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Re.:
DNB's capital position

Dear Ms Kaag,

I am writing to inform you of the negative trend in the capital position of De Nederlandsche Bank (DNB) resulting from expected losses. Central banks in the euro area have contributed to prosperous economic development over the past decade by easing monetary policy and mitigating the impact of the COVID-19 pandemic on the economy and the financial system. The currently high inflation comes as a surprise and necessitates a tightening of monetary policy, which, through interest rate increases, is expected to result in losses for DNB. Whereas I have informed you through our annual reports and in our discussions about the possibility of losses in the event of an interest rate increase, I am using this letter to let you know about the materialisation of this possibility. Below, I will discuss the context of the expected losses, the specific consequences for DNB and the room for manoeuvre available to us and our shareholder.

The primary mandate of the Eurosystem central banks is to safeguard price stability. These banks are the ECB and the national central banks, including DNB. In the decade leading up to the COVID-19 pandemic, the euro area faced inflation persistently below the ECB's 2% inflation target. The ECB was therefore forced to pursue an accommodative monetary policy, first and foremost by maintaining low key policy rates.

As inflation remained persistently low and key policy rates could not be brought down further due to the effective floor in nominal interest rates, the Eurosystem started to purchase government and other bonds in the secondary market in

2015 under the Asset Purchase Programme (APP). This put a lot of liquidity into the market, thereby allowing monetary policy to be eased further by pushing down capital market rates. As inflation began to converge towards the ECB's inflation target, the ECB discontinued its net purchases under the APP in late 2018.

However, these net purchases under the APP were resumed in 2019 following a return of persistently low inflation. Then, at the outbreak of the COVID-19 pandemic, the Eurosystem faced turmoil in financial markets that threatened to disrupt the transmission of monetary policy to the real economy. There was also the risk that the pandemic would spark a financial crisis. The Eurosystem therefore launched the Pandemic Emergency Purchase Programme (PEPP) in March 2020, under which bonds were purchased on a larger scale, alongside the APP.

The ECB's purchase operations proved effective during the pandemic: a financial crisis was averted and the real economy continued to receive liquidity. This ensured that the impact of the pandemic on the economy was cushioned more than would have been the case without these measures. In a broad sense, the Dutch economy has benefited from sustained economic activity in the euro area as a result of lower financing costs. Lending was also maintained in the Netherlands and elsewhere in the euro area, partly thanks to bank refinancing operations at favourable interest rates. In addition, the government has benefited from the low financing costs resulting from the purchase programmes, although the extent of this is surrounded by uncertainty.[1] At the same time, low interest rates have brought challenges for those saving for their pension or for other purposes.

Whereas inflation was consistently too low before the COVID-19 pandemic, we are now facing unexpectedly high inflation. This high inflation, which is caused

[1] Eser et al. (2019) 'Tracing the impact of the ECB's asset purchase programme on the yield curve' estimate that the APP reduced the 10-year interest rate by 95 basis points over the period under review. This estimate implies considerable interest savings for the Dutch State. Assuming total debt issuance of €267 billion over the 2015-2021 period, with average maturity of 10.6 years, this estimate produces a total benefit of €28 billion over that period for the Dutch State.

by supply chains disruptions and energy scarcity, among other factors, is forcing the ECB to intervene and recalibrate its monetary instruments. The ECB is tightening monetary policy by raising key policy rates and it has discontinued net purchases under its purchase programmes. This policy aims to bring inflation down to 2% over the medium term, which is consistent with price stability.

DNB is experiencing the financial consequences of this reversal of monetary policy. As the unexpectedly swift reversal of the inflation pattern takes place and key policy rates rise, DNB is facing increases in the rates it pays on deposits which banks hold with DNB. At the same time, its income on the purchased bonds is not rising in parallel. The discrepancy between the rates paid and those received is particularly wide due to the programmes undertaken in response to the COVID-19 pandemic outbreak. The scenario that is now unfolding is roughly in line with what we considered an extreme but plausible interest rate scenario at the end of last year.

All central banks implementing purchase programmes, both in the euro area and beyond, are facing these negative consequences.[2] DNB purchased mainly Dutch government bonds under the Eurosystem's purchase programmes. Losses are greater for national central banks that have purchased bonds from governments that enjoy relatively high credit ratings – as is the case for DNB. After all, government bonds from these countries carry the lowest interest rates and are therefore more likely to be loss-making when financing costs rise.

Price stability is the ECB's single primary objective. This implies that potential negative financial consequences do not outweigh the ECB's need to support or fight inflation in line with its mandate. Because the purchase programmes entail financial risk, DNB has built up an additional buffer since the start of the purchases in 2015 in the form of a provision to absorb potential losses. We calibrate the size of the provision to an extreme but plausible scenario of interest

[2] See for example the Federal Reserve here, the Riksbank here and the Bank of England here.

rate increases and build up the provision by adding part, or sometimes even all, of our profits annually.[3] DNB has faced the challenge that, due to the low interest rates in recent years, its income was limited, both in historical terms and in relation to the size of its balance sheet. In addition, banks could claim favourable interest rates under the Targeted Longer-Term Refinancing Operations (TLTRO), provided that they maintained lending levels, which further depressed DNB's result. While this maintained lending levels during the pandemic, thereby stimulating economic activity and averting deflationary risks, it made it difficult for DNB to raise this provision to the desired level.

Although the buffers available to DNB can absorb substantial shocks, they are not infinite. In the last two annual reports, DNB warned about the risks that are now materialising, stressing that the buffers would be insufficient under certain scenarios. A buffer deficit means that the losses calculated according to such scenarios exceed our buffers. In addition to the provision for financial risks (€2.8 billion), the buffers consist of capital and reserves (€8.5 billion). The total risks at the end of last year were calculated at €13.7 billion and consisted for the most part (€9.4 billion) of the interest rate risk, which we now see materialising.

We estimate the extent to which we expect to draw on these buffers based on the expected trend in interest rates as priced by the financial markets. We expect to end this year with a small loss. For the coming years, however, the expected cumulative losses will be considerable. According to the estimate as at 31 May 2022 that I sent you, the cumulative losses would be €2.7 billion between 2023 and 2026. Since that estimate, the ECB's Governing Council has raised key policy rates in two steps by a total of 125 basis points and market rates have continued to rise. As a result, we are now expecting cumulative losses equivalent to the interest rate risk as at 31 December 2021, or about €9 billion.

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[3] DNB's gross profit or loss is determined before any addition to or withdrawal from the provision for financial risks. The net result is determined following this addition or withdrawal. Since 2015, DNB has used three quarters of its cumulative gross profit (€4,552 million) to build up the provision (€2,810 million) and bolster its capital and reserves (€565 million). The remainder was paid out as dividends (€1,176 million).

The expected cumulative losses are surrounded by uncertainty. DNB's gross profit or loss is sensitive to interest rate movements. As a consequence, the large interest rate movements of 2022 are reflected in wide fluctuations in our estimated financial results. Further upward interest rate shocks, in line with the aforementioned scenarios, may result in additional losses. In such scenarios, DNB would be forced to draw on its buffers. If the losses continue to mount, a situation may arise in which DNB is faced with negative capital. Conversely, a downward interest rate shock would lead to financial results that are better than expected under the scenario outlined above. There is also uncertainty about the future size and composition of our balance sheet. For example, the ECB's Governing Council may take further measures to curb inflation that affect our balance sheet – and thus our profit outlook – either positively or negatively. The uncertainty is greater the further we look ahead.

The rules governing DNB's buffers are laid down in the capital policy that we agreed in 2019. In that capital policy, the Ministry of Finance and DNB jointly endorsed the need for an adequate capital position that would safeguard DNB's financial independence. In many respects, the 2019 policy has worked well and has allowed DNB to build additional buffers to a certain extent. However, the policy does not provide for the present situation.

While a temporary negative capital is permissible and workable, the Eurosystem's rules stipulate that this should not be the case over an extended period.[4] The possibilities for DNB to supplement its buffers are currently limited. In principle, DNB supplements these by retaining future profits. However, should the deficit be too large or expected profits too low, additional measures may be necessary to restore the balance sheet to solidity. In an extreme case, a capital contribution from the shareholder may be necessary, as you also mentioned in your annual information letter to the House of Representatives about DNB's risks.[5]

[4] ECB Convergence Report, June 2022.
[5] See also the "Annual information letter on risks incurred by DNB and the Dutch State due to ECB policy" of July 2022 (in Dutch).

The expected losses will occur over a period of several years. According to the estimate, the largest losses will occur in 2023 and 2024, followed by several smaller annual losses. Naturally, I will inform you in good time if there are any significant changes to DNB's profit forecasts and capital position. The experiences of the COVID-19 pandemic and the impact of monetary policy on buffers may be included in the capital policy review to be initiated in 2023.

Yours sincerely,