DNB
Supervisory Strategy
2010 - 2014
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Summary and conclusions

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 will not provide guarantees. Risks can never be fully ruled out, nor would that be appropriate in our free market economy. The adjustments are in line with international trends and 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.

We need a tighter supervisory framework. 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 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 from 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 pay-out 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 already 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) on the one hand, and in the way in which DNB organises and implements its own supervision (Chapter 4) on the other.
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 in our current dynamic times, 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.
3 Supervisory framework

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 remediying 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 on the adjustments in supervision advocated by DNB. The advocated 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 the regulatory tightening is currently ongoing.

Regarding the supervision of insurance, DNB has high expectations of the introduction of the new 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 cost allocation 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 in so 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 most 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 DNB 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)section 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, payments, 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 is 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. Deeper 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 already largely reflected in the themes to which DNB will devote extra attention in its supervision in 2010. As outlined in the brochure 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. But 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.
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