



# Banking supervision in the Netherlands

DNB's prudential supervision of medium-sized and small banks in the Netherlands

2017



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## **Original title**

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## Executive summary: Banking supervision in the Netherlands

## Introduction

The Netherlands Court of Audit audited De Nederlandsche Bank's (DNB) supervision of medium-sized and small banks in the Netherlands in 2016 and 2017. The supreme audit institutions of Austria, Cyprus, Finland and Germany carried out similar audits in their home countries during the same period. The findings of their joint audit will be published at the end of 2017. This present report considers the situation in the Netherlands.

### Banking crisis and the introduction of the banking union

#### Bank crisis and debt crisis

The fall of Lehman Brothers in the United States in September 2008 triggered the biggest financial and economic crisis since the 1930s. 'Bad loans' brought banks across the world close to the abyss and national governments had to step in with financial support to prevent further economic and financial collapses.

In the Netherlands, the crisis led to the nationalisation of ABN AMRO. Furthermore, ING, AEGON and Volksbank (formerly SNS) received state aid, and DSB had to be wound up. The Dutch government provided nearly €90 billion in financial aid and nearly €80 billion in guarantees to prop up the financial sector.

The banking crisis and the subsequent economic recession placed extreme pressure on public finances in many countries. In the eurozone, Greece, Ireland, Portugal, Cyprus and Spain received financial support in the form of emergency assistance. Public finances in the Netherlands, too, were badly affected.

#### European banking union

Both national and international measures were taken to prevent a repetition, or in any event to mitigate the disastrous consequences of such a crisis. A measure that is having a significant impact in the Netherlands is the European Council's decision in 2012 to establish a banking union in the eurozone.

### European banking union

The main components of the banking union are:

- the creation of a supranational supervisor, the European Central Bank (ECB), with the power to supervise significant banks in collaboration with national supervisors (the Single Supervisory Mechanism, SSM);
- a European resolution mechanism to assume the critical functions of a failing bank and minimise the negative consequences for taxpayers;
- a European deposit insurance scheme (yet to be established) to guarantee the savings (up to a maximum amount) of savers in the eurozone if a bank is in difficulties.

**Source:** European Commission website

The EU also tightened up and further harmonised the rules for all banks in the euro countries. All 19 countries that have introduced the euro as their currency are participating in the banking union.

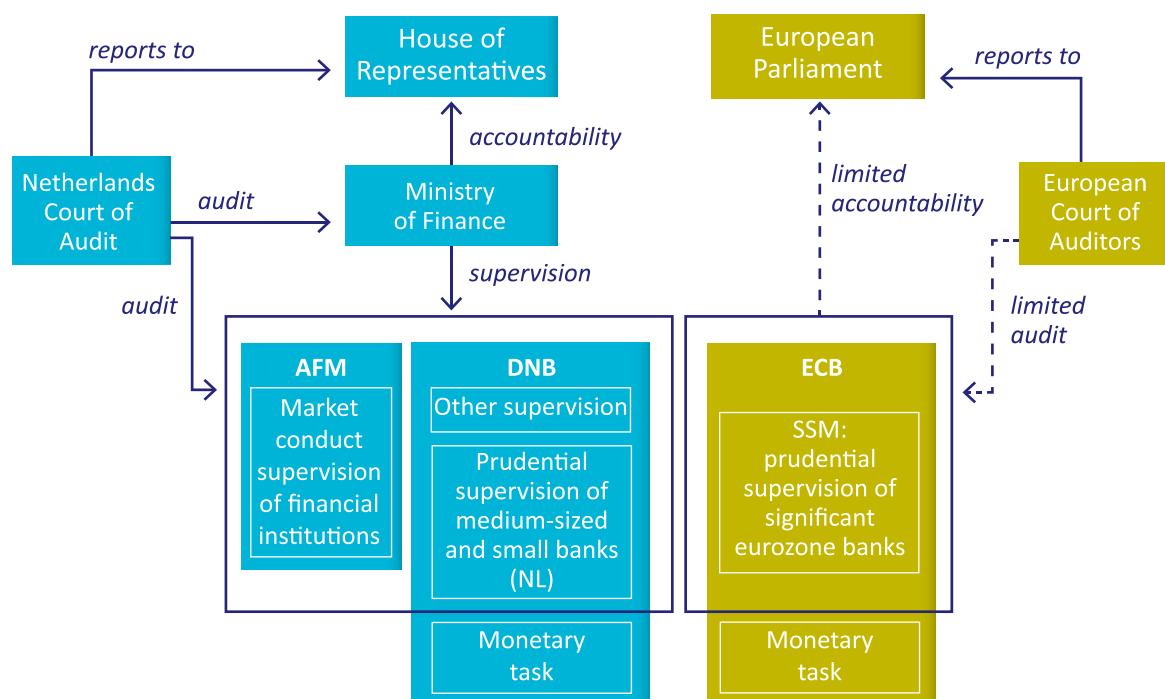
These measures are designed to restore confidence in the European banking sector, to ensure that banks are not as prone to difficulties, and to prevent them from having to be rescued by means of public funds.

The SSM came into effect on 4 November 2014. Since then, the ECB has been responsible for the direct supervision of 'significant' banks in the eurozone rather than the national supervisors (such as De Nederlandsche Bank, DNB, the Dutch central bank). The underlying reason is that the cross-border activities of significant banks are of primary importance to the stability of the financial system in the eurozone as a whole. In the Netherlands, the ECB has been responsible for supervising ING, ABN AMRO, Rabobank, Volksbank (formerly SNS Bank), Nederlandse Waterschapsbank and Bank Nederlandse Gemeenten since November 2014. These banks had a joint asset value of approximately €2,200 billion in 2016.

The ECB is tasked with the prudential supervision of these banks. The objective of prudential supervision is to protect the financial solidity of individual financial institutions and strengthen the stability of the financial system as a whole.

DNB has retained its responsibilities for the prudential supervision of medium-sized and small banks in the Netherlands (the 'less significant banks'). There are about 30 of these banks, together representing a asset value of approximately €300 billion. DNB is also responsible for all other forms of supervision of banks, insurers and pension funds.<sup>1</sup> The Netherlands Court of Audit has audited DNB's prudential supervision of medium-sized and small banks.

## National and European supervision of banks



**Figure 1** Supervision of banks in the Netherlands (Source: Netherlands Court of Audit)

### DNB's supervision of medium-sized and small banks is effective, intensive and strict

Owing to the far-reaching changes in banking supervision introduced at EU level, DNB has had to modify its supervision of medium-sized and small banks in the Netherlands. In our opinion, it has successfully adapted to the new situation and organised its supervision effectively. Its assessment of medium-sized and small banks is the outcome of a dedicated process with clearly defined steps.

DNB has organised its supervision largely along the same lines as the ECB's supervision of significant banks. DNB's approach to assess the financial solidity of medium-sized and small banks is comparable with the ECB's approach to significant banks. Its ongoing risk analyses of individual institutions are also based on the ECB's approach. Finally, the organisation of DNB's supervisory organisation itself is based on the ECB's supervisory organisation.



DNB has designed a straightforward supervisory process, with an appropriate internal allocation of responsibilities and related control mechanisms. The control mechanisms, however, could be strengthened in some areas. DNB's Risk Management & Strategy Department, for example, drafts high quality reports regarding DNB's supervision and how its performance can be improved. We found, however, that DNB had not formally introduced a procedure to follow up the recommendations. Furthermore, its Internal Audit Department has not yet investigated DNB's supervision of medium-sized and small banks. And the staff at DNB responsible for supervision could strengthen the internal debate (referred to as 'the challenge') in decision-making on individual banks.

DNB supervises medium-sized and small banks intensively. It performs a comprehensive assessment of all medium-sized and small banks every year, expresses an overall opinion on each assessment and contacts the banks' managers and directors every year. DNB thus supervises the medium-sized and small banks more frequently than required under the guidelines set by the European Banking Authority (EBA).

DNB's supervision is strict as well as intensive. The capital and liquidity requirements it sets regarding the banks' equity and cash positions are higher than the minimums required under the regulations. DNB, moreover, makes frequent use of the possibilities provided in the regulations to set additional capital adequacy requirements. Until the end of 2016, banks had to meet the capital requirements using the most secure, and therefore most expensive, form of capital. DNB also sets higher capital requirements in respect of the larger medium-sized banks than the ECB sets in respect of significant banks. DNB's requirement regarding the period in which banks must hold sufficient liquid funds in the event of a crisis is also stricter. In most cases, DNB requires them to hold sufficient liquid funds for six months; under EU regulations, the minimum period is 30 days. DNB does not explain why its supervision of medium-sized and small banks is so intensive and so strict.

### The Ministry of Finance's supervision of DNB is limited

The Minister of Finance is responsible for the functioning of the financial system as a whole and for the legislation and regulation of the financial markets. He is accountable to parliament for his performance of public tasks and use of public money. In this capacity, he is also responsible for supervising DNB's performance as banking supervisor. The legislator has explicitly opted for 'remote supervision': DNB has a duty to supervise the banks independently and confidentially. In an extreme case, the minister can intervene if DNB's

supervision is below standard. The minister must accordingly have sufficient powers and information to fulfil his responsibilities.

The minister's role is laid down in the Financial Supervision Act (WFT) and the Autonomous Administrative Authorities Framework Act (ZBO Framework Act), which lays down the relationship between ministers and autonomous administrative authorities (ZBOs). The legislation provides the minister with sufficient instruments to supervise DNB in its capacity as a ZBO. The minister must, for example, review and approve DNB's budget and accounts every year. He may obtain information on DNB's performance and if necessary can intervene in many ways.

The minister exercised only limited supervision of DNB in the period between 2011 and 2016. He did not prepare annual plans, for instance, setting out how he intended to exercise his supervision. Every five years, ministers must evaluate the ZBOs for which they are responsible. The most recent evaluation of DNB contains scant information on the efficiency and effectiveness of DNB's supervision of medium-sized and small banks. Furthermore, the minister did not proactively request information from DNB regarding its supervision. In practice, however, there is regular contact between DNB and the Ministry of Finance at civil service and management level. As minutes are not usually kept of these meetings, though, it is impossible to assess the results of the contacts. The lack of records can also lead to uncertainty about agreements and decisions when changes are made at management or civil service level.

The Ministry of Finance is confident that DNB will provide timely and full information in the event of a crisis. It is uncertain, however, what information will or must be provided and when. In our opinion, when and how DNB must inform the minister during a crisis should be known in advance. There is a Memorandum of Understanding (MoU) concerning the exchange of information between the Minister of Finance and DNB but it dates from 2007 and has not been revised since then.

### Gaps in supreme audit institutions' ability to perform external audits under the SSM

Since November 2014 the Netherlands Court of Audit has been unable to audit the prudential supervision of significant banks in the Netherlands. The SSM came into effect in that month and prudential supervision of significant banks in the Netherlands passed to the ECB. National supreme audit institutions do not have the power to audit the ECB.

The European Court of Auditors cannot audit the functioning of the ECB's supervision of significant banks either because the SSM does not give it the power to do so. We have already informed the House of Representatives of this shortcoming. An audit of the SSM by the European Court of Auditors in 2016 confirmed this weakness in the independent, external audit of the supervision of significant banks. The ECB refused to provide the European Court of Auditors with documents on its actual supervision of significant banks.

Despite the extensive reach of our mandate, our audit of DNB's supervision of medium-sized and small banks ran into the same difficulties. Firstly, we were granted only very limited access to the SSM supervisory manual, which sets out the principles, methods, requirements and standards for the supervision of medium-sized and small banks. After consultation with the ECB, DNB was unwilling, on formal grounds, to share a copy of this ECB document with us. Secondly, we found that DNB was registering more and more information on its supervision of banks into the ECB's Information Management System (IMAS). The use of IMAS is not yet compulsory but DNB expects it will be in the near future. DNB believes it must request the ECB, as the owner of IMAS, permission to grant access to information in its system. In view of the ECB's refusal to allow us access to the SSM supervisory manual, it is highly unlikely that it will grant us access to IMAS. This means that we can no longer exercise our statutory audit powers.

## Recommendations

We make the following recommendations based on the above conclusions.

To DNB:

- Clearly explain to the banks how the capital and liquidity requirements are arrived at. Explain to the medium-sized and small banks why the requirements set for them are higher than those set for significant banks. Explain the frequency and depth of supervision at each bank and explain why the supervision is more intensive and stricter than the minimum required under the regulations.
- Ensure that the Netherlands Court of Audit retains its statutory access to confidential information on the supervision of medium-sized and small banks, even when DNB adopts the ECB's methods and information systems.

To the Minister of Finance:

- Ensure that internal reports are made of the contacts between the Ministry of Finance and DNB so that decision-making can be reconstructed and the continuity of decision-making is guaranteed.

- Update and strengthen the 2007 Memorandum of Understanding between DNB and the Ministry of Finance. Have it clearly explain when and how DNB must inform the ministry of risks to the stability of the financial system. Also ensure that compliance with the MoU is monitored.
- Make more effective and frequent use of the instruments available to supervise DNB and so ensure that DNB is performing adequately in its capacity as banking supervisor. For example, prepare an annual plan with risk analyses for the supervision of DNB and report on the implementation of this plan to the House of Representatives.
- Find a structural solution at EU level to the shortcomings in the independent, external audit by supreme audit institutions of the supervision of both significant banks and medium-sized and small banks. The European Court of Auditors' audit mandate should be modified so that it can audit the functioning of supervision.

# Banking supervision in the Netherlands

# 1 The audit

## 1.1 Introduction: banking supervision in the Netherlands

### The Dutch banking sector

Financial institutions and markets play an essential role in the Dutch economy. They provide households and businesses with credit, they enable people to save and to use their savings to improve the economy. They help businesses and households control their financial risks, to insure themselves and to carry out payment transactions. By enabling these functions, an efficient financial system contributes to economic prosperity, stability and growth.

The Netherlands has a relatively large banking sector. Dutch banks had a combined balance sheet total at the end of 2016 of more than €2,500 billion.<sup>2</sup> The significant institutions (SIs) in the Netherlands had a combined balance sheet total of approximately €2,200 billion.<sup>3</sup> The significant banks in the Netherlands on 1 January 2017 were ING, ABN AMRO, Rabobank, Volksbank (formerly SNS Bank), Nederlandse Waterschapsbank (NWS) and Bank Nederlandse Gemeenten (BNG). The Netherlands also has about 30 less significant (medium-sized and small) institutions (LSIs).<sup>4</sup> Their combined balance sheets were worth approximately €300 billion.<sup>5</sup> The LSIs can be roughly divided into medium-sized banks such as Van Lanschot Bankiers, NIBC and Triodos Bank, and small banks such as Delta Lloyd Bank, ASR Bank, Bank Ten Cate and Hof Hoorneman Bankiers.<sup>6</sup>

### Prudential supervision of banks in the Netherlands

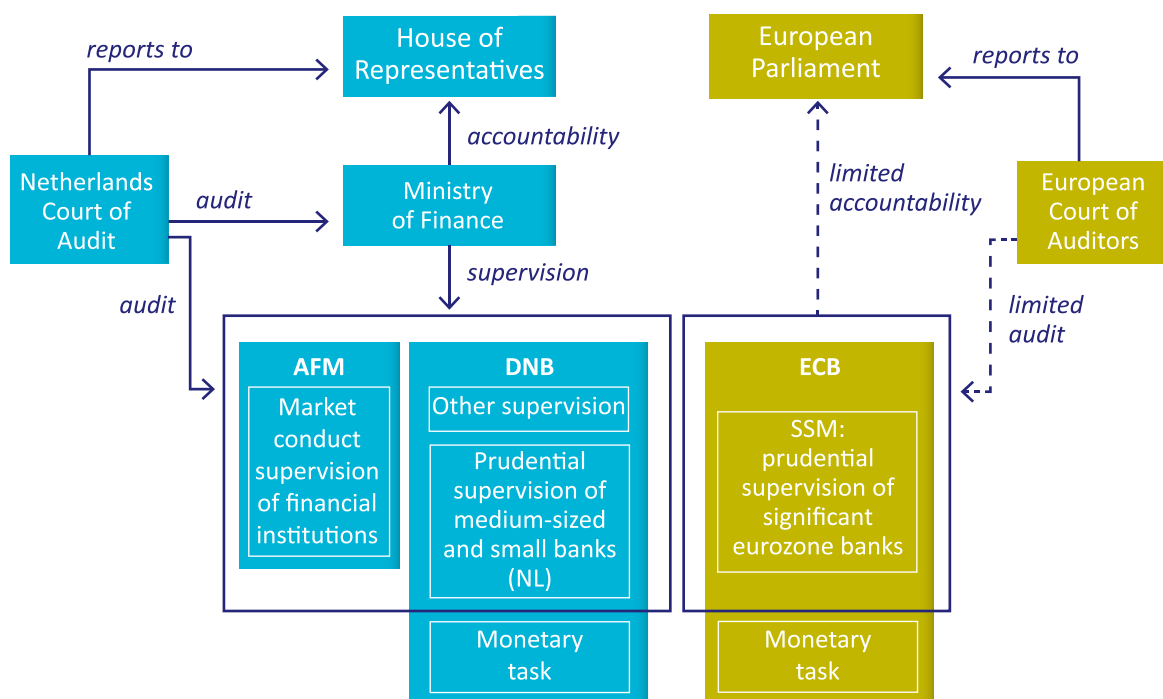
The Minister of Finance is responsible for the functioning of the financial system in the Netherlands. Under the Financial Supervision Act (WFT), he is responsible for the legal framework, the quality of regulation, the availability of appropriate instruments and has the power to appoint and dismiss the managers of the supervisors, including those at DNB. He supervises the supervisors at DNB and the Dutch Authority for the Financial Markets (AFM), and renders account for his supervision to parliament.

There are two kinds of supervision:

- *Prudential supervision* is<sup>7</sup> concerned with the financial solidity of financial institutions and contributes to the stability of the financial sector.
- *Market conduct supervision* is concerned with orderly and transparent market processes, honest relations between market parties and the conscientious treatment of the clients of financial institutions.

The WFT designates DNB as the prudential supervisor. Market conduct supervision is exercised by the AFM and does not fall within the scope of this audit.

### National and European supervision of banks



**Figure 1.1** Banking supervision in the Netherlands (Source: Netherlands Court of Audit)

DNB's tasks are laid down in the Bank Act 1998,<sup>8</sup> in the WFT and in DNB's own articles of association.<sup>9</sup> DNB is a 'legal person with a statutory task' (RWT) and as a supervisor enjoys the independence of an 'autonomous administrative authority' (ZBO).

### Supervision of significant banks: role of the ECB

In June 2012, the European Council decided to establish a European banking union to ensure that banks do not get into financial difficulties in the future and that, in the event they nonetheless did, they would not have to be rescued by public money. To this end, national tasks and powers were transferred to the supranational level.

The first pillar of the banking union came into effect on 4 November 2014. Since then, prudential supervision of significant banks has no longer been exercised by national supervisors but by the European Central Bank (ECB) within the Single Supervisory

Mechanism (SSM). The ECB performs its tasks within the SSM in consultation with 'national competent authorities' (NCAs), such as DNB in the Netherlands.

The ECB must ensure that banks in all countries in the eurozone are supervised consistently and in accordance with the rules of the EU. This means, among other things, that the intensity of supervision must be consistent with the risk score set by the supervisor, and with the size and complexity of the institution.

The ECB decides on the granting and withdrawal of licences to significant and medium-sized and small banks and on granting declarations of no objection for the acquisition or disposing of qualified participations in banks. One of the ECB's specific tasks is to supervise the capital and liquidity positions of significant banks. It does so by means of a 'supervisory review and evaluation process' (SREP).

Not all supervision of significant banks was transferred to the ECB on the introduction of the SSM. DNB remains responsible for those tasks and responsibilities that were not explicitly transferred to ECB. They include supervision of integrity and the prevention of the use of the financial system for the purpose of money laundering and financing of terrorism.

### **Supervision of medium-sized and small banks in the Netherlands: role of DNB**

Medium-sized and small banks in the Netherlands are subject to DNB's direct supervision and the ECB's indirect supervision. The ECB can supervise these banks directly if, in its opinion, there are reasons for doing so.<sup>10</sup> It can also issue instructions that the national supervisors of medium-sized and small banks must observe.<sup>11</sup> In practice, DNB can supervise medium-sized and small banks itself until the ECB has fully worked out its policy for those banks.<sup>12</sup>

The main elements of DNB's supervision of medium-sized and small banks are:

- submitting draft decisions on issuing licences and declarations of no objection to the ECB for a formal decision;
- assessing and reassessing the banks' executive directors and supervisory board members;
- the SREP, including assessing the banks' capital and liquidity positions.



DNB must report to the ECB on its supervision of medium-sized and small banks. The ECB also checks DNB's application of the supervisory standards, processes and procedures in the supervisory mechanism, such as the SREP.

## 1.2 Organisation of the audit

### Reason for the audit: alliance of supreme audit institutions

The Netherlands Court of Audit has been working with other supreme audit institutions (SAIs) and the European Court of Auditors in the Banking Union Task Force since 2014. In 2015, the SAIs together highlighted the shortcomings in the audit of public tasks, the audit gap, since the introduction of the SSM.<sup>13</sup> In 2016 the Task Force provided information for the European Commission to evaluate the SSM.<sup>14</sup>

In 2015 the European Court of Auditors began an audit of the ECB's supervision of significant banks. Its audit was published at the end of 2016.<sup>15</sup> In mid-2015 the supreme audit institutions of Austria, Cyprus, Finland, Germany and the Netherlands decided to audit the supervision of medium-sized and small bank in their home countries, in part to gain a better understanding of the audit gap.

### Audit powers of the Netherlands Court of Audit

The Netherlands Court of Audit carries out its activities in accordance with the Government Accounts Act. This act mandates us to audit public companies whose issued share capital is held wholly or nearly wholly by the state. We are also mandated to audit legal persons that perform a statutory task (RWTs) and that are funded wholly or partially from taxes and contributions. Under the Treaty on the Functioning of the European Union (TFEU), our audits may not consider DNB's monetary tasks but they can cover its supervisory tasks.

Since May 2014, the WFT has explicitly allowed DNB and the AFM to provide the Netherlands Court of Audit with confidential information or intelligence that they obtain during the performance of their tasks under the WFT.<sup>16</sup>

### Audit scope

The audit considered DNB's prudential supervision of medium-sized and small banks in the period between 2015 and 2016. In particular we looked at DNB's assessment of the capital and liquidity positions of these banks in accordance with the SREP.<sup>17</sup> Our audit also considered areas where the ECB's policies had a direct influence on DNB's supervision of

medium-sized and small banks. In addition, our audit covered the Minister of Finance's role because he is responsible for the framework in which DNB operates, and he is accountable to parliament for the supervision exercised by DNB.

The main audit question was:

- How has the supervision of medium-sized and small banks in the Netherlands been organised since the introduction of the Single Supervisory Mechanism (SSM), and how does it work in practice?

The audit was broken down into the following secondary questions:

1. What are the main European and national frameworks for the national prudential supervision of banks? And what are the main changes brought about by the introduction of the SSM?
2. How has DNB organised its supervision of medium-sized and small banks since the introduction of the SSM?
3. How does DNB currently exercise prudential supervision of medium-sized and small banks in practice?
4. How does the Minister of Finance fulfil his responsibilities for the system of prudential supervision? Does he fulfil them adequately in practice, including his accountability to the House of Representatives?

Independent external audit by supreme audit institutions of the performance of prudential supervision is essential. There has to be a comprehensive system to audit the performance of public tasks. We therefore also mapped out the gaps in audit mandate and the ability to carry out independent audits of the supervision of medium-sized and small banks.

### **Lessons learned from the crisis, measures taken by DNB**

Many studies have been carried out in recent years of the financial crisis of 2009 and the debt crisis of 2011. Many of those studies have led to changes in the prudential supervision of banks.<sup>18</sup> The financial crisis led to stricter and more consistent European regulation of capital requirements, liquidity requirements and risk management and to closer cooperation among supervisors at EU level. The 2011 debt crisis accelerated the reorganisation and EU-wide centralisation of prudential supervision as part of the banking union.

DNB has gone to great lengths in recent years to learn the lessons of the successive crises. In a short period of time and under extreme pressure, DNB has restructured its organisation and strengthened its internal governance. It has also improved its organisation and implementation of banking supervision. Our audit findings should be seen in the light of the steps DNB has already taken.

### **Other audits**

Several institutions have recently audited banking supervision. The European Court of Auditors published a report on the SSM in 2016, the IMF issued a Financial Sector Assessment Programme (FSAP) for the Netherlands in 2017 and the Ministry of Finance carried out an evaluation of ZBOs in 2017. These audits are summarised in Annexe 3.

### **Audit methodology**

Annexe 2 presents the methodology used in this audit. It explains our audit standards framework, the approach we took, the external experts we consulted and the access we had to information and opinions.

We enjoyed fruitful cooperation with DNB during the audit. The bank provided virtually all the information we requested, in so far as it fell within its mandate, as interpreted by DNB and the ECB. We did not receive all the information we requested.<sup>19</sup> We received only very limited information from the ECB; we did not have access, for example, to the SSM supervisory manual. DNB informed us that the ECB was of the opinion DNB had no legal grounds according to the Treaty to provide such information. We asked the ECB to cooperate voluntarily in the audit but it declined. As a result, we did not have a precise understanding of the ECB's confidential rules that co-determine DNB's implementation of the SREP.

## **1.2 Structure of this report**

The following chapters in this report present our main conclusions.<sup>20</sup> Chapters 2 and 3 consider DNB's supervision and chapter 4 looks at the Minister of Finance's role. Chapter 5 discusses the audit gap in banking supervision. Chapter 6 presents our conclusions and recommendations and chapter 7 summarises the response of the President of DNB and the Minister of Finance to our audit report, and presents our afterword.

In chapters 2 and 3, we refer in general terms only to the confidential information underlying our findings and conclusions.

## 2 Organisation of banking supervision

### 2.1 Conclusions

We arrived at the following main conclusion regarding DNB's supervision of the capital and liquidity positions of medium-sized and small banks:

- The regulations are comprehensive, complex and change quickly. DNB supervises the capital and liquidity positions of medium-sized and small banks in accordance with these complex regulations. Its supervision is effectively organised, intensive and strict. There is room for further improvement in some areas.

This main conclusion can be broken down into four secondary conclusions: 1) the rules are complex, 2) DNB has organised its supervision effectively. These secondary conclusions are considered in this chapter. The next chapter looks at the other two secondary conclusions: 3) the supervision is intensive and strict, and 4) in practice, the supervision can be improved in a number of areas.

#### Complex rules

The international, EU and national regulations in place for banking supervision are comprehensive and complex, and are subject to rapid change. The legislation is accordingly difficult to apprehend and hard to implement in practice. It is a huge challenge for banks – especially medium-sized and small banks – to comply with the requirements as a whole. Furthermore, supervisory legislation is not yet fully harmonised at EU level. EU rules still allow national discretion and some goldplating - rules. Banking supervision can therefore be organised and implemented differently from one country to another, even within the framework of a single European supervisory system – the SSM.<sup>21</sup>

#### Supervision organised effectively

DNB's supervisory organisation reflects that of the ECB. Furthermore, DNB has voluntarily adopted as many of the ECB's methods as possible in its national supervision of medium-sized and small banks. In our opinion, DNB has organised its implementation of the SREP effectively. The decisions it has taken to integrate the SREP into its supervision of medium-sized and small banks have created a transparent structure with straightforward successive steps. Within the supervision, DNB has given priority to the quantitative components of the SREP. It is not always clear to the banks it supervises, however, how and on the basis of what criteria they are assessed.

At the same time, we found shortcomings in DNB's insight into the supervisory capacity it needs. It has not analysed the capacity requirement using cost accounting principles. It is not clear whether the available capacity is sufficient to mitigate the risks, and there is no insight into the actual time spent on supervision. In addition, the 'three lines of defence' model is still inadequate to supervise medium-sized and small banks. Internal audits performed by the Risk Management & Strategy Department are of high quality but stronger assurances must be in place to ensure that the recommendations will be followed up. We also found that the Internal Audit Department had not audited the operation of the supervisory process for medium-sized and small banks in recent years.

## 2.2 Complex rules

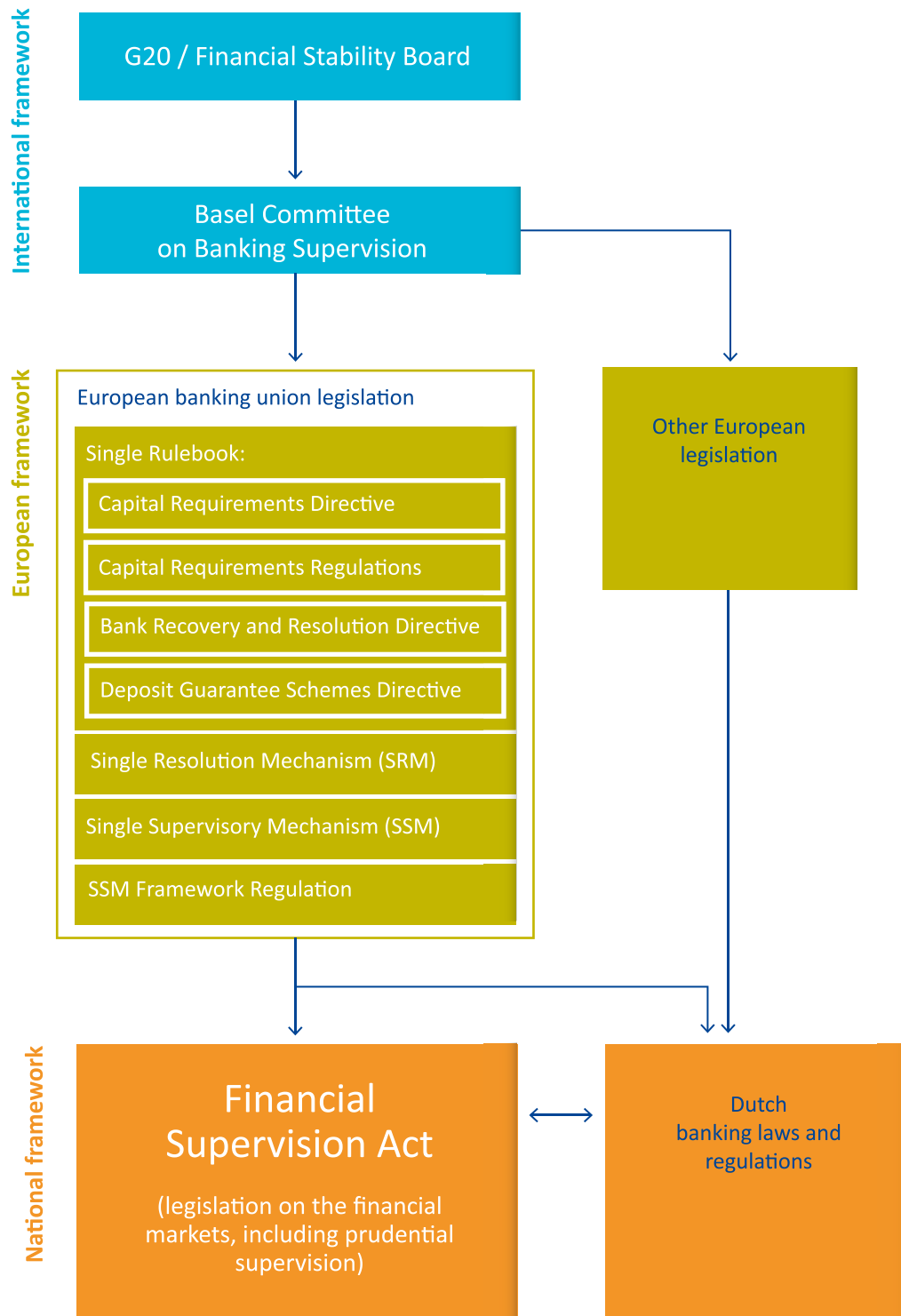
Banks are supervised in compliance with international and EU rules. In 2012, the EU established the European banking union in order to harmonise banking supervision. The supervisory rules are laid down in the Single Rulebook. Banking supervision in the Netherlands is regulated largely by the WFT.

### 2.2.1 Legislation and regulations

In response to the financial crisis and the debt crisis, the EU developed stricter rules for banks, including higher capital requirements. It also introduced the Single Supervisory Mechanism (SSM, with the ECB as the supervisor). In the first instance the EU sought a means to facilitate the direct recapitalisation of weak banks by means of the European Stabilisation Mechanism (ESM).<sup>22</sup> In 2012 it decided to create the European banking union. It will ultimately consist of three pillars: a Single Supervisory Mechanism, a Single Resolution Mechanism and a European deposit insurance scheme.

The European banking union is at the heart of an extensive and complex system of global, European and national rules that together make up prudential supervision of banks, as shown in *Figure 2.1*.

## International and European rules implemented at national level



**Figure 2.1** Regulatory framework for the prudential supervision of banks (Source: Netherlands Court of Audit)

## 2.2.2 Banking union

### Single Supervisory Mechanism

The first pillar of the European banking union is the SSM, the European Single Supervisory Mechanism. Since 4 November 2014, the ECB has been the prudential supervisor of all banks registered in the eurozone. Within this framework, the ECB has been allocated specific tasks relating to the prudential supervision of banks.<sup>23</sup>

### Single Resolution Mechanism

The second pillar of the banking union, the Single Resolution Mechanism (SRM), came into effect on 1 January 2016.<sup>24</sup> Its purpose is to ensure the orderly resolution of failing banks. The ECB must determine whether a bank subject to the SSM is, or is likely to be, in such serious financial difficulties (failing or likely to fail) that it must be resolved. If so, the Single Resolution Board (SRB), also known as the Resolution Authority, (consisting of the ECB, the European Commission and the relevant national resolution authorities) resolves the bank at EU level. Under the SRB's supervision, the national resolution authorities ultimately carry out the decision. The resolution authority in the Netherlands is DNB.

### European deposit insurance scheme

The third pillar of the banking union is the European deposit insurance scheme (EDIS). The national deposit guarantee schemes currently in force<sup>25</sup> guarantees savers that up to €100,000 of their savings with an institution will be protected if the bank in question is in financial difficulties. As the scheme is implemented nationally, there is a risk that a country experiencing a serious banking crisis will be unable to bear the cost at a given moment. In November 2015, the European Commission published a proposal for a European deposit insurance scheme.<sup>26</sup> The scheme is still being negotiated by the EU member states and the European Parliament.

## 2.2.3 Single Rulebook

For the banking union to function properly, the same rules must apply to all banks. It has therefore been decided to harmonise the supervision of credit institutions and investment firms at EU level. The rules are laid down in the Single Rulebook. The most important rules are:

- A directive and a regulation on capital requirements for banks and investment firms (Capital Requirements Directive IV and Capital Requirements Regulation, CRD IV/CRR).

- A directive on the recovery and resolution of banks and investment firms (Bank Recovery and Resolution Directive, BRRD).
- A directive on deposit guarantee schemes (Deposit Guarantee Schemes Directive, DGSD).

The purpose of the CRD and CRR is to strengthen the financial solidity, stability and resilience of banks and investment firms. The BRRD provides instruments and requirements for the orderly resolution of European banks in difficulties, without the taxpayer having to bear the costs. This reduces systemic risk and the state aid needed to maintain financial stability.

#### 2.2.4 Implementation of the rules in the Netherlands

EU regulations for banks and other financial undertakings have been transposed into Dutch law chiefly through their incorporation into the Financial Supervision Act (WFT). The SSM is restricted to the supervision of credit institutions (i.e. banks); other financial undertakings therefore fall outside the scope of the European supervisory system and accordingly remain subject to national supervision only. According to the Minister of Finance, the WFT had to be amended following the introduction of the SSM Regulation and the SSM Framework Regulation in order to allow for the ECB's supervision.<sup>27</sup> The WFT is also amended by means of the annual Financial Markets Amendment Act.

Amendments of the WFT over the years have led to a substantive change in the density of regulations and to the act becoming more complex and comprehensive. Implementation of the Capital Requirements Directive (CRD IV) was therefore complicated.<sup>28</sup> DNB has called for the structure and design of the WFT to respond to the growing influence of European law, which is still organised primarily along sectoral lines, and to the ambition of full harmonisation by means of regulations that have direct application. These points have not yet been incorporated into the WFT.

The part of the WFT entitled 'Prudential Supervision of Financial Undertakings' is relevant to DNB's prudential supervision. It contains rules on maintaining and strengthening the solidity of financial undertakings where necessary.

### 2.3 Supervisory structure

In this section we first consider in general terms how DNB has organised its supervisory structure and how it plans and accounts for its supervision. We then look at the organisation of the SREP supervision of banks more specifically.



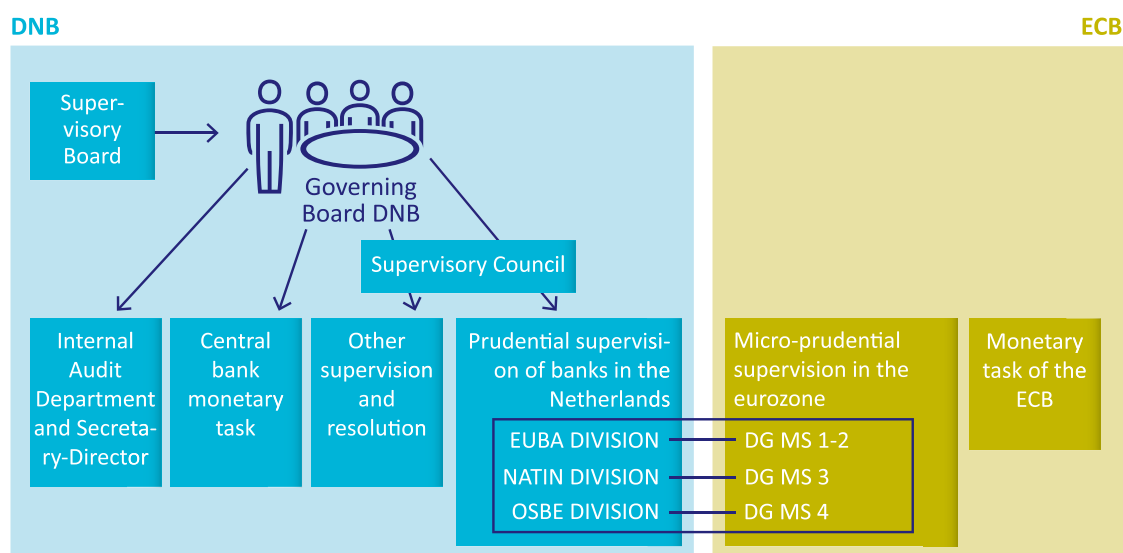
### 2.3.1 Organisation of DNB

De Nederlandsche Bank (DNB, the Dutch central bank) is a public limited company with a Governing Board, a Supervisory Board and a Bank Council. The Governing Board is made up of the President, an Executive Director of Monetary Affairs and Financial Stability, an Executive Director responsible for supervision of banks and insurance companies, and an Executive Director responsible for supervision of pension funds, who is also director of the national resolution authority.

The Supervisory Board oversees the management and general operation of DNB and the Governing Board's policy on the performance of DNB's tasks. It also approves the annual budget and adopts the annual accounts.<sup>29</sup> The Supervisory Board is informed of individual banking dossiers that are receiving extra attention from the Governing Board. The Supervisory Board reports on its activities in DNB's annual report.<sup>30</sup>

The Bank Council acts as a sounding board for the Governing Board. It consists of members of the Supervisory Board and representatives of the Ministry of Finance, the social partners, the financial sector and independent experts. The Bank Council does not concern itself with supervisory matters.<sup>31</sup>

#### DNB's three supervisory divisions have their counterparts at the ECB



**Figure 2.2** Organisation of DNB (Source: Netherlands Court of Audit)<sup>32</sup>

## Supervisory organisation based on the ECB

DNB has made substantive and procedural changes to the organisation of its prudential supervision in recent years. They were prompted in part by the lessons learned from the financial and debt crises and by the introduction of the Single Supervisory Mechanism.

DNB took the first step by introducing more thematic investigations in its supervisory strategy for 2010-2014 and giving higher priority to qualitative elements such as behaviour and culture.<sup>33</sup> The second step was taken on the introduction of the SSM. The ECB and EU regulations might not set requirements on the organisational structure of the supervisors but they do make change necessary.<sup>34</sup> DNB opted to mirror its supervisory organisation on the ECB's and to have its new organisational structure coincide with the start of the SSM.

In broad lines, the decision-making process for the new organisational structure was carefully implemented, although we could not determine what scenarios had been considered before the new structure was introduced. An explanatory note on the selection of the organisational structure was included in the request for advice submitted to the works council but it included few alternatives to the proposed organisational structure. Furthermore, the request did not contain an analysis of the capacity required for the supervisory tasks.

## Supervision of banks

Supervision of banks is a responsibility of the Executive Director responsible for the *supervision of banks, supervisory policy and the supervision of insurance companies*. In agreement with the structure of the SSM, he is supported by the *European Banks Supervision Division* (EUBA), which supervises significant banks, the *National Institutions Supervision Division* (NATIN), which supervises medium-sized and small banks, and the *On-Site Supervision & Banking Expertise Division* (OSBE), which performs on the spot investigations of the supervised institutions at the request of the supervisory divisions and provides banking expertise.

The Supervisory Council is the highest consultative body for supervision matters. It prepares the reports and decision-making by the two executive directors responsible for supervision. The Supervisory Council is made up of the two executive directors responsible for supervision and ten divisional directors, including the directors of the EUBA, NATIN and OSBE divisions. It is chaired by the executive director responsible for the supervision of banks and insurance companies.

The Supervisory Council discusses relevant matters in the supervisory process, such as declarations of no objection and licences, internal evaluations made by the Risk Management & Strategy Department (RMS) and miscellaneous management reports.

The agendas of the Supervisory Council show that the supervision of individual medium-sized and small banks was discussed during 14 of the 29 meetings held between January and June 2016.

The supervisory directors report the main points of their meetings to the Governing Board. The plenary Governing Board discusses supervisory decisions in only a few cases.<sup>35</sup> This procedure, according to DNB, safeguards the independence of monetary policy. It also prevents supervisory calamities damaging the reputation of DNB's monetary operations. The supervisory chair renders account to the House of Representatives for the supervision where necessary.

Bank resolution is separate from supervision. The Director of the Pension Funds Supervision Division is responsible for the Resolution Authority. DNB's articles of association explicitly separate him from banking supervision,<sup>36</sup> although he is a member of the Supervisory Council. If developments in the supervision of individual banks are discussed, he participates in his capacity as director of the National Resolution Authority.

### 2.3.2 Planning and accountability for the supervisory organisation

#### Supervisory strategy and annual plans

DNB formulates a supervisory strategy every four years. The most recent strategy covers the period 2014–2018.

#### Main points of DNB's supervisory strategy for 2014–2018

The strategy identifies three medium-term challenges in the banking sector:

1. restoring confidence;
2. further strengthening financial resilience;
3. working towards less complex banks that are easier to resolve.

DNB will contribute to the following sector-wide ambition in 2014–2018:

1. **A strong player in the SSM** committed to achieving supervision that is effective, practicable and enforceable.
2. **Sharp analysis** for supervision with a new system for accessing, analysing and reporting supervision data, improving risk analysis, more effective influence on the conduct of supervised institutions and strengthening the expertise and competences of its staff.
3. **Transparency where possible:** DNB communicates openly with the sector about its activities, findings and intended impacts and enters into dialogue with its stakeholders.

4. **Alertness to integrity** with a transparent strategy, greater priority to detection of integrity breaches, better risk analysis and internal exchange of information, more cooperation with external parties and transparent where possible.

**Source:** DNB (2014), DNB Supervisory Strategy 2014-2018

The supervisory strategy is the outcome of a multistep process to arrive at the end product. The chosen priorities are the result of consultation within DNB, not of a systematic, fixed analysis, and are based on underlying products such as risk analyses and decision-forming documents used to develop the supervisory strategy.

### **ZBO budget and accounts**

In its capacity as supervisor, DNB is an autonomous administrative authority (ZBO). DNB sets the priorities for all its supervisory activities and the supervisory strategy for the year in its budget for this ZBO task. The ZBO budget also identifies the risks that could endanger the achievement of its goals.<sup>37</sup> The draft budget is submitted to an advisory panel for consultation. The panel includes representatives of supervised institutions. The Supervisory Board adopts the budget, which is then put to the Minister of Finance for approval (and to the Minister of Social Affairs and Employment as regards the supervision of pension funds). Following approval by the ministers, DNB publishes the budget by posting it on its website. A summary is published in the Government Gazette.<sup>38</sup>

DNB's supervisory budget is assessed every year against a multiyear cost framework that sets the maximum amount of the budget.<sup>39</sup> The advisory panel is not consulted on the multiyear financial framework.<sup>40</sup> The most recent framework, for the period 2017-2020, was submitted to the House of Representatives in July 2016.<sup>41</sup>

The Financial Supervision Funding Act came into effect on 1 January 2013. Under the act, the supervised institutions bear more of the cost of supervision. The government contribution was stopped in 2014 and the financial sector itself has borne nearly all the cost of supervision since then.

DNB prepares the accounts for its ZBO activities before 15 March each year. They are accompanied by a certificate of accuracy (including a declaration issued by an independent auditor on the collection and use of the funds). The accounts, like the budget, are put to the advisory panel for consultation. After the minister has approved the ZBO accounts, DNB publishes them on its website and an announcement is placed in the Government

Gazette.<sup>42</sup>

### Budget and capacity

The supervisory budget has been increased on several occasions in recent years. In each year between 2011 and 2016, the budget also stated that the supervisory capacity needed to be increased in order to keep pace with the more intensive supervisory strategy. Table 2.1 summarises the cost and capacity of banking supervision in 2011–2016.

**Table 2.1** Cost (in millions of euros) and capacity (in FTEs) of banking supervision, 2011–2016<sup>43</sup>

	2011	2012	2013	2014	2015	2016
<b>Budgeted cost</b>						
Banks*	50.4	52.8	53.5	55.3	Not specified	
Significant banks						45.4
Medium-sized and small banks						22.6
<b>Actual cost</b>						
Banks*	46.7	51.5	61.6	53.2		
Significant banks					42.5	Partially specified
Medium-sized and small banks					19.7	
<b>Budgeted FTEs</b>						
Banks*	270	273.5	Not specified	Not specified	Not specified	
Significant banks						236.7
Medium-sized and small banks						124.7
<b>Actual FTEs</b>						
Banks*	251.1	276.8	315.7	335.5		
Significant banks					226	Partially specified
Medium-sized and small banks					110.9	

\* Consisting of banks, electronic monetary institutions and clearing houses.

Following the introduction of the SSM and the related distinction between significant banks and medium-sized and small banks, the cost and capacity of supervising the two categories of banks were broken down and specified in the ZBO accounts for the first time. Both the ZBO accounts for 2016 and the ZBO budget for 2017 specify only the *operational* activities, which account for about half the total cost of supervising significant banks and medium-sized and small banks. The *supervision-wide* activities of banking supervision are not specified.<sup>44</sup>

During the advisory panel's meeting in April 2016, representatives of the banks asked for more insight into the cost of supervising significant banks and the cost of supervising medium-sized and small banks. They also expressed a wish to discuss the cost of European supervision more systematically in the panel meetings.<sup>45</sup>

DNB uses the time management information it collects on the capacity deployed in the previous year to account for its supervisory costs but this information is not suitable to plan activities in the coming year.<sup>46</sup> The ZBO budgets therefore do not contain structured reasons to substantiate the capacity requirement. DNB commissioned a bottom-up analysis in 2015 but it, too, did not produce step-by-step underpinning for the personnel capacity necessary per bank per annum, and thus the total capacity requirement.<sup>47</sup> The supervisory costs are not backed up by reliable cost accounting.

In the cover letter to the multiannual cost framework submitted to the House of Representatives, the Minister of Finance wrote that the increased supervision required from DNB would be facilitated largely by 'reprioritising'.<sup>48</sup> Neither the Minister of Finance nor DNB explained the underlying considerations or consequences, not even in reply to written questions from the House of Representatives.<sup>49</sup> It is therefore not clear what priorities DNB will set in the light of the capacity considerations and what risks will consequently not be covered in whole or in part. Owing to the absence of a good cost accounting analysis, it is uncertain whether the Minister of Finance can determine whether the statutory supervision is adequate and the residual risk is acceptable.

#### Necessary and available supervisory capacity since the start of the SSM

DNB stated in the bottom-up analysis that the SSM had not led to a reduction in its activities. On the contrary, many existing tasks had become more demanding owing to the coordination required with the ECB and the transition from 'principle-based' supervision to 'rule-based' supervision. This had strengthened the supervision but it also cost more time and required more capacity. Furthermore, DNB has had less discretion since the introduction of the SSM to decide on its staffing as the ECB was directly responsible for supervising the significant banks. The ECB had established joint supervisory teams for day-to-day supervision in the Netherlands, made up of staff from both the ECB and DNB. In 2014, a team from DNB spent a large part of the year on comprehensive assessments of significant banks.<sup>50</sup> This capacity demand forced DNB to make choices in its other banking supervision in 2014.<sup>51</sup> In 2015 60 members of staff were temporarily allocated to international activities.<sup>52</sup> In its ZBO budget for 2016, DNB noted that the ECB had said 'DNB's joint supervisory teams re understaffed' and it expected more capacity from DNB.<sup>53</sup> DNB addressed this problem by means of a capacity increase in 2016.<sup>54</sup>

**Source:** DNB's ZBO accounts, 2014; annual report, 2015; ZBO budget, 2016.

## Planning and control

DNB prepares several management documents at a variety of planning levels. At strategic level, the guiding principles are laid down in the 'Polaris ambitions'.<sup>55</sup> The medium-term supervisory strategy is defined in the Supervisory Strategy 2014-2018. The ZBO budget is the starting point for the further internal discussion. DNB prepares an annual plan that synthesises the various divisional plans. It describes relevant developments, the divisions' goals and the intended results. Risks, controls, capacity developments, costs and investments are also considered. The divisions' plans are short and concise and are not worked out into departmental plans. The departments issue progress reports every three months. These quarterly activity reports are synthesised within each division and discussed by the division's management team. The divisions prepare annual reports at the end of each calendar year. These serve as the basis for DNB's annual report and the ZBO accounts.

## Assurance on the efficiency and effectiveness of supervision

One of the requirements of the supervisory arrangement between the Minister of Finance and DNB is that the external auditor must attach a report of findings to his report on the ZBO accounts. In the report of findings, the auditor must state whether the supervisor's management and organisation met the efficiency requirements. The explanatory notes to the supervisory arrangement explain that 'it [is] difficult to determine how the costs incurred by the supervisors relate to the results achieved'. The auditor therefore suffices in his report accompanying the opinion with a general consideration of efficiency.<sup>56</sup>

In his report of findings on the ZBO accounts for 2015, the external auditor confines himself to commenting that DNB clearly explained its approach to efficiency in its overarching annual report.<sup>57</sup> We found that neither DNB's annual report nor the auditor's report included a qualitative opinion on efficiency. A reliable capacity analysis has not been made based on the statutory tasks and the capacity requirement has not been assessed against the available personnel capacity or an international benchmark.

DNB has been working with key performance indicators (KPIs) to monitor the achievement of its ambitions since 2013. It carried out its first stakeholder analyses in the same year by asking supervised institutions what they thought about its supervision. In early 2016, DNB published its *State of Supervision*. DNB claims this publication adheres to international best practice on impact measurement and that it not only accounts for the supervisory activities but also considers their impact. It is not yet clear whether a follow-up document will be published.

### Quality assurance: three lines of defence

DNB has built three lines of defence into its checks and balances.<sup>58</sup> The first line of defence is the line organisation responsible for quality assurance and risk management in the primary process. The Risk Management & Strategy Department (RMS) forms the second line of defence and the Internal Control Department (IAD) the third.

RMS is an internal expertise centre whose object is to increase DNB's quality and effectiveness. The department was set up as part of a programme to improve quality assurance in response to the lessons learned from the crises. It reports to the Secretary-Director and is independent from the operational divisions. The Governing Board and Supervisory Council can use the RMS's findings and recommendations to set and modify priorities.

We studied the reports the RMS issued in 2015 and 2016 on the supervision of medium-sized and small banks. The evaluations consisted mainly of quantitative analyses supplemented with interviews. In our opinion, the reports are of high quality, in part because of the good methodological account they render and the straightforward conclusions. A mature system to monitor the follow-up to the RMS's recommendations was not in place during our audit. As a matter of course, RMS has asked management for a response to its reports since 2016 and it has checked whether the problems detected have actually been resolved. Three of the 17 reports we studied included a response from management. The responses did not contain specific, measurable undertakings. The IAD reviews the design and operation of the entire process within DNB. It also provides assurance by auditing external accountability documents. The IAD reports to the Governing Board.<sup>59</sup> As risk management is relevant to DNB's supervisory task, the IAD provides assurance to the Governing Board and management that supervisory processes are adequately managed.

The list of audits performed by the IAD since 2011 and the explanatory notes to them show that the IAD has not audited the supervisory process or its operation in respect of medium-sized and small banks (or in respect of other sectors supervised). This is remarkable as this is one of the concrete actions named in the Supervisory Strategy 2010–2014.<sup>60</sup>

#### 2.3.3 Design of the supervision of bank capital and liquidity positions

This section looks at the structure in place to supervise banks' capital and liquidity positions. We first consider the capital and liquidity requirements currently in place and then DNB's design of its Supervisory Review and Evaluation Process (SREP).



## Bank capital and liquidity requirements

As part of the Bank of International Settlements, the Basel Committee sets standards in respect of banks' capital buffers and liquidity management.<sup>61</sup> These standards are the starting point for EU<sup>62</sup> and national regulations. They are also the basis for DNB's opinion on the amount of capital and liquid assets banks must hold.

## Calculation of quantitative capital requirements

The Basel I agreement of 1988 requires banks to hold capital equal to at least 8% of their risk-weighted assets (RWA).<sup>63</sup> Basel II, dating from 2004, built on this requirement and introduced a system of capital requirements in pillars.<sup>64</sup> Pillar 1 defines the capital requirement as 8% of RWA. Additional capital requirements, known as capital add-ons, can be imposed in Pillar 2 following analyses. In 2010 Basel III extended and stepped up the requirements by introducing additional capital requirements and strengthened the quality of the capital required.<sup>65</sup>

### *Requirements on the ratio of different capital qualities*

Different qualities of capital have been defined to satisfy the capital requirements. The higher the quality the more assurance a bank has that it can absorb losses, but the cost is also higher. Under the EU Capital Requirements Regulation (CRR) 4.5% of the capital must be of the best quality ('core capital' CET1<sup>66</sup>). At least 4.5 percentage points of the overall 8% capital requirement in Pillar 1 must therefore be CET1 capital and no more than 1.5 percentage points may be AT1 capital. The supervisor sets the amount of capital required in Pillar 2. Under DNB's policy (and the ECB's), only CET1 capital can be used.<sup>67</sup>

There are also unweighted capital requirements. As from 2019, banks must hold at least 3% of their total assets as capital, regardless of their risk exposure. This leverage ratio means that a bank must hold at least 3% of its total assets as capital even if it has very few risky assets on its balance sheet.

### *Calculation of liquidity requirements*

The Basel III agreement introduced a minimum liquidity ratio for banks, known as the Liquidity Coverage Ratio (LCR), in 2015.<sup>68</sup> The LCR is the ratio of the actual liquidity to the required liquidity. It requires banks to hold an amount of liquid assets equal to their net cash outflow over a 30-day stress period. This 30-day grace period is thought to be long enough for national central banks, supervisors and governments to take measures to reverse a looming liquidity crisis. The grace period was later replaced with the term

‘survival period’.<sup>69</sup> As from 2018, banks must have an LCR of 100% or more.<sup>70</sup> Phase-in arrangements were agreed in 2015 but DNB has decided not to introduce the new requirements in phases, preferring instead to apply them in full as from 2015.<sup>71</sup>

### SREP for medium-sized and small banks

The European Banking Authority (EBA) issued new SREP guidelines in 2014.<sup>72</sup> They divide banks into the following categories:

- 1: global systemically important institutions (significant banks);
- 2: medium to large institutions that operate domestically or with sizable cross-border activities;
- 3: small to medium institutions that operate domestically;
- 4: other small non-complex domestic institutions.

Our audit covered medium-sized and small banks (categories 2-4). The EBA has issued guidelines on the frequency at which key indicators must be monitored, capital and liquidity positions must be assessed (SREP elements) and the institutions must be contacted.

**Table 2.2** Summary of EBA guidelines on frequency of supervision

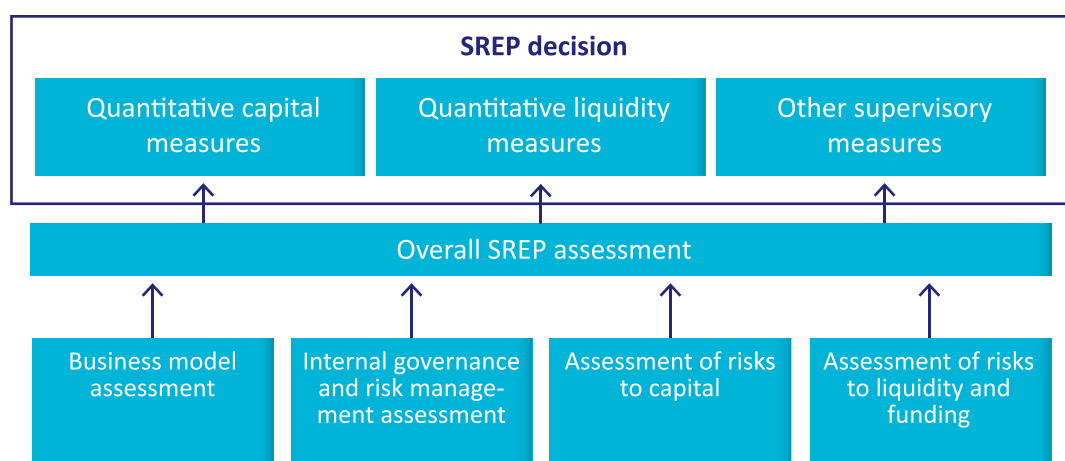
Cat.	Monitoring of key indicators	Assessment of SREP elements	Summary of overall SREP assessment	Minimum contact with institution	Information on outcome of SREP assessment
2	Every quarter	Every two years	Annually	Ongoing	Every two years
3	Every quarter	Every three years	Annually	Risk based	Every three years
4	Every quarter	Every four years	Annually	Every three years	Every three years

**Source:** EBA 2014, p. 21-23.

The ECB has laid down how national supervisors must exercise their SSM-based supervision in the *SSM Supervisory Manual*. The manual must ensure that the countries participating in the banking union apply the same supervisory standards. It is an internal confidential document that only national supervisors can access. It is not made available to the banks that are assessed. The ECB did not allow us access to the relevant parts of the manual. We were therefore unable to form a precise picture of DNB’s application of the SREP rules issued by the ECB.

In November 2014, the ECB published the public *Guide to Banking Supervision*.<sup>73</sup> The guide is not legally binding and considers the SREP and the central principles of SSM supervision only in broad lines.<sup>74</sup>

In 2016 the ECB published an overview of the elements in the SSM's Supervisory Review and Evaluation Process (SREP).<sup>75</sup> It shows that the SREP – in line with the EBA's earlier categorisation – consists of four key elements: business model assessment, governance and risk management assessment, assessment of risks to capital, and assessment of risks to liquidity and funding.



**Figure 2.3** Main SREP elements of SSM (Source: ECB 2016, p. 14).

Within the SSM, a distinction is made between three types of medium-sized and small banks: High Priority (HP), Medium Priority (MP) and Low Priority (LP). This agrees by and large with the EBA's division into category 2, 3 and 4 institutions.

We were unable to determine what impact the supervisor's use of these SSM priorities had on the proportionality of its supervision because the ECB denied us access to the relevant parts of the SSM supervisory manual. The *Guide to Banking Supervision* and the recent *SSM SREP Methodology Booklet* contain no concrete information on the supervision of medium-sized and small banks.<sup>76</sup>

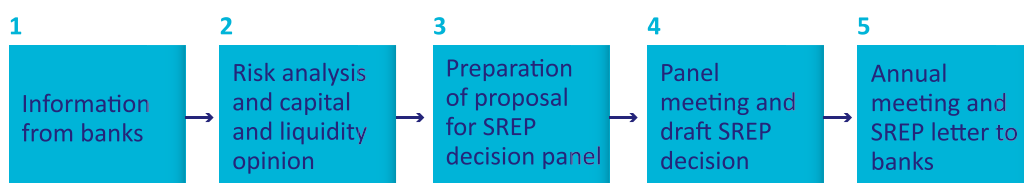
## Organisation of the SREP for medium-sized and small banks

The National Institutions Supervision Division (NATIN) is responsible for actual supervision of medium-sized and small banks. It supervises them through its Medium-sized Banks Department and its Small Banks & Branches Department. Clusters of staff within these departments together supervise a number of banks. We found that there were differences in the way in which the clusters performed their work. In one cluster, for example, all supervisors were involved with each bank, with one supervisor having primary responsibility. In another cluster in the same department, each supervisor was responsible chiefly for his or her 'own' banks and there was little involvement with other supervisors. NATIN's Payment Institutions & Special Projects Department coordinates the SREP for medium-sized and banks.

DNB has deliberately opted for the SSM methodology as the basis for its SREP. DNB's methodology focuses more on the quantitative aspects of the key SREP elements named by the EBA and ECB, namely the assessment of medium-sized and small banks' capital and liquidity positions. The more qualitative elements of the SREP – such as assessment of the business model, government and risk management – have less emphasis in DNB's assessment.

The SREP for medium-sized and small banks consists of a series of distinct steps that are taken in two separate rounds each year (for different groups of banks). The main steps are shown in figure 2.4.

### SREP step by step



**Figure 2.4** Organisation of SREP within DNB for medium-sized and small banks  
(Source; Netherlands Court of Audit)

A number of the SREP steps are considered further below.

## 1 Information from banks

For monitoring purposes, DNB receives a continuous stream of financial information from the banks. At a particular moment in the year, it requests a capital, liquidity and stress test assessment from the banks for the SREP.

## 2 Risk analysis and capital and liquidity opinion

DNB's ongoing analysis includes risk estimates in several areas<sup>77</sup> at all medium-sized and small banks. Automated risk analyses were carried out in 2014-2016 using a tool developed by DNB based on the SSM model for significant banks. It was developed using the methods and limits named in the SSM manual. In 2016 DNB also used a Risk Assessment System/ Risk Control model developed by the ECB for medium-sized and small banks. The risk scores generated by this model range from 1 (low risk) to 4 (high risk). The scores are assessed by the principal supervisor. He can correct the scores based on his knowledge of the bank and its operating environment.<sup>78</sup> In the draft SREP decision, the supervisor must explain why any changes have been made to the score. The scores produce a *Risk Level Score* in each of the risk areas. It is combined with qualitative *risk control scores*<sup>79</sup> and professional judgement to produce an overall score in each risk area. The scores are aggregated, finally, to produce an overall risk score for each small and medium-sized bank.<sup>80</sup>

During the SREP, the supervisors – together with experts from the On-Site Supervision & Banking Expertise (OSBE) Division – also assess each bank's capital and liquidity positions. On the basis of risk analysis, a full assessment may be made, with an in-depth assessment of all relevant substantive issues, or a limited ('smart') assessment. Stress tests are also reviewed and information generated by thematic investigations and other interventions are assessed.

### What does DNB do if it detects acute problems at a bank?

In its capacity as supervisor, DNB can detect problems at a bank, such as a failure of governance, if its capital position is under pressure from excessive (and rising) non-performing loans, or in the event of an unforeseen excessively high cash outflow. To guarantee financial stability in the Netherlands, DNB is tasked with intervening on a timely basis to guide the bank to safer waters using all the resources at its disposal.

### Problem dossier

A problem dossier (PDR) is formed if a bank is in difficulties but not in acute danger. DNB can then supervise the bank in question more stringently. A PDR is prepared on a proposal of the supervisor in consultation with the head of department. The management team decides on the preparation and closure of PDRs for small institutions, and the Supervisory Council in respect of medium-sized institutions.

### Protocol

In the case of more urgent problems or price sensitive information, DNB activates a protocol. It does so immediately it thinks a bank's continuity is in danger or when a measure is being considered that will have an adverse outcome (such as a bank run) after its announcement. The protocol provides rules on how the information must be shared in the circle of people who are privy to confidential information on the bank. A protocol can be activated and de-activated by the Governing Board, Supervisory Director, General Counsel or Secretary.

**Source:** Internal DNB documents

## 3 Preparation of a proposal for the SREP decision panel: compilation of the panel pack

To prepare for the panel meetings, the supervisors collate all the SREP information in a 'panel pack', with a proposal for a SREP decision. The panel pack covers, amongst other things:

- the depth of the supervision;
- a proposal for a SREP decision on capital and liquidity requirements;
- risk scores, with explanatory narratives;
- an opinion on the bank's capital, including the SREP requirement to be set and any proposals for add-on requirements;
- an opinion on the bank's liquidity, accompanied by proposals for the LCR and survival period.

In anticipation of the panel meeting the Payment Institutions & Special Projects Department prepares benchmarks and analyses outliers.<sup>81</sup> It also establishes the relationship with the underlying risk analyses.

## 4 Panel meeting and draft SREP decision

The panel meetings are the most important moments in the SREP for DNB and lead to a provisional SREP decision. The intended participants are the bank supervisors, the NATIN director (chair) and departmental heads and experts from the horizontal functions within the OSBE Department. According to DNB, an important function of the panel meeting is to

act as a ‘critical counterweight’, or to set the internal technical challenge, for the proposed decisions.

## 5 Annual meeting and SREP letter to banks

The NATIN director takes the formal SREP decision for most of the medium-sized and small banks. In some cases (for the high priority medium-sized and small banks), the Chairman for Prudential Supervision takes the decision. Following the panel meeting, DNB sends draft SREP letters with its provisional decisions to the banks. The letter includes an assessment of the bank’s capital, with an indication of the main risks, any capital add-ons that DNB imposes, and an assessment of the liquidity position. The letter does not say precisely how the bank was assessed or with respect to what requirements.

An annual meeting is then convened between DNB and the bank. Depending on the size of the institution, the divisional director and/or the departmental head and the supervisor attend the meeting on behalf of DNB. The bank is represented by members of its executive board. A meeting is also held with the bank’s supervisory board. DNB then issues the final SREP letter.

## 3 Supervision in practice

### 3.1 Conclusions

#### Intensive and strict

DNB conducts the SREP, the review and evaluation procedure for prudential supervision, just as frequently and as strictly for all medium-sized and small banks. The supervision is therefore relatively more onerous for small banks. DNB also uses the instruments at its disposal and in all cases imposes higher capital and liquidity requirements than the minimum requirements:

- DNB takes a quantitative approach.
- DNB makes frequent use of the regulatory opportunities to impose capital add-ons on medium-sized and small banks. Until the end of 2016, the banks had to satisfy the requirements with the most secure, and therefore most expensive, form of capital.
- DNB imposes capital add-ons in virtually all cases.<sup>82</sup> It requires banks that have a positive risk score to hold additional capital.
- DNB imposes higher capital requirements on the larger medium-sized banks than the ECB imposes on significant banks.

Decision-making within the SREP focuses principally on whether or not additional capital and liquidity requirements should be imposed. DNB does not demonstrably consider other public interests, such as the efficiency of lending, in its decision-making.

#### In practice, supervision is open to improvement

DNB introduced the SREP in its current form in 2014 and has gone to great lengths to implement it correctly. We found that the process was sufficiently embedded in DNB's operational management in 2015 and, particularly, in 2016 and was continuously being improved. We also found, however, that there were some gaps in the process. For example, there are weaknesses in the consistency of the supervisory process:

- Dossier formation among supervisors was inconsistent, which compromised the ability to reconstruct decision-making.
- The grounds for the risk opinion in the SREP differed as regards substance and depth and were sometimes inadequate.
- Some aspects of the structure and content of the SREP decisions that banks received from DNB differed.



Internal assurances on the quality and consistency of decision-making is not optimal. The technical challenge by supervisors, managers and line staff from other parts of the organisation to proposed decisions, for example, is inadequate in its current form.

## 3.2 Intensive and strict

In this section we explain why we concluded that DNB's supervision of medium-sized and small banks was 'intensive and strict'.<sup>83</sup> We look at DNB's supervisory capacity and activities and discuss the proportionality of the supervision, the capital and liquidity requirements set by DNB and the banks' opinions on the supervision.

### 3.2.1 Supervisory capacity and supervisory activities for medium-sized and small banks

When it set up the NATIN division in 2014, DNB assumed that 30 FTE supervisors would be sufficient for the medium-sized and small banks. The information on its supervision of medium-sized and small banks that DNB provides to the ECB each year discloses that NATIN had 30 FTE supervisors in 2015 and 28.4 in 2016. This gives a distorted view. In practice the medium-sized and small banks are supervised by about 20 FTEs: 9 FTEs for medium-sized banks and 11 for small banks and branches.

Using the information DNB must submit to the ECB regarding its supervision of medium-sized and small banks, we determined what supervisory activities DNB had actually performed at these banks in 2015 and 2016. We found that:

- DNB had held more than 600 meetings with the 28 medium-sized and small banks in 2015 and 466 with 27 banks in 2016. There was also a great deal of written correspondence, 416 instances in 2015 and 483 instances in 2016.
- DNB set additional quantitative capital requirements for virtually all medium-sized and small banks in 2015 and 2016.
- DNB set additional quantitative liquidity requirements for virtually all medium-sized and small banks in 2015 and 2016.
- DNB rarely set additional requirements in respect of the banks' business models or governance arrangements. Its supervision was concerned chiefly with quantitative aspects.

### 3.2.2 Proportionality of supervision in 2015-2016

We investigated whether the supervision of medium-sized and small banks was proportional. As the information published by the ECB does not provide concrete indications of what proportionality means for high, medium and low priority banks, we

based our investigation on the supervisory guidelines provided by the EBA for banks in categories 2, 3 and 4.<sup>84</sup> The findings are summarised in Table 3.1.

**Table 3.1** EBA guidelines on the frequency of SREP opinions and DNB's practice

Element	EBA guidelines	DNB practice
Periodicity assessment of key indicators	Every quarter for category 2, 3 and 4 institutions	Every quarter for category 2, 3 and 4 institutions
Periodicity assessment by DNB of all SREP elements	Every two years for medium to large institutions and every three years for small to medium institutions operating domestically and other institutions	Every year for every institution
Periodicity overall SREP opinion by DNB per institution	For category 2 institutions, at least once every two years, for category 3 and 4 institutions at least once every three years	Every year for every institution
Periodicity contact between DNB with managers and directors of the institutions	For category 2 institutions, ongoing, for category 3 institutions based on risk, for category 4 institutions at least once every three years	Every year for every institution

**Source:** EBA and Netherlands Court of Audit

The table shows that DNB supervises all medium-sized and small banks with the same frequency. There is therefore some disproportionality in the supervision of these banks. A number of aspects are considered below.

### DNB's assessment of all SREP elements

DNB carries out a full SREP for all medium-sized and small banks every year. With only one exception, the panel packs reveal that both the capital and liquidity statements of the banks were assessed. DNB thus expresses an opinion on the main SREP elements at every medium-sized and small bank every year. We found differences in the extent to which the capital and liquidity statements were assessed. In both 2015 and 2016, DNB fully reviewed the capital statements of virtually all banks, i.e. it reviewed all relevant factors at all banks equally strictly. It reviewed the liquidity statements in greater depth in 2016 than in 2015.<sup>85</sup>

### Periodicity DNB's overall SREP opinion per institution

NATIN carries out the SREP as follows:

- NATIN carries out a SREP for each individual small and medium-sized bank every year.
- Every bank receives an annual letter with a SREP decision.

- The letters can consider a bank's business model and internal governance and risk management as well as a decision on its capital and liquidity positions, but in practice they do not do so for every bank.

### **Periodicity contact between DNB with managers and directors of the institutions**

Since the introduction of the SSM and the establishment of NATIN, NATIN has consistently held talks with the executive boards and supervisory boards of every small and medium sized bank every year. The proposed SREP decision is on the agenda of every annual meeting. The banks can respond to the proposal. The meetings were not as structured in the period before introduction of the SSM.

### **3.2.3 Capital and liquidity requirements**

This section asks whether DNB sets its requirements in accordance with the Capital Requirements Directive (CRD IV) in the Single Rulebook. With regard to the capital requirements set for medium-sized and small banks, we found that:

- In our opinion, the capital requirements set by DNB were considerably higher than the 8% RWA requirement in the Basel I agreement. Furthermore, the average capital requirement is roughly the same for both medium-sized and small banks. According to DNB, setting a high capital requirement for medium-sized and small banks is justified because their profiles are less diversified.
- Until the second SREP round in 2016, medium-sized and small banks had to satisfy the capital requirements set by DNB in full by means of CET1 capital. This is the least risky form of capital, and the most expensive for the banks.
- DNB adopted the ECB's new procedure as from the second SREP round in 2016.<sup>86</sup> DNB informed the medium-sized and small banks of this change by letter.<sup>87</sup> As a result, the capital requirement need no longer be satisfied in full by means of CET1 capital.
- In virtually all cases, DNB imposed a capital add-on in addition to the standard capital requirement. It varied from less than one million euros to several hundred million euros and had to be satisfied by means of CET1 capital.
- In 2015 a pillar 2 capital add-on was set for so called FICO banks<sup>88</sup> as a matter of course on account of the risks in their business models.<sup>89</sup> In 2016 this capital add-on for FICO banks differed from bank to bank.

With regard to the liquidity requirements, we found that DNB nearly always required an LCR of 100%. The survival period set by DNB was not 30 days but in practice ranged from three to 12 months. In most cases it was at least six months.

We would note the following regarding DNB's requirement that banks must always satisfy the capital requirement using CET1 capital:

- DNB specifically opted for this at the start of the SSM.
- It did so because the ECB had indicated it would also do so in respect of the significant banks. In the end, the ECB did not do so but DNB continued with the requirement for medium-sized and small banks.
- Under the standards provided for in EU legislation, this is not mandatory.<sup>90</sup> The regulations do not require banks to hold capital in excess of the 4.5% requirement in the form of CET1 capital.

DNB dropped this requirement in the second SREP round in 2016, partly because of the new guidelines the ECB published at the end of 2016. The ECB added the *Pillar 2 Guidance* (P2G) of 1% CET1 capital to the capital requirement in force at the time. At the same time it also reduced the capital requirement by 1%. We would note that the P2G was developed on the basis of EBA stress tests of significant banks. The EBA observed at the time that the P2G *could* be applied to banks with capital-related problems, but it did not have to be nor need to be applied to *all* banks.<sup>91</sup>

Finally, on the introduction of the new ECB methodology at the end of 2016, DNB changed the assessment criteria during a SREP round. Medium-sized and small banks may have anticipated the SREP decision in their capital positions based on the previous methodology. Another outcome of this decision was that the banks were assessed in different ways within a single SREP assessment year, resulting in different capital requirements.

### **Unweighted capital requirements: leverage ratio**

With one exception, the SREP letters do not contain an opinion on the leverage ratio (it is currently not compulsory for them to do so). In 2015, three panel packs for medium-sized and small banks contained a preliminary decision by DNB on the leverage ratio. In 2016, two panel packs had.

### **Comparison of capital requirements set for medium-sized and small banks with those set for significant banks**

As far as we are aware, no public information is available on the capital requirements national supervisors set for medium-sized and small banks. There is some – albeit limited – information available, however, on the requirements the ECB sets for significant banks. We determined how the ECB's requirements for significant banks related to the capital requirements DNB set for the larger Dutch medium-sized banks, given that their profiles, size and activities are the most comparable with those of the significant banks.

The ECB does not publish information on the capital requirements it sets for individual banks. It has stated with regard to the supervision of significant banks, however: *‘The aggregate capital demand for 2017 for the directly supervised banks remains comparable to 2016 – at an average and median of around 10% Common Equity Tier 1 (CET1).’*<sup>92</sup>

It is known from press releases that the capital requirement for significant banks in the Netherlands in 2016 was approximately 10%. Information is also available on capital requirements in France and Spain. The CET1 capital requirement for Spanish banks in 2016 was between 9% and 10%.<sup>93</sup> The CET1 capital requirement for French banks in 2016 ranged from just over 9% to just over 10%.<sup>94</sup> We found that the capital requirements DNB set for the larger medium-sized banks was higher than those that arose from the ECB’s supervision of significant banks.<sup>95</sup> In our opinion, these differences are significant. They mean that DNB implements a strict policy and banks that represent a small systemic risk to the markets must satisfy higher capital requirements than banks that represent a greater risk.

### **Relationship between risk scores and capital add-ons**

Apart from assessing the capital positions, DNB’s process of setting capital add-ons includes a calculation of risk scores. It is to be expected that there is a relationship between the risk score and the amount of the capital add-on. An explorative quantitative analysis we carried out, however, found that there was no such relationship. In other words, higher risk scores do not lead to higher capital add-ons and vice versa. In practice, DNB imposed higher add-ons on banks with a lower risk score.

#### **3.2.4 Opinions of the banks on DNB’s supervision**

We asked the banks about their experience of DNB’s supervision. Their opinions are summarised in Annexe 5. Some of the more notable points were:

- Supervision was stepped up and became more systematic after the introduction of the SSM.
- The supervisory process is meticulous and the banks are generally positive about the substantive quality of the SREP decisions. DNB’s decisions, however, were considered to be ‘faits accomplis’.
- The supervision is not regarded as proportionate. The banks find the reporting requirements are disproportionate to the scale of medium-sized and small banks and the capital requirements set for them are systematically higher than those set for significant banks. The playing field in both the Netherlands and Europe is according to them therefore not level. The amount of some capital add-ons is considered arbitrary.

- According to the banks, DNB’s imposition of higher capital buffers is at the expense of their lending operations. Banks are not considering a legal challenge to SREP decisions as it could jeopardise a good supervisory relationship.

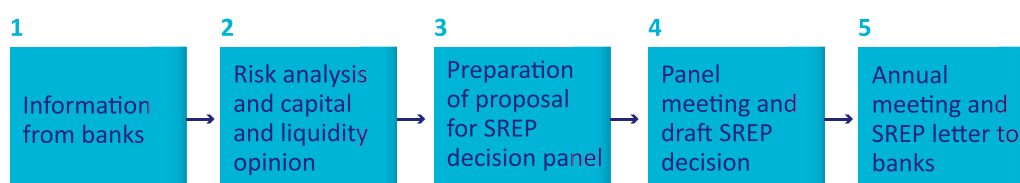
### 3.3 Performance of supervision

This section successively considers the steps in the SREP, the ability to reconstruct DNB’s opinions and the supervisors’ dossier formation.

#### 3.3.1 Steps in the SREP

We saw in the previous chapter that the SREP for medium-sized and small banks consisted of five successive steps (in two rounds each year for different groups of banks).

##### SREP step by step



**Figure 3.1** DNB’s organisation of the SREP for medium-sized and small banks

(Source: Netherlands Court of Audit)

#### 1 Information from banks

The panel packs prepared by the supervisors for the SREP decision comment on the quality of the information provided by the banks. The 2015 panel packs, for example, state that the quality of the data received from a number of banks was a matter of concern and that poor quantification was a weakness in all the banks’ capital statements. It was noted that DNB had in the past provided some smaller banks with little feedback on the quality of their capital and liquidity statements. DNB therefore thought it would take some time before the quality was of an acceptable standard. The 2016 panel packs do not contain such comments. Our analysis of 29 panel packs available for 2016 found that DNB assessed the quality of the capital statements as follows: 15 were adequate to good; progress had been made in six cases in comparison with the previous year but improvement was still possible; and in four cases the information was inadequate.

## 2 Risk analysis and capital and liquidity opinion

DNB's assessment of the banks' capital and liquidity positions is the outcome of continuous risk analyses using automated models. On the basis of these assessments, the banks are categorised from 1 (best score) to 4 (worst score). Most of the banks in the Netherlands fall into categories 2 and 3. An important element of the risk analysis is a *qualitative opinion* expressed by the supervisors on the outcomes of *quantitative models* for the various risk areas, the '*automated scores*'. We found that at least half of the automated scores calculated for the medium-sized and small banks in 2015 and 2016 had had to be adjusted on qualitative grounds. We also found that DNB did not always follow the prescribed SSM methodology.<sup>96</sup> The many adjustments revealed, as DNB acknowledged, that the model used was not yet completely satisfactory.

## 3 Preparation of a proposal for the SREP decision panel: composition of panel-pack

An analysis of the 2015 and 2016 panel packs found that:

- In accordance with the SSM, all panel packs contained a proposal for an SREP decision on the banks' capital and liquidity positions, albeit with slight differences in wording.
- In 2016 DNB explained more clearly than in 2015 whether the capital and liquidity review had been comprehensive or limited in scope. All panel packs contained an opinion on the capital position,<sup>97</sup> some included proposals for capital add-ons and an assessment of the liquidity position.
- All panel packs included the aggregate risk opinion reached by the supervisor for the bank concerned. The statements of risk scores in the panel packs, however, did not always include the automated scores. As a result, it was not always possible to reconstruct the opinion.
- In 2015 the content of the narratives to the risk statements was mixed. Narratives were not present for all the banks and only a small number of panel packs explained how the supervisor had adjusted the risk scores. The 2016 panel packs were better and, with the odd exception, contained a more detailed and informative description of the risk opinions.

Since the introduction of the SSM, the panel packs have also included a Supervisory Examination Plan (SEP) for the following year. The SEP is a general and relatively limited document providing little guidance. It is unclear how it estimates capacity.

The quality of the 2015 SEPs was mixed, with information of varying depth. The 2016 plans were better.

The panel packs for the medium-sized banks explained the SEPS in broad lines. The panel packs for most of the small banks included a detailed description that agreed with the operational planning, including the number of days required.

#### 4 Panel meeting and draft SREP decision

The reports of the panel meetings include the decisions taken on the basis of the panel packs in a variety of ways. Assurance therefore cannot be given that the final opinions are entirely consistent. The reports on the first SREP round in 2015, for example, contained only a short sentence on the final decisions. Not all the reports in the second 2015 round included a written decision on what should be included in the SREP letter. The summary report on the first round in 2016 closed every discussion with an explicit statement of the decision, including quantitative requirements, but not all the reports on the second round did. The benchmarking information on medium-sized and small banks provided by the Payment Institutions & Special Projects Department is a key feature for a good discussion and consistent decision-making in the panel meetings. We found that this information was of high quality and had been further developed in 2015 and 2016.

The main characteristics of the panel meetings are:<sup>98</sup>

- The meetings last between two and three hours and decisions are taken on between four and ten banks. Given the huge amount of information the participants must absorb, we wonder whether the meetings' objective – the substantive challenge – can be realised.
- In most cases, the supervisors' SREP proposal is adopted without change.
- It had been the intention to have experts from outside NATIN participate in the panel meetings, but this has increasingly not been the case. This is due in part to the significant investment of time necessary. The supervisors usually consult with the experts who participate in the panel meetings during the preparatory stage. This can be efficient but it also limits the scale of the expert's challenge.
- Decision-making is concerned chiefly with the need to set additional capital and liquidity requirements. Supervision is therefore directed mainly at the quantitative prudential risks. We did not find that other public interests, such as efficient banking operations that support the economy, were specifically discussed.



## 5 Annual meeting and SREP letter to banks

An analysis of the SREP decisions and the letters sent to the banks in 2015 and 2016 led to the following comments:

- All the letters provided an explanation of the pillar 1 and 2 prudential requirements for capital and liquidity and of any capital add-ons. The weighted capital requirement was always given, the unweighted requirement was not (with one exception).
- In a handful of the 2015 letters the explanation of the liquidity requirement specified the LCR that the banks had to hold. Most of the 2016 letters did. The survival period was also specifically stated.
- Not all letters contained an assessment of the banks' internal governance and business models.
- Since 2016, DNB's letters have stated the statutory *Combined Buffer Requirement* (CBR), including a *Capital Conservation Buffer* (CCB), and referred to its website for more information. A few of the letters specifically stated the percentage of any add-on requirement the bank concerned had to hold; it would not be unreasonable to expect every letter to state this as a matter of course. Some letters refer only to the CBR, others to only the CCB.

We also have a number of comments on the content of the letters. They often contain phrases such as 'we recommend that the bank' or 'DNB assumes that the bank'. In our opinion, it is not always clear to the bank whether such phrases are suggestions or demands. We also found differences in the structure of the letters, particularly between those addressed to medium-sized banks on the one hand and those addressed to small banks on the other. This lack of consistency is not optimal. The differences relate to, for instance, the sequence of the sections, and the transparency of DNB's risk assessments. The letters to the medium-sized banks in 2016, for example, did not state that the ECB/SSM model had been used but most of the letters to the small banks did.

### 3.3.2 Ability to reconstruct DNB's opinion

We attempted to reconstruct the SREP decisions (on process and content) for a sample of medium-sized and small banks. To do so we held talks with the supervisors concerned, reviewed additional documents and, in collaboration with the supervisors, studied the supervisory dossiers.<sup>99</sup>

#### Reconstruction of decision-making: SREP letters and panel packs

We determined 1) whether the risk scores had been adjusted for the draft SREP decision and whether the adjustments had been explained in the panel packs, 2) whether there

were differences between the draft decision and the final decision in the letter, and 3) whether the differences had been discussed during the panel meetings.

1. Adjustment of risk scores, with argumentation:

- To adopt the risk scores for the quantitative prudential requirements, the supervisors consistently adjusted one or more scores on qualitative grounds in 2015 and 2016. The risk statements did not present the automated scores for some banks. All the risk scores for the business model were adjusted.
- In 2015 only limited argumentation was given for adjustments made to the risk scores for the medium-sized banks in the sample. Better argumentation was given for adjustments at the small banks. Improvements were made in 2016 and argumentation was given for the adjustments made to the risk scores for all banks.

2. Differences between the draft decision and the final decision in the letter:

- There were few substantive differences between the draft decision in the panel pack and the final decision in the letter. Most decisions seem to be ‘final’ before the panel meeting was held and the panel packs were passed on the nod. The challenge in the panel meeting was therefore limited.
- We detected only a few differences in 2015. They related to internal governance and the business model in 2015. The SREP letters considered them but the panel packs contained no information on them.

3. Discussion of differences between the draft and final decision during the panel meeting:

- The panel discussions were concerned chiefly with quantitative prudential requirements and in particular with the imposition of capital add-ons. The proposal in the panel pack was adopted in nearly all cases, sometimes without further discussion.
- If the letter considers an issue that differs from the panel pack, it is discussed during the panel meeting.

### **Reconstruction of decision-making: supervisory dossiers**

To determine whether the SREP decisions could be reconstructed from the supervisory dossiers, together with the supervisors we studied the dossiers. We found:

- In virtually all cases, the supervisors could show why a particular risk or capital decision had been taken and the argumentation for it.
- They could show where experts from OSBE had been involved in the decision-making, the information that had been used and whether it had led to a change in an opinion. If an expert had not been involved, they could explain why not.

- The line structure in place to agree the draft decisions was clear. Documentation in the line was not always complete.
- It was often difficult for the supervisors to find all the information in the dossiers quickly. Information is saved in various places and is not always collated in the supervisory dossier. To avoid problems, some supervisors have developed their own system to record and retrieve documents.

### **Influence of banks on the draft decision**

For the 2016 SREP decisions, we determined whether the annual discussion of the draft decisions with the medium-sized and small banks in our sample had led to changes in the decision. We found that the quantitative requirement had been changed as a result of the discussion in just one case. The change related to an inaccuracy in DNB's calculation method.

## 4 Role of the Minister of Finance

### 4.1 Conclusions

This chapter considers how the Minister of Finance has organised responsibility for the functioning of prudential supervision and how he exercises it in practice. We drew the following main conclusion:

- In theory, the Minister of Finance has sufficient powers to supervise DNB appropriately. In practice, the supervision is limited. It cannot be said with certainty that the minister will always have access to all relevant information in crisis situations.

The main conclusion can be broken down into two secondary conclusions:

- In theory, current laws and regulations give the Minister of Finance sufficient powers to supervise DNB appropriately. In practice, his supervision is limited.
- The Ministry of Finance tends not to record the content of ad hoc talks with DNB in writing. It trusts DNB will provide them with information as and when appropriate. Owing to the absence of hard agreements, there are no assurances that the minister will have access to all the information he needs to fulfil his responsibilities during a crisis that could destabilise the financial system. This is also a risk to the reconstructability and continuity of decision-making in such a crisis.

#### **Limited exercise of supervision**

Within the SSM system, the Minister of Finance still has a responsibility for supervising DNB. He has several opportunities to exercise active supervision. Between 2011 and 2016, however, the minister's supervision of DNB was limited and rarely proactive. The ministry has no plans explaining how the supervision will be exercised each year. The documents that could be expected to contain an opinion on the efficiency and effectiveness of the supervision of DNB, such as the five-year ZBO evaluation and the annexe to the ministry's annual report, provide only limited insight. Ad hoc talks and regular contacts between the Ministry of Finance and DNB at senior civil service and management level are seldom recorded in writing. The content therefore cannot be checked and the continuity of decision-making is at risk.

#### **Information position of the minister in a crisis cannot be determined**

It is uncertain when and how DNB will inform the Minister of Finance of developments at supervised banks that might have an impact on the stability of the financial system. We

could not assess the minister's information position in such situations because ad hoc talks between the ministry and DNB are usually not recorded.

The Minister of Finance thinks parliament needs to be informed of crisis situations at banks only if the stability of the financial system is at risk. It is not known, however, what specifically constitutes a destabilisation of the financial system and how parliament will be informed of it.

## 4.2 Supervision in practice

Below, we consider the Minister of Finance's customary supervision of DNB. We look at the supervisory strategy, the associated supervisory arrangement and DNB's ZBO budget and accounts. We also look at how the ministry exercises its other powers.

### 4.2.1 Supervisory strategy and arrangement

The minister is responsible for the functioning of the financial system as a whole, and for the legislation and regulation of the financial markets and their supervision. He also oversees DNB's performance as a supervisor. The legal framework is laid down in the Financial Supervision Act (WFT) and, since 2013, in the ZBO Framework Act. The minister must assess the functioning of the supervisor and its efficiency and effectiveness. DNB is free to exercise its prudential supervision independently but the Minister of Finance is responsible for how this public task is performed and for the use of public funds and has to account to parliament accordingly.<sup>100</sup>

The Minister of Finance published a strategy paper entitled Remote Supervision in February 2011.<sup>101</sup> The strategy paper describes how the minister supervises DNB and the Authority for the Financial Markets (AFM).<sup>102</sup> The strategy is set out in more detail in the Supervisory Arrangement for supervisors of the financial markets, which was updated in March 2014.<sup>103</sup> The supervisory arrangement is described as an elaboration of the statutory and regulatory provisions that define the relationship between the supervisor and the line minister responsible for the policy. The minister's responsibility for supervision is summarised as 'ascertaining the efficiency and effectiveness of supervision'. The minister has several instruments at his disposal. They relate in part to DNB's budget and accounts for its ZBO tasks and in part to the way in which the supervisor fulfils its duties.<sup>104</sup>

A first evaluation of Remote Supervision was planned for 2016. Thereafter, it would be evaluated every five years. The Ministry of Finance is currently making preparations for the

evaluation, with the report due to be published in autumn 2017. The strategy will probably be updated in response to the introduction of the SSM and an amendment of the Financial Supervision (Funding) Act (WBFT).

#### 4.2.2 DNB's ZBO budget and accounts

DNB submits the budget for its ZBO tasks to the Minister of Finance for approval.<sup>105</sup> The budget is first subject to a consultation procedure before it is sent to the minister.

##### DNB's ZBO budget procedure

- Before mid-September, DNB's Governing Board and the Secretary-General of the Ministry of Finance discuss the main points of the supervisory budget for the coming year and the cost framework.
- In September/October, following consultation with the advisory panel, DNB sends the draft documents to the ministry.
- In October/November, talks are held between DNB's Supervisory Board and the Secretary-General of the Ministry of Finance.
- At the end of November, the budget is submitted to the ministry for approval. The minister receives an internal report that considers the advice of the advisory panel.
- With the ministry's approval, DNB announces the budget.

**Source:** *Supervisory Arrangement, pp. 9-10, Annexe to parliamentary paper 32 648, no. 5.*

A civil service working group was set up in 2016 to increase the transparency of the ZBO budgets of the AFM and DNB. The working group has made proposals to clarify the relationship between DNB's costs and tasks.<sup>106</sup>

The ZBO budget is not submitted to the House of Representatives. In 2014, the minister said he would in future submit DNB's annual cost framework to the House at the beginning of each year.<sup>107</sup> In October 2014 he announced that he would also submit the multiannual financial framework to the House.<sup>108</sup>

The minister assesses DNB's ZBO accounts against the statutory criteria. The criteria cover the reliability of the accounts and the regularity of DNB's collection and use of funds.

#### DNB's ABO accounts procedure

- In February, the Ministry of Finance contacts DNB to discuss DNB's ZBO accounts in relation to the ministry's annual report.
- In February, DNB informally provides the ministry with a draft version of its accounts.
- In March, DNB sends the accounts approved by the Supervisory Board to the Minister of Finance and the Minister of Social Affairs and Employment.
- In March-April, the ministry reviews the accounts and the independent auditor's report on them. The minister receives an internal advisory report and takes a decision.
- In March-April, DNB publishes the ZBO accounts on its website.

**Source:** *Supervisory Arrangement, pp. 13-15, Annexe to parliamentary paper 32 648, no. 5.*

### 4.2.3 Other supervision exercised by the Minister of Finance

The Minister of Finance's supervision of DNB also includes collecting information on DNB's performance, forming an opinion on the performance and intervening when necessary.

#### Collection of information

The ministry collects information chiefly by means of its many regular formal and informal contacts with DNB. According to the ministry, there is no comprehensive and documented record of the contacts. The supervisory arrangement names the following formal contacts:

- Supervisory meeting between the minister and the Executive Director of DNB responsible for supervision, three times a year. The meeting is also attended by the president of the AFM.
- Talks between the Ministry of Finance and DNB in the Mixed Supervisory Working Group (in principle four times a year<sup>109</sup>).
- Legislative talks with DNB, once a year.<sup>110</sup>

An official from the Ministry of Finance also attends the advisory panel meetings that discuss DNB's ZBO budget and accounts. According to the Ministry of Finance, the regular talks cover individual supervisory dossiers only if they might have consequences for the ministry's supervision.

Aspects of supervision can also be discussed during the minister's fortnightly lunch appointment with DNB's President and during the weekly conference call between DNB's Financial Markets Director and Supervisory Policy Director. No formal written reports are made of either contact. An oral report is made internally. A departmental head at the Ministry of Finance discusses meetings of DNB's Supervisory Board in advance with the government-appointed supervisory member of the Board. The discussion is informal and minutes are not kept.

## Opinion

The minister must regularly form an internal opinion on the regularity of DNB's use of public funds, the efficiency and effectiveness of DNB's supervision and DNB's implementation of the WFT in relation to other public interests. His opinion must take account of undesirable side effects. As mentioned above, the minister must also approve the annual ZBO accounts. There are also a number of other moments when the minister must form an opinion on DNB's performance.

Annexe 1 of the Ministry of Finance's annual report, Supervisory relations with ZBOs/ RWTs, includes a description of the DNB's statutory supervision in practice.<sup>111</sup> Efficiency and effectiveness receive scant consideration. The ZBO Framework Act has applied to DNB since 2013. It obliges the Minister of Finance to submit a report on DNB's efficiency and effectiveness to parliament every five years. In his report of March 2017, the minister concludes that DNB functioned efficiently and effectively as a ZBO in the period 2010-2015.<sup>112</sup> He comments, though, that the opinion relates to DNB's performance as a financial supervisor, which is not the same as an opinion on the efficiency and effectiveness of the financial supervision itself.<sup>113</sup> We believe the report should include an opinion on the efficiency and effectiveness of the supervision in order to improve the information provided to parliament.

The Ministry of Finance has not carried out (or commissioned) any other evaluations of DNB's supervisory tasks in the past five years. The Ministry of Finance assumes that the capacity provided in the multiyear financial framework, and verified by DNB's capacity analysis, will be sufficient for DNB to perform its supervisory tasks. It has not established that that is actually the case. A review of the policy on financial markets, however, (article 2, Budget of the Ministry of Finance and the National Debt) is being prepared, with publication expected at the end of 2017.<sup>114</sup>

In our 2011 report on DNB's supervision of banking stability, we concluded that the ministry's supervision of DNB could be overshadowed by policy-related tasks.<sup>115</sup> In his response to this conclusion at the time, the Minister of Finance said he had decided to ask the policy directorate responsible for the financial markets to report to the ministerial audit department on the supervision of DNB's supervision at least once a year.<sup>116</sup> Two reports have since been issued, the latest in May 2015.<sup>117</sup> In our opinion, an annual report would be desirable as it would improve insight into the Ministry of Finance's supervisory activities and their effect.



## Intervention

The Ministry of Finance has developed an ‘intervention pyramid’. The ministry’s *Remote Supervision strategy* paper describes the intervention pyramid, or enforcement pyramid, as an ‘intervention ladder’ with graded steps of intervention.<sup>118</sup> They range from persuasion and soft legal powers (such as introducing policy rules or supervisory rules) to hard legal powers (such as approval of the budget and accounts, regulations on neglect of duty, and suspension of governing and supervisory board members). The recently published five-year ZBO report on DNB includes an up to date overview of intervention measures.<sup>119</sup>

At the Court of Audit’s request, the ministry compiled a list of dates when DNB had been contacted regarding medium-sized and small banks between 2011 and 2016. The contacts relate to the various categories of intervention: persuasion, soft legal powers and hard legal powers. It shows that the ministry has made little use of the various intervention opportunities other than the annual approval of the cost framework and the ZBO budget and accounts.

## 4.3 Information position of the minister in bank crises

The fact that talks between DNB and the Ministry of Finance are not recorded in writing has consequences for the Ministry of Finance’s information position, especially if a supervised bank is entangled in a crisis that could destabilise the financial system.

### 4.3.1 Information position in crises

The Minister of Finance must be informed immediately of any crisis situation at a bank. Under the WFT the supervisor must provide the minister with confidential information or intelligence of its own volition or at the minister’s request if he needs it with a view to the stability of the financial system.<sup>120</sup> The five-year report on DNB’s efficiency and effectiveness as a ZBO (as from March 2017) also states that in certain circumstances it can be necessary for DNB to share specific information on an individual institution with the minister.<sup>121</sup>

In our opinion, when, how and what DNB should inform the ministry is laid down in a Memorandum of Understanding of 2007. It states:

*‘If DNB observes signs of a crisis at a financial enterprise, DNB will inform the minister on a timely basis of its assessment of the situation and of any crisis measures. If developments at a financial enterprise or elsewhere threaten the stability of the financial system, DNB and the minister will immediately consult each other and exchange information.’<sup>122</sup>*

We would note that this document does not have a formal status and has not been amended or updated since 2007. This is noteworthy given the problems in the Dutch banking sector since then.

According to the ministry, DNB has not needed to provide information on medium-sized and small banks relating to a potential threat to financial stability recently. The ministry, it says, received information several times in 2015 on potential high risk situations at certain institutions.<sup>123</sup> Owing to the lack of precedent, the interpretation of the WFT in this area is uncertain.

The Ministry of Finance has said it trusts DNB to provide it with timely and full information if a crisis could have an impact on the financial system. According to the ministry, this is assured by its many contacts with DNB. As there are virtually no reports on these contacts, however, we cannot verify this.

The absence of reports could also jeopardise the continuity of decision-making, for example on the installation of a new government when information must be passed on to the new minister.

#### 4.3.2 Information position of parliament

The second report of the De Wit Committee (April 2012) states that the Minister of Finance is reluctant to inform parliament of the policy and decisions of supervisors such as DNB. In response to this criticism, the minister informed the House of Representatives by letter of 23 February 2015 about the consequences of the European banking union for the working agreements on the provision of information to the House.<sup>125</sup> The letter contains an information protocol for non-banking situations. It explains how and when the House will be informed of a possible intervention. It is concerned only with interventions ‘that involve the direct use of public funds’, as this is relevant to parliament’s right to approve the budget.<sup>126</sup> Public funds will no longer be used to rescue banking institutions. The establishment of the resolution fund and the responsibility of the national resolution authority make it unnecessary to use public funds in a bank resolution. In 2016 the Minister of Finance told the House that when acting in a crisis DNB was under no obligation to inform the minister before or during the process. At the same time, he noted that he would appreciate being informed.<sup>127</sup>

In our opinion, this creates uncertainty. On the one hand, DNB provides information in its capacity as supervisor if a bank is in difficulties. On the other hand, DNB provides

information in its capacity as resolution authority. It is uncertain when DNB is able or obliged to inform the minister and in what capacity.

The minister thinks his responsibility for bank rescues and the House's close involvement in the past will be 'non-existent' in the future, because, according to the minister, national public funds will not be used to rescue banks.<sup>128</sup> In our opinion, situations may arise in the future in which medium-sized and small banks will require public funds. Some medium-sized banks are too big to be rescued by funds from the resolution mechanism.

We would note that at present there are no firm agreements on the provision of information on problems at a medium-sized or small bank that could require the use of public funds and/or could destabilise the financial system. In both cases, it could be desirable for the minister to receive information. Clear procedural agreements are needed for crisis situations, including assurances on confidentiality.

## 5 Audit gap in the supervision of banks

### 5.1 Conclusions

The ECB and DNB are responsible for prudential supervision of banks in the Netherlands. It is essential that the audit system is closed and that the prudential supervision can be audited externally by an independent supreme audit institution. A system that is not closed undermines the Dutch and European parliaments' audit ability. We therefore determined to what extent supreme audit institutions were able to carry out their work.

We concluded that:

- The assumed audit gap in the supervision of significant banks actually exists. We also found new audit gaps that will grow in size in the years ahead. Ultimately, independent external audit by supreme audit institutions will be unable to give assurances on the public function of the prudential supervision of small, medium-sized and significant banks.

Our conclusion breaks down into two secondary conclusions:

- An audit by the European Court of Auditors in 2016 confirmed the existence of a gap in the ability to audit the supervision of significant banks. It arose from the new prudential supervision powers exercised by the ECB since 2014.
- Partly because DNB has increasingly adopted the ECB's methods and systems to supervise medium-sized and small banks, new audit gaps have arisen. DNB and the ECB significantly restrict the Netherlands Court of Audit's access to confidential supervisory information on medium-sized and small banks.

There are therefore fewer opportunities for independent external audit to detect shortcomings in banking supervision – and, in extreme cases, failing supervision – at both significant and medium-sized and small banks. This can also have consequences for parliament's information position and the assessments it makes.

### 5.2 Audit gap in the supervision of significant banks

Before the introduction of the SSM, DNB was responsible for the prudential supervision of all banks in the Netherlands. Introduction of the SSM transferred supervision of the significant banks to the ECB. This shift in supervisory responsibilities has had major consequences for the performance of independent external audit. The supreme audit

institutions in the eurozone countries that were mandated to audit the performance of prudential supervision<sup>129</sup> have no powers to audit the ECB or its prudential supervision of the significant banks in their home countries. On the introduction of the SSM, the European Court of Auditors did not receive any specific powers to audit the ECB's supervision of significant banks. It is mandated to audit only 'the operational efficiency of the ECB's management'. It does not have access to confidential supervisory information.

We have informed the House of Representatives by letter of this audit gap in recent years.<sup>130</sup> The Contact Committee of the heads of supreme audit institutions in the EU issued a statement in 2015 that drew this problem to the attention of the European Parliament, the Eurogroup, the Council of the European Union and the European Commission.<sup>131</sup> In our letter of 9 February 2015, we calculated the aggregate value of the balance sheets of the banks in the eurozone whose supervision could not be audited by supreme audit institutions at approximately €22,000 billion. In the Netherlands the amount concerned was €2,150 billion.

On 18 November 2016, the European Court of Auditors published its first investigation of the SSM.<sup>132</sup> During its audit, the ECB did not provide the European Court of Auditors with any documents that could provide an insight into the actual functioning of its supervision of significant banks. This confirmed that the European Court of Auditors did not have the responsibility or power to audit the supervision of significant banks. The audit gap is an outcome of this.

### 5.3 Audit gap in the supervision of medium-sized and small banks

We tested the extent of our mandate to audit DNB's supervision of medium-sized and small banks:

- DNB gave us access to virtually all the relevant documents it holds, including information on the performance of supervision in the dossiers on medium-sized and small banks.<sup>133</sup>
- We had very limited access to the *SSM supervisory manual*. In consultation with the ECB, DNB provided only a small part of the manual, which, moreover, had little relevance to our audit. We accordingly had no insight into the SSM principles or the SREP methods, criteria and standards for medium-sized and small banks.<sup>134</sup>
- Since 2016 DNB has gradually been migrating to the ECB's Information Management System (IMAS). This system is used in the SSM for the supervision of significant banks. DNB currently records risk analysis data on the riskier medium-sized and small banks in

it. In the coming period, it will also voluntarily enter other supervisory information on all medium-sized and small banks in IMAS.<sup>135</sup> As IMAS is owned by the ECB, DNB will in future have to ask the ECB for permission to give the Court of Audit access to the information stored in it. Given the ECB's refusal to grant access to the SSM supervisory manual, it is highly unlikely that it will give its permission. This means the technical migration of data from DNB to ECB systems will create a gap in the Court of Audit's statutory powers to audit the supervision of medium-sized and small banks.

It is also relevant that the ECB is planning to further harmonise the SREP for these banks. Common standards came into force in several areas in 2016.<sup>136</sup> A pilot scheme has been launched with a risk model developed by the ECB for the ECB for medium-sized and small banks that might ultimately replace DNB's own model.<sup>137</sup> In 2017 a pilot was also started in which all countries work with IMAS for a number of medium-sized and small banks.

According to DNB, the ECB will require national supervisors to use IMAS to supervise medium-sized and small banks in the near future. The ECB has said this is the only way to ensure high and consistent standards in the supervision of medium-sized and small banks. Obligatory use of IMAS will indeed increase the consistency of the supervision of these banks, but it will also significantly reduce the national audit institutions' ability to audit the public supervision of medium-sized and small banks. In this case, too, the European Court of Auditors' audit powers are inadequate.

We repeatedly asked the ECB to cooperate voluntarily in this audit, not only because the SSM is key to the supervision of all eurozone banks. We also wanted to gain clarity on both the known and the newly detected audit gaps in the supreme audit institutions' powers and their future development. On formal grounds, the ECB declined our requests.

## 6 Conclusions and recommendations

We audited DNB's prudential supervision of medium-sized and small banks in the Netherlands. Our first conclusion was that DNB must supervise the capital and liquidity positions of medium-sized and small banks in accordance with rapidly changing, extensive and complex regulations. We also concluded that the supervision was well organised, that it was both intensive and strict and that it was open to improvement in certain areas. The potential improvements we identified related chiefly to changes in internal working procedures that DNB could make relatively simply. Measures could also be taken to increase the transparency of decision-making on the capital and liquidity requirements that DNB sets for medium-sized and small banks.

More specifically, we made the following recommendations to DNB.

- Use cost accounting methods, improve insight into the capacity required for supervision, specifically stating what risks are not covered in full or in part by the planned capacity.
- Improve the system of *three lines of defence* within DNB. Strengthen the organisation's follow-ups to the Risk Management & Strategy Department's internal audits and involve the Internal Audit Department in checks of the supervisory process for medium-sized and small banks.
- Harmonise the internal work processes to ensure consistency in the supervisors' dossier formation and the reconstruction of opinions.
- Strengthen the internal quality assurances in SREP decision-making, for instance by using a co-referent for each bank and/or risk element during the panel meeting.
- Make the considerations underlying DNB's decisions and their impact transparent to the medium-sized and small banks in order to maintain the quantitative and systematic approach to supervision.
- Periodically reconsider the frequency and depth of the supervision of each bank and explain the reasons if supervision exceeds the minimum required under the regulations.
- In an ECB context, discuss the difference in the capital requirements set for significant banks and those set for the larger medium-sized banks in the Netherlands and consider what changes can be made.
- Clearly explain to the banks how the capital requirements are arrived at and the underlying considerations for and effects of the relatively high capital requirements for medium-sized and small banks relative to significant banks.

- Together with the Minister of Finance, periodically discuss with parliament whether and, if so, how the financial resilience of the banking sector measures up against other public interests (such as efficient lending operations).

Our second conclusion relates to the role of the Minister of Finance. We conclude that in theory the Minister of Finance has sufficient powers to supervise DNB. In practice, the minister's supervision is limited. It is not certain that the minister has all the information he would need to fulfil his responsibilities during a bank crisis that could destabilise the financial system. This situation would be improved if the minister made more active use of the supervisory instruments available to him and if he reported on them transparently to parliament. Furthermore, an existing, though dated, Memorandum of Understanding on DNB's provision of information to the Minister of Finance could be updated and strengthened.<sup>138</sup> This would prevent gaps arising in the minister's information position in the event of a bank crisis.

We make the following recommendations to the Minister of Finance:

- Ensure that DNB functions adequately as a supervisor, use the available supervisory instruments more effectively and frequently. For instance, draw up an annual supervisory plan for DNB, including risk analyses. Report on the plan internally each year and in the accounts submitted to the House.
- Have the five-year ZBO evaluation carried out by an external party. The evaluation should consider the efficiency and effectiveness of DNB's supervision and the Minister of Finance's supervision of DNB.
- Ensure that internal reports are prepared of the contacts between the Ministry of Finance and DNB so that the continuity of decision-making can be guaranteed and reconstructed.
- Update and strengthen the 2007 Memorandum of Understanding between DNB and the Ministry of Finance. Have it clearly state when and how DNB will inform the ministry if the stability of the financial system is at risk. Also ensure that it is implemented and its implementation is overseen.
- Evaluate the effective operation of the information agreements by studying the method used in DNB's protocol dossiers five years after the agreements take effect.<sup>139</sup>
- State whether the protocol on the provision of information on non-banking institutions to parliament of February 2015 can also be applied to medium-sized and small banks if financial stability is at risk or if public funds are involved.



Our third and final conclusion concerns the audit gaps that hinder independent audit of the supervision of both European and national banks. We conclude that the assumed audit gap in the supervision of significant European banks really does exist. New audit gaps have also been found that will only increase in the years ahead. Ultimately, it will not be possible to give assurances on the independent external audit by supreme audit institutions of the prudential supervision of small, medium-sized and significant banks.

We believe the legislator should repair the audit gaps facing supreme audit institutions in the eurozone so that the audit system is closed.<sup>140</sup> Furthermore, DNB could take several simple steps to ensure the Court of Audit has access to information on the supervision of medium-sized and small banks. To this end we make the following recommendations:

- To the Minister of Finance: Find a structural solution at European level to the gaps in the independent external audit by supreme audit institutions of the supervision of both significant banks and medium-sized and small banks. The audit mandate of the European Court of Auditors should be adjusted in such a way that it can audit in full the functioning of banking supervision of the ECB. The European Court of Auditors must also have access to all relevant ECB documentation, including information systems such as IMAS.
- To DNB: in consultation with the ECB, allow the Netherlands Court of Audit access to relevant ECB information so that it can use it in its audits of the functioning of supervision.
- To DNB: ensure that the Court of Audit continues to have access to confidential supervisory information on the supervision of medium-sized and small banks, even if DNB switches to the ECB's information systems.

## 7 Official response and the Court of Audit's afterword

The Netherlands Court of Audit received the President of DNB's response to this report on 5 September 2017. We received the Minister of Finance's response on 11 September 2017. The responses are summarised in sections 7.1 and 7.2 respectively (the full responses of the Minister of Finance and the President of DNB have been posted on our website, [www.rekenkamer.nl](http://www.rekenkamer.nl)). Our afterword is presented in section 7.3.

### 7.1 Summary of the President of DNB's response

The President of DNB wrote that the Netherlands Court of Audit had drawn a broad picture of DNB's supervision and it had produced a valuable report with a clear structure and clear recommendations.

#### The importance of intensive supervision

DNB welcomed the report's main conclusion that its supervision was effective and the performance of supervision was 'intensive and strict'. DNB would stand by the current frequency and depth of the SREP assessment as it was appropriate to the risks at the institutions it supervised. Financial problems at those institutions, according to DNB, were of direct importance to deposit holders and had consequences for the confidence placed in the financial system as a whole.

In response to the recommendations, DNB noted that the process would be strengthened as follows:

- Internal reports and files would be structured so that all available and relevant documents could be retrieved easily and decision-making could be traced. To this end, DNB had initiated a project to strengthen and harmonise its administrative processes.
- To further increase the institutions' understanding of the SREP, DNB will pay extra attention to the transparency of the process and clarify how the capital and liquidity requirements are arrived at.
- DNB will make more use of existing internal quality assurances. It will ensure that supervisory checks and balances, such as the use of co-referents, continue to work effectively. The Risk Management & Strategy Department will systematically monitor the follow-up to external reports and internal evaluations. DNB will also continue to implement agreements to strengthen the *three lines of defence* model, while paying attention to the internal risk management process and the role of the Internal Audit Department.

### **Effective cooperation with the Ministry of Finance**

As the supervisor of the solidity of financial institutions, DNB is an autonomous administrative authority (ZBO). Further to the Court of Audit's recommendations, the customary internal reports of relevant meetings between DNB and the Ministry of Finance will be recorded more systematically. The President of DNB also noted that the current agreements could be updated during the normal revision of the Remote Supervision strategy, the Supervisory Arrangement and the *Memorandum of Understanding*.

The advisory panel discusses the documents for the ZBO budgets and accounts with the financial institutions concerned and the Ministry of Finance. According to the President of DNB, measures had been taken to strengthen this process by means of written records and reports from the minister to the House would make the ministry's involvement more transparent.

### **Assurances on appropriate audit opportunities for the Court of Audit**

The President of DNB noted that the introduction of the SSM had influenced the Court of Audit's performance of its tasks. The additional audit powers conferred on the Court of Audit under the WFT in 2014 allowed DNB, he wrote, to provide individual and confidential supervisory information during this audit. There is currently no such basis in law at EU level. This restricts DNB's ability to provide information because, according to the President, it does not have autonomous power to share information provided by the ECB.

The President of DNB wrote that he would make every effort to ensure that comparable audits, in which accountability for supervision is rendered to the Netherlands Court of Audit or the European Court of Auditors, remain possible in the future. At the same time, according to the President, however, DNB will comply with the applicable legal requirements and a solution needs to be found at European level.

## **7.2 Summary of the Minister of Finance's response**

The Minister of Finance received the report with interest and appreciation.

### **Exercise of powers**

The minister wrote that he would act on our recommendation to make more effective and frequent use of the available instruments to supervise DNB. By doing so, he would improve 'familiarity with' and accountability for his use of his powers. He would achieve this by providing greater clarity on the powers and their use in the *Remote Supervision strategy* and

the *Supervisory Arrangement for supervisors of the financial markets*. He would also explain more clearly how DNB was actually supervised in practice. He noted that the ministry and DNB had a consultation structure but not all the content of the consultation was recorded. He would therefore decide during the evaluation and updating of the aforementioned documents how the regular contacts between DNB and the ministry ‘could be organised so that they were more recognisable to outside parties’.

The minister also responded to our finding that he had made little use of his intervention powers in the *intervention pyramid* between 2011 and 2016. He thought this finding was understandable because the recording of contacts was open to improvement. He explained that, in line with the ideas underlying the intervention pyramid, he would always first attempt to use dialogue and persuasion to achieve the desired results. Our finding, according to the minister, showed that the structure of the intervention pyramid worked. He had seen no reason to use hard statutory powers without consulting DNB. According to the minister, appropriate use had been made of the powers underlying the intervention pyramid. This had led to fruitful consultations based on mutual trust.

### Five-year ZBO evaluation

The Court of Audit had recommended that an external party should carry out the five-year ZBO evaluations and that they should cover the efficiency and effectiveness of DNB’s supervision. The minister observed that he was obliged under section 39, subsection 1 of the ZBO Framework Act to submit a report to the Senate and the House of Representatives every five years. That report must make it possible to establish whether a ZBO was operating efficiently and effectively and whether it was desirable for it to continue to perform its tasks. These reports, he noted, would in future be prepared by a party other than the directorate responsible for policy. His preferred external party would not be part of central government.

### Internal reports of contacts

In response to the Court of Audit’s recommendation that assurances should be in place regarding the internal reporting of contacts between the Ministry of Finance and DNB, the minister said he shared our opinion that reports could contribute to the reconstructability and continuity of decision-making. They could also strengthen accountability. Internal reporting of the contacts between the ministry and DNB would therefore be improved.

## **Information sharing and consultation regarding financial stability and crisis management**

In response to our recommendation, the minister wrote that together with DNB he would update the Memorandum of Understanding entitled '*Agreements between De Nederlandsche Bank and the Minister of Finance regarding the exchange of information and consultation on financial stability and crisis management*'.

### **Protocol files**

The Court of Audit recommended that the minister should evaluate the effective operation of information agreements. He should do this by assessing the method used in DNB's protocol files five years after the agreements took effect. The minister undertook to determine what method was used after five years without considering the confidential supervisory content.

### **Provision of information to parliament**

The Court of Audit also recommended that the minister should state whether the protocol to provide information to parliament on non-banking institutions of February 2015 could also be applied to medium-sized and small banks if financial stability was at risk or if public funds were involved. The minister wrote in his response that this information protocol was not applicable to medium-sized and small banks but in exceptional circumstances when national powers had to be called upon and national funds were involved, the national right to approve the budget would be at issue and the agreements in the protocol would then be applicable.

### **Gaps in independent external audit (audit gap)**

The minister welcomed our recommendation to find a structural solution at EU level to the gaps in independent external audit facing supreme audit institutions. He noted that external independent audit of banking supervision at both national and EU level was an essential element in the checks and balances in the democratic legitimacy of the performance of public duties. He has worked on strengthening the position of both the Netherlands Court of Audit and the European Court of Auditors in recent years. The minister will continue to argue that the European Court of Auditors should have appropriate access to relevant ECB documents.

## 7.2 Court of Audit's afterword

We were pleased with DNB's undertakings in response to the recommendations on its internal processes and cooperation with the Ministry of Finance. DNB did not consider our recommendation that it and the Minister of Finance should periodically discuss with parliament whether and, if so, how the financial resilience of the banking sector and the capital requirements measure up against other public interests (such as efficient lending operations). We continue to think the public impact of using public powers should be a matter for parliament to debate.

We are grateful to the Minister of Finance for his positive and constructive response to our recommendations. We wish to comment on his response to our recommendation that the five-year report issued under section 39, subsection 1 of the ZBO Framework Act be accompanied by an assessment of DNB's efficiency and effectiveness. Evaluations of ZBOs differ markedly from each other. It is not unusual for them to consider the efficiency and effectiveness of the primary task. We suggest that the minister also have future ZBO evaluations consider the efficiency and effectiveness of DNB.

Our final comment relates to the audit of banking supervision. We agree with DNB that a solution should be sought at EU level. The goal has to be a closed audit system. This means that the European Court of Auditors must be able to audit the functioning of supervision on significant institutions. The European Court of Auditors must have assurance that the ECB will give it full access to the confidential information it requires. This is not the case at present. If the European Court of Auditors does not have such assurance in the near future, DNB must ensure that our statutory right to access all information necessary to audit the supervision of medium-sized and small banks in the Netherlands remains fully intact. We appreciate the Minister of Finance's effort to strengthen the Court of Audit's and the European Court of Auditors' supervision of banks in recent years and are grateful he will continue to do so in the years ahead.

In conclusion, we would note that both the Minister of Finance and the President of DNB write that they will 'make efforts'. So will we. Nevertheless we cannot guarantee that our joint efforts will have the desired effect, namely a comprehensive system of checks and balances at EU level. More is needed, and the Dutch parliament has a role to play in achieving it.

## Annexe 1 Abbreviations and definitions

### Abbreviations

AFM	Dutch Authority for the Financial Markets
BRRD	Banking Recovery and Resolution Directive
CBR	Combined Buffer Requirement
CCB	Capital Conservation Buffer
CRD	EU Capital Requirements Directive
CRR	EU Capital Requirements Regulation
CW	Government Accounts Act
DGS	Deposit Guarantee Scheme
DNB	De Nederlandsche Bank N.V.
EBA	European Banking Authority
EC	European Commission
ECA	European Court of Auditors
ECB	European Central bank
ESCB	European System of Central Banks
ESFS	European System for Financial Supervision
ESRB	European Stability and Risk Board
EU	European Union
EUBA	European Banks Supervision Division of DNB
FSAP	Financial Stability Assessment Programme (IMF)
IAD	Internal Audit Department of DNB
ICAAP	Internal Capital Adequacy Assessment Process
ILAAP	Internal Liquidity Adequacy Assessment Process
JST	Joint supervisory team of the ECB and the national supervisor
KBB	Small Banks & Branches Department of NATIN
KPI	Key Performance Indicator
LCR	Liquidity Coverage Ratio
LSI	Less significant institution (medium-sized and small banks)
MSB	Medium-sized Banks Department of NATIN
NATIN	National Institutions Supervision Division of DNB
NCA	National competent authority (DNB in the Netherlands)
NVB	Dutch Banking Association
OSBE	On-Site Supervision & Banking Expertise Division of DNB
PDR	Problem dossier
RAS	Risk assessment system, ECB
RMS	Risk Management & Strategy Department of DNB
RvC	Supervisory Board

RWA	Risk-weighted assets
SI	Significant institution (large banks)
SRB	Single Resolution Board
SREP	Supervisory review and evaluation process
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism
TFEU	Treaty on the Functioning of the European Union
TR	Supervisory Board
TSCR	Total SREP Capital Ratio
WBFT	Financial Supervision (Funding) Act
WFT	Financial Supervision Act
ZBO	Autonomous administrative authority

## Definitions

Bank balance sheet	The left-hand side of a balance sheet discloses a bank's assets such as mortgages and loans to small and medium-sized enterprises. The right-hand side discloses the liabilities or debts, such as borrowings and deposits.
Banking union	Agreements within the EU to ensure financial stability and to strengthen banks. The same rules apply to all banks in the euro countries, and regulate centralised supervision and agreements on interventions at banks in difficulties.
Bank equity	The difference between assets and debts. It comprises issued shares, reserves and retained earnings. Like debt, it is used to finance banking activities, such as lending operations.
Capital	From the supervisor's perspective, capital is a bank's ability to absorb losses. Capital forms part of a bank's equity.
Leverage ratio (unweighted capital requirement)	The ratio between equity and total assets. If a bank has €1 in equity and €25 in assets, the lever is 25 and the unweighted leverage ratio 4% (1/25).
Risk-weighted capital requirement	Depending on the risk present in its assets, a bank must hold a certain amount of capital. A bank with €1 billion in low risk mortgages, for example, will have to hold less capital than a bank with €1 billion in high risk mortgages.
Basel I	1988. Required banks to calculate a risk-weighted capital requirement and hold capital equal to 8% of their risk-weighted assets (RWA).



Basel II	2004. System based on three pillars: <i>Pillar 1</i> : includes the Basel I capital requirement, plus the option for banks, under certain conditions, to calculate the capital requirement for credit, market and operating risks using their own internal models.
	<i>Pillar 2</i> : imposes additional capital requirements where necessary on top of pillar 1 requirements. The amount depends on the supervisor's assessment of the bank's exposure to risks that are not adequately covered by the pillar 1 capital requirement.
	<i>Pillar 3</i> : requirements on the publication of information by banks and supervisors.
Basel III	2010. Tightened up both the amount and quality of the pillar 1 capital requirement. Equity capital of the highest quality (core capital) within the minimum 8% capital requirement was doubled. CRD IV also introduced capital buffers that must be satisfied with core capital.
	<i>Common Equity Tier 1 (CET1)</i> : consists of share capital, reserves and retained earnings. This form of capital can be used for all elements of both the risk-weighted and the unweighted capital requirements. This core capital is intended primarily to absorb going concern losses.
	<i>Additional Tier 1 (AT1)</i> : consists of perpetual debt instruments such as contingent convertible capital instruments (CoCos). This type of capital can be used to a limited extent (up to 1.5% of RWA) for the risk-weighted capital requirement. AT1 capital counts in full towards the unweighted capital requirement. It can also be used to absorb going concern losses.
	<i>Tier 2 (T2) capital instruments</i> : mainly subordinated debt instruments with a minimum maturity of five years. Counts to a limited extent (up to 2% of RWA) towards the risk-weighted capital requirement. AT1 capital does not count towards the unweighted capital requirement.
Basel III Minimum pillar 1 requirement:	Must ensure that a bank holds a minimum amount of capital to absorb the most common risks (credit risk, market risk, operating risk). The total amount of capital (CET1 + AT1 + T2) must be equal to at least 8% of the risk-weighted assets. Furthermore, CET1 + AT1 must be equal to at least 6% of the risk-weighted assets and CET1 (capital of the very highest quality) must be equal to at least 4.5%.
Basel III pillar 2 add-on	The SREP determines whether a bank's liquidity management is in order or not and whether it has sufficient capital to cushion the risks arising from its activities. Where necessary, the supervisor can require the bank to hold more capital on account of 1) additional risks, such as interest rate risk, legal risk, business model risk or reputation risk, or 2) if the supervisor thinks the capital held in respect of the credit risk, market risk and operating risk is inadequate. Only CET1 capital can be used for the add-on.

Basel III combined buffer	<p>Extra low CET1 capital that hierarchically is in addition to the risk-weighted requirements. Banks are not obliged to hold this combined buffer in whole or in part. If banks eat into this buffer, measures automatically take effect to restore the capital position.</p> <p>The amount of the combined buffer is determined by:</p> <ul style="list-style-type: none"> <li>(a) the capital conservation buffer (2.5% RWA) +</li> <li>(b) the institution-specific countercyclical buffer (0-2.5% RWA) + the sum of:</li> <li>(c) the general system relevance buffer (1-3.5%),</li> <li>(d) the other system relevance buffer (max 2%)</li> <li>(e) the system risk buffer (max 3%).</li> </ul>
Unweighted Basel III requirements	<p>Leverage ratio: requires banks to hold capital equal to at least 3% of a non-risk-weighted exposure basis, regardless of the risk run by the bank. The non-risk-weighted exposure basis consists of all assets on a bank's balance sheet and all off balance sheet exposures.</p> <p>The leverage ratio is an additional safety valve: even if a bank's balance sheet comprises low risk assets (so that RWA and thus the risk-weighted capital requirement are relatively low) it must still hold capital equal to at least 3% of its balance sheet total.</p> <p>Provisional Basel agreement: a leverage ratio of at least 3% as from 2018. In anticipation, significant banks in the Netherlands must have a leverage ratio of at least 4% by 2018 at the latest.</p>
Bank resolution	<p>To complement the requirements on the amount and quality of equity that banks must hold, the resolution of problem banks has been improved. The goal is to prevent the use of public funds by means of bail-ins, in which creditors can be obliged to absorb losses if an institution cannot be wound up. Under the Bank Recovery and Resolution Directive (BRRD) a bank's entire liabilities, with a few exceptions, can be used for the bail-in.</p>
Bail-in	<p>Debts are converted into capital to strengthen a bank's balance sheet. To this end, banks are required to hold instruments that can be easily converted for the bail-in. They are generally referred to as the Total Loss Absorbing Capacity (TLAC). At EU level they are known as the Minimum Requirement for own funds and Eligible Liabilities (MREL): a requirement set for the loss-absorbing capacity of European banks.</p>

## Annexe 2 Audit methodology

### Standards framework

For the purposes of this audit, we updated a standards framework we had initially prepared in 2011 for an audit of DNB's supervision of bank stability (Netherlands Court of Audit, 2011) and adapted and expanded it in certain areas, chiefly to take account of the introduction of the SSM. The main structure of the standards framework is unchanged. Before carrying out the audit, we agreed the standards framework with DNB and the Ministry of Finance.

### Method

For the audit, the Court of Audit first analysed the relevant EU and national regulations on the prudential supervision of banks. To establish how DNB was currently implementing the rules in its organisation, among other things, we then held talks with and requested information from DNB. On the basis of a literature study, we determined what lessons DNB had learned from the 2008 banking crisis.

DNB informed us through interviews and documents how it supervised medium-sized and small banks in practice and what methods and procedures it used. To determine how the supervision worked on the ground, we carried out an in-depth audit of a sample of DNB's dossiers on medium-sized and small banks. This audit included talks with the supervisors responsible for the banks and (on a voluntary basis) with most of the banks concerned. As final responsibility for the functioning of the financial system lies largely with the Minister of Finance, and he is accountable for the supervision to the House of Representative, we also held talks and gathered information at the Ministry of Finance.

The supervision of banks in the eurozone is currently a matter principally of the ECB. Through DNB, we therefore requested information from the ECB and asked it to take part in talks with us.

### External experts

Owing to the specialised nature of this audit, we sought assistance from external experts on a number of occasions. We held background talks with them on the development of supervisory rules in the EU and supervision of the banking sector. The experts had no access to confidential supervisory information.

## Availability of information and formation of opinion

### Availability of information

Under the Financial Supervision Act (WFT), the Court of Audit has access to all the data and information it needs to carry out its statutory task laid down in section 91 of the Government Accounts Act 2001. DNB closely cooperated with us on this audit and provided information. Nevertheless, we did not receive all the information we requested.

We did not have access to:

- *The ECB's SSM manual.* At the Court of Audit's request, DNB asked the ECB to give us access to its SSM manual. We received access to only a small part of the manual, which did not cover the SREP or the on-site audits.<sup>141</sup>
- *Further information from ECB.* We asked the ECB several times to discuss the work of its DG MSIII (directorate-general responsible for medium-sized and small banks) and future developments in the supervision of medium-sized and small banks. The ECB constantly told us that we had to put all our questions to DNB.
- *External evaluation of DNB's Supervisory Board.* DNB's Supervisory Board commissioned an external evaluation of its own performance. It was not willing to share this evaluation with us.
- *DNB's digital filing system.* The Court of Audit did not have independent access to DNB's internal digital filing system and bank supervision dossiers. Access was only permitted in the company of the banks' account supervisors.

We relied on financial information provided by the medium-sized and small banks supervised by DNB. To increase transparency, DNB has posted a summary on its website of the information provided by the banks themselves. The information relates to, for example, mortgage and commercial credit portfolios, ratios for loans and loan provisions, and the ratio of equity as a percentage of a bank's balance sheet total. This information is not complete, it dates from 2014 and the summary does not include all banks.

### Formation of opinion

Our opinion is based on the information that we ourselves had access to and the talks we held. A large proportion of the information that DNB uses to supervise the banks is derived from reports issued by the supervised banks themselves. We were unable to establish the quality of this information. Furthermore, the methodology used by DNB is derived from the ECB. As we did not have access to the chapters in the SSM manual that relate to the SREP and on-site audits, we could not establish whether DNB worked in accordance with the SSM manual.

As a result of these limitations, the Court of Audit cannot express a full opinion with certainty on the process, content and quality of DNB’s supervision of medium-sized and small banks in the Netherlands. The opinions we express in this report cannot be read as any form of assurance on DNB’s activities.

## Annexe 3 Other audits

Several institutions have recently audited the supervision of banks. We first look back at an audit we carried out in 2011.

### Netherlands Court of Audit 2011

An audit report on DNB's supervision of banks published by the Court of Audit in 2011 concluded, among other things, that DNB had made progress since the credit crisis and had improved the organisation of its banking supervision. DNB was planning to pay more attention to the conduct and culture of financial institutions and had adapted its risk analysis procedure. Its analyses will consider the threats present in a financial institution's external environment. We cannot say whether DNB has implemented this new approach in full and whether it has been effective because we did not have access to confidential supervisory information.

The audit referred to uncertainties regarding DNB's ability to translate the macroeconomic risks it identifies into measures at individual banks. In other words, can DNB oblige a bank to hold a higher capital buffer if international economic conditions suggest a higher buffer is required? We concluded in our report that DNB acted hesitantly in this respect.

Another finding from the audit was that the Minister of Finance did not sufficiently supervise all aspects of DNB at the time. It was uncertain, for example, what supervisory assurances the minister used to assess DNB's supervision and to determine when DNB was functioning effectively. We recommended in 2011 that DNB should have its new approach to risk analyses evaluated within two years. We advised the Minister of Finance to work out his strategy for the supervision of DNB in greater detail and to account to the House of Representatives for his supervision every year. We consider these points in this report.

### European Court of Auditors 2016

On 18 November 2016 the European Court of Auditors published its first audit of the ECB's supervision of significant banks in accordance with the SSM. The audit was confined to the governance of the SSM and the joint supervisory teams of the ECB and national supervisors. It concluded:

- Owing to the involvement of national supervisors, cooperation is difficult to organise. A great deal of coordination is needed between the ECB and the national supervisors. This complexity is a challenge to the governance of the SSM as complicated information exchange procedures can weaken the efficiency and effectiveness of

decision-making.

- In practice, the national supervisors tend to implement the SSM at significant banks. The ECB does not have sufficient influence over the composition and quality of the supervisory teams. The national supervisors' use of resources does not meet the requirements. It is therefore uncertain whether the supervisory teams can supervise adequately.

DNB was involved in this audit as one of the national supervisors in the eurozone countries. It cannot be concluded from the European Court of Auditors' report to what extent the findings relate specifically to the Netherlands.

The ECB did not want to give the European Court of Auditors access to documents that could provide an insight into the actual performance of the ECB's supervision. An annexe to the report lists all documents to which the European Court of Auditors had been denied access. The European Court of Auditors accordingly recommended that the ECB should cooperate in full in its audits and provide all requested documents. The ECB did not respond to this recommendation. The European Court of Auditors' report did not include any recommendations to the European Commission to propose legislation to relax the restrictions in its limited mandate with regard to the ECB.

### **IMF Financial Sector Assessment Programme (FSAP) 2017**

The IMF published its latest Financial Sector Assessment Programme (FSAP) for the Netherlands on 13 April 2017. The IMF had studied the ECB's and DNB's prudential supervision of banks in the Netherlands. The report makes the following observations that are also relevant to the supervision of medium-sized and small banks:

- DNB had taken several measures in response to the crisis: it had stepped up supervision and made it more intrusive and decisive. The supervision was more forward-looking and DNB used a risk-based approach.
- The SSM has strengthened banking supervision. DNB had responded by addressing problems in its supervision. It had developed a new supervisory strategy, deployed more resources and adopted stricter rules and a more assertive style of supervision.
- Data quality problems at the supervised institutions compromised the reliability of the data and, amongst other things, could make off-site supervision more difficult.
- The supervisors should prioritise assessments of the banks' business models and strategies. Banks were having to cope with low interest rates and regulatory change that could force them to change their strategies and assume more risks.

- The IMF was concerned about certain aspects of DNB's independence. In particular, it thought the Ministry of Finance's influence was problematic. The ministry, for example, had to approve DNB's budget and the proposed rules relating to salaries at DNB. Secondly, the IMF thought DNB had only limited means to implement technical rules. The ministry, moreover, had the power to ignore the rules set by DNB. Finally, the ministry's power to dismiss DNB's Governing Board was open to wide interpretation.
- The IMF's main recommendations to DNB were:
  - Prioritise business model analysis.
  - Enter into talks with the banks' supervisory boards.
  - Raise the standards for data aggregation.

### Ministry of Finance 2017

On 28 March 2017, the Ministry of Finance submitted its five-year assessment report on the efficiency and effectiveness of DNB's performance as an autonomous administrative authority to parliament. A similar report had first been prepared in 2010. The first report had been required under section 1:44 of the WFT. The recent report was prepared in compliance with section 39 of the ZBO Framework Act and covered the period 2010-2015. The report presents findings on DNB as an organisation, developments in financial supervision, and costs and results. The main conclusion was that DNB was an efficient and effective ZBO. The report specifically stated that it did not include an opinion on the efficiency and effectiveness of the financial supervision itself. The report's main findings, conclusions and recommendations were:

- DNB explained the relationship between its costs and activities, and what those activities delivered in terms of performance and impact, more emphatically than in the past.
- DNB was willing and able to accept criticism and make changes in its internal organisation.
- Since the introduction of the SSM, cooperation in the supervisory landscape had become less clear and sometimes less efficient.<sup>143</sup>

The report recommended that DNB should safeguard the transparency of its supervision, embed new tasks into its organisation as efficiently as possible and demonstrate and explain that higher capital and liquidity requirements were reasonable and in keeping with DNB's stricter supervision.



## Annexe 4 Internal organisation of DNB

### Organisation of DNB

The 1998 Bank Act brought DNB's monetary tasks into line with the 1991 Treaty of Maastricht. DNB's objectives and tasks are formulated within the framework of the European System of Central Banks (ESCB). This framework allows the national central bank to perform other functions, such as prudential supervision of banks.<sup>144</sup> The institutional relationship between DNB and the Minister of Finance for prudential supervision is laid down in the WFT (2007) and the ZBO Framework Act (2006).

It is important to separate monetary policy and banking supervision properly in order to prevent conflicts of interest. This separation is achieved through the legal form and internal organisation of DNB.<sup>145</sup> Separate budgets and annual accounts are prepared for the ZBO tasks.

### Governing Board of DNB

De Nederlandsche Bank (DNB) is a public limited liability company (naamloze vennootschap, NV). Its day-to-day management is in the hands of its Governing Board, which is headed by DNB's President. The members of the Governing Board share joint responsibility for all decisions. They are appointed by the Crown for a term of seven years. The Governing Board is made up of the President, the Executive Director of Monetary Affairs and Financial Stability, the Executive Director and Chairman for Prudential Supervision and the Executive Director responsible for supervision of pension funds, supervision of horizontal functions and integrity, and legal services. The Governing Board is supported by the Secretary-Director.

### Supervisory Board

DNB has a Supervisory Board. The Supervisory Board has a number of important powers, such as power to approve the budget and annual report, to approve certain decisions taken by the Governing Board and to adopt the annual accounts. One member of the Supervisory Board is appointed by the government. The Supervisory Board's independence is laid down in DNB's articles of association.

The Supervisory Board oversees the management of DNB and the general operations of the company. Since 2012, the Supervisory Board has also overseen the performance of supervision in general and the quality assurance and effectiveness of the supervision. In

principle, the Supervisory Board monitors the operation of the internal control systems and all checks and balances, such as reports issued by the Risk Management & Strategy Department (RMS) and the Internal Audit Department (IAD). The Supervisory Board also regularly discusses individual bank dossiers that are receiving heightened attention within DNB. The Supervisory Board reports on its activities in DNB's annual report. In 2015 both the Governing Board and the Supervisory Board were subject to external evaluation. We did not receive access to the external evaluation of the Supervisory Board for this audit.<sup>146</sup>

### Bank Council

DNB has a Bank Council. It acts as a sounding board for the Governing Board. Two members of the Supervisory Board serve on the Bank Council, including the member appointed by the government. The other members of the Bank Council are the Treasurer General of the Ministry of Finance, representatives of the social partners and the financial sector and independent experts. We found that the member to attend the fewest meetings of the Bank Council (about 40-50%) was the Ministry of Finance's representative. We also found that the Bank Council did not discuss DNB's supervision of banks.

### Relationship with external parties

The tasks, responsibilities and powers of DNB and the AFM are laid down in a number of supervisory laws. The two institutions must work together in many areas, such as issuing and withdrawing licences, dismissing directors of financial institutions and appointing trustees in bankruptcy. They also implement a joint enforcement policy that provides general principles to decide what measures should be taken if one of the two detects an offence.<sup>147</sup>

Internationally DNB works within the SSM with fellow central banks in the eurozone. Decisions in the SSM are taken by its Supervisory Board (with one vote for each national supervisor and six for the ECB). The Supervisory Board discusses the supervision of medium-sized and small banks only in exceptional circumstances, mainly in problem cases.

DNB participates in a variety of SSM networks for the supervision of significant banks. There are no such networks for the supervision of medium-sized and small banks. However, there is a senior management network made up of representatives of the senior managers of the ECB's DG MS-III and of the national supervisors. DNB's representative is the director of the NATIN Division.

Furthermore, DNB works with supervisors from other EU member states in the European Banking Authority (EBA). At a global level, the main platform for cooperation among bank supervisors is the Basel Committee on Banking Supervision (BCBS), which sets banking supervision standards. About 40 working groups are active within the Basel structure.

## Annexe 5 Impressions of the banks supervised by DNB

For the purposes of our audit, we asked several medium-sized and small banks for their impressions of DNB's supervision. Their main thoughts are summarised below.

### Changes since the introduction of the SSM

The banks said the supervision had become more intense and its structure had improved since the introduction of the SSM. This, they thought, was not necessarily a result of the SSM. The new approach was the outcome of the lessons DNB had learned from the crisis. The banks also thought the supervision had become clearer. Decision-making was explained better and it was clear what rules DNB was applying. The banks were generally positive about the new on-site inspections.

At the same time, the banks thought the current supervision was not proportionate:

- The reporting requirements are not proportionate to a bank's size and complexity. The banks think the supervisory burden is heavy.
- DNB rigidly applies the supervision of significant banks to medium-sized and small banks. This increases the burden and results in disproportionate requirements.
- The capital requirements set for medium-sized and small banks are relatively high and, according to the banks, systematically higher than those set for significant banks.

### Substantive quality of decision-making

In general the banks are positive about the substantive quality of the SREP decisions. In their eyes, the supervisory process is fair and careful and the reasons for and content of the opinions were transparent. The banks thought the 2016 SREP was better than the 2015 SREP.

It was not always clear to the banks how the SREP opinions were arrived at. They did not always recognise themselves in the results of the risk analyses and they would like to receive more insight into the background and structure of some capital add-ons. The level of some of the add-ons was thought to be arbitrary.

The banks thought the supervision had become more quantitative and was based more on models. They saw benefits in this because it supported objective decision-making but it was not without criticism. According to some of the banks, DNB's conclusions and recommendations had little value in the context of the overall banking operations.

Moreover, quantification and modelling gave a false sense of certainty and the approach had inherent risks. Another undesirable effect was that outliers were treated as higher risks, and focusing on them reduced the diversity of the banking landscape.

### **Procedural quality of decision-making**

Banks thought the SREP functioned well. DNB involved them in each of the steps and the banks generally enjoyed a good working relationship with the account supervisors. The annual SREP dialogue was said to be positive. The banks also commented:

- DNB's opinions were *faits accomplis*.
- It was sometimes uncertain what DNB did with the information they provided. Both the request for information and DNB's response to the information were unpredictable.
- There were occasionally long delays between the announcement and conduct of supervisory activities. This made planning difficult.

### **Contribution of supervision to the banks' financial resilience**

The banks said supervision increased discipline and the supervision had become more efficient and effective in recent years. Virtually none of the banks, however, thought the supervision had contributed to their financial resilience. Some said their capitalisation was good and they would hold the same capital positions without supervision.

Several banks noted that the playing field among the significant and the medium-sized and small banks was not level, and Dutch banks might not enjoy a level playing field with other EU banks. They argued that the SREP ratios for medium-sized and small banks were substantially higher than the published SREP ratios of several significant banks; the differences were in fact so high they could not explain them to the market and rating agencies. The banks thought DNB interpreted the rules 'Calvinistically' whereas foreign supervisors did not. According to the banks, DNB's pursuit of higher capital buffers was at the expense of lending operations and support for the economy. Banks did not consider legal remedies against SREP decisions because they thought they would have little benefit and might spoil a good supervisory relationship.

## End notes

1. The text initially adopted by the Court of Audit was revised in response to new information received during the clearance procedure.
2. See <https://www.dnb.nl/statistiek/statistieken: dnb/financiële stabiliteit/index.jsp>
3. Bruegel (2016): European banking supervision: the first eighteen months, Brussels 2016.
4. Owing to mergers and new market entrants, the precise number of banks differs from one year to the next.
5. Bruegel (2016), p. 128.
6. In addition, there are banks that offer products and services in the Netherlands that are licensed within the European Economic Area (EEA: EU, Norway and Iceland) by the supervisor in their home country. Banks that are licensed in one member state may operate in the others using their 'European passport'.
7. We make a distinction between micro and macro-prudential supervision. Micro-prudential supervision relates to individual institutions whereas macro-prudential supervision relates to the financial system as a whole. Our audit considered DNB's micro-prudential supervision.
8. Bank Act 1998, section 4, subsection 1: The tasks of the Bank are to exercise supervision of financial institutions in pursuance of the relevant statutory provisions.
9. DNB's articles of association, article 4: To realise the objectives referred to in article 3, the Bank shall perform the tasks and activities it is empowered to perform by or pursuant to the law.
10. SSM Directive, article 6 paragraph 5 (b).
11. The ECB is responsible for the effective and consistent operation of the SSM. DG Micro-Prudential Supervision III is tasked with ensuring the supervision is of the highest possible quality and that the supervision of less significant institutions is appropriate and consistent.
12. See ECB annual report on supervisory activities 2015, p. 45 ff.
13. Contact Committee of the heads of supreme audit institutions and the European Court of Auditors (2015): Statement ensuring fully auditable, accountable and effective banking supervision arrangements following the introduction of the Single Supervisory Mechanism.
14. Letter from the President of the Netherlands Court of Audit, Arno Visser, and the President of the Bundesrechnungshof, Kay Scheller, to the Vice-President of the European Commission, Valdis Dombrovkis, of July 2016.
15. European Court of Auditors: Preliminary observations (pursuant to Article 287(4),

second subparagraph, TFEU), Single Supervisory Mechanism - Good start but further improvements needed. Luxembourg, 18 November 2016.

16. See WFT section 1:93d. This amendment of the WFT is due to the transposition into Dutch law of article 59.2 of EU Directive CRD IV: Member States may authorise the disclosure of certain information relating to the prudential supervision of institutions to parliamentary inquiry committees in their Member State, courts of auditors in their Member State and other entities in charge of enquiries in their Member State (...).
17. The audit did not consider DNB's other supervisory tasks for the Single Resolution Mechanism (SRM, second pillar of the banking union).
18. Lessons were also learned in other areas, including the role of credit rating agencies, complex financial products/derivatives, reporting standards, resolution, deposit guarantee scheme, the structure of banks, etc. These lessons helped set the context and the conclusion, i.e. resolution, of prudential supervision. Lessons were also learned with regard to European supervision of national budgets, macroeconomic developments, monetary policy, the structure of the financial sector, tax laws, etc.
19. The external evaluation of DNB's Supervisory Board is an exception. See section 2.3.1 and Annexe 4.
20. This report also contains a number of annexes. Annexe 1 presents the main abbreviations and definitions, and Annexe 2 explains the audit methodology. Annexe 3 includes a summary of related audits and Annexe 4 describes the internal organisation of DNB. Annexe 5 summarises the banks' impressions of DNB's prudential supervision.
21. We will return to this in the joint report to be issued by the SAls of Austria, Cyprus, Finland, Germany and the Netherlands in the context of the Banking Union Task Force. Publication is expected before the end of 2017.
22. See 'The role of the banking union in achieving financial stability', speech by Vítor Constâncio, Vice-President of the ECB, at the FT Banking Summit, 'Ensuring Future Growth', London, 26 November 2014.
23. The SSM Directive refers to the Capital Requirements Regulation 575/2013 for a definition of 'credit institution': 'an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account.' Under the WFT (section 1:1) a bank is a credit institution within the meaning of article 4 of the Capital Requirements Regulation, not being a credit union with its seat in the Netherlands, on the understanding that, unless decided otherwise, a bank is equal to the holder of a licence as referred to in section 3:4 of the WFT. A number of elements of section 3:4 of the WFT differ from the CRR.

24. Regulation (EU) 806/2014 of the European Parliament and of the Council of 15 July 2014.
25. Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes (recast), OJ 173/149 of 12 June 2014.
26. European Commission COM(2015) 586 of 24 November 2015, Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 806/2014 in order to establish a European Deposit Insurance Scheme.
27. Act of 4 May 2015 amending the Financial Supervision Act and other Acts on account of Regulation (EU) No. 1024/2013 of the Council of 15 October 2013, Government Gazette 2015 184.
28. Most of the CRR's provisions came into effect on 1 January 2014. The Capital Requirements Regulation and Directive Implementation Act came into effect on 1 July 2014.
29. The text initially adopted by the Court of Audit was revised in response to new information received during the clearance procedure.
30. Both the Governing Board and the Supervisory Board were evaluated by an external party in 2015. For the purposes of this audit we did not have access to the external evaluation of the Supervisory Board. By email of 21 October 2016, DNB explained why not as follows: it is a confidential document expressing the thoughts and opinions of Supervisory Board members on the understanding that the document would not be seen by third parties.
31. The text initially adopted by the Court of Audit was revised in response to new information received during the clearance procedure.
32. The figure does not show the Bank Council.
33. To this end, DNB set up the *Thematic Supervision of Integrity Department and the Expert Centre on Governance, Behaviour & Culture Department* within its Horizontal Functions & Integrity Supervision Division. The supervision also had to be 'more intensive', 'intrusive' and 'tenacious'. See DNB (2010), *Van analyse naar actie – plan van aanpak cultuurverandering toezicht DNB* ('From Analysis to Action – Action Plan for a cultural change in DNB's supervision'). This in turn led to the establishment of an *Expert Centre on Intervention & Enforcement* (EHI) The expert centre advises on the treatment of long-running supervisory problems and can take charge of problem cases if necessary. The text initially adopted by the Court of Audit was revised in response to new information received during the clearance procedure.
34. Cooperation agreements have been made regarding, for example, the staffing of the Joint Supervisory Teams to supervise significant banks. See European Court of Auditors



(2016) regarding the ECB's SSM supervision. <http://www.eca.europa.eu/en/Pages/DocItem.aspx?did=39744>

35. This is the case if the stability of the financial system is at risk, if a supervisory decision is relevant to one of DNB's other statutory tasks, if a situation or decision would have serious consequences for DNB's equity position, if the supervisory directors cannot come to a consensus or if there is a risk to DNB's reputation. Source: DNB's articles of association, 16 January 2015, article 6a, paragraphs 5 and 6.
36. DNB's articles of association 2015, article 6a, paragraph 8.
37. Because DNB has also fulfilled the task of resolution authority since 1 January 2015, with separate mandates and powers, the ZBO budget and accounts have since consisted of two separate parts: the supervision part and the resolution part, DNB ZBO budget 2015, p. 3. The ZBO budget is prepared in close cooperation with the Ministry of Finance. This is considered further in chapter 4.
38. House of Representatives, session 2013–2014, appendix to 32 648, no. 5, p. 10.
39. In principle, the cost framework is based on the following formula: total cost of supervision in the current year (excluding the cost of EU banking supervision) + salary and price movements + the cost of changes in tasks + costs relating to EU supervision. This has been formalised by the De Vries amendment of 1 October 2014. The amendment was passed in order to limit any increase in the cost of supervision. House of Representatives, session 2014–2015, 33 957, no. 11.
40. House of Representatives, session 2015–2016, 33 957, no. 26. The Dutch Banking Association called in April 2016 for the financial institutions to be involved in the adoption of the multiyear cost framework. Report of DNB ZBO accounts panel meeting, 16 April 2016.
41. House of Representatives, session 2015–2016, 33 957, no. 24.
42. *Supervisory Arrangement regarding the supervisors of the financial markets*, House of Representatives, session 2013–2014, 32 648, no. 5.
43. Source: DNB ZBO budget and accounts 2011–2016.
44. DNB, ZBO budget 2017, p. 23, and ZBO accounts 2016, p. 17. In the years in which the costs and FTEs were not specified by supervision of banks, they were specified by task and not by sector.
45. Panel meeting report, DNB ZBO accounts, 18 April 2016, advisory report 81.
46. The text initially adopted by the Court of Audit was revised in response to new information received during the clearance procedure.
47. DNB results of bottom-up analysis of the capacity for banking supervision, 9 July 2015.
48. House of Representatives, session 2015–2016, 33 957, no. 24, p. 2.

49. House of Representatives, session 2016–2017, 33 957, no. 26.
50. External staff were also temporarily hired for this task. The comprehensive assessment in 2014 cost €45.9 million in total. These costs were recharged to the Dutch banks involved.
51. The annual assessment of the solidity of each bank was then limited to an update of the previous analysis and the resultant prudential requirements rather than a comprehensive assessment. DNB ZBO accounts 2014, p. 50.
52. DNB annual report 2015, pp. 122–123.
53. DNB ZBO budget 2016, p. 40.
54. The text initially adopted by the Court of Audit was revised in response to new information received during the clearance procedure.
55. This is the DNB-wide strategy with the long-term ambitions DNB set in 2012, DNB annual report 2012, p. 95.
56. *Supervisory Arrangement regarding the supervisors of the financial markets*, House of Representatives, session 2013–2014, 32 648, no. 5, p. 75.
57. The external auditor refers in this regard to p. 131 of DNB's annual report for 2015.
58. DNB Internal Audit Charter of 12 February 2015. For an explanation of the three lines of defence model, see *The three lines of defence in effective risk management and control* (IIA position paper), the Institute of Internal Auditors, January 2013.
59. DNB Internal Audit Charter of 12 February 2015.
60. DNB Supervisory Strategy 2010–2014, p. 24.
61. The Basel Committee is part of the Bank of International Settlements (BIS). It has no supranational powers and its standards and recommendations have no legal power. Proposals made by the Basel Committee are nevertheless afforded a great deal of weight and are usually adopted and implemented in the regulations of about 160 countries worldwide.
62. In the Capital Requirements Directive IV and Capital Requirements Regulation (CRD IV/CRR).
63. Basel I recognised several types of asset, each with its own standard risk weighting. The total is the RWA.
64. Pillar 1 includes the Basel I capital requirements, which allow the banks to calculate the capital requirements for credit, market and operating risks on the basis of standard risk weights but, under certain conditions, on the basis of their own internal models. In addition to pillar 1, add-on capital requirements are imposed in pillar 2 where necessary. The level of the add-ons depends on the supervisor's opinion on the bank's exposure to risks that are not adequately covered by the pillar 1 capital requirement.

There is also a third pillar, which is concerned with the requirements for the publication of information by banks and supervisors.

65. See the letter from the Minister of Finance to the President of the Senate of 16 February 2016, Summary of the various capital requirements, pp. 4-5.
66. Basel III recognises three types of capital, in descending order of quality: CET1, AT1 and T2. *Common Equity Tier 1 (CET1)*: chiefly share capital, reserves and retained earnings. *Additional Tier 1 (AT1)*: consisting largely of perpetual debt instruments. *Tier 2 (T2) capital instruments*: usually subordinated debt instruments with a minimum maturity of five years. For further information see the letter from the Minister of Finance to the Senate of 16 February 2016.
67. Certain additional capital buffers also have to be held. See letter from the Minister of Finance to the House of Representatives of 16 February 2016, pp. 6–8.
68. The other liquidity ratio, ‘Net stable funding ratio’ (NSFR), is not considered here as it does not need to be introduced until 2018.
69. The grace period assessment relates to historical outflow figures. The stress test carried out for the survival period is based on pre-set risk factors.
70. The Basel Committee has said that national supervisors must have discretion to allow banks to let the LCR fall below 100% in times of crisis.
71. Article 38 (1) of delegated Regulation (EU) 2015/61 of the Commission of 10 October 2014: The LCR must be at least: a) 60% of the liquidity coverage requirement as from 1 October 2015; b) 70% as from 1 January 2016; c) 80% as from 1 January 2017; d) 100% as from 1 January 2018.
72. EBA 2014: Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP), EBA/GL/2014/13, 19 December 2014. Guidelines are not legal rules and need not be applied but DNB has stated in its Policy Rule on the application of guidelines for European supervisory authorities WFT 2016 that it would observe the guidelines (including the SREP).
73. The guide is designed in part to explain to banks, the general public and the media how the SSM works and to explain the supervisory practices of the SSM.
74. The principles are 1) application of best practices, 2) integrity and decentralisation, 3) consistency within the SSM, 4) agreement with the internal market, 5) independence and accountability, 6) risk-based approach, 7) proportionality, 8) appropriate levels of supervision for all credit institutions, 9) effectiveness and timely corrective measures. The principles of consistency and proportionality are relevant to this audit.
75. ECB (2016), SSM SREP Methodology Booklet, Frankfurt, December 2016.
76. A letter from Danielle Nouy of the SSM to Sven Giegold MEP of 2 October 2015 (The

principle of proportionality: application in the SSM) reveals that the ECB classifies medium-sized and small banks as high, medium and low priority. The ECB uses this classification to realise the principle of proportionality for supervisory tasks, including the development of supervisory policy and standards for these banks, or in relation to the reports of national competent authorities regarding their supervision of medium-sized and small banks.

77. As stated in the ECB SREP methodology: credit, market, operating, IRRBB (Interest rate risk in banking book), short-term liquidity, funding sustainability and business model.
78. The supervisor can lower the automated score by 1 notch, i.e. a high (poor) score of 4, for example, can be adjusted to 3, or raise the score by 1 or 2 notches, so a good score of 1 can be adjusted to a poorer score of 2 or 3. As a rule, departures from this are not allowed. See ECB (2016), SSM SREP Methodology Booklet, slide 16.
79. These are qualitative scores on risk management in each risk area. The scores are derived from questionnaires completed by the supervisor.
80. The way in which these scores are calculated and how they are aggregated into an overall risk score for the risk area in question for medium-sized and small banks, and then aggregated into a total score, is laid down in the SSM supervisory manual. We had no access to relevant parts of the manual and cannot form an opinion on whether the calculations were made correctly.
81. Outliers are observations that depart in some way from the general pattern of a dataset.
82. This text on p. 40 and two comparable sentences on p. 41 was revised in response to new information received from DNB during the clearance procedure.
83. We think the supervision is intensive if more work is carried out than is to be expected under the guidelines. The supervision is strict if the requirements imposed are higher than those agreed internationally and in the EU.
84. DNB has said it does not use the discretionary EBA supervision categories or the EBA guidelines on SREP intensity per supervisory category. DNB uses the SSM categorisation of medium-sized and small banks and its own categorisation from the period before the SSM. As we had no access to the SSM manual, we were unable to determine what it says about medium-sized and small banks. We would also note that the ECB indicates that it follows the EBA guidelines on the SREP. See ECB (2016): SSM SREP Methodology Booklet, slide 2. Furthermore, EBA (2014), Appendix 1, states that DNB will apply the EBA guidelines.
85. Our opinion is restricted by the limited information on this matter in the panel packs. This might be connected to the new LCR rules introduced in 2015.

86. ECB (2016), SSM SREP Methodology Booklet, Frankfurt, December 2016.
87. DNB (2016), Letter to LSIs: SREP 2017, Amsterdam, 2012-2016. The P2G is partly based on EBA stress tests carried out in 2016. See <https://www.eba.europa.eu/-/eba-clarifies-use-of-2016-eu-wide-stress-test-results-in-the-srep-process>.
88. FICO stands for Financial Conglomerate. These are groups that have acquired one or more banks and one or more insurers.
89. DNB has applied this FICO add-on since 2010. The structure, benchmarking and explanation of this add-on has improved since 2015.
90. The text initially adopted by the Court of Audit was revised in response to new information received from DNB during the clearance procedure.
91. The EBA states: 'if Competent Authorities (CAs) identify capital shortfalls leading to potential breaches of applicable own funds requirements revealed by the stress tests, they can employ the capital guidance to address their concerns'. Source: <https://www.eba.europa.eu/-/eba-clarifies-use-of-2016-eu-wide-stress-test-results-in-the-srep-process>.
92. <https://www.bankingsupervision.europa.eu/press/pr/date/2016/html/sr161215.en.html>.
93. Scope Ratings AG (2016), Spanish Banks' Capital Regime: More Clarity Entering 2016, London, January 2016.
94. ACPR Banque de France (2016), Major French banks: results, solvency, liquidity. Banking regulation, some challenges, London, 9 March 2016.
95. Owing to the confidential and price sensitive nature of this information, we do not disclose details in this report.
96. We found that the automated score for operating risks had nearly always been adjusted in both 2015 and 2016. In 2016, this score had been lowered by two notches in eight cases (thus improved on qualitative grounds). We found such an adjustment in two cases of credit risk. For 2015, we found four adjustments for operating risk and one for credit risk. According to DNB the scores could be adjusted by more notches during the 'test phase' than the ECB prescribed. We would note that DNB has been using the model since 2014 and in our opinion the test phase ended a long time ago.
97. The ICAAP assessment was developed in Cluster A of the Medium-Sized Banks Department in 2015 but was not a standard requirement within DNB at the time.
98. We studied reports of panel meetings in 2015 and 2016, reviewed the information that the participants in the panel meetings studied, talked to those involved and attended a panel meeting in December 2016.
99. DNB gave the Court of Audit no independent access to the digital filing system.

100. House of Representatives, session 2013–2014, appendix to 32 648, no. 5, p. 4.
101. House of Representatives, session 2011–2012, appendix to 32 648, no. 1.
102. See the six principles of the Framework-setting Supervision Strategy (KVOT), published in October 2005: selective, effective, cooperative, independent, transparent and professional, House of Representatives, session 2004–2005, appendix to parliamentary paper 27831, no. 15.
103. House of Representatives, session 2013–2014, appendix to parliamentary paper 32 648, no. 5.
104. Appendix 2 of the Supervisory Arrangement lists the laws and regulations governing various processes at both the supervisor and the ministry.
105. And the Minister of Social Affairs and Employment (SZW) regarding the supervision of pension funds.
106. Ministry of Finance, Insight into DNB's Budget, consultation paper, 10 May 2016.
107. House of Representatives, session 2013/2014, 33 957, no. 6.
108. Proceedings II, 2014–2015, no. 8, item 7.
109. The text initially adopted by the Court of Audit was revised in response to new information received from DNB during the clearance procedure.
110. House of Representatives, session 2013–2014, appendix to parliamentary paper 32 648, no. 5, p. 18.
111. The Annual Report IX, Ministry of Finance and National Debt 2016 describes DNB's supervisory activities on pages 165–169; the section on banking supervision can be found on page 166.
112. The previous report dates from 2010: House of Representatives, session 2009–2010, appendix to parliamentary paper 32466, no. 1.
113. House of Representatives, session 2016–2017, appendix to parliamentary paper
114. 25 268, no. 143, p. 56.
115. For the structure of the policy review, see House of Representatives, session 2015–2016, 31 935, no. 31. Under the Regulation on Periodic Evaluations every budget article should be reviewed at least once every seven years. The most recent policy review of article 2 was in 2007–2008.
116. Netherlands Court of Audit 2011, DNB's Supervision of Bank Stability, House of Representatives, session 2011–2012. 32 255, no. 12.
117. The audit committee would then decide whether the supervision had been appropriate with regard to the ministry's final responsibility for it. Any risks or shortcomings detected would be reported to the Secretary-General for a decision. Letter from the Minister of Finance on the Court of Audit's draft report, DNB's

Supervision of Bank Stability, 23 September 2011.

118. Ministry of Finance, Financial Markets Department, Ministry of Finance's Responsibility for Remote Financial Supervision, May 2015. According to the Ministry of Finance, a report was not issued in 2016 on account of the publication of the ZBO report.
119. House of Representatives, session 2010–2011, appendix to parliamentary paper 32 648, no. 1.
120. Five-year assessment report of the Minister of Finance on the efficiency and effectiveness of De Nederlandsche Bank's performance as an autonomous administrative authority, House of Representatives, session 2016–2017, appendix to parliamentary paper 25 268, no. 143, p. 17.
121. See Section 1:90 (5) Financial Supervision Act and the Minister of Finance's answer to a written question in March 2015. House of Representatives, session 2014–2015, 21 501-07, no. 1246, p. 9.
122. Five-year assessment report of the Minister of Finance on the efficiency and effectiveness of De Nederlandsche Bank's performance as an autonomous administrative authority, House of Representatives, session 2016–2017, appendix to parliamentary paper 25 268, no. 143, p. 16.
123. Our translation of the Memorandum of Understanding, Agreements between De Nederlandsche Bank and the Ministry of Finance on the exchange of information and consultation on financial stability and crisis management, 12 April 2007.
124. According to the ministry these cases had policy implications.
125. Final Report, Parliamentary Inquiry Committee on the Financial System, April 2012, 31 980, nos. 60, 61.
126. Letter on the start of the European banking union and working agreements on interventions in the financial sector, House of Representatives, session 2014–2015, 21 501-07, no. 1241.
127. House of Representatives, session 2014–2015, 21 501-07, no. 1241.
128. House of Representatives, session 2015–2016, 34 208, no. 11, pp. 26 and 27.
129. Legislative consultation on an implementation act for the BRRD and SRM Regulation, House of Representatives, session 2015–2016, 34 208, no. 11, pp. 26 and 27.
130. Some supreme audit institutions do not have the power to audit banking supervision. This is undesirable with a view to the proper functioning of the system of checks and balances.
131. Letter from the Court of Audit to the President of the House of Representatives on this matter in 2014 and 2015, see [www.rekenkamer.nl](http://www.rekenkamer.nl)



132. See Contact Committee of the heads of supreme audit institutions and the European Court of Auditors (2015).
133. <http://www.eca.europa.eu/en/Pages/DocItem.aspx?did=39744>.
134. One exception is the external evaluation of DNB's Supervisory Board.
135. Fellow supreme audit institutions in the Banking Union Task Force have carried out comparable audits and encountered the same restrictions in their mandates. This will be considered further in our joint report to be published in December 2017.
136. As far as we are aware, DNB, as the only supervisor of *all* medium-sized and small banks, has been doing this since 2016.
137. For example internal governance of medium-sized and small banks and business model analysis.
138. The parameters for medium-sized and small banks are recalibrated during the pilot project and it must be clear what differences there are between the risk calculation methods for significant banks on the one hand and for medium-sized and small banks on the other.
139. The text initially adopted by the Court of Audit was revised in response to new information received during the clearance procedure.
140. If an institution is in serious difficulties, DNB prepares a protocol dossier in order to resolve the problems as quickly and as effectively as possible and also – with a view to the undesirability of the situation becoming known – to drastically reduce the number of people involved within DNB.
141. This is in accordance with the Minister of Finance's undertaking in the memorandum prepared in response to the amendment of the WFT of 29 November 2013.
142. These are relevant to this audit because in practice DNB applies the methodology developed by the ECB for the prudential supervision of significant banks almost in full in its supervision of medium-sized and small banks in the Netherlands.
143. <http://www.dnb.nl/statistiek/statistieken-dnb/financiele-instellingen/banken/gegevens-individuele-banken/index.jsp>.
144. The text initially adopted by the Court of Audit was revised in response to new information received from the Ministry of Finance during the clearance procedure.
145. Bank Act 1998, Explanatory Memorandum, House of Representatives, session 1997–1998, 25 719, no. 3.
146. DNB's website speaks of administrative appearance. Formally, however, Dutch administrative law is only applicable for the zbo-activities of DNB, not the central bank activities.
147. By email of 21 October, DNB explained this as follows: it is a confidential document



expressing the thoughts and opinions of Supervisory Board members on the understanding that the document would not be seen by third parties – in other words, the Supervisory Board discusses matters in confidence and wishes to respect that confidence.

148. <https://www.afm.nl/nl-nl/over-afm/werkzaamheden/nationale-samenwerking/dnb>, retrieved on 29 June 2016.

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