Kingdom of the Netherlands-The Netherlands Financial Sector Assessment
Preliminary Conclusions by the Staff of the International Monetary Fund
December 14, 2010

Introduction

1. At the request of the Netherlands authorities a Financial Sector Assessment Program (FSAP) team led by the Monetary and Capital Markets Department of the IMF has visited the Netherlands between November 29 and December 14, 2010 in order to conduct an update of the Fund's 2004 assessment of the soundness and stability of the Netherlands financial sector. It has been the practice that such assessments are undertaken roughly every seven years.[1] The following provides some initial findings from the mission. These findings are subject to further review, and will also serve as background to the Article IV discussions to be held with the IMF's European Department in spring 2011.

2. **The Netherlands has over the past decade introduced a financial sector supervisory model that is being studied closely in many countries.** Prudential oversight of all financial institutions—banks, insurance and pension funds, and securities firms—is exercised by a single authority. This reflects the increasing interconnectedness of the various elements of the financial system, with large complex financial institutions (LCFIs) spanning the sector. In the Netherlands, the decision was made to place prudential supervision in the Netherlands Central Bank (DNB), leveraging on the synergies between the macro monitoring and micro supervisory aspects, as well as on its long-standing credibility. With regard to conduct-of-business supervision, the Financial Markets Authority (AFM) has a strong focus on market behavior and consumer/investor protection.

3. **The "twin peaks" model of supervision, with DNB as the prudential supervisor and the AFM responsible for conduct-of-business supervision, remains appropriate.** Additional strengths, perhaps not foreseen at the outset, have become evident: with all prudential oversight concentrated in one institution, DNB has the ability to take a systemic view across the financial sector as a whole, and the ability to react quickly and decisively.

4. **As elsewhere, the Netherlands has been heavily affected by the global economic crisis.** Public expenditure to provide capital support to banks and insurance

[1] Participation in the exercise until recently had been voluntary, but following a recent IMF Board decision, the FSAP exercise has become mandatory for the 25 most interconnected economies in the world (which includes the Netherlands). For the 25 economies, the FSAP is to be undertaken following a five year cycle.

companies as a share of GDP was significant. Few large financial institutions survived without substantial state support, and state ownership or participation is now extensive. Four of the five largest financial groups are therefore subject to restructuring programs, at the behest of the Dutch authorities and the European Commission (EC).

5. **In view of some high-profile domestic failures, the credibility of the prudential authorities has been tested.** DSB bank was closed in 2009. A government report on the failure of DSB criticized DNB's handling and called for a change of culture. The failure of IceSave, an internet branch of an Icelandic bank with a substantial Dutch customer base, has led to difficult international negotiations.

6. **Conduct-of-business problems have negatively affected confidence in the integrity of the financial institutions, particularly in insurance.** Extensive selling of products with high commission has reduced public confidence in insurance companies. With the settlement of the resulting claims likely to take many years, supervisors have taken proactive measures to ensure that financial institutions rebuild confidence in the industry, which remains an immediate priority.

Macrofinancial situation

7. **The Netherlands' economy has so far weathered the economic crisis better than many other countries in Europe.** After growing 1.9 percent in 2008, the economy fell by 4 percent in 2009, and is now projected to rise 1.8 percent in 2010. Unemployment remains about 4.5 percent, amongst the lowest in the European Union (EU). Growth is projected to remain relatively subdued over the medium term; unemployment is projected to decline gradually from around 2012.

8. **The concentration of the financial sector, particularly the banks, already high before the crisis, has increased further and is amongst the highest in the EU.** With the activities of several of the largest institutions heavily constrained by EC requirements, competitive forces seem to be weaker than elsewhere, risking worsening the access of the public to financial products and reducing pressures on the banks to adapt to the new post-crisis environment.

9. **Households remain heavily indebted, with levels amongst the highest in the EU, while corporate balance sheets appear to be recovering.** Borrowing is particularly related to housing, and is frequently ascribed to the tax and the mortgage structure that allows for tax deduction of interest payments for full principal value even when the principal in essence has already effectively been amortised in a separate account. House prices did not rise as rapidly as did those of some other countries in the EU. Conversely, they have so far not fallen as much, and while there is no consensus, it is argued that

house prices may be close to their equilibrium levels. Meanwhile, corporate bankruptcies look to be declining.

Overall stability assessment

10. **Netherlands financial institutions look to be able to maintain their soundness not only on the basis of forecast scenarios, but also in the face of the extreme shocks against which they were tested.** The authorities have taken a number of welcome steps that enhance their financial supervisory practices. Future financial stability will require the maintenance of strong, and indeed enhanced, supervisory standards, as well as close monitoring of unfolding circumstances by the institutions and their supervisors, and their willingness and ability to react quickly as circumstances require**.**

11. **Banks' financial soundness has improved compared to 2008.** All large banks maintain high capitalization buffers well above minimum requirements, which reflects substantial official support to several of the largest banks. The capital augmentation, along with the general return to profitability, appear to place the banks in a good position to meet the increasingly robust capital requirements under Basel III.

12. **In 2010, the Committee of European Bank Supervisors (CEBS) conducted stress tests on the major banks in the Netherlands and elsewhere in the EU; this Financial Sector Assessment Program (FSAP) extends these tests.** The FSAP follows the framework of the CEBS**,** and tests for a "double dip" in economic activity over the coming two years; but while the CEBS tests covered four banks, seven banks, comprising around 83 percent of the market, were tested here. Prospects for the banks were examined up to 2015, and particularly severe stresses were imposed on the baseline projection in order to examine the soundness and resilience of the banks under extreme conditions.

13. **Banks seem able to weather even the extreme tests.** Under the baseline scenarios Tier 1 capital ratios rise for all banks through the projection period. Even under extreme stress, the banking system remains resilient. Overall, the situation looks to be manageable; if the system faces an extreme negative scenario, affected banks are expected to be able to make the necessary adjustments.

14. **Insurance companies are suffering from a saturated market compounded by low economic growth and low interest rates. With the loss of tax advantage, they are also confronting growing competition from banks and asset managers.** The longer this situation persists, the more pervasive this problem will be. Life insurers have a serious problem of image, and need to restore public confidence by making a clear break in business plans and in perceptions. This is widely being called for.

15. **Stress tests on the insurance companies reveal wide disparity in their prospects under the adverse scenarios.** While some companies clearly suffer under the medium-term low growth/low interest rate scenarios, others are much less affected, or even strengthen their position over the projection period. Persistence of sovereign debt turmoil could be more threatening, given the general absence of hedging on exposures that until recently looked to be risk-free. Overall, one might expect industry consolidation; adaptations in the business model reflecting the new environment seem already evident.

16. **Facing low interest rates and extended life expectancy, pension funds too are under financial stress, with widespread news reports on the uncertainty of the future level of pension benefits.** Indexation of benefits has already been widely abandoned, and maintenance of commitments in nominal terms is under threat. Stress tests indicate vulnerabilities; formally the funds appear able to pass on the risks to their customers to preserve their own financial positions. The proactive approach to pension fund supervision is welcomed.

17. **Overall, vulnerabilities look to be: (i) largely external, or (ii) related to high mortgage indebtedness by home buyers.** External risks stem from the foreign activities of Dutch financial institutions and the activities of foreign financial institutions, including those from elsewhere in the European Economic Area (EEA), in the Netherlands. Key safeguards will be multilateral and bilateral engagement and coordination, through the supervisory college process, robust monitoring through off site surveillance, and stress testing that takes account of the external risk dimensions. The domestic risks from high indebtedness in the housing sector continue to require close scrutiny, though mitigating factors appear to offer reassurance. Nevertheless, the high loan-to-value (LTV) ratio, as well as elevated bankruptcies flag the vulnerability and need for continued vigilance.

Financial and systemic oversight

18. **The Netherlands has a long history as an open trading nation, with household-name institutions operating worldwide.** With this history, the financial sector is dominated by systemically important institutions that operate in diverse markets. Such institutions bring considerable benefit to the country—however, the crisis has shown that they also bring sizeable risks. An IMF study has concluded that the Netherlands is the seventh most financially interconnected country in the world. Mitigating the risks in this position requires careful and comprehensive monitoring and supervision. This in turn requires strong supervisory institutions, with well-recognized powers, and the willingness and ability to use them.

19. **Independence of supervisors is recognized to be an essential element for effective supervision, and the DNB and the AFM have histories of broad**

independence. Current law affords the Minister of Finance residual powers under certain qualified circumstances to take back supervisory functions and override regulations. This balance between the executive and the delegated agencies is explained in terms of the Netherlands' practice, and the formal powers vested with the position of the minister have never been exercised. It is important that use of the ministerial override powers be exceedingly rare, and that they not be seen as a threat that could chill appropriate actions.

20. **DNB is making intensive and well-focused efforts to redress earlier criticisms.** It has issued two publications "DNB Supervisory Strategy 2010-2014" and "From Analysis to Action" that indicate a commendable sensitivity to the perceptions of earlier difficulties, and a change in culture that can lead to a more pro-active and decisive role in supervising the financial sector and enforcing prudential requirements. These publications are being widely circulated inside and outside DNB; it will be important that full buy-in for their objectives and methods is achieved both inside and outside the institution.

21. **The allocation of the prudential function to DNB reflected the recognition of the benefits of having a strong and credible institution to carry out this role; clear delineation of its powers, and demonstrated use of these powers would be important to restore credibility**. The strategy of higher intensity supervision will be important, including greater use of formal enforcement powers when merited, for which the latter confronts an increasingly litigious environment. To address this concern DNB and the AFM should be provided with legal protection for their official actions as institutions, except in cases of gross negligence or willful misconduct, in line with practice in many neighboring countries. It would be helpful to provide similar protection to State and resolution trustees in the case of resolution actions.

22. In the Netherlands a robust supervisory framework for the securities market has developed. As the primary supervisor of the securities market, the AFM uses a risk-based approach based on themes that become the focus of onsite-supervision, complemented with an institution-based program of both off-site and on-site supervision of high-impact firms.

23. **The crisis has revealed worldwide a lack of sufficient granularity in data for full monitoring of financial sector developments.** In the Netherlands this is evidenced for instance by lack of regular and consistent data on sectoral breakdowns on banks' non-performing assets. Data collection efforts are constrained by the ambition of the government to limit the administrative burden on the industry, but the costs of data provision are far outweighed by the potential losses from the absence of early detection of emerging problems. Greater dissemination of such data also would assist market assessment of the strengths and weaknesses in the financial sector.

Banks

24. **The assessment of the Basel Core Principles for Effective Banking Supervision indicates that the supervision of Netherlands banks by DNB has achieved a high level of compliance.** There are some areas for improvement. In particular, consolidated supervision could be strengthened. Also, DNB does not have full powers to impose resolution tools.

Insurance companies

25. **The assessment of the Insurance Core Principles indicates also that supervision of Dutch insurance companies has a high level of observance.** With the implementation of the 2006 Act for Financial Services, which is incorporated into the 2007 Financial Supervision Act, and related regulations, the authorities have addressed almost all the recommendations in this area arising from the 2004 FSAP. DNB has strengthened its risk-based supervision. It has also embarked on more intrusive supervision of insurers' business models and culture. The remaining weaknesses relate more to inadequate legal authority of DNB and the AFM in supervising insurance groups and insurers' product development process. The implementation of Solvency II requirements in 2013 will further enhance risk-based supervision.

Securities markets

26. **Overall the Netherlands has developed a robust supervisory framework that exhibits high levels of implementation of the IOSCO Principles.** The AFM's main goal is to influence behavior, and it uses the various tools at its disposal (including fines) to achieve its results. A few issues deserve attention. The AFM has limited authority to request information from issuers in order to ensure their compliance with financial reporting standards. Furthermore, prudential requirements for management companies should be strengthened, reporting obligations for prudential purposes established and prudential supervision should strike a better balance between off-site and on-site supervision.

Addressing macroprudential risks

27. **Macroprudential instruments will be an important element to mitigate the likelihood of a recurrence of economic and financial turmoil**. Much work in this regard is being undertaken in the Netherlands. Given the centrality in many cases of housing-related factors as key components of macroprudential difficulties, many of these instruments are likely to relate to the housing market. Amongst such instruments, limits on the maximum loan-to-value (LTV) ratio may be considered useful, especially given that in the Netherlands this ratio is amongst the highest in the world, exacerbated by generous provisions of tax deductibility. Measures may need to be introduced

progressively, given the state of the housing market and of the economy, but perpetuation of the present arrangements would be unlikely to stand the Netherlands' economy in good stead. It could be helpful to allow the delegated agencies discretion to move the instruments as their assessments of conditions evolve.

Increasing resilience of the banking sector

28. Important work is under way to design "buffers" that could protect banks in the event of weakness without incurring the full cost of raising capital. Supervisory authorities are examining a variety of instruments that could add to the resilience of the sector, reducing the likelihood that a bank has to move to closure or public rescue. Amongst these instruments DNB is exploring the possible use of contingent capital instruments.

Deposit insurance

29. **The increase in deposit insurance was an essential element for stabilizing the situation during the crisis.** Many of the preparations look appropriate. At the moment, however, the deposit guarantee scheme is unfunded, leading to possible scrambling in putting together the financing ex post if it is used, and constraining prompt interventions if these become necessary. The deposit insurance scheme would benefit from being funded ex ante, and from a more timely payout schedule. The scheme at the moment envisages only payouts in the event of bank failure, not financing bank resolution, in particular purchase and assumption, if this were the cheaper option.

Resolution arrangements

30. **The coordinated response of the Ministry of Finance (MoF), DNB, and AFM during the crisis proved effective in handling an unprecedented situation.** Going forward, it would be helpful to have a framework in place to guide the decision making that would be needed in the event of crisis in the future. A welcome enhancement would be a standing financing authority for interventions in the event of institutional insolvency. Additionally, to reduce the need for public financial support, urgent reform is needed to strengthen the tools for resolving banks in going and gone concern.

Exit from current arrangements

31. **Plans are under way to facilitate the exit from the current arrangements.** The banks and insurance companies that have received state aid are working under plans to pay back loans, IPOs for equities participations, and structural reorganizations so that the state can recoup at least a large part of its contributions. Timing will require careful management.

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The next Article IV is slated for the spring of 2011, and would provide an opportunity to discuss progress in implementing the comprehensive action plan for enhancing supervisory oversight.

The mission would like to thank the Netherlands authorities for frank and constructive discussion, and active cooperation in updating the latest FSAP.