an investment code;
- The acquisition of the Ethibel certificate for 'FIRST pension savings';

¹⁵⁸ Fortis Jaaroverzicht 2007 p 73-74. , Corporate Governance bij Fortis (reports.fortis.com/2007/nl);

¹⁵⁹ Ethias & CSR, Philippe Lallemand, Chairman of the Ethics Committee, AMICE seminar, 23-24 October 2008, Paris (www.isurance-mutuals.org);

¹⁶⁰ Corporate Brochure 2006, (ethias.be);

During the financial crisis, Ethias has observed there were shortcomings of traditional reporting tools. Also they noticed a loss of credibility towards rating agencies and a lack of stakeholder's confidence. Corporate Social Responsibility has played a role by increasing the importance of non-financial elements in the valuation of the institution and the trust put in it. They paid more attention and value to human aspects, relationships with stakeholders and innovation.

6. Conclusion

In general, we can conclude that these large banks are willing to take the step of making changes, out of their own initiative. All seem to have taken into account the trade-off between aligning executives' incentives and the incentives of risk-taking. Although Dexia promotes transparency, Fortis complies to separate corporate governance codes and Ethias started a multi-annual plan to coordinate its CSR practices, it looks like KBC takes it even further. Having social commitments and reports in line with the KBC staff transparency, will increase their credibility towards outsiders such as customers, investors, regulators and the remaining stakeholders. Furthermore, a lot of KBC's financial reports, corporate social responsibility information and remuneration information was easily available on the internet.

It is obvious that both these banks do more than just do what regulatory is required or do more than just take into account the public opinions. This covers the *Institutional theory*. According to the Institutional theory, the role of the governing board can be described as a maintaining role. This is, maintaining the relationship between the financial markets and the public opinion.

The Institutional theory views the organizations (financial institutions in this case) as comprised of rules, practices or beliefs that have attained a high degree of resilience. The institutional rules are often invisible, have a taken-for granted status and sometimes members of the organization are not even aware of these rules. Such as the remuneration schemes of executives are more or less like 'business as usual'. This because for a long time people didn't consider these high-payments, but since the last financial crisis the critics have risen from public opinions, regulators, politicians and investors.

Also, according to Meyer and Rowan in their article '*Institutionalized Organizations*¹⁶¹', organizational survival and success is not only related to effective control of its activities. Organizational survival is mainly related to the organization's capability to identify and incorporate the practices of institutional rules. Hence, KBC and Dexia for example, have been trying to change the remuneration schemes, because it is important for an organization to adapt to pressures from outside such as public opinion and critics from regulators. Clearly, they understand that organizational legitimacy can be achieved by appearing trustworthy or by incorporating institutional strategies. Incorporating legitimacy can be done by some extent and for some period of time, like for example with KBC's commitments and reports.

¹⁶¹ John W. Meyer and Brian Rowan 1977. Institutionalized Organizations: Formal Structure as Myth and Ceremony. *The American Journal of Sociology*, Vol. 83, No. 2, Pages 340-363.

Furthermore, like we mentioned before, institutional processes bring about resistance to change. This means that usually organizations have such strong structures or rules that an introduction of new changes in the organization's culture will take several years to be accepted in the culture of the social organization. So institutionalization reduces the flexibility of an organization to adapt to changes in organization's culture, which may be needed to remain competitive in the market. It already has been a couple of years since the last financial crisis has occurred and executive payments have been dealing with a lot of criticisms. Nowadays, alternative remuneration schemes are still not yet fully integrated in all financial companies because it still needs some time to be accepted by executives and society.

The advantages of these institutional processes is that these provide the financial institutions with stability in their structure. However, the downside of institutionalization is that it brings about resistance to change. Top executives are not easily willing to lower their salaries just because of public opinions. The stability of the structure has a positive influence on long-term performance, while resilience has a negative influence on long-term performance.

7. Additional remarks

There is a dynamic perspective that has to be taken into account when we speak of controlling behavior versus self-directed work. The Stewardship theory comprises that the board faces the risk that they are being taken advantage of, if they trust executives too much when they are hired. Otherwise, the Agency theory comprises that if too much controlling behavior is used when hiring executives, the board could face the risk of creating self-serving behavior (which you want to preserve by using control).

So too much control doesn't work, but too much emphasis on collaboration doesn't work either. Thus a possible solution could be to make use of a dynamic mix of insiders and outsiders in boards of teams. This will create a combination of people with different perspectives but similar personal characteristics. Also, this way task-conflict doesn't become relational-conflict.

Proposed Principles of Conduct for Compensation Policies

The Basel II capital accord contains mechanisms in pillar II enabling regulators to impose additional capital charges for incentive structures that encourage risky behavior. Following are some proposed principles of conduct for compensations policies that illustrate the concerns about many past practices¹⁶²:

- I. Compensation incentives should be based on performance and should be aligned with shareholder interests and long term, firm-wide profitability, taking into account overall risk and the cost of capital.
- II. Compensation incentives should not induce risk-taking in excess of the firms risk appetite.
- III. Payout of compensation incentives should be based on risk-adjusted and cost of capital adjusted profit and phased, where possible, to coincide with the risk time horizon of such profit.
- IV. Incentive compensation should have a component reflecting the impact of business unit's returns on the overall value of related business groups and the organization as a whole.
- V. Incentive compensation should have a component reflecting the firm's overall results and achievement of risk management and other goals.
- VI. Severance pay should take into account realized performance for shareholders over time.
- VII. The approach, principles and objectives of compensation incentives should be transparent to stakeholders.

Source: Institute of International Finance (2008b), Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations, Washington, D.C.

¹⁶² Corporate Governance Lessons from the Financial crisis p. 1-13, Grant Kirkpatrick, OECD Steering Group, 11 February 2009, France;

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