DNB Supervisory Strategy 2010 - 2014 and Themes 2010
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Summary

The credit crisis severely tested the resilience of the financial system as well as the supervision of that system all over the world. This Supervisory Strategy 2010-2014 outlines the lessons that The Netherlands Bank (DNB) has drawn for its prudential supervision. DNB argues in favour of tighter supervision in various areas, in aspects of the national and international supervisory framework on the one hand; and of DNB’s own supervisory approach on the other. The crisis has demonstrated that, now more than ever, supervisors should look beyond individual institutions. In addition, supervision should devote more attention to institutions’ business models and strategies as well as their culture and conduct.

Even with the proposed adjustments, supervision can not provide guarantees. Risks can never be fully ruled out, nor would that be appropriate in our free market economy. However, the adjustments, which are in line with international trends, will reduce the risk of accidents.

Supervisory framework

The quality of supervision depends largely on the quality of the regulatory framework. Both in the run-up to and during the credit crisis, supervisory instruments fell short in several areas. These deficiencies emerged in both the scope and the substance of supervision. The trend towards lighter supervision, reflecting developments within the financial sector as well as changed social attitudes, has gone too far. A tighter supervisory framework is needed. Alongside generally higher liquidity and solvency requirements for banks, more stringent capital requirements – notably for securitised credit products, off-balance sheet vehicles and trading book positions – are imperative. Regarding insurance supervision, the shortcomings of the existing international solvency framework make it difficult, if not impossible, to exercise adequate risk-based supervision. Ahead of the new supervisory framework, DNB wants to strongly encourage maximum participation by insurers in the necessary preparations. In the supervision of pension funds, the crisis has prompted a review of the functioning of the Financieel Toetsingskader or FTK [Financial Assessment Framework] in certain areas. In addition, the risk management of all supervised institutions needs to be reinforced and limits must be imposed on remuneration structures that induce risk-taking behaviour.
One key lesson from the crisis is that the quality of macro-prudential supervision should be enhanced and the ensuing insights translated into risk-mitigating policies. Important elements in this process are the adjustment of regulations to limit procyclicality and the more frequent conduct of macroeconomic stress tests at financial institutions. The movement towards European-style regulation of both macro-prudential developments and cross-border institutions marks a major step forward. In general, the crisis has demonstrated the vital importance of further improvement in the international cooperation between supervisors and of close consultation and contacts between monetary and supervisory authorities. The Twin Peaks supervisory model (prudential supervision by DNB and conduct-of-business supervision by The Netherlands Authority for the Financial Markets (AFM)) that was introduced in the Netherlands in 2004 is increasingly being adopted by other countries. The crisis has revealed the added value of the combination of central bank and prudential supervisor.

The scope for crisis intervention needs to be increased. The public authorities should be given broader means and powers to take over or help relaunch institutions that are in serious difficulty or on the brink of bankruptcy. One option might be to impose debt-to-equity conversion measures on the troubled institution. The effectiveness of the deposit guarantee scheme should be enhanced, too, for example by switching to an ex ante funded system based on risk-based premiums with a shorter payout term. A major step forward would be the introduction of a European deposit guarantee system. Finally, a limit on financial supervisors’ liability would boost the effectiveness of supervision.

**DNB supervision**

DNB sees the need for two major changes in its own supervisory approach. First, supervision should look beyond individual institutions. It became clear during the credit crisis that financial institutions are more connected with each other and with the real economy than had previously been thought. Moreover, the most critical risks often occur simultaneously at several institutions. Supervision should hence adopt a stronger macro-perspective with a focus on specific risk areas and supervisory themes, obviously without detracting from the traditional institution-oriented approach. Methods of tightening macro-supervision include the structural application of sectoral and sub-sectoral analyses as well as peer benchmarking of individual institutions. Insights from the entire spectrum of macro-prudential supervision (monitoring of financial stability) and micro-prudential supervision (supervision of individual financial institutions) must be taken on board in the risk reduction efforts. In order to think and act in a more risk-based manner, specialised risk knowledge within the supervisory organisation will be enhanced. This knowledge will be utilised for more frequent in-depth analysis of specific themes. The supra-institutional approach will be accompanied by a more flexible deployment of...
staff, including more temporary hiring of external specialists. To obtain a broader information base, more systematic and closer contact will be maintained with the supervisory boards of institutions, external auditors and actuaries who have their own important (internal) supervisory role to fulfil.

Second, alongside traditional supervision, which is mainly aimed at quantitative criteria such as solvency and liquidity, more attention must be given to the strategic and qualitative elements in supervision, notably the supervised institutions’ business models and strategies as well as their conduct and culture.

These adjustments in the supervisory framework and approach will lead to concrete actions in various fields, including the enhancement of the available expertise, expansion of the number of in-depth investigations, strengthening of the supra-institutional nature of the risk analysis methodology and decision-making processes, broadening of the information base, reinforcement of international group supervision and intensification of efforts in international consultation about supervisory regulations and risk analysis. Various analyses and proposals are reflected in the supervisory themes to which DNB will devote extra attention in its supervision in 2010.

DNB will discuss the consequences for the supervisory budget with the Minister of Finance, the Minister of Social Affairs and Employment, and representatives of the financial sector.
1 Introduction

This DNB Supervisory Strategy 2010-2014 builds on the foundations laid in the DNB Supervisory Strategy 2006-2010. The strategic objectives have remained unchanged, namely to promote the stability of the financial system and protect consumers’ financial interests. To this end, DNB verifies that financial institutions are solid and have sufficient capital to meet their obligations to consumers. Furthermore, supervision aims to ensure the integrity of the financial system and promote a smooth, reliable and efficient settlement of payments. The basic principles underlying the implementation of the supervisory task still stand. DNB conducts its supervision in a market-oriented, efficient and independent manner. Supervision is also risk-based and proportional.

Building on these foundations, this DNB Supervisory Strategy 2010-2014 focuses mainly on the lessons that can be drawn from the credit crisis (Chapter 2). DNB’s experiences with integrated supervision after its merger with the Pensions & Insurance Board (PVK) resonate in the background. This Supervisory Strategy attempts to convert the acquired experiences and insights into concrete actions, in the national and international supervisory framework (Chapter 3), in the way in which DNB organises and implements its own supervision (Chapter 4) and in specific themes for 2010 (Chapter 5).
2 Credit crisis

The credit crisis poses a challenge to supervisors. In the 1980s a process of liberalisation and deregulation got underway in the Anglo-Saxon world and gradually spread all over the world. This process went hand in hand with the globalisation of markets and companies, and contributed to unprecedented innovation. These developments served to boost global prosperity. Laws and regulations and supervision were not always able to keep pace with these developments. The credit crisis, which originated in the United States, has been a systemic crisis which also showed gaps in the supervisory framework, such as insufficient capital requirements, the absence of an international liquidity standard and the procyclical character of supervisory and accounting rules. Chapter 3 deals in more detail with the desired adjustments to the supervisory framework.

It is important to form a clear idea of what supervision can be expected to deliver. Supervision aims to promote financial stability, but was never intended to eliminate all risk. Such an objective would also be incompatible with our free market economy where scope for private initiative is seen as a conditio sine qua non. Risk-taking is part and parcel of this economic model. Supervisors cannot look over the shoulder of each and every manager in the financial sector – and, clearly, the supervisor has capacity constraints too. Moreover, in certain areas the supervisor’s powers to intervene depend on the cooperation or approval of other authorities, such as foreign supervisors or the courts. In addition, intervention can be counterproductive, for instance if it leads to undesirable changes in the conduct of the supervised institution or to destabilising market reactions if it becomes public.

The credit crisis came from outside. Though DNB identified most of the vulnerabilities in the sector in time, it, like other authorities worldwide, failed to foresee the fall-out of this crisis in terms of scale, scope and speed. This is true of, say, the impact of relevant macro-economic developments and the interdependence between the institutions. To operate more effectively in this area, DNB is working on closer consistency between macro-prudential supervision (monitoring of financial stability with a particular focus on growing imbalances and systemic risk) and micro-prudential supervision (supervision of individual financial institutions). This means a stronger emphasis on the supra-institutional perspective.

As the crisis has so clearly reaffirmed, soundness not only has a business component but also an integrity component. Incidents in such fields as high remunerations, excessive risk appetite and the sale of risky financial products have generated mistrust
in financial institutions and their corporate culture. This has prompted DNB to devote extra attention to issues surrounding integrity, governance, conduct and culture at supervised institutions. DNB also looks at whether institutions sufficiently control the risks arising from the incentives attached to variable remuneration, particularly in cases where these incentives induce risk-taking behaviour. This ties in with the growing awareness that problems concerning conduct-of-business supervision can rapidly develop into a prudential problem. In this context, we underline once again the importance of our close cooperation with the Netherlands Authority for the Financial Markets (AFM).

The past decade saw a shift from rules-based to principle-based supervision. The institutions were thus entrusted with more individual responsibility. DNB’s role in this respect is to safeguard compliance with the principles and norms, particularly in relation to risks (such as perverse behavioural incentives and the vulnerability of certain business models) where rules provide only limited guidance. This places greater demands on the assessment of prudential risks and the subsequent translation of the findings into an intervention strategy.

Finally, it should be noted that, as part of our crisis management efforts, internal cooperation and information-sharing at DNB were raised to a higher level than existed before. In reaching decisions during the crisis, DNB’s Supervision staff drew extensively on the information about market developments available from their colleagues in the Financial Markets and Payments divisions. In addition, the project-based approach adopted to tackle supra-divisional problems proved efficient, allowing a rapid reallocation of staff whenever circumstances demanded. The cooperation with the Ministry of Finance, in particular in the autumn of 2008, was both intense and effective.
The experiences with the credit crisis call for further improvements in the supervisory system, notably changes in the regulations. The quality of supervision depends largely on the quality of the regulatory framework. The supervisory instruments as currently laid down in global, European or national regulations are not up to par in certain areas. Supervisory regulations often lag behind developments and innovations at supervised institutions, in part because formulating regulations is a time-consuming process, particularly in an international context. Another factor is that regulations are the outcome of negotiations in which both national interests and the interests of the supervised sector are at play. Combined with pressure on the supervisor to refrain – both for competition (level playing field) and cost reasons – from imposing additional national requirements on top of the (sometimes insufficient) international standards, this can restrict the supervisor’s ability to respond quickly and effectively to risks.

The credit crisis has exposed flaws in supervisory instruments. It is time to make up for lost ground by remedying them. Wherever possible, principle-based regulation must be upheld as this permits a fast and flexible response to new developments in the sector and thus strengthens the anticipatory nature of supervision. Uniformity of policy and execution remains as important as ever. It should be clear, however, that principle-based regulation does not imply light-touch regulation.

The primary authority to set laws and regulations rests with the national government or the EU. In its roles as central bank and prudential supervisor, DNB is an active participant in national and international fora to provide legislative and regulatory authorities with advice and to set standards and good practices with its fellow supervisors. Meanwhile, numerous processes are underway to adjust and tighten laws and regulations. This chapter summarizes the conclusions that are being drawn at the international level from the credit crisis and the adjustments in supervision advocated by DNB. These changes are in line with the government’s vision on the future of the financial sector that was published in 2009.
3.1 International

Solvency and liquidity

In reaction to the financial crisis, the international supervisory community has taken several steps to improve the internal risk management of financial institutions and reinforce supervision. Regarding banking supervision, this tightening is aimed specifically at the liquidity risks and the capital requirements for securitised credit products, off-balance sheet vehicles and positions in the trading book of banks. These were the main areas in which problems occurred. In addition, the Basel Committee – the worldwide standard-setting forum for banking supervision – has increased the standards for internal risk management, liquidity management and stress tests, as well as the transparency and disclosure practices of institutions. Even before the outbreak of the crisis, the Basel Committee was engaged in tightening the Basel 2 framework. The credit crisis has accelerated the introduction of these adjustments.

In addition, DNB sees a need for a general reinforcement of the solvency requirements for financial institutions. In the Basel context, work is ongoing to improve the risk cover and increase the core Tier 1 capital ratio – the minimum capital buffer consisting of share capital and free reserves. Moreover, an additional capital requirement is to be introduced in the form of a leverage ratio (a measure of shareholders’ equity and total assets), in which the assets are not risk-weighted. This ratio may later be subject to a hard minimum requirement. The capital requirements for trading book risks are also being tightened. The impact of these adjustments is being tested in a worldwide study in the first half of 2010. The results will feed into the decisions due in the second half of the year. The pace of the introduction will be brought into step with the economic recovery. Consultation with the sector on regulatory tightening is currently ongoing.

Regarding the supervision of insurance, DNB has high expectations of the introduction of the new EU solvency framework, known as Solvency 2. The shortcomings of the Solvency 1 framework make adequate risk-based supervision a virtual impossibility. Solvency 1 takes almost no account of the actual risks that an insurer runs. It is based solely on the legal insurance entity (instead of the economically relevant group) and the reporting frequency is low. As early as 2005, DNB recognised the need for improvement and developed plans for the introduction of an appropriate financial assessment framework for insurers at the national level. This did not happen in the end. In view of the expected introduction of Solvency 2 in 2007, the launch of the FTK [Financial Assessment Framework] for insurers was called off at the last minute. Ahead of the introduction of Solvency 2, which is now planned for October 2012, DNB has since the start of 2009 requested quarterly reports from insurers and carries out stress tests to assess their resilience. In addition, DNB is encouraging maximum participation by insurers in the preparations for Solvency 2.

As for the supervision of pension funds, the credit crisis has re-emphasised the importance of a good balance between risks and buffers. The current buffer
requirements under the *FTK* are aimed at ensuring that pension funds on average do not slip into underfunding more than once every 40 years. In the periods around 2001 and 2008, the pension funds took severe hits in the stock market, showing that they had been been far too optimistic in their projections, which they had based on unrealistic expected returns. The crisis has consequently prompted a review of the *FTK* in a number of areas; its evaluation has already been set in motion. In reaction to the credit crisis, the international fora of supervisors and regulators have begun a debate on how to deal with institutions whose size in itself poses major risks for the financial stability. Some institutions are not so much ‘too big to fail’ as ‘too big to save’. A system needs to be set up that prices in the external effects of an institution’s size on the stability of the system. In concrete terms: the bigger the institution, the higher the capital requirements that could be imposed.

**Scope of supervision**

Players such as hedge funds, private equity funds and credit rating agencies fall outside the (direct) reach of supervision. In light of the credit crisis, it is advisable to carefully reconsider the scope of supervision. Hedge funds and private equity funds did not play a major role in the crisis. However, in winding down their positions, they did exacerbate the crisis in the financial markets. It follows that a certain degree of regulation for these players is desirable. However, this requires international coordination, taking care to ensure that the level playing field is not undermined. Regarding credit rating agencies, this crisis has made it clear that undue faith was placed in their opinion. It is reasonable to require financial institutions to carry out better due diligence themselves and to take more responsibility when adopting substantial positions. In addition, there must be a clear segregation between the credit rating agencies’ advisory and rating tasks. This makes more sense than to make the public authorities responsible for assessing credit risks of companies and products.

As for the scope of supervision in the pension sector, service providers largely determine the financial and administrative situation at pension funds. However, DNB can only supervise these organisations indirectly, namely via the pension funds. DNB and the Minister of Social Affairs and Employment are currently holding consultations about this issue.

As part of risk-based supervision, the question whether and to what extent DNB should continue supervising collective investment schemes, investment firms, trust offices, money transaction offices and small general insurers, such as exempt mutual benefit associations, needs to be reviewed. This review should be based on an impact analysis, focusing on the possible consequences of a bankruptcy for the stability of the system and the financial entitlements of consumers. The effects for the integrity of the financial markets should also be taken on board.
Macro-prudential framework

The credit crisis has shown that the quality of macro-prudential supervision (monitoring of financial stability) must be improved at the global level and this must be translated into risk-mitigating policies. Although the focus on macro-prudential supervision had already been sharpened before the outbreak of the credit crisis, and vulnerabilities in specific areas had already been exposed, the overall view of the risks in the complex financial system has been shown to be lacking. Little consideration was given to the possibility of a systemic crisis. Moreover, the international surveillance was too fragmented and the expertise at various international organisations was not properly shared. Many events that materialised and had been previously recognised as risks took place so quickly and on such a scale that they could not be matched by policies in time. This was partly due to a lack of political support for the required measures, such as tackling balance of payments imbalances and the limitation of loan-to-value ratios. In certain cases, there was not sufficient data to convincingly demonstrate that a problem was imminent.

The authorities have meanwhile taken several measures to reinforce the macro-prudential architecture. The G20 and the Financial Stability Board (FSB) have a coordinating role here. The FSB is working together with the International Monetary Fund (IMF) to set up an early warning system for macro-economic and financial risks. This exercise – which will comprise both a qualitative and quantitative analysis – is not aimed at predicting the timing of crises, but seeks to identify risks and vulnerabilities in the system that might lead to a crisis. Within the EU, the European Systemic Risk Board (ESRB) will issue risk warnings and recommendations for corrective policy. In addition, efforts to reinforce macro-prudential analysis are underway at the Bank for International Settlements (BIS), where instruments are being devised to tackle specific macro-prudential problems.

Regulatory adjustments are also being carried out in respect of macro-prudential policy. At present, the provisioning rules are mainly retrospective. This encourages excessive risk-taking during economic boom periods. The Basel Committee is currently working to make capital requirements and provisions less procyclical. Institutions could build up extra buffers in good times that can be used to absorb setbacks in bad times. Stress testing could also be used more extensively to permit a more accurate estimation of the required buffers. Efforts are also underway to dampen the procyclical effect of fair value accounting. During the crisis, the procyclical nature of fair value accounting became particularly clear in illiquid markets, where no balanced market prices were available.

Cooperation

Due to its open character, the Dutch economy is relatively sensitive to international developments. The same applies to the financial stability and soundness of Dutch institutions, as emerged during the credit crisis. The Netherlands possibly stands to benefit even more than many other countries from well-functioning international arrangements for the supervision of cross-border financial institutions and the
promotion of open borders. Whether in good or bad times, close and effective cooperation can never be taken for granted. When national interests are at stake, authorities are inclined to seek national solutions. In this light, a more European-oriented supervision for cross-border institutions would be desirable. Indispensable elements in this connection are a pre-determined burden sharing between the Member States and a Europe-wide deposit guarantee scheme.

Although regulations for banks (Basel 2) and insurers (Solvency 2 under construction) are already largely determined at the international level, there is no institutional supervisory structure. One welcome step in the short term has been the creation of colleges of supervisors for large financial institutions. While these colleges institutionalise the existing cooperation between supervisors, they can not offer a guarantee for a substantial improvement in cooperation in times of stress. More promising may be the advent of the three European Supervisory Authorities (ESAs) with a legally binding role in micro-prudential mediation that is still to be elaborated. The ESRB must in turn be given the right to make recommendations in the field of financial stability.

As long as no integrated international supervisory structure has been put in place, we need to consider how to deal with the three following types of institutions which lie largely outside the scope of DNB’s supervision. First and foremost, these are Dutch institutions – mainly insurers – that undertake important activities abroad, but whose group operations are not yet under sufficient international supervision. Apart from pressing for adequate international regulations at every opportunity, DNB is addressing this problem by organising its own group supervision of these institutions as far as possible. The second type are foreign institutions that undertake major activities in the Netherlands, but fall under the supervision of the home country as a branch office in the European Economic Area. The European regulations must be adjusted in this area. The third are foreign institutions that wish to open a PPB (principal place of business) in the Netherlands. The concentration of funding and assets in different countries generates extra risks. This calls for a critical assessment of such institutions’ business models, both before and after their admission to the market.

3.2 National

Twin Peaks

International committees are the appropriate place to deal with most of the above proposals and this is indeed the case in such areas as: the European supervisory structure (EC), adjustments to capital requirements of banks (BCBS), a new capital framework for insurers (EC), accountancy standards (IASB) and the supervisory scope (Joint Forum). This section looks at issues specific to the Netherlands, starting with the Dutch Twin Peaks cross-sector supervisory model. In this model, DNB is responsible for prudential supervision and AFM for conduct-of-business supervision.
Partly as a result of recent experiences, several countries have taken their cue from Twin Peaks and are also adopting this model. In Belgium, Germany, France, Ireland, Italy, Portugal, Spain, the United Kingdom and Sweden, sector-specific supervisors are being merged into cross-sector supervisors or the ties between the central bank and (banking) supervisor are being strengthened. The discussion on the design of the US supervisory model also seems to be evolving in this direction. DNB is of the opinion that the credit crisis has shown the added value of a combined central bank–prudential supervisor: information and expertise on supervision, payments, financial markets, macroeconomics and financial stability were all present under one roof. But even in normal circumstances it is useful to harness the full power of this combination.

Both the subprime crisis and the failure of the Dutch DSB bank make it clear that market conduct (such as extending home loans to people with low income and assets) can have prudential consequences. This underlines the desirability of continuing the close cooperation between DNB and AFM, and to intensify this cooperation whenever circumstances demand.

Institutional framework

Adjustments are desirable in the institutional framework in terms of the crisis instruments, the deposit guarantee scheme and the regulations on supervisors’ liability.

Regarding the bankruptcy regime for banks and insurers, public authorities must be given the power to dispossess shareholders of institutions in case of emergency. In addition, authorities should be empowered to transfer the assets, rights and obligations of a troubled bank to a private party or a bridge bank. This would allow rapid intervention in the institutions’ balance sheets. Such powers would also enable the transfer of deposits at a failing bank, possibly providing an alternative to the activation of the deposit guarantee scheme. Deposit holders would then have faster access to their money and the operating costs would be lower than those involved in deposit guarantee payments.

The deposit guarantee system requires two improvements. Firstly, incentives need to be built in to encourage the participating banks to take less risk. All banks could be required to contribute via risk-based premiums to a fund for payments in the event of bankruptcy. The level of the premiums should relate to the institution’s risk profile. One advantage is that the contributions would be spread over a number of years, thus reducing the system’s volatility. Secondly, the effect of the deposit guarantee system should be strengthened by shortening the payment term. No longer allowing depositors to set off receivables against their debts would simplify the administrative process and help speed it up.

Society is becoming increasingly litigious and this also has implications for supervision. The handling of legal proceedings against DNB is putting increasing demands on the available human and financial resources. DNB would prefer to use these resources for its core tasks, such as supervision. Therefore, DNB would like
to see limits on the liability of financial supervisors, as is the case in surrounding countries. Cases involving gross culpability or deliberate intent should be excepted from this basic principle.
4 DNB supervision

The Supervisory Strategy 2010-2014 builds on the Supervisory Strategy 2006-2010. Four years ago this Supervisory Strategy introduced two shifts in emphasis which are still fully valid: more focus on risk orientation and more openness. Briefly put, risk-based supervision entails that DNB targets its supervisory resources to where the risks are most pronounced. This approach is not in question. The development of the FIRM risk analysis method helped to arrive at a uniform way of thinking about risks and the appropriate risk management measures and buffers, both within the merged DNB-PVK and in the field under supervision. Nor is there any doubt about the usefulness of external communication as a supervisory instrument. Transparency to the outside world about the supervisory strategy, regulations, findings and results not only promotes accountability but also increases effectiveness and efficiency. Transparency creates broader support and acceptance which, in turn, encourages spontaneous compliance with the standards. It also prompts the stakeholders of the supervised institutions, such as supervisory boards, external auditors and shareholders, to keep the institutions sharply focused on supervisory issues. One example of such external communication is Open Book Supervision, an internet knowledge window that is intensively used by supervised institutions, and the DNB Supervisory Themes which are published annually.

On the basis of recent experiences and insights, DNB arrives at three priorities in this Supervisory Strategy 2010-2014: alongside the discussed changes in the supervisory framework, supervision should have a stronger supra-institutional perspective than before, ensuring a close connection between macro and micro supervision. In addition, more attention must be given to institutions’ business models and strategies as well as their conduct and culture.

4.1 Looking beyond individual institutions

The effects of the interdependency of the financial institutions mutually and with the real economy have proved greater than previously thought. Risks are often supra-institutional. This calls for a supervisory method which, alongside the institution-oriented approach, has a stronger macro orientation and a sharper focus on risk areas and supervisory themes. This approach must be supported by a management information system that systematically provides clear aggregated
information about the institutions in their environment and the (mutual) vulnerabilities.

The structural application of analyses per (sub)sector is a primary part of this supra-institutional approach. In providing an overview of the regular conditions, the trends occurring in the sector as well as relevant themes and risks relating to these trends, these analyses provide a good picture of the sector-wide vulnerabilities. Comparisons of individual institutions with similar institutions (benchmarking) are an effective instrument for identifying outliers. Systematic sector analyses also promote the harmonisation of supervision, both in terms of risk analysis and in terms of risk-reducing programmes.

A second element is that supervision must think and work more in terms of risk areas. Cases in point are over-arching risk areas, such as ‘strategy and governance’, ‘financial risk’, ‘operational and ICT risk’ and ‘legal, integrity and compliance risk’. In order to do justice to the complexity of these areas of risk, a substantial number of the supervisors have specialised in one of these areas. This knowledge is used to produce more frequent in-depth analyses of specific themes. This ‘deeper view’ entails a shift from an assessment of the set-up of business processes to an assessment of their operation. Both the performance of these analyses and the conversion from analysis into targeted action rest on supra-institutional information. Supervisors that operate as general examining officers of a group of institutions fulfil a coordinating role in this respect. They are the first point of contact for the institutions in question and actively enlist specialists where necessary. Specialists have their own responsibility for maintaining an up-to-date picture of the specific risks in a sector (or several sectors) and for mitigating these risks where necessary. To this end, they prepare targeted risk analyses and propose interventions in their areas of expertise.

A third component is the reinforcement of macro-prudential supervision. This is mainly being done by enhancing consistency between micro and macro supervision, and by planning the introduction of instruments for reducing macro-prudential problems. Insights from the entire macro and micro spectrum (developments at individual institutions, sectors, payment systems, supervisory frameworks, financial markets and the monetary and real economy) are included in the analysis, prioritisation and reduction of risks. National and international macro-prudential risk identification (including from the ESRB) is converted into micro-prudential action. This can lead to situations where discrepancies exist between the interests of micro and macro supervision. In such cases, the selected solution may not be optimal for the individual institution, but should be optimal for the system. To achieve good coordination between macro and micro levels, the information channels within the organisation must be open. The aim is to ensure that signals are rapidly disseminated and made accessible to those for whom the information is relevant. Risk analyses are carried out from the various relevant positions on the macro and micro spectrum. The coordination between macro and micro supervision must take place at all levels. This is reflected in the OFS (Financial Stability Overview). Supervisory staff are actively engaged in feeding the OFS analyses, whose conclusions spur them on to further action.
4.2 Strategy and conduct

The aim of supervision is to safeguard a stable financial system with sound institutions, so that consumers’ financial interests are safe. Traditionally, supervision was mainly concentrated on checking whether the institutions meet the statutory requirements in terms of solvency, liquidity and controlled business operations. This angle remains key, but it takes more to realise the said goal. Supervision must probe to a deeper level. It must track down and tackle the possible sources of later problems before these translate into deteriorating solvency and liquidity ratios. This is necessary given the increased speed with which developments in the financial sector arise and can escalate into a crisis.

Institutions’ business models and strategies form a primary source. Relevant questions are: how does the institution create competitive advantages? How does it retain its customers’ trust? How efficient is it? To what extent is the institution’s strategy endorsed by its stakeholders and capable of withstanding external dynamics?

A second source of potential problems is the conduct and culture at institutions. The crisis has reaffirmed that soundness not only has a business component but also an integrity component. A culture of integrity is one in which actions can be explained and accounted for; it not only respects the letter of the law, but also the spirit. One major factor in influencing institutional conduct and culture is whether policymakers at the institutions have the expertise and integrity expected of them. In addition, DNB devotes more attention to the integrity risks at institutions that arise from involvement in money-laundering and financing of terrorism, and violation of international sanctions.

By giving more attention to these aspects, supervision becomes more forward-looking. However, it is harder to form an objective picture of the vulnerability of an institution’s strategy and its conduct and culture than to establish its compliance with financial rules. It is also more difficult to raise these issues with the leadership of the institutions. Identifying and solving problems of this nature demands more alertness, assertiveness and persistence on the part of the supervisor.

4.3 Actions

The above priorities will be translated into the following concrete actions.

1. Enhanced expertise. This applies in particular to expertise relating to (illiquid) investments and innovative financial products, and specific knowledge in the field of financial risk, fair value reporting, governance and strategy. The first action is the in-house development of expertise among the current employees. This quality enhancement also means that the recruitment policy will be more focused on specific experience and knowledge. Where necessary, more professional knowledge will be insourced for specific projects. In addition, DNB will assess how the organisational structure can promote a more powerful role
for the expertise centres and specialised policy departments in the supervisory process. The existing knowledge networks will be expanded to promote knowledge acquisition and sharing.

2. More in-depth studies. Experience with e.g. the pension fund investment study shows that from a supervisory perspective substantial gains can be made by bringing together expertise in project teams. This makes it possible to put certain parts of the sector under the microscope. DNB is going to employ this method more often. It is working towards an approach where several such studies are carried out annually in each sector.

3. Strengthening risk analysis. To support the development towards more supra-institutional supervision, the risk analysis methodology will be adjusted. To this end, DNB will review the functioning of its risk analysis tool (FIRM). This has traditionally been focused on analysing risks at individual institutions. In the new set-up, the tool will provide more scope for taking on board macro-prudential risks in the assessment of individual institutions. In addition, micro-prudential analyses will lead more quickly to macro-prudential signals by placing more emphasis on sector analyses and benchmarking.

4. Reinforcement of supra-institutional analysis and decision-making. DNB will embed the supra-institutional angle more firmly in its analysis and decision-making processes. Cooperation and knowledge sharing between different departments will be promoted, partly by setting up knowledge networks on a broader footing and by working more often on a project and multi-disciplinary basis. The role of risk consultation will be reinforced, and stress tests will be used more intensively.

5. Broader information basis. To supplement the standardised reports, DNB will continue to request and assess management information from the institutions. DNB will strengthen the ties with parties who are closely related to the institutions such as the Supervisory Board, external auditors, actuaries and asset managers, thereby improving access to relevant information.

6. Strengthening international group supervision. One lesson from the crisis is that the international dimension must be given stronger emphasis in supervision. This entails a need to intensify group supervision for banks and insurers which largely operate abroad. Ahead of international regulations, DNB is, wherever possible, already taking steps to reinforce group supervision of institutions relevant to the Netherlands. To this end, it is establishing closer ties with the local supervisors by actively organising group meetings. These efforts are facilitated by a special day-to-day communication tool that DNB has developed to enable the fast and safe dissemination of supervisory information between supervisors.

7. Reinforcement of international supervisory regulations and risk analysis. The increased international dimension also calls for an intensification of the European consultation about regulations and micro- and macro-prudential analyses. DNB supports the move towards more Europe-wide supervision, in which the European Supervisory Authorities and the European Systemic Risk Board have been given mediation and advisory powers respectively. DNB will clearly communicate and gather support for its views in international fora.
8. **Quality assurance.** The quality assurance mechanisms in supervision, such as peer reviews and random testing by the internal audit department, are being strengthened where necessary. DNB encourages employees to challenge each other about their supervisory findings, opinions and actions. In addition, DNB remains open to external evaluations of its supervision function.

9. **Rotation.** DNB rotates employees and management on a systematic basis. Rotation helps employees to retain sufficient distance to every institution, which is in the interests of independent opinion-making. In addition, rotation promotes knowledge sharing and helps employees to take a broader view.

10. **Supervisory themes 2010.** The analyses and proposals of this Supervisory Strategy are reflected in the themes to which DNB will devote extra attention in its supervision in 2010. As outlined in Chapter 5 on DNB Supervisory Themes 2010, this includes extra attention for integrity (conduct and culture, remuneration policy, tax risks, sanction regulations), strategy and business models and stress tests.

### 4.4 Resources

The deregulation and liberalisation policies initiated in the last century set off a worldwide process with its own dynamics, resulting in the globalisation of financial markets and vigorous financial innovation. The ensuing crisis showed that supervisory authorities around the world have struggled to keep these dynamics in the financial sector on the right track. Neither the statutory regulations nor the supervisory processes and procedures were geared to the demands of the new situation. Another relevant factor was that the scale and resources of financial sector supervision failed to keep pace with the cross-border expansion of financial institutions. Recent experiences suggest that the balance between free entrepreneurship and supervision-driven risk reduction was tipped against the latter.

One aspect that needs to be taken into account when judging the scale of supervision is the society’s prosperity in relation to its risk tolerance. Given the pronounced reactions to the problems at financial institutions and the provision of government support, this risk tolerance appears to be significantly lower than the risk assurance that can be delivered with the current level of supervision.

Since the onset of the crisis, the trend in international supervisory intensity has been upward. In reaction to the crisis, the Financial Stability Forum explicitly called for supervisors to be provided with adequate resources. This was later echoed in statements by the IMF. Various countries (such as the United Kingdom, Ireland and Australia) have significantly expanded their supervisory capacity.

In this Supervisory Strategy, DNB sets out how it proposes to tighten up supervision. DNB will enter into a dialogue with the Minister of Finance, the Minister of Social Affairs and Employment and the representatives of the financial sector about the consequences for the supervisory budget.
5 Supervisory Themes in 2010

5.1 Introduction

The top priority for supervision in 2010 is to ensure that financial institutions tackle the financial crisis in an orderly fashion. At the same time, DNB wishes to further explore and start implementing the key strategic themes listed above. Some of these themes are components of DNB’s regular supervision and will be discussed during visits to financial institutions. Others will be the subject of separate examinations. Finally, the themes will be given more weight in policy development and the establishment of better supervisory frameworks. In this way, DNB seeks to make 2010 the year of restoring confidence in the financial sector.

5.2 Overarching supervisory themes

Integrity
The crisis has once again brought it home that soundness not only rests on a business component but also hinges on integrity and moral conduct. A number of incidents related to large bonuses, an excessive appetite for risk and the mis-selling of financial products has led to public mistrust of the culture and conduct at financial institutions. In recent years, DNB has paid ever more attention to issues related to integrity and governance; it will continue intensifying this focus in the years ahead. Even in times when budgets are under pressure, DNB sets great store on the adequate performance of the compliance and risk management function. Besides specific integrity-related topics, the theme of integrity also covers the wider area of ‘conduct and culture at institutions’. In view of the link with market conduct supervision, DNB is working closely with the AFM on these points. DNB will also address some topics with its partners in the Financial Expertise Centre (FEC).

Conduct and culture
In 2009, DNB conducted an inventory of the impact of conduct and culture on the integrity of institutions and the role of supervision in this regard. DNB will now use its insights from this inventory in its supervision. DNB understands sound conduct as a professional, individual responsibility, whereby an individual is aware
of the rights, interests and wishes of other interested parties and conscientiously
takes them into account, operates transparently, and is willing to take responsibility
for his decisions and actions. A sound culture also encompasses a climate in which
an institution acts in a way it can explain and account for, and which stimulates and
rewards individual responsibility, observing not only the letter but also the spirit of
the law. In defining this theme, DNB will concentrate on two issues in 2010: careful
decision-making (identifying and demonstrably weighing up all the relevant interests)
and consistency (acting in line with objectives, principles and choices). Examining
officers will give explicit attention to these issues during supervisory meetings and
DNB will conduct an in-depth examination at a number of institutions. This focused
approach will not stop DNB from always homing in on the core of a sound corporate
culture: individual professional responsibility and a commitment to operate within
the spirit of the law.

Remuneration policy
Remuneration policies at financial institutions are still in the spotlight. DNB focuses
on whether institutions are adequately managing the risks attached to performance-
based remuneration, especially where incentives could be risk-enhancing. In this
light, DNB published a study of remuneration at Dutch financial institutions on 18
September 2009. The annex to this study contains a detailed description of the DNB/
AFM Principles in the form of good practices (see Open Book on Supervision, www.
dnb.nl). In addition, various international bodies developed remuneration rules or
principles in 2009. These international rules and principles must be implemented
at national level and incorporated into good practices. The (inter)national rules
and principles also require national supervisors to assess institutions’ remuneration
policies. In 2010, DNB will carry out its first assessment of institutions’ remuneration
policies against DNB principles and good practices. This assessment will subsequently
be embedded in DNB’s regular supervision.

Tax risks
Institutions have to deal with a range of tax issues that require adequate control. In
2010 DNB will keep an extra sharp eye on institutions that test the boundaries of tax
legislation, for example by setting up financing structures that have no economic
purpose and serve only to evade taxes. Partly in view of the growing public distrust
of financial institutions, such constructions are highly undesirable. DNB will make
this clear to institutions and will carry out checks in 2010 on the adequacy of their
risk management of fiscal aspects.

Mortgage fraud
DNB is also working with its FEC partners on a project to counter mortgage fraud.
Drawing in part on real-life incidents of fraud, the FEC will conduct an analysis of the
required improvements in the control structures at mortgage lenders. The aim is to put up
effective barriers against this form of fraud, which often facilitates other criminal activities.
Sanctions regulations, customer due diligence for banks and real estate

DNB will continue and complete work on three integrity projects that were initiated in 2009. The first is a review of banks’ compliance with sanctions regulations, focusing particularly on trade finance. As part of this review, DNB is looking closely at compliance with the sanctions regime against Iran. The second project examines banks’ progress in implementing risk-based customer due diligence policies in accordance with the Wet ter voorkoming van witwassen en financiering van terrorisme or Wwft [Anti-Money Laundering and Anti-Terrorist Financing Act]. The objective of the third ongoing project is to devise, lay down and promote a code of conduct in respect of real estate.

Strategy and business models

A lesson from the credit crisis is that supervisors should pay closer attention to supervised institutions’ strategies and business models. Particularly in the current era, these are the subject of debate in all sectors. Some of these fundamental strategic issues arise from the restructuring that must now be undertaken by a few large groups. Others are being demanded of the institutions by the EU in response to state aid during the crisis. However, there is also a degree of ‘overdue maintenance’, with the attendant likelihood of mergers, acquisitions and break-ups.

Another cause is that a number of traditional business models no longer appear profitable. Banking activities are under pressure from the effects of the crisis (with possible losses on lending and real estate) and higher capital requirements. If institutions do not withstand the pressure from investors and credit rating agencies to perform, there could be a new search for yield. DNB will take care that this does not lead to undesirable conduct in the form of excessive risk-taking. DNB will also check that banks hold adequate capital against transfer risk, i.e. the risk that capital may no longer be withdrawn from a particular country, convertibility risk (currency risk) and collective debtor risk. It is important for banks with an extensive trade portfolio to contain their market risk.

Strategic choices are unavoidable for life and non-life insurers, too. The saturated market in the Netherlands, competition from banks offering savings products for mortgage repayments or retirement, and a poor public image resulting from the profiteering policies scandal are some of the factors threatening the profitability of traditional models.

Stress tests

Being forward-looking, stress tests are a valuable supervisory instrument. Nonetheless, the crisis has highlighted a number of shortcomings in the existing (micro-)stress tests of financial institutions. The stress tests were too often based on overly mild scenarios. They did not take enough account of extreme events; their time horizon was too short; they underestimated the liquidity risk attached to new instruments; and did not take enough account of feedback effects from the financial markets and the real economy on the institutions’ own conduct. Risks were generally not
tested across the whole institution and stress tests were not sufficiently embedded in the organisation. In response, the Basel Committee published principles for sound stress testing by banks, aimed at removing these flaws. DNB supports the Basel principles and monitors their implementation by institutions, in respect of both the design of the stress tests and any ensuing management measures. Interest rate risk should at any rate be a component of the stress tests. Current short-term interest rates could suddenly shoot up, but could also stay at this low level for many years to come. Institutions should be resilient to both scenarios. Stress tests will be carried out on those institutions that received state aid in order to thoroughly assess their liquidity and capital planning when the unwinding of support measures comes up for discussion. The tendency to repay the support prematurely could expose the institutions concerned to certain vulnerabilities. In addition, DNB itself is introducing a broad stress test for banks, insurers and pension funds in 2010, with a specific structure for each sector.

**Sound conduct of business**

**Governance**
The crisis has once again shown that adequate governance is a necessary prerequisite for the sound conduct of business. In 2010, DNB will not only concentrate on financial institutions’ corporate governance at holding level but also on the governance within financial groups. It will concentrate on intra-group transactions, conflicts of interest and the independence of internal control functions within groups. Moreover, DNB attaches great importance to the quality and functioning of supervisory boards. In recent years, supervisory boards have assumed ever more tasks and responsibilities. In crisis situations, it is often up to supervisory boards to take the lead. In this light, DNB is firmly insisting that supervisory board members are suitably competent, even though a test of expertise is not yet required by law.

**Outsourcing**
Financial institutions are increasingly outsourcing activities to external parties. Notably in the pensions sector, outsourcing (to pension administration agencies and asset managers, for example) is sometimes so extensive that it risks that the management of the institution will lose control of the outsourced tasks and fail to build in adequate segregation of duties and checks and balances. In some cases, institutions even lack their own adequate, independent risk management function or are so heavily reliant on external advisors that they are not fully capable of forming an independent opinion on the risks attached to, say, their investment policy. In 2010 DNB will more closely monitor whether the management of institutions has a firm enough grip on the institutions’ core processes by judging how they manage their outsourcing risk.
In addition, DNB will launch a closer analysis of risk management practices when outsourcing IT services to service providers. In recent years, various banks, insurers and pension funds have outsourced their IT-related business operations in full or in part. The attendant risks sometimes proved greater than expected. In some cases, financial institutions terminated the outsourcing prematurely, taking the processes back under their own management or outsourcing them to another service provider. Points for attention in the DNB analysis include the institutions’ dependency on the chosen service provider (lock in), the exit scenarios in the outsourcing contract, the method of managing the outsourcing process, the safeguarding of sound and controlled business operations in relation to the outsourced activities, and the monitoring of the service provider’s stability. The analysis will be carried out at a small number of banks, insurers and pension funds.

**Information security**

The quality of automated information supply is crucial within the financial sector. Managers and users within financial institutions must give adequate attention to safeguarding the continuity, security and optimum performance of information and customer systems. This not only matters for the sake of management information, competitive advantage and efficient operations but also, and above all, for the sake of sound business operations. Notably because of rapid technological developments, many reorganisations within the financial sector and the increased risk of cyber crime, DNB expects all institutions to make extra efforts to bring their information security up to standard and consistently maintain it. In 2010 DNB will carry out a risk-based examination at a number of institutions, particularly in the banking sector. DNB will look at the quality of their security management (activities geared at controlling security risks) and security monitoring (structured checking of whether the security measures are effective and the timely identification and remediation of any deficiencies).

**Reporting accuracy**

The reports by institutions to DNB form an essential source of supervisory information. DNB must be able to assume that the information provided is correct. That, however, is not always the case. This is unacceptable, regardless of whether it is caused by carelessness or inexperience at the institution. In 2010 DNB will take a stricter approach to verifying that the returns are completed correctly and will take corrective measures if they are not. In cases where inaccurate reports have been certified by an external auditor or actuary, DNB will hold the auditor or actuary concerned to account.

**Change in reporting rules**

During the crisis, the application of the International Financial Reporting Standards (IFRS) came in for criticism. Amid the turbulent market conditions, the market value approach prescribed by IFRS led to high levels of volatility and sharp falls in
valuations. The International Accounting Standards Board (IASB) took the criticism on board. The IASB has already come up with proposals for adjustments in the regulations which, on its implementation as planned in 2010, will have a major impact on the external reporting of large financial institutions and consequently on the reports to supervisors (as well as the use of filters). In 2010, DNB will enter into contact with individual institutions and controlling auditors on the required preparations for the implementation of IFRS 9. In the case of institutions that choose early adoption of IFRS 9, DNB will verify that they do so adequately.

**Commercial property**
Owing to the recession, DNB is taking account of the risk of losses on investments in commercial property (such as offices and industrial real estate), both internationally and in the Netherlands. Financial institutions are involved in this area as investors or project financers. In addition, a fall in the value of real estate translates into a deterioration in the value of collateral, possibly influencing the development of bank credit to Dutch enterprises. In 2010, DNB will hence pay extra attention to Dutch financial institutions’ exposures to real estate portfolios.

5.3 **Specific themes per sector**

**Banks**

**Capital requirements**
The credit crisis has exposed the need for tighter capital requirements for banks and the build-up of larger (and anticyclical) buffers. The Basel Committee is hence consulting on a package of measures aimed at tightening the requirements, both with regard to the level of the capital buffers and to their composition (the quality of capital). In addition, it is expected to introduce a leverage ratio in the form of a simple measure for the size of banks’ own funds relative to the amount of (non-risk-weighted) assets. These proposed changes will lead to a broad impact study in 2010 serving to test the combined effect of the measures. Depending in part on this study, a decision will be taken on the exact shape of the necessary measures. The implementation will proceed with due consideration of the incipient recovery of the economy.

**Liquidity requirements**
The liquidity risks proved substantial during the credit crisis. Although, in extreme circumstances, risk can all but never be absorbed by an institutions’ own buffers for any length of time, having a strong liquidity position and keeping it under tight control is essential to survival in times of crisis. In the Netherlands quantitative liquidity requirements have already been imposed for some time. Now, liquidity buffer requirements have been introduced at the European level too and banks
are expected to take these into account as of mid-2010. In parallel, the committee in Basel is working on internationally harmonised liquidity requirements for banks based on quantitative minimum requirements for liquidity buffers and their qualitative composition. On the one hand, this is expected to lead to the instigation of a liquidity coverage ratio (LCR) for the period up to one month in advance and, on the other, of a structural liquidity ratio (SLR) that sets standards for the structural liquidity position up to a year ahead. A quantitative study aimed at testing the Basel proposals will be held in the first half of 2010. DNB will incorporate the Basel and European proposals into revised liquidity reports by banks. Besides minimum requirements on the basis of existing or revised liquidity reports, higher liquidity requirements may be imposed on individual institutions. These requirements will be derived from an individual liquidity assessment (ILA) which DNB is introducing for banks. The ILA is based on an internal liquidity adequacy assessment process (ILAAP) and supervisory review and evaluation process (SREP) with regard to the quality of the liquidity management, analogous to the existing process assessing capital adequacy. DNB will thus systematically determine banks’ individual liquidity requirements and assess their liquidity management systems.

Banks’ administrations and the deposit guarantee scheme
The EU Directive on Deposit Guarantee Schemes provides for a payout delay of 20 working days maximum as of 1 January 2011. Banks should amend their administration such that, if the deposit guarantee scheme comes into effect, they can provide the required data to DNB at very short notice. DNB will discuss the required adjustments in their administration with the banks and will check on their progress in the course of the year.

Insurers
Solvency II
The new European framework for insurance supervision, Solvency II, will come into effect as of 31 October 2012. Insurers must make intensive preparations to meet all the Solvency II requirements in time. The new regulations for capital requirements, valuation principles and risk management will result in a risk-sensitive solvency regime that will stimulate proper risk management. As part of the preparation, the fifth quantitative impact study, QIS5, will take place in 2010. DNB is also organising a pre-application for insurers who intend to submit an application for the use of an internal model for calculating their solvency requirement. The pre-application is effectively a final rehearsal for the application process. The criteria for approval are not statistical but relate to how the model is organisationally embedded in the insurer’s risk management. For one, DNB will form an opinion on the insurer’s use of the model in its day-to-day operations, and the correctness of the methods, assumptions and data used in the model. The material in question is complex and its assessment requires intensive dialogue.
Many insurers have already been working on preparations for Solvency II for some time. DNB expects that, as part of their preparations, the insurers will carry out a self-assessment to identify any points on which they do not yet comply with the future requirements. They should then draw up a realistic plan of implementation in order to close these gaps in time. The assessment of the insurers’ state of readiness for Solvency II will be a fixed item in supervisory discussions over the next few years.

**Examination of insurers’ investments**

In 2010 DNB will conduct an examination of investment policy and risk management at a number of large insurers. The objective of this examination is to enhance insight into the risks ensuing from investments and how they relate to liabilities. The scope of the examination is broad. Besides the inherent market risks arising from the composition of the investments, DNB will examine risk management. To this end, DNB will inspect the investment policy, risk management, mandate structure and governance surrounding investments and asset and liability management.

**Pension administrations at insurers**

Further to the examination initiated in 2009, DNB will also take a closer look at insurers’ pension administrations under the project name Quinto. One of the requirements for sound and controlled business operations is that the rights of members in direct schemes should be adequately administered and that the insurer has made all the necessary arrangements. DNB will focus on members’ (individual) pension entitlements.

**Governance and risk management at small insurers**

Good governance is the basis for the control of business operations. Small insurers in particular must give full attention to the design of their risk management. Adequate internal supervision as a component of governance is a challenge for these insurers. Many small insurers arrange general members’ meetings but have no specific organ for internal supervision. When insurers do have a supervisory board, it is often difficult to solicit expert members. DNB hence intends to expressly consult directors and managers on the issue of maintaining a sharp focus on risk management.

**Pension funds**

**Amendments to FTK**

In the context of the broader financial problems in the area of supplementary pensions, the Minister of Social Affairs and Employment announced in a letter to the Lower House of Parliament that he would deal with various pension issues. Part of this process is the evaluation of the *Financieel Toetsingskader* or FTK [Financial Assessment Framework] in which DNB plays an active role. A key point is the adequacy of buffers for pension funds in relation to their risk profile. This evaluation process has now been completed and the report is ready for political discussions.
**Evaluation of recovery plans**

In 2009, DNB assessed 340 recovery plans from pension funds that had reported a solvency shortfall on 1 January 2009. Under the Pensions Act, funds that have submitted a recovery plan should report in early 2010 on the progress of their recovery and the implementation of the measures included in their recovery plan. In the first months of 2010, DNB has been assessing whether the pension funds are adequately executing their recovery plans, how far their recovery has proceeded and whether supplementary measures are required. The progress assessment of the recovery will be used in supervision and is important for the evaluation of the recovery periods that will be conducted by the Minister of Social Affairs and Employment in the summer of 2010.

**Financial structure**

A sound financial structure must be consistent with the commitments made by a fund to its members and laid down in pension schemes and administration agreements. The financial structure must be aligned to the agreed type of commitment and the contribution, indexation and investment policies in such a way that there is a consistent relationship between the method of funding and the promised entitlements. In pursuing their indexation policies, pension funds must give proper effect to the legal requirement on consistency. In 2010 DNB will assess the extent to which pension funds arrive at realistic estimates of pension promises by assessing the financial structure of twenty funds in relation to their promises. DNB will use this assessment to tighten its regular supervision on this point.

**Follow-up to examination of pension funds’ investments**

The evaluation in 2009 of how the pension sector implements investment policy and risk management gives cause for follow-up activities. Key points for attention are the performance of the risk management function, the mixing of tasks when outsourcing investments and the valuation of financial products. In 2010 DNB will carry out some ten specific examinations into the control environment for investments; it will explore the valuation of several complex products, looking at the adequacy of the method used and ascertaining the role played by external parties. Where possible, DNB will support initiatives in the sector to realise good practices.

**Pension Fund Governance**

It is vital that pension funds comply efficiently with the requirements for pension fund governance. DNB will examine the effect of the governance principles in practice by, for one, stepping up its attention for the preparation and realisation of decisions by the pension funds’ executive boards. DNB will also check on the decision-making process within the internal supervision function.
**Investment firms and managers of investment funds**

Besides the overarching themes in relation to business models and commercial real estate, the focus in the supervision of investment firms in 2010 lies on enhancing risk awareness in the sector. DNB will stimulate risk awareness by verifying that parties adequately perform the Internal Risk Assessment Process (ICAAP). It will concentrate particularly on the more risky parties.

**Payment institutions**

The coming into effect of the Payment Services Directive (PSD) on 1 November 2009 introduced a new group of payment institutions. In 2010 DNB will map out the risks incurred by these payment institutions and outline the scope of its supervision. Money transaction offices that conduct money transfers and all credit card companies have at any rate also become payment institutions as of 1 November 2009. In addition, institutions with a foreign licence may also carry out payment services in the Netherlands. These institutions are not directly subject to PSD supervision by DNB. However, pursuant to the Wet ter voorkoming van witwassen en financieren van terrorisme or Wwft [Anti-Money Laundering and Anti-Terrorist Financing Act] DNB will obviously exercise integrity supervision on these institutions.

In the case of payment service providers that offer money transfers, DNB will in 2010 focus particularly on a clear transaction analysis within the sector for the purposes of customer due diligence. The objective is to realise a level playing field for all institutions in the area of detecting unusual transactions. In addition, DNB will look closely at preventing identification fraud. The sector is still insufficiently detecting false identifications, enhancing the risk of money laundering. Finally, DNB will check on the educational level of employees of payment service providers that offer money transfers.

**Trust offices**

As part of its supervision of trust offices, DNB will research the flows of funds through these offices. It will notably look at the source and destination of funds at object companies. A key theme will be the risks related to real estate activities at object companies. The real estate sector is vulnerable to mala fide practices. Object companies engaged in project development or trade in real estate thus run a higher integrity risk. DNB will also intensify attention on operational target companies that develop trade or manufacturing activities. The attendant cash flows heighten the integrity risks. Finally, DNB will examine object companies’ feeder funds. The use of feeder funds may compromise transparency because they shield the ultimate beneficial owner.

Drawing on the experience and insights it has gained over the past few years, DNB, in consultation with the sector organisation, is compiling money laundering typologies. These typologies will help to prevent money laundering within the trust sector by raising awareness of frequent money laundering constructions.
Casinos
DNB will review the extent to which casinos comply with anti-money laundering and anti-terrorist financing legislation (Wwft). Its focus will be stricter customer due diligence with the attendant research into the source of funds. DNB will also check whether casinos meet the rules for recognizing and reporting unusual transactions.

5.4 Concluding remarks
The priorities for supervision in 2010 set out in this chapter were laid down in December of last year. However, the financial world has rarely seen as much action as in the recent period. Unexpected developments will no doubt occur in the course of 2010, too. DNB expects to incorporate any new themes flexibly into its supervision.
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