De Nederlandsche Bank

Annual Report 2012

De Nederlandsche Bank
Eurosysteem

Working on trust

DNB seeks to safeguard financial stability and thus contributes to sustainable prosperity in the Netherlands.

To this end, DNB operates as an independent central bank and supervisor to ensure:

- price stability and balanced macroeconomic development in Europe, together with the other central banks of the Eurosystem;
- a shock-resilient financial system and a secure, reliable and efficient payment system;
- strong and sound financial institutions that meet their obligations.

By issuing independent economic advice, DNB strengthens policies aimed at its primary targets.

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Governing Board, Supervisory Board, Bank Council and Employees Council

From left to right: Job Swank, Jan Sijbrand, Klaas Knot, Joanne Kellermann and Frank Elderson

At the adoption of the 2012 Financial Statements, the members of the Governing Board, Supervisory Board, Bank Council and Employees Council of De Nederlandsche Bank were as follows:

Governing Board

President: Klaas Knot.
Executive Directors: Joanne Kellermann, Jan Sijbrand, Frank Elderson and Job Swank.

Company Secretary: Louisa van den Broek.

Supervisory Board

Chairman: Alexander Rinnooy Kan (1949, Dutch)
Member of the Supervisory Board since 2012. (End of current term: 2016)
Member of the Remuneration and Appointments Committee.
Observer member of the Supervision Committee.
Professor of Economics and Business at the University of Amsterdam.

Vice-chairman: Annemiek Fentener van Vlissingen (1961, Dutch)
Member of the Supervisory Board since 2007. (End of current term: 2015)
Chairman of the Remuneration and Appointments Committee.
Chairman of the Supervisory Board of SHV Holding NV.

Secretary: Bert van Delden (1941, Dutch) *
Member of the Supervisory Board since 2004. (End of current term: 2016)
Member of the Supervision Committee.
Member of the Bank Council on behalf of the Supervisory Board.
Chairman of the Supervisory Committee for the Intelligence and Security Services.

Other members:

Kees Goudswaard (1955, Dutch)
Member of the Supervisory Board since 2012. (End of current term: 2016)
Member of the Audit Committee.
Member of the Supervision Committee.
Professor of Applied Economics and Professor by special appointment of Social Security at Leiden University.

Jaap van Manen (1950, Dutch)
Member of the Supervisory Board since 2011. (End of current term: 2015)
Chairman of the Audit Committee.
Professor of Corporate Governance at the University of Groningen.

Feike Sijbesma (1959, Dutch)
Member of the Supervisory Board since 2012. (End of current term: 2016)
Member of the Remuneration and Appointments Committee.
Chairman of the Managing Board of DSM.

Hélène Vletter-van Dort (1964, Dutch)
Member of the Supervisory Board since 2010. (End of current term: 2014)
Chairman of the Supervision Committee.
Professor of Banking and Securities Law at Erasmus University Rotterdam and Professor by special appointment of Securities Law at the University of Groningen.

Government-appointed member:

Wim Kuijken (1952, Dutch)
Member of the Supervisory Board since 2012. (End of current term: 2016)
Member of the Audit Committee.
Member of the Bank Council since 2012.
Delta Commissioner.

* Not eligible for reappointment

In the year under review, Gerard Kleisterlee resigned at his own request on 1 February 2012. In addition, government-appointed member of the Supervisory Board André de Jong stepped down on 1 April 2012 following his appointment as Director General at the Ministry of Education, Culture and Science. Wim Kuijken succeeded him as of 1 April 2012. Fokko van Duyne stepped down as Chairman on 1 July 2012 and as of the same date resigned on the expiry of his term. Alexander Rinnooy Kan joined the Supervisory Board on 1 July 2012 and as of the same date was appointed Chairman, for a period of four years. Ewald Kist resigned as of 1 September 2012 and effective from the same date Feike Sijbesma was appointed for a four-year term. With effect from 1 October 2012, Kees Goudswaard was appointed for a four-year period. In addition, Wouter Tuinenburg stepped down as of 31 October 2012 on the expiry of this term. Bert van Delden was reappointed for a period of four years, with effect from 1 November 2012.

Remuneration and Appointments Committee

Annemiek Fentener van Vlissingen, Chairman
Alexander Rinnooy Kan
Feike Sijbesma

Audit Committee

Jaap van Manen, Chairman
Wim Kuijken
Kees Goudswaard

Supervision Committee

Hélène Vletter-van Dort, Chairman
Bert van Delden
Kees Goudswaard
Alexander Rinnooy Kan, Observer member

Bank council

Chairman: Arnoud Boot (as of 15 May 2012, successor to Pieter Bouw)
Professor of Corporate Finance and Financial Markets at the University of Amsterdam.

Members:

Bert van Delden
Member of the Supervisory Board.

Harry Garretsen (as of 15 September 2012, successor to Arnoud Boot, who was appointed Chairman)
Professor of Economics and Dean at the University of Groningen.

Wim Kuijken (as of 1 April 2012, successor to André de Jong)
Government-appointed member.

Ton Heerts (as of 15 September 2012, successor to Agnes Jongerius)
Chairman of FNV in Beweging.

Marco Keim (as of 15 January 2013, successor to Ronald Latenstein van Voorst)
Chairman of the Dutch Association of Insurers.

Hans Biesheuvel
Chairman of MKB-Nederland.

Albert Jan Maat
Chairman of LTO-Nederland.

Jaap Smit
Chairman of CNV.

Kick van der Pol
Chairman of the Federation of the Dutch Pension Funds.

Boele Staal
Chairman of the Netherlands Bankers' Association.

Reginald Visser
Chairman of MHP.

Bernard Wientjes
Chairman of VNO-NCW.

Representative of the Ministry of Finance:
Hans Vijlbrief, Treasurer General.

Employees Council

Jerry van Duivenbooden
Arno Eijgenraam
Saideh Hashemi
Leo Kaizer
Usseb Karakhalil
Nico Kloosterman (Chairman)
Miriam Kraal (Chairman)
Berndt Rif
Jerry Rijmers
Twan Roubroeks
Erik Smid
Paul Suilen
Ingrid Voorn
Peter Wagelmans
Jos Westerweele

Sandra Koentjes *(professional secretary)*

Introduction by the President

2012 was a difficult year, but also one in which problems were addressed.
The continuing financial crisis exposed a broad array of vulnerabilities; initially at banks, then in governments and subsequently in the broader economy.
Uncertainties surrounding the necessary policy changes and the future of the European monetary union translated into diminishing confidence, declining spending, rising unemployment and dwindling economic activity. Meanwhile, as a result of the worse-than-expected debt problems, the short-term economic outlook for Europe in general, and the Netherlands in particular became bleaker.

But 2012 also laid the foundations for a turn for the better. Far-reaching institutional agreements were made in Europe on greater economic discipline, the establishment of a banking union and the creation of a more robust stabilisation fund. Emergency support was provided under strict conditions to Greece, Ireland, Portugal and Spain, and the economic imbalances in these countries are being reduced through determined policy changes. In addition, the European Central Bank (ECB) introduced powerful measures to reaffirm the irreversibility of the monetary union.

Important decisions were also taken to strengthen the economic structure in the Netherlands. The new government introduced measures to reverse the accumulation of household debt, create a larger and more flexible labour market and put public finances in order. Taken as a whole, these changes created the conditions for a durable solution to the euro crisis and a healthy revival of the Dutch economy. As a precursor to this, calm returned to the financial markets towards the end of the year. Still, economic recovery will require determination in sticking to the chosen path, both in Europe and the Netherlands.

Disappointing global economic growth

Global economic growth continued to disappoint in 2012. Although policy-makers managed to avoid a deep recession following the onset of the credit crisis, restoring growth is proving more elusive. The underlying problems in the developed countries are considerable and can only be resolved gradually.
The principal cause is the unhealthy financial position of households, financial institutions and governments. This situation developed over a period of more than ten years, and it will likewise take time to bring about the necessary debt reduction and rebuild adequate buffers. The process of restoring balance is now well under way in the private sector, but has barely begun in the public sector. The amount of time needed for the recovery process should therefore not be underestimated, and it must be accepted that the pace of global economic growth in the future will not match pre-crisis levels.

The differences between countries are striking. Australia, Canada and Sweden, for example, whose financial sectors were hardly affected by the credit crisis, do not face a process of adjustment and are growing the fastest. Another striking feature is that the United States is among the more rapid growth countries in the developed world, with over 5% cumulative growth over the 2008-2013 period. This reaffirms the role of the United States as the engine of the global economy. Explanations for this recovery in US growth can be found in the speed with which the private sector has reduced its level of debt and banks have strengthened their financial buffers. This echoes the lesson drawn from the Scandinavian banking crisis 20 years ago, namely that economic recovery requires a fully recovered financial sector. Conversely, experiences in Japan show that convincing growth will not return while imbalances persist in the financial sector. A further factor is that the reduction in demand in the United States has been addressed through huge fiscal stimulus. However, this has created new risks and the limits of this line of government policy are in sight. From a fiscal perspective, the conflicting experiences of Scandinavia and Japan following their respective banking crises are also illustrative: while the Scandinavian countries rapidly put their public finances in order and restored economic growth, the Japanese economy continues to struggle under the crushing weight of its national debt.

The emerging countries, too, have been affected by the slowdown in growth in the developed world. While it is true that these countries account for a growing share of global production (50% in 2012) and an even greater share of global economic growth (80%), they are not yet capable of acting as the drivers of world trade. This is partly due to the vertical integration of production processes via the system of world trade, which ensures that the developed countries, led by the United States, remain the driving force. It is interesting to note, meanwhile, that the economic cycles of Brazil, Russia, India and China have in recent years become strongly correlated with that of the euro area. The impact of increased trade relations with the euro area is certainly a factor, but this also stems from financial integration through interbank lending. This all points to greater mutual dependencies in the global economy and underlines the importance of a balanced international policy that takes external effects into account. The same applies to exchange rates, which countries can use in a bid to prop up a weak domestic economy but which will not provide lasting benefits. International policy coordination needs to counter competitive depreciations, especially in the case of countries with strong external positions.

Progressing adjustment in Europe

The credit crisis in 2008 exposed vulnerabilities in banking systems and public finances which led to an aggravating debt crisis in Europe from 2010 onwards. Major financial uncertainties squeezed confidence and put a brake on spending in a self-reinforcing dynamic. As a result, the European economy again lost momentum. The financial tensions increased in the euro area in particular, because member states have less individual policy scope to soften adjustment processes. This raised doubts about the sustainability of the monetary union and caused some funding markets to dry up. As a result, the risk exposures of banks and governments increased more than elsewhere. In order to break through the negative spiral, a three-pronged approach was adopted: policy changes were implemented aimed at reducing the excessive level of debt in deficit countries and strengthening their economic structures; official support was provided to bridge the funding needs while these policy changes take effect;

and institutional strengthening measures were taken to prevent future derailments.

It took some time for politicians in all the peripheral countries – Greece, Ireland, Italy, Portugal and Spain – to recognise the inevitability of profound reforms. Valuable time was lost and the required adjustments became more demanding, both for the countries concerned and for their partners in the euro area. In the meantime, however, policy changes have been introduced in all these countries and the imbalances are declining at an impressive rate. For example, the primary fiscal deficit of the combined peripheral countries was reduced from 5.3% of GDP in 2009 to 0.9% of GDP in 2012, roughly half the loss of competitiveness since the launch of EMU has been recouped, and the deficit on the current account of the balance of payments was cut from 6.9% of GDP in 2008 to 1.2% in 2012. These developments will continue in 2013, with surpluses projected on both the aggregate primary budgets and the current account. Ireland is leading the way in this process of adjustment. Irish unit labour costs have fallen by more than 15% in four years, restoring the country's competitive position and allowing the economy to grow again.

However, the borrowing requirements of some peripheral countries have eroded their ability to meet their challenges independently. The necessary external support is being provided subject to strict policy conditions, under the watchful eye of the so-called Troika – the trio made up of the European Commission, the ECB and the IMF. In the case of Greece, however, the sovereign debt proved too large to be resolved through policy adjustments, and in April 2012 a debt restructuring programme of unprecedented size was implemented in an orderly fashion.

To ensure a robust structure for the emergency financing of the euro area, the European Stability Mechanism was launched in September 2012, with the capacity to lend up to EUR 500 billion. In order to decouple weak banks from their national governments, it was agreed that, where necessary, banks can be recapitalised directly through this mechanism. The involvement of the IMF in these international bail-out operations is important, not only because of the extra financial power it brings to bear, but also because of its expertise and objective view. The IMF involvement was achieved also at the request of the Netherlands, which joined forces with Belgium in the autumn of 2012 by sharing a seat on the IMF board.

Towards a sustainable monetary union

The experience of the last few years shows that restoring confidence in the monetary union also requires institutional strengthening. The heart of the message is that a monetary union is not sustainable unless it is accompanied by far-reaching economic integration. There are three essential dimensions to such economic integration: public finances, competitiveness and the financial sector. On the one hand, widely diverging developments in national budgets, competitiveness and lending are ultimately inconsistent with a monetary union. On the other hand, healthy public finances, flexible markets and a sound banking sector within a monetary union enable it to absorb shocks smoothly. The Maastricht Treaty devoted insufficient attention to this, which is now being addressed through far-reaching agreements on fiscal discipline, coordination of economic policy and the creation of a banking union.

The notion that sovereign debt problems can be avoided through market discipline and only occur in emerging economies and developing countries was revised once and for all in 2012. It also became apparent that governments in the euro area are more vulnerable to loss of market confidence than other developed countries, even though their debt positions are smaller on average. This is because countries in the euro area do not have their own central banking levers such as interest rates and exchange rates, and fiscal policy therefore plays a bigger role in the stabilisation of the national economy. Put differently, the lack of national monetary stabilisers and supranational fiscal stabilisers implies that the individual euro area countries need to maintain larger buffers in order to accommodate diverging economic developments. This cannot be achieved without firm agreements on fiscal policy discipline.

The need for stricter budgetary rules is broadly acknowledged and has recently resulted in several amendments to the Stability and Growth Pact. The changes have reinforced the preventive and corrective components, which include incorporating a balanced budget objective in national legislation, strengthening the position of the competent European Commissioner and binding provisions that only a qualified majority can overrule. These are impressive improvements. It is furthermore desirable that greater emphasis is placed on the 60% of GDP sovereign debt ceiling and that the scope for imposing political rather than financial sanctions is increased. In this connection, reinforcing EU economic policy coordination is also welcome. This can be achieved in the Macroeconomic Imbalance Procedure, under which structural reforms can be imposed and economic growth promoted. Stricter sanctions and decision rules are also needed here, in order to be able to prevent competitive divergences in the future.

The making of a banking union

The most far-reaching measure for strengthening the monetary union is the creation of a banking union. The unprecedented speed at which the first steps were taken – less than six months from the submission of the proposal at the European Summit in late June 2012 to agreement on European supervision in December – illustrates the political determination to reinforce the foundations of monetary union. The aim is to launch the banking union in early 2014.
The primary purpose of the banking union is to reinforce the solidity of the banking sector at the euro area level, thus breaking the negative feedback loop between banks and governments at the national level. The following example illustrates how the risks of contagion between these two sectors will be reduced: while ING Bank has a balance sheet approximately one and a half times the size of Dutch GDP, the balance sheet of Deutsche Bank – the biggest financial institution in the banking union – is equivalent to ‘only’ a quarter of the euro area GDP. A banking union will also give a fresh impulse to the internal market for financial services and fits in with the cross-border character of the European banking sector.

At the heart of the banking union are the three pillars: supervision, bank resolution and deposit guarantee. To ensure a broad diversification of risk and consistent decision-making, these three components will eventually all need to be regulated at the European level. In the short term, when prudential supervision is moved to the European level, the same needs to apply to bank resolution, i.e. the winding up of an insolvent bank. Otherwise, tensions could arise between decisions taken by the supervisory authority and those taken by the national authority that has to wind up the institution and bears the financial consequences. Also, the link between national central banks and governments

would remain intact. Less urgent, but equally desirable from a perspective of consistency, is the requirement to provide for a European-level deposit guarantee scheme. First, however, the methodology and funding of the deposit guarantee system will have to converge across the member states. This will take time. Whatever the ramifications, these changes imply further risk sharing between the euro countries. It is therefore advisable for all banks to be thoroughly vetted by an external party before the start of the process, in order to prevent hidden risks from migrating to the banking union. The resolution legislation in the euro area also needs to be strengthened so that any losses accrue to the risk-bearing financiers, while critical economic functions are protected and costs to taxpayers and depositors are minimised.

The practical details of European banking supervision will be worked out over the coming period. One key element is that the ECB is given exclusive authority regarding the supervision of all banks, so that the supervisory approach is of comparable strictness throughout and a level playing field is created. National supervisors will of course carry out the lion's share of the on-site activities, especially in the initial phase. This will ensure that expertise and supervisory capacity are used effectively and that continuity is ensured. However, some capacity is likely to shift towards the centre over time. It is also important that a clear segregation should be provided within the ECB between the supervision of individual institutions and monetary decision-making, so as to protect the independence and credibility of the ECB as a monetary authority.

European monetary policy in a time of crisis

The financial crisis in the euro area made monetary policy extraordinarily challenging in the year under review. Banks faced severe liquidity shortage. With virtually no scope to further reduce key interest rates, the economy slipped into recession. The financial markets also began to anticipate the departure of some countries from the monetary union; this led to fragmentation of the financial markets and to further divergence of monetary conditions within the euro area. This latter development impacted the peripheral countries in particular, which entered a negative spiral on the back of sharply rising bond yields. But also in the Netherlands, the fragmentation of the financial markets, combined with a heavy dependence on foreign funding, caused mortgage interest rates to remain at relatively high levels. In these circumstances, the ECB went to the limits of its mandate to remove any doubts about the cohesion of the monetary union, to promote smooth monetary policy transmission and to support economic recovery.

As conventional policies became less effective due to the above-mentioned fragmentation, the ECB deployed innovative monetary instruments to address the crisis. In particular, it eased the liquidity tensions at the start of 2012 by injecting more than EUR 1 trillion into the banking sector through three-year so-called Very Long Term Refinancing Operations, or VLTROs. Both the scale and the duration of this monetary operation were exceptional. The operation enabled banks to secure their longer term liquidity requirements, while it reduced uncertainties about their future funding. In July, the ECB cut its key refinancing rate by a quarter of a percentage point to a new record low of 0.75%, and the deposit rate was even reduced to zero. In a final move in September, the ECB announced its intention to intervene on a large scale in the event of disruptions in the bond markets of countries that duly implemented an adjustment programme. These interventions, referred to as Outright Monetary Transactions (OMTs), will not be aimed at a particular interest rate or spread

level, but at countering expectations of a monetary union break-up that were reflected in interest rate movements. With this instrument, the ECB makes clear that scenarios involving the collapse of monetary union are out of the question.

These unconventional monetary measures were evidently effective. In general, it can be observed that the inflationary outlook in the euro area remained firmly anchored, the fragmentation of financial markets was reduced and a destructive deflationary scenario such as that seen in the earlier financial crisis in Japan was averted. More specifically, the VLTROs brought temporary calm to the markets, although they proved insufficient in themselves to completely turn the tide of market sentiment. That was achieved in the summer, following the announcement of possible OMT interventions. Once the uncertainties surrounding the financing of banks had been eased, the excessive risks in relation to the financing of governments were also reduced. Interest rate spreads between the core countries and the periphery, which had to that point reflected increased risk of a euro break-up, narrowed sharply in the second half of the year. At the same time, capital flows from the peripheral member states to the core countries came to a halt and even reversed to a limited degree. As a result, the imbalances in the euro area payments system (Target2), which had reached ahigh point of almost EUR 1 trillion in the summer, fell by more than a quarter. Funding markets are tentatively reopening their doors to weaker banks and, in the periphery, Ireland and Portugal are gradually regaining market access.

The OMT has proven to be an effective instrument, even though to date it has not actually been deployed. It differs on a number of essential points from its now definitively defunct predecessor, the Securities Market Programme (SMP), which aimed to counter the dysfunctioning of certain government bond markets in 2010-2011. OMT interventions are in principle unlimited, do not enjoy privileged creditor status and are explicitly linked to sound policy. This underlines the striking power of the ECB, does not scare off other financiers and promotes healthy policy. The conditionality attached to the OMT instrument also resolves coordination issues between the fiscal and monetary authorities. And as the interventions are sterilised, they essentially have no inflationary impact.

Finally, a few words about the monetary strategy of the Eurosystem. It has recently been suggested that monetary policy should target the economy's nominal growth rate rather than price stability. It has also been suggested that economic variables such as employment be included as a policy target, following the example of the Federal Reserve which has made its interest rate policy partly dependent on the unemployment rate. However, recent experience has shown that the Eurosystem's strategy of targeting price stability offers sufficient flexibility to take real economic factors into account. Moreover, these proposals would make the ECB jointly responsible for structural developments over which monetary policy has little influence, thus muddying the waters of policy responsibility. Several statistical and communicative complications would also arise. Given an average inflation rate of around 2% since the launch of EMU – in line with the objective of maintaining inflation rates below, but close to, 2% over the medium term – there is every reason to stick to the existing strategy. The challenge is rather how, within the framework of this strategy, more weight can be assigned to countering the build-up of financial imbalances in good times. A thorough evaluation of the monetary strategy over the coming years will have to make clear what role financial variables should play in shaping policy and how policy expectations can best be managed.

Increased risks for the Eurosystem

The ECB's far-reaching interventions have increased the financial risks for the Eurosystem, including DNB. The balance sheet of the Eurosystem has grown by more than half in just over a year and is now equivalent to roughly a third of the economic output of the euro area. At the same time, money markets are still not operating smoothly, market confidence remains fragile and underlying tensions have not been allayed. These tensions may re-emerge suddenly if a member state's policies go off track or if European plans to strengthen the institutional structure of the monetary union run into difficulties. The monetary measures taken by the ECB have mainly bought time for governments and banks to put their own balance sheets in order and for European politicians to implement the necessary institutional strengthening of the monetary union outlined earlier.

Increasing financial risks prompted consultations with the Minister of Finance regarding a guarantee on crisis-linked risk exposures facing DNB. The Government and Parliament have approved the establishment of such a guarantee, which will expire once the exposures have returned to normal levels.

Faltering Dutch economy

The Dutch economy is faltering although its fundamentals are sound, international comparisons show. The competitive position of the Netherlands is still strong: the labour participation rate is high, the labour force is well educated, the labour market is flexible in many respects, the infrastructure is highly developed, pension savings are high and the government has solid credit ratings. There are certainly points for improvement, but the starting position is favourable. This begs the question why the performance of the Dutch economy is lagging behind the European average. While the indicators cited above warrant a leading position in Europe, the Dutch economy contracted by 0.7% in 2012 and by a projected 1.0% more than Europe as a whole in 2013. On a cumulative basis, economic growth in the Netherlands has lagged behind that of Germany by 4.2% over the last five years.

The main causes of this disappointing performance can be traced to the 1990-2000 period, when Dutch house prices rose by 160%, the AEX stock exchange index surged by 450% and private household assets grew by an estimated EUR 1 trillion, or an average of 55% of disposable household income each year. This provided a powerful impulse for consumer spending during that period, even though the increase in wealth took place only on paper for most households. The persistent house price rises were a typically Dutch phenomenon, attributable primarily to the stimulus provided by mortgage interest tax relief and the relaxation of banks' lending policies. As a consequence, the rise in house prices was fuelled by massive credit growth (260%), giving it all the characteristics of a bubble: precisely when asset wealth was growing strongly, the amount of debt was also rising sharply. Household debt more than doubled during this period, from 76% to 163% of net household income, and the balance sheet total of the banking sector rose from 190% to 275% of GDP (excluding securitisations). The dreaded housing market correction then took place gradually, with relatively stable prices in the first years of the 21st century and a fall in prices of almost 20% since the peak in 2008. Just as the house price increases of the 1990s had pushed up economic consumption and production through positive wealth effects and boosts to the construction and financial sectors, so the on-going price decline is reflected in negative wealth effects and reduced demand for construction activities and related financial

services. The impact of this cycle is reinforced by the fully funded pension system, as contributions were reduced in the 1990s but had to be raised again in the last ten years to make up for capital losses.

These developments illustrate the importance of balanced financial development and a policy that counters excessive debt accumulation. It is therefore to be welcomed that the tax incentive to borrow as much as possible for as long as possible to purchase a home is being reduced. The introduction of macroprudential policy is also helpful here, by gradually lowering the loan-to-value ratios and introducing countercyclical buffers in capital requirements for banks. The balance sheet problems facing private households and banks are thus slowly being resolved. In the meantime, the Dutch housing market is seeking a new equilibrium. While the tightening of credit standards points to a further price adjustment, affordability indicators for the trend in mortgage costs in relation to incomes suggest that further falls in house prices may remain limited.

The dampening influence on spending and lending exerted by these balance sheet adjustments raises the question where economic recovery is to come from. Traditionally the Dutch export sector has been the first to recover, followed by investments and consumption. In this respect, Dutch industry, thanks to its strong competitive position and ample cash reserves, is well positioned to benefit from the anticipated recovery in world trade. Initial signs of a revival are visible in the improving order books of exporters, which offer some counterweight to the sluggish domestic demand.

Another question is whether the Netherlands should stick to its chosen path of fiscal consolidation. There are several reasons why priority should be given to implementing the agreed measures in 2013 and continuing the deficit reduction from 2014 onwards, even in the present unfavourable economic circumstances. The main reason is the weakened state of public finances, with a debt ratio that has risen by more than 25% of GDP within five years and that is now significantly higher than the agreed ceiling of 60% of GDP. Continuation of such an excessive government deficit could increase the risk premium on Dutch interest rates, partly defeating the benefits of the present historically low rates. It would also consume the scope for stabilising policies in the future. After all, one can drive only so far on reserve fuel. In this context, international research shows that high debt ratios have an increasingly negative impact on economic growth. Added to these considerations, postponing budgetary adjustments would also be unwise in view of the ageing population. In short, the key is a policy aimed at ensuring sustainable public finances. In addition, the Dutch budget has proven to be much more sensitive to shocks than expected. Preventing pro-cyclical adjustments when times are bad requires a more prudent policy when times are good.

When assessing fiscal policy, it is also important to look at the quality of the consolidation measures and the rest of the policy mix. The sluggish growth in recent years was partly linked to a lack of structural reforms, but the new coalition agreement has clearly changed this situation. The new government has, for example, announced far-reaching measures to create a more flexible labour market and to accelerate the increase in the state retirement age, a move which is in line both with the increased life expectancy and the rise in the actual retirement age by an average of four months per year over the last seven years. Working beyond the age of 65 is occurring more frequently. If this trend is to be continued, sufficient investment in training and flexible pay for older workers are important. Meanwhile, the impact of less generous mortgage interest relief

on the housing market has been mitigated through the permanent lowering of the property transfer tax.

The large Dutch financial sector

The Netherlands is a highly developed country with substantial savings, broad risk sharing and a good deal of income from international trade. The country has traditionally been a centre of financial expertise that should be matched by a broad-based, strong financial sector which extends across national borders. Going forward, however, the financial sector is expected to show only modest expansion, and could even shrink slightly, as mandatory mortgage loan redemptions and decreasing tax relief for debt accumulation and pension savings translate into reduced demand for financial products. At the same time, many of the international activities of Dutch financial institutions have been scaled back since 2008 amid disappointing returns.

The Dutch financial sector is not only large, but also concentrated. This is particularly true of the banking sector, where the degree of concentration has increased further as a result of the recent problems. This high concentration implies that essential banking functions such as lending and payment services are provided by a small set of institutions in the Netherlands. In addition, the deposits they hold are too large for a failure to be absorbed through the deposit guarantee scheme. This makes these institutions systemically important in the sense that they are indispensable for the proper functioning of the Dutch economy. Because they are too important to fail, these institutions enjoy implicit state support and are, to some extent, able to avoid market discipline. This is problematic: after all, one of the lessons from the crisis is that the risks of systemic importance need to be vigorously reduced.

DNB is addressing the risks of systemic importance in several ways, in line with the international proposals of the Financial Stability Board. As a starting point, systemically important institutions are subject to stricter supervision and higher risk management standards. Second, the amount of capital that systemically important Dutch banks are required to hold will be raised by between one and three percentage points, over and above the stricter standards already introduced. In addition, over the past year these banks have worked with DNB to draw up recovery plans, which define measures that will enable them to survive a crisis. Finally, resolution plans will be developed for each of these institutions in the coming year. These will set out how the institution could be dismantled if the need arises whilst preserving the critical activities and minimising the cost to government and depositors. The more robust these plans are, the less need there will be for regulations that separate banks functionally or geographically. The establishment of the European banking union will further alleviate the problem of systemically important institutions: should a large institution fail, the direct costs can be apportioned more broadly. However, because certain banks will still be difficult to replace in certain countries, targeted policies for systemically important institutions will continue to be necessary.

Another characteristic of the Dutch financial sector is its heavy dependence on market funding. This can be attributed to the size of banks' mortgage portfolios, which far exceeds their deposit base. At the same time, pension fund savings are predominantly invested abroad. By consequence, Dutch banks rely heavily on international capital markets to meet their funding needs. The deposit funding gap has remained stable in recent years (at around EUR 460 billion) and is likely

to decline if the present growth in deposits and slower credit growth continue, but this will be a long-term process. During the transitional period towards lower debt ratios, funding risks will remain high.

Several approaches are possible to reduce this vulnerability. The government policy of curbing the accumulation of household debt is the starting point. In the meantime, strengthening the capital position of banks will bolster market confidence, while standardisation of Dutch mortgage lending can promote funding through securitisation. The share of Dutch mortgage loans in the investment portfolios of pension funds may also be slightly increased without causing undesirable concentration risks. However, this will have to take place on normal market terms in order to make it attractive for pension funds to provide this financing. Another option is to develop a National Mortgage Bank, which issues guaranteed debt paper that can be used to fund a proportion of mortgage lending. When working out the details of different options, it is important that government guarantees do not increase sharply and that risks are fully compensated for. Incentives must also remain with banks to ensure solid risk management, for example by stipulating that the banks will be the first to bear any losses.

Banking sector in turbulent waters

The present environment is a difficult one for the banking sector, which is still dealing with the aftermath of the credit crisis. While some institutions continue to be burdened by a legacy of toxic assets, the continuing economic malaise is leading to higher credit risks and driving up the costs of funding. At the same time, prudential requirements are being tightened and banks will be required to contribute to a deposit guarantee fund. These are all essential improvements, whose implementation is being spread out over time to avoid excessively burdening the economy. On top of this, a bank tax has been introduced and a tax on financial transactions is being considered.

The difficult circumstances are evident from the downgrades experienced by most Dutch banks in the past year. One concern is that the vulnerable bank balance sheets could lead to constraints on lending, which would hamper economic development and hence the recovery of the banking sector.
The marked slowdown in lending – actually negative growth in real terms – can be attributed in part to reduced demand for credit and to justifiably tightened credit standards. Yet it is clear that the squeezed balance sheet ratios in the banking sector also play a role and that increasing numbers of credit applications, especially in the SME sector, are being turned down.
This underlines the importance of restoring balance sheets to health. International experience has shown that strengthening banks' capital positions is a determining factor in the speed of economic recovery. While mortgage lending is determined mainly by the availability of finance, the higher-risk lending to businesses depends primarily on the availability of capital.

Some progress was made in the past year in strengthening solvency ratios and, encouragingly, this was achieved mainly by shoring up banks' equity capital and hardly through balance sheet reduction. Although Dutch banks are internationally among the leading group in terms of risk-weighted capital ratios, in terms of simple, unweighted leverage ratios they lag behind the competition. This means that going forward, banks' efforts to strengthen their equity positions must continue unabated. Since the capital markets are practically closed to new issues, profit retention will be the main route to achieve this. There will be

limited, if any, scope for dividend payments. Banks can speed up this recovery process through further cost cutting. There does appear to be scope for this; for example, in the year prior to the crisis, salaries in the banking sector far outgrew those in other parts of the economy, whereas the high profits recorded in those years later proved to be distorted and excessive. The scarcity of capital also implies that additional taxation of banks will have a relatively large impact on lending. If economic recovery is the aim, great caution in applying this form of fiscal adjustment is advisable.

One specific area of concern for the banking sector is the commercial property market, where prices have fallen for four successive years and write-downs have been accumulating since the onset of the credit crisis. Both structural and cyclical factors are at work here, and the excess supply is proving difficult to resolve. Banks are vulnerable because loans to property investors total almost EUR 100 billion (around EUR 80 billion of which concerns property in the Netherlands) while property has also been used as collateral in loans. At the start of 2013, the slump in the property market led to acute problems at SNS Reaal, which had a relatively large and poor quality property portfolio under management. The anticipation of exceptionally high losses on these property investments led to a capital shortfall, which the company was unable to cover on its own. Although private sector solutions were the preferred option for all concerned, in the end none of them proved feasible. The Dutch Minister of Finance subsequently had no other option but to exercise his powers under the new Intervention Act (Interventiewet) and to nationalise SNS Reaal. The key consideration was the desire to safeguard the stability of the Dutch financial system, protect depositors and minimise the costs and risks for the Dutch State. To achieve this, the holders of equity and of subordinated bonds were expropriated. In addition, a one-off levy of EUR 1 billion was imposed on the banking sector.

In addition to SNS Reaal, Friesland Bank also ran into difficulties during the year under review. The bank was struggling under a vulnerable business model, rising loan losses and a relatively sharp increase in funding costs.
The inadequate profitability and increasing risks prompted an alliance with Rabobank at the start of the review year in a bid to create greater certainty.

Insurers in a changing environment

Insurers, too, are facing a difficult external environment. In the first place, interest rates are extremely low, while life expectancy is rising and competition from tax exempt bank saving schemes has increased significantly. Moreover, the insurance industry is having to adapt to changes in government policy: tax relief for pension savings is being reduced, while it has been abolished altogether for mortgage endowment policies (KEW); the insurance premium tax has more than doubled and a ban on commissions has been introduced.
The different parts of the insurance sector have been affected by these measures in varying ways. Hardest hit have been life insurers, especially their contracts with guaranteed returns which, due to the persistently low interest rates, carry greater financial risks. In addition, demand for new individual life policies has been in decline for some years, a trend that continued in the year under review. Since 2010, the life insurance sector has witnessed a net cash outflow, as benefits paid have outstripped premiums collected.

The non-life insurance market has been less affected by these changes due to the shorter contracts, the frequent opportunities to adjust premium rates and the

low correlation with macroeconomic developments. Nonetheless, this market is also saturated and the government measures are putting a damper on demand here, too. Health insurance is the only sector that is still growing. There is scope to continue along the path of regulated market forces, which were introduced in the collective health care system in 2006. While a certain stability is needed in the system for insurers to promote greater efficiency in the health care sector, the phasing out of the 'ex-post risk redistribution' scheme strengthens their incentive to do so.

The changing and unfavourable environment for insurers underlines the importance of flexibility in business operations and distribution. Further cost reduction is essential in those segments facing shrinking or saturated markets. Consolidation within the sector could help here, but is barely taking place. This is presumably due to uncertainties surrounding disputed unit-linked insurance policies, which need to be resolved urgently. In view of the exceptional market circumstances, DNB in the summer decided to review the yield curve by which liabilities are discounted, and introduced the ultimate forward rate (UFR). This was done in line with the method outlined in the prospective Solvency II supervisory framework. The result is a more stable valuation for long maturities, leading to less volatility in insurers' solvency ratios. It also mitigates the impact of the low interest rates. In these difficult circumstances, measures aimed at strengthening the capital position of insurers, for example through profit retention, remain as important as ever.

A future-proof pension system

The Netherlands has one of the best pension systems in the world, with a high accrual rate and wide coverage of the labour force. Paradoxically, the average Dutch person has saved considerable pension capital but has little confidence in the delivery of the pension commitments. This is because, unless changes are made, the Dutch pension system is unsustainable. The prospect of modest returns, in combination with accelerating population ageing and rising life expectancy, has made the high, guaranteed commitments in Dutch pension contracts ever more expensive. In a bid to boost expected returns and thus maintain the ability to index pensions, pension funds have invested in risk-bearing securities. This has resulted in volatile returns. Given a gradually growing number of pensioners, the scope for absorbing this volatility by adjusting contributions is steadily declining. The deepening confidence crisis is exacerbated by the continued propagation of the notion that people can count on high, indexed pensions, which has not been the case since the turn of the century.

The financial crisis has revealed the need for changes to the Dutch pension system. Over the past six years, for example, the liabilities of Dutch pension funds have grown more than twice as fast as their assets. Many measures were taken during this period to avoid abrupt curtailment of pensions and to spread out adjustments over time. However, the depth of the financial downturn has made it inevitable that pensions will become less generous, and any further delay in making changes would be unjustifiable if the interests of different generations are to be properly balanced. The current Dutch pension system, with its high, guaranteed benefits, has reached the end of its life cycle.

Accordingly, steps were taken in September 2012, supported by a number of mitigating measures. Their aim is to both limit the macroeconomic consequences of further contribution increases and large cuts in pension

benefits, and prevent shortfalls from being pushed into the future.
This 'September Pension Package' introduced several welcome changes, including a higher standard retirement age of 67, automatic adjustment of pension entitlements to changes in life expectancy and deferral of indexation until a pension fund has recovered sufficiently. In line with the adjustment for insurers, a more stable yield curve has been introduced for pension funds regarding the valuation of future commitments through the introduction of the UFR. The new Coalition Agreement builds on the September Pension Package by limiting the scope for pension tax relief to 1.75% of an individual's annual income up to a maximum of EUR 100,000. The money saved through this change should be used first to bring contributions to a cost-covering level. Once this has been achieved, there will be scope to improve the purchasing power of employees, without adversely affecting competitiveness. The savings could also be used to strengthen the financial position of vulnerable pension funds and reduce cuts in pension entitlements, for example. If it is used to reduce labour costs or increase pension entitlements, the beneficial effects on purchasing power and consumer confidence will be partly or wholly cancelled out.

Structural problems require structural solutions. In this light, the new pension contract due to be launched in 2015 is an urgently needed reform. It spreads the risks more broadly and above all more transparently among pension scheme members, thereby safeguarding the system's attractiveness for youngsters.
The new pension contract comes in two variants. The nominal contract builds on the present pension contract with unconditional nominal guarantees, but is made more robust by higher buffer requirements and a more prudent method of calculating the cost-covering contributions. The real contract takes as a starting point the ambition of maintaining a pension's purchasing power, whereby accrued entitlements are entirely conditional and move up and down with financial shocks. Pension benefits will be adjusted more often under the real contract, but in small steps. This will limit the risk of major shortfalls, especially if funds build up an equalisation reserve. Automatic adjustment to account for sharp increases in life expectancy is optional in the nominal pension contract and mandatory in the real contract. Under both variants, the funding ratio is averaged over an extended period of time, thereby ending the dependence on daily rates. Two aspects warrant special attention when the new pension contract is introduced. First, a feasibility test will need to establish whether the policy on contributions, investments and benefits is consistent with the long-term ambitions and risk tolerance of the pension fund. It will be particularly important to guard against the strong tendency to use optimistic return forecasts and take insufficient account of downside risks. Second, the inherent risks in the new pension contract will be borne almost entirely by pension scheme members. This underlines the importance of providing clear information, which makes members aware of the uncertain pension outcomes they must take into account.

Strengthening supervision

The financial crisis has made the shortcomings in international and national supervisory frameworks painfully clear. The size and quality of capital requirements were too low across the sector; there were no liquidity requirements in the global supervisory standards; the macro perspective received inadequate attention; the business models, culture and conduct of financial institutions were virtually ignored, and the supervisory standards were insufficiently risk-based and forward-looking. Major steps have been taken in recent years to strengthen the prudential supervision frameworks: Basel III/CRD

IV for banks, Solvency II for insurers and the new Financial Assessment Framework for pension funds. In practice, however, the introduction of these new frameworks has been delayed for a year or more in all three sectors. This delay should be seen in the light of the slow recovery from the crisis. The transition to more stringent rules imposes an additional burden in a period of economic downturn and continuing risk aversion in the financial markets. In these circumstances, a short delay in the introduction of the new rules is preferable to diluting them.

Financial institutions would nonetheless be well-advised to make an early start on the transition and, where possible, begin implementing parts of the new frameworks. Banks need to continue working on the migration to the Basel III rules. The financial markets are also demanding this, particularly when it comes to capital strengthening and deleveraging. Most Dutch banks already meet the future liquidity standard, which has much in common with the present Dutch liquidity regime that will remain in force for the time being. The challenges are greatest in the insurance sector, which has been preparing for the introduction of Solvency II since 2004 and where the deficiencies of the Solvency I regime dating from the 1970s have become urgent. If elements such as valuations, risk-weightings and reporting are geared to the forthcoming European regulation, the transparency of risks will be significantly enhanced and the administrative burden will be limited to what is already in the pipeline. This enhanced transparency is not only essential for DNB as the supervisor, but also for the sector itself. For the pension sector, it means that recovery measures are also viewed in the light of the future framework.

DNB adopted a new governance model in early 2012. Its supervisory activities are now more clearly separated from the other central bank tasks. A Prudential Supervision Council for Financial Institutions was set up for this purpose, chaired by Executive Director Jan Sijbrand. A new supervisory model named 'Focus!' has been introduced, with a more risk-based, cross-institutional and forward-looking approach. Supervised institutions are divided into five risk categories, whereby the institutions with the highest inherent risks are placed in the highest categories and fall under a specific, more extensive regime. Supervision of the other institutions takes place mainly on the basis of industry and sector-wide surveys, which provide deeper insights and bring to light unusual developments. In addition to the traditional attention for solvency and liquidity, the new supervisory model has a stronger focus on forward-looking aspects such as business strategy, revenue model, culture, conduct and governance. This enables problems to be identified and addressed earlier. The theme-based supervision of business models has enabled institution-specific measures to be taken such as balance sheet reduction, risk mitigation in the funding mix, discontinuation of new business and restrictions on asset encumbrance. The supervision of conduct and culture has led to changes in the governance structure and staffing at several financial institutions. A great deal has also been done to strengthen governance in the financial sector. For instance, the suitability of executive and non-executive directors has been tested, rules have been drawn up concerning the independence of supervisory board members and compliance with the new Regulation on Sound Remuneration Policies has been monitored. In all these areas, DNB has worked closely and fruitfully with the Netherlands Authority for the Financial Markets (AFM). In all, the new supervisory approach – which also entails more intensive supervision – may be expected to lead to better risk management at financial institutions.

Introducing macroprudential policy

Recent experience has shown that a stable financial sector requires more than microprudential supervision focusing on individual financial institutions and monetary policy aimed at price stability. To secure the stability of the financial system as a whole, macroprudential policy is also needed. This policy has a structural dimension, which relates to the resilience of the system, and a dynamic dimension, which addresses the cyclical build-up of financial imbalances. This second dimension of macroprudential policy is even more important in a monetary union, because monetary instruments are not available to mitigate differences in financial cycles. This is illustrated by the fact that credit growth in the different euro countries diverged much more in the first decade of the monetary union than in the preceding ten years.

At the European level, the macroprudential perspective is the responsibility of the European Systemic Risk Board (ESRB), which makes non-binding recommendations to the competent authorities. The establishment of the banking union and the associated increased risk sharing between the countries concerned have made it desirable to create an institutional structure with binding power at the European level. Ways are being explored to create a structure that reflects both this European interest and the primarily national impact of macroprudential policy. Under the current proposal, national authorities must take the initiative in setting macroprudential instruments, but the ECB can tighten such instruments in its banking supervision. Macroprudential policy in the banking sector will thus become a shared responsibility of national authorities and the ECB, where the stricter of the two will prevail. This will foster alert and strict policy formation. The ESRB will also have to continue its surveillance role, though the emphasis in this institution's activities is likely to shift towards monitoring policy consistency, both cross-sector within the euro area and cross-border with non-euro EU Member States.

The macroprudential perspective will also be fleshed out further at the national level. Policy instruments are being developed and cautiously introduced. In the Netherlands, they include the recent introduction of a loan-to-value limit for mortgage loans, which will be gradually reduced from 106% in 2013 to 100% in 2019, as well as higher capital requirements for systemically important institutions (between one and three percentage points from 2016) and a counter-cyclical capital buffer that banks must hold (up to 2.5% additional capital from 2016). As part of its supervision of managers of 'alternative investment firms', from 2013 DNB will have the power to limit the leverage of institutions such as hedge funds. At the institutional level, a Financial Stability Committee was formed in the autumn of 2012 in which the AFM, the Ministry of Finance and DNB jointly participate under my chairmanship. This Committee discusses the risks to financial stability in the Netherlands and how they can be mitigated, and can issue public or private warnings and make policy recommendations. The first meeting of the Committee in December 2012 was devoted to the Dutch housing market, and reached the principal conclusion that the proposed reform of home financing must be rigorously pursued. The Committee's autonomy is naturally accompanied by an accountability to the Minister of Finance, who in turn reports to Parliament.

A reliable and efficient payment system

Despite the financial turbulence of recent years, the payment systems have operated excellently. The infrastructure has stood up faultlessly and public

confidence in these systems is as strong as ever. This must continue to be the case. In the retail sector, there is a steady shift from cash to electronic payments. The number of cash payments is declining steadily, while the volumes of debit card and on-line transactions continue to break new records, for both domestic and cross-border payments. The advance of electronic payment is welcome and fits in with the observation that the Netherlands has one of the most efficient payment systems in the world. More specifically, the Dutch retail payment system is estimated to cost EUR 1 billion less per year than the European average. The introduction of the Single Euro Payments Area (SEPA) in 2014 will create new opportunities to generate cost savings on a European scale. This will benefit consumers, who will be able to make SEPA payments within Europe at no charge. In the coming year, as part of the migration to SEPA, consumers will switch to longer (IBAN) bank account numbers and businesses and financial institutions will need to make considerable changes to their financial records and software. Major efforts are still required – particularly in the banking and SME sectors – to ensure a smooth and timely transition. Given the major common interests in the payment system, these efforts deserve to be wholeheartedly supported and appreciated.

The growing share of electronic transactions increases the efficiency of the payment system, but also underlines the fact that the systems must be reliable and that cybercrime must be effectively countered. The targeted approach to skimming illustrates how the persistent attention of bank directors, ICT security personnel, retailers and consumers can drive back cybercrime. A market-wide crisis exercise was also conducted in the year under review. In the area of securities transactions, the settlement of derivatives transactions has been made more secure and transparent. To this end, it has become mandatory in 2013 to settle standard derivatives contracts through central counterparties and higher capital requirements apply for other derivatives contracts.

Looking ahead, the payment system will continue to be characterised by innovation, with large-scale use of mobile devices for payments set to be the next breakthrough. The establishment of an internal euro payment market will provide an extra impulse here, because it will be possible to roll out these innovative payment methods across the entire euro area. In describing all these changes, it should be remembered that cash will continue to play a key role in our payment system for a long time to come. Cash is the only means of payment that is accepted almost universally, but is also the alternative of last resort if the electronic payment chain should malfunction for whatever reason. DNB is therefore committed to making the cash payment chain as secure, reliable and efficient as possible, so that cash continues to be available as a generic means of payment.

Conclusion

We can look back on a difficult year, but also a year in which major progress was made. Both in Europe as a whole and in the Netherlands, the reform agenda has been strengthened and financial vulnerabilities are being reduced. Cycling into the wind one must tread harder. The solution to the financial problems will take some time and will require continuous efforts, but the recent positive developments in the financial markets are signs of growing confidence in the future.

Major challenges remain across the whole spectrum of DNB's activities. Several adjustments were made to DNB's internal organisation in the year under review,

including the introduction of a new governance model, a new supervisory approach, a cultural change programme, the creation of an Intervention Department, a stricter job rotation policy, a revamped communication strategy, an exchange programme with the AFM and a trainee programme. All this will contribute to the organisation's flexibility and openness, as well as to more rigorous supervision.

Amidst all these changes, DNB will continue to focus unrelentingly on policy discipline, stable prices and European cohesion, and on ensuring a resilient financial system in the Netherlands, with a reliable payment system and sound institutions that meet their obligations. After all, this is a necessary condition for sustained prosperity.

1 Sights set on stability and growth

1.1 Introduction

Since the outbreak of the crisis, financial vulnerability and low economic growth have gone hand in hand within the euro area. Meanwhile, measures taken under pressure from precarious circumstances have bolstered the financial stability of the economic and monetary union (EMU). Partly as a result of these measures, the international financial markets now appear to have entered a period of relative calm. But the situation remains far from ideal and many complex challenges lie ahead. With the crisis contained, we must now set our sights on a sustainable recovery of financial stability, alongside more robust economic growth. This chapter highlights four selected topics relating to this subject.

Section 1.2 deals with the damage to the financial balance sheets of households, banks, pension funds and the government, which the credit crisis has so relentlessly exposed. Balance sheet increases and debt accumulation underpinned economic growth in the Netherlands for a long time, but this unsustainable process has come to a fairly abrupt halt. The painful process of balance sheet repair that is currently under way through various channels is a slow uphill struggle. And while this will also act as a drag on the Dutch economy in the short term, it is nevertheless inevitable. Next, section 1.3 deals with the current state of lending to businesses and households in the Netherlands. Since the outbreak of the credit crisis, supply and demand factors have combined to cause a substantial decrease in lending. As banks and households are still busy repairing their balance sheets by enlarging their financial buffers and reducing their debts, credit growth is set to remain low in the coming period. Section 1.4 reviews the various options for boosting economic growth in the euro area. To get the economy back on track, a reorientation of the export package, both in terms of sales markets and higher-tech products, seems inevitable. In view of the ageing population, higher economic growth will depend mainly on labour productivity improvements. Many euro area countries still have ample scope for enhancing productivity – particularly in the services sector – through further liberalisation of their labour and product markets. The final section of this chapter (Section 1.5) discusses how the institutional organisation of the EMU can be made more stable and future-proof, with an assessment of the extent to which lessons for designing an efficient banking union, as well as common fiscal and economic policies, can be learnt from the US model.

1.2 Balance sheet repair: painful but inevitable

The credit crisis has knocked the balance sheets of households, pension funds, banks and the government out of kilter. Various measures designed to achieve a gradual improvement in these balance sheets were taken in the past period. Although these will impede economic growth in the short term, they are the inevitable price to be paid for recovery.

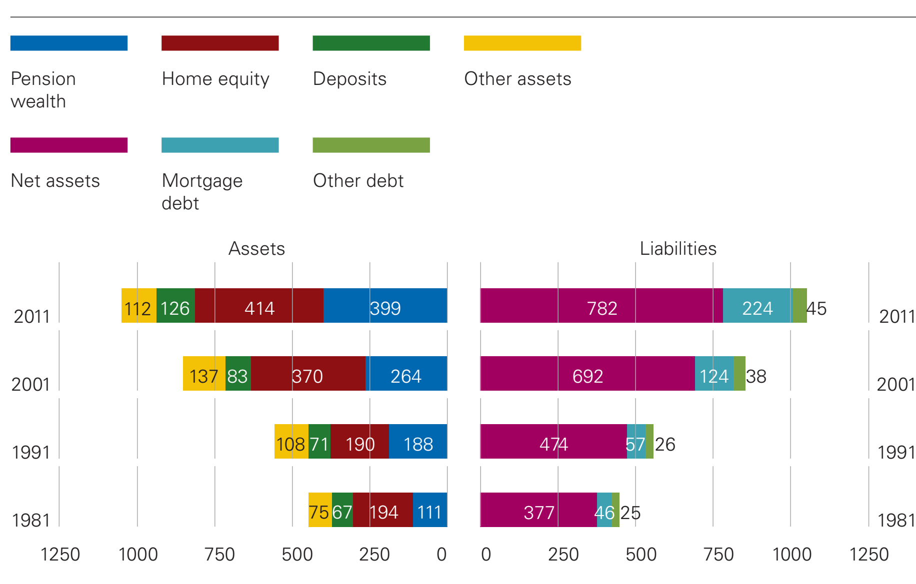
1.2.1 *Damage to household balance sheets*

The economic problems currently affecting the Netherlands cannot be seen separately from the drastic change in the make-up of household balance sheets. While net assets increased over recent decades, so, too, did balance sheet totals (see Chart 1.1). Assets in the form of pension plans and home equity expanded strongly, but liabilities also surged. Measured in percentages of disposable household income, mortgage debt has increased fivefold since the early 1980s, with this growth in mortgage lending being driven by multiple factors. From the mid-1990s onwards, lenders were permitted to calculate the maximum mortgage lending amounts on the basis of two incomes. At the same time, banks launched new mortgage products that enabled homeowners to take maximum advantage of mortgage interest relief, while also relaxing their credit requirements. Banks' more generous lending policies, combined with the lack of supply of new housing, sent house prices soaring. The decline in prices since mid-2008 actually constitutes a correction of the exuberant increases in house prices seen from the 1990s onwards. By the end of 2012, Dutch house prices had fallen back to their end-2003 level. The most vulnerable households are first-time buyers who purchased a property after that turning point with an interest-only mortgage and an LTV exceeding 100%.

Vulnerable households have struggled to repair their battered financial balance sheets. Developments in their income in recent years have been subdued, leaving them little room to fatten their available savings (see Chart 1.2).

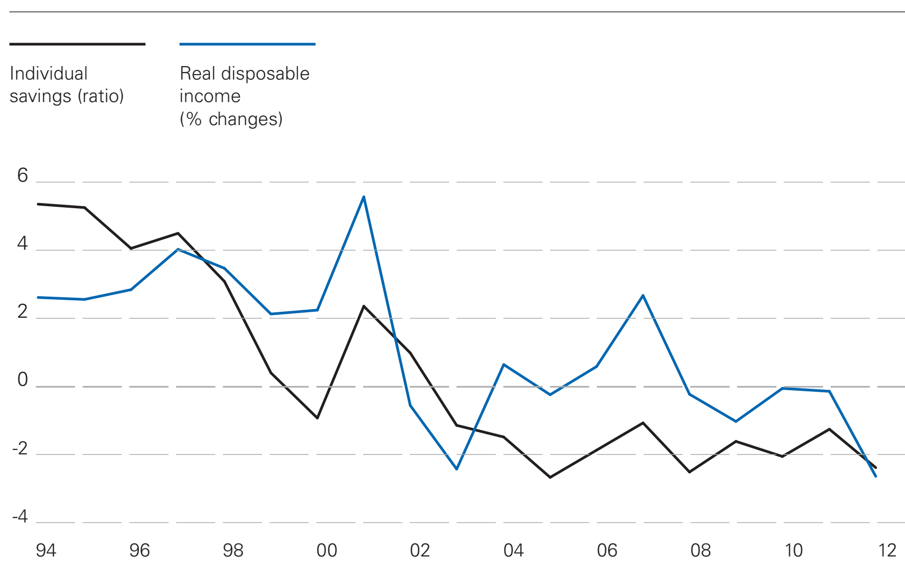
Chart 1.1 - National household balance sheet

Percentages of disposable income [1]



1 Including pension provision correction.
Sources: Statistics Netherlands and DNB.

Chart 1.2 - Real disposable income and individual savings
Percentage change and percentages of disposable income [1]



1 Including pension provision correction.
Sources: Statistics Netherlands and DNB.

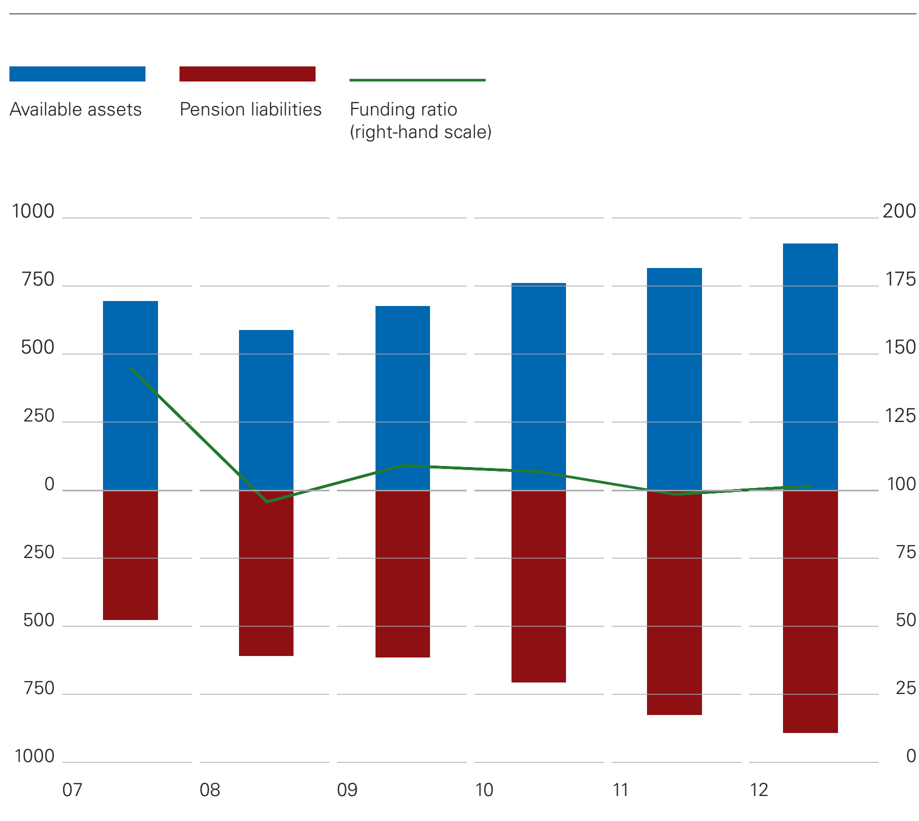
For various reasons, real household incomes have been contracting since 2008. Alongside falling numbers of hours worked and a moderate increase in negotiated wages and pensions, these reasons include higher direct taxes, healthcare insurance premiums and pension contributions, as well as relatively high inflation. In October 2012, for example, the VAT hike resulted in inflation surging to 3.3%, its highest level in ten years.

1.2.2 *Gradual recovery of buffers at pension funds and banks*

Apart from home ownership, pension wealth constitutes the principal asset in Dutch household balance sheets. In this respect the Netherlands differs from most other countries, where collective pension wealth tends to be much smaller. Pension wealth in the Netherlands is in fact currently higher than ever, but so, too, are pension liabilities (see Chart 1.3). Owing to the low interest and much longer life expectancy rates, liabilities have grown at an even faster pace than assets, thus causing net funding ratios to worsen. With hindsight, the contributions paid in return for the pension rights granted were too low over a fairly lengthy period.

Pension funds are seeking to restore their funding ratios to the required level through a combination of non-indexation, contribution increases and – in the most extreme cases – pension entitlement reductions. This is being done with a close eye on the income effects for retirees and employees. The government's 'September package' contained various mitigating measures in this respect, specifically an adjustment to the permitted discount rate for longer maturities, the option to deviate from the requirement for contributions to be high enough to assist the pension fund's recovery, and the option to spread pension entitlement reductions over time. The September package also tightened up certain existing measures, including providing for an accelerated increase in the state retirement age and the automatic inclusion of any further life expectancy increases in the calculation of existing pension entitlements. The overall result is a balanced package of adjustments (see also Section 2.4.2).

Chart 1.3 - Funding ratio of the Dutch pension sector
EUR billion and in percentages of technical provisions



Source: DNB.

In addition, the coalition agreement provides for an adjustment of the 'Witteveen' framework. The tax relief on additional pension accrual will be limited to 1.75% of annual income, while contributions on income above EUR 100,000 will no longer be deductible from tax. Any extra revenue resulting from these measures is to be used initially to bring contributions to a cost-effective level. Once this level has been reached, the additional revenue will preferably be used to improve the purchasing power of employees and to reinforce the financial position of the pension fund, rather than to reduce labour costs or increase pension rights.

The banks' buffers are also not yet at an adequate level. Although Dutch banks' core capital has increased since 2008, the rise as a percentage of the total risk-weighted assets has so far been limited (see Section 2.3). The banking industry is working hard to achieve the necessary reinforcement of its buffers, mainly through profit retention and asset sales. This is not an easy task as the persistent economic weakness and various government measures, including the bank tax, the financial transaction tax and the resolution levy, mean profits are under pressure. Banks will have to make all-out efforts to boost their profits by cutting costs and improving their efficiency. The new liquidity and capital requirements set under Basel III will be introduced very gradually, thus minimising any negative repercussions on lending and, by extension, the economic recovery.

1.2.3 *Fiscal consolidation now, not later*

The government absorbed the first blow from the crisis through its fiscal policy, activating automatic stabilisers and taking several stimulus measures. Public debt consequently jumped from 45% of GDP in 2007 to more than 70% by the end of 2012. Last year, five political parties agreed on a tough package of measures, known as the Spring Accord, designed to bring the deficit back below 3% of GDP in 2013. In the period from 2014 to 2017 the Rutte-Asscher government will add a further EUR 15 billion in spending cuts and increases in taxes and social insurance contributions. The main short-term effect of these austerity measures is to put a brake on the rising debt ratio, but it will be some time before this ratio actually begins to fall.

The policy of spending cuts and increases in tax and social insurance contributions will indisputably put a damper on economic growth in the short term, with the extent to which this happens being reflected in the fiscal multiplier. The fact that households and financial institutions are currently repairing their balance sheets means it is more difficult for households to borrow, and this will spread the effects of a decline in income more evenly over time. As a result, the fiscal multiplier may be greater than usual. On the other hand, the multiplier can also come out lower in difficult economic times. According to what is referred to as the 'Zijlstra effect', lower spending during an economic downturn has a stronger negative impact on imports than on domestic production. However, the dampening effect that fiscal consolidation can have on growth is not an argument justifying backtracking. Sooner or later, the Netherlands must tackle this situation. Postponing consolidation now will only make the task harder, as public debt will then be even higher.

The Dutch economy cannot pull itself out of the crisis through a fiscal stimulus policy. The small and open character of the country means that a large proportion of any stimulus measures will automatically drain away to other countries. This is much less the case in a large, less open economy such as that of the US. Given the open character of the Netherlands, a revival of world trade is a key condition for the recovery of the Dutch economy, just as it was in the past. As a rule, domestic spending bounces back only after exports have recovered. A protracted high public deficit would also harm the Netherlands' reputation in the financial markets. And if this in turn led to higher interest expense, it would only add to the consolidation efforts required.

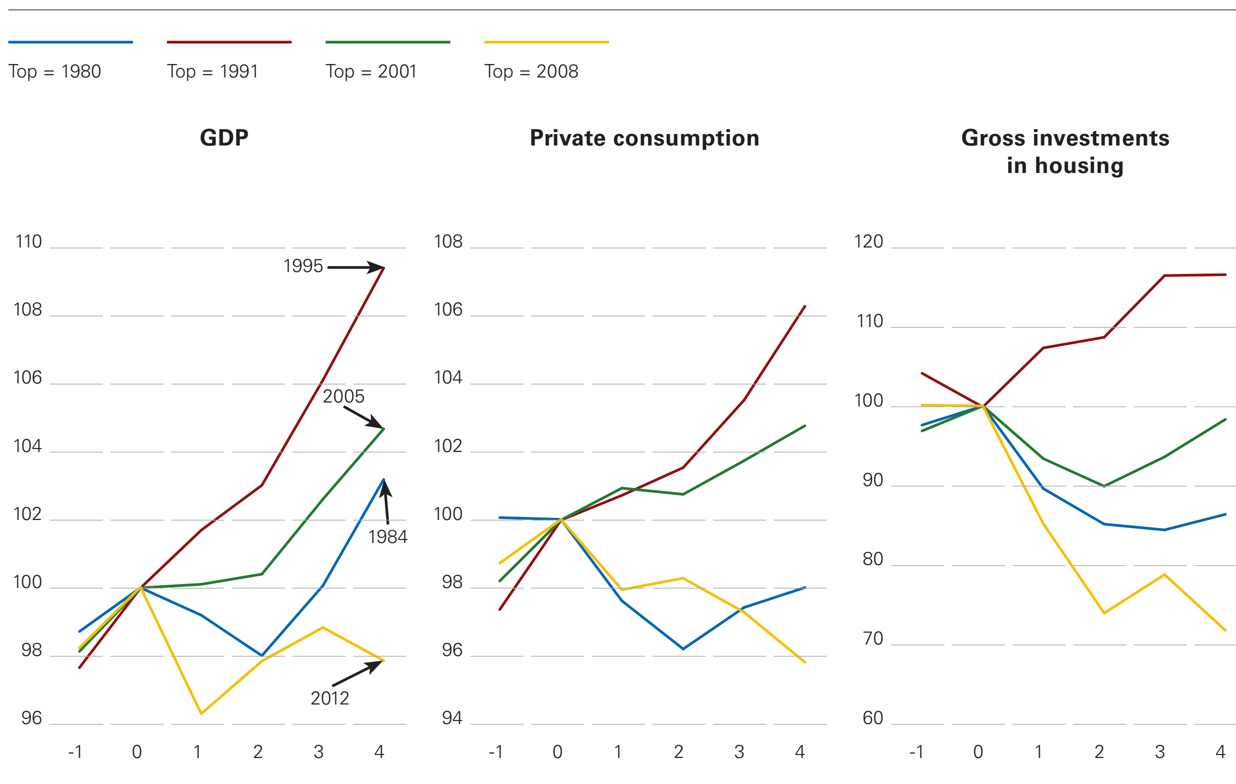
1.2.4 *Balance sheet repair depresses growth, but is inevitable*

History shows that economies are often slow to recover in the wake of a financial crisis. So it is not surprising that the current growth rate is even lower than it was after the severe crisis in the early 1980s (see Chart 1.4).
Private consumption and home investments in particular are clearly weaker now. The subdued domestic spending constitutes the downside of the unsustainable financial-economic dynamics that held sway before the crisis. For years, Dutch economic growth was fuelled by an accumulation of household debt. Households used this extra debt to finance investments in homes and additional consumer spending.

Under the current difficult economic circumstances it is vital to implement the repair measures at a responsible pace. The government's policy is catering to this need. The structural fiscal deficit, for example, will serve as an important guideline during the fiscal consolidation process, while pension funds have been given ample time to restore their funding ratios. In the case of the housing market, the government has opted to gradually decrease mortgage interest relief

Chart 1.4 - Four economic cycles compared

Percentage year changes



Note: Top is based on the output gap.
Sources: Statistics Netherlands and DNB.

and for a step-by-step reduction in the LTV ratio for new mortgages. In addition, agreements have been reached at an international level to give banks sufficient time to meet the new capital and liquidity requirements.

The gradual but steady implementation of the above measures can help to restore confidence among consumers and producers. As in the 1980s, such an upturn in confidence could give a positive boost to growth. In particular, consumer spending and housing investments by households that are in good or reasonably good financial shape, but are reluctant to spend due to the pervasive uncertainty could accelerate. Improved confidence could also make Dutch businesses more willing to invest, but only once the uncertainty surrounding the European debt crisis has been dispelled and the euro area economy resumes its upward growth trend (see Section 1.4). The Netherlands' high position in international competitiveness rankings means that the open Dutch economy should be able to benefit from any positive turnaround in the international economy.

1.3 Lending in the Netherlands

Growth in commercial and retail lending has slumped in the past few years. Growth will also remain low in the coming period, due to the depressed demand for credit, the on-going balance sheet restructuring among banks and households, and various policy measures designed to dampen mortgage lending.

1.3.1 *Restricted bank lending depresses business investments*

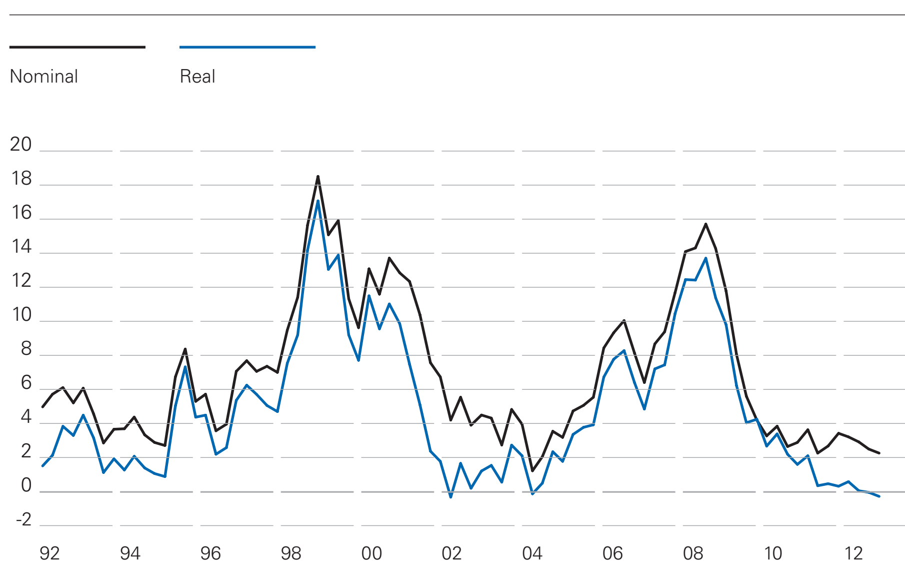
Growth in lending to businesses in the Netherlands has weakened substantially since the outbreak of the credit crisis in 2008. Although commercial lending in nominal terms is growing at a moderate rate of about 3% a year, bank lending adjusted for inflation has been contracting since early 2012 (see Chart 1.5). However, the overall macroeconomic picture of commercial lending in the Netherlands masks important differences between sectors, company sizes (large corporates versus SMEs) and banks.

Moderate credit growth during a recession is not exceptional from a historical perspective and is usually mainly attributable to lower demand for credit. Nevertheless, the stagnation in credit growth during the current crisis does raise certain specific concerns. For one thing, the period of limited growth in business lending has now lasted for three years, which is almost twice as long as the average during previous recessions, and there are still no signs of recovery on the horizon. International research shows that a financial crisis has a more protracted impact on lending, partly because it forces banks, households and companies to restructure their balance sheets (see also Section 1.2), while balance sheet restructuring at banks can also lead to lending bottlenecks.

Banks in the Netherlands have tightened up their commercial lending conditions for various reasons in recent years: the financial outlook for businesses and households has deteriorated, banks have to restore and reinforce their balance sheets to comply with new supervisory rules, and the costs of capital and long-term funding have also increased. A DNB survey shows that the stricter credit regime has curbed growth in commercial lending in the Netherlands by an annual rate of 1 to 3 percentage points in the past few years. This supply effect comes on top of the lower demand for credit. The small and medium-sized enterprises sector (SME), where the credit risks for banks are relatively high, is being particularly hard-hit by banks' stricter lending requirements. Since the onset of the crisis, SME lending standards have

Chart 1.5 - Contraction of real growth in commercial lending in 2012

Percentage change on previous corresponding period



Note: Adjusted for securitisations.
Source: DNB.

relentlessly tightened, whereas large companies enjoyed a relaxation of lending standards in late 2010 and the first half of 2011 (see Chart 1.6). A recent European survey also confirms that Dutch SMEs are encountering problems in raising funds. This survey highlights growing concerns among SMEs in the Netherlands about their access to finance, while also showing that the rejection rate for loan applications in the Netherlands is not only high at 31%, but has increased sharply compared with other countries in the euro area.

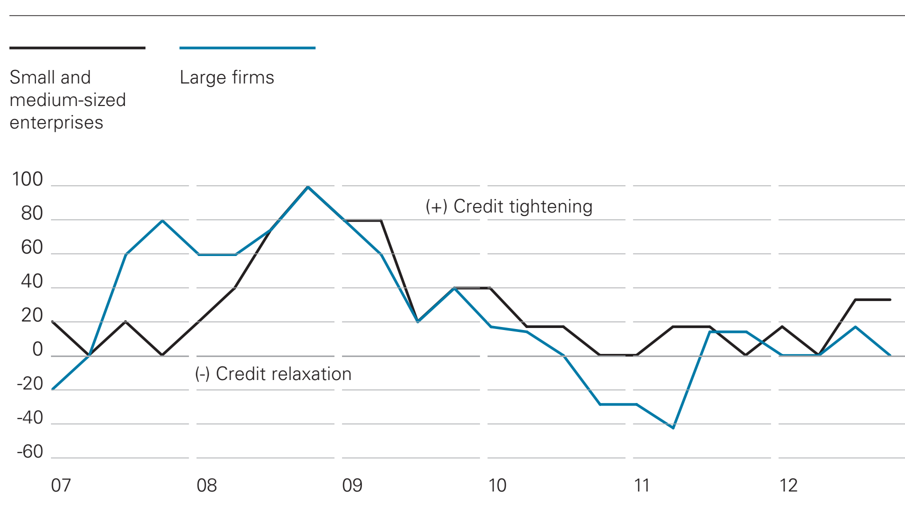
The curtailed supply of bank credit is depressing business investment. Although any attempt at quantification carries great uncertainty, the current squeeze on bank credit in the Netherlands could dampen business investments by 0.5% to 1.5%. According to an international survey, companies that depend on bank funding, such as SMEs, are particularly likely to reduce capital expenditure during a financial crisis. This could be due to constraints on the supply of bank credit. Year-on-year contraction in investment growth will eventually have a noticeable impact on the Dutch economy's production capacity and production volume. Thanks to their direct access to the capital market, large companies have an alternative to bank credit, particularly given that the climate for new issues has improved since the second half of 2012. SMEs, by contrast, have few sources of funding other than bank credit. Alternative forms of funding (such as crowd funding, credit unions and venture capital) are starting to emerge, but will remain niche markets for the time being. SMEs will continue, therefore, to rely primarily on bank credit for the foreseeable future.

1.3.2 *Deceleration in mortgage lending growth*

After a brief and modest upturn, growth in mortgage lending slowed down again in 2012 (see Chart 1.7). The growth of 1% in the outstanding volume was, with the exception of 2010, the lowest rate of growth seen in mortgage lending in the past 30 years. The deceleration started several years ago and was triggered in 2005 by gradually rising mortgage interest rates. The turning point coincided with the credit crisis and the deep recession in 2009. The attendant confidence and income shocks caused mortgage lending growth to drop sharply. In addition, 2009 was the year in which almost all banks tightened their acceptance criteria for new loans, partly because banks started to make less use of the exceptions available to them

Chart 1.6 - Bank lending conditions for businesses

Net percentage of all banks



Sources: DNB; Bank Lending Survey.

Chart 1.7 - House prices and value of home mortgages
Percentage changes on previous corresponding period

Sources: Statistics Netherlands / Land Registry and DNB.

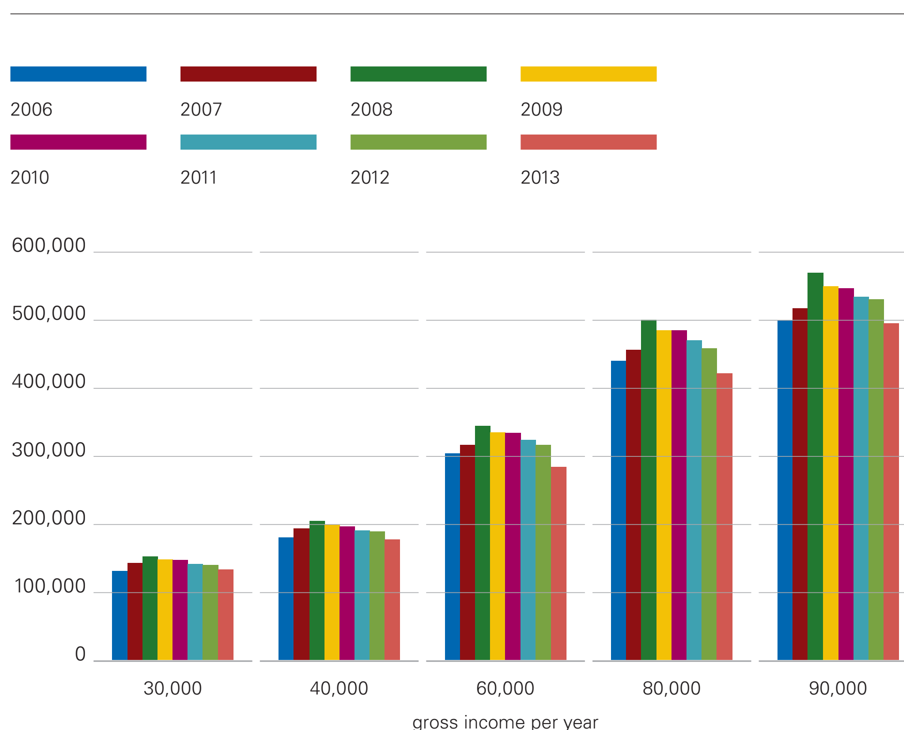
in the Code of Conduct for Mortgage Financing (GHF). Based on the 'Nibud' standards, this Code caps permitted housing expenses at a percentage of income, and this limit is then used to calculate a maximum permitted amount for loans in each income category.

Chart 1.8 shows that the maximum amounts permitted to be lent have fallen almost every year since 2009. And the amount will be lower still in 2013, as average household budgets will be less able to cover housing expenses. The maximum loan amounts are currently around or below the 2006 level for virtually all incomes. Thanks to the annual growth in income, households' actual maximum loan amount will develop slightly more favourably than the maximum limits per income category. However, even taking this into account, the maximum loan amounts will be slightly lower in 2013 than in 2012.

Alongside the gradual decrease in the maximum loan amounts, various other measures will be taken in 2013 that will have consequences for mortgage lending (see Box 1.1). The most important of these changes relates to mortgage interest relief. The Netherlands is the only country in the euro area where interest paid on primary home mortgage loans is fully deductible over a long period of time. Since the start of 2013, however, mortgage interest relief has been available only on new loans that are repaid under an annuity schedule within a maximum period of 30 years.

In most euro area countries, an annuity-based repayment schedule for home mortgages is the standard. Only 7.5% of new mortgages granted in the region in 2007 were interest-only. In the Netherlands, Ireland and Cyprus, however, the proportion of interest-only mortgages is significantly higher, at around 50%. The government's measures mean monthly costs of mortgage loans will increase because homeowners must make full principal repayments from the start if they are to qualify for mortgage interest relief. The advantage, from a financial stability perspective, is that in repaying a significant part of their loan from the outset, first-time buyers immediately start to build net home equity. This limits the risk

Chart 1.8 - Maximum loan amount according to bank lending criteria (GHF)
EUR



Note: Based on a mortgage interest rate of 5%.
Sources: Statistics Netherlands and NHG; DNB calculations.

of a residual debt upon the sale of the property and also has a favourable effect on banks' deposit financing gap. A comparable effect will be achieved by the phased reduction in the LTV ratio for new loans. In five years' time, loans will no longer be allowed to exceed the value of the collateral. The reason for this change is that, during the housing boom, high maximum LTV ratios and their increasingly lenient application helped to drive house prices higher and higher.

Box 1.1 Recent mortgage lending measures

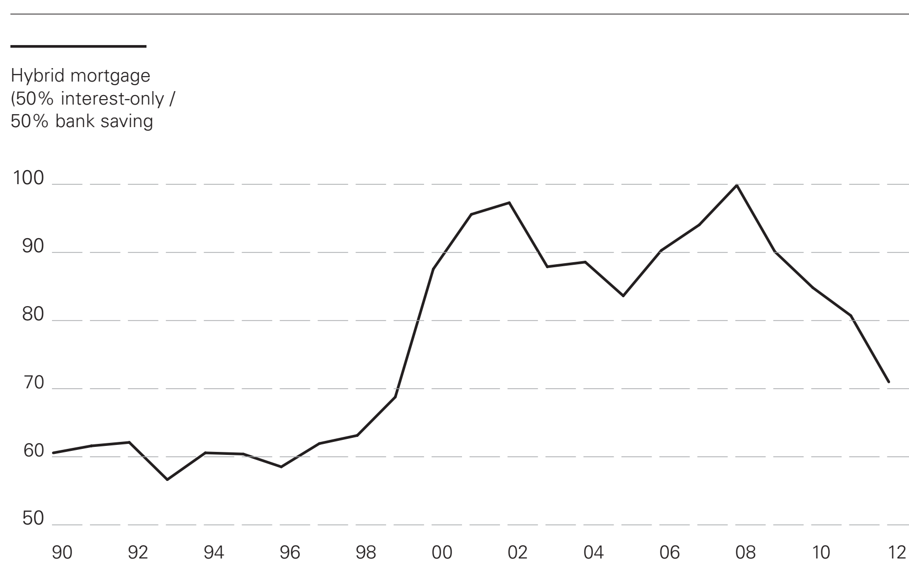
- From 2013, new mortgage loans must be repaid on an annuity basis within 30 years to qualify for mortgage relief.
- If an additional loan is taken out, the obligatory repayments can be limited to a minimum of 50% of the value of the property. The interest on the additional loan is not tax-deductible.
- The maximum rate at which interest on existing mortgage loans can be deducted will be reduced annually by 0.5 percentage points between 2013 and 2040, so that ultimately the relief will be limited to the rate applying in the third tax bracket.
- The maximum LTV ratio for new mortgage loans has been set at 105% from 2013 and will be reduced by 1% a year until it reaches 100% in 2018.
- From 2013, the income tax (box 1) exemption for mortgage endowment policies will no longer be available for new cases.
- Since October 2012, interest on residual home debts has been tax-deductible for up to ten years after the date of sale.

High mortgage debt leads to vulnerabilities in banks and households, while also making the housing and mortgage markets sensitive to fluctuations in incomes and mortgage lending rates. Measures that dampen mortgage lending growth (see Box 1.1) consequently help to stabilise the housing and mortgage markets. The stricter standards mean that first-time buyers wanting to maximise their mortgage can now borrow less relative to their income than previously. Given the requirement for repayment, new loan amounts are also expected to be lower than the interest-only (or partially interest-only) loans that were customary until recently. Loan amounts requested will only, however, be lower for first-time buyers seeking to borrow the maximum, and the tighter criteria will have a less restrictive effect on other borrowers. Moreover, fewer people will need to borrow their permitted maximum as average house prices have fallen by a substantial 16% since the peak in 2008 (see Chart 1.7). This has had a favourable effect on the affordability of owner-occupied housing. At the end of 2012, net housing expenses for an average owner-occupied property were almost 30% lower than four years previously (see Chart 1.9), with the main contributors (both for over 10%) to this fall being declining house prices and lower mortgage interest rates.

The housing market is expected to find a new equilibrium at a lower price level. Demand for housing is under pressure due to the sluggish development of income and the increased risk of unemployment. In addition, the stricter mortgage conditions and banks' increasing reluctance to grant mortgage loans are also having an effect. Banks rely heavily on market funding to finance their lending operations (see also Section 2.3). In the current market environment, this leads to vulnerabilities that can make mortgage providers even less willing to lend. The aforementioned supply constraints may not be seen as a restricting factor by all first-time buyers, but will put an additional brake on mortgage lending growth and, therefore, on house prices.

Chart 1.9 - Housing expenses for an average owner-occupied property between 1990 and 2012

Index 2008 = 100



Note: Net mortgage expenses (net interest + repayments) with 100% financing of an average owner-occupied property (including property transfer tax) compared to average disposable household income.
Sources: Statistics Netherlands / Land Registry and DNB.

1.4 Growth potential in the euro area

With the global economic centre of gravity steadily shifting towards the emerging markets, the euro area urgently needs to rebalance its export mix in order to ensure a better response to this development. For some countries this means a stronger focus on higher-tech products, with increased economic growth coming from labour productivity gains within sectors. This will require structural reforms in institutions, as well as in labour and product markets, alongside investments in education, research and development.

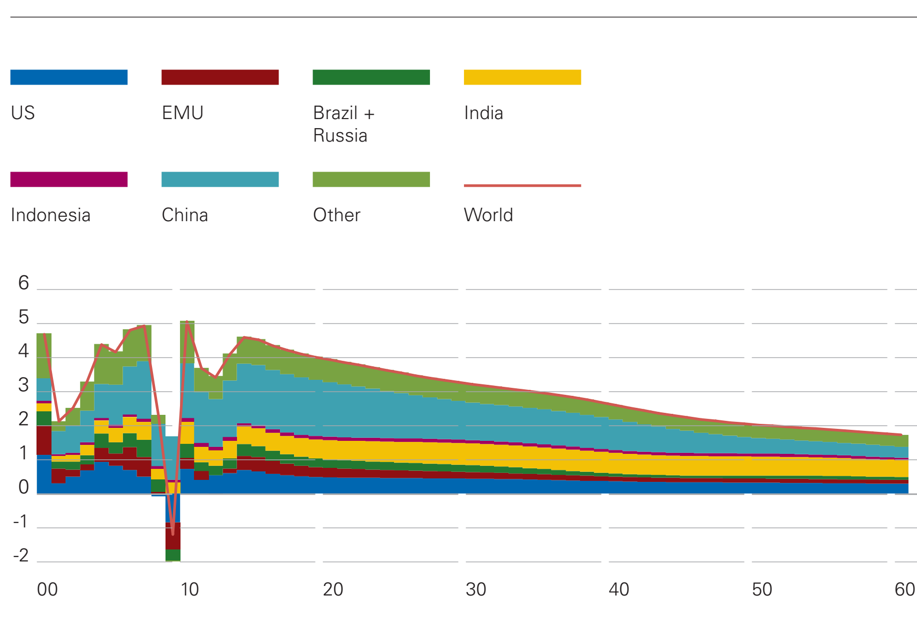
1.4.1 *Where are the euro area's export opportunities?*

Global economic growth has been disappointing over the past two years, particularly in the developed countries, where the risk of a 'lost decade' has not entirely receded. Cumulative growth over the six years since the credit crisis started (2008-2013) is expected to average out at a mere 3.9%, or 0.7% a year. In the same period, emerging economies grew by an average of 5.6% a year; although this is higher than in the developed countries, it is markedly lower than the 7.6% achieved in the preceding five-year period. Due to the divergence between the two groups of countries' growth rates, the emerging economies' contribution to global growth is continuing to increase.

According to the OECD's most recent long-term projections, global economic growth is set for a period of gradual decline from 2014 onwards, mainly due to demographic developments and the resultant shrink in the potential labour force. Over the coming decades (2015-2060), global GDP volume is forecast to grow at an average of 3% a year compared with 4% between 1997 and 2007. The persisting growth gap between emerging and developed countries means the global economic centre of gravity will continue steadily shifting towards the emerging regions (see Chart 1.10). China is expected to remain the key driver of global growth (accounting for over a third), but India's contribution is also expanding steadily, and may one day even surpass that of China.

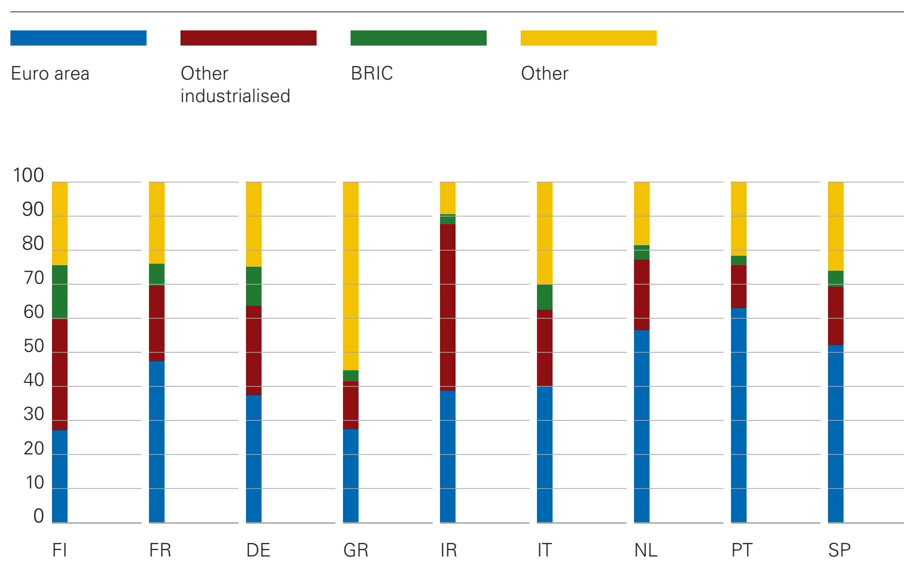
Chart 1.10 - Individual countries' contribution to global GDP growth

Percentage of year-on-year movements and percentage points



Sources: OECD; DNB calculations.

Chart 1.11 - Geographical export orientation, 2011
Percentages



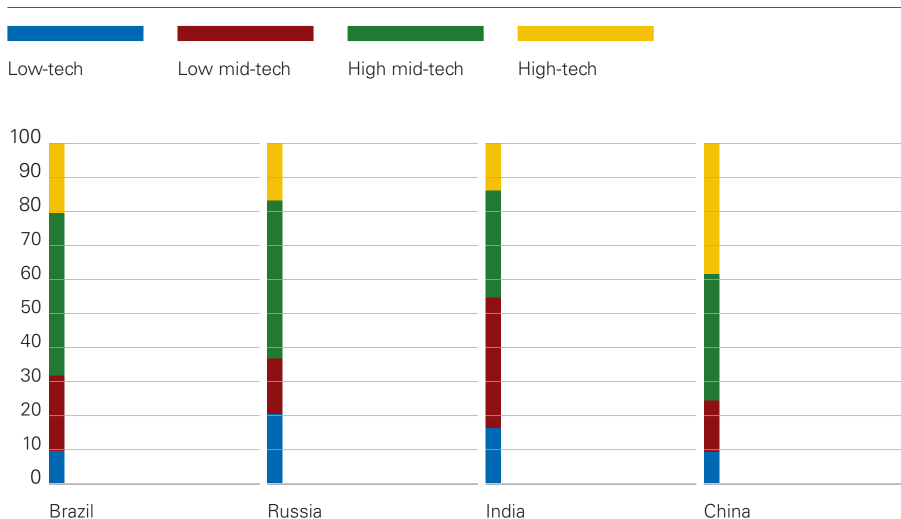
Source: OECD.

To benefit from this global shift, the euro area must adjust the focus of its export to accommodate this development. Chart 1.11 shows the export orientation of various European countries in 2011. Exports from the euro area countries shown in the chart are still strongly focused on that area, as well as on other industrialised countries. However, major differences exist between EMU member states. Germany and Finland are exporting relatively more to the fast-growing BRIC countries (Brazil, Russia, India and China), while this is much less so in the cases of Portugal, Ireland, Spain and Greece, but also the Netherlands.

Price and quality of products, geographical location and cultural affinity are obviously important factors in explaining differences in the various European countries' export orientation. Another key factor, however, is product specialisation. In the past decade, the BRIC countries mainly imported mid-tech goods, such as motor and other vehicles, industrial chemicals and, from the euro area, primarily heavy machinery and other equipment required for their rapid industrialisation (see Chart 1.12). Germany, which has traditionally held a strong position in these segments, capitalised on this demand. France, Italy and Finland also benefited from their specialisation in such products to sell greater shares of their exports to the BRIC countries. The countries that are less well-represented in these sectors, such as Greece, Spain, Portugal, Ireland and the Netherlands (see Chart 1.13), clearly exported less to these rapidly emerging countries. A distinction can be made here between Greece, Portugal and Spain, on the one hand, and Ireland and the Netherlands on the other. The first group mainly exports relatively low- and mid-tech goods. Such goods are also produced in the emerging economies themselves, and so there is less potential for exports from this first group.

Ireland and the Netherlands, by contrast, exported relatively large volumes of high-tech products. The more industrialised and consumer-centric the emerging economies become, the greater their demand for high-tech goods will be.
A DNB survey shows that countries with a strong high-tech export sector stand

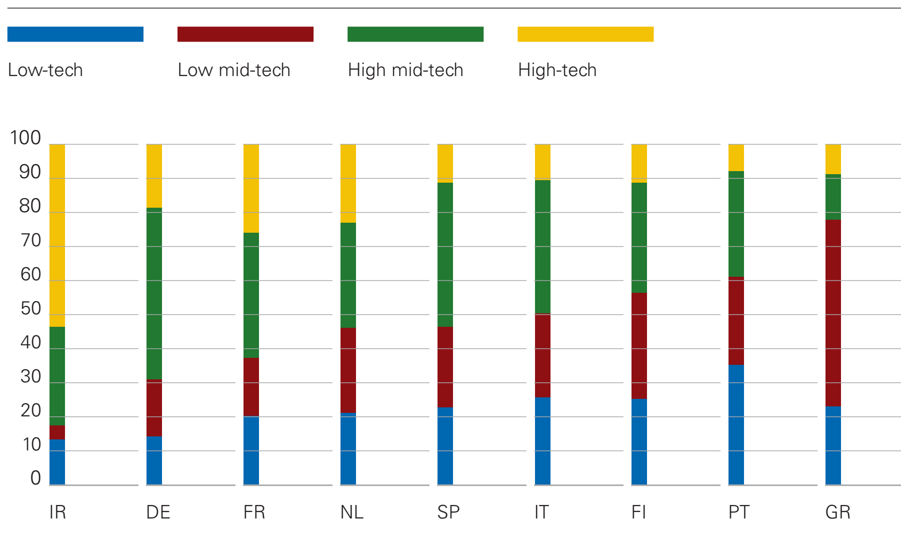
Chart 1.12 - Imports from BRICs by type of technology, 2011
Percentages



Source: OECD.

to benefit more from accelerating income growth in partner countries. Countries currently specialising in low-tech products must therefore 'upgrade' their exports to higher-tech products. Other countries will have to ensure on the one hand that their economies are sufficiently flexible to allow them to deploy production factors wherever the best opportunities for success arise, while on the other hand also stepping up their research and development efforts in order to retain their technological edge. Meanwhile, the emerging economies are rapidly catching up by upgrading their own technology exports.

Chart 1.13 - Euro area exports by type of technology, 2011
Percentages



Note: The data for Spain are for 2010.
Source: OECD.

1.4.2 *Importance of higher growth in productivity*

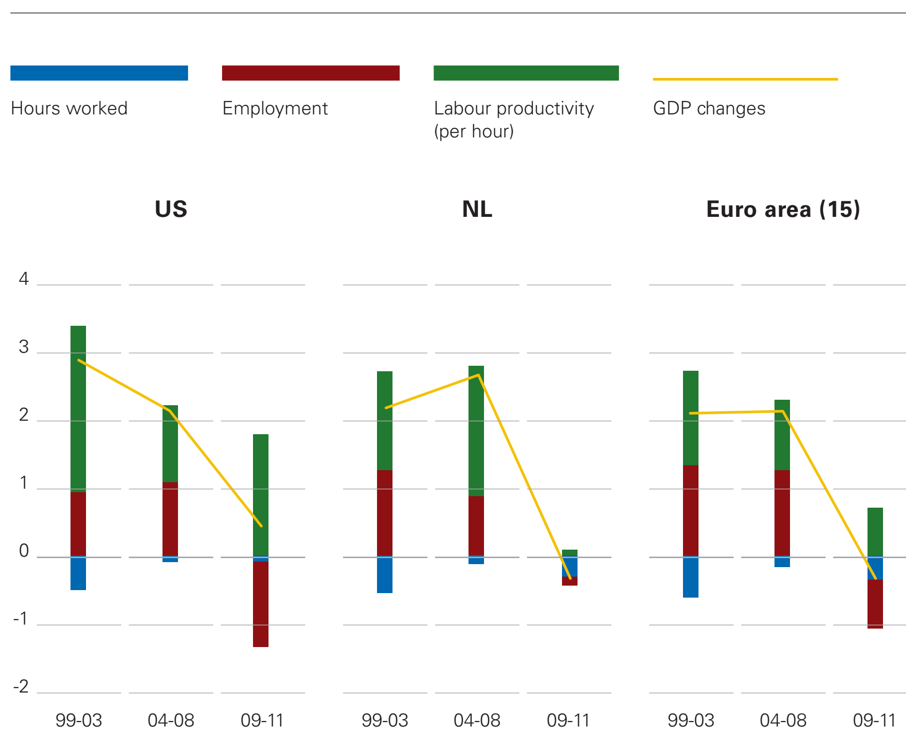
Higher economic growth is crucial in order for the euro area to move on from the current crisis. Higher growth will help restore public finances and in the medium term contribute to debt reduction, both in the public and private sectors, thereby helping to rebuild trust. Higher growth is also necessary to reverse the decline in real GDP and prosperity that has resulted from the crisis. Another essential reason for promoting growth is to prevent the crisis from leaving a damaging legacy of high long-term unemployment (particularly youth unemployment) that could inhibit growth and erode prosperity for years to come.

Real GDP growth can be subdivided into growth in labour input (i.e. number of hours worked) and growth in macroeconomic labour productivity (i.e. the ratio of real output to the number of hours worked). Developments in the labour input are determined mainly by demographic trends and changes in labour market laws and regulations, while growth in labour productivity is principally driven by investment and technological innovation. In recent decades, real GDP growth has primarily been propelled by higher macroeconomic labour productivity, while the contribution by number of hours worked has been negative (see Chart 1.14).

According to the long-term projections in the European Commission's 2012 Ageing Report, the labour factor will make a relatively small contribution to structurally higher economic growth in the coming decades, particularly due to the developments foreseen in the supply of labour. Growth in available labour input depends on developments in the potential labour force, the labour participation rate, structural unemployment and the number of hours worked

Chart 1.14 - Contribution of labour input and labour productivity to real GDP growth

Percentage change and percentage points



Sources: OECD; DNB calculations.

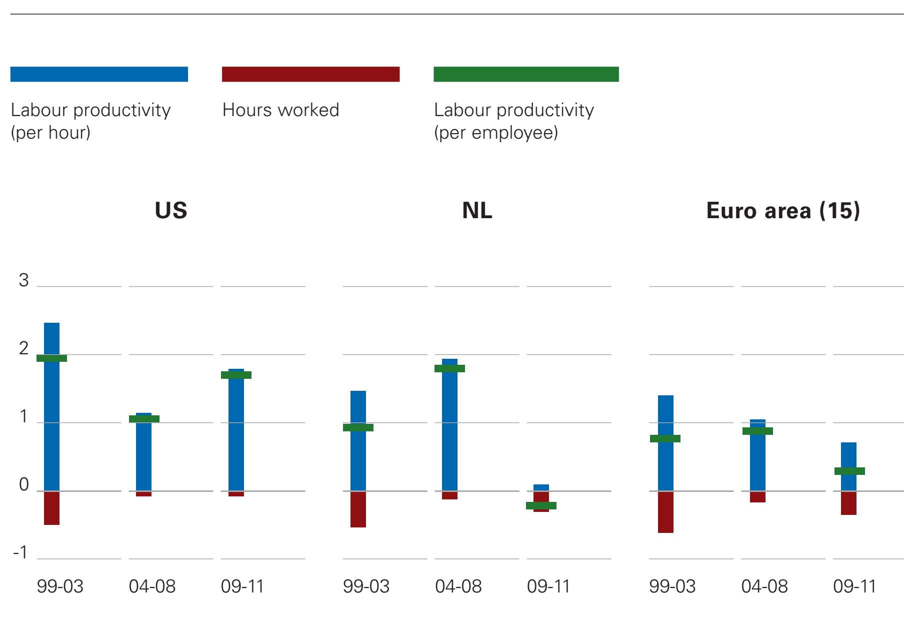
per employee. Ageing will cause the potential labour force in the euro area to contract. Only in a few countries (Belgium, Cyprus, Ireland, Italy, Luxembourg and Spain) will the potential labour force continue to grow in the coming decades, mainly due to a positive contribution from migration. Thanks to a rising labour participation rate among women and older people, the total labour participation rate in the euro area will continue to increase for the time being, while the structural unemployment rate is expected to decrease.

Net labour input will continue to make a marginally positive contribution to GDP growth in most euro countries in the coming decades, with the exception of Germany, Finland, the Netherlands and Austria. In the longer term, however, this effect will slowly ebb away and turn negative.

Higher GDP growth must therefore come mainly from growth in labour productivity. The pace of labour productivity development (per hour) in the euro countries was already decelerating in the period before the crisis, falling from an annual average of 1.4% in 1999-2003 to 1.0% in 2004-2008 (see Chart 1.15). In the US, growth in labour productivity declined somewhat more rapidly between 1999-2003 and 2004-2008, resulting in growth in the two regions being comparable. Since then, the US – in contrast to the euro area – has witnessed a certain degree of recovery. In some countries that proved vulnerable to market unrest, such as Ireland and Spain, labour productivity growth also showed a recovery in 2009-2011, which is favourable for these countries' competitiveness. Nevertheless, labour productivity per employee remains about a third higher in the US than in the euro area. For the euro area as a whole this difference can largely be explained by lower labour productivity per hour. However, this does not apply to the Netherlands, where labour productivity per hour is comparable to that in the US (with a lower number of hours worked per person).

Chart 1.15 - Labour productivity growth per employee per hour

Percentage changes



Sources: OECD; DNB calculations.

1.4.3 *Sector-based view of productivity growth*

Average labour productivity growth in the overall economy is partly influenced by the economy's sector structure, i.e. the division of employment across agriculture, industry and services, or at an even more detailed level. In most developed countries, for instance, industrial productivity is growing faster than productivity in the services sector. In countries with substantial industrial employment, this 'automatically' leads to higher macro-productivity growth than in countries with proportionately more services-oriented employment.

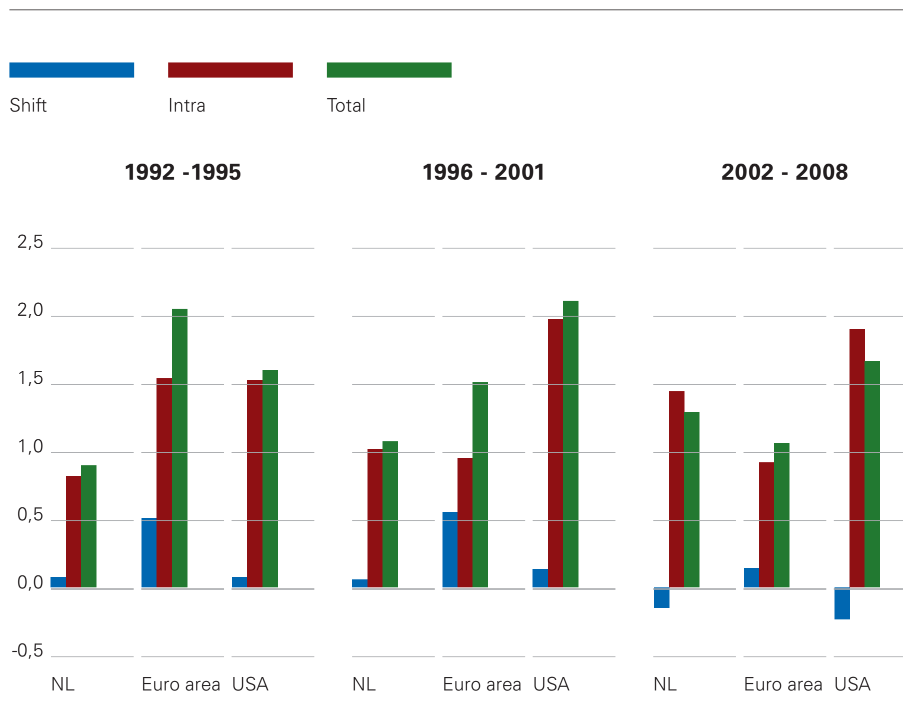
Economies' sector structures change over time and vary between countries. As economies develop, the shares of the primary and secondary sectors (agriculture and industry) shrink, whereas the tertiary sector (services) expands. This is a largely organic process: growth in consumer income fuels demand for services, while demand for agricultural and industrial products lags behind. As a result, employment gradually shifts towards the services sector. This process started early in the Netherlands, where industry has been contracting since the mid-1960s. Today, commercial and public services account for more than 70% of total Dutch employment. This organic shift towards services limits the extent to which a country's sector structure can be 'redirected' with a view to concentrating employment in high-productivity sectors. Increasing labour productivity at a macro level therefore depends primarily on the potential for increasing labour productivity within sectors.

When average labour productivity was higher in the services sector than in other sectors, the economy's increasing focus on services contributed to productivity growth at a macro level. Employees in services sectors (such as healthcare or business services) were able to achieve greater productivity gains than those in industry or agriculture. This situation, which prevailed in the Netherlands until the 1990s, has now come to an end. Productivity in the services sector has been overtaken and is rising less rapidly than in other sectors. Therefore, higher levels of employment in the services sector no longer necessarily contribute towards higher productivity growth. This can be seen if growth in countries' productivity levels is broken down into its constituent elements. On the one hand, productivity rises as a result of employment shifting towards sectors with higher productivity levels (the 'shift effect'). On the other hand, the sectoral division of employment means it rises at a macro level as a result of productivity growth within sectors (the 'intra effect'). To provide a more accurate picture of this process, the economy has been subdivided into nine sectors. As our focus here is on the long-term pattern, the recent crisis period has been omitted. Chart 1.16 shows the decomposition of macroeconomic labour productivity growth (per employee) in three periods for the Netherlands, the euro area and the US.

Total productivity growth in the Netherlands was below the euro area average in the first two periods and lower than in the US in all three periods. The decomposition shows that the intra effect exceeds the shift effect in all countries (or groups of countries) and periods. This means that, until the end of 2008, macroeconomic productivity growth was driven by productivity growth within sectors rather than by a shift in employment to sectors with higher labour productivity. The euro area as a whole gained a modest benefit from the shift effect. In the Netherlands and the US, however, the shift effect made a small negative contribution to productivity growth as, in the 2002-2008 period, employment in these countries shifted predominantly towards sectors with lower labour productivity.

Chart 1.16 - Decomposition of labour productivity growth per employee

Percentages



Sources: OECD; DNB calculations.

In all countries or groups of countries, the shift effect in the most recent period was significantly lower than in the preceding period. Within the euro area, this was particularly true in the case of Germany, France and Finland.
The diminishing shift effect is a consequence of the trend towards services, which has advanced the furthest in the US economy. After initially producing a positive productivity effect due to the high level of productivity in the services sectors, this development has since progressed so far, both in the core countries and in the Netherlands, that it now has a negative impact on macro labour productivity growth. Until 2008, it was only in countries such as Spain, Portugal and Greece that sectoral shifts still made a positive, albeit relatively small contribution to labour productivity growth at a macro level.

All in all, sectoral shifts contributed little to labour productivity growth in the 1992-2008 period in either Europe or the US. Productivity growth as a result of employment shifting to more productive sectors was seen in only a few, mainly peripheral, European countries. The underlying trend suggests that in these countries, too, macro productivity growth will ultimately consist mainly of intra-sector growth. Moreover, the shift in employment between sectors does not appear to be a process that governments can easily control as it is primarily driven by changing consumer preferences, demand from abroad and relative price movements. Consequently, macroeconomic policies are largely ineffective in altering a situation where, as in the Netherlands, productivity growth is inhibited by a negative shift effect. On the other hand, this clearly signals that higher labour productivity should be promoted primarily within individual sectors. In view of its relative size, higher productivity growth within the services sectors would therefore seem the most obvious way forward.

1.4.4 *Policy options*

The above analysis points to various policy options for increasing the growth potential in the euro area. To benefit more from the on-going shift in the global economy towards emerging economies, the euro area needs to reorient its export mix towards these countries. Some member states, such as Greece, Portugal, Spain and (to a lesser extent) Italy, are hampered by their specialisation in lower-tech products. These member states must therefore aspire towards a higher-tech export mix. Although this process is difficult to influence directly by means of policies, it can be facilitated by certain initiatives. The first prerequisite is to invest in good education, and research and development. In addition, labour and product markets must be made sufficiently flexible by minimising entry barriers to ensure that capital and labour can easily find their way to the most productive companies. These measures will create a business climate that makes it easier to attract foreign direct investment to drive the dissemination of technology.

An increase in intra-sector labour productivity is also an indispensable condition for lifting economic growth to a structurally higher level. Effective competition, openness and innovative capacity are vital for this purpose. Greece, Portugal, Spain and Italy can benefit in this way from the same type of structural reforms as those mentioned in respect of the upgrading of the export mix. To a certain degree, the same applies to France, although productivity there is already relatively high.

Table 1.1 - Core policy indicators

Rankings of 144 countries

	VS	GB	DK	SE	FI	NL	DE	FR	IR	GR	IT	PT	SP
Institutions	41	13	14	6	3	7	16	32	19	111	97	46	48
Efficiency of legal framework in settling disputes	35	11	13	5	2	8	20	37	29	135	139	121	69
Irregular payments and bribes	42	17	4	10	2	12	18	32	14	104	68	34	40
Transparency of government policy	56	13	45	8	2	14	27	47	28	122	139	71	77
Higher education and training	8	16	14	7	1	6	5	27	20	43	45	30	29
Quality of educational system	27	27	19	12	2	13	20	41	9	115	87	61	81
Goods market efficiency	23	17	19	12	18	6	21	46	9	108	65	61	55
Intensity of local competition	18	5	29	22	68	1	8	28	40	95	67	62	23
Effectiveness of competition policy	17	9	10	3	4	1	24	20	22	91	100	68	49
Time required to start a business	16	59	16	71	66	34	71	25	59	48	16	10	97
Labour market efficiency	6	5	8	25	15	17	53	66	16	133	127	123	108
Redundancy costs	1	23	1	66	38	25	95	51	18	89	19	129	84
Hiring and firing practices	8	33	5	133	80	126	127	141	75	111	136	131	129
Pay and productivity	12	13	53	72	46	67	41	66	32	132	128	120	133
Financial market development	16	13	30	10	4	20	32	27	108	132	111	99	82
Innovation	6	10	12	4	2	9	7	17	21	87	36	31	35

Source: WEF Global Competitiveness Indicators 2012.

First and foremost, labour and product markets need to be liberalised by dismantling restrictive licensing systems, reducing the red tape on starting a business, limiting the dismissal protection available to employees on permanent contracts and reducing the levels of statutory severance pay. Table 1.1 also shows the presence of important institutional inefficiencies, such as corruption (particularly in Greece and Italy), judicial inefficiency and excessive bureaucracy, which scare off foreign direct investment.

The table also highlights shortcomings in the quality of education and innovative capacity. Improvements in the educational system and investments in research and development create the right conditions for developing and absorbing new technologies. It is much more difficult for countries such as Finland, Germany and the Netherlands to achieve further market efficiencies as most of these countries' core indicators are already at a high level. In fact, Table 1.1 shows that these countries already have comparable or better scores than the US in many areas. However, the US, UK and Denmark clearly score better on labour market flexibility. Labour market liberalisation can therefore still yield productivity gains. The gap in productivity levels between the US and countries such as Germany, the Netherlands and France is largely due to the fact that employees in the US work more hours. Higher productivity in these European countries consequently depends on society's acceptance of longer working hours as a means of raising productivity per employee.

1.5 Towards a future-proof and stable EMU

A comparison with the US shows that a properly designed European banking union can break the negative interaction between banks and governments and promote monetary policy effectiveness. Other prerequisites are the restoration of financial buffers and increased enforceability of commitments to healthy fiscal and macroeconomic policies within the EMU. The level to which national public debt must ultimately be reduced depends partly on the extent of risk-sharing and political integration within the EMU.

1.5.1 *Institutional flaws in the EMU*

The current crisis has exposed serious flaws in the institutional set-up of the EMU. First of all, insufficient enforcement of the Stability and Growth Pact meant that the fiscal positions of many euro countries were too weak to absorb the impact of the financial crisis. Secondly, insufficient account was taken of long-term macroeconomic and financial imbalances within the EMU and their consequences for countries' public finances. In countries with large current account deficits or property bubbles, public revenues reacted unexpectedly severely to the recession, causing a sharp increase in public debt. Thirdly, the interaction between the banking industry (and its financial health) and the government was insufficiently acknowledged. The crisis has revealed that a vicious circle can arise in which doubts about the sustainability of public debt and the stability of the banking industry have a mutually reinforcing effect. As the credit crisis has shown, the national government acts as a safety net for the national banking sector, whenever necessary, to protect the financial stability. Conversely, weak public finances can also contaminate banks with large volumes of government debt in their books (see also Section 2.2). These three short-comings have in turn exposed a fourth flaw in the EMU: the potential instability resulting from the combination of national debt financing and a common currency. As EMU countries are no longer masters of their own monetary and exchange rate policies, they are unable to temporarily counter a crisis situation by cutting interest rates and allowing the value of their currency to fall.

The stable currency union of the US is often held up as a model by parties seeking to address these flaws. To what extent can the institutional design of the US serve as an example for the EMU?

1.5.2 *US lessons for a banking union*

The institutional set-up of the US proved successful during the credit crisis in containing the negative interaction between banks and individual US states. By contrast, the negative interaction in some euro area countries was much stronger and the impact on financial stability accordingly severe. This raises the question of whether the US set-up may offer interesting lessons for the EMU.

First of all, individual US states play virtually no role in funding bank rescue operations. The states supervise only smaller local banks. In the event of problems, these can be resolved by the Federal Deposit Insurance Cooperation through a rapid and orderly process and without incurring high costs. This has been done successfully on numerous occasions in the past few years. The FDIC also manages the federal deposit guarantee system (DGS), which has statutory priority over ordinary creditors in the event of bankruptcy and is financed by the banking sector. This system ensures that the losses to the government arising from such bankruptcies are limited and largely borne by shareholders, creditors and the banking industry. Larger, more systemically important banks are under the supervision of the Federal Reserve and, if necessary, can be supported with federal funds in order to prevent any disruption of financial stability. Such support also enjoys preferred creditor status and must be repaid by the sector. Thanks to this division of roles, the financial problems of individual US states never posed a threat to the banking industry during the crisis. The same applies in respect of the banking industry's strong concentration in certain states. These states did not need to bail out their banking sector; that was up to the federal government. Centralised financing is more efficient than requiring each separate state to build its own buffers for rescuing troubled banks. In addition, it is easier for the central government to bear the risks as the individual banks' capital is substantially lower than the GDP of the currency union as a whole.

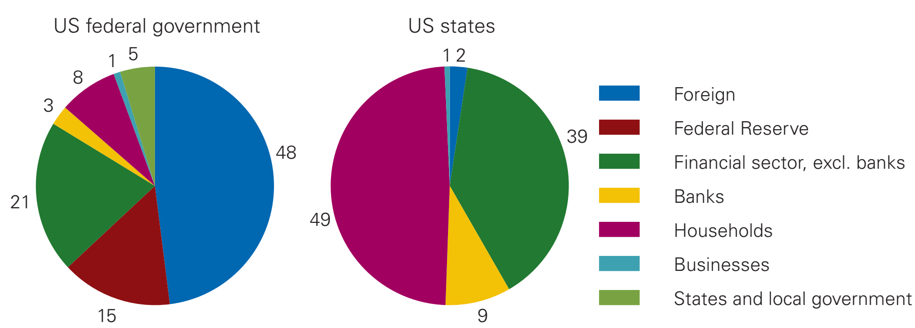
A second difference with the euro area is that the loan exposure of US banks to both the federal and regional governments is limited. As US banks hold only a low percentage of federal debt in their books (see Chart 1.17), the risk of negative interaction between the public finances and the banking industry is much lower. In Europe, by contrast, banks' loan exposure to their own governments has steadily increased in the past few years.

Indirect contagion of banks and governments via a deterioration of the real economy can admittedly also occur in the US, but to a much lower degree than in the EMU. One reason for this is that the debts of US states are much smaller (see Table 1.2). In addition, the indirect effect in the US mainly impacts on the federal government, which has a larger budget. The reverse applies in Europe, where it is national governments that are saddled with high debts, while the European Union's budget is limited. Nevertheless, an interplay between the recession (and, more specifically, the price correction in the property market) and the problems in the banking sector can also be seen in the US as states with a large banking sector were particularly hard hit by the fact that this sector was an important driver of economic growth and tax revenue in the pre-crisis period.

The US institutional set-up illustrates that the negative interaction between banks and governments can be broken in a currency union at national level.

Chart 1.17 - Breakdown of holders of US federal and state debt paper

Total size at end of Q2 2012, USD 11,026 billion and USD 2,972 billion, percentages



Source: US Federal Reserve.

To achieve the same effect in the euro area, the EMU could take its cue from the US and centralise the resolution of banks, as well as the associated financing. This also implies the introduction of central European supervisory and resolution mechanisms for significant banks. It must also be possible to resolve non-significant banks in a fast and orderly process and at no cost to the taxpayer. These non-significant banks would remain under national supervision, but subject to the same prudential requirements and supervisory methods in order to guarantee a level playing field and limit the risks to governments. Central resolution would lead to better cross-border crisis management, including more stringent demands concerning the resolvability of banks. To reduce the risks of contagion from governments to banks, banks' exposure to their national government and governments in general should also be curbed. Given, however, the currently high debt levels of EMU governments and their reliance on bank funding, this cannot be achieved in the short term. Additional policy is therefore required within a European banking union to mitigate these risks.

Breaking the negative interaction between banks and governments would also improve the transmission of monetary policy in the EMU. Governments'

Table 1.2 - Top-10 debtors

GDP percentages 2012

US states		European governments	
1 Massachusetts	18.3	1 Greece	176.7
2 Rhode Island	18.1	2 Italy	126.5
3 Vermont	13.1	3 Portugal	119.1
4 Connecticut	12.7	4 Ireland	117.6
5 New Hampshire	12.7	5 Belgium	99.9
6 Maine	12.4	6 France	90.0
7 Alaska	12.3	7 Cyprus	89.7
8 New Jersey	12.2	8 Spain	86.1
9 Hawaii	11.5	9 Germany	81.7
10 Montana	11.2	10 Austria	74.6

Sources: US Census Bureau and European Commission.

financing costs place a floor under the financing costs of banks because of the (implicit) state guarantee. At present, borrowing rates within the euro area vary widely because banks face large differences in funding costs. Within a banking union, the financing costs of banks would be less closely related to those of governments, and so borrowing rates would also vary less from one country to another. This would reduce any future risk of the ECB once again having to resort to extraordinary monetary policies in order to restore monetary transmission.

As in the US, national supervision within the EMU was unable to prevent unsustainable lending and asset bubbles, partly because the quality of the supervision was not always up to standard. European oversight of all banks would assure the same quality and intensity of supervision throughout the EMU and reduce the risk of national supervisors delaying interventions.
To be effective, supervision at a national level would still have to be of sufficient quality, as experience in the US has shown that organising supervision at a federal level is not sufficient in itself. Alongside the microprudential banking supervision, macroprudential supervision and policy, which focus on systemic risks, also need to be partly centralised. National authorities sometimes intervene too late and thus insufficiently mitigate these risks. A centralised authority would therefore have to be empowered to impose more stringent requirements if national authorities failed to take effective action. Nevertheless, national discretion remains important in the deployment of macroprudential instruments. In view of the variances in national credit cycles, a geographically differentiated deployment of instruments would be desirable.

European supervision is not effective without the simultaneous introduction of a European resolution mechanism. National authorities are keen to limit reputation damage and the costs for taxpayers, and therefore have an incentive to postpone the resolution of banks. Such delays mean the final bill can work out higher. As US practice shows, a European resolution authority can promote timely and consistent intervention. To limit the risks for the European resolution fund, losses must initially be borne by shareholders and, where necessary, by certain creditors. Temporary resolution financing must have preferred creditor status. European governments will then form a joint safety net, for instance in the form of the European Stability Mechanism, only as a last resort. In order to break the negative interaction between banks and governments, a European deposit guarantee system could be introduced as the finishing touch of the banking union.

1.5.3 *Fiscal and economic union in the US and the EMU*

Fundamental differences exist between the fiscal structure of the US and that of the EMU. In the US, the federal budget is by far the most important budget, representing about 24% of GDP in 2012. In the EMU, by contrast, the common budget amounts to some 1% of GDP. Whereas EMU member states are required to absorb economic shocks in their own national budgets, this is largely done at a federal level in the US. During a recession, federal tax revenues decrease and expenditure increases, partly as a result of rising social security costs. In the event of asymmetrical shocks, this creates an insurance mechanism involving a redistribution of income from states that are doing well to states that are struggling. If the US economy as a whole suffers a downturn, this is mainly reflected in higher federal deficits. The federal government then issues federal debt paper to cover this shortfall.

One of the consequences of a stabilising federal budget is that a redistribution also takes place from stronger states to those that are less strong.

This redistribution is accepted in the US because it is much more of a unified nation than the EMU. The redistribution is also less visible, partly because the federal government does not rely on direct payments from states, but instead raises its own tax revenues. Moreover, the total scale of the structural redistribution in the US is limited by the country's high labour mobility. Migration from states with long-term unemployment to states where jobs are more plentiful helps to limit unemployment and hence the social security transfers to less successful states.

Partly because of its expansive fiscal policy in previous years, the US saw its total public debt rise to about 107% of GDP in 2012, whereas total public debt in the EMU amounted to an estimated 94% of GDP in 2012. One crucial difference, however, is that public debt in the US is largely federal. The average debt of US states amounts to only about 7% of their GDP (see Table 1.2). Some states even have a modest 'rainy day' fund to provide a temporary (and partial) cushion in case revenues fall. As a result, individual US states are not saddled with excessive levels of public debt after a recession. This makes it considerably easier to achieve a balanced recovery in the aftermath of a crisis than in the EMU, where debts are unevenly spread and several countries are finding it difficult to finance their high levels of debt.

The low debt levels in individual US states are partly the consequence of strict fiscal rules at a state level. Virtually all states are committed by law to maintaining a permanent fiscal equilibrium. Many of these fiscal rules were introduced in the 19th century after the federal government refused to come to the rescue of several bankrupt states. Since then, states must be independently able to convince the financial markets of their creditworthiness. Thanks to low public debts, the bankruptcy of an individual state poses no problem for the US as a whole. Although the strict fiscal rules mean that individual states in the US are largely unable to stabilise their economy through fiscal policy, this does not pose a problem as this role is already fulfilled by the federal government.

In order to increase economic stability in the EMU and create national fiscal relief, it has been suggested to create a new common EMU budget. A common budget could serve to absorb certain asymmetrical economic shocks. Sharing risks can help the EMU to gain stability (see also Box 1.2). However, it is important to note that the current differences in growth and unemployment rates in the EMU are not purely cyclical and actually stem largely from structural differences in areas such as labour market flexibility, liberalisation of product markets, innovative capability and the composition of the export mix (see also Section 1.4). Moreover, automatic mechanisms to dampen divergences between member states, such as labour mobility, are largely absent in the EMU. Under these circumstances, the introduction of a federal budget would lead to a structural one-sided redistribution between EMU member states and would thus diminish the incentive for structural reforms. This, in turn, would heighten the risk of new imbalances. For these reasons, an EMU budget would be useful for stabilisation purposes only if sufficiently strong safeguards to ensure the health of national public finances and economies are put in place. Only then will all euro countries run a comparable risk of asymmetrical shocks. This would require further political integration, which would not only involve a sharing of risks, but also a transfer of sovereignty.

The first task for national governments within the EMU is to reduce their public debt. The crisis has illustrated that the measures needed to absorb a deep recession can lead to a sharp rise in debts, particularly in countries with large

macroeconomic imbalances. Many countries lacked the buffers for absorbing a substantial shock; in some cases their public debts soared to such levels that the markets started to question their sustainability.

Box 1.2 - Ultimately, a federal EMU budget or euro bonds?

In the US, bonds issued by individual states are not collectively guaranteed. Apart from the banking union, risks in the US are shared through a large federal budget. Looking at the EMU context, how does a federal budget compare with euro bonds that are commonly issued and guaranteed?

If all national and collective economic shocks could be absorbed by a federal budget, member states would no longer need to pursue their own stabilising fiscal policy. Fiscal discipline can be enforced by demanding balanced budgets. This would lead to member states gradually reducing their public debts. The EMU would then steadily work towards a US-type situation in which the inherent instability of national debt issuance alongside a common currency would be resolved. But that is only possible if the federal budget is large enough and the federal government is empowered to engage independently in debt financing activities. This calls for far-reaching political integration and, in view of the structural economic differences, could also lead to an extended period of one-way redistribution between member states.

A small federal budget, which could only absorb a degree of asymmetrical shocks, can serve as a step up towards a larger federal budget, but is not sufficient in itself to ensure a stable EMU. Automatic stabilisers at a national level would then remain necessary, while public debt would remain at a national level, and the instability of national debt issuance alongside a common currency would continue to exist.

If, instead of the federal budget option, preference is given to euro bonds for the issuance of national debt, fiscal policy will remain a largely national affair. The introduction of euro bonds for the entire public debt would put a final end to the instability of national debt issuance alongside a common currency. After all, if euro bonds are issued for the entire public debt of all euro countries, a liquidity problem in one euro country would no longer unnecessarily lead to a solvency problem. In addition, it would create a barrier against the danger of contagion. At the same time, the introduction of euro bonds would entail a redistribution, at least implicitly, between member states as all member states would pay the same interest rate, irrespective of the health of their public finances. Euro bonds would thus reduce the incentives for national fiscal discipline and structural reforms, which could have an upward effect on interest rates. A far-reaching transfer of national fiscal sovereignty would be required to compensate for this as far as possible.

In conclusion, both a federal budget for stabilisation purposes and euro bonds offer a form of insurance against asymmetrical shocks. Both, however, reduce the incentives for responsible government policy at a national level. They must therefore be seen as the final piece in the EMU puzzle, after the safeguards for healthy national economic and fiscal policies have been sufficiently strengthened and public debts substantially reduced.

In order to strengthen government buffers, fiscal discipline must be made more enforceable in the EMU, particularly for reasons of prevention. Within the context of corrective fiscal supervision, the enforceability of the 3% limit within the Stability and Growth Pact has already been greatly improved. To create higher buffers, however, countries must at least achieve fiscal equilibrium, while the enforcement of preventative fiscal supervision and the debt rule must be made more robust and more politically independent. This means that the European Commission's position relative to the European Council will also need to be strengthened within the Stability and Growth Pact decision-making process.

In addition, macroeconomic and financial imbalances must, insofar as possible, be prevented. Alongside macroprudential policy, this will at least require reinforcement of the Macroeconomic Imbalances Procedure (MIP).
The effectiveness of the MIP can be improved by making decision-making in all stages of the procedure less politically dependent. Doing so will make it easier to enforce vital structural reforms. These reforms should include measures to facilitate the ease with which wages and prices in the EMU adjust to changing circumstances. This, in turn, should serve to promote a rapid recovery in competitiveness and economic growth after a shock. All these measures should combine to reduce the risk of boom-bust cycles and the strong undermining impact they have on public finances. By reducing divergences between countries, they will also pave the way for a common monetary policy better suited to all EMU countries.

Increasing the enforceability of fiscal discipline, limiting the accumulation of macroeconomic and financial imbalances and breaking the negative interaction between banks and governments within the EMU are key conditions for a sustainable and stable EMU. They do not, however, guarantee it.
The combination of national debt financing with a common currency remains inherently unstable. Concerns about the sustainability of a specific country's debts can trigger a self-fulfilling prophecy within the EMU, with rising interest rates and evaporating liquidity ultimately driving the ailing country into insolvency. As all EMU countries are vulnerable in this respect, financial unrest in one country can rapidly spread to other (distressed) countries. All else being equal, this vulnerability means that EMU member states must maintain higher buffers than individual states in the US. Further risk-sharing within the EMU can reduce the need for high national buffers (see Box 1.2), but would also require political integration. Viewed in this light, preserving national sovereignty comes at a price.

1.5.4. *Van Rompuy Report and European Commission Blueprint*

Both the President of the European Council, Herman van Rompuy, and the European Commission recently outlined their future vision for repairing the flaws in the fabric of the EMU. The most important elements in these proposals are a) a banking union with European supervision and crisis resolution, b) country-specific reform contracts linked to financial compensation from a new EMU budget which in due course will also be given an economic stabilisation role, c) common debt financing via euro bonds, and d) democratic reinforcement with the European Parliament as the most important elected body.

These elements can in principle contribute to a more stable EMU. As explained above, a banking union can help prevent mutual contagion between the national banking sector and public finances. Country-specific reform contracts

can also have a preventative effect in essential policy areas for the EMU, as well as promote national acceptance and implementation of economic recommendations and reforms. However, certain critical comments can also be made about the proposals. One important criticism is the lack of attention for solid safeguards, particularly compared to the attention given in the reports to public and private risk-sharing in the form of a banking union, euro bonds and a stabilisation budget. Due to the weak enforceability of the reform contracts, the aforementioned measures to increase the enforceability of the Stability and Growth Pact, as well as the MIP, are necessary. Unfortunately, it is precisely in these areas that the visions outlined for the future are lacking in ambition. Before proceeding towards further – and, in principle, efficient – risk-sharing via the introduction of euro bonds or an economic stabilisation budget, it is absolutely vital to implement control mechanisms to prevent fiscal and macroeconomic imbalances.

Some of the proposals by the European Commission and Van Rompuy were already adopted last year by the European Council. The most important decision was the decision to create a European supervisory mechanism on 1 March 2014. The national supervisors will then carry out their supervision in conjunction with the ECB. Section 2.2 explains this decision in further detail, as well as its implications for national supervision and DNB. The European Council also concluded that it would aspire towards the implementation of a European resolution mechanism (including financing) in June 2014. This ambition would, in principle, permit the simultaneous introduction of European supervision and resolution mechanisms.

2 The changing face of supervision

2.1 Introduction

The financial sector is undergoing a transformation in response to the crisis. In some respects this necessary transition is already well advanced, for example with regard to the strengthening of capital buffers and the scaling back of high-risk activities. At the same time, the problems from the past are not entirely behind us – a point starkly illustrated by what happened with SNS REAAL. Meanwhile, the supervision of the financial sector is also in a transitional phase. All in all, experiences from the crisis have delivered an extensive agenda for change, the implementation of which is in full swing.

This chapter uses selected cases to illustrate the current status of some key challenges. It focuses on developments that will take place over the coming years and, to a lesser extent, on the supervisory activities in the year under review. A detailed review and account of the supervisory activities carried out by DNB in 2012 can be found in the 2012 independent public body report (ZBO-verantwoording 2012).

Section 2.2 of this chapter describes developments related to the introduction of European banking supervision, a move that addresses a major shortcoming in the European supervisory framework. This section describes the main challenges and parameters for effective and efficient European banking supervision. Section 2.3 examines the changes in the structure of the financial sector resulting from the crisis. It also describes the impact on supervision of the specific structure of the Dutch financial sector, particularly its relatively large size and highly concentrated nature Section 2.4 highlights a number of areas where supervision is being reformed and tightened up; in turn it considers the international regulatory agenda, developments in the pension system and the supervision of governance, conduct and culture. Finally, this section looks at DNB's activities in relation to the accurate valuation of commercial property portfolios.

2.2 European banking supervision

European banking supervision will rapidly become a reality this year. On 13 December 2012, the Economic and Financial Affairs Council (Ecofin) reached agreement on a regulation establishing the single supervisory mechanism (SSM). The SSM Regulation is expected to come into effect in mid-2013, following completion of negotiations between the European Council, the European Parliament and the European Commission. This means that the necessary structures will be put in place this year to ensure that implementation of European supervision can begin during the course of 2014.

It may be worth reiterating the importance of having a single European banking supervisory authority. A major problem in the current debt crisis has been the interaction between banks, governments and the real economy, resulting in a negative spiral in individual countries and contaminating the rest of the euro area. It thus became clear that problems at banks often have major consequences for public finances and the real economy, and vice versa (see also Section 1.5). National governments are sometimes incapable of controlling the losses in the banking system – a problem that became a reality in Spain in 2012, hard on the heels of a similar situation in Ireland. The situation in Greece and Portugal is the reverse, with weak public finances contaminating the balance sheets of the banks, which invest heavily in their own country's sovereign debt. Ultimately, the interaction between banks and governments in all these countries exacerbated the problems and in some cases actually made them insurmountable. This caused serious tensions within the euro area. Section 1.5 discusses the institutional strengthening that is needed to ensure a future-proof currency union. At the end of June 2012, European leaders decided to establish a key element of that strengthening process in the form of a banking union. This is an essential step in breaking through the negative interaction between banks, governments and the real economy. Its purpose is to raise to European level supervision, resolution mechanisms and deposit guarantee and resolution funds financed ex ante by the sector. The advantage here is that if banks or governments run into difficulties, this no longer gives rise to a vicious circle in individual member states, with the potential to infect other member states. So European supervision in itself is not the sole solution, but it contributes to that solution as part of the banking union. Apart from this, the goal is clearly also to ensure more effective supervision, partly by making certain that supervision is more in line with the cross-border nature of today's European banking community. Ecofin's decision on 13 December 2012 can therefore be seen as a major step towards European supervisory integration.

Given the size and international character of Dutch banks, the Netherlands stands to benefit from the banking union. In fact, many Dutch banks are active in several European countries. Placing the supervision of all these European activities under a single authority will counter fragmentation of supervision and help create a level playing field for financial institutions. Moreover, the current system of national supervision means that national interests are sometimes given priority over common European interest, potentially denting the effectiveness of supervision. European supervision also lessens the risks posed to public finances by a relatively large banking sector.

The creation of a European supervisory authority represents the first tangible building block for the banking union. And it is important that other building blocks follow quickly. There is a particularly urgent need to establish a European resolution authority, backed by a European resolution fund. This is also stressed in the conclusions of the European government leaders,

who are seeking to reach agreement on a resolution mechanism before June 2014. This is important, because even European supervision cannot entirely rule out the possibility of a bank failing. The resolution authority must be capable of resolving a failed bank in an orderly fashion and of seeking solutions whereby the losses are first borne by shareholders and, where necessary, by certain creditors. Funding could also be provided from a resolution fund, which would be financed ex ante by European banks. A resolution fund at European level limits the financial risks to which European governments are exposed: in principle bank failures would be resolved without having to draw on national public resources. And in extreme cases, the European Stability Mechanism (ESM) can serve as a safety net. The third building block of the banking union, a European deposit guarantee scheme, can be put in place at a later date as a further means of breaking through the negative interaction. Convergence of national guarantee schemes with pre-financed funds marks an important step forwards in this regard.

If supervision only is placed at European level, with the resolution mechanism remaining at national level for the time being, conflicts of interest could arise. This would undermine the effectiveness of supervision. Supervisory decisions, for example to wind up a bank, would then be taken at central level, whereas the bill that comes with the decision would have to be paid at national level. Simultaneous establishment of the European supervisory and resolution frameworks would ensure that the European resolution authority can intervene at an early stage and therefore mitigate the risks for taxpayers.

While the ECB will have an important supervisory task within the single supervisory mechanism, national supervisors will continue to play a significant role. The SSM Regulation assigns the role of supervision to the ECB, which will supervise large banks, while the national supervisors will oversee the smaller banks. The ECB will also be responsible for the consistent and effective functioning of the entire supervisory system. It may issue regulations, guidelines and instructions to this end and can assume tasks 'for one or more' banks that fall under the national supervisory regime. Large banks are defined here as banks with total assets in excess of EUR 30 billion or over 20% of a member state's GDP, and will include at least the three largest banks in each participating member state. The level of international activity also plays a role. In total, the ECB will supervise between 130 and 150 such banks. The ECB will also directly supervise banks that receive or have received direct support from the European Financial Stability Fund (EFSF) or the ESM.

In consultation with national supervisory authorities, the ECB must establish a framework for the practical organisation of the various duties, for both large and smaller banks, within six months of the new regime coming into effect. This framework, which will be placed in the public domain, will be an important document that governs the division of tasks between the ECB and national supervisors.

Supervision of the large banks will be exercised by joint supervision teams from ECB and the national regulators. The ECB will play the lead role and is likely to be closely involved in the preparation of decisions. To ensure effective supervision, it is important that ECB supervisors are able to work closely and flexibly with the national supervisory authorities, despite their dispersed locations. Given the extent of the European supervisory task, the availability of local expertise and the advantages of physical proximity, it makes sense for the

supervisory tasks to be largely implemented on a decentralised basis, also for large banks.

Supervision of the remaining banks will continue to be carried out by the national supervisory authorities. However, here too the ECB will have a bigger role in monitoring the quality and consistency of supervision, and if necessary taking over the supervision of high-risk institutions. Recent experiences have shown that several small banks together can also pose a threat to the financial stability of a country or region. Solid periodic reporting on developments in the banking sector and the supervisory activities performed should enable the ECB to form an opinion and to intensify its involvement if necessary.

Placing supervisory tasks with the ECB offers synergy benefits, but must not undermine the independence of the ECB's monetary policy. Under present EU treaties, the Governing Council – as the ECB's principal decision-making body – is responsible for all tasks performed by the ECB, both monetary and supervisory. To ensure that monetary policy is kept separate from other considerations, a new body, the ECB Supervisory Council, will be created, which will prepare formal decisions to be taken by the Governing Council. From the perspective of effective supervision and democratic legitimacy, and in view of the importance of the independent performance of its tasks, it is appropriate that the ECB be subject to the highest standards of accountability for the performance of its mandate. The different roles of the ECB, as a monetary authority and as a supervisory authority, demand separate accountability for these tasks.

It will be mid-2014 at the earliest before the ECB assumes these supervisory tasks. There must be at least a year between the date on which the Regulation comes into effect and its operational implementation. The process could take longer, however: the ECB must report to the European Council and European Parliament each quarter on the progress it has made with implementation, and if the ECB is not ready, the operational implementation can be deferred. There are two exceptions to this. The first concerns the supervision of banks that receive direct ESM support. If necessary, the ECB can take over this supervisory task immediately. The second exception relates to the asset quality review (AQR) of European banks. The SSM Regulation charges the ECB with performing this review, at least for large banks. The Regulation gives the ECB the freedom to begin this task immediately after the Regulation comes into effect. DNB welcomes the asset quality review. To create support for a fully-fledged banking union (including risk-sharing), clarity about the present quality of the balance sheets of European banks is essential. After all, no hidden risks should migrate to the banking union. A review can also help reinforce the trust of the markets in the valuation of bank balance sheets. The AQR must be carried out as quickly as possible and if feasible, before the European supervisory authority begins performing operational supervision.

In addition to the euro area countries, some – but by no means all – of the other EU member states are expected to participate in the single supervisory mechanism. This means that the European supervisors and the national supervisors from the other member states will have to continue working closely together to ensure the unity of the EU-wide single market for financial services. The single market is a cornerstone of European cooperation and makes a major contribution to European prosperity. It guarantees a level playing field for financial institutions and prevents supervisory arbitrage. By bringing an end to the financial instability - and thus financial segmentation - in the euro area,

the banking union itself is a major benefit to the single market. There is an important role here for the European Banking Authority (EBA), which will continue to supervise the harmonisation of supervisory practices within the single market and the completion of the related Single Rule Book.

2.3 Rebuilding the financial sector: ensuring a stable and efficient system

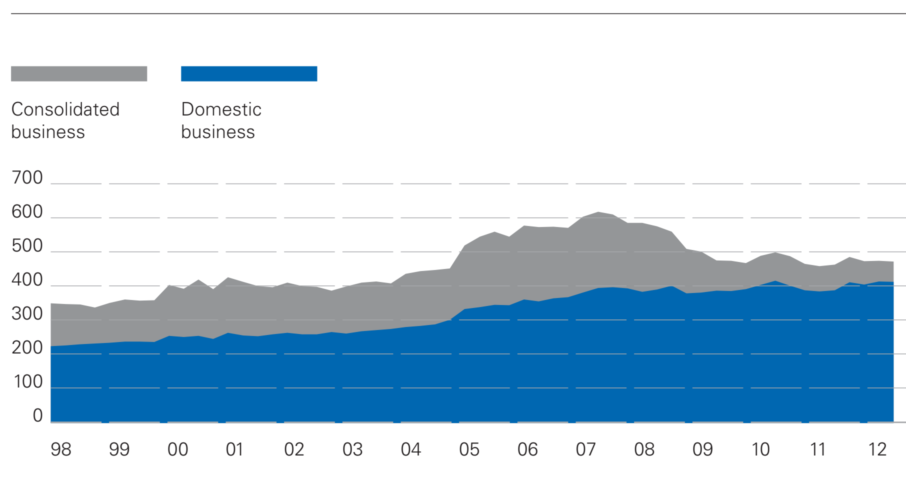
The Dutch financial sector is in transition, as the size and relative importance of various activities are undergoing a shift. This is partly in response to the changed market environment and partly as a consequence of stricter supervisory standards. In establishing a new equilibrium, two issues are key to DNB: the financial sector must continue to support the country's economic development and financial stability must be safeguarded.

The Dutch banking sector has contracted considerably since its peak in 2007 (see Chart 2.1). The main shrinkage has been in foreign operations, following the break-up of ABN AMRO and the restructuring operations (voluntary or imposed by the competition authorities) implemented in response to the crisis. This development fits in with an international trend towards a stronger focus on the home market. In addition to their foreign operations, the merchant banking activities of the Dutch banking sector have also declined (see Section 1.3). This reflects the reduced demand for these services due to the economic climate, the stricter standards imposed by the supervisory authorities and the increased role of major foreign (generally Anglo-American) banks in this segment.

Shrinkage has not been restricted to the banking sector, and is likely to extend into the insurance sector over time. Leaving aside the care sector, which has dynamics of its own, the insurance sector has in fact been contracting for several years, with premium volumes falling to EUR 34 billion in 2011 from EUR 39 billion in 2007. This is particularly apparent in life insurance, where new business has halved since the introduction of bank saving (banksparen). Moreover, the long-term nature of the product means that the contraction will continue to work through into premium volumes.

Chart 2.1 - Size of bank assets

As percentages of GDP



Source: DNB.

The net effect of these changes is that the Dutch financial sector is a good deal smaller than it was before the crisis. Leaving aside the impact on employment, this is not necessarily a bad thing for the Dutch economy. Recent research by the IMF and the BIS has shown that a bigger financial sector is not always beneficial to economic growth. Prosperity may be affected by excess borrowing or overinsurance, for example because consumers do not have sufficient knowledge of the financial products they are buying. The same applies to a financial sector that takes on excessive risks on the assumption that the government will step in to bail them out.

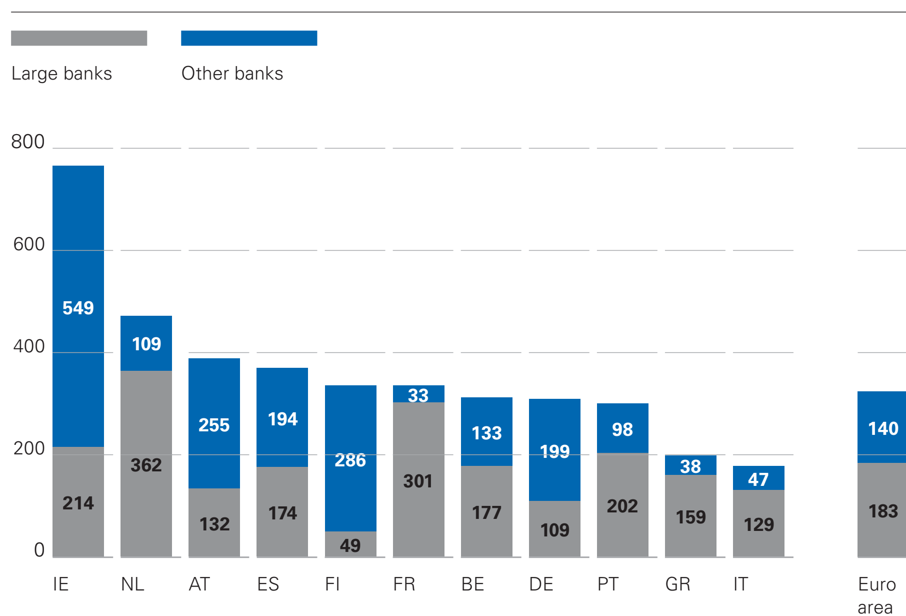
The fact that a smaller financial sector can offer advantages does not mean that the Netherlands should aim to reduce it as far as possible. If the sector is too small, this can also be harmful to prosperity. For example, if the banking sector is unable to meet the demand for commercial credit, this will smother economic development by blocking necessary and potentially successful investments.

The key is to ensure that the financial sector is sufficiently large and comprehensive to serve the real economy. This means that some activities could, in time, perfectly well be scaled back (e.g. mortgage lending), but that others cannot (e.g. a complete product range to support exports). The very open nature of the Dutch economy may be expected to continue to nurture the need for a relatively large banking sector. Chart 2.2 confirms this: despite its contraction, the Dutch banking sector is still among the larger ones in Europe relative to the size of the Dutch economy. The Dutch insurance and pensions sectors are also comparatively large as health insurance is operated by the private sector and the pension system is funded to a large extent.

Chart 2.2 also shows that the Dutch banking sector is dominated by large banks: the three biggest banks in the Netherlands have a combined market share of more than 80% in many segments, and concentration has increased in recent

Chart 2.2 - Total assets of the European banking sector

As percentages of GDP, year-end 2011

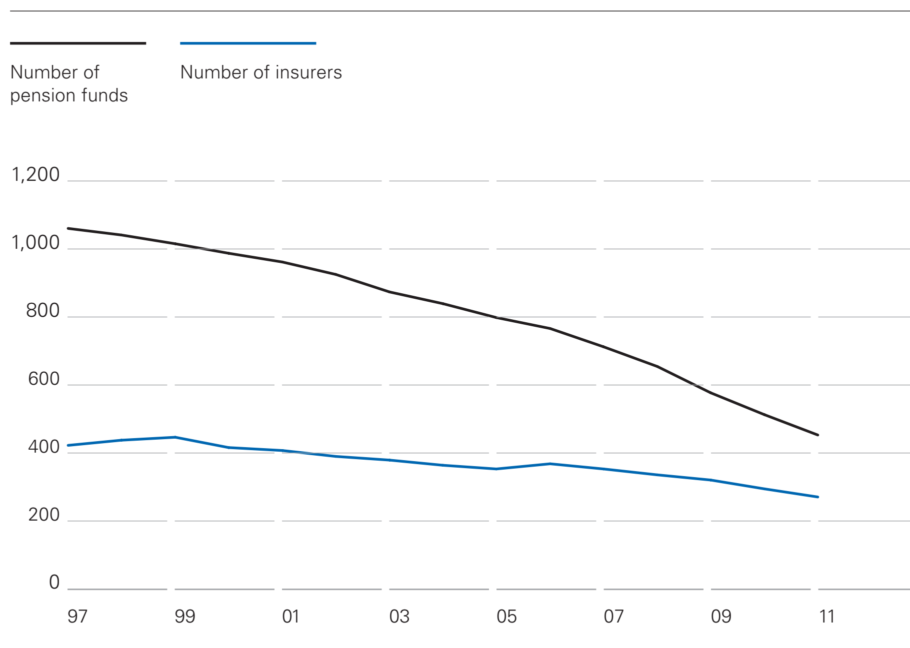


Note: The shares of large banks are based on participation in the 2011 EBA stress test.
Sources: Annual reports, EBA, ECB and Bankscope.

years. The banking sector is not alone in this either: the number of insurers and pension funds has also been falling for several years (see Chart 2.3). However, the level of concentration in the banking sector is much further advanced. One positive aspect of a high level of concentration is that it delivers efficiency through benefits of scale. This is for instance reflected in the Dutch payment system, which is among the most efficient in Europe. However, those benefits are negated if the level concentration is so high that it reduces competition. A high threat of new entrants to the market is the best way to ensure sufficient competition. The banking union could play a role here by making it easier for banks to compete across Europe.

In the medium term, therefore, the picture that emerges is one of a still sizeable and relatively highly concentrated financial sector in the Netherlands. The crisis has made clear that this can carry risks for financial stability. DNB believes that those risks are only justified if the sector (and particularly the systemically important banks, see Box 2.1) becomes more resilient. A relevant factor here is that in a banking union, the risks are largely borne at European level.

Chart 2.3 - Number of supervised pension funds and insurers



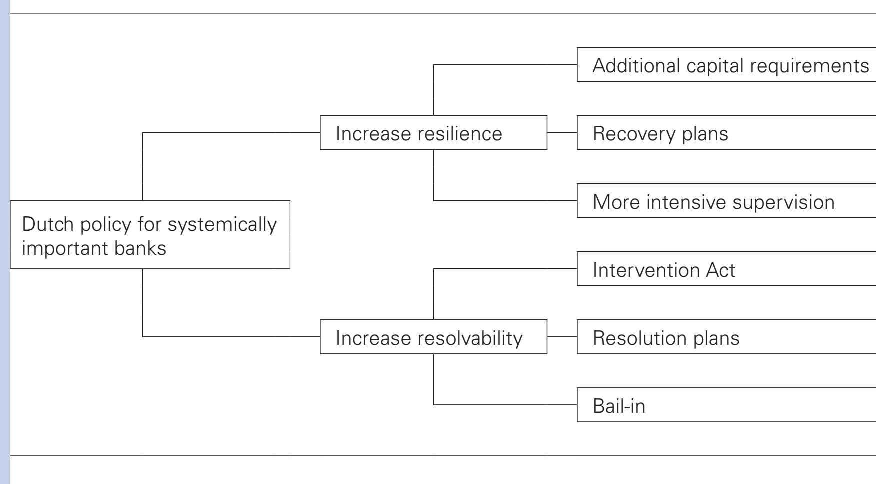
Source: DNB.

Box 2.1 - Policy framework for systemically important banks

The collapse of a systemically important bank may have a destabilising effect on other financial institutions, consumers and businesses. In an emergency, national governments therefore act as a safety net for these institutions. At present, however, this sometimes requires large amounts of taxpayers' money, as recently happened with SNS REAAL. Moreover, the implicit government guarantee may tempt banks to take on excessive risks. In order to address these problems, DNB and the Dutch Ministry of Finance are developing additional, more stringent rules for systemically important banks (see Figure 2.1). This policy is aimed on the one hand at limiting the risk of a bank failure by increasing the resilience of systemically important banks, and on the other at containing the consequences of a bank failure by increasing the resolvability of these institutions. The Wijffels Commission on the Structure of Dutch Banks is looking at ways of segregating activities within Dutch banks and will report on the recommendations of the Liikanen Commission on Banking Reform and their applicability in the Netherlands. In line with the 'Volcker Rule', these recommendations include mitigating the risks of proprietary trading by banks.

Increasing the resilience of systemically important banks
In order to limit the risks posed by systemically important banks in the Netherlands, these institutions will be required to hold an additional 1 - 3% of capital. The additional capital requirements are currently being embedded in Dutch legislation in anticipation of the completion of the European Capital Requirements Directive. In addition, systemically important Dutch banks have formulated recovery plans setting out measures that they themselves can take in order to withstand a serious crisis. A third method of increasing the resilience of systemically important banks is to intensify the supervision of these institutions. DNB introduced its Focus! methodology for intensified supervision, which tightens the link between the degree of systemic importance and the level of supervision.

Figure 2.1 - Policy framework for systemically important banks

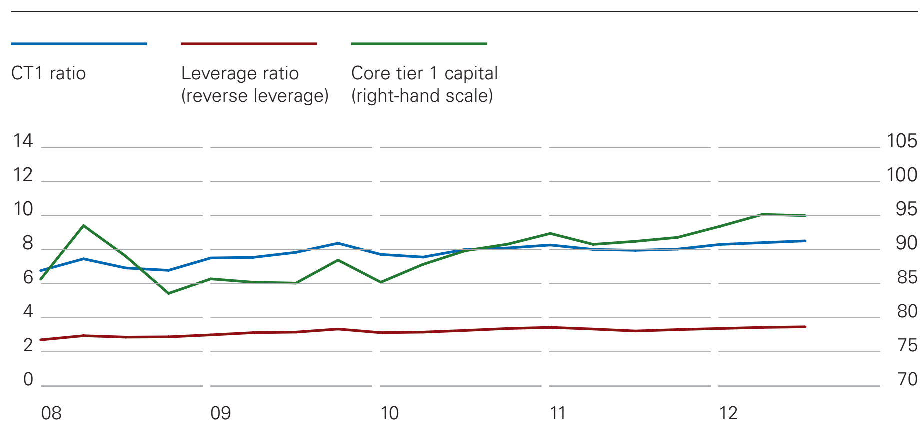


Increasing the resolvability of systemically important banks
To limit the impact of the failure of a systemically important bank, the authorities should be enabled to liquidate such banks in an orderly fashion. This means that the government steps in with targeted interventions in order to stabilise and continue the systemically important activities of the institution in question (such as payments, lending and deposits). During the crisis it became apparent that the available instruments did not facilitate such targeted intervention. In response to this, the Intervention Act was introduced, which was deployed for the first time to intervene at SNS REAAL. As a result of the SNS REAAL case the Minister of Finance announced that the Act will be reviewed. In order to make full use of the Act, it is necessary to unravel the legal, financial and operational entanglements in addition to other obstacles to targeted intervention. With this in mind, DNB and the Ministry of Finance are currently formulating resolution plans for systemically important Dutch banks. In order to minimise the amount of taxpayers' money required during the resolution process, an explicit 'bail-in' mechanism is also needed, in which the creditors of a failing systemically important bank contribute to the bank's recapitalisation. To ensure a level playing field, the bail-in system should be introduced at European level. This is expected to be arranged in the Bank Recovery and Resolution Directive.

Creating a more resilient financial sector means firstly that capital buffers must be strengthened. Another step was taken to this end in the past year, in which bank solvency increased further (see Chart 2.4). The reported solvency of insurers and the funding ratios of pension funds have risen – albeit primarily due to the effect of the adjusted calculation method for long-term commitments. On balance, this puts the sector in a better position than a year ago. The strengthening of capital buffers however requires staying power and will take several years. Given the difficulty of raising capital in the current climate, capital buffers will have to be built up mainly through profit retention. This is why DNB takes a critical view of initiatives such as the bank tax and proposals for a transaction tax. Capital that is withdrawn from the sector in this way cannot be used to build up capital buffers. In addition, in the event of a scarcity of capital, banks may curb their lending operations, which would hurt economic growth (see also Section 1.3).

Chart 2.4 - Buffers in the Dutch banking sector

As percentages of risk-weighted assets, of total assets, and EUR billion (right-hand scale)



A resilient and stable financial sector also means a stable and diversified funding structure for banks. The Dutch banking sector is known to depend heavily on international capital markets because the relationship between savings and lending is out of kilter due to excessive mortgage lending. For some time now, DNB has been calling for the closing of this deposit funding gap. The measures set out in the government coalition agreement aimed at reducing the high level of mortgage debt in the Netherlands mark a welcome first step in this direction. It is important that financial institutions have proper control of the risks stemming from their dependence on (foreign) market finance.

The possibility of using assets invested by pension funds is also being considered as a means of closing the funding gap. DNB is open to this proposal, providing certain conditions are met. The long-term solution of curtailing excessive mortgage lending should not be undermined, and incentives for mortgage borrowers and lenders must remain in proper balance. Solutions must moreover be effected on market terms, and must in principle not be accompanied by an increase in explicit and implicit government guarantees. From the perspective of the pension funds, the concentration and solvency risks should not be excessive and there should be no question of force. Finally, capital requirements should adequately reflect the institutions' risk profiles.

Further enhancement of the financial sector's resilience is one of the focus areas in the supervisory themes that DNB has selected for 2013. Other themes include working towards a sustainable business model and risk management at financial institutions. These and other supervisory themes are described in the brochure entitled DNB Supervisory Themes 2013 published in January 2013.

2.4 Supervisory response to the crisis: current status and outlook

2.4.1 *Delays in the international reform agenda*

The European regulations for banks (CRD IV) and insurers (Solvency II) are currently being reviewed. The revamped regulations will come into effect later than initially planned, which is threatening the progress of financial sector reform. The process of change should continue to progress steadily.

European regulations governing banks and insurers are currently undergoing major reforms aimed at increasing financial buffers and improving risk management. The requirement for banks to maintain larger and better quality capital buffers is laid down in global agreements in the Basel III Agreement. The new CRD IV Capital Requirements Directive provides for harmonised implementation of the Basel III Agreement in European legislation. For insurance companies the transition to the new Solvency II supervisory framework, with market-consistent valuations and risk-based capital requirements, has been running for much longer.

The new rules have not yet been finalised. Such negotiations take time, because of the need to look carefully at the legal design, the harmonisation of different national regimes and (unintended) effects on the sector. The delay is likely to be limited in the case of the banking rules, and the present framework was moreover reformed relatively recently. However, the reforms to insurance supervision are seriously behind schedule. The present framework dates from 1973 and is insufficiently risk-based and forward-looking. The preparations for Solvency II began in 2004, and domestic improvements have been suspended in light of the forthcoming new European rules. The sluggish progress being made

in the negotiations in Brussels on the further details of the Directive means it is still unclear when the updated framework will come into effect.

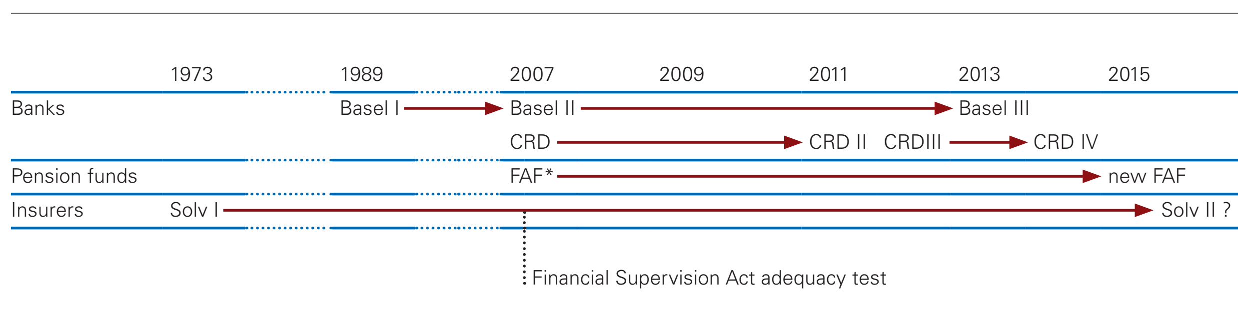
A quick agreement on the reform of European regulations is needed. Not only will stricter rules benefit the solidity of the financial sector, but until the regulations have been finalised, the sector will continue to be in a state of transition between two regimes. While this is to a certain extent unavoidable in a constantly changing environment, it cannot continue for too long. It makes things difficult for the sector, which is having to deal with two types of regulations as well as additional administrative and other obligations. That said, DNB must be able to operate from a clear and consistent legal framework if it is to perform its supervisory tasks efficiently and effectively. It will therefore continue to push for rapid conclusion of the negotiations, though this should of course not be achieved at the expense of the quality of the regulations. But there is no risk of that happening: the measures for Basel III will be carefully implemented and phased in, while the impact of the Solvency II measures is also being carefully considered.

The financial sector needs to act now in anticipation of the new regulations. All parties involved (the European Commission, the European Parliament and the member states) are aware of the importance of the reform agenda and will feel the responsibility of coming to an agreement in the near term. Financial institutions will accordingly continue to prepare for the new regulations, as financiers in the international capital markets will expect them to do.

The banks have drawn up migration plans for the transition to Basel III/CRD IV. In most cases the new rules will come into operation immediately, creating a more uniform system of regulation within Europe and leaving no scope for national discretion. In addition, CRD IV incorporates new formal elements of supervision (leverage, liquidity ratios). These are also important conditions for effective European banking supervision. The European Commission and the European Parliament are taking slightly longer to ensure that this process is properly structured. In the meantime DNB will continue to work with the sector on the migration of banks towards Basel III/CRD IV. With a view to building higher capital buffers, the capacity for banks to distribute dividend is very limited under present circumstances. Where capital instruments are issued or refinanced, compliance with the new regulations will be scrutinised.

For insurers, the delay in migrating to Solvency II presents additional challenges. The deferral of its introduction is threatening to delay the necessary strengthening of the sector's structure. This is a key difference compared with

Figure 2.2 - Timelines for supervisory frameworks



* *Financial Assessment Framework.*

the banking sector, where the market is enforcing the Basel III reforms much more emphatically and the present framework already offers a reasonably good basis. In the insurance sector, by contrast, the international debate focuses mainly on reducing the effects of market valuation and higher regulatory standards. Moreover, the fall-back option (Solvency I) is outdated, less harmonised and therefore no longer fit for purpose. Compliance with the rules relating to the minimum solvency margin, for instance, no longer guarantees that the level and composition of the solvency margin matches the risks that could affect the solidity of insurers. As an example, the buffer requirement that applies for life insurers is based on a fixed percentage of the technical reserves: 4% insurance contracts in which the insurer is exposed to investment risk, regardless of the nature and magnitude of such risks, and 1% where the insurer is not exposed to investment risk. This results in a standard that may not match the risks taken on by an insurer. In addition, there is a perverse incentive, which discourages prudence. At the end of June 2012, the yield curve was adjusted by means of the introduction of the ultimate forward rate, in the wake of the continuing unrest in the financial markets and the low liquidity in the 20-year plus maturity segment.

DNB is exploring how best to bridge the coming transitional period. It is crucial to continue taking meaningful steps in the years ahead towards a more risk-based and forward-looking insurance supervisory regime. As far as possible, alignment will be sought with the European agenda. Based on agreements at European level, DNB is working on an impact study to assess the effects of Solvency II (the long-term guarantee assessment). In addition, DNB will ask insurers to prepare risk self-assessments in 2013. The current project for internal models will also be continued and developed further. Large and medium-sized insurers, for which participation in the EIOPA stress test is not mandatory, will be asked to complete the opening balance sheet section of this test.
In addition to these steps, the new Focus! method contributes to a more forward-looking approach to supervision, and therefore fits in better with the regulatory framework reforms.

The European Commission has also made great strides in broadening supervision. From 2013, alternative investment firms such as private equity firms, hedge funds, property funds and investment institutions aimed at professional investors will all be placed under supervision. This means they will need to have a licence issued by the Netherlands Authority for the Financial Markets (AFM) and that DNB and the AFM will supervise the prudential standards and conditions in respect of aspects such as risk management, transparency and reporting. In addition, DNB will supervise the leverage in the underlying investment funds. And the European Commission has proposed a European Market Infrastructure Regulation (EMIR) for the centralised settlement of derivatives through central counterparties, which will be subject to supervision. Meanwhile, Europe has also taken steps to map out and control shadow banking more effectively.

In the area of pensions, the Dutch regulations will continue to take the lead for the time being. In its reform of the Pensions Directive (IORP Directive), the European Commission is seeking further harmonisation of the rules governing supplementary pensions and has also proposed that Solvency II be taken as a starting point. At the request of the Commission, European pensions regulator EIOPA (European Insurance and Occupational Pensions Authority) has developed options for further harmonisation (the holistic balance sheet approach) which are currently being assessed on the basis of a quantitative

impact study. EIOPA has made clear that there can be no question of one-on-one application of Solvency II to pension funds. In the discussions on this topic, DNB has also emphasised that future European regulations should continue to take sufficient account of the specific characteristics of the Dutch pension system and the forthcoming reform of the Financial Assessment Framework. Unlike the situation at banks and insurers, there are still marked differences between pension schemes across the EU and there are virtually no cross-border activities.

The developments described above illustrate that the international reform agenda has not yet been completed. Many lessons learned from the financial crisis have already been implemented, but major steps still have to be taken both in terms of international consultations and national preparation. This is necessary in order to maintain the momentum in the reform process and create a more robust financial sector.

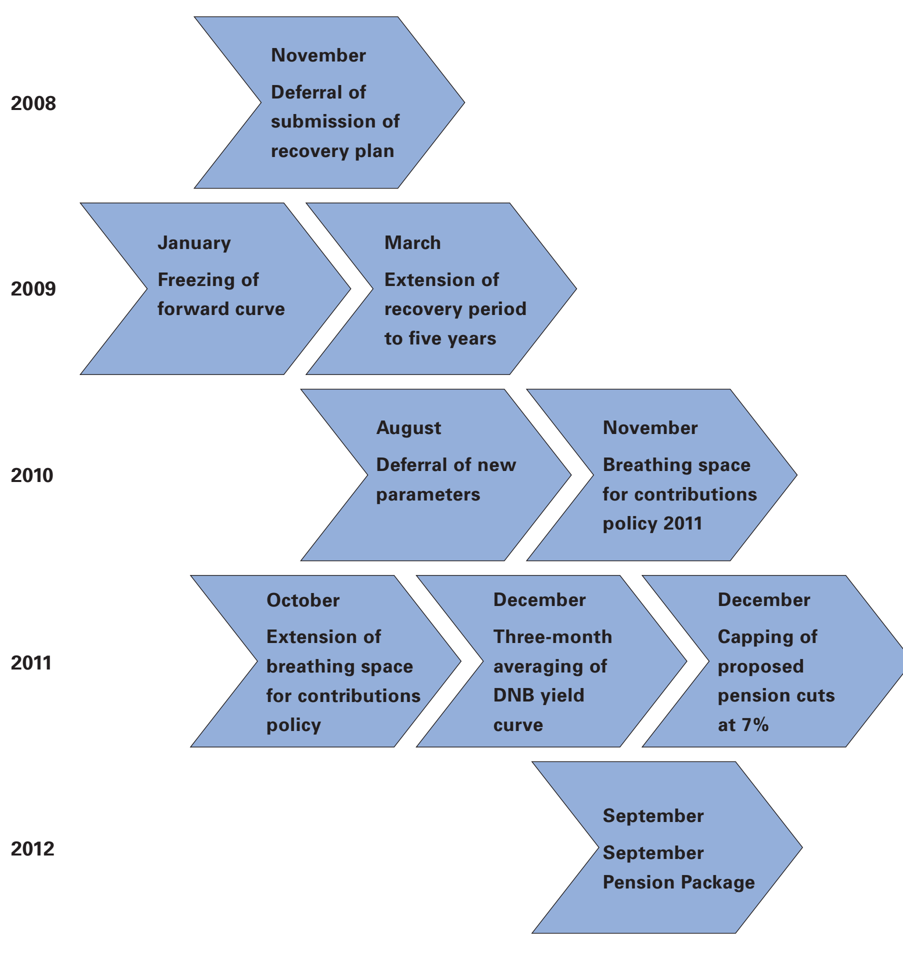
2.4.2 *Pensions*

It is high time for the Netherlands to move to a more modern pension system. The government, social partners, pension funds and supervisory authorities have been aware of this for several years, and a large number of measures designed to make the system future-proof have been implemented or are in the pipeline. This has been accompanied by a shift of risks to pension scheme members, and means that attention must be given to transparency, clear communication and adequate supervisory instruments.

The developments during the 2008-2012 period illustrate the need for structural reform of the Dutch pension system. Since the onset of the credit crisis, a variety of measures has been taken to limit the need for deep cuts in pensions (see Figure 2.3). Despite these measures, even now that the sector is approaching the end of the – already extended – five-year recovery period (which expires at the end of 2013), the financial position of many pension funds is still unacceptable. Pension curtailments or contribution increases are therefore unavoidable. Pension fund commitments are growing as a result of rising life expectancy and on-going low interest rates. At the same time, pension funds are being confronted with volatile investment returns. These economic and demographic trends mean that the growth in pension fund assets is barely able to keep pace with the growth in commitments, let alone that pensions can be indexed to prices and wages on a large scale, which is what most pension funds want. On top of that, population ageing leaves little room for absorbing fluctuations in returns and life expectancy. In early 2010, the Goudswaard Commission highlighted both these problems and their structural character.

This structural nature of the above developments makes it necessary to trim pension contracts. The September Pension Package, which introduced measures in anticipation of the new Pensions Act and Financial Assessment Framework, partially addresses this need. The September Package was developed in response to the further deterioration in the financial position of many pension funds in 2012. Its purpose is to ensure that necessary measures are no longer put off, while easing the pain somewhat, also across generations. The Package limits the macroeconomic consequences of further contribution increases and deep pension cuts, while at the same time seeking to ensure that the bill will not be passed on to future generations. The Package incorporates three mitigating and three austerity measures. Firstly, it includes the introduction of the ultimate forward rate, which adjusts the yield curve for long maturities (see Box 2.2 for details). A higher discount curve leads to lower pension cuts and lower

Figure 2.3 - Summary of measures since 2008



contribution increases. The second measure is the introduction of a breathing space, which allows pension funds facing a funding shortfall to deviate under certain conditions from the requirement that recovery must partly come from increased pension contributions. Pension funds that are unable to meet the conditions can make use of the breathing space to seek a customised solution from DNB. The third measure concerns the ability to spread reductions in pension rights and to limit them to a maximum of 7% per annum in 2013 and 2014. Although the remaining reductions have been declared unconditional, their introduction has been deferred until 2015. Set against these three mitigating measures, pension funds may only spread reductions and request customised solutions during the breathing space if they also take the following three austerity measures: accelerating the raising of the retirement age to 67, automatically adjusting pensions to new jumps in life expectancy and only compensating for inflation if the funding ratio is at a minimum of 110%.
The Coalition Agreement of the Rutte II government also contains measures to make pensions less generous.

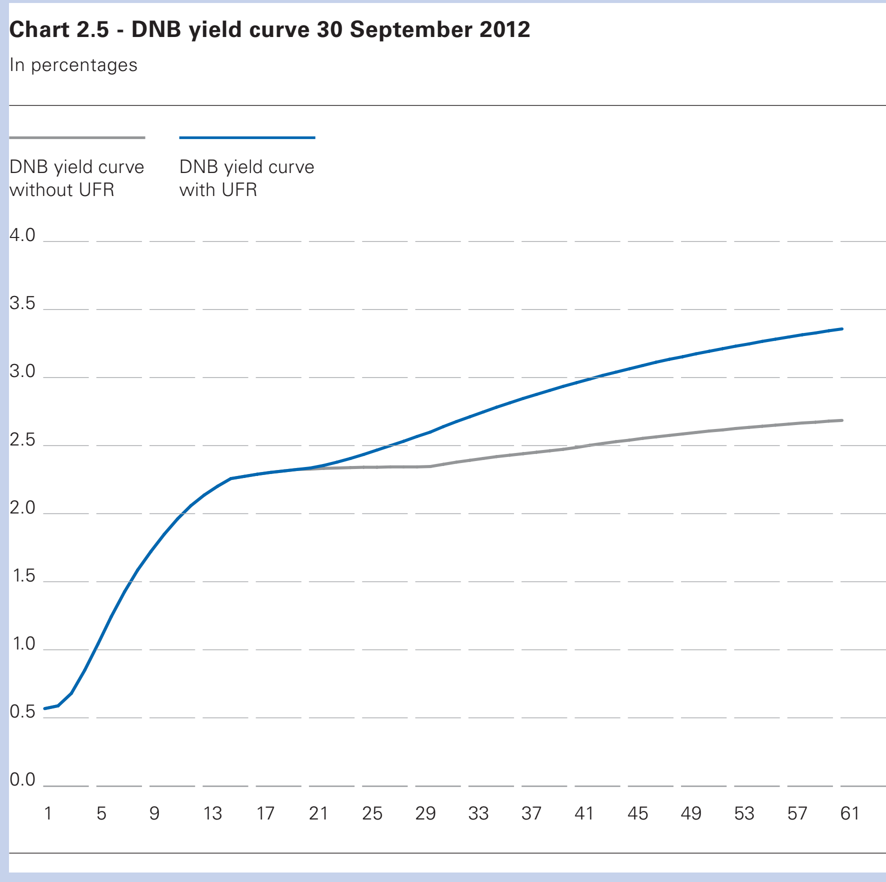
Box 2.2 Ultimate forward rate (UFR)

In markets that are sufficiently liquid, the risk-free yield curve can be derived from market data. The absence of a sufficient number of active market players means this information is less reliable for interest rates upwards from a certain maturity. This makes it more difficult to estimate long-term interest rates reliably for the discounting of commitments. The longest maturity at which the market is fully functional is referred to as the last liquid point (LLP). The UFR approach assumes that one-year forward rates will move upwards from the last liquid point to an expected level within a predetermined convergence period. The interest rate to be used by pension funds for the valuation of future pension commitments is derived from this. Market interest rates are taken into account to a decreasing extent in calculating the actuarial interest rate. The current UFR method assumes a UFR of 4.2%, a last liquid point of 20 years, and a 40-year convergence period. The UFR of 4.2% is based on a 2% long-term projection for inflation and a long-term forecast of 2.2% for real short-term interest rates.

The UFR does not remove the uncertainty surrounding interest rates, however. This uncertainty is very real, not only concerning the level of the UFR, but also the LLP and the convergence period within which it will be reached. The Langejan Commission, in which DNB participates, is to advise the Dutch government on a realistic value for the UFR.

Chart 2.5 - DNB yield curve 30 September 2012

In percentages



Ultimately, structural problems demand structural solutions. The required overhaul of regulations is in full swing and is currently nearing the final stage. Employees' and employers' representatives signed a new Pensions Agreement with the Dutch government in 2011; a key element in the Agreement was a new Financial Assessment Framework, the main lines of which were established in 2012. Within the Framework, parties can either retain the present nominal pension contract, with stricter rules, or switch to the new, real contract.
The feasibility test will be an important tool in the supervision of both contract types, and will test whether the policy on contributions, investment and pension benefits is in line with the ambitions and risks communicated to members. Supervision of investment policies will also become more important as pension benefits correlate more strongly with the performance of investment portfolios. The new system has been announced to come into effect in early 2015.

Explicit risk sharing is also a characteristic of the two contract types. In many respects, pension schemes will be more complete than they currently are.
All risks will be shared among stakeholders in accordance with predetermined allocation rules. This will require pension scheme members to accept a greater proportion of risk than they currently do. In order to prevent unpleasant surprises, a pension fund's ambitions must match the expectations of its members. This means that members must understand the risks to which they are exposed. This is no small challenge and good, clear communication about expectations and risks is of vital importance. This is especially relevant as the members will bear full responsibility for these risks under the new contract.
So it would also be wise to keep pension schemes as simple as possible.
The way in which pension funds should communicate with members about the risks that they are exposed to is as yet to be fully fleshed out. This issue lies mainly within the competence of our fellow supervisor, the Netherlands Authority for the Financial Markets (AFM). In addition, it is important that members are informed about how they can anticipate these risks.

2.4.3 *Corporate governance: structure, functioning and conduct*

Good governance requires a comprehensive approach encompassing structure, functioning and conduct. Where the emphasis to date has been on the design of governance, the supervision of governance is entering a new phase, with more attention being given to implementation and behavioural aspects.

The crisis has not only led to enhanced attention to rules relating to the capital and liquidity of financial enterprises and accounting issues, but also to a global drive to improve the governance of financial institutions and the supervision of that governance. Shortfalls in the area of governance almost invariably point to problems in the financial position of institutions, or to the fact that their integrity and reputation have been undermined. Supervision of governance, conduct and culture therefore has a preventive effect. Before the crisis, these issues received relatively scant attention from either financial institutions or supervisory authorities. Studies by the Basel Committee for Banking Supervision and the EBA, for example, have shown that the existing governance principles were insufficiently implemented.

Compared to most other countries, the Dutch supervisory authorities and government have devoted a great deal of attention to governance, as well as to the development of new policy in areas such as the remuneration, suitability and independence of Supervisory Board members. In 2009, for example, DNB and the AFM published remuneration principles and in 2011 the Supervisory Regulation on Sound Remuneration Policies and the Policy Rule on Expertise

came into effect. In 2012, DNB published requirements relating to the independence of Supervisory Board members and amended the Policy Rule on Expertise, renaming it the Policy Rule on Suitability. The latter change means that Supervisory Board members as well as Management Board members will now be tested not only on their knowledge, but also on their skills and professional conduct. All current Supervisory Board members will be screened upon reappointment. In 2012, the Supervisory Boards of the four biggest banks and four largest insurers in the Netherlands were submitted to suitability screening, which involved scrutiny of the functioning of the Supervisory Board members both individually and as a team. The government has also taken a number of initiatives. For example, the Sound Remuneration Policies Decree was adopted in 2011, and the Banking Code and Governance Code for Insurers were anchored in law. The bankers' oath was introduced on 1 January 2013, as was the Management and Supervision Act (Wet Bestuur en Toezicht). The latter Act contains rules to ensure that Supervisory Board members are able to devote sufficient time and attention to their duties. The government is currently developing a set of rules in relation to the governance of pension funds, to be laid down in the Reinforcement of Pension Funds Governance Act (Wet Versterking bestuur pensioenfondsen).

Although the governance of institutions is improving, it needs to be strengthened further. There is scope for additional measures both at financial institutions and with regard to supervision and regulations. This is also important for restoring trust in the financial sector. Financial institutions have still done too little to meet the need felt by society for a cultural change in the financial sector. To help bring this about, more attention will also be given to the future functioning of governance in practice. So far, attention has been focused on drawing up policies and putting the necessary structures in place, but this is not enough. The effectiveness of internal supervision is not only determined by the formal structure of the Supervisory Board, but also by the independence of its members in exercising their supervision and applying their skills.

In order to foster good governance, regulations should offer clear guidelines to institutions and supervisors. At a global level, the BCBS and IAIS governance principles serve as the benchmark. These global principles are being translated into European practice through the EBA Guidelines on Internal Governance, which constitute a European normative framework. DNB is also seeking to make governance rules both clearer and more effective. Based on recent insights from behavioural economics, DNB is looking at how and with which instruments the conduct of institutions and directors can best be influenced in order to achieve the envisaged goal. Among other things, DNB will investigate whether setting quantitative upper limits, lower limits and percentages will prompt companies to comply better with the essence of the rules. DNB is also developing criteria for measuring the effectiveness of governance rules.

Properly functioning governance in itself does not necessarily lead to the desired results. Conduct and culture also play an important role, and the attention given to these matters needs to be stepped up. Although improvement is needed throughout organisations, the emphasis is being placed on the boardroom as the tone at the top goes a long way in determining how organisations deal with governance issues. It is therefore important that Management and Supervisory Board members take the necessary time to contemplate their own conduct and examine the dynamics of the group. Chairs are expected to be capable of flexibly applying several leadership styles. In 2011 and 2012, DNB carried out

supervisory examinations of decision-making processes and leadership styles at senior executive levels among 30 banks, insurers and pension funds.
This showed that many Management Board and Supervisory Board members focus heavily on content in their functioning and devote less (conscious) attention to the decision-making processes and communications that help shape the success of the institution. Feeding back the examination results to the Board members concerned made them more aware of the importance of conduct and group dynamics. In the year ahead, DNB will re-examine a number of the Boards concerned to see whether there has been a lasting improvement.

2.4.4 *Commercial property*

The risks associated with banks' exposures to commercial property have prompted DNB to conduct an in-depth, sector-wide investigation and to press for adequate valuations and capital levels at these institutions.

Dutch financial institutions have significant amounts tied up in commercial property loans, making them sensitive to changes in the value of these properties. Dutch banks have lent a total of almost EUR 80 billion to property-related businesses (property companies, investors and developers), with commercial property in the Netherlands as collateral. This type of secured lending is not necessarily directly affected by value reductions; provided the loan is repaid on time and in full and interest payments are made on the loan, banks do not feel the direct impact of reductions in the value of the collateral. Nonetheless, the SNS case has shown that exposure to property can have wide-ranging consequences: the bank ran into difficulties mainly because of its property portfolio (see Box 2.3). However, SNS Bank's property portfolio made up a substantially larger share of its balance sheet compared with the average for Dutch banks, and no other bank has encountered comparable problems with the quality and structure of its property portfolio. The investments of pension funds and insurance companies in commercial property are of a different nature, and these institutions have relatively small Dutch property portfolios (approximately EUR 20 billion and EUR 11 billion, respectively).
However, reductions in the value of investments in commercial property have an immediate impact on the balance sheets of these institutions.

Box 2.3 SNS REAAL nationalised on 1 February 2013

The chief cause of the problems at SNS REAAL lies in its property portfolio, which was added to the balance sheet through the acquisition of Bouwfonds Property Finance in 2006.

SNS REAAL has been under increased supervision by DNB since June 2008. In late 2008, the bank received a capital injection from the Dutch State because of problems related to the investments of its insurance division. Later, the bank's property portfolio came under pressure and as the credit crisis worsened, SNS REAAL's problems also exacerbated. DNB intensified its supervision of the measures taken by the bank to remedy the situation, and subsequently initiated further action on several occasions. The property portfolio was reduced substantially, starting with the international investments in 2009 and followed by the domestic investments from early 2011. When this proved insufficient, an action plan was drawn up in 2011 to address the vulnerabilities of the group as a whole. At the end of 2011, however, DNB came to the conclusion that SNS REAAL could no longer be considered capable of stabilising its financial position under its own steam.

From that point on, DNB took the initiative of intensifying discussions with the Ministry of Finance. Alternative private and public-private options were explored, as was the use of DNB's powers under the Intervention Act, such as creating a 'good bank' and a 'bad bank' and splitting the bank up by means of an asset/liability intervention. Unfortunately, these options proved not to be feasible due to the legal conditions set by the Intervention Act and the risk of bankruptcy of the SNS REAAL holding company, which was considered too risky from the perspective of financial stability.

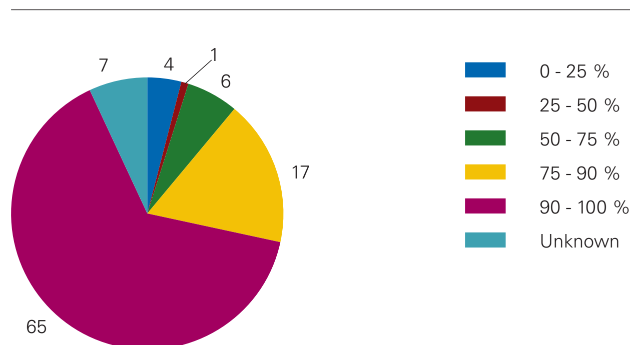
When SNS REAAL was unable to meet DNB's demand that it top up its capital effectively, DNB felt it was no longer warranted to allow the institution to continue performing banking activities. DNB then advised the Minister to make use of the powers offered by the new Intervention Act and to safeguard SNS REAAL's vital operations and the interests of its savers and policyholders.

Reductions in the value of commercial property pledged as collateral signify potential losses to banks. Those losses can manifest themselves quite suddenly, for example in the event of the refinancing or bankruptcy of the counterparty. Growing vacancy rates mean lower rental income and a deteriorating financial position for the property owner. A proportion of the property pledged as collateral to banks is also being confronted with vacancies (see Chart 2.6). Property owners can also run into difficulties and run a greater risk of bankruptcy if they are unable to renew expiring rental contracts. If the property owner defaults on the loan repayment, the bank can foreclose on the collateral property, or even put it on its own books. If loan-to-value ratios (the value of the loan relative to the attached collateral) are high, this may cause losses for the lending banks. The level of risk in the commercial property market also influences the banks' willingness to refinance property loans. Some 60% of these loans will need to be refinanced within three years. Property owners failing to renew their funding may lead to forced sale of properties and downward price effects.

The current market conditions are leading to substantial downward adjustments in the value of commercial property, and the specific characteristics of properties, such as location, vacancy rates and rent reductions are also impacting their value. Although there are locations where properties are still in good demand and values are still rising, the number of properties facing difficulties is

Chart 2.6 - Occupancy rates of property pledged as collateral

As a percentage of the commercial property loan portfolio



Source: Estimate based on a DNB sample taken at year-end 2011.

increasing. Prices of Dutch commercial property have now been falling for around four years, especially in the offices (-20%) and industrial (-26%) segments. The gap between the supply of and demand for space is widening steadily, again particularly in the offices and commercial segments. Market data point to vacancy rates of between 14 and 15% in the offices segment at year-end 2011. The fact that vacancy rates have been rising for some time suggests that, in addition to economic factors, trend-based aspects are also increasingly depressing demand for office space. Due to the ageing labour force, employment is for instance growing less strongly than it used to. The nature of office work and other employment is also changing, so that less space is needed per employee. The rise of on-line shopping is also reducing demand for retail space. These trend-based factors will continue to exert downward pressure on demand, which will depress property values.

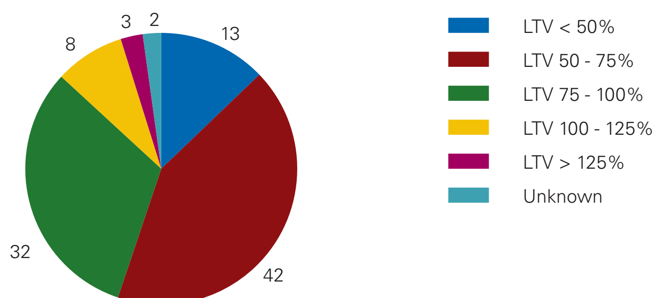
This presents a risk for banks. Based on a sample, the average loan-to-value ratio of property loans extended by Dutch banks is 70 - 80% (see Chart 2.7). Value reductions push up this ratio. Moreover, the proportion of non-performing loans is larger amid higher loan-to-value ratios, especially where values exceed 100%.

These developments imply that more attention should be given to valuation processes and that appraisals of commercial property need to be carried out more accurately. Banks should value their collateral property realistically. Current regulations require that banks verify the valuation of collateral property at least once a year. If the value of collateral property is likely to have fallen sharply, the valuation must be carried out by an independent appraiser, in other words someone who possesses the necessary qualifications, skills and experience to perform accurate valuation surveys. The appraiser should not play any role in nor have any interest in the credit acceptance process. DNB is calling for these independent valuations to be carried out on the basis of the recommendations issued by the Dutch Appraisers and Auditors Platform, which was set up by initiative of the market players concerned (see Box 2.4). Compliance with these recommendations will lead to valuations that are a better reflection of the economic reality. Banks must inform DNB of how they are complying with these statutory requirements.

As part of their risk and capital management, banks will also have to translate the valuation and other risks of collateral property accurately into their capital

Chart 2.7 - Loan-to-value ratios of commercial property loans

As percentages of the commercial property loan portfolio



Source: Estimate based on a DNB sample taken at year-end 2011.

and provisions to ensure that they maintain adequate buffers. The policy and processes used by banks for monitoring and controlling the risks of outstanding commercial property loans must be put in order. In its assessing, DNB will evaluate the property models that banks use. DNB will also examine whether banks are adequately testing the assumptions made in those models against a thorough review of the current property landscape and whether they are adapting their models if necessary. In addition, DNB will look at how their policies are applied in practice, and how this affects their risk-weighted assets and provisions.

Their investments also expose pension funds and insurers to commercial property risks. Although these investments are generally valued once a year by an external appraiser, it appears that changes in property and market conditions are not always fully taken into account. DNB will further investigate this. Moreover, the majority of the pension funds' property investments are located outside the Netherlands. As little is known about the quality of these investments, DNB will also examine the management of pension fund investments in property abroad.

Box 2.4 Recommendations by Dutch Appraisers and Auditors Platform

The Appraisers and Auditors Platform (*Platform Taxateurs en Accountants*) was established in 2012 on the initiative of the Netherlands Institute of Chartered Accountants (NBA) and in cooperation with VastgoedCert, the association of property appraisers and estate agents. The Platform aims to pool the knowledge and perceptions of two professional organisations in a bid to enhance the transparency of property valuation. In a document published this year entitled Properly valued property - 27 recommendations for appraisals and valuation reports, the Platform published some suggestions for improving appraisal processes and writing more transparent valuation reports. The recommendations are based on the International Valuation Standards 2011, which is the international gold standard for valuation principles and definitions.

The recommendations are designed to enhance the transparency and uniformity of commercial property valuations and cover the following elements:

- The appraiser's independence;
- The appraiser's qualifications;
- The appraiser's and the client's responsibilities with regard to the valuation and the information to be made available;
- The tasks and reporting method of the appraiser, i.e. the minimum activities to be carried out, the methods to be used and the sensitivity analysis to be performed, and the unambiguous way in which the considerations, the principles applied, and the sources used are explained in the valuation report;
- Enhancing the quality of the valuation process.

Sector-specific best practices are among the items to be considered when these recommendations are fleshed out in greater detail.

3 A robust financial infrastructure

3.1 Introduction

The payment and settlement system is constantly evolving: the use of electronic channels is growing, the European payment market is integrating and financial derivatives are moving towards central trading and settlement. A robust infrastructure is essential to preserving trust in the payment and settlement system. The main current developments are highlighted in this chapter.

Section 3.2 reviews the measures taken to safeguard the security and reliability of the payment and settlement system. In the past year, much attention was devoted to fighting fraud and to the introduction of new and tighter laws and regulations that are more in line with the evolving payment and settlement landscape. This development is set to continue in the year ahead. Section 3.3 focuses on the unification of the European payment market. In 2013, the bulk of Dutch payments must be switched over to European standards, which will be obligatory in the euro area from 1 February 2014 onwards. The closing section 3.4 discusses current developments in the cash chain. Though cash accounts for a diminishing share of total payments, it continues to play a key role in the payment system. It is therefore vital to ensure that the cash chain remains safe, reliable and efficient and that cash remains available as a widely accepted payment method.

3.2 A more robust and safer payment and settlement system

A robust infrastructure is essential, both to maintain society's trust in the payment and settlement system and to secure the smooth operation of the economy as a whole. In the past year, considerable attention was devoted to the prevention of fraud and the introduction of new and tighter laws and regulations that are better suited to the needs of the evolving payment and settlement system.

3.2.1 *Retail payments*

Electronic channels accounted for about 90% of total domestic payments in 2012. This implies a growing dependence on the proper operation of the electronic payment systems. Since the start of 2012, all point-of-sale (POS) payments made using debit cards have been EMV chip-based rather than magnetic stripe-based. This has made debit card payments more fraud-resistant. Data provided by the Dutch Banking Association (NVB) show that in the first half of 2012 fraud due to debit card skimming (copying) receded by 24% compared to the second half of 2011 (to EUR 18 million from EUR 24 million). The reason why skimming still occurs despite the introduction of the EMV chip is that debit cards continue to be entered entirely into some types of POS

terminals and into ATM card readers. This means that the magnetic stripe can still be copied. Skimmers then use the copied card in POS terminals that still read the magnetic stripe, usually outside Europe.

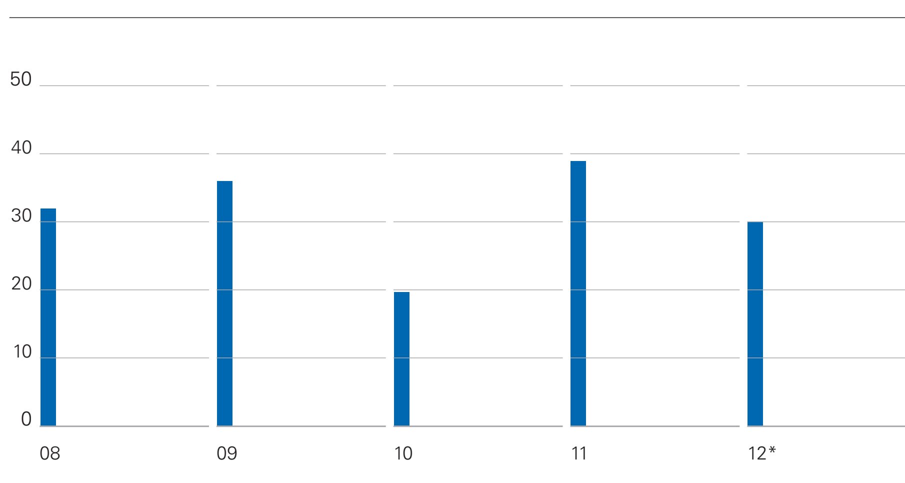
One way to prevent losses from skimming is to block debit cards for use outside Europe as a standard procedure, while giving consumers the option of unblocking their debit card when necessary. Some banks introduced this measure in 2012 and others are planning to follow suit.

In view of the growing volume of debit card purchases in the Netherlands, the availability and the reliability of the underlying systems are becoming increasingly important. Telecom has been found to be a relatively weak link in the debit card payment chain. Various measures have been implemented recently to remedy this weakness. Retailers are being encouraged to link their POS terminals to two different networks, instead of only one. Since mid-2012, the Dutch Payments Association has been publishing the various certified network services and accompanying guaranteed availability levels on its website. Certified datacom suppliers are obliged to be connected to the system for reporting and registering faults in the payment chain. Since June 2012, Radiocommunications Agency Netherlands has had the statutory authority to supervise public network services. As a result, market parties now have a duty of care to take all necessary measures in order to ensure the continuous availability of services and networks as well as adequate mitigation of any risks of system failure. Opportunities for making debit card payments even when the networks are not available ('deferred debit card payments') have also been explored. The concept for this service is ready for implementation. It is now up to the banks to do so.

Remote payments are also affected by various forms of fraud. One of these is phishing emails, where customers are asked to divulge their internet banking log-in codes. Banks and other financial institutions emphasise in consumer campaigns that they will never ask for log-in data. If customers forward these phishing emails to the special email addresses of banks and other financial institutions, the websites linked to the emails will be deactivated as far as

Chart 3.1 - Skimming-related losses at banks

EUR million



* DNB estimate.
Source: NVB.

possible. Another form of internet banking fraud is malware. This is malicious software that secretly installs itself on the consumer's computer. To counter this threat, banks are constantly adapting the detection methods embedded in their own systems. According to NVB data, losses due to internet banking fraud came to EUR 27 million in the first half of 2012.

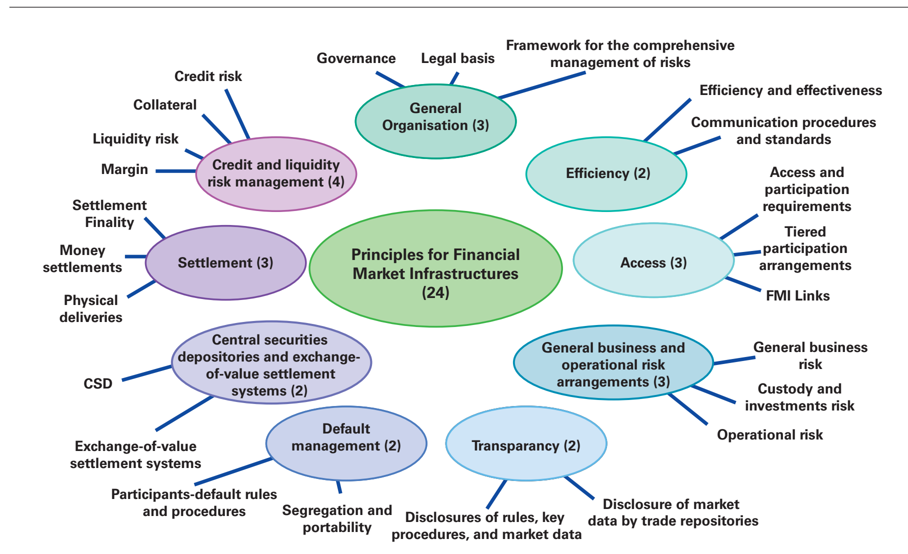
In 2011, the SecurePay Forum, a joint European initiative, was launched by central bankers and supervisors to draw up minimum security requirements for retail payments within Europe. This forum has meanwhile drafted recommendations for internet banking and online credit card payments. One recommendation concerns access to payment accounts. The past years witnessed the emergence of internet payment services providers who carry out payments on the consumer's behalf and obtain access to the consumer's payment account for this purpose. Consumers are not always able to check whether such payments are safe, for instance because they do not know the payment services provider that the web retailer uses. Another problem is that the buyer is sometimes only required to give implicit, rather than explicit, permission for the payment to go ahead. DNB is therefore seeking to achieve an approach where both the consumer's bank and consumers themselves must give explicit permission before a third party can gain access to their payment accounts. In view of the importance of the security and integrity of payment accounts, and in an effort to create scope for innovations in payment services, DNB has proposed to regulate these services by incorporating them into the EU Payment Services Directive, which is currently being evaluated.

DNB supervises payment systems, payment products and securities settlement systems. This supervision is known as oversight and is based on voluntary participation. In recent years, the oversight of retail payment systems has been confronted with a retail payment chain that has become more complex. It is therefore increasingly important to provide a solid statutory basis and sound instruments. A proposal to review the Financial Supervision Act with this objective in mind was submitted to the Council of State for advice in early 2013. The Act adopts the standards currently applied by law and will therefore only lead to small changes compared to current practice. The envisaged introduction date is 1 January 2014.

3.2.2 *Securities settlement*

In the first half of 2013, securities legislation will also come into force with the aim of making the securities infrastructure more robust. In extension of the 2009 G20 objective to make central clearing obligatory for OTC derivatives contracts (contracts not traded on a stock exchange), Europe has drawn up the European Market Infrastructure Regulation (EMIR) including provisions for OTC and exchange-traded derivatives contracts, central counterparties and trade repositories. DNB will be the competent authority and licensing authority for central counterparties and will carry out prudential supervision of derivatives contracts entered into by banks, pension funds or insurers. Other financial and non-financial companies trading derivatives as well as trade repositories will be supervised by the AFM. The introduction of EMIR will give the Netherlands a statutory oversight framework for central counterparties. As a result, DNB will also be equipped with the accompanying enforcement instruments that are available under the Financial Supervision Act. It is expected that a large proportion of the derivatives contracts will be standardised by late 2013/early 2014 and that increased use will be made of central trading and settlement.

Figure 3.1 - 24 CPSS-IOSCO Oversight standards for FMIs



3.2.3 *Oversight standards*

Partly in response to the crisis, central banks and securities supervisors around the world harmonised and tightened the existing oversight standards in April 2012. The recommendations made for central counterparties, settlement systems and custodian companies were merged with those made for systemically important payment systems to form a set of 24 principles that are applicable to all these entities, known as financial market infrastructures (FMIs).
These 24 principles are minimum standards and apply to entities active in systemically important payments and settlements. Their purpose is to mitigate the risks mentioned in Figure 3.1 and to create sufficient safeguards for the other aspects mentioned. The principles are intended to bolster the resilience of FMIs in the face of financial crises and, above all, participants' bankruptcies. One important change is that from now on international central counterparties must be able to absorb the bankruptcy of their two (formerly one) largest participants. In addition to the principles applying to the systems and their operators, the responsibilities of the central banks and securities supervisors of FMIs have also been laid down. DNB will use these new principles as oversight standards from 1 January 2013. An overview of the standards that are applied to the specific oversight objects is included in the annual oversight report that DNB publishes on its website.

3.3 Switching to IBAN

The unification of the European payment market is continuing unabated. Within one year, the euro area will have switched over to IBAN, after which consumers and businesses will be able to make domestic and cross-border credit transfers in the same way. Though the transition to European payment standards is mainly a technical matter, it is still a huge project. In fact, for many companies the implications are even more wide-ranging than at the introduction of the euro. Major efforts are still required from businesses, banks and software providers to meet the migration deadline.

Payments are being standardised within the Single Euro Payments Area (SEPA). The aim is to facilitate competition at a European level, leading to better payment products, greater efficiency and lower costs. There will also be scope for

innovative, pan-European payment products. To this end, a European regulation has been introduced obliging payers to use the International Bank Account Number (IBAN) and to adhere to international standards for the delivery of payment instruction files (the ISO 20022 XML standards). This obligation will become effective in the euro area from 1 February 2014. DNB has been designated as the competent authority to oversee compliance in the Netherlands.

Only 3.4% of credit transfers in the Netherlands meet these standards (fourth quarter 2012). Virtually no direct debits used in the Netherlands comply with the European standards. In order to meet the statutory deadline, the vast majority of business and private users of the payment system will need to switch over to the new credit transfers and direct debits in 2013. To achieve this, all parties need to adhere to the arrangements made by the National Forum on SEPA Migration (NFS), comprised of representatives of banks, businesses, consumers and other interested parties and chaired by DNB.

Various parties are running behind the schedule outlined in the National SEPA migration plan as adopted on 17 February 2012. The banking infrastructure, for instance, is not yet fully ready for the large-scale use of European-compliant payment instruments. Further important changes in such areas as internet banking are planned for the first half of 2013. In addition, not all financial and accounting software packages have been adapted yet. The adjustment of the packages must be completed in the first quarter of 2013. Any further delays by banks and software providers will jeopardise the timely migration of businesses.

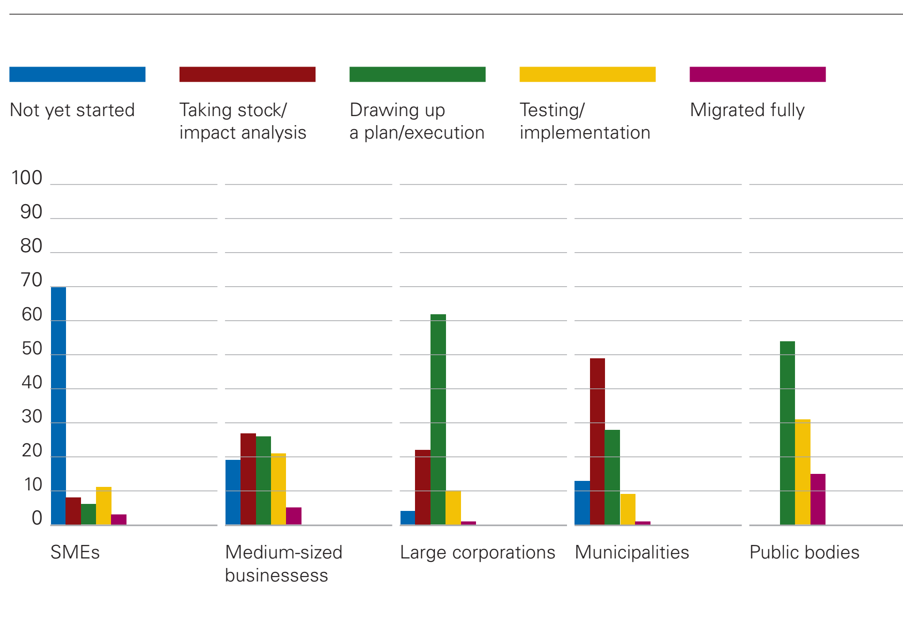
The migration is a complex project for many businesses, involving both accounting and software adjustments. Moreover, businesses that make use of direct debits to collect payments must conclude new contracts with their banks. They must also adjust their mandate forms and accounting systems and allow for earlier direct debit delivery times. Most large companies are now implementing the project and have set migration dates. According to the current schedules, mass migration by large companies will start in the spring of 2013, with peaks occurring in June/July and September/October.

Many SMEs have not yet started preparing for the new standards (see Chart 3.2) and are consequently unable to say when they will start migrating. If they leave their migration until the end of 2013, they will run the risk of having to join a long queue of businesses and government organisations needing support from their banks and software providers. The migration process is often simpler and shorter for SMEs than it is for large companies. Their accounting and software systems are less complicated, and they often use their banks' internet banking environment, which the banks will adapt themselves. This group can quite easily avoid the queue by starting in time and bringing their migration forward.
The migration for SMEs that make use of direct debits is much more complex. This group must start as soon as possible and take stock of the adjustments that need to be made. The IBAN Impact Check, which forms part of the Switching to IBAN campaign, is a handy tool that can help them assess what they need to do.

The most important change for consumers is that they must fill in the longer IBAN when transferring money or completing a direct debit mandate.
In addition, they must provide their own IBAN to people or organisations from whom they wish to receive money. It is therefore particularly important that consumers know what an IBAN is and where they can find it. Consumers will be informed by means of the Switching to IBAN campaign as well as by umbrella organisations, banks, businesses and public bodies. Most consumers will switch

Chart 3.2 - Preparations of businesses for new credit transfer standards

Percentages



Source: SEPA Migration Monitor, autumn 2012 measurement.

to IBAN when the banks convert their internet banking environments: IBAN will then be the preferred option and the account numbers in online address books will be converted to IBAN. The banks have planned this conversion for the period up to July 2013. Consumers who still use paper payment instructions will receive new SEPA credit transfer forms. The IBAN payment transfer form will be available from 1 July 2013.

The immediate focus is on migration to the SEPA standards, but more changes are planned for the future. The SEPA direct debit, for instance, enables collection of payments using a mandate issued online. This product is scheduled to be launched in the Dutch market in 2015. In the longer term it should become possible to issue online mandates for the whole of Europe. The same applies to online payments in web stores, such as with the current iDEAL payment system.

Europe-wide innovation is also possible for POS payments. Dutch debit cards and POS terminals already comply with international standards. This means that Dutch residents can use their debit cards for payments all over Europe, while people from abroad can use their debit cards in Dutch shops. In the future this will probably also apply to contactless payments made with cards or mobile telephones. Consumers will then be able to make mobile payments at check-outs across Europe. In preparation for mobile payments, two Dutch banks are introducing contactless debit cards in 2013. These can be used to make payments by holding the card against a suitable POS terminal (like the public transport smartcard).

The switch to European payment standards therefore is an investment in the future. An integrated payment market offers more opportunities for both providers and users of payment services and forms an important part of the European internal market. The migration currently demands a major effort from banks and businesses, but in the longer term the SEPA standards lay the basis for a European payment market with increased efficiency, lower costs and more innovative payment products, which will benefit everyone.

3.4 Cash remains important

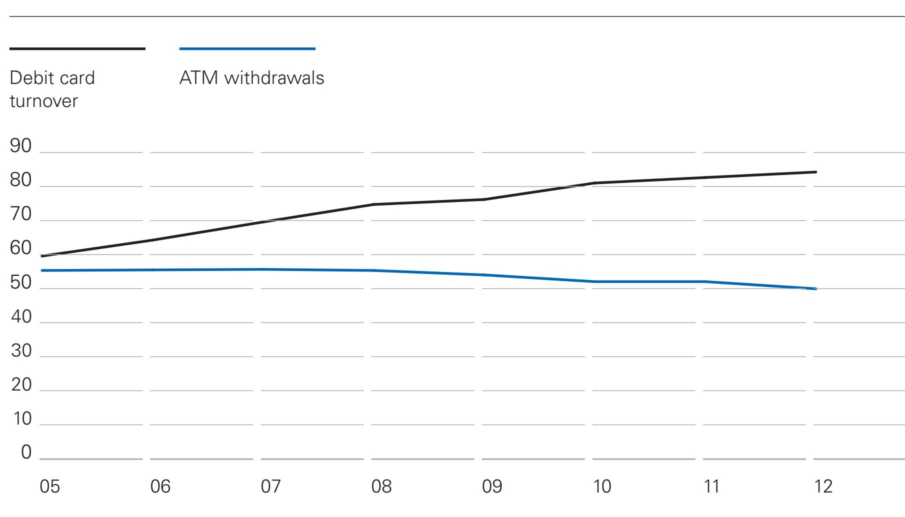
While the use of debit cards continues to gain ground, cash is on the retreat. Even so, cash remains crucially important to the payment system. DNB therefore remains committed to preserving a smoothly operating cash chain and to ensuring that cash remains a universally accepted means of payment.

Debit card payments are becoming more frequent at retail checkouts, whereas the use of cash is gradually diminishing. In the past four years, debit card turnover rose to EUR 84 billion from EUR 75 billion, while the value of cash withdrawals at bank ATMs decreased to an estimated EUR 50 billion in the year under review from EUR 55 billion in 2008 (see Chart 3.3). This is consistent with the objective of the National Forum on the Payment System (MOB) led by DNB, which aims to make payments more efficient and safer by promoting the use of debit cards more often, in particular for low value transactions. Nevertheless, cash remains important. It is still the only payment method that is almost universally accepted for POS transactions. Cash is also the last alternative if the electronic payment chain is disrupted by a technical fault, a cyber attack or any other unforeseen event. Cash has the further advantage of being the fastest means of payment. In addition, there are still people who (sometimes temporarily) do not have a debit card or credit card at their disposal, while others may have specific problems using debit cards. The visually impaired, for instance, may have trouble reading the text on POS terminals.

Cash is expected to continue playing a key role in our payment system in the foreseeable future. In any case, society is not ready to do without cash. This is why DNB is committed to ensuring that cash remains easy to access and use. This means that consumers must be able to withdraw cash easily from their payment accounts, that retailers have good facilities for depositing their cash earnings into their payment accounts, and that cash remains generally accepted for making payments. DNB is not opposed to experiments with cashless stores but, in view of the reasons given above, considers it undesirable if retailers were to start refusing cash on a wider scale. This would also be at odds with the function of cash as legal tender. The almost universal acceptance of cash is of

Chart 3.3 - Debit card usage is growing, cash is decreasing

EUR billion



Note: 2012 estimate.

Table 3.1 - Counterfeit banknotes found in the Netherlands

	2008	2009	2010	2011	2012
Counterfeit banknotes	49,294	54,949	39,631	29,710	29,291
Of which EUR 50 - banknotes	*74%*	*79%*	*70%*	*63%*	*60%*
Of which EUR 20 - banknotes	*14%*	*14%*	*21%*	*27%*	*30%*
Financial losses (EUR million)	2.7	2.8	1.9	1.5	1.4

great value to society and should not be jeopardised in any way. The option to pay in cash can also serve to protect people's privacy. In this day and age, in which society is increasingly encroaching on people's personal lives through electronic channels, there is still a legitimate demand for protecting one's privacy. The drawback, of course, is that cash also facilitates tax evasion and money laundering, which is why the government introduced the obligation to report high-value cash transactions.

As part of its responsibility, DNB makes specific efforts to ensure that the cash chain, as organised by banks, security transport firms, cash processors and DNB itself, is as safe, reliable and efficient as possible. One aspect that is receiving attention in this context is the recirculation of banknotes by market parties. These banknotes must be checked in accordance with the ECB regulations prior to their redistribution to the public. New legislation that became effective early in 2012 enables DNB to impose a penalty or a cease and desist order on parties who fail to comply with the European regulations in this respect. The public must be able to rely on the authenticity of banknotes from ATMs.
The banknotes must also be of good quality, so that retailers and consumers can verify that they are genuine; this is more difficult with worn notes. Though significantly fewer counterfeit banknotes are being found in the Netherlands now than a few years ago (see Table 3.1), vigilance remains necessary. Partly for this reason, the ECB has announced that it will gradually replace the current series of banknotes in the coming years. Replacement will start with the five euro note, a new design of which will be brought into circulation in the near future. DNB is also exploring whether parties in the cash chain are sufficiently prepared to respond to electronic system failures and cope with the consequences. Regarding efficiency, significant progress has been achieved in the Netherlands in the past years. The cash function of bank branches, for instance, has become much more streamlined and the number of branches has been sharply reduced (by more than 35% between 2002 and 2012, while the number of bank branches with cash facilities has fallen even more sharply).
In addition, the large banks have started cooperating in the field of money processing. All these initiatives are helping to keep payment costs in the Netherlands relatively low (see Table 3.2).

Table 3.2 - Payment costs

	Netherlands	Europe
Social costs of cash + debit card	0.42% GDP	0.59% GDP
Social costs per cash payment	EUR 0.39	EUR 0.42
Social costs per debit card payment	EUR 0.32	EUR 0.70
Debit card market share	30%	14%

Sources: DNB and ECB, figures relate to 2009.

4 Accountability

4.1 Introduction

In this chapter, DNB reports on the main results achieved in the year under review (Section 4.2). The main developments and results of the core task Supervision are summarised in the separate independent public body (ZBO) report. Section 4.3 looks at the development of costs, while Section 4.4 describes the corporate governance of the organisation. This is followed by a description of the effectiveness and legitimacy of the use of financial resources (Section 4.5) and internal risk management (Section 4.6) as well as information on DNB's investments and financial risks (Section 4.7). Finally, Section 4.8 describes the activities undertaken by DNB to convey its financial knowledge to the Dutch public and the technical support offered by DNB to fellow central banks and supervisors in other countries.

4.2 Results achieved

4.2.1 *Financial stability*

DNB published two editions of the Overview of Financial Stability (OFS) in 2012, setting out the risks to financial stability and pointing out the heavy dependence of Dutch banks on market funding and the need to increase capital buffers. The translation from macroprudential analysis to risk-mitigating action was further reinforced. A key element of this involves embedding the financial stability risks described in the OFS in a macro-register. For supervisors, this register forms the starting point for the top-down risk analysis of individual institutions and is part of the new supervisory method Focus!

As part of its drive for better institutional embedding of macroprudential policy, DNB has submitted a number of proposals to the Dutch government in recent years and several of these have been taken up and are being translated into legislation and regulations. For example, DNB's financial stability task has been further emphasised in the Bank Act (Bankwet) and the Financial Supervision Act (Wet op het financieel toezicht or Wft). In order to foster cooperation with other authorities, the Financial Stability Committee was officially established in November 2012. This Committee, which is chaired by DNB President Klaas Knot, includes representatives of the Dutch Ministry of Finance and the Netherlands Authority for the Financial Markets (AFM) as well as DNB. Another government measure for which DNB has long argued is the reduction of loan-to-value ratios for mortgage lending, a move that diminishes the risk to which homeowners are exposed and also strengthens financial stability.

Work continued in 2012 to promote better risk management at financial institutions. A key development here was the entry into force of the Intervention

Act (Interventiewet), which gives DNB and the Ministry of Finance wider powers to intervene if an institution gets into difficulties and to resolve the institution if necessary. Special attention is paid to systemic risks, and in this context recovery and resolution plans are being developed in accordance with the European draft directive on the recovery and resolution of banks and investment firms. It has also been agreed that systemically important banks must hold more capital, and a bill has been tabled to this effect. In addition, preparations have been made for the transition to a pre-funded deposit guarantee scheme with risk-weighted contributions. This measure is expected to come into effect in July 2013.

Finally, DNB played an active role in international discussions aimed at improving financial stability. On the European stage, these take place chiefly in the European Systemic Risk Board; at global level, the relevant organisations are the Financial Stability Board, the Bank for International Settlements (BIS) and the International Monetary Fund (IMF). The Netherlands and Belgium have joined forces within the IMF and formed a new joint constituency, to which Luxembourg and the members of the former Dutch constituency are also affiliated (see Section 4.8.2). This has consolidated the Dutch position in the IMF, while making it possible for emerging economies to have a greater say on the IMF board.

4.2.2 *Monetary tasks*

In response to market tensions stemming from the European debt crisis, DNB has contributed to the decision-making within the Eurosystem and to the implementation of monetary policy measures. Alongside a cut in interest rates in July 2012, those measures mainly relate to the allocation of a three-year secured loan to banks and the announcement and introduction of the Outright Monetary Transactions (OMT) programme (see www.ecb.int), though this programme was not used in 2012. The introduction of OMTs marked the formal end of the Securities Markets Programme (SMP). A second covered bank bond purchase programme (CBPP2) was also completed in the reporting year.

Only politicians can take measures to secure a sustainable solution to the currency union, such as stricter and more enforceable fiscal rules and structural measures to boost competitiveness and growth. OMTs impose the explicit requirement that the conditions of a formal EU adjustment programme must be met, so that governments still have incentives to develop fundamental solutions despite interventions by the Eurosystem.

In its contacts with national and international decision-makers, DNB contributes its expertise with a view to making the economic and monetary union (EMU) stronger and more stable. In its advisory role, DNB also uses its expertise in other national policy debates, for example in working out the details of the new Pension Accord, fiscal policy, future-proofing the Dutch housing market and advising on and answering parliamentary questions on the impact of the bank tax on lending. In addition, DNB publishes forecasts of future macroeconomic trends twice a year.

In its 2012 research programme DNB devoted a good deal of attention to improving and developing economic models so they take more account of the complex interrelationships within the financial markets and the interaction between the financial sector and the real economy. This research for instance led to better insight into the effectiveness of various macroprudential and micro-prudential policy instruments.

4.2.3 *Payments*

Part of DNB's role involves recirculating banknotes in the Netherlands more efficiently. As part of this effort, banknotes that are suitable for reuse are placed back into circulation by market players as far as possible. The related internal reorganisation at DNB was completed in 2012. The processing of cash by ABN AMRO, ING Bank and Rabobank has been centralised in the joint cash services company GeldService Nederland (GSN). DNB participates as an observer in the meetings of the GSN Supervisory Board. The recirculation of banknotes now falls under the strengthened cash supervision of DNB. In 2012, DNB received 10% more banknotes than in 2011, which means that the envisaged reduction of 4% in the number of banknotes received was not achieved. This increase in returned banknotes was caused partly by shifts in the volumes to be processed in the market. Some market parties channel their cash processing and settlement through a different service provider, which has insufficient outlets and returns more notes to DNB. In addition, one market party was temporarily unable to recirculate part of its notes. To be permitted to recirculate banknotes, market parties must use sorting machines that meet the required standards. Since 1 January 2012, DNB has had power of enforcement if banks and other parties that fill ATMs fail to comply with the ECB regulations on banknote authenticity checks. The increase in the number of returned notes also meant that the expected reduction in the number of transport movements to and from DNB, and hence the decrease in CO_2 emissions, was not achieved.

On 17 February 2012, the National Forum on SEPA migration (NFS), which is chaired by DNB, published a National Migration Plan for the migration of the Dutch payment system to the European standard, the Single Euro Payments Area (SEPA). The IBAN promotion campaign developed to support this process began in May. Since the start of the campaign, there has been a marked increase in knowledge about IBAN and SEPA among both consumers and businesses. Changes to the payment system, including the migration to SEPA, can cause difficulties for vulnerable groups such as the elderly, people with a functional impairment, people without Internet access, people with a low education level and people who are economically inactive. The accessibility of the payment system is therefore a key focus area for the National Forum on the Payment System (MOB), which promotes the efficiency of the Dutch payment system. As long ago as 2009, the MOB Working Group on Availability and Accessibility (WTB) highlighted the future of telephone banking as an area of concern in relation to the migration to SEPA. The great advantage of telephone banking is that visually impaired people can manage their banking affairs completely independently. Following extensive consultations within MOB, Dutch banks promised to ensure that this select group of customers would still be able to manage their payments independently after the introduction of SEPA (1 February 2014). The WTB is monitoring developments in this respect.

On 9 November 2012, a market-wide exercise was carried out in which organisations from the financial sector underwent training in dealing with large-scale operational disruptions in the payment and securities transactions systems. The main focus was the simulation of cybercrime. It was established that the crisis management structure for the sector and the agreements made function as intended.

4.2.4 *Supervision*

The Dutch financial sector is going through a radical transformation. The crisis prompted changes in many areas. Financial institutions are reviewing their

business models and adapting their activities; regulators are imposing new and stricter standards; customers and politicians are placing heavier demands on quality and corporate social responsibility. This transition creates a dual task for supervision, which should, on the one hand, guide and support this transition so that it can take place in a controlled and prudent manner. On the other hand, supervision also needs to be constantly calibrated and renewed. DNB made major strides on both fronts in 2012.

Financial sector in transition

Maintaining and strengthening buffers received high priority. In some cases, painful measures had to be taken, such as the curtailment of pension rights. DNB contributed to putting the funding of institutions on a solid footing, for example by pressing for accurate valuations of commercial property and formulating realistic recovery plans for banks. Overall, the Dutch financial sector is now in better shape than a year ago. The solvency of banks and insurers has improved slightly, as has the funding ratio of pension funds. This is a step in the right direction, though further strengthening is still needed. The process of balance sheet repair is likely to take considerable time and the risks have not yet disappeared.

DNB was also closely involved in the further development and implementation of national and international policy and regulations. Key projects in this regard are the development of and preparation for Basel III/CRD IV, the framework for systemically important financial institutions, Solvency II, the amendment of the Pensions Directive and the supervisory framework for the new pension contract. Delays in (political) decision-making mean that less progress was seen on these fronts than intended, but satisfactory progress has been made in preparing Dutch institutions for new and stricter rules. The formulation of resolution plans for the largest banks is a good example of this. Although it is only a first step, the decision to establish a banking union, a move which DNB wholeheartedly supports, is a major success in strengthening the international supervisory framework.

In its supervision of business models, strategy, conduct and culture (corporate governance), DNB succeeded in cultivating a fruitful dialogue with the sector on the changes that are needed to put operations on a sustainable footing. Themes to which DNB devoted a good deal of attention in the past year included the transition to sustainable business models (including the funding of banks and profitability of insurers), the suitability screening for Management Board and Supervisory Board members, effective remuneration policies and an effective corporate culture. These topics are crucial in regaining and retaining the trust of customers and society.

Supervision in transition

DNB's supervision has been greatly strengthened by the introduction of Focus!, a new supervisory method which makes it possible to deploy the available capacity in a more targeted way and to use the available expertise more powerfully by facilitating better cooperation between disciplines. In addition, it has been decided to increase the direct supervision capacity by 54 FTE in 2013. Recruitment began in 2012, and the vacancies are expected to be filled during the course of 2013. Together with the changes previously introduced in the context of the DNB Supervisory Strategy 2010-2014 and the Action Plan for a Cultural Change in DNB's Supervision, major strides have once again been taken, though it remains essential to subject supervision to continuous critical scrutiny and to improve it where necessary. Another important development in

2012 was the intensified cooperation with the AFM, which takes place in many fields and at various levels: regular administrative consultation, joint projects – such as the screening of Management Board members – more intensive sharing of information, and operational cooperation, e.g. in the areas of procurement and human resources policy. More information on DNB's supervisory activities can be found in the 2012 ZBO report (see www.dnb.nl).

4.2.5 *Statistics*

The financial and economic crisis is leading to rapidly changing information needs. This is reflected partly in a large increase in the number of ad hoc requests for data from financial institutions. In order to more effectively meet the growing demands imposed by these changing information needs, DNB made further preparations in 2012 for a complete overhaul of its statistical systems. In addition, on the initiative of the G20 and under the auspices of the Financial Stability Board, new international reporting frameworks were established for global (including Dutch) systemically important banks to enable systemic risks to be addressed more effectively. A trial reporting exercise was carried out for banks on the ex-ante funding of the deposit guarantee scheme, the formal introduction of which has been deferred by the Ministry of Finance until July 2013. A reporting requirement has been introduced for premium pension institutions and the reporting frameworks for pension funds have been tightened in order to improve the transparency of the risks. As regards publications, DNB introduced new statistics on foreign exposures of the Dutch financial sector. A more detailed geographical breakdown of cross-border securities holdings and direct investments will also be published. Partly in view of the greater importance of the external asset position as a macroeconomic policy indicator, those holdings and investments are now also measured at market value for the Netherlands. DNB has issued an increasing number of Statistical Newsletters to explain key developments. In addition, special attention was devoted in 2012 to mapping out the shadow banking system in the Netherlands.

4.2.6 *Operations*

The DNB Governing Board presented the new strategy (Polaris) to the organisation in the first quarter of 2012. Polaris consists of a renewed mission, ten long-term ambitions and a strategic framework. The ambitions are as follows:

1. DNB is an influential bank in the European System of Central Banks (ESCB).
2. DNB is a leading institution in the area of financial stability.
3. DNB stands for efficient and robust payment and securities chains.
4. DNB's supervision sets a benchmark and is authoritative.
5. DNB influences financial and economic policy in its preferred direction.
6. DNB makes full use of the synergy stemming from its combined role of central bank and supervisor.
7. DNB hires only the best people for all positions.
8. DNB has a modern information system and produces useful statistics for internal and external users.
9. DNB helps build trust in the financial system through consistent communication.
10. DNB has an effective governance model.

In formulating these ambitions, the Governing Board has in fact set the course to be followed in the coming years. Although other organisational goals will also be relevant in the years ahead in addition to these long-term ambitions,

they are where the Governing Board wishes to place the emphasis.
In the coming years, the regular planning and control cycle will be used to monitor progress towards the achievement of the specific targets set as part of the ambitions, so that any necessary adjustments can be made.

Steps have been taken to further improve DNB's operations. To enhance efficiency, DNB's long-term accommodation policy is geared towards minimising the number of locations. Existing buildings are being modernised and, where possible, functions are being combined. The revamped communication strategy has also been put into effect, with the main focus on proactive communication about the implementation of DNB's core tasks. Improvements have also been made to the performance management system, which will lead to a stepped-up focus on results from 2013. As part of the ambition to employ only the best people, a training programme has been set up, a staff exchange programme has been agreed with the AFM and a vision on future compensation and benefits has been formulated.

In the year under review, architecture descriptions were completed within the ICT function. They provide an important framework for future ICT changes. The result is a flexible and future-proof infrastructure. A first draft for a new configuration of the ICT organisation was also completed, with a stronger focus on customer orientation. With effect from mid-2012, after training of project managers and principals, all ICT projects are carried out using the same method. This improves direction and control.

4.3 Development of costs

The costs attributed to DNB's core tasks amounted to EUR 301.4 million in 2012 (see Table 4.1), EUR 31.9 million below budget. The costs of support tasks were once again a focus area during the year.

The costs for the core task Financial stability undershot the budget by EUR 0.8 million in 2012, mainly due to lower staff costs and less use of legal advice. The budget allowed for legal input for crisis-related issues, but this proved unnecessary in 2012.

Table 4.1 - Costs per core task

EUR million

	Actual 2012	Budget 2012	Variance	Actual 2011	Actual 2010
Core task					
Financial stability [1]	14.2	15.0	-0.8	15.0	17.9
Monetary stability and economic advice	56.4	61.0	-4.6	57.4	53.3
Payment operations	78.6	98.0	-19.4	83.2	108.0
Supervision (excl. FEC)	127.6	133.1	-5.5	118.1	104.3
FEC	0.8	1.2	-0.4	1.0	0.8
Statistics	23.8	25.0	-1.2	27.7	25.8
Total	**301.4**	**333.3**	**-31.9**	**302.4**	**310.1**

1 Including costs of implementing the deposit guarantee scheme.

Spending on the core task Monetary stability and economic advice was EUR 4.6 million below budget. This difference can be explained mainly by delays in the programme to develop DNB's reserve management system. These delays meant that fewer costs were incurred for hiring temporary external staff than budgeted. Understaffing also led to lower staff costs, and less support was provided for this task.

The underspend of EUR 19.4 million on the core task Payment operations compared with the budget was due largely to the release of the provision for a collateral management project within the Eurosystem. At year-end 2010 it was expected that not all project costs would be covered by the system, and a provision of EUR 10 million was formed. In reality, at year-end 2012 the amount covered by the system turned out EUR 9.8 million higher than envisaged. As a result of a shift in production to the beginning of 2013, there was also an underspend on banknotes (EUR 5.2 million), the costs of which are impossible for DNB to predict. Staff costs also turned out lower as a consequence of lower staffing and a release from the provision for restructuring the cash organisation. This reorganisation was completed on 1 January 2013 and the envisaged reduction in permanent staff by more than 30 FTEs was achieved. Finally, the costs of support were lower here, too.

The costs of the core task Supervision were EUR 5.5 million below budget. Staffing levels were virtually in line with the budget, but fewer costs were incurred in support activities. This underspend was caused by lower travel and accommodation expenses, lower costs for insourcing and legal activities and lower support costs. The separate ZBO report provides a detailed overview of the development of costs within the core task of supervision.

The costs associated with the Financial Expertise Centre (FEC) were EUR 0.4 million below budget, due to savings on support and lower staff costs.

Spending on the core task Statistics came in EUR 1.2 million below budget, principally because of delays in the multi-year programme plan for renewal of the statistical systems. These delays led to an underspend on ICT and external insourcing.

4.4 Corporate governance at DNB

DNB is a public limited company incorporated under Dutch law. In its capacity as central bank, DNB forms part of the European System of Central Banks (ESCB). DNB's president Klaas Knot is a member of the Governing Council and the General Council of the European Central Bank (ECB). In its capacity as a supervisor, DNB has the status of an independent public body (zelfstandig bestuursorgaan/ZBO).

4.4.1 *Changes in the governance structure of DNB*

A new law, the Act strengthening the governance of financial supervisors DNB and AFM (Wet versterking governance van de Nederlandsche Bank en de Autoriteit Financiële Markten), came into force on 16 February 2012. Among other things, the Act fleshes out the supervisory role by means of the introduction of a Prudential Supervision Council for financial institutions and a Chairman for Prudential Supervision at DNB (Jan Sijbrand). The statutory duties of the Supervisory Board have also been expanded to include a duty to supervise policy aspects and related safeguards, alongside the more operational

and management aspects. Examples include the implementation of supervision in a general sense and ensuring the quality and effectiveness of policy.
More information about the present governance structure of DNB can be found on DNB's website, where the institutional documents, including the amended Articles of Association, the Rules of Procedure and the regulations on integrity, are also posted

4.4.2 *The Dutch Corporate Governance Code*

Although the Dutch Corporate Governance Code (the Code) only applies to listed companies, DNB applies its principles and best practice provisions as far as possible. A table may be found on DNB's website which clearly shows how DNB implements the Code.

4.5 Efficiency and legitimacy

DNB strives for efficient, effective and legitimate use of resources. To realise this, the planning and control (P&C) cycle includes a specific link between the objectives of DNB and the related costs incurred. DNB has instructed the external auditor to assess the efficient and legitimate use of financial resources and to give an account of this in the auditor's report that is included in the report on the role of DNB as an independent public body. This also complies with the obligation of DNB under the Financial Supervision Act (Wet op het financieel toezicht) and the Pensions Act (Pensioenwet). The efficiency indicator used is the proper operation of the P&C cycle. The actual costs in relation to the budget in the reporting year provide a reliable picture of efficiency.
DNB aims to achieve 100% legitimacy in its expenditure. The internal standard is a legitimacy rate of 99%. The percentage achieved in 2012 was 99.2% (in 2011, 2010 and 2009: 99.4%, 99.2% and 94.5%, respectively).

4.6 Risk management

4.6.1 *Description of risk management within DNB*

The internal risk management and control systems at DNB are derived from the internationally accepted Enterprise Risk Management framework of the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

The governance structure of DNB risk management is based on the three lines of defence model. These three lines of defence – line management, supporting risk management and control functions and the internal audit function – operate independently of each other and contribute to the quality of the risk management and control system. The DNB Governing Board bears ultimate responsibility and adopts the risk management policy. It is supported in this by the Risk Management Committee (RMC) and the Investment Committee. The RMC advises the Governing Board on asset and liability management and associated risks.
This includes the strategic investment policy, risk framework and buffers.
The Investment Committee takes tactical positions within the scope established by the Governing Board and the RMC, with the aim of deriving additional returns over and above a strategic benchmark.

The risk management and control systems are reviewed periodically. As a basic principle, DNB also wishes to comply with the applicable legislation and regulations governing supervised institutions and to implement progressive insights. In 2012, this led to a study to determine how the existing risk management

could be further professionalised. The aim is to create a more cohesive, effective and integrated risk management system within DNB. One of the principles here is that risks will be addressed in a consistent manner, but that risk management can be applied in a differentiated way across different parts of the organisation. The analysis led to a proposal at the end of 2012 to update the risk management framework and policy. This update will be implemented in 2013.

4.6.2 *Management of specific risk types*

As part of the integral risk management and control systems, DNB also has a risk management system for specific risk types, which are divided into financial and non-financial risks. The financial risk management is described in Section 4.7. The non-financial risks and any special features are described below.

The non-financial risks include information security risks, operational risks, business continuity risks, physical security risks and compliance and integrity risks.

The purpose of information security is to assure the confidentiality, integrity and availability of information in a consistent and effective manner. In addition to the continual risk analyses of individual systems and raising awareness through training and other means, an internal study of information security in 2012 suggested a need to improve coordination. The findings will be acted upon in 2013.

Operational risk management focuses on the entire process of identifying, analysing, managing and monitoring operational risks with the aim of safeguarding controlled operations. The performance of risk self-assessments at tactical and operational level, both in the operational activities and in individual projects, remains an important element of operational risk management within DNB. New risk analysis methods and techniques were introduced in 2012. In addition, the frequency of risk reporting to the Governing Board was increased and the information on risk development was amended during the year under review.

The purpose of business continuity management (BCM) is to coordinate measures to mitigate material and non-material loss as a result of an actual or threatened crisis in which the stability and continuity of DNB, the financial markets and/or the financial infrastructure are jeopardised. BCM risk management is at a mature level within DNB. As part of the continual professionalisation process, the BCM policy will be reviewed in 2013 to take account of the ESCB requirements and best practices that apply within the financial core infrastructure in the Netherlands. Physical security at DNB focuses among other things on the security of individuals and buildings and the transportation of people, valuables and goods. The main change made in 2012 was the commissioning of a completely new control room. Security staff will need to build up experience and routine in 2013 in using the new control room methods and procedures.

The risk management system in the Compliance & Integrity (C&I) department is focused mainly on contributing to the adequate management of the integrity risks and preventing and mitigating losses resulting from actions contrary to internal and external laws and regulations, standards and codes of conduct. In 2012, C&I specifically targeted risks in relation to the careful handling of information, social safety, outsourcing and outsourcing dependency.

4.6.3 *Key risks*

The key risks that DNB faces in implementing its strategy are as follows:

1) In the wake of the financial and European debt crisis and the measures taken by the Eurosystem to control the crisis, the financial risks for DNB increased further in 2012. Given the significant increase in risks, the Dutch State, after consultation with the Ministry of Finance, issued a guarantee for the crisis-related exposures of DNB.

2) The ECB is competent to supervise all banks in the euro area and intends to supervise the larger banks in collaboration with the national supervisory authorities, including DNB. European banking supervision is currently in a transitional phase from national authorities to the ECB. During this phase, the inadequate organisation of the European resolution mechanism means that any resolutions may not be effected in an orderly fashion. The effectiveness of supervision is weakened if its financial or other consequences will still be felt at national level. DNB considers this situation undesirable and is arguing for the simultaneous introduction of a European supervision and resolution mechanism.

3) A further deepening of the European debt crisis could have a negative impact on several supervised institutions simultaneously. For DNB, this could lead in extreme cases to significant or excessive efforts being demanded of the organisation simultaneously and could result in less than optimum supervision of any resolutions or failures. In order to mitigate this risk, DNB aims to have sufficient knowledge and experience in addition to capacity that can be deployed flexibly.

4) DNB deals with confidential information. If this information should enter the public domain through a deliberate act or theft (including cybercrime), loss or leakage, this could cause serious damage both to the organisation and to other stakeholders. In line with the intensive policy it has pursued in this regard in recent years, DNB will continue to raise risk awareness among its staff and to keep its information security policy and procedures up to date.

5) DNB is carrying out its tasks in an ever more difficult environment. Within the cash sector, in particular, violent crime is increasing. Preventing and mitigating the use of violence against DNB and its employees has a high priority within the organisation. To this end, among other things DNB performs risk analyses on an ongoing basis and implements the measures stemming from them. In addition, the organisation maintains an adequate level of physical and other security and shares relevant knowledge and experience with national and international agencies. A security awareness programme has been introduced to make DNB staff aware of potential threats and controls.

4.6.4 *Evaluation of internal risk management and control systems*

The Governing Board evaluates the functioning of the internal risk management and control systems on the basis of reports from the planning and control cycle, which are used to establish the extent to which the divisions manage operational risks and implement appropriate measures to control those risks. The Governing Board also uses Risk Self Assessments (RSAs) at strategic level, in the divisions, chains and processes as well as periodic reports from second-line functions and reports by the internal and external auditor.

The Board also assesses whether the processes and systems used for financial reporting are carried out in a sound manner, so that they cannot lead to financial reporting risks. To achieve this, relevant information sources and statements by the owners of the systems and processes concerned are analysed.

The evaluation of the functioning of the internal risk management and control systems, any material shortcomings, significant changes and the key risks are discussed in the various meetings of the Financial Committee and subsequently reported to the entire Supervisory Board.

4.6.5 *In control statement concerning financial reporting risks*

Based on the evaluation it has carried out, the Governing Board of DNB declares that, with regard to the financial reporting risks in 2012, the internal risk management and control systems provide reasonable assurance that the financial reporting is free of material misstatement. The internal risk management and control systems in respect of the financial reporting risks operated satisfactorily in 2012.

4.7 Financial exposure

The financial exposure of DNB is related to its monetary operations, external reserves and the euro investment portfolio. These define the risk profile of DNB. The underlying risk (excluding gold) stood at EUR 13.5 billion as at the end of December 2012. The guarantee issued by the Dutch State means that the potential losses from the crisis-related exposures have been hedged up to an amount of EUR 5.7 billion.

4.7.1 *Monetary operations*

As part of the implementation of the common monetary policy in the euro area, the central banks in the Eurosystem perform monetary policy transactions with counterparties. In 2012, DNB's exposure from monetary operations rose by EUR 14.8 billion to EUR 79.0 billion (see Table 4.2). The term 'financial exposure' is used in this section because the magnitude and the risk of a number of assets (refinancing operations and Securities Market Programme) are determined on the basis of the consolidated balance sheet of the Eurosystem multiplied by DNB's capital subscription. These items are not disclosed on a one-to-one basis in the DNB balance sheet. The share of DNB in the capital paid into the ECB by the Eurosystem central banks is 5.7%. If, despite the collateral provided, a bank's insolvency were to cause the Eurosystem to suffer losses on monetary policy credit operations, these losses would be divided among the national central banks (NCBs) pro rata to their share in the capital of the ECB.

Table 4.2 - Exposure due the monetary operations
EUR billion

	31-12-2012	31-12-2011	Difference vs. Dec. 2011
Refinancing operations	63,769	48,711	+15,058
SMP	11,741	12,126	-385
CBPP	3,442	3,311	+131
Total	**78,953**	**64,149**	**+14,804**

The monetary credit operations of financial institutions, or refinancing operations, are intended to steer short-term money market interest rates towards the level established by the Governing Council of the ECB with a view to maintaining price stability. In 2012, the refinancing operations rose by EUR 15.1 billion to EUR 63.8 billion due to sharply increased lending during the second three-year LTRO (Long Term Refinancing Operations) at the end of February 2012.

In order to promote the availability of monetary collateral and therefore the accessibility of loan instruments and the transmission of ECB policy, the rating requirements for asset-backed securities (ABS) were relaxed, subject to certain conditions, and the minimum rating requirement for countries in an OMT (Outright Monetary Transactions Programme) or EU/IMF programme were suspended as long as the set conditions were met. At the same time, additional risk management measures were taken, such as the loan level data initiative to promote the acceptability of ABS as collateral. This makes the risk and return of the underlying assets more transparent. It should be noted that NCBs can also temporarily accept additional collateral that meets the more flexible credit requirements. In this case, any losses suffered are not shared. There was no reason for DNB to accept additional collateral in 2012.

In addition to monetary credit operations, DNB is exposed to monetary portfolios consisting of purchase programmes for peripheral European government bonds (SMP; EUR 11.7 billion) and the Covered Bond Purchase Programme (CBPP; EUR 3.4 billion). The SMP portfolio fell slightly in the year under review compared with 2011 because redemptions exceeded purchases. The creditworthiness of the peripheral countries deteriorated in 2012.

Due to the sharing of losses in the Eurosystem, the SMP exposure is calculated in a similar way to that used for the refinancing operations. The CBPP is executed for the bank's own account and risk and is equal to the exposure on the DNB balance sheet. The announcement of the new OMT formally ended the SMP; purchases under the CBPP have also ceased.

The financial exposure from monetary operations is discussed above on the basis of the consolidated Eurosystem balance sheet. The link with the DNB balance sheet can be made by means of the intra-Eurosystem relationships. DNB has a net intra-Eurosystem claim, with the largest item being a positive TARGET2 balance. DNB's TARGET2 balance is the result of the decentralised provision of central bank liquidity and the existing imbalance in the liquidity requirements of the banking systems in individual countries. The TARGET2 balance gradually decreased in the second half of 2012 from EUR 153 billion to EUR 121 billion. This was partly the result of the announcement of the OMT programme, which led to increased confidence in peripheral countries and their banking systems, making it possible for them to once again independently seek finance from the markets to a limited extent.

The Eurosystem TARGET2 receivables could have an impact on DNB's risk exposure. It should be stressed that these TARGET2 claims are receivables from the ECB, not from other national central banks. DNB could be indirectly affected by the risks to which the ECB is exposed. Such risks could manifest themselves in an extreme scenario where a country with a negative TARGET2 balance leaves the euro area and the central bank of that country is unable to meet its commitments.

4.7.2 *External reserves and euro investments*

The external reserves and euro investments (EUR 54.5 billion, see Table 4.3) serve to support the common European monetary policy and the financial stability mission of DNB. This places high demands on the credit quality and liquidity of the investment instruments used. The components of the external reserves and euro investment portfolio are described below.

DNB's physical gold holdings (EUR 24.8 billion) serve as an anchor of trust, and are also maintained for diversification purposes. The euro investment portfolio (EUR 17.3 billion) consists of fixed-income securities such as (semi-) government bonds, covered bonds and bonds issued by supranational institutions. A proportion of these investments is classified as a held-to-maturity (HTM) portfolio (EUR 3.5 billion).

The US dollar portfolio (EUR 6.7 billion) enables DNB to meet requests for currency from the ECB, IMF or the Dutch State. For example, the ECB can call on the Eurosystem central banks during interventions if its own currency reserves are not sufficient; the IMF can designate DNB to supply currency for its credit operations; and the Dutch State can ask DNB to settle transactions in foreign currencies. The US dollar portfolio consists largely of short-term, liquid US government bonds, and also includes bonds issued by supranational and semi-government institutions. The investment in agency mortgage-backed securities (agency MBS) was unwound completely in August 2012.

The Australian dollar portfolio (EUR 1.0 billion) is held in order to spread debtor risks more broadly. The portfolio consists of central government paper (EUR 0.9 billion) and covered money market loans (EUR 0.1 billion).
DNB receivables from the IMF (EUR 3.2 billion) are unchanged.

The equity investments (EUR 1.6 billion) – included to provide diversification – are in large part managed passively by three external managers. Two of them apply a benchmark comprising the weighted average of regional MSCI indices, with Europe being overweight and North America being underweight compared with the MSCI World index. A third portion of the equity portfolio has been placed with a fund that pursues a responsible investment policy in line with the principles formulated by DNB. The organisation aims not to invest in companies that are directly involved in the production of goods and services that are prohibited under Dutch legislation and regulations and the

Tabel 4.3 - Composition of the external reserves and investment portfolio
EUR billion

	31-12-2012	31-12-2011
Gold	24.8	24.0
Euro investment portfolio	17.3	18.5
US dollar portfolio	6.7	7.0
Australian dollar portfolio	1.0	0.0
IMF receivables	3.2	3.2
Equities	1.6	1.4
Total	**54.5**	**54.0**

international treaties to which the Netherlands has committed. The fund in which DNB invests pursues an active investment policy and uses the MSCI World index as a benchmark. DNB has the ambition of applying its corporate social responsibility (CSR) policy to all its equity investments. However, there are no plans to add further actively managed CSR funds to the equity portfolio, in view of the desired risk profile of the portfolio. DNB will, however, seek to increase its passively managed CSR investments.

In response to the sharp increase in the risks stemming from monetary operations, a conservative policy was pursued for the external reserves and the euro investment portfolio. Examples include the reduction of the interest rate risk of both the euro and the US dollar portfolio by shortening the term to maturity of the investments, discontinuing investments in agency MBS, constructing an Australian dollar portfolio and discontinuing build-up of the HTM portfolio because its risks are similar to the risks associated with unconventional monetary portfolios.

4.7.3 *Results*

In 2012, DNB recorded an accounting result of EUR 2.08 billion, excluding gold (see Table 4.4; a detailed description may be found in the financial statements). The income from monetary operations totalled EUR 1.27 billion, mainly comprising interest income from increased lending and the SMP. DNB's own investments realised an accounting result of EUR 687 million. Sundry items include commission income, other income and operating costs.

Based on mark-to-market valuation, a return of 2.6% (EUR 693 million) was achieved on the external reserves and euro investment portfolio (excluding gold and SDR; see Table 4.5), compared with 1.7% (EUR 436 million) a year earlier. The increase was due to a high 16.1% return on equity investments. The bond valuations rose primarily because of a fall in yields on virtually all European government bonds. This fall occurred in the first half of the year and was concentrated mainly in AAA-rated countries, including Germany, the United States and Australia, due to the deepening European debt crisis and the deteriorating European and global growth outlook. In the second half of the

Table 4.4 - Overview of the accounting result

EUR million

	2012	2011
Monetary operations [1]	1,268	769
Own investments (including write-downs) [2]	687	556
SDR (Special Drawing Rights)	5	10
Participation in ECB, BIS	44	53
Sundry (including costs)	76	-175
Total (excluding gold)	**2,079**	**1,213**

1 This item consists of the result from the refinancing transactions, SMP, CBPP, ECB commitments and claims.
2 Positive unrealised gains are not taken to the result, but to the revaluation accounts. Losses are charged to the result if there is no positive revaluation.

Table 4.5 - Performance investment portfolios

	Relative return (%)			Absolute return (EUR million)		
	2012	2011	2010	2012	2011	2010
Euro investment portfolio	2.5	2.4	2.6	356	348	151
Euro HTM portfolio	2.2	1.73		78	40	
US dollar portfolio (incl. MBS)	0.5	1.9	2.1	38	130	474
Australian dollar portfolio [1]	0.4			3		
Equities	16.1	-5.8	16.7	219	-81	225
Total investment portfolio [2]	**2.6**	**1.7**	**3.3**	**693**	**436**	**850**

1 Including the results from the currency hedge.
2 EUR, USD, AUD and total investment results are weighted returns.

year, interest rates in other European countries also fell and the equity markets climbed after the ECB had announced the OMT and European government leaders had reached agreement on a new support package for Greece and the Spanish banks and on the formation of a banking union.

4.7.4 *Management of financial risks*

DNB uses the expected shortfall (ES) method to measure and manage financial risks, in combination with the extrapolation of different scenarios.
The magnitude of the total risk is determined using the expected shortfall method with a one-year horizon and a reliability interval of 99%. The risk in non-investment-grade countries (rating lower than BBB-) is assessed using a default scenario with a recovery rate of 40%.

The euro, dollar and equity portfolios are managed at three levels: strategic, tactical and current. Each year, the Governing Board determines whether the strategic investment policy for the medium to long term needs to be adjusted. The strategic investment policy incorporates the extent, term and composition of the investments, based on risk tolerance and a derived budget for financial risks. There are degrees of freedom within this policy which are used at tactical and current level.

The interest rate risk on the investments is managed in a general sense by setting a limit for the size and term of the fixed-income portfolios. To manage the default risk on its investments, DNB accepts only covered exposures to commercial banks, with only high-quality collateral. A strict limits framework also applies for public authorities, issuers and counterparties. The currency risk, which stems mainly from the investments in the US dollar, Australian dollar and the IMF receivable in respect of SDR, is hedged using forward exchange contracts. The default risk in relation to the IMF receivable is hedged by means a guarantee from the Dutch State.

4.8 Financial education and technical assistance

4.8.1 *Financial education*

DNB employs a wide range of resources to share the knowledge and information available within the organisation with the Dutch public. DNB not only provides information about its own tasks and activities, but also about money and the financial world in a broad sense. This helps people make better financial decisions. Along the same lines, DNB also participates in the Money Wise Platform (Wijzer in geldzaken), an initiative of the Ministry of Finance.

DNB's Visitors' Centre welcomed almost 17,000 visitors in 2012. New items of interest completed in the Centre in the reporting year included two animations offering an explanation of monetary policy and a presentation about the creation of the EU and the euro. The Centre will move in a few years' time from its present location in the canal warehouses to the computer centre building, which will be refurbished for this purpose. The new Visitors' Centre, which will stage special exhibitions, will be open to individual visitors as well as continuing to offer guided tours.

The free educational material focused on schoolchildren was expanded further in 2012, including the addition of a learning pack about the euro for primary schoolchildren in year groups 5/6, and the money-box learning package, which teaches children in the lower vocational tracks of secondary education how to manage money. The material also includes lesson packs, brochures, films, online games, posters and comic strips.

In November 2012, DNB took part in the third national Money Week event. During this week DNB, together with other participants, teaches primary school children how to handle money effectively. In close liaison with the AFM, more than a hundred DNB staff (and a member of the Governing Board) delivered guest lectures at primary schools throughout the Netherlands. In addition, an open day was held at DNB's Visitors' Centre.

DNB also supports Aflatoun, a global organisation that develops financial education initiatives for children, mainly in developing countries. Children learn skills such as saving, planning, budgeting and running a business, which teaches them how to handle money responsibly. DNB's website contains a link to this programme and other Aflatoun materials (www.dnb.nl).

4.8.2 *Technical assistance*

DNB provides technical assistance to fellow central banks and supervisors in the twelve constituent countries which are represented by the Netherlands in the IMF and the World Bank. This technical cooperation contributes to the strengthening of the financial stability and resilience of these countries (which are primarily in the former Yugoslavia, the former Eastern Bloc and the former Soviet Union). Although these countries are generally less exposed to the volatility of the global economy, they are still vulnerable and are therefore working to strengthen their financial and institutional development.
The technical cooperation has proved to be important for the cohesion of the constituency. In order to help reduce the number of seats on the IMF board that are occupied by developed European countries, the Netherlands and Belgium decided that they would share a seat. Henceforth, the Netherlands and Belgium will jointly represent a constituency consisting of the former Dutch constituency, Belgium and Luxembourg. The fact that the former Dutch

constituency has remained intact, i.e. that none of the countries have moved to a different constituency, is important in retaining the weight carried by the group in the IMF. This has been achieved largely thanks to the technical support provided by DNB to the central banks and supervisors of the constituent countries. The capacity devoted to technical assistance in 2012 amounted to 810 days, equivalent to four FTEs. A further 1.6 FTEs were devoted to coordination, control and support, taking the total to 5.6 FTEs.

5 Corporate Social Responsibility (CSR)

5.1 Introduction

In this chapter DNB wishes to inform its stakeholders about its role in society, and the social, ecological and economic progress it has made. Stakeholders are individuals and parties with whom DNB works or who attach importance to the work, role and influence of DNB as a public institution that plays an important role in society. The content of this chapter should be seen as 'work in progress', a basis for an exchange of views with stakeholders and for assessing whether it meets their need for information. DNB will use the outcome of this dialogue to supplement, tighten or adjust its CSR policy.

The material topics included in this chapter are documented on the basis of a (periodic) stakeholder dialogue. This is also reflected in DNB's reporting policy: where in 2010 a separate CSR annual report was published, and in 2011 a separate chapter was dedicated to CSR in the main annual report, CSR has been further integrated into this Annual Report. For example, the CSR topics related to DNB's core tasks are discussed in Chapter 4 of this report, while Chapter 5 reports on the environmental and social policy, sustainable procurement and social commitment. The 2012 CSR document on DNB's website explains the approach taken to CSR policy and reporting. It also includes a summary of all CSR themes, including targets and results (Appendix 1 of the 2012 DNB CSR document).

DNB applies the Sustainability Reporting Guidelines (version G3.0) published by the Global Reporting Initiative (GRI). The GRI table can be found in Appendix 2 of the 2012 DNB CSR document.

To ensure objectivity and independence, DNB instructed Deloitte Accountants BV to perform a review of its 2012 CSR report, as set out in this chapter and in the 'MVO DNB 2012' document. This also contains the unqualified report issued by Deloitte Accountants BV on its review of the 2012 CSR report.

5.2 Our staff

5.2.1 *Diversity of our workforce*

Diversity policy

In 2012 DNB continued to implement its target groups policy. As part of its new vision and strategy, the Governing Board announced in 2012 that it wished to create added value by capitalising on the diversity of DNB's workforce.

By signing the Talent to the Top Charter, DNB has set itself the target of having 32% of management positions filled by women. As this target had not yet been achieved, additional measures were initiated in 2012, including a target of 50% participation by women in the DNB traineeship programme and recruitment of women with management experience at other companies and institutions.

The 'UAF meets DNB' mentoring project, launched in 2010, was extended at the end of 2012. Nine DNB employees are each mentoring a refugee student from the Foundation for Refugee Students UAF to help them find their way around the Dutch jobs market and expand their networks. In the process, DNB employees learn to look at their own work environment from a different perspective.

Social safety

DNB regards social safety as a key condition for staff diversity. In 2012, the Personnel and Organisation (P&O) and Compliance and Integrity (C&I) departments organised an information session on social safety, which was attended by more than 25 managers. In order to document the various indicators in relation to social safety, a subsequent meeting was held with trade unions, the Employees Council, the company doctor, the internal confidential counsellor and C&I. In 2013, these partners will jointly formulate improvement proposals and ensure that they are implemented.

5.2.2 *Staff development and deployment*

The best people in all positions

As part of its strategy for the coming years, the Governing Board defined ten ambitions in 2012, including the ambition of taking on only the best people in all positions. This means that DNB must be capable of attracting and retaining highly talented people and making full use of their competences. It is also very important to create added value by capitalising on the diversity of staff. The best people can be retained for the organisation by giving them an interesting and challenging work environment, offering sufficient growth and development opportunities and promoting job rotation and training opportunities. In cases where we do not yet have 'the best people' filling certain positions, training courses, career counselling, job rotation and departure will be used to ensure that staff move on to the most suitable positions. In 2012, EUR 5.37 million (EUR 3,303 per FTE) was spent on training programmes.

Table 5.1 - Male/female breakdown

Year-end 2012, in percentages

Position	Target F 2012	Dec. 2009	Dec. 2010	Dec. 2011	Actual Dec. 2012
Governing Board	25	25	25	20	20
Division Director	25	25	33	33	31
Head of Department	30	15	22	23	25
Head of Section	40	43	41	40	37

Supervisory Academy and Basic Central Banking course

The Supervisory Academy, set up in 2009 to stimulate the development of all staff working in the supervisory divisions, expanded rapidly in 2012. This growth is necessary to continue facilitating the development of every member of staff. Three learning pathways are used: basic, advanced and updating of knowledge. In addition, the Supervisory Academy provides training programmes to help staff achieve DNB's strategic goals, including the change in conduct and culture already set in motion. The training courses are taught mainly by internal trainers, supplemented by a number of external trainers. There were 150 training activities in 2012.

Forty new employees working in or for the central banking divisions embarked on the first edition of the Basic Central Banker (BCB) training course in 2012. The purpose of the course is to enable participants to gain a thorough knowledge of the interaction between the central banking tasks and their relationship with supervision, and to understand how those tasks contribute to DNB's mission of financial stability. A group of lecturers from within DNB teaches the course. In 2012, the possibilities of setting up a DNB Academy, which would coordinate the various training programmes centrally, were also explored. This Academy will become operational in 2013.

Strategic personnel planning

DNB aims to recruit and retain motivated, high-quality staff and managers who together form the right team to achieve DNB's goals. This necessitates a continuous process of strategic personnel planning (SPP). With this in mind, the SPP project was launched in 2012. The project will culminate in an advisory report in early 2013 on the broader implementation of this HR instrument at DNB. The software used will enable DNB to access relevant information much more quickly and to present that information in a more accessible way. Personnel data can also be extrapolated for future situations. The system is expected to provide management with better support in achieving its objectives, as it enables a proactive focus on the availability of the right staff, who also stand to benefit from this. As managers can communicate clearly how they see the future and what this will require from their staff, they will be able to anticipate better on the future situation and develop in the required direction in time.

Traineeship programme

On 1 April 2012, seven trainees embarked on a traineeship programme developed by DNB. Over a period of two years, the trainees will work in different departments and receive support from a training and development programme. Given the large number of applications for the programme and the high quality of the candidates' CVs, it was decided that a new group of trainees should start on the programme as early as 2013. DNB will also cooperate with its fellow supervisor, the Netherlands Authority for the Financial Markets (AFM) on this project. This means that one trainee from the AFM will spend eight months working at DNB and vice versa.

5.2.3 *Working at DNB*

Employee satisfaction survey

As in other years, an employee satisfaction survey was conducted in 2012. The response rate was high, at 83.1%. The score for general satisfaction increased

to 7.6 from 7.5 in 2011, meaning that DNB scored above the Combined Business Market Benchmark score of 7.5. The scores on 'inspired at work' and 'committed to the organisation' were respectively at and above the benchmark. Inspired and committed employees contribute towards achievement of the organisation's ambitions. The results show that our employees are satisfied with their work, the conditions under which they perform their work, their immediate colleagues and their development opportunities at DNB. The main point for improvement remains efficiency. Although improvements are visible in a number of departments and divisions, this continues to be a focus area and the divisions have been asked to make improvements. In addition, employees who participate in DNB's new leadership development programme (VLOT) in 2013 will be asked to investigate why employees across the organisation do not consider DNB to be as efficient as it could be. This study should result in a number of proposals for improvement.

DNB employees and their health

All DNB employees, regardless of their age and position, are entitled to a periodic medical examination. In 2012, 898 employees went for the examination after being personally invited. Its purpose is to identify the threat of long-term absence due to a poor work-life balance. The employees concerned received a written report of the results. If necessary, recommendations were included concerning work or lifestyle. In 2013, DNB will further define its role in boosting staff vitality.

In the fourth quarter of 2012, the sickness absence rate rose to 3.21% from 2.43% in the third quarter, while the sickness absence rate at the large Dutch banks stood at 3.68% in the fourth quarter. This takes the sickness absence rate over 2012 as a whole to 2.88%, 0.29 percentage points higher than in 2011 (2.59%). The increase was due mainly to a rise in long-term absence, which stood at 1.52% compared with 1.23% in 2011. Long-term absence will be given extra attention in 2013.

Working conditions

DNB is committed to continuously improving its working conditions. In 2012, the globally accepted OHSAS 18001 standard was implemented in the Cash Operations department, where the physical workload is relatively high. OHSAS stands for Occupational Health and Safety Assessment. An external audit was carried out in December, which yielded a positive result. For 2013, formulating a safety policy for working with third parties is on the agenda. This will include the requirements and obligations both for the principal and the contractor in relation to the activities to be carried out. A policy for older employees will also be introduced, as the average age in the Cash Operations department is over 50. The policy will focus on reducing the physical workload and encouraging task rotation and employability. DNB also wishes to share knowledge about safe working in the cash chain with commercial banks, security transport companies and other central banks.

The New World of Work

The New World of Work incorporates the many ways in which DNB employees are now able to work independently of time and place. They can, for example, log on to DNB systems from other locations than the office. This aspect will be included in discussions on the future-proofing of DNB's terms of employment.

Owing to the diverging nature of DNB's activities, the different parts of the organisation can put their own interpretation on the New World of Work. For example, the ICT department has developed its particular view on revitalising the computer centre (ACS) where the department will be housed. Given the differences between the various parts of the organisation, no DNB-wide policy for the New World of Work will be developed.

New collective labour agreement

In early December 2012, DNB signed a new collective labour agreement with the unions. The agreement applies to all DNB employees and will run until 1 July 2013. Under the agreement, DNB will from now on track what is called the AFM basket for collective pay rises. The basket is made up as follows: 40% General Banking Collective Labour Agreement, 30% ING Collective Labour Agreement, 20% civil service Collective Labour Agreement and 10% audit firms. As part of the new collective labour agreement the current Social Plan will be extended until 1 January 2014.

DNB networks

Various active staff networks

Some examples of active staff networks include GayNB (DNB's 'pink' network), JongDNB (for employees up to 35) and Female Capital (DNB's women's network). The networks organise a wide variety of activities for both their members and all other DNB staff. In 2012, for example, DNB had its own boat in the annual Amsterdam Canal Parade for the fourth time, and on this occasion more than 70 employees took part. Among the events organised by JongDNB was a seminar on informal supervision planned together with two other supervisors (the Consumer and Market Authority and the AFM). The events organised by Female Capital included a well-attended lunch meeting on diversity dilemmas. Members of the Governing Board also contributed to the two latter events.

Recruitment

An external agency was asked to draw up a new labour market strategy. This strategy forms the basis of the new starters campaign, the social media campaign and the campaign to be developed for raising staffing levels in the supervisory divisions. Fifty-four new supervisory staff will be taken on for 2013.

5.2.4 *Cultural and behavioural change for staff and management*

Performance Management

By instruction of the Governing Board, the present performance management (PM) system was evaluated. It was then decided to adopt the new version of the system (PM2.0). Its starting point is the existing ambitions – i.e. to lead and motivate individuals to optimise the performance of the organisation as a whole – but by implementing the new PM, DNB is seeking to focus more on performance. To this end, the organisation will adopt a seven-point assessment scale, which replaces the existing five-point scale, and it will clarify the rules of the system. All employees will be governed by the new system from 2013 onwards.

Cultural change

The P&O department supports the management of the supervisory divisions in implementing the action plan for a cultural change in supervision. Among other things, masterclasses are being offered on change management and leadership during change. Several activities have also been developed for the focal points of the cultural change programme, being managing impact, making explicit choices and encouraging and improving cooperation between departments.

5.3 Compliance and integrity

The Compliance and Integrity (C&I) department developed a number of activities in 2012 to draw attention to compliance. An intranet blog was one way of raising awareness about integrity. In 2012, C&I focused mainly on managing the principal integrity risks within DNB, raising awareness of integrity and social safety, promoting continued progress on the development model and ensuring that DNB fulfils its role efficiently and effectively.

Table 5.2 - Key HR statistics

F/M inflow in 2012

Total	F	M	F in %	M in %
128	51	77	39.8%	60.2%

F/M outflow in 2012

Total	F	M	F in %	M in %
106	33	73	31.1%	68.9%

Secondment	44
to DNB from abroad	2
Average age DNB 2009	44.3
Average age DNB 2010	44.2
Average age DNB 2011	44.3
Average age DNB 2012	44.6
Average age on joining DNB	35
Average age on leaving DNB	46

Reasons for leaving in 2012

Own request	31
Termination of contract	32
End of temporary employment contract	25
Incapacity for work	0
(Early) retirement	15
Death	3
Total	**106**

Chart 5.1 - Male/female breakdown

Percentages

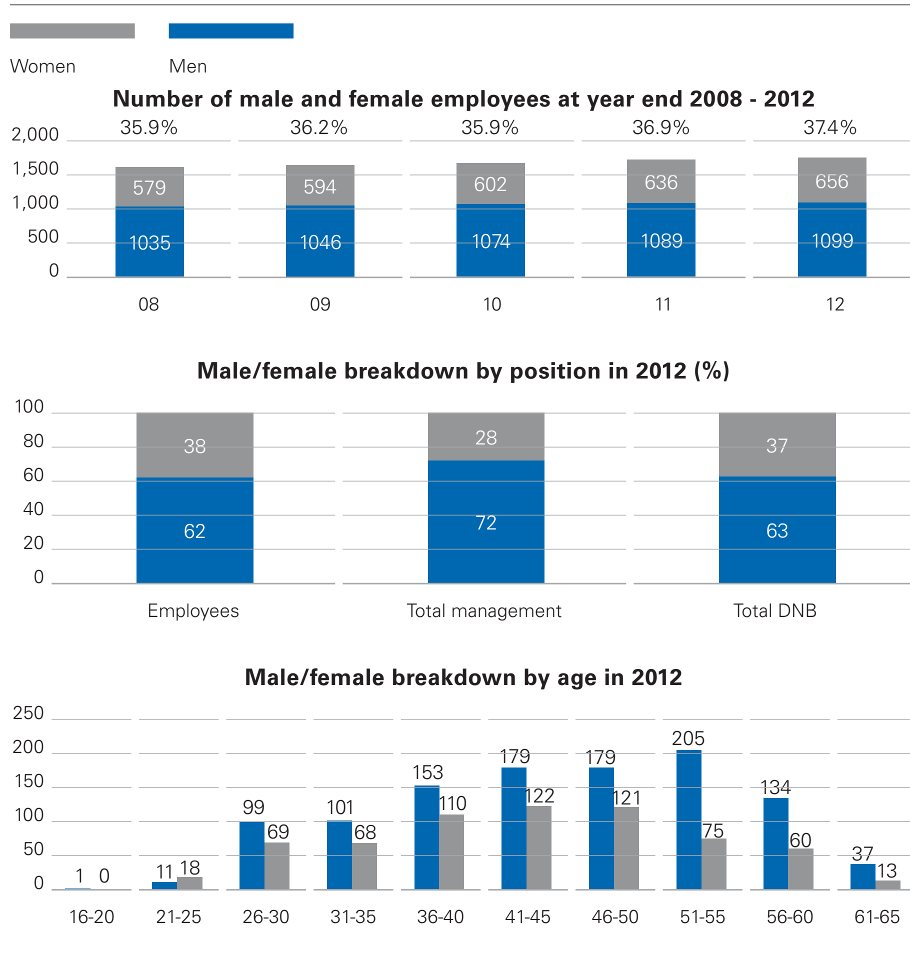
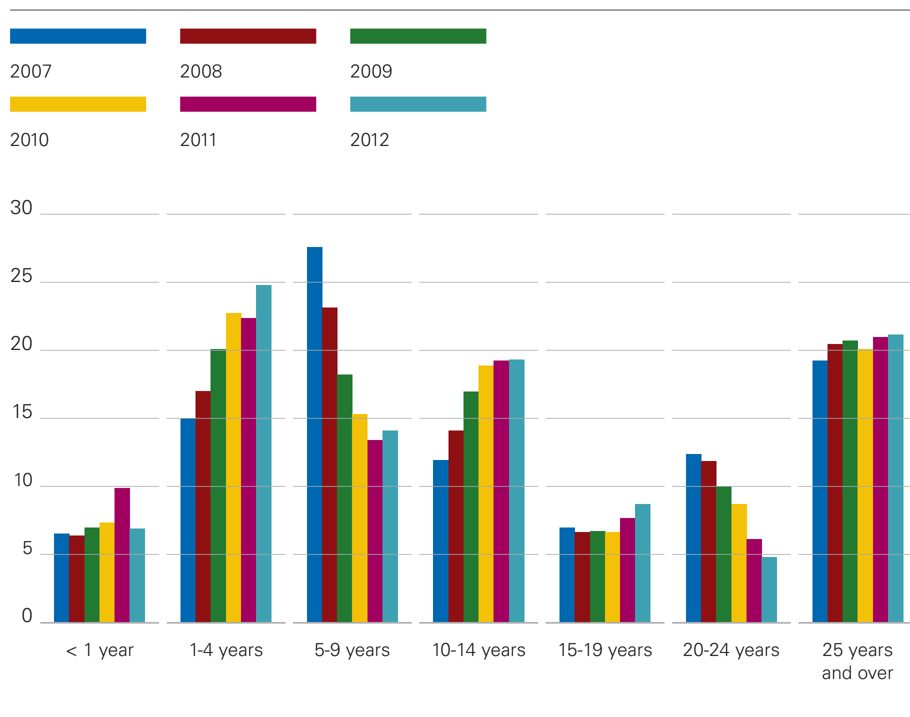


Chart 5.2 - Staff profile by years of service

Percentages



Continued management of principal integrity risks

In 2012 integrity risks were inventorised across DNB, especially in the departments that were identified in 2011 as being more vulnerable than average to these risks. The priority risks identified served as one of the starting points for the C&I annual plan and the DNB-wide risk inventory.

Raising awareness of integrity and social safety

Several activities were undertaken in 2012 to raise employee awareness of the importance of integrity and social safety. Nine workshops were held on integrity dilemmas for new employees and 13 departments held integrity workshops or department meetings devoted to this subject with support from C&I. A meeting on social safety was organised for managers, and a social safety platform was launched, in which several parties (trade unions, Employees Council, P&O, C&I and the company doctor) together went in search of an overall approach to promoting social safety.

DNB as a socially sound organisation

The Compliance & Integrity development model is an assessment tool that helps to clarify what managers within DNB specifically do, or can do, to promote a socially sound working culture and to limit integrity risks.

The discussions on the assessment results of this tool were completed in early 2012. A logo was developed to increase recognition. This makes it easier for managers to identify the topics where they may be able to make improvements. The C&I department also issues regular alerts that bring relevant integrity themes to the attention of managers in a short and punchy way. A follow-up measurement will be performed in 2013. Finally, the C&I page on the intranet was modified to enable managers to find specific information quickly.

Effective and efficient implementation of basic operational tasks; compliance with integrity rules

Employees submit reports, requests for advice and incident reports electronically, which C&I then also handles using a computerised system. Table 5.3 shows the notifications received, assessed and dealt with.

All notifications were assessed to determine whether the activities, interests and gifts concerned met the criteria set out in the rules. In seven of the 106 cases notified, dispensation was not granted for a subsidiary activity (2011: five out of 99). In these cases it was judged that the activity in question would conflict with the position of the employee concerned. In seven cases (18 in 2011) in which an employee intended to accept a position outside DNB, it was decided that a cooling-off period should be applied in accordance with the prevailing rules, in order to eliminate any semblance of conflicts of interest. There were also 11 cases of conflicts of interest or potential conflicts of interest (11 in 2011), in which special arrangements were made. Finally, in 13 of the 102 cases reported, it was decided that a gift or invitation should not be accepted (20 out of 102 in 2011).

Integrity incidents

An integrity incident or suspected integrity incident occurs when there is a risk that DNB's integrity or reputation or that of its employees could be compromised by an infringement of internal or external laws or regulations.

Table 5.3 – Notifications under integrity rules

Notifications	2012	2011
Independence	235	220
Private investment transactions	462	546
Internal complaints	1	0
Third-party complaints	1	0
Integrity incidents, total	35	55
of which		
– Careless handling of information	18	30
– Infringement of private portfolio investment transaction rules	3	0
– Employee in high-risk position in financial difficulties	3	2
– Inappropriate behaviour	1	4
– Other	10	19
Questions from employees	580	663

Most incidents in 2012 related to careless handling of information (see Table 5.3). All incidents were investigated. In 32 of the 35 cases it was established that an irregularity had indeed occurred. A special investigation or preliminary investigation is launched for incidents where an employee's reliability is being questioned. Three such investigations were initiated in 2012, two of them in connection with the disposal of small business assets and one in connection with inappropriate behaviour. No infringement of integrity was established in the latter case.

5.4 Sustainable business operations

5.4.1 *Environmental care*

Environmental policy

Since 2009, DNB's environmental policy has been aimed at reducing CO_2 emissions by 50% compared with the baseline year 2007. DNB is also committed to 100% sustainable procurement in accordance with the environmental criteria set by the Dutch government (NL Agency). The environmental policy was established for the 2009-2013 period.

Environmental care

DNB is ISO 14001-certified for the three departments most concerned with environmental care. This certification demonstrates that DNB has professionally embedded concern for the environment in its business operations. The key tenets of environmental care at DNB are compliance with legislation and regulations, control of environmental risks and a commitment to permanently improving the organisation's environmental performance. Numerous initiatives were undertaken in 2012 to meet these goals.

Energy consumption

DNB uses electricity, natural gas and heating oil to heat its buildings. The energy management system monitors the electricity and gas consumption on a monthly basis. DNB tests its buildings during maintenance, renovation and modifications to see whether improvements could contribute towards reducing CO_2 emissions.

Several measures were taken in 2012 to reduce energy consumption, such as optimising the settings on various items of equipment, as well as on the lighting and climate control systems.

Reducing CO_2 emissions

DNB is seeking to reduce its CO_2 emissions by 50% in 2013 compared with the baseline year 2007. During the reporting period, DNB compensated for approximately 84% of the CO_2 emissions (some 72% in 2011) from its total energy use (purchased electricity and fuel) through the purchase of carbon credits. This equates around 58% of the total reported CO_2 emissions (energy consumption, commuting, business travel, goods and passenger transport) in 2012 (approximately 51% in 2011). Compared with the baseline year 2007 (14,143 tonnes) CO_2 emissions were reduced by about 62% in 2012 (52% in 2011).

5.4.2 *Green mobility*

In April 2012, Athlon Car Lease (ACL) was selected as the new lease company for DNB's vehicle fleet (approximately 170 vehicles at the time). It was agreed that in addition to meeting the NL Agency sustainability criteria, ACL would offer scope and support for making DNB's lease policy greener. This tender can therefore be regarded as a 100% sustainable procurement.

Table 5.4 - Measurement data

CO_2 emissions	2012 [1] (in tonnes)	Adjusted 2011 [2]
Energy	8,972	9,809
- Purchased electricity	6,536	6,858
- Natural gas for heating	2,373	2,765
- Heating oil	63	186
Commuting		
- Public transport	806	813
- Car	1,263	1,266
Business travel	1,728	1,906
– Car	386	400
– Flights	1,342	1,506
Goods and passenger transport	88	83
Total CO_2	**12,857**	**13,877**
Compensation through purchase of carbon credits	7,494	7,106
Total CO_2 emissions	**5,363**	**6,771**
Number of FTES	1,625	1,589
CO_2 per FTE	**3.3**	**4,3**

1 The 2012 reporting period runs from 1 October 2011 to 30 September 2012 inclusive.

2 The 2011 reporting period runs from 1 October 2010 to 30 September 2011 inclusive.

In the second half of 2012, DNB's lease policy was evaluated to assess whether it is still appropriate and to see which improvements might be made. With regard to green mobility, it was decided to anchor sustainability in DNB's lease policy more solidly, using market-based and practical measures as well as communication. The most notable measure taken is the restriction in the choice of vehicles to a maximum CO_2 emission level in each vehicle category. This will contribute to DNB's overall environmental objective of reducing CO_2 emissions. The other measures taken focus on communication on vehicle use per lease vehicle driver and facilities such as charging points for electric cars on the DNB site. Staff can also take part in the eco-driving course or make use of the NS business railcard. An additional measure involves the replacement of the travel budget scheme with a first-class public transport card (including the high-speed line) as an alternative to a lease car.

The above measures will be implemented in January 2013, while a study of a new lease policy based on a remuneration benchmark (on market terms) will also be carried out in the first half of 2013.

5.4.3 *Green ICT*

DNB's ICT policy is aimed at the sustainable supply of ICT services to the organisation, from procurement up to and including the disposal of ICT

Table 5.5 - Measurement data

	Unit	2012 [1]	2011 [2]	CO_2 parameter
Energy				
Purchased electricity	kWh	14,365,114	15,071,678	0.455 kg CO_2/kWh
Natural gas	m³	1,300,077	1,515,231	1.825 kg CO_2/m³ gas
Heating oil [3]	litre	20,007	59,389	3.135 kg CO_2/litres diesel
Commuting				
Public transport	Km	12,405,626	12,510,638	0.0650 kg CO_2/km
Car	Km	6,014,255	6,026,456	0.210 kg CO_2/km
Business travel				
Car	Km	494,014	527,128	0.210 kg CO_2/km
Car (lease)	in litres petrol	101,509	103,962	2.78 kg CO_2/litre
Flights (regional) (< 700 km)	Km	1,217,841	1,044,890	0.270 kg CO_2/ passenger km
Flights (Europe) (< 2500 km)	Km	1,744,580	1,978,224	0.200 kg CO_2/ passenger km
Flights (world) (>2500 km)	Km	4,944,932	6,163,514	0.135 kg CO_2/ passenger km
Goods and passenger transport	litres diesel	27,959	26,364	3.14 kg CO_2/litre

1 The 2012 reporting period runs from 1 October 2011 to 30 September 2012 inclusive.

2 The 2011 reporting period runs from 1 October 2010 to 30 September 2011 inclusive.

3 Based on the number of litres of diesel delivered.

resources. Written-off equipment is given a new lease of life via the Close the Gap foundation. When new ICT resources are purchased, the environmental policies of both DNB and the Dutch government are followed. Sustainability is on the agenda for all DNB ICT projects. Hardware energy consumption was one of the criteria included in the tendering procedure for the storage environment, a large-scale project planned for 2013.

When a part of the servers in the computer centre were renewed in 2012, low-energy replacements were chosen. This is estimated to reduce energy consumption by 50%. An application was also implemented for more flexible allocation of disk space and memory. This enables more efficient use of ICT resources and reduces the amount of useless and unused capacity.

5.4.4 *Sustainable procurement*

One of the objectives in DNB's procurement policy was 100% sustainable procurement in 2012. To this end, DNB used the environmental criteria as formulated by the Dutch government (NL Agency) as far as possible.

The NL Agency sustainability criteria were applied in eight of the 21 European tender procedures carried out and completed in the year under review.
For the remaining 13 tenders, NL Agency had not or not yet formulated criteria at the time of the tender. Consideration was also given to whether additional sustainability aspects could be incorporated in all European tenders.
To determine which additional themes might be relevant for the product groups and services concerned, DNB uses a previously developed method for analysing sustainability aspects. Based on this method, further requirements were added to two tender projects, being the renovation of the computer centre and interior planting (see below). In addition, the DNB code of conduct and integrity rules – focusing among other things on preventing conflicts of interest and bribery – apply to everyone (not just DNB's own staff, but also insourced workers and external advisors).

DNB defined its level of ambition for sustainable procurement in the year under review. DNB wants to apply the NL Agency's social criteria as well as its environmental criteria where possible. In 2013, DNB will put this ambition into practice by ensuring that the available social criteria developed by NL Agency are consulted as a matter of course and applied where possible. The sections of the tender documents dealing with CSR will be adapted accordingly.
The opportunities for socially responsible procurement, including chain management, are also being examined more closely within the context of the legislation and regulations applicable for tenders.

DNB's suppliers and their suppliers and subcontractors are required to adhere to the NL Agency criteria specified in the tender. If suppliers or subcontractors do not (or no longer) meet these requirements, DNB talks to them in order to ensure that they meet the requirements. If necessary, DNB will consider the legal options for enforcing compliance. One of the objectives of DNB's procurement policy is that when awarding assignments, products and services with a lower environmental impact are chosen as far as possible. The degree of sustainability of suppliers and subcontractors themselves, for example in relation to energy-efficiency and CO_2 emissions, is difficult for DNB to control and therefore falls outside the scope of this annual report unless stated otherwise.

DNB routinely monitors and measures the application of the NL Agency social and environmental criteria. In addition, the organisation talks to suppliers and challenges them to produce proposals for making their services more sustainable. DNB of course also adheres to the government policy on sustainability and corporate social responsibility, and monitors market trends in this area.

Computer centre renovation

DNB started renovating its computer centre (ACS) building in early 2012. Sustainability ambitions were formulated for the project, which were set as requirements in the European tender procedure for the selection of the parties to be involved in the design process, i.e. the building architect and the installation contracting consultants. DNB aims to construct a CO_2-neutral building that meets the energy label A+ requirements. To this end, underground heat and cold storage systems will be used. The use of climate ceilings will contribute towards a comfortable working environment for staff. The contract was awarded to the Inbo/Deerns consortium at the end of 2012. The consortium later produced a transparent outline design for an outer building shell carrying the A+-label

Interior planting awarded to work reintegration company

The interior planting contract signed in 2012 is the first project that specifically meets the need to incorporate social aspects in addition to environmental criteria. The tender procedure included a requirement for 'social return', meaning that subscribers were required to allocate 5% of the contract value to the deployment of people with a distance to the labour market. As a result, the contract was awarded to a reintegration company specialising in interior planting and floristry. The company supports people in finding and retaining work by developing and increasing their fitness for employment. They are trained and supported by experienced professionals, so that they are able to meet the quality requirements set in the tender.

Banknotes made with sustainable cotton

Although NL Agency has not formulated environmental criteria for banknotes, DNB nonetheless seeks to meet the need for more sustainable banknotes by using sustainably produced cotton.

In 2012, DNB celebrated five years of using sustainably farmed cotton in the production of banknotes. An example of sustainable cotton is fair trade cotton. The fair trade system guarantees that cotton farmers receive a fair price and sets conditions for issues such as human rights (no child labour) and environmental aspects (no use of pesticides). The Fairtrade Labelling Organization carries out local inspections to verify that these conditions are being observed. Starting from the 2012 reporting year, DNB also offers suppliers the option of using a proportion of organically farmed cotton in addition to fair trade cotton.

DNB's supplier produced 866 million banknotes in 2012. The paper used contained 5% fair trade cotton and 25% organically grown cotton, meaning that a total of 30% of the cotton used was sustainably produced.

By analogy with the use of fair trade cotton in the clothing industry, DNB agreed to pay a bonus for increasing the availability of fair trade cotton for banknotes. The Solidaridad Network was again involved in allocating this bonus in 2012.

The money went to the ProCotton project, an initiative of the Rabobank Foundation and Solidaridad aimed at having small-scale farming organisations in developing countries participate in sustainable textile chains thereby increasing the supply of all kinds of sustainable cotton. Examples in 2012 include training and recruitment of new partners in Zambia. The services provided by the Cotton Association of Zambia reached more than 12,000 cotton farmers in three Zambian districts in 2012. The services included providing teaching materials, books, training programmes and organising field days to give information on improved farming practices.

5.4.5 *The best use and re-use of materials*

Where possible, DNB ensures the best use and re-use of materials and raw materials. The durability of the new five euro notes, one of the denominations most susceptible to wear, was for instance improved with the application of a protective layer, which increases their expected life cycle.

In addition, rejected money containers are recycled into pellets. The seals used to secure them are ground down and separated into their constituent materials for re-use. In 2012, 375 rejected money containers were crushed into pellets. No seals were recycled, but seals are always collected separately and when their number is sufficiently large, they are transported to the waste recycling company.

Coins will be swapped with Finland in 2013. Finland has agreed to supply 24.1 million 5 eurocent coins to the Netherlands in exchange for 1.3 million Dutch two euro coins and 1.9 million one euro coins. The exchange saves costs and benefits the environment as it saves 106,000 kg of metal, which would otherwise have been needed to strike new coins.

5.5 Social commitment

5.5.1 *Donations*

DNB regularly receives requests for financial contributions from organisations. An amount of EUR 1.6 million was reserved for this purpose in 2012, the same as in 2011. Most of the donations go to organisations that DNB helped set up, such as the Duisenberg School of Finance, the Money Museum and the Money Wise Platform, an organisation created in 2012 from a partnership of more than 40 institutions. Consumers can go to the Platform's website for reliable information to help them take important financial decisions. DNB is one of the four institutions sponsoring the project. The remaining donation funds go to civil society organisations, often in the form of commitments spanning several years. Applications must be connected with a community project or with DNB's tasks. Among the recipients of DNB donations in 2012 were the Dutch literacy foundation, the Alpe d'HuZes foundation for cancer research and the SIRE public service advertising organisation. Small donations were also made to Child's Destiny of Hope, the International Foundation for Alzheimer's Research (ISAO) and the Droomboom foundation for autistic children through members of staff who sit on the boards of these foundations.

In addition, every six weeks DNB organises a new art exhibition in its head office. DNB's aim here is to offer a stage to talented young artists. Each year, DNB also purchases new works. In 2012 it acquired 19 new works (25 in 2011), among which 'Silence is golden' but this is no silence by Sarah van Sonsbeeck, which last year won the public award in the Volkskrant Visual Arts Prize

competition. The majority of DNB's art collection of around 1,200 works is displayed in employees' office rooms. In addition to providing a stylish way of decorating the building, they also serve as a source of inspiration and make for a more a pleasant working environment.

5.5.2 *Building Together*

Under the heading 'Building Together' (Samen Bouwen), DNB employees can take part in organised volunteer work projects. DNB offers free assistance in the form of manpower. Some 250 DNB employees took part in a total of 20 voluntary work projects in 2012, a slight increase compared with the previous year.

Volunteer work under the Building Together initiative breaks down into three categories:

- activities involving patients in health care institutions, such as sea fishing, sports days for people with multiple disabilities, games days and barbecues for children in children's homes and football matches with disabled teams;
- activity projects, whereby DNB employees do odd jobs such as gardening or painting;
- knowledge transfer, for example job application training courses and coaching programmes for students.

A new three-day work experience project for five students from the Reigersbos school community in Amsterdam-Zuidoost was started up in 2012. DNB employees also helped the management secretaries of Heliomare, a convalescence and rehabilitation centre, organise the Heliolympics sports event in the Ronald McDonald Centre in Amsterdam. For the second successive year, DNB also partnered with JINC in providing hints and tips to pre-vocational secondary pupils from various schools and helping them to make the right choices for their further education.

The aim of Building Together is to offer staff a varied range of between 15 to 20 projects every year. 'Varied' means DIY, helping those in need or knowledge transfer projects. In time, Building Together will seek to further increase variety and innovation in its projects and to organise them on a departmental basis.

6 Report of the Supervisory Board

6.1 Introduction

The year 2012 was another year of movement and trust-building. The European debt crisis continued unabated while the economic climate deteriorated further, both in the Netherlands and beyond. Partly in light of DNB's position as central bank within the ESCB and as prudential supervisor, these exceptional circumstances were a recurring topic of discussion at the meetings of the Supervisory Board in the presence of the Governing Board. These external developments are reviewed in greater detail elsewhere in this annual report. Obviously, they also had significant internal consequences. In view of the heightened financial risks and protracted uncertainty, particularly in relation to losses that DNB may sustain as a consequence of the ESCB operations, the Supervisory Board considered it prudent to refrain, as in the preceding year, from an interim dividend for 2012. At the time of adoption of the financial statements, the above-mentioned financial risks had not yet led to actual losses, so that the net profit for 2012 came to EUR 2,079 million. With a view to the substantially increased risks, the Dutch state issued a guarantee for DNB's crisis-related exposure. The guarantee will end when risks have returned to normal levels. The profit distribution to the Dutch State amounted to EUR 1,975 million.

In the year under review, the process of cultural change that is aimed at further improving the effectiveness of our supervision continued apace. The adjustment to the governance structure initiated in 2011 was implemented. On 16 February 2012 a Prudential Supervision Council for Financial Institutions was formed from among the members of the Governing Board and it is headed by a Chairman for Prudential Supervision, who acts as the first point of contact for supervision issues. This Council, which is primarily responsible for supervisory duties, gives prudential supervision a more prominent position while simultaneously maintaining the crucial connection with DNB's central bank tasks. At the start of the year under review, the Supervisory Board was involved in the further elaboration of this model. The preparations for the Supervisory Board's tasks relating to the implementation of the new governance model were performed by a Governance Working Group comprised of members of the Supervisory Board. Among other things, the adjusted governance model resulted in amendments to DNB's Articles of Association and Rules of Procedure. The amended Articles of Association and Rules of Procedure are posted on the DNB website. In connection with the new governance model, the Governance Working Group and the Supervisory Board discussed the envisaged expansion of its own tasks. Whereas, in conformity with its statutory mandate, the Board's role formerly focused mainly on supervising management and operations at DNB, this mandate was expanded in February 2012 to include supervision of the

Governing Board's policy in relation to the implementation of DNB's national tasks. This concerns such matters as the policy aspects (and associated safeguards) of the prudential supervision conducted by DNB. The expansion of the Board's supervisory role not only places demands on its composition and profile, but also on the way it operates. By setting up a Supervision Committee from among its members, alongside the existing Audit Committee and the Remuneration and Appointments Committee, the Supervisory Board can effectively mobilise its expertise for the performance of this new task.

6.2 Composition, appointments

There were no changes to the composition of the Governing Board in 2012. No appointments or reappointments occurred in the year under review, so that the Board's male/female mix remained unchanged. However, the Supervisory Board did experience a substantial number of changes. In view of its collective nature and, hence, the desired profile of new members joining the Board, the Supervisory Board could not further balance its male/female mix through the nominations for appointments.

The Supervisory Board underwent the following changes in the year under review. Gerard Kleisterlee resigned at his own request on 1 February 2012. The government-appointed member of the Supervisory Board, André de Jong, left the Board on 1 April 2012 following his appointment as Director-General at the Ministry of Education, Culture and Science. He was succeeded by Wim Kuijken with effect from the same date. Mr Kuijken also joined DNB's Bank Council. On 1 July 2012, the Board bade farewell to Fokko van Duyne, who had been a member since 2000 and Chairman since 2004. He was succeeded as Chairman by Alexander Rinnooy Kan who joined the Board with effect from that same date. Ewald Kist left the Board on 1 September 2012 having been a member since 2004 and Vice-Chairman from 2007. The Board appointed Annemiek Fentener van Vlissingen as Vice-Chairman. With effect from 1 September 2012, Feike Sijbesma joined the Board, followed by Kees Goudswaard on 1 October. Wouter Tuinenburg departed from the Board on 1 November 2012. On that same date Bert van Delden was reappointed for a third and final term. He also continued his membership of DNB's Bank Council. Bert van Delden was a member of the Board during the entire year, as were Annemiek Fentener van Vlissingen, Hélène Vletter-van Dort and Jaap van Manen.

At the time of the adoption of the financial statements for 2012, the Supervisory Board consisted of eight members. In conformity with Article 13 (1) of the Banking Act 1998, the Board numbers a minimum of seven and a maximum of ten members. The Board is currently considering possible candidates to fill the vacancies, taking account of the adopted profile which includes a balanced composition of the Board. The full composition of the Supervisory Board, its committees and the Governing Board at the time of adoption of the 2012 financial statements is provided on page 5 of this annual report. The profiles of the Supervisory Board and Governing Board members are posted on the DNB website.

The Supervisory Board is extremely grateful to its resigning members for their valuable contributions over many years. They have unquestionably contributed to the functioning of DNB and the fulfilment of its pivotal role within the national and international social order. More particularly, the Supervisory Board would like to take this opportunity to thank Fokko van Duyne for the tremendous commitment, effort and expertise that he brought to his role as Chairman of the Supervisory Board over the past eight years.

6.3 Activities

During the year under review, the Supervisory Board held nine plenary meetings in the presence of the Governing Board. On average, the attendance rate of the Supervisory Board members at these meetings was 85%. None of the members was regularly absent. In addition, there was also frequent contact between the Chairman and the President on issues concerning the Supervisory Board's work. The meeting frequency and activities of the Board's committees are briefly described later in this chapter.

The financial results for 2012 were discussed by the Audit Committee and in the plenary Supervisory Board meetings. These discussions were based on the periodic financial reports, quarterly reports of the monetary operations and investments, the Management Letters from the external auditor and the internal audit department (IAD) as well as the quarterly reports by the IAD.
One recurring issue for the Board was the development of the financial risks on the balance sheet as a result of the unfolding of the debt crisis in the year under review. The Supervisory Board established that the net profit increased by EUR 866 million in 2012 (to EUR 2,079 million from EUR 1,213 million in 2011). This was partly attributable to a one-off income item of EUR 243 million due to the release of the entire amount of guilder bank notes that had not been presented for exchange on 31 December 2012. No gold sales took place in 2012.

The Board discussed the 2012 financial statements in detail with the Governing Board, in the presence of the external auditor. The opinion of the external auditor and the IAD's analyses were taken into account in these discussions. Pursuant to Article 19(6) of the Articles of Association, the Board subsequently adopted the financial statements and offered them for approval to the General Meeting of Shareholders. On 13 March 2013, the latter adopted the financial statements, discharged the Governing Board of responsibility in respect of their management and the Supervisory Board in respect of their supervision.

With regard to the internal operations, the Supervisory Board noted that in 2012, the Governing Board and management again devoted considerable attention to the processes of change within supervision. These changes have created safeguards for more intensive and conclusive supervision. As with all processes of change, this is a long-term operation lasting several years.
It poses major challenges for the Governing Board and the employees of DNB. The Supervisory Board established that the Governing Board addressed these challenges with great energy and vigour. For this and other reasons, the Supervisory Board looks forward with great confidence to its further cooperation with the Governing Board. The budget for 2013 was discussed and approved by the Supervisory Board on 23 November 2012. Part of that budget relates to the foreseen expansion of the supervisory capacity in order to enable the implemenation of the recalibrated approach to supervision. The Supervisory Board spoke regularly about this in its meetings, while also reflecting on the need to find the right balance between cost awareness and possible savings, on the one hand, and the importance of capacity expansion on the other.

The Supervisory Board also devoted attention to a variety of other subjects, including DNB's mission and strategy as recalibrated by the Governing Board; its vision for the future of the financial sector (partly in the light of the creation of a banking union); DNB's efforts in connection with the debt crisis and the migration to a Single European Payment Area. Regarding the general conduct of business, the Supervisory Board approved changes to the regulations on private investment transactions, conflicts of interest and incompatible positions;

reflected on the elaboration of the long-term budgetary arrangements with the Ministry of Finance and, finally, adopted several policy frameworks for the Governing Board, including the related benefits and expenses policy.

On 1 January 2012, Deloitte Accountants BV was appointed as DNB's new external auditor. The Supervisory Board established that the most important internal business and operational control instruments, such as the planning and control cycles and the risk mangement and control system, had operated effectively. No points for attention were raised here.

In 2012, the Supervisory Board again assessed its own performance, based on the completion of a questionnaire and the Chairman's interviews with the individual members, after which the outcomes were discussed at a plenary meeting without the presence of the Governing Board. At that meeting, the Supervisory Board also assessed the performance of the Governing Board. In 2012, various adjustments were made to the information flows for the Supervisory Board in order to further improve their efficiency. Now, in advance of each meeting, the Supervisory Board receives an update containing information about issues touching on DNB's core tasks. In 2012, attention was again devoted to the manner in which the Supervisory Board carried out its supervisory role in the new governance model. This was prepared by the aforementioned Governance Working Group consisting of Fokko van Duyne, Jaap van Manen, Hélène Vletter-van Dort and Bert van Delden. In connection with the expansion of the supervisory task, the permanent learning programme was largely devoted to this subject. In addition, the programme devoted attention to DNB's other tasks which the Supervisory Board, due to external developments or changes in the governance, discussed with some frequency in its meetings in the year under review. Finally, the new members of the Supervisory Board attended an orientation programme.

In conformity with Article 24 of the Works Councils Act (*Wet op de ondernemings-raden*), members of the Supervisory Board twice attended Consultation Meetings between the management and the Employees Council. In the year under review, one meeting also took place between the plenary Supervisory Board and the Employees Council in the presence of the Governing Board. The Supervisory Board believes that these consultation meetings are particularly valuable in allowing it to stay in touch with the different parts of the organisation and gather useful insights for performing its duties.

6.4 Audit Committee

In the year under review, the Audit Committee consisted of Ewald Kist (member and Chairman until 1 September 2012), Wouter Tuinenburg (member until 1 November 2012), Jaap van Manen (member from 1 March 2012 and Chairman from 1 September 2012), Wim Kuijken (member from 1 September 2012) and Kees Goudswaard (member from 1 December 2012). There are no vacancies.

The Audit Committee met four times during the year. All members attended all meetings. The meetings took place in the presence of the responsible member of the Governing Board, Frank Elderson, as well as the external auditor, the Director of Finance & ICT, the Director of the Financial Markets Division, the Head of the Internal Audit Department, the deputy Company Secretary and a number of internal officials from the relevant policy areas.

The Audit Committee discussed the financial statements at length, including the relevant reports of the IAD and the findings of the external auditor. Extensive attention was devoted to the balance sheet risk exposure in connection with the European debt crisis. The committee advised the Supervisory Board to adopt the financial statements as well as to approve the Independent Public Body Report for 2012. Based on the discussion of the draft budget for 2013 and the resulting definitive budget, the Audit Committee concluded that the budget is clear and responsible. It therefore advised the Board to approve the 2013 (Independent Public Body) Budget.

In 2012, the Audit Committee, as customary, paid considerable attention to the report and the Management Letters of the external auditor and the IAD, the financial reports, the quarterly reports of the IAD, the quarterly reports of the monetary operations and investments from the Financial Markets Division and the quarterly reports from the Compliance and Integrity Department. In addition, attention was devoted to the realignment of risk mangement responisbilities within DNB. It was established that the Governing Board gave sufficient attention to the findings and recommendations set out in the Management Letters.

6.5 Remuneration and Appointments Committee

In the year under review, the Remuneration and Appointments Committee consisted of Fokko van Duyne (member and Chairman until 1 July 2012), Annemiek Fentener van Vlissingen (member during the whole of 2012 and Chairman from 1 July 2012), Gerard Kleisterlee (member until 1 February 2012), Alexander Rinnooy Kan (member from 1 July 2012) and Feike Sijbesma (member from 1 September 2012). There are no vacancies.

The Remuneration and Appointments Committee met ten times in 2012. All members attended all meetings, which took place in the presence of the President, the responsible member of the Governing Board, Frank Elderson, and the company secretary.

The regular and the extra meetings of the Remuneration and Appointments Committee devoted a great deal of attention to the selection of, and the selection process for new Supervisory Board members, including the new Chairman. The adopted profile, and the individual job profiles based on that profile, served as the key guideline in this respect. The plenary Supervisory Board discussed the outcomes of this process in various stages. This led to several new appointments in 2012 (see section 6.2). Further to the discussion of these new appointments, the Remuneration and Appointments Committee spoke with the President about his performance and that of the other Governing Board members.

6.6 Supervision Committee

Partly in the light of the expanded tasks of the Supervisory Board, a Supervision Committee was set up with effect from 1 March 2012. This Supervision Committee is responsible for the preparation of the Supervisory Board's activities in the field of supervisory policy. The Supervision Committee met for the first time on 25 May 2012. In the year under review, the composition of the Supervision Committee was as follows: Hélène Vletter-Van Dort (member and Chairman from 1 March 2012), Bert van Delden (member from 1 March 2012) and Kees Goudswaard (member from 1 December 2012). The members attended all meetings of the

Supervision Committee. Alexander Rinnooy Kan has been an observer member since 1 July 2012. There are no vacancies. In principle, the Supervision Committee, like the Audit Committee, meets four times a year. It met three times in its inauguration year 2012. The meetings took place in the presence of the responsible members of the Governing Board, Jan Sijbrand and Joanne Kellermann, the company secretary and the secretary of the Prudential Supervision Council for Financial Institutions, as well as a number of internal officers of the supervision divisions. The first meetings focused on a combination of practical cases, current policy issues, the divisional plans of the supervision divisions and a further clarification of DNB's renewed supervisory approach. In addition, the Supervision Committee, like the Audit Committee, advised the Supervisory Board to approve the Independent Public Body Budget for 2013.

6.7 Joint Meeting

The Joint Meeting of the Governing and Supervisory Boards was a separate corporate body within DNB which, on the Governing Board's initiative and with due regard for both the ESCB Statute and the applicable confidentiality provisions, discussed matters pertaining to the ESCB, supervision and payments. The Joint Meeting also fulfilled a number of duties relating to company law, including drafting nominations for Governing Board members to be appointed by the Crown. However, due to the introduction in 2012 of the new governance model, the Joint Meeting has now been discontinued. The 848th and last Joint Meeting (and also the only meeting in 2012) was held on 17 January 2012. The abovementioned tasks have been taken over by the Supervisory Board.

6.8 Declaration of Independence

The Regulation on Incompatible Positions and the Regulation on Conflicts of Interests apply to Supervisory Board members without restriction. Supervisory Board members are not and have never been employed by DNB, nor do they have any relationship with DNB from which they could obtain any personal gain. Supervisory Board members receive a fixed annual fee that is not related to the DNB's results in any given year. All Supervisory Board members are independent within the meaning of the Dutch Corporate Governance Code.

The year 2012 was another eventful year in which DNB was confronted with an undiminished flow of challenging developments, both as a central bank within the ESCB and as a prudential supervisor, while also continuing to press ahead with the initiated change of culture. The Supervisory Board would like to express once again its appreciation for the efforts that the Governing Board and employees made towards the fulfilment of DNB's tasks and objectives in 2012.

Amsterdam, 13 March 2013

The Supervisory Board of
De Nederlandsche Bank NV

Alexander Rinnooy Kan, Chairman
Bert van Delden, Secretary

Financial statements

Balance sheet as at 31 December 2012 (after allocation of profit)

EUR million

		31 December 2012	31 December 2011
	Assets		
1	Gold and gold receivables	24,834	23,961
2	Claims on non-euro area residents denominated in foreign currency	16,414	15,973
2.1	Receivables from the International Monetary Fund (IMF)	8,867	8,948
2.2	Balances held with banks and investments in securities, external loans and other external assets	7,547	7,025
3	Claims on euro area residents denominated in foreign currency	152	364
4	Claims on non-euro area residents denominated in euro	185	126
5	Lending to euro area credit institutions related to monetary policy operations, denominated in euro	24,511	3,380
5.1	Main refinancing operations	32	190
5.2	Longer-term refinancing operations	24,479	3,190
5.3	Fine-tuning reverse operations	0	0
5.4	Structural reverse operations	0	0
5.5	Marginal lending facility	0	0
5.6	Credits related to margin calls	0	0
6	Other claims on euro area credit institutions denominated in euro	0	4,628
7	Securities of euro area residents denominated in euro	26,563	28,050
7.1	Securities held for monetary policy purposes	14,778	14,826
7.2	Other securities	11,785	13,224
8	Intra-Eurosystem claims	153,195	182,458
8.1	Participating interests in the ECB	469	402
8.2	Claims equivalent to the transfer of foreign reserves to the ECB	2,297	2,297
8.3	Claims related to the issuance of ECB debt certificates	0	0
8.4	Other intra-Eurosystem claims (net)	119,860	152,480
8.5	Net claims related to the allocation of euro banknotes within the Eurosystem	30,569	27,278
9	Other assets	8,538	7,637
9.1	Euro area coins	7	11
9.2	Tangible and intangible fixed assets	250	244
9.3	Other financial assets	6,968	6,924
9.4	Accruals and prepaid expenses	1,299	441
9.5	Sundry	14	17
	Total assets	**254,392**	**266,577**

Amsterdam, 13 March 2013

The Governing Board of De Nederlandsche Bank NV

K.H.W. (Klaas) Knot, *President*

A.J. (Joanne) Kellermann

J. (Jan) Sijbrand

F. (Frank) Elderson

J. (Job) Swank

		31 December 2012	31 December 2011
	Liabilities		
1	Banknotes in circulation	47,856	46,600
2	Liabilities to euro area credit institutions in connection with monetary policy operations, denominated in euro	158,038	175,606
2.1	Current accounts (covering the minimum reserve system)	87,593	16,126
2.2	Deposit facility	14,370	131,036
2.3	Fixed-term deposits	56,075	28,444
2.4	Fine-tuning reverse operations	0	0
2.5	Deposits related to margin calls	0	0
3	Liabilities to other euro area residents denominated in euro	134	166
3.1	General government	7	5
3.2	Other liabilities	127	161
4	Liabilities to non-euro area residents denominated in euro	5,873	6,171
5	Liabilities to euro area residents denominated in foreign currency	0	0
6	Liabilities to non-euro area residents denominated in foreign currency	0	0
7	Counterpart of special drawing rights allocated by the IMF	5,638	5,740
8	Intra-Eurosystem liabilities	0	0
8.1	Liabilities related to the issuance of ECB debt certificates	0	0
8.2	Other intra-Eurosystem liabilities (net)	0	0
9	Other liabilities	4,726	1,101
9.1	Accruals and income collected in advance	2,049	849
9.2	Sundry	2,677	252
10	Provisions	32	73
11	Revaluation accounts	24,284	23,413
12	Capital and reserves	7,811	7,707
12.1	Issued capital	500	500
12.2	General reserve	7,296	7,198
12.3	Statutory reserve	15	9
	Total liabilities	**254,392**	**266,577**

Amsterdam, 13 March 2013

Adopted by the Supervisory Board of De Nederlandsche Bank NV

A.H.G. Rinnooy Kan, *Chairman*

A.M. Fentener van Vlissingen, *Vice-chairman*

A.H. van Delden, *Secretary*

K.P. Goudswaard

W.J. Kuijken

J.A. van Manen

F. Sijbesma

H.M. Vletter-van Dort

Profit and loss account for the year 2012

EUR million

	2012	2011
1 Interest income	2,933	2,354
2 Interest expense	-377	-779
Net interest income	2,556	1,575
3 Realised gains/losses arising from financial operations	337	235
4 Write-downs to lower market value	-42	-223
Net result from financial operations, write-downs and risk provisions	2,851	1,587
5 Income from fees and commissions	10	17
6 Expenses relating to fees and commissions	-8	-9
Net result from fees and commissions	2	8
7 Income from ordinary shares and participating interests	61	71
8 Net result of pooling of monetary income	-909	-270
9 Other income	385	122
Total net income	2,390	1,518
10 Staff costs	194	191
11 Other administrative expenses	79	77
12 Depreciation of (in)tangible fixed assets	27	30
13 Costs of production of banknotes	14	10
14 Other expenses	1	0
15 Capitalised costs of software	-4	-3
Total operating expenses	311	305
Profit for the year	**2,079**	**1,213**

Amsterdam, 13 March 2013
The Governing Board of De Nederlandsche Bank NV

K.H.W. (Klaas) Knot, *President*
A.J. (Joanne) Kellermann
J. (Jan) Sijbrand
F. (Frank) Elderson
J. (Job) Swank

Amsterdam, 13 March 2013
Adopted by the Supervisory Board of De Nederlandsche Bank NV

A.H.G. Rinnooy Kan, *Chairman*
A.M. Fentener van Vlissingen, *Vice-chairman*
A.H. van Delden, *Secretary*
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F. Sijbesma
H.M. Vletter-van Dort

Notes to the balance sheet as at 31 December 2012 and the profit and loss account for the year 2012

1 Valuation and accounting policies

The Financial Statements are compiled according to the accounting models and policies applying to the European Central Bank (ECB) and the European System of Central Banks (ESCB) and the harmonised notes to the balance sheet and the profit and loss account (hereafter referred to as the 'ESCB accounting policies'). Otherwise, the Financial Statements observe the provisions of Title 9, Book 2 of the Dutch Civil Code, in line with the provisions of Section 17 of the Bank Act 1998.

The ESCB accounting policies are broadly in line with financial reporting principles generally accepted in the Netherlands. In deviation from Title 9, Book 2, Dutch Civil Code:
a. Unrealised positive results from revaluable assets and liabilities are not reported in the profit and loss account but included in a revaluation account on the balance sheet;
b. No cash flow statement is included.

Comparison with preceding year

The accounting policies have not changed compared with the preceding year.

General

Gold and gold receivables, marketable securities and on- and off-balance sheet claims and liabilities denominated in foreign currency are valued, where applicable, at market price as at the last business day of the financial year. Readily marketable equities reported on the balance sheet under 'Securities of euro area residents denominated in euro' are valued at amortised cost, taking any unusual depreciation or unusual market value into account. Other assets and liabilities are reported at acquisition price or at nominal value. Transactions in financial assets and liabilities are reflected in the accounts on the basis of the date on which they are settled, with the exception of foreign exchange transactions, financial instruments denominated in foreign currency and the concomitant accruals, which are reported as the cut-off date (in accordance with the economic approach).
Revaluation differences arising from price differences in respect of securities are determined on a security-by-security basis. Revaluation differences arising from exchange rate differences are determined on a portfolio-by-portfolio and a currency-by-currency basis. Unrealised revaluation gains are added to the 'Revaluation accounts'. Unrealised revaluation losses are charged to the 'Revaluation accounts' if the balance of these accounts was positive. Any shortfall is taken to the profit and loss account as at the end of the financial year. Losses arising from exchange rate revaluation in any one currency are not netted against gains arising from exchange rate differences in any other currency or against price gains. Losses arising from price revaluation of a security are not netted against gains arising from a price revaluation of another security or gains arising from exchange rate differences. For gold and gold receivables, no distinction is made between price revaluation and exchange rate revaluation.

Conversion of foreign currencies

Assets and liabilities denominated in foreign currency are converted into euro at the market exchange rate stated by the ECB for the last business day of the financial year. Income and expenses are converted at the market exchange rate prevailing at the time of the transaction. The exchange rate revaluation of foreign currency assets and liabilities, including foreign currency off-balance-sheet claims and liabilities, is performed on a per-portfolio and per-currency basis.

Gold and gold receivables

Gold and gold receivables are valued at market price. This market price in euro is derived from the gold valuation in USD as at the last working day of the financial year as stated by the ECB.

Marketable securities and private loans

Marketable securities and private loans are valued at market price as at the last business day of the financial year, except for marketable securities classified as held to maturity. The latter are valued at amortised cost, taking any unusual depreciation (held to maturity) into account, and represented on the balance sheet under 'Securities of euro area residents denominated in euro'. Price revaluation is performed on a security-by-security basis; unlisted securities are valued at cost or at lower market price. Investments in securities and private loans are included in the following balance sheet items: 'Claims on non-euro area residents denominated in foreign currency', 'Claims on euro area residents denominated in foreign currency', 'Claims on non-euro area residents denominated in euro', 'Other claims on euro area credit institutions denominated in euro', 'Securities of euro area residents denominated in euro' (sub-item 'Other financial assets') and 'Other assets'.

(Reverse) repurchase agreements

Repurchase agreements consist of a spot sale of securities hedged by a forward purchase of the same securities. The receipts from the spot sale are shown in the balance sheet as a deposit. In the light of the forward purchase, the securities continue to be shown under assets; hence, the amount involved in the forward purchase is shown in the balance sheet under liabilities.
Reverse repurchase agreements are reported as lending. The collateral received is not shown in the balance sheet and does not, therefore, affect the balance sheet position of the portfolios concerned.
(Reverse) repurchase agreements are included in the following balance sheet items: 'Balances held with banks and security investments, external loans and other external assets', 'Claims on non-euro area residents denominated in euro', 'Other claims on euro area credit institutions denominated in euro', 'Other financial assets', 'Liabilities to other euro area residents denominated in euro' (Other liabilities), 'Liabilities to non-euro area residents denominated in euro', 'Liabilities to non-euro area residents denominated in foreign currency' and 'Other Liabilities'.

Other financial instruments

The item 'other financial instruments' includes currency forward, currency swap contracts and interest rate swap contracts. Currency forward and currency swap contracts are valued at forward prices, taking account of currency revaluations.

Such revaluation differences observe the revaluation rules set out under General above. The results of the revaluation of these forwards and swaps, and any as yet unamortised forward returns are reported on the balance sheet under 'Accruals and prepaid expenses'. For further specification see the item concerned in the Notes to the balance sheet below.
Interest rate swap contracts engender mutual cash flows. Results are allocated to the associated periods. Interest rate swaps are revalued as at the balance sheet date. Any differences arising are shown in accordance with the policies stated under General above.

Intra-ESCB and intra-Eurosystem claims and liabilities

– Participating interest in the ECB
DNB's participating interest in the ECB is accounted for under the asset item of that name.

– Claims equivalent to the transfer of foreign reserves to the ECB
Upon their accession to the Eurosystem, all NCBs have assumed a euro-denominated position within the ESCB ensuing from the transfer of foreign reserve assets to the ECB and accounted for under 'Claims equivalent to the transfer of foreign reserves to the ECB'.

– Other claims and liabilities within the Eurosystem
Intra-ESCB positions are the result of cross-border payments within the EU settled in euro by the central banks. Most are settled within TARGET2 (Trans-European Automated Real-time Gross settlement Express Transfer system) and give rise to bilateral balances in the TARGET2 accounts held by the EU central banks. On a daily basis, such bilateral balances are netted and assigned to the ECB, leaving every NCB with a single net bilateral balance vis-à-vis the ECB. DNB's position vis-à-vis the ECB and arising from TARGET2 transactions is presented, together with other euro-denominated positions within the ESCB (such as interim profit distributions to the NCBs and monetary income results), as a single asset or liability item under 'Other intra-Eurosystem claims (net)' or 'Other intra-Eurosystem liabilities (net)'. Positions held within the ESCB vis-à-vis NCBs outside the euro area and arising from TARGET2 transactions are accounted for under 'Claims on non-euro area residents denominated in euro' or 'Liabilities to non-euro area residents denominated in euro'.

– Net claims related to the allocation of euro banknotes within the Eurosystem
Intra-ESCB balances arising from the allocation of euro banknotes within the Eurosystem are included as a net single asset or liability under 'Net claims/liabilities related to the allocation of euro banknotes within the Eurosystem' (see below under 'Banknotes in circulation').

Participating interests

Participating interests are valued at purchase price. Income from participating interests are included in the profit and loss account under 'Income from ordinary shares and participating interests'.

Tangible and intangible fixed assets

(In)tangible fixed assets are valued at purchase price less depreciation and/or special write-downs. For investments in intangible assets, in addition to the

primary purchase price and the costs of external advisers relating to these assets, the in-house hours spent on these assets are also capitalised. For intangible fixed assets, a statutory reserve has been created. Depreciation is calculated on a straight-line basis over the estimated useful life of the asset. The estimated useful life of buildings and renovations is 25 years, that of equipment, plant and furniture 10 years and that of computer hardware, software, motor vehicles and intangible assets 4 years. Land is not depreciated. Retired tangible fixed assets are valued at the lower of book value and expected realisable value.

Banknotes in circulation

The ECB and the seventeen participating NCBs, together forming the Eurosystem, issue banknotes [1]. The total value of the banknote circulation is apportioned to the individual Eurosystem NCBs on the last business day of every month, according to the banknote allocation key [2].
The ECB has been allocated a share of 8% of the total value of euro banknotes in circulation, while the remaining 92% is allocated to the NCBs in proportion to their weightings in the capital key of the Eurosystem. The share of banknotes in circulation allocated to each NCB is accounted for on the liabilities side of the balance sheet under 'Banknotes in circulation'.
The difference between the value of the euro banknotes allocated to each NCB in accordance with the banknote allocation key and the value of the euro banknotes actually circulated by that NCB gives rise to further intra-Eurosystem positions. These claims or liabilities, which incur interest, [3] are disclosed under the sub-item 'Intra-Eurosystem claims: Net claims related to the allocation of euro banknotes within the Eurosystem' (see above).

For the five years following the year of the cash changeover, [4] the intra-Eurosystem positions arising from the allocation of euro banknotes are adjusted in order to prevent significant changes in NCBs' relative income positions as compared to previous years. The adjustments are effected by taking into account the differences between the average value of banknotes put into circulation by each NCB in the reference period [5] and the average value of banknotes that would have been allocated to them during that period under the Eurosystem capital allocation key. The adjustments are reduced in annual stages until the first day of the sixth year after the cash changeover year. From then on, the income on banknotes is allocated fully to the NCBs in proportion to their paid-up shares in the ECB's capital. For Banka Slovenije, this period ended on 31 December 2012, for the Central Bank of Cyprus and the Central Bank of Malta it will end on 31 December 2013, for Národná banka Slovenska on 31 December 2014 and for Eesti Pank on 31 December 2016.

The interest income and expense on these positions are settled through the accounts of the ECB and are disclosed under 'Net interest income'.

1 Decision of the European Central Bank of 13 December 2010 on the issue of euro banknotes (recast) (ECB/2010/29), OJ L 35, 9.2.2011, p. 26.
2 The banknote allocation key is based on the ECB's share in the total euro banknote issue and the shares of the national central banks in the remainder of such issue in proportion to their contributions to the ECB's subscribed capital (Capital Share Mechanism (CSM)).
3 Decision of the European Central Bank of 25 November 2010 on the allocation of monetary income of the national central banks of Member States whose currency is the euro (recast) (ECB/2010/23), OJ L 35, 9.2.2011, p 17.
4 The year of cash changeover is the year in which the Member State concerned introduces euro banknotes as legal tender.
5 The reference period is the 24-month period starting 30 months before the day on which euro banknotes become legal tender in the Member State concerned; for Eesti Pank, this is the July 2008-June 2010 period.

Distribution of profit by the ECB

The Governing Council of the ECB has decided that the seigniorage income of the ECB, arising from the 8% share of euro banknotes in circulation allocated to the ECB, as well as the proceeds from securities ensuing from the Securities Markets Programme (SMP), will accrue in full to the NCBs in the year in which this income is realised. Unless the ECB Governing Council decides otherwise, the ECB will, in January of the following year, distribute this amount among the NCBs in the form of an interim profit distribution.[6] Before year's end, the Governing Council may decide to retain the proceeds from the Securities Markets Programme (SMP), and, if necessary, the seigniorage income from euro banknotes, in full or in part, if the amount to be distributed exceeds the ECB's net profit for the year. Subject to a decision to that effect by the ECB Governing Council, the amount concerned may be reduced by the expenses of the ECB arising from the issue and handling of euro banknotes; in addition, it may be added to a provision for foreign exchange rate, interest rate and gold price risks.

Recognition of income and expenses

Income and expenses are recognised in the period in which they are earned or incurred. Realised gains and losses arising from investments are taken to the profit and loss account on the basis of an average cost method, except those relating to securities valued at amortised cost, taking any unusual depreciation into account (held to maturity). In the event that a revaluation at market value yields an unrealised loss on any security as at year-end, the average price of that security is reduced in line with the end-of-year market price and exchange rate. Unrealised gains are not recognised as income, but are transferred directly to the revaluation accounts. Unrealised losses are taken to the profit and loss account to the extent that they exceed the balance of the corresponding revaluation accounts. These unrealised losses are not netted against any unrealised gains in later years. Unrealised losses on any security, currency or gold are never netted against unrealised gains on gold, other securities or currencies.

Pension and other retirement schemes

The pension entitlements of staff and former staff of DNB and PVK as well as of others having comparable entitlements have been transferred to Stichting Pensioenfonds van De Nederlandsche Bank NV (DNB Pension Fund). Through an agreement, DNB has undertaken to make payments, subject to conditions agreed for the purpose, to the DNB Pension Fund DNB to such amounts as to ensure the pensions under the Pension Fund's pension schemes. In the agreement, the financial methodology is set out in a premium, supplement and risk policy ladder; in the target assets, allowance is made for the indexation ambition.

The level of the amounts payable by DNB and the liabilities to be shown in the financial statements in respect of other retirement schemes are calculated on an actuarial basis.

Owing to a funding deficit having arisen at the DNB Pension Fund, the Fund has drawn up a recovery plan. To make up for the deficit, a premium policy has been drawn up under which the Fund will restore its assets to the minimum funding level within a period of five years, as from end-2008, and that the

6 Decision of the European Central Bank of 25 November 2010 on the interim distribution of the income of the European Central Bank on euro banknotes in circulation and arising from securities purchased under the securities markets programme (recast) (ECB/2010/24), OJ L 6, 11.1.2011, p. 35.

required level will be recovered within 15 years. As at 31 December 2012, the funding ratio of DNB Pension Fund was 107.6%.

2. Notes to the balance sheet

The figures in parentheses following the descriptions refer to the corresponding items in the balance sheet.

Assets

Gold and gold receivables (1)
In the year under review, the gold stock, including the gold receivables, did not change. The gold stock, on the last business day of the financial year, consisted of some 19.7 million fine troy ounces (or circa 612 tonnes) of gold at a market value of EUR 1,261.18 (year-end 2011: EUR 1,216.86) per fine troy ounce.
As a result of the higher market price of gold, the euro value of this balance sheet item has increased.

Millions

	EUR
Balance as at 31 December 2010	20,782
Revaluation of gold stock 2011	3,179
Balance as at 31 December 2011	23,961
Revaluation of gold stock 2012	873
Balance as at 31 December 2012	**24,834**

Claims on non-euro area residents denominated in foreign currency (2)
These liabilities, amounting to EUR 16,414 million as at year-end 2012 (year-end 2011: EUR 15,973 million). It breaks down as follows:

– Receivables from the International Monetary Fund (IMF) (2.1)
On the last business day of the financial year, the receivables stood at SDR 7,607 million at the rate of EUR 0.8579 (year-end 2011: EUR 0.8427).

Millions

	31 December 2012		31 December 2011	
	SDR	EUR	SDR	EUR
Special drawing rights	4,661	5,433	4,739	5,624
Reserve tranche position	1,569	1,829	1,551	1,841
Loans	1,377	1,605	1,250	1,483
Total	**7,607**	**8,867**	**7,540**	**8,948**

As at year-end 2012, Special Drawing Rights amounted to EUR 5,433 million (year-end 2011: EUR 5,624 million). Special drawings rights represent the right, in the event of balance-of-payments problems, to exchange (part of) the SDR holdings to obtain other currencies, such as USD or EUR. These rights were created against the liability item ‘Counterpart of special drawings rights allocated by the IMF’ (7) of EUR 5,638 million (year-end 2011: EUR 5,740 million).

The reserve tranche position (EUR 1,829 million) concerns the funds which DNB has provided to the IMF for lending by the IMF through the General Resources Account (GRA). IMF Member Countries are required to make at least 25% of their quotum available in the form of gold or convertible currencies. The Dutch quotum, for which DNB acts as manager/agent, equals SDR 5,162 million. In 2010, it was decided to increase the quotum, which will result in a higher reserve tranche position through the transfer of 25% of the enlargement. The prospective increase is likely to be enacted in 2013. As a result the Dutch quotum will grow by SDR 3.6 billion.
The IMF remunerates this position at an interest rate which is updated weekly. In 2012, this rate was between 0.03% and 0.15% on an annual basis (2011: between 0.11% and 0.59%). This rate reflects the prevailing SDR interest rate.

The loans (EUR 1,605 million) are to the Poverty Reduction and Growth Facility-Exogenous Shock Facility Trust (PRGF-ESF Trust) and a special bilateral loan arrangement which was included in 2010 in the New Arrangements to Borrow (NAB).
The PRGF-ESF Trust (EUR 336 million) is a fund set up to supply the principals of subsidised low-interest loans to the poorest developing countries. The Netherlands has pledged SDR 500 million to the 'PRGF loan account'. In respect of these amounts, a contract was agreed with the IMF entailing that each drawing must be repaid in ten equal tranches within 5.5 to 10 years after the drawing. DNB receives the prevailing market rate on the loan; the interest rate subsidy is financed by the Ministry of Foreign Affairs.
Under the NAB (EUR 1,269 million), a credit line with a maximum of EUR 10.5 billion has been made available for use by the IMF for its regular operations in addition to the regular quotum.
In 2011, it was decided to increase the financial efficacy of the IMF through new bilateral loans totalling EUR 456 billion. Of this, euro countries are to shoulder EUR 150 billion. The contribution of the Netherlands, EUR 13,6 billion, was effected in 2012. The IMF has not yet drawn on this facility. The new bilateral loans will function as the IMF's last financial line of defence in case the quota and the NAB both face exhaustion.

Since DNB is the implementing body of the Dutch membership in the IMF, credit guarantees up to the sum of the maximum commitment for each facilities have been extended by the Dutch State.

– Balances held with banks and security investments, external loans and other external assets (2.2)
In 2012 this item increased from EUR 7,025 million to EUR 7,547 million. It includes the investment portfolio denominated in Australian dollars (AUD) built in the course of 2012. This reflects an aim to diversify DNB's portfolio investments.

The item breaks down as follows:

Million

	31 December 2012			31 December 2011		
	Foreign currency	EUR	Exch. rate	Foreign currency	EUR	Exch. rate
USD	8,050	6,101	1.3194	8,404	6,495	1.2939
JPY	54,260	478	113.61	53,006	529	100.20
AUD	1,231	968	1.2712	-	-	-
Other currencies		0			1	
Total		**7,547**			**7,025**	

These foreign currency balances break down by investment category as follows:

Millions

	31 December 2012	31 December 2011
	EUR	EUR
Fixed-income securities	6,697	6,206
Mortgage Backed Securities	0	572
Reverse repurchase agreements	814	207
Deposits	2	2
Nostro accounts	34	38
Total	**7,547**	**7,025**

All investments in Mortgage Backed Securities were divested during the review year.

A breakdown of the maturities of the fixed-income securities can be found in the table following the notes to balance sheet item 'Other assets' (9).

Claims on euro area residents denominated in foreign currency (3)
As at year-end 2012, this item totalled EUR 152 million (year-end 2011: EUR 364 million). At year-end 2012, it included only reverse repos denominated in USD. At year-end 2011 this item amounted to EUR 364 million, comprising fixed-income securities denominated in USD.

Claims on non-euro area residents denominated in euro (4)
As at year-end 2012, this item totalled EUR 185 million (year-end 2011: EUR 126 million), consisting of short-term liabilities, not being deposits.

Lending to euro area credit institutions related to monetary policy operations denominated in euro (5)[7]
Together, asset item 5 and liability item 2 relate to euro area monetary policy insofar as it is implemented by DNB on behalf of the Eurosystem. The amount of this item depends on the liquidity need of Dutch-based credit institutions bidding on monetary policy operations through DNB.
As at year-end 2012, the Eurosystem's total claim arising from the item 'Lending to euro area credit institutions related to monetary policy operations denominated in euro' amounted to EUR 1,128,794 million (year-end 2011: EUR 863,568 million). Of this total, lending by DNB to Dutch-based credit institutions amounted to EUR 24,511 million as at 31 December 2012 (year-end 2011: EUR 3,380 million). In conformity with Article 32.4 of the ESCB Statute, all risks relating to such lending will, once they manifest themselves, be borne in their entirety by the Eurosystem NCBs in proportion to the ECB capital key in force at the time when a loss is suffered.

To have access to this facility, a financial institution must meet the requirements made by the ECB, including the collateral eligibility criteria. Losses occur only if the counterparty defaults on the repayment and, in addition, the sale of the collateral fails to cover the debt. It should be noted here that national central banks may temporarily accept supplementary collateral that fails to meet the eligibility standards. Any losses on such collateral will not be shared across the ESCB. In 2012, DNB did not have occasion to accept supplementary collateral.

– Main refinancing operations (5.1)
Main refinancing operations, amounting to EUR 32 million as at year-end 2012 (year-end 2011: EUR 190 million), meet part of the financial sector's refinancing needs. They are conducted on a weekly basis, usually with a maturity of one week, as fixed or variable rate tenders. Since October 2008, these operations have been conducted on a fixed-rate basis. All eligible counterparties may submit bids. In 2012, all main refinancing operations were conducted as fixed-rate tenders with full allotment. The interest rate applied is the key policy rate adopted by the ECB Governing Council. In 2012, the average return on the main refinancing operations was 0.9% (2011: 1.3%).

– Longer-term refinancing operations (5.2)
Longer-term refinancing operations, amounting to EUR 24,479 million as at year-end 2012 (year-end 2011: 3,190 million), are refinancing operations which provide longer-term liquidity. They are usually conducted on a monthly basis, with a maturity of three months. In 2012 another longer-term refinancing operation was conducted with a maturity of approximately 36 months (the first such longer-term refinancing operation was carried out in December 2011). The longer-term refinancing operations were conducted as fixed-rate tenders at a rate equalling the average of the rates applied in the main refinancing operations over the life of the respective operations. In 2012, the average return on the longer-term refinancing operations was 0.9% (2011: 1.4%).

– 'Fine-tuning' reverse transactions (5.3)
'Fine-tuning' reverse operations – with nil outstanding value as at both year-end 2012 and year-end 2011 – are conducted both regularly and on an ad hoc basis with the aim of providing temporary liquidity to the market. Fine-tuning reverse

7 To hedge the inherent credit and interest rate risk, the State has extended a partial guarantee (see: 'Guarantee scheme for crisis-related assets' on page 161).

operations are usually conducted by the NCBs as quick tenders. As in 2011, no such operations were conducted in 2012.

– Structural reverse operations (5.4)
The ECB is empowered to conduct these operations in order to adjust the structural position of the ESCB vis-à-vis the financial sector. As in 2011, no such operations were conducted in 2012.

– Marginal lending facility (5.5)
Counterparties may use this facility (amount outstanding nil as at both year-end 2012 and year-end 2011), to obtain overnight liquidity from NCBs at a predetermined interest rate against the usual collateral. The facility is intended to meet temporary credit needs. In 2012, the average return on the marginal lending facility was 0.0% (2011: 2.7%). In 2012, as in 2011, recourse to this facility remained very limited.

– Credits related to margin calls (5.6)
These credits arise when the value of the underlying collateral is exceeded. Credits granted without the shortfall of collateral being supplemented are included in this item. In 2012, as in 2011, no credits related to margin calls were extended.

Other claims on euro area credit institutions denominated in euro (6)
As at year-end 2012, this item was nil (year-end 2011: EUR 4,628 million). At year-end 2011, this item consisted solely of deposits.
These were deposits held in the context of the Eurosystem Reserve Management Services (ERMS). ERMS is a standard package of services for non-EMU central banks and international institutions.
As at year-end 2012, no such deposits were managed by DNB: amid relatively low money market rates, the demand for ERMS services was low.

Securities of euro area residents denominated in euro (7)
As at year-end 2012, this item totalled EUR 26,563 million (year-end 2011: EUR 28,050 million); it consists of 'Securities held for monetary policy purposes' and 'Other securities'.

– Securities held for monetary policy purposes (7.1)
This item represents securities obtained by DNB in the context of programmes for the purchase of covered bonds [8], and sovereign debt securities obtained under the Securities Markets Programme (SMP) [9, 10].

8 Decision of the ECB of 2 July 2009 on the implementation of the covered bond purchase programme (ECB/2009/16), OJ L 175 of 4 July 2009, p. 18 and the Decision of 3 November 2011 on the implementation of the second covered bond purchase programme (ECB/2011/17), OJ L 297, 16 November 2011, p. 70.
9 Decision of the European Central Bank of 14 May 2010 establishing a Securities Markets Programme (ECB/2010/5). OJ L 124, 20 May 2010, p. 8.
10 To hedge the inherent credit and interest rate risk, the State has extended a partial guarantee (see: 'Guarantee scheme for crisis-related assets' on page 149).

Millions

	31 December 2012 EUR	31 December 2011 EUR
Securities Markets Programme	11,395	11,516
Covered Bond Purchase Programme 1	2,647	3,168
Covered Bond Purchase Programme 2	736	142
Total	**14,778**	**14,826**

Under the Securities Markets Programme (SMP), the ECB and the national central banks of the Eurosystem were enabled to purchase debt securities issued by euro area governments and private organisations so as to improve the functioning of certain segments of the euro area capital markets and to restore the sound operation of the monetary policy transmission mechanism. This programme was discontinued in 2012.

The total holdings of securities held by the national central banks of the Eurosystem in the context of the SMP amount to EUR 192,252 (year-end 2011: EUR 194,155 million). As at year-end 2012, such securities held by DNB amounted to EUR 11,395 million (year-end 2011: EUR 11,516 million).
In conformity with Article 32.4 of the ESCB Statute, all risks relating to this lending will, once they manifest themselves, be borne in their entirety by the Eurosystem's NCBs in proportion to the ECB capital key applying at the time when a loss is suffered.

Under the Covered Bond Purchase Programmes' (CBPP1 and CBPP2), the ECB and the Eurosystem national central banks, including DNB, purchased euro-denominated covered bonds issued in the euro area. The aim was to ease the funding conditions for credit institutions and enterprises, and to encourage credit institutions to maintain and expand their lending to clients. Both programmes have been formally discontinued: no new purchases are made under these programmes.

Securities purchased under the Securities Markets Programme (SMP) and those purchased under the Covered Bond Purchase Programmes (CBPP1 and CBBP2) have been designated as held to maturity and are shown at amortised cost less any special write-downs.

The annual test to determine any special write-downs is performed by the Eurosystem on the basis of the accounting policies applicable to the European System of Central Banks (see under 'Accounting policies' above), the available information and the expected realisable value as at balance sheet date. This is in accordance with a Decision by the ECB Governing Council, which DNB observes. As regards the securities purchased under the Securities Markets Programme (SMP) and under the Covered Bond Purchase Programmes (CBPP1 and CBPP2), no special write-downs have been made either.

Although the ESCB tests did not result in any special write-downs on these positions, considerable risks owing to the debt crisis remain and may still give rise to losses. The Governing Council of the ECB and the Governing Board of DNB regularly assess the financial risks attaching to the securities held in the SMP and CBPP portfolios. Chapter 4.7 of the Annual Report on Financial

exposure provides a more detailed discussion on various risks including the risk inherent in these portfolios.

– Other securities (7.2)
As at year-end 2012, this item totalled EUR 11,785 million (year-end 2011: EUR 13,224 million) and consisted, as in 2011, entirely of fixed-income securities.

This balance sheet item also includes DNB's own portfolio built up in the course of 2011 and consisting of euro-denominated securities valued at amortised cost (held to maturity basis). The test conducted to determine any special write-downs has not given rise to a write-down.

Millions

	31 December 2012	31 December 2011
	EUR	EUR
Securities		
- marked to market	8,263	9,569
- valued at amortised cost	3,522	3,655
Total	**11,785**	**13,224**

A breakdown of the maturities of the fixed-income securities can be found in the table following the notes to balance sheet item 'Other assets' (9).

Intra-Eurosystem claims (8)
As at year-end 2012, this item totalled EUR 153,195 million (year-end 2011: EUR 182,458 million).

– Participating interest in the ECB (8.1)
This item represents DNB's capital interest in the ECB of EUR 469 million (year-end 2011: EUR 402 million), including EUR 39 million worth of premium. According to Article 28 of the ESCB Statute, the national central banks of the ESCB are the only shareholders in the capital of the ECB. Each NCB's capital interest depends on its share fixed in accordance with Article 29.3 of the ESCB Statute. This share is reviewed every five years. The capital interests in the ECB are valued at purchase price. As of 29 December 2010, the ECB increased its authorised and paid-up capital from EUR 5,761 million by EUR 5,000 million to EUR 10,761 million. For DNB, this meant an increase of its capital interest by a total of EUR 199 million. This amount was paid up in three equal annual instalments. The first instalment was paid on 29 December 2010, the second on 28 December 2011 and the last on 27 December 2012.

The NCBs' shares in the authorised and the issued/paid up capital of the ECB are as follows.

EUR million

	Eurosystem capital key in % as of 1 Jan. 2011	Capital key in % as of 1 Jan. 2011	Authorised and issued capital as of 29 Dec. 2010	Paid-up capital until 26 Dec. 2012	Paid-up capital as of 27 Dec. 2012
Nationale Bank van België	3.4666	2.4256	261	221	261
Deutsche Bundesbank	27.0647	18.9373	2,038	1,722	2,038
Eesti Pank	0.2558	0.1790	19	16	19
Central Bank and Financial Services Authority of Ireland	1.5874	1.1107	119	101	119
Bank of Greece	2.8082	1.9649	211	179	211
Banco de España	11.8679	8.3040	894	755	894
Banque de France	20.3246	14.2212	1,530	1,293	1,530
Banca d'Italia	17.8598	12.4966	1,345	1,136	1,345
Central Bank of Cyprus	0.1957	0.1369	15	12	15
Banque centrale du Luxembourg	0.2497	0.1747	19	16	19
Central Bank of Malta	0.0903	0.0632	7	6	7
De Nederlandsche Bank	**5.6998**	**3.9882**	**429**	**363**	**429**
Oesterreichische Nationalbank	2.775	1.9417	209	177	209
Banco de Portugal	2.5016	1.7504	188	159	188
Banka Slovenije	0.4699	0.3288	35	30	35
Národná banka Slovenska	0.9909	0.6934	75	63	75
Suomen Pankki-Finlands Bank	1.792	1.2539	135	114	135
Total euro area NCBs	*100.0000*	*69.9705*	*7,529*	*6,363*	*7,529*
Bulgarian National Bank	-	0.8686	93	3	3
Česká národní banka	-	1.4472	156	6	6
Danmarks Nationalbank	-	1.4835	160	6	6
Latvijas Banka	-	0.2837	30	1	1
Lietuvos bankas	-	0.4256	46	2	2
Magyar Nemzeti Bank	-	1.3856	149	6	6
Narodowy Bank Polski	-	4.8954	527	20	20
Banca Natională a României	-	2.4645	265	10	10
Sveriges Riksbank	-	2.2582	243	9	9
Bank of England	-	14.5172	1,562	58	58
Total non-euro area NCBs	-	*30.0295*	*3,231*	*121*	*121*
Total EU NCBs	**-**	**100.0000**	**10,760**	**6,484**	**7,650**

– Claims equivalent to the transfer of foreign reserves to the ECB (8.2)
The claims are denominated in euro at a value fixed at the time of the transfer. They are remunerated at the current rate for the Eurosystem's main refinancing operations. The gold component is unremunerated.

– Other intra-Eurosystem claims/liabilities (net) (net asset item 8.4/net liability item 8.2)
The amount of these claims or liabilities fluctuates daily and arises from transfers between credit institutions within the Eurosystem. Using a netting technique developed within the Eurosystem, the ECB determines each country's net position (claims/liabilities) vis-a-vis the ECB on account of payments traffic on a daily basis. A net claim of DNB is shown under 'Other intra-Eurosystem claims (net)' (asset item 8.4); a net liability of DNB is shown under 'Other intra-Eurosystem liabilities within the Eurosystem (net)' (liability item 8.2). As at year-end 2012, there was a net claim of EUR 119,860 million (year-end 2011: a net claim of EUR 152,480 million) The decline was due to the decrease in the amount of surplus liquidity held with DNB.

– Net claims related to the allocation of euro banknotes within the Eurosystem (8.5)
This item, of EUR 30,569 million (year-end 2011: EUR 27,278 million), consists of a net claim of DNB on the Eurosystem relating to the reallocation of euro banknotes (see 'Banknotes in circulation' and 'Net claims related to the allocation of euro banknotes within the Eurosystem' under 'Accounting policies').

Other assets (9)
As at year-end 2012, this item totalled EUR 8,537 million (year-end 2011: EUR 7,637 million).

– Tangible and intangible fixed assets (9.2)
The sub-items included in this item break down as follows:

EUR million

	Development costs (software)	*Total intangible fixed assets*	Buildings and land	Fittings	Fixed assets under construction	*Total tangible fixed assets*	***Total tangible and intangible fixed assets***
Book value as at 1 January 2012	**9**	***9***	**191**	**38**	**6**	***235***	***244***
Changes:							
Reclassification	-	-	-	-	3	*3*	3
Investments	9	*9*	4	14	3	*21*	30
Disinvestments	-	-	-	-	-	-	-
Amortisations	-3	*-3*	-12	-12	-	*-24*	-27
Special depreciation losses	-	-	-	-	-	-	-
Book value as at 31 December 2012	**15**	***15***	**183**	**40**	**12**	***235***	***250***
Prices or production prices	22	*22*	394	87	12	*493*	515
Cumulative amortisation	-7	*-7*	-211	-47	-	*-258*	-265
Book value as at 31 December 2012	**15**	**15**	**183**	**40**	**12**	***235***	***250***

– Other financial assets (9.3)
In terms of currencies, the items included in 'Other financial assets' break down as follows:

Millions

	31 December 2012	31 December 2011
	EUR	EUR
USD	275	250
Other foreign currencies	413	366
EUR	6,280	6,308
Total	**6,968**	**6,924**

'Other financial assets' can be sub-classified as follows:

Millions

	31 December 2012	31 December 2011
	EUR	EUR
Participating interests	61	61
Fixed-income securities	4,996	5,166
Equities	1,560	1,372
Reverse repurchase agreements	150	0
Other claims	201	325
Total	**6,968**	**6,924**

The participating interests are those in the Bank for International Settlements (BIS), the share equalling 3.09% (year-end 2011: 3,16%), the Society for Worldwide Interbank Financial Telecommunications s.c. (SWIFT), at a share of 0.06% (year-end 2011: 0.10%) and NV Settlement Bank of the Netherlands (SBN), the share being 100%.
The BIS shares are 25% paid-up; as at balance sheet date, the contingent liability for calls was SDR 64.9 million (year-end 2011: SDR 64.9 million).
Although DNB holds 100% of the shares in the SBN, this entity is not consolidated into DNB's financial statements. This is because the activities of the SBN are unrelated to the position and duties of DNB. The authority on this point rests with external parties.

'Other claims' consist mainly of claims on account of mortgage loans extended to DNB staff.

A breakdown of the maturities of the fixed-income securities can be found in the table following the notes to balance sheet item 'Other assets' (9).

The reverse repurchase agreements, deposits and other claims have maturities of less than one year.

– Accruals and income collected in advance (9.4)
As at year-end 2012, this item totalled EUR 1,299 million (year-end 2011: EUR 441 million). This item consists mainly of accrued interest, EUR 916 million (year-end 2011: EUR 960 million).

Also included are currency revaluation differences on off-balance sheet instruments and unamortised forward returns on these instruments. As at year-end 2012, this item totalled EUR 356 million (net) (year-end 2011: -EUR 516 million). A breakdown is presented in the overview of off-balance sheet positions in respect of currency swaps and currency forwards, on page 148).

The unamortised returns break down as follows:

Millions

	31 December 2012	31 December 2011
	EUR	EUR
Currency swaps	16	-1
Currency forwards	-2	-1
Interest rate swaps	-34	-26
Total	**-20**	**-28**

Maturity tables
The maturities of the fixed-income securities included in asset items A2, A7 and A9 can be represented as follows:

Balance sheet (asset) items A2 and A7
EUR million

				Remaining maturity 31 December 2012
	Total	0-1 year	1-2 years	> 2 years
EUR	26,563	5,993	6,884	13,686
USD	5,400	2,255	2,826	319
JPY	449	449	-	-
AUD	848	44	292	512
Other currencies	-	-	-	-
Total	**33,260**	**8,741**	**10,002**	**14,517**

Balance sheet item A9
EUR million

	Total	0-1 year	1-2 years	Remaining maturity 31 December 2012 > 2 years
EUR	4,996	2,626	1,822	548
USD	-	-	-	-
JPY	-	-	-	-
AUD	-	-	-	-
Other currencies	-	-	-	-
Total	**4,996**	**2,626**	**1,822**	**548**

Liabilities

Banknotes in circulation (1)
This item consists of DNB's share in the total euro banknotes circulated by the Eurosystem (see 'Banknotes in circulation' under 'Valuation and accounting policies' above).

As at year-end 2012 and year-end 2011, the breakdown of the banknotes put into circulation by DNB by denomination was as follows:

Numbers and values in millions

	31 December 2012		31 December 2011	
	Number	EUR	Number	EUR
EUR 5	-76	-380	-65	-323
EUR 10	-65	-646	-55	-545
EUR 20	-362	-7,240	-329	-6,571
EUR 50	390	19,501	375	18,737
EUR 100	-2	-194	0	21
EUR 200	31	6,108	31	6,152
EUR 500	0	138	4	1,851
Total euro banknotes circulated by DNB	-84	17,287	-38	19,322
Reallocation of euro banknotes in circulation		34,730		31,330
		52,017		50,652
Euro banknotes allocated to the ECB (8%)		-4,161		- 4,052
		47,856		**46,600**

This item increased by EUR 1,256 million owing to an increase in the number of euro banknotes issued by the national central banks of the Eurosystem.
The negative numbers of banknotes for certain denominations are accounted for by the fact that, on a net basis, DNB issued fewer of these banknotes than it received from circulation.

Liabilities to euro area credit institutions related to monetary policy operations denominated in euro (2)
Together, liability item 2 and asset item 5 relate to the monetary policy in the euro area insofar as it is implemented by DNB.
Liability item 2 relates to interest-bearing liabilities to credit institutions arising from the money market policy conducted by DNB on behalf of the ESCB.
As at year-end 2012, this item was EUR 17,568 million lower than as at year-end 2011 (year-end 2012: EUR 158,038 million, year-end 2011: EUR 175,606 million).
Within this item amounts shifted from deposit facilities to current accounts.

'Liabilities to euro area credit institutions related to monetary policy operations denominated in euro (2)' as at year-end 2012 and year-end 2011 were as follows:

– Current accounts (covering the minimum reserve system) (2.1)
These liabilities, amounting to EUR 87,593 million as at year-end 2012 (year-end 2011: EUR 16,126 million), relate to the amounts held by banks in accounts at DNB, including amounts held in order to meet their obligations under the

minimum reserve system. Interest is paid on these compulsory reserve holdings at a rate equal to the average marginal rate in the main refinancing operations during the reserve maintenance period. No interest is paid on 'excess reserves'. In 2012, an average interest rate of 0.2% was paid on the current accounts (2011: 1.3%).

– Deposit facility (2.2)
This is a permanent facility, amounting to EUR 14,370 million as at year-end 2012 (year-end 2011: EUR 131,036 million), which credit institutions may use to place overnight deposits at DNB at a predetermined interest rate. The interest rate on these deposits was reduced to 0% during 2012. In 2012, an average interest rate of 0.2% was paid on the deposit facility (2011: 0.6%).

– Fixed-term deposits (2.3)
These are deposits placed at DNB, amounting to EUR 56,075 million as at year-end 2012 (year-end 2011: EUR 28,444 million). This balance sheet item covers the liquidity-absorbing operations that are conducted weekly by the Eurosystem to offset the liquidity effects of the Securities Markets Programme (SMP), as well as the Eurosystem's fine-tuning operations to absorb excess liquidity. In 2012, an average interest rate of 0.2 % was paid on the fixed-term deposits (2011: 0.9%).

– 'Fine-tuning' reverse transactions (2.4)
These are monetary policy operations to tighten liquidity. In 2012, as in 2011, no fine-tuning reverse operations were effected.

– Deposits related to margin calls (2.5)
These are deposits made by credit institutions to compensate depreciation of securities pledged as collateral for credits granted. In 2012, as in 2011, no deposits related to margin calls were held.

Liabilities to other euro area residents denominated in euro (3)
This item, amounting to EUR 134 million (year-end 2011: EUR 166 million), consists mainly of other liabilities to financial institutions and margin calls to euro area residents.

Liabilities to non-euro area residents denominated in euro (4)
This item, amounting to EUR 5,873 million (year-end 2011: EUR 6,171 million) consists mainly of liabilities to financial institutions and margin calls to non-euro area residents.

Counterpart of special drawing rights allocated by the IMF (7)
This item is explained under asset item 2.1.

Other liabilities (9)
As at year-end 2012, total other liabilities amounted to EUR 4,726 million (year-end 2011: EUR 1,101 million).

– Accruals and income collected in advance (9.1)
This item, amounting to EUR 2,049 million (year-end 2011: EUR 849 million), includes the profit to be disbursed to the central government of EUR 1,975 million (year-end 2011: EUR 750 million).

– Sundry (9.2)
This item, amounting to EUR 2,677 million (year-end 2011: EUR 252 million) consists mainly of an an accrual in the amount of EUR 2,500 million that was settled in early 2013.

At year-end 2011 this item amounted to EUR 252 million and consisted almost entirely of Dutch guilder banknotes in circulation. The full amount of the banknotes not presented and accepted for exchange on year-end 2012, less the amounts added to profit as at year-end 2002 (EUR 85 million) and year-end 2007 (EUR 153 million), were released at the year-end. The release in 2012 of EUR 243 million brought the total release to EUR 481 million. In 2012, Dutch guilder banknotes totalling EUR 7 million were still presented for exchange.

As at year-end 2012 and year-end 2011, the breakdown of guilder banknotes by denomination was as follows:

Millions

	31 December 2012	31 December 2011
	EUR	EUR
NLG 5	0	0
NLG 10	0	24
NLG 25	0	2
NLG 50	0	9
NLG 100	0	89
NLG 250	0	26
NLG 1.000	0	100
Total guilder banknotes in circulation	**0**	**250**

Provisions (10)

EUR million

	Total	Provision for Monetary policy operations	Provision for staff remuneration	Other provisions	Rounding
Position as at 31 December 2010	**149**	**123**	**12**	**13**	**1**
Withdrawals	4	0	0	4	0
Release	72	70	0	1	1
Addition	0	0	0	0	0
Position as at 31 December 2011	**73**	**53**	**12**	**8**	**0**
Withdrawals	4	0	1	3	0
Release	39	36	2	1	0
Addition	2	0	2	0	0
Position as at 31 December 2012	**32**	**17**	**11**	**4**	**0**

– Provision for monetary policy operations
In conformity with Article 32.4 of the ESCB Statute, the provision against the risk of default on the part of counterparties has been divided within the Eurosystem among the national central banks of the participating Member States in proportion to their capital key in the year of default. On the basis of generally accepted accounting standards, the ECB Governing Council has assessed the amount of the provision and decided to reduce it by EUR 309 million from a total of EUR 949 million at year-end 2011 to EUR 640 million at year-end 2012. For DNB this resulted in a provision of EUR 17 million (year-end 2011: EUR 53 million) and a release of EUR 36 million to profit (see also 'Net result of pooling of monetary income' in the notes to the profit and loss account').

– Provision for staff remuneration
DNB operates the following arrangements:
- a defined benefit pension arrangement;
- a contribution to the health care insurance premiums of pensioners (limited group);
- a (limited) inactivity arrangement;
- a service anniversary and retirement bonus arrangement;
- a redundancy programme.

The pension scheme is an index-linked career-average scheme, with guaranteed indexation in line with general wage increases. Pensions of existing pensioners and former DNB employees are indexed only if the pension fund's financial position allows this. As the pension contributions paid are included as an expense, no provision has been created.

The contribution towards the health insurance premiums payable by pensioners concerns an allowance for a limited group of pensioners towards the costs concerned and may be characterised as a temporary transitional arrangement.

The service anniversary and retirement bonus arrangement provides for bonuses payable to staff upon 20, 30 and 40 years' service and for bonuses payable to staff upon retirement and payments made to surviving dependants.

The liabilities and annual costs are actuarially determined. The assumptions used were:

	31 December 2012	31 December 2011
Discount rate other staff remuneration (%) 4.6	anniversaries 2.8 Other 2.4	4.6
General wage increase (%) 2.0	2.0	2.0
Individual wage increase (average) (%)	2.0	2.0
Indexation (%)	2.0	2.0
Mortality rate	AA projection table 2012-62 acc. to scheme-dependent mark-up on GBM/V life tables 2000-2005 (-1, -2)	AA projection table 2010-60 acc. to mark-up on GBM/V life tables 2000-2005 (-1, -2)
Development of mortality trend other staff remuneration (%)	anniversaries -3.5 health care cost scheme 13.9 Miscellaneous 0.0	4.4

The changes in the provision for staff remuneration were as follows:

EUR million

	Total	Contribution to pensioners' health care insurance premiums	Other
Position as at 31 December 2011	12	7	5
Expense	1	1	0
Addition	2	0	2
Release	2	2	0
Position as at 31 December 2012	**11**	**6**	**7**

– Other provisions

These provisions relate to past reorganisations. A total of EUR 2 million of ‘Other provisions’ has a maturity of less than 1 year, while EUR 2 million has a maturity of between 1 and 5 years. No new provisions were made in 2012.

Revaluation accounts (11)
The revaluation accounts break down as follows:

EUR million

	Total	Gold	Foreign currency	Securities and other financial instruments
Balance as at 31 December 2010	20,365	19,655	109	601
Net revaluation change	3,048	3,179	-19	-112
Balance as at 31 December 2011	23,413	22,834	90	489
Net revaluation change	871	873	-20	18
Balance as at 31 December 2012	**24,284**	**23,707**	**70**	**507**

The net increase in the total revaluation accounts is attributable mainly to the increase in the gold price in 2012.

Capital and reserves (12)
DNB's authorised capital, which is fully issued and paid-up, amounts to EUR 500 million and is divided into 500 shares of EUR 1 million each.
All shares are held by the central government. The statutory reserve comprises the book value of the intangible assets.

Capital and reserves developed as follows during the year:

EUR million

	Total	Capital	General reserve	Statutory reserve
31 december 2010	**7,244**	**500**	**6,735**	**9**
Tranfer of net profit	463		463	
Change in statutory reserve	0		0	0
31 December 2011	**7,707**	**500**	**7,198**	**9**
Tranfer of net profit	104		104	
Change in statutory reserve	0		-6	6
31 December 2012	**7,811**	**500**	**7,296**	**15**

Other

Balance sheet amounts in foreign currency
DNB has fully hedged the exchange rate risk of its USD and AUD positions under asset items 2.2 'Balances with banks and security investments, external loans and other external assets' and 3 'Claims on euro area residents denominated in foreign currency' and that of the SDR position included in asset item 2.1 'Receivables from the International Monetary Fund (IMF)' and liability item 7 'Counterpart of special drawing right allocated by the IMF', except for working stocks.

The countervalue in euro of the sum total of assets denominated in foreign currency (included in asset items 2, 3 and 9.3) was EUR 17,255 million on year-end 2012 (year-end 2011: EUR 16,953 million). As at year-end 2012, the euro equivalent of the sum total of liabilities denominated in foreign currency (included in liability items 5, 6 and 7) was EUR 5,638 million (year-end 2011: EUR 5,740 million). The off-balance sheet position for foreign currencies is shown below.

Overview of off-balance sheet positions in currency swaps and forward contracts

EUR million

	31 December 2012							31 December 2011						
	Total	EUR	USD	JPY	GBP	AUD	SDR	Total	EUR	USD	JPY	GBP	AUD	SDR
Currency swaps														
Receivables	11,775	11,292	483	0	0	0	0	10,247	9,743	504	0	0	0	0
Payables	-11,421	0	-6,794	-459	-14	-1,007	-3,147	-10,761	-5	-7,445	-509	-13	0	-2,789
	354	11,292	-6,311	-459	-14	-1,007	-3,147	-514	9,738	-6,941	-509	-13	0	-2,789
Currency forwards														
Receivables	689	341	348	0	0	0	0	1,025	647	378	0	0	0	0
Payables	-687	-341	-346	0	0	0	0	-1,027	-348	-382	0	0	0	-297
	2	0	2	0	0	0	0	-2	299	-4	0	0	0	-297
Total	**356**	**11,292**	**-6,309**	**-459**	**-14**	**-1,007**	**-3,147**	**-516**	**10,037**	**-6,945**	**-509**	**-13**	**0**	**-3,086**

The financial instruments shown in the above overview are currency swaps and forward contracts. These instruments are used to hedge currency exposure. The total of EUR 356 million is the net currency revaluation for these instruments. These are included in the balance sheet in 'Accruals and prepaid expenses' (9.4).

A currency swap is a transaction in which parties agree to directly buy or sell one currency in exchange for another currency at the spot or current rate and later to sell or buy back the currency at the forward rate. The spot purchase or sale is shown in the balance sheet, while the forward sale or purchase is recorded as an off-balance sheet item at the forward rate.
A currency forward contract is a transaction in which parties agree to buy or sell a currency in return for another currency at a specific rate and for delivery at a date in the future. The off-balance sheet positions are shown at the forward rate. Differences between the spot and forward rates for currency swaps and forward contracts are amortised and taken to the profit and loss account. forward returns still to be amortised are included in the balance sheet in 'Accruals and prepaid expenses' (9.4). Theses currency positions are included in the revaluation accounts in the balance sheet.

Interest rate swaps
The underlying value of interest rate swaps is also shown as an off-balance sheet item. The purpose of an interest rate swap is to hedge interest rate risk. An interest rate swap is an agreement to exchange interest cash flows during a predetermined period. The interest amounts are calculated on the underlying value of the interest rate swap. Only the interest flows are actually exchanged. Interest rate swaps are revalued on the balance sheet date. Any differences arising are shown in accordance with the policies stated under 'General'.
The underlying values with regard to interest rate swaps were as follows:

Millions

	31 December 2012	31 December 2011
	EUR	EUR
Euro portfolio	224	545
USD portfolio	227	172
Other Financial Assets (OFA)	192	377
Total	**643**	**1,094**

Custody
DNB holds securities and other documents of value in custody for third parties. Such custody is for the account and risk of the depositors.

Guarantee scheme for crisis-related assets
As a result of the measures taken by the Eurosystem to counter the debt crisis, the financial risks for DNB increased further in 2012 [11]. The total financial risk (excluding gold) at year-end 2012 was EUR 13.5 billion. DNB uses the expected shortfall (ES) method to measure and manage its financial risks, with calculations for various scenarios being made. The total risk is significantly higher than the total capital and general reserve of EUR 7.8 billion. In view of the significant level of these risks the Minister of Finance has provided a contribution-free unconditional guarantee, with a ceiling of EUR 5.7 billion. This guarantee relates to DNB's share in possible losses on crisis-related exposures in the monetary portfolios.

Off-balance sheet liabilities

Notices of liability
By reason of its supervisory task or otherwise, DNB may receive notices of liability or preannouncements of such liability notices. The Governing Board assesses (partly on the basis of legal advice) whether these notices or preannouncements, given their content, materiality and probability, could lead to a claim not qualifying for full or partial recovery as supervisory costs, in which case a provision is made. Where an expected settlement amount cannot be determined with sufficient reliability, it is only mentioned in these notes. The Governing Board saw no reason to make a provision on this account in 2011. The relevant current cases are discussed in more detail below.

11 More information on DNB's financial risks can be found in Sections 4.6 and 4.7 of the Annual Report.

Claim of a money transactions office and two former directors of the office
In these proceedings, the Amsterdam Court of Appeal gave an interlocutory ruling in 2011 in liability proceedings in connection with the deletion from the register of the entry of a money transactions office in 2004. On 31 July 2007 the Trade and Industry Appeals Tribunal, as the highest administrative court, dismissed the appeal against the decision to delete the entry as being unfounded. In civil liability proceedings, the institution and its directors sought once again to obtain compensation on the grounds of allegedly unlawful decision-making. The Amsterdam District Court dismissed the institution's claim in its ruling of 14 April 2010. The institution subsequently filed an appeal against this ruling at the Amsterdam Court of Appeal. In 2011 the Court of Appeal issued an interlocutory order requiring DNB to produce evidence. This was followed in 2012 by the examining of witnesses.

Claims of Fortis shareholders
A group of Belgian Fortis shareholders has brought proceedings against DNB – as well as against the Dutch central government and Fortis – before the Brussels Commercial Court in an action including a claim for damages of EUR 5 per share. It is not known how many shares are involved. In its ruling of 8 December 2009, the Commercial Court honoured the Dutch central government's and DNB's invocation of immunity in these proceedings. Some Fortis shareholders appealed against this ruling in 2011. As part of the appeal proceedings, written statements were exchanged in 2012, while one party's plea was heard. A ruling is expected in the first half of 2013.

Stichting Pensioenfonds Vereenigde Glasfabrieken
This matter relates to the appeal against DNB's decision to instruct a pension fund (Stichting Pensioenfonds Vereenigde Glasfabrieken) to substantially reduce its investments in gold. On 15 March 2012 the District Court ruled against DNB, reversed the decision on objection, revoked the principal decision and reopened the investigation in preparation for a further ruling on the amount of compensation payable. The pension fund has provisionally estimated its loss at EUR 9,500,000. DNB has appealed against the Rotterdam District Court's decision. The District Court has postponed the compensation proceedings until after the ruling in the appeal case. The Trade and Industry Appeals Tribunal heard the latter appeal on 11 December 2012 and is expected to announce its ruling in 2013.

Vereniging Icesaving
In 2011 the Association of aggrieved savers with Icesave ('Vereniging Icesaving') summoned DNB to appear before the Amsterdam District Court. Vereniging Icesaving's demands included requesting the District Court to rule that DNB had acted unlawfully towards the Association's members (or at least towards savers holding deposits at Landsbanki as at 13 October 2008 that were in excess of EUR 100,000) and to order DNB to pay compensation. The District Court ruled in DNB's favour on 19 September 2012 and rejected all the Association's claims. The Association has since appealed against this ruling.

Stichting Gedupeerden Easy Life
A foundation (Stichting Gedupeerden Easy Life) set up to represent investors claiming to have lost money as a result of the activities of Easy Life initiated legal proceedings against DNB at the Amsterdam District Court in 2012. The foundation's claims include a request for the Court to rule that DNB acted unlawfully towards investors who invested in various companies (not subject

to supervision) that operated under the Easy Life banner and to order DNB to compensate the losses the investors suffered.

Greek shipping company and business owner
A natural person and an enterprise in Greece have instigated legal proceedings in Greece against parties including DNB and the Dutch State. The dispute leading to the summons concerned a commercial dispute between the company and a banking consortium on repayment of a credit facility and the related call on a bank guarantee. The main complaint against DNB would seem to be that DNB failed to intervene after allegedly being told about the laundering of proceeds from criminal activities.

DNB received several notices of liability in 2012, but these have not yet been followed by civil proceedings.

Article 32.4 of the Statute of the ESCB
Under Article 32.4 of the Statute of the European System of Central Banks and the ECB, the Governing Council of the ECB may decide that costs incurred in connection with the issue of banknotes and, in exceptional circumstances, specific losses arising from monetary policy operations undertaken for the ESCB will be borne by all national central banks of the participating Member States, in proportion to their capital key.

Outright Monetary Transactions (OMT)
On 6 September 2012 the ECB Governing Council announced the strict conditions applying to secondary-market purchases of government paper in the Outright Monetary Transactions (OMT) programme. As a national central bank in the Eurosystem DNB will participate in this programme. Any losses on these transactions will be shared among the participating Member States' national central banks in accordance with the Eurosystem capital key.

3 Notes to the profit and loss account

The figures in parentheses following the descriptions refer to the corresponding items in the profit and loss account.

Operating income

Net interest income (1) and (2)
This item includes interest income and interest expense in respect of the assets and liabilities denominated in euro.

Composition of interest income
Millions

	2012	2011
	EUR	EUR
Investments	398	575
Money market lending	184	85
Monetary portfolios	769	482
Eurosystem claims/liabilities	1,582	1,212
Total interest income	**2,933**	**2,354**

Composition of interest expenses
Millions

	2012	2011
	EUR	EUR
Money market liabilities	358	740
Miscellaneous	19	39
Total interest expenses	**377**	**779**

Net interest income came out higher in 2012 than in 2011 thanks to a combination of higher interest income and lower interest expense Interest income rose as a result of the increase in the average receivables, primarily because of the Dutch commercial banks participating in the longer-term refinancing operations.
In addition, the substantial easing of the euro area money market has induced commercial banks, since 2011, to place surplus liquidity at the national central banks of strong euro area countries such as the Netherlands. These holdings of surplus liquidity are one of the reasons for the increase in intra-Eurosystem claims and hence an increase in interest income. Interest income also rose as a result of purchases under the 'Securities Markets Programme' (SMP) and the 'Covered Bond Purchase Programmes' (CBPP1 and CBPP2).
The easing of the money market referred to above also resulted in higher average amounts being owed by DNB to the commercial banks. Despite the rise in average liabilities, however, interest expense was lower because of the fall in the average interest rate paid on banks' balances held at DNB.
Since 2012 income from ordinary shares and participating interests has been shown separately in the profit and loss account. The comparative figures have been restated accordingly.

Realised gains/losses arising from financial operations (3)

Millions

	2012	2011
	EUR	EUR
Exchange rate gains/losses	4	42
Price gains/losses on sales of fixed-income securities	312	116
Price gains/losses on sales of equities	21	77
Gains/losses on sales of gold	-	-
Total	**337**	**235**

The lower exchange rate gains were primarily attributable to lower sales of shares in foreign currencies in 2012. The increase in price gains on sales of fixed-income securities was attributable to the fall in the average EUR and USD interest rates and the reduction in risk that resulted in shorter durations.
The fall in the price gains on sales of equities resulted from lower sales in 2012.

Write-downs to lower market value (4)
The write-downs consist mainly of price revaluation losses on fixed-income securities (EUR 42 million).

Income from ordinary shares and participating interests (7)
This item amounted to EUR 61 million at year-end 2012 and included the results of DNB's participating interest in the ECB (EUR 37 million) and dividends from equity index investments (EUR 18 million). This item amounted to EUR 71 million at year-end 2011, with the largest individual item being the participating interest in the ECB (EUR 47 million). In 2011 this item was included in interest income.

Net result of pooling of monetary income (8)
The amount of each Eurosystem NCB's monetary income is determined by measuring the actual annual income that derives from the earmarked assets held against its liability base. The liability base consists of the following items: 'Banknotes in circulation', 'Liabilities to euro area credit institutions related to monetary policy operations denominated in euro', 'Other liabilities within the Eurosystem (net) resulting from TARGET2 transactions', and 'Net liabilities related to the allocation of euro banknotes within the Eurosystem'. Any interest paid on items included in the liability base has to be deducted from the monetary income to be pooled.
The earmarkable assets consist of the following items: "Lending to euro area credit institutions related to monetary policy operations denominated in euro', 'Securities held for monetary policy purposes (covered bonds)', 'Securities ensuing from the Securities Markets Programme (SMP)', 'Claims equivalent to the transfer of foreign reserves to the ECB', 'Other claims within the Eurosystem (net) resulting from TARGET2 transactions', 'Net claims related to the allocation of banknotes within the Eurosystem' and a limited amount of each NCB's gold holdings in proportion to the capital key. Gold is considered to generate no income. Where the value of an NCB's earmarked assets exceeds or falls short of the value of its liability base, the difference is offset by applying the refinancing percentage to the value of the difference. The income on the earmarked assets is included under 'Interest income and dividend'.

The net result of pooling monetary income can be broken down as follows:

Millions

	2012 EUR	2011 EUR
Monetary income accruing to DNB	1,335	894
Monetary income earned by DNB	-2,283	-1,236
Net monetary income	-948	-342
Adjustment of monetary income pooling preceding years	3	2
Total net result of monetary income pooling	-945	-340
Share of DNB in release of 'Provision for monetary policy operations'	36	70
Net result of pooling of monetary income	**-909**	**-270**

The monetary income pooled by the Eurosystem NCBs is to be allocated among the NCBs in proportion to the subscribed capital key. For DNB, the net result arising from the pooling of monetary income (EUR 948 million) arises from the difference between the monetary income pooled by DNB, amounting to EUR 2,283 million, and the monetary income reallocated to DNB, amounting to EUR 1,335 million. In addition, corrections were made in 2012 in respect of the pooling of monetary income in 2008, 2009 and 2011, leading to a net gain for DNB of EUR 3 million. Hence, the total net result of the pooling of monetary income is a charge of EUR 945 million (year-end 2011: EUR -340 million). Furthermore, it includes DNB's share in the net result of the change in the 'Provision for monetary policy operations', being a release to profit of EUR 36 million against a release of EUR 70 million in 2011.
(see 'Provisions' (note 10) in the Notes to the balance sheet) The net amount withdrawn in 2012 was -EUR 909 million (year-end 2011: EUR -270 million).

Other income (10)
This item includes the proceeds arising from the fact that the costs of supervision are passed on to the supervised institutions, as well as the government contribution to the performance of supervisory activities.
The increase in other income is attributable to the release of EUR 243 million from the provision for guilder banknotes.

Millions

	2012 EUR	2011 EUR
Contribution of supervised institutions	97	93
Government contribution	31	26
Other	257	3
Total	**385**	**122**

Operating expenses

The operating expenses break down as follows:

Millions

	2012 EUR	2011 EUR
Staff costs	194	191
Other administrative expenses	79	77
Depreciation of (in)tangible fixed assets	27	30
Costs of production of banknotes	14	10
Other expenses	1	0
Capitalised costs of software	-4	-3
Total operating expenses	**311**	**305**

Staff costs (11)
The average number of employees, expressed as full-time equivalents (FTEs), came to 1,625 in 2012, compared to 1,589 in 2011. The increase was largely accounted for by the filling of vacancies and an increase in staff in the supervisory divisions.

The total staff costs in 2012 and 2011 break down as follows:

Millions

	2012 EUR	2011 EUR
Wages and salaries	126	122
Social security contributions	12	13
Pension burden	40	41
Other staff costs	16	15
Total	**194**	**191**

The annual costs (EUR 40 million) relating to the pension scheme are included under 'Pension burden'. It equals contributions made (EUR 45 million) minus a an employer-paid contribution (EUR 5 million).

The annual costs on account of the 'Contribution to the health care insurance premiums of pensioners' are included under 'Social insurance contributions'. The annual costs on account of other staff remuneration are included under 'Wages and salaries' and 'Social insurance contributions'.

Remuneration of the Governing Board
The salaries of Governing Board members for 2012 as fixed by the Minister of Finance are on an annual basis and include a holiday bonus and an additional month's salary as well as an increase of 1.75% as from 1 October 2011 (in conformity with the collective labour agreement for staff) approved by the

Minister. The pension scheme for the members of the Governing Board is in accordance with the agreements made with the Minister of Finance in 2005. Like other staff, the members of the Governing Board contribute to their pension premiums.

The salaries of, the employer's social insurance contributions and other payments and the pension premiums paid for each member of the Governing Board were as follows in 2012 and 2011:

EUR

Governing Board member	Salary		Employer's expenses and other compensation*		Employer's 'crisis levy' expenses**		Pension burden	
	2012	2011	2012	2011	2012	2011	2012	2011
A.H.E.M. Wellink [12]		226,800[13]		7,553	-	-	-	-
H.J. Brouwer [12]		162,400		8,873	-	-		37,352
A.J. Kellermann	289,988	286,401	17,218	21,453	26,826	-	86,082	85,078
L.H. Hoogduin [14]		190,000		9,548	-	-		56,443
K.H.W. Knot [15]	320,513	158,980	18,111	7,837	26,349	-	95,080	47,194
J. Sijbrand [15]	292,617[16]	134,880	16,284	10,621	23,601	-	86,875	40,085
F. Elderson [15]	271,926	134,880	23,902	7,390	24,239	-	80,757	40,085
J. Swank [17]	271,926	22,660	16,028	1,232	18,525	-	80,796	6,734
Total	**1,446,970**	**1,317,001**	**91,543**	**74,507**	**119,540**	**-**	**429,590**	**312,971**

* As from 2011, these costs also include, where applicable, an approximation of the costs of private use of the car made available by DNB. The members of the Governing Board do not receive compensation for the addition to taxable income on account of private use.
** In 2013, employers are required to pay a 16% levy on individual salary sums in excess of EUR 150,000 paid in 2012. The calculation base for this levy ('loon voor de loonheffingen') includes bonuses, company car use addition etc. For all Governing Board members together, this levy comes to EUR 119,540, payable in 2013 but charged to financial year 2012.

The table below presents the mortgage loans extended to Governing Board members under DNB's staff mortgage loan scheme.

EUR

Governing Board member	Principal outstanding 31 December 2012
F. Elderson	340,335
J. Swank	444,705
Total	**785,040**

12 Resigned effective 1 July 2011.
13 Including severance pay for employers having served over 20 years, in accordance with the DNB staff collective labour agreement.
14 Resigned effective 1 September 2011.
15 Joined the Governing Board on 1 July 2011.
16 Appoined to the role of Supervisory Council chairman on 15 February 2012, with remuneration adjustment.
17 Joined the Governing Board on 01 December 2011.

Remuneration of the Supervisory Board
Under Section 15 of the Articles of Association, the General Meeting of Shareholders, on the Supervisory Board's recommendation, adopts the amounts and indexing method for the annual compensation paid to Supervisory Board members. The General Meeting of Shareholders has decided for annual indexation by the consumer price index published by Statistics Netherlands (CBS). Accordingly, the compensation base for a Supervisory Board member was EUR 24,754 per annum in 2012, and for the Chairman EUR 30,801 per annum. Members of the Supervisory Board who also sit on a Committee receive an additional fee of EUR 6,188. The fees apply pro rata. The total fees (excluding VAT) paid to the members of the Supervisory Board for the year 2012 amounted to EUR 254,101 (2011: EUR 279,100).

In 2012 and 2011, the members of the Supervisory Board were remunerated as follows:

EUR

Member	2012	2011
A.H.G. Rinnooy Kan *(Chairman)*	21,589	
J.F. van Duyne *(Chairman)*	18,495	36,088
A.M. Fentener van Vlissingen *(Vice-Chairman)*	30,942	30,188
E. Kist *(Vice-Chairman)*	20,628	30,188
F. Bolkestein		27,672
A.H. van Delden**	29,911	24,150
K.P. Goudswaard	7,220	
T. van de Graaf**		12,075
A.H.M. de Jong**	6,188*	10,063*
G.J. Kleisterlee	2,579	30,188
W.J. Kuijken**	20,628	
J.A. van Manen	29,911	24,150
F. Sijbesma	10,314	
W.G. Tuinenburg	25,785	30,188
H.M. Vletter-van Dort	29,911	24,150
Total	**254,101**	**279,100**

* Fee paid to the employer.
** Also a member of the Bank Council. Bank Council members receive a pro rata annual fee of EUR 2,850. This fee is not included here.

Other administrative expenses (12)
The total other administrative expenses in 2012 and 2011 were as follows:

Millions

	2012	2011
	EUR	EUR
Temporary staff and outsourcing	30	29
Travel and accommodation expenses.	4	5
Accommodation	10	10
Office equipment, software and office expenses	22	23
General expenses	13	10
Total	**79**	**77**

The General expenses include the fee paid to the external auditor. This fee breaks down as follows:

EUR

	2012	2011
Audit of the financial statements	284,762	348,830
Other audit	114,094	34,647
Tax consultancy	0	79,128
Other non-audit services	57,861	167,139
Total	**456,717**	**629,744**

Costs of DNB's tasks as a public body
In its capacity as a public body, DNB exercises prudential supervision over financial institutions. Pursuant to the supervisory legislation, more information is given in a separate publication, which is drawn up in conformity with the public principles (VBTB) which DNB applies to its tasks as a public body. The actual costs as accounted for in that 'ZBO Account' were as follows:

Millions

	Actual 2012	2012 budget	Actual 2011
	EUR	EUR	EUR
Banks [18]	51	53	46
Pension funds	29	30	27
Insurers [19]	35	37	34
Other institutions and Sanctions Act	12	13	11
Total costs of supervision	127	133	118
FEC unit [20]	1	1	1
Total public-body costs	**128**	**134**	**119**

For detailed notes, the reader is referred to DNB's (Dutch-language) account of its public tasks in 2012.

Amsterdam, 13 March 2013
Governing Board of
De Nederlandsche Bank NV

K.H.W. Knot, *President*
A.J. Kellermann
J. Sijbrand
F. Elderson
J. Swank

Amsterdam, 13 March 2013
Adopted by the Supervisory Board of
De Nederlandsche Bank NV

A.H.G. Rinnooy Kan, *Chairman*
A.M. Fentener van Vlissingen, *Vice-chairman*
A.H. van Delden, *Secretary*
K.P. Goudswaard
W.J. Kuijken
J.A. van Manen
F. Sijbesma
H.M. Vletter- van Dort

18 Banks including other (non-bank) credit institutions.
19 Including the costs for health care insurers totalling EUR 5.4 million (budgeted:EUR 5.5 million).
20 Under the new Financial Supervision Funding Act (Wet bekostiging financieel toezicht), expenses on behalf of the FEC unit are no longer included in the costs of supervision. The comparative figures have been restated accordingly.

4. Other information

Independent auditor's report
To the Governing Board, the Supervisory Board and the General Meeting of Shareholders of De Nederlandsche Bank NV

We have audited the accompanying 2012 financial statements of De Nederlandsche Bank NV, Amsterdam, as set out on pages 120 to 159, which comprise the balance sheet as at year-end 2012, the profit and loss account for the year then ended and the notes, including an overview of the accounting policies and other notes.

Governing Board's responsibility
The Governing Board of De Nederlandsche Bank NV is responsible for the compilation of the Financial Statements in accordance with the accounting principles set out in Guideline ECB/2010/20, supplemented by the applicable provisions of Title 9, Volume 2, of the Dutch Civil Code, pursuant to Section 17 of the Bank Act 1998, and for the wording of the Annual Report set out on pages 5–119 herein, in accordance with Title 9, Volume 2, Section 391 of the Dutch Civil Code. The Governing Board is also responsible for maintaining such internal control as it considers necessary to ensure the compilation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's responsibility
Our responsibility is to express an opinion on the financial statements based on our audit. We conducted our audit in accordance with Dutch law, including the Dutch auditing standards. This requires that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance that the financial statements are free from material misstatement.

An audit involves performing procedures to obtain verification evidence regarding the amounts and explanatory notes set out in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risk that the financial statements may contain any material misstatement, whether due to fraud or error.

In making those risk assessments, the auditor considers internal control relevant to the company's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the company's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the Governing Board, as well as evaluating the overall presentation of the financial statements. In our opinion, the audit evidence we have obtained provides a sufficient and appropriate basis for our audit opinion.

Opinion on the financial statements
In our opinion, the Financial Statements of De Nederlandsche Bank N.V. have, in all material respects, compiled in accordance with the accounting principles based on Guideline ECB/2010/20, supplemented by the applicable provisions of Title 9, Volume 2, of the Dutch Civil Code, as provided in Section 17 of the Bank Act 1998.Declaration regarding other statutory and legal requirements Pursuant to Section 2:393(5), subparagraphs e and f, of the Dutch Civil Code,

we state that no evidence of insufficiencies has emerged from our inquiry as to whether the Annual Report set out on pages 5-119 herein has, to the extent of our competence, been drawn up in accordance with Title 9, Volume 2, Section 391 of the Dutch Civil Code, and whether the data required pursuant to Section 2:392(1), subparagraphs b through h, of the Dutch Civil Code have been included on page 162.

We also state that, to the extent of our competence, the Annual Report set out on pages 5-119 herein, conforms to the requirements set out in Section 2:391(4) of the Dutch Civil Code.

On the basis of our obligation pursuant to Section 157(4) of the Pension Act (Pensioenwet) and Section 1:34(4) of the Financial Supervision Act (Wet op het financieel toezicht), both as in force on year-end 2012, we state that nothing has come to our notice that would cause us to conclude that the information on efficiency as stated on pages 82-98 of the Annual Report is incorrect.

Amsterdam, 13 March 2013

Deloitte Accountants BV

H.H.H. Wieleman

Provisions governing the allocation of profit
These provisions are set out in article 22(2) of the Articles of Association of De Nederlandsche Bank NV and read as follows:

The profit, as shown in the adopted Financial Statements, shall be at the disposal of the general meeting of shareholders.

Allocation of profit
With due observance of the above provisions of the Articles of Association, the allocation of profit has been fixed as follows:

Allocation of profit
Millions

	2012	2011
	EUR	EUR
Transfer to General reserve	104	463
Distribution to the State	1,975	750
Result for the year	**2,079**	**1,213**

Events after balance sheet date

On 1 February 2013, SNS Reaal and SNS Bank were expropriated by the State of the Netherlands. The expropriation comprised all paid-up shares in the capital of SNS Reaal NV, all Stichting Beheer SNS Reaal Core Tier 1 capital securities issued by SNS Reaal NV, all paid-up shares in the capital of SNS Bank NV insofar as held by others than SNS Reaal NV or its group companies, all subordinated bonds of SNS Reaal NV and SNS Bank NV and all subordinated private debts of SNS Reaal NV and SNS Bank NV.