Strategy, conduct and improved risk management

DNB Supervisory themes 2011

De Nederlandsche Bank
Eurosysteem

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Preface

Supervision of strategy and conduct, anchoring of new supervisory frameworks, better risk management and a sharper focus on data quality and interpretation – these are the key elements of DNB's 2011 supervision programme. DNB is allocating a larger share of its capacity to thematic supervision. This is one of the ways in which DNB implements the supra-institutional approach to supervision announced in its Supervisory Strategy 2010–2014.

Although the aftershocks of the recent financial crisis continue to impact the supervision agenda, DNB is now gearing itself to the future. A stronger thematic focus on supervision will contribute to an early detection of problems so that they may be nipped in the bud. In order to reinforce this process and to involve firms at an early stage, the main themes for 2011 are communicated to the industry through seminars and other contacts with the sector. We hope to look back on 2011 as the year when the financial sector finally found the path upward to stability and the restoration of public confidence. DNB will put in its best efforts towards this goal.

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1 Introduction

The world over, real economies and financial markets are still recovering from the most severe financial crisis since World War II. Although firm strides have been taken, bringing structural improvements in the financial sector, considerable uncertainties remain. To name a few, there are concerns about the financial position of several European governments, the turbulence in the financial markets has not subsided and there are fears of a possible relapse upsetting the global economic recovery. And finally, long-term interest rates have fallen to historically low levels.

Apart from taking steps against acute supervisory challenges, DNB made an effort this past year to make the financial sector more resilient against shocks. In March 2010, the DNB Supervisory Strategy 2010–2014 was published, in which the main lessons from the crisis were translated into improvements in the supervisory framework and in DNB's supervisory approach. One overarching lesson is that apart from supervision of individual institutions there should be more emphasis on the macroprudential perspective. In August 2010, partly in order to implement the intended change in supervisory approach, DNB presented its action plan entitled *From Analysis to Action*. The presentation marked the launch of a more effective, more forceful supervisory approach. The energetic efforts made to realise the plan soon led to the first milestone, the creation of a new organisational unit tasked with coordinating supervisory interventions and actions.

The Supervisory Themes 2011 provide further substance to the frameworks outlined in the Supervisory Strategy. The themes showcase DNB's current supervisory priorities. The thematic approach is in line with the flexible allocation of supervisory capacity announced in the Strategy.

All projects identified for 2011 fit within at least one of the four cross-sectoral main themes: (1) supervision of strategy and conduct; (2) embedment of new supervisory frameworks; (3) improved risk management; and (4) stronger supervision through better data. These four themes are discussed below. Some of the themes – e.g. business models / strategy and conduct / culture – build on ongoing projects that we already initiated in 2010.

2 Supervision of strategy and conduct

One important lesson taught by the crisis is that supervision must be more forward-looking. Thus the Supervisory Strategy 2010–2014 announced that DNB will pay more attention to strategic and qualitative elements in its supervision. This is relevant because the experience of recent years has shown that the rate at which certain developments can mushroom into a crisis has increased considerably. More than in the past, supervision will therefore seek to detect and address possible sources of future problems at an early stage, that is, before they are translated into deteriorating solvency and liquidity ratios. Therefore DNB is to assess the business models / strategy and conduct / culture of financial institutions. Current sector-specific developments may affect the business model and conduct of individual firms.

2.1 Business models and strategy

Banks and insurers

How does an institution hold on to its customers? How does it position itself amid its competitors? Is its income model sustainable? The answers which financial institutions and their stakeholders (including e.g. Supervisory Board members) give to these questions can help to make supervision more forward-looking. This is why DNB is to assess banks' business models and strategies more intensively. Such an assessment will include among others an inventory of the asset side of a firm's balance sheet to identify possible large concentrations. The core issue, then, is where (that is, to what asset categories) deposits have been allocated. Also, the Dutch life insurance sector appears to suffer from overcapacity, partly owing to the introduction of tax-relieved saving plans with banks. In such market conditions, the risk arises that firms will offer loss-making products that may jeopardise the long-term viability of life insurers. This, in turn, justifies an appraisal of the economic profitability of life insurers' products and strategic plans. In concrete terms, this project aims to make insurers aware of the risks they run and to induce them to resolve any issues and to develop a business model that is sustainable in the long term.

Pension funds

In recent years the resilience of many pension funds has also proved wanting. DNB therefore focusses on the reinforcement of that resilience and improvement of pension fund directors' long-term perspective on financial risks. The presence of such a long-term perspective promotes the timely deployment of instruments to counter those risks. At the same time, it is important that members are made aware of the circumstances that may necessitate their pension fund to take emergency measures such as reducting their pension rights. DNB will, in 2011, pay special attention to the long-term sustainability of pension funds' financial structure and their emergency plans. At the same time, DNB will see that pension funds manage their chosen financial structure so as to ensure they can meet their liabilities in both good times and bad.

2.2 Conduct and culture

Expanded supervision of conduct and culture

The crisis was a severe reminder of the fact that conduct and culture aspects may seriously affect prudential and ethical requirements. An ethical culture is one where everyone's actions can be explained and accounted for. Conduct befitting such a culture involves abidance by both the spirit and the letter of the law. Corporate culture provides an indicator of certain types of risk within firms. DNB will carry out several thematic examinations regarding conduct and culture. The subjects covered will be the cultural elements of remuneration, board effectiveness, model behaviour and frankness. Remuneration and board effectiveness are briefly discussed below.

Remuneration

DNB will continue on its path of intensified supervision of financial institutions' remuneration policies. Such supervision has been encased in a supervisory rule in implementation of the *Capital Requirements Directive (CRD) III*, although it applies to insurers as well. Controlled remuneration policy is especially important for the prevention or control of prudential risks. During the run-up to the crisis, (certain types of) remuneration proved to convey perverse incentives. This applied both to upper management and to all those employees who could materially influence a firm's risk profile, such as securities traders. Eventually, this may lead to considerable (financial, but also reputation) risks. In 2011, therefore, DNB will supervise compliance with the implementation of the supervisory rule and with the principles for sound compensation practices of the Financial Stability Board (FSB). Finally, DNB's principles on compensation policies also extend to pension funds.

Board effectiveness

The effectiveness of a firm's Board (Management Board, MB, and Supervisory Board, SB) is the cornerstone of sound and controlled operational management. This is why DNB aims to enhance board effectiveness, identifying three channels by which this aim may be achieved. To begin with, independence of Supervisory Board members is an important component of an effective SB. An independent outlook requires expertise (knowledge, skills and professional conduct) and conditions safeguarding the balanced input of the individual SB members. In this context, DNB will be given the statutory duty to assess the expertise of prospective SB members. Secondly, an effective Board is one that is responsible, contributes towards the realisation of the organisation's objectives, takes the interests of all stakeholders into consideration and promotes the continuity of the organisation. Important elements in this respect are information provision and opinion formation. And third, effectiveness is also determined by the set-up of the Management and Supervisory Boards in terms of both their composition (diversity, independence) and their size. Where board effectiveness falls short, DNB will take action, ultimately in the shape of formal measures against firms that fail to implement (in time) the necessary changes.

3 New supervisory frameworks

3.1 Banks: Basel III

In late 2010, the G-20 gave its political approval to new proposals on bank regulation put forward by the Basel Committee: Basel III. The new framework aims to strengthen the resilience of the banking industry and of the financial system as a whole. It will be introduced in several phases so that individual institutions have time to 'grow into' the new framework and to limit any negative effects on the real economy. DNB will discuss with individual banks the specific course of their growth tract towards the final situation. This will be done in the context of the Supervisory Review and Evaluation Process (SREP), partly on the basis of banks' Internal Capital Adequacy Assessment Process (ICAAP) and Internal Liquidity Adequacy Assessment Process (ILAAP). The purpse of these processes is to assess the quality of banks' internal capital and liquidity planning. Despite the phased introduction, institutions already have to put in maximum effort to implement Basel III. Speed is an asset here: the market, including potential investors, will take this as a signal of strength.

Intensive focus on the new supervisory framework Basel III is called for. Yet the effort must not be allowed to interfere with the careful adherence to the current supervisory framework including recent improvements (as laid down in CRD II and CRD III). DNB monitors the adequate implementation of CRD II and CRD III alongside the preparations for Basel III.

On an international level, DNB will continue to promote the further development and implementation of supervisory instruments specially geared to systemically relevant institutions. Measures in respect of such institutions are needed to enhance overall financial stability and to rein in any moral hazard that might result from (implicit) government guarantees. Once even large financial institutions may fail in an orderly manner – that is, without jeopardising financial stability – such firms will be less likely to walk too close to the edge. Meanwhile, the G-20 has approved the supervisory framework for systemically relevant institutions as developed by the Financial Stability Board (FSB). This framework, aiming to reduce both the likelihood that a systemically relevant institution will fail and the impact if it does fail, rests on four pillars. Pillars 1 (intensified supervision) and 2 (enhanced power to absorb losses) aim to reduce the chance of failure. In order to limit the impact of a failure, national powers and instruments are to be implemented so that financial institutions may be resolved quickly and without systemic risks (Pillar 3). Finally, the infrastructure of financial markets is to be reinforced (Pillar 4) so that problems at one institution become less likely to spread to others. DNB heartily endorses the principles underlying this framework and will, from 2011, actively pursue this policy in respect of the relevant Dutch firms under its supervision.

Finally, DNB is also working for reinforcement at the European level of the Deposit Guarantee Scheme (DGS). A key change to the DGS would be a requirement on banks to pay the premiums up-front.

3.2 Insurers: Solvency II

The new supervisory framework for insurers named Solvency II will have to be finalised in 2011 by the European and national Parliaments. Given the diverging interests emerging in the negotiations on Solvency II, it is hard to predict in quantitative terms what the impact of the new framework on the Dutch insurance market will be. For now, however, the fifth Quantitative Impact Study (QIS5) currently under way is to provide insights into the impact of the proposals in their present form. The proposals are expected to be modified on the basis of the QIS5 outcomes. DNB closely monitors the impact not only of the current but also of the modified proposals. As a result, DNB will be aware at an early stage if the new supervisory framework looks like causing problems for Dutch insurers. The outcome of DNB's analyses will be translated into a plan of action for the finalisation of the implementation of Solvency II in the Netherlands.In addition, there will be dialogues with and steps concerning insurers that turn out to have difficulty meeting the Solvency II requirements.

Apart from a standard framework for the calculation of firms' Solvency Capital Requirement (SCR), Solvency II offers insurers the possibility to use an internal risk model to determine their SCR. The internal model must be prevalidated by the supervisor. The criteria for approval are not statistical but relate to how the model is organisationally embedded in the insurer's risk management. The validation assessment is a complex, time-consuming and intensive process. Therefore DNB has enabled insurers planning to use internal models to take part in a pre-application run. Participation is important for both insurers and their supervisor as an exercise in preparation for the formal application to use an internal model. The internal model pre-application exercise will be continued at the current pace in 2011.

Furthermore, DNB will direct more of its energy towards the substantive aspects of Solvency II's qualitative Second Pillar. The Second Pillar focusses on insurers' risk management and operational control. The outcome of the questionnaire on these issues which was circulated

in 2010 suggests that the sector as a whole must make serious efforts in order to prepare itself in good time. Insurers in particular might do more to ready themselves for Solvency II, including drafting a plan of action and a straightforward gap analysis charting outstanding issues. DNB will not accept insurers being tardy in starting preparations and will therefore pay extra attention to late starters in the context of operational supervision.
A questionnaire will be circulated to monitor insurers' progress in implementing the Second Pillar. In addition, there are plans for a pilot exercise involving a small selection of insurers, for the purpose of setting up an Own Risk and Solvency Assessment (ORSA). In order to offer practical support, DNB will hold two symposions in 2011 on the implementation of the Second Pillar of Solvency II. The first of these will focus on what needs to be done according to the supervisor and to insurers, while the second one, in late 2011, aims to share the findings from the questionnaire and the ORSA pilot with the industry.

3.3 Pension funds: Financial Assessment Framework

Evaluation of the Financial Assessment Framework (Financieel Toetsingskader or FTK) has revealed that the framework is inadequate to safeguard the target 97.5% level of certainty. By implication, the level of certainty promised to pension plan members does not match the certainty actually provided. Funds have experienced more frequent and more serious underfunding than had been anticipated. Supervision by DNB aims to ensure that promises to plan members are kept. In this context, the Ministry of Social Affairs and Employment (*Sociale zaken en werkgelegenheid* or SZW) and DNB are working together on a review of the regulatory capital calculation framework. Risk factors are being included that had not been covered by the assessment, and risk parameters are being reviewed. In addition, another framework is in the making regarding the use of partial internal models to improve appraisal of fund-specific risks.

Apart from the Financial Assessment Framework, a more general overhaul of the Dutch pension system is also being contemplated. Employers and employees have reached a pension accord which proposes two novel types of pension contract: the combo contract and a contract conferring 'soft' real rights. New contracts will affect the supervisory framework. An adequate framework based on market principles is required to protect the interests of current and future members. An important objective of such a framework is that it should prevent a gap from growing between members' expectations and what their pension fund is able to deliver. DNB will contribute to the development of a supervisory framework for new pension contracts, in close collaboration with the

Ministry of Social Affairs and Employment and the Netherlands Authority for the Financial Markets (AFM).

3.4 Stress tests

DNB hopes to strengthen its insight into the sector's long-term viability and to enable timely intervention by asking institutions to perform more and improved stress tests. This applies to banks, pension funds and insurers. The main objective is to provide the institutions themselves with a structured overview of the impact certain scenarios would have. It will be possible not only to evaluate certain financial market developments (such as the impact of low interest rates or the impact of developments in the real estate market on financial institutions), but also to quantify the impact of new regulatory measures. The outcomes of the stress tests will be highly useful to DNB as well, because they will reveal more specifically what institutions or what sectors are most sensitive to certain developments. This will lend extra speed and focus to DNB's supervision. Also, more extensive stress testing at banks will be in line with the wishes of the European Banking Authority (EBA) and the International Monetary Fund (IMF) to have an international perspective on how institutions are doing.

3.5 Crisis management tools

DNB will continue to make an active, substantive contribution to the intended expansion of the crisis management toolbox. Under the current legislative regime, when a bank or (non-life) insurer is in danger of collapse and nothing can be done to salvage it, no other formal option remains but to declare emergency regulations. In practice, emergency regulations act as the antechamber of bankruptcy, terminating the activities of a bank or insurer. In many cases, this is not the most desirable outcome, given the importance of financial stability, the continuation of financial services to private individuals (utility function) and the conservation of wealth. For this reason, the Ministry of Finance is currently preparing a bill providing for, among other things, expanded, or improved, transfer options: (a) deposits financed by the deposit guarantee system (b) other liabilities and assets and (c) shares of a problem bank or insurer. This puts the bill in alignment with the work of the European Commission on a European crisis management framework and the powers available under the special resolution regime recently introduced in Brittain. DNB is closely involved in the drafting of the bill, to ensure, among other things, that the resolution instrument is set up so as to be optimally workable for DNB in practice.

3.6 Macroprudential perspective

Another important lesson drawn from the credit crisis is that supervision of the financial system as a whole should be strengthened. Rather than to individual institutions, such macroprudential policy is primarily geared to developments that might compromise the stability of the entire system. As a combined central bank and supervisor, DNB is particularly well-placed to give shape to macroprudential policy. In the most recent period, DNB units worked intensively together to place these issues in a system-wide perspective. Building on this, DNB worked this past year to reinforce the macroprudential policy organisation. This work aimed to translate macroprudential risks into microprudential supervision. As a result, financial stability aspects are incorporated into supervision of individual institutions.

In the context of macroprudential policy, DNB issues its halfyearly Overview of Financial Stability (OFS) to make and keep policy-makers, institutions and the public aware of risks posed to the financial system. For financial institutions, the OFS provides useful risk management input, with policy recommendations wherever possible to mitigate risks. In its November 2010 OFS, DNB identified ongoing, if tentative, recovery of the financial system. Important risks are posed by the continuing financial market restlessness surrounding the sustainability of government finances and the low level of the long interest rate. In order to reinforce the system, strengthening the resilience of financial institutions will be the main objective for the coming years.

During the first half of 2011, DNB will pay additional attention to country risk from a macroprudential perspective, particularly against the backdrop of the current market turbulence. Another attention point will be the possible counterparty risk of holding synthetic Exchange Traded Funds. Here, efforts will be directed especially towards strengthening financial institutions' risk awareness. Finally, the events of recent years have shown that legal claims may have prudential implications and may even threaten the stability of the financial system as a whole. DNB will therefore explore ways to detect and chart legal claim risks at an early stage, in close cooperation with the AFM.

4 Improving risk management: quality and governance

4.1 Banks and insurers

The crisis has demonstrated that banks' risk management functions were unable to detect and anticipate prudential risks adequately. The central cause was found to be inadequate integration of the risk management function within the larger organisation. In addition, risk management also turned out ineffective in the face of the complex interplay of accumulating risks within the banking sector, excessive confidence in rating agencies and the asymmetry between accounting and supervisory standards. As a principal link in banks' risk identification, measurement and appraisal chain, risk management is an important point of engagement for supervisors.
In assessing a firm's risk management, DNB specifically looks at the set-up of the risk management function.
In principle, a firm's degree of risk aversion and the attendant trade-off between earnings and risk is a direct consequence of the firm's strategy and objectives.
Close surveillance is exercised to ensure that the chosen degree of risk aversion is translated into a clear management framework in the shape of stated policies and limits.

Insurers' risk management function will have to be improved as well. This also appears from a recent management circular issued by the Dutch Auditors' Professional Organisation (*Nederlandse Beroepsorganisatie van Accountants* or NBA). An underperforming risk management function cannot ensure controlled operational management. After all, risk management lies at the core of every insurance business. DNB urges the insurers concerned to improve the quality and governance of their risk management.

4.2 Pension funds

It would appear that many pension funds also lack an integrated risk management function of adequate standing. Earlier investment examinations by DNB already showed that some funds' control and monitoring rules are inadequately aligned with the complexity of their investment policies. DNB is to examine the quality of the risk management function of a number of pension funds in more detail during 2011. The outcome of this analysis will be discussed with the sector organisation and the pension funds concerned. The funds will be asked to implement necessary improvements.

Earlier examinations of pension funds' investment practices have shown that not all funds are able to control their financial risks or to produce adequate and independent asset and liability valuations. An inadequate control environment may cause underestimation of financial risks, unforeseen investment losses and insufficient buffers. In fact, these effects may be reinforced in the case of complex investments, because in many cases transparent market prices and/or valuation models for such products are lacking. DNB will this year examine the quality of pension funds' control environments as regards innovative investments. Pension funds found wanting will be asked to either address the insufficiencies in their control environment or phase out or mitigate uncontrolled risks. The overall results will be shared and discussed with the industry.

Also, DNB will zoom in on pension funds' outsourcing risk control in the context of asset management mandates. Many of the mandates issued to asset managers or fiduciary managers are too broadly formulated and leave service providers ample degrees of freedom in taking (active) risks. At the same time, many funds lack a countervailing power in the shape of independent and adequate risk management. As a result, there is a possibility that a fund's investment portfolio may contain more and/or different risks than had been contemplated, and that the fund's directors may be surprised by (negative) returns. In order to protect the interests of pension scheme members, directors will have to either reduce investors' freedoms or tighten their control measures.

5 Improved supervision through better data

5.1 Data quality

Banks are required to report on a quarterly basis on their solvency and operating results (through so-called COREP and FINREP reports). In assessing these reports, DNB relies to a major extent on the quality of the external auditor's work and on the quality of institutions' own control measures. In 2011, DNB will verify whether such reliance is (still) justified. Correct and timely information is of the essence for the adequate fulfilment of DNB's supervisor's mandate.

Through this assessment, DNB explicitly aims to form an adequate image of the reliability of reported figures and of the capital ratios based thereon. At the same time, the assessment will provide an insight into the operation of (part of) the control measures applying in the finance and risk functions of the institutions concerned.

Likewise, DNB will also focus on the quality of insurers' figures, in particular that the quality of technical reserves. These reserves are pivotal to the insurance business. The adequacy of technical reserves determines whether an insurer will be able to meet its anticipated future obligations. Insurers must perform adequacy assessments on at least a yearly basis. DNB appraises these assessments and discusses its findings with each insurer. The basic criterion in the appraisal is that the methods and assumptions used are in line with Solvency II principles. DNB will enter into a dialogue with auditors and actuaries in order to improve data quality at banks and insurers.

5.2 Behind the figures

Apart from its focus on data quality, DNB will also focus more on the information underlying the data. This is done in order to prevent supervisory arbitrage. Intragroup transactions of insurers, but also banks, for instance, may obscure the view of key data – for instance because they induce errors in the calculation of regulatory own funds or solvency at several entities within an insurance group, or because of double leverage. Also, some financial institutions developed products in the run-up to and during the crisis that appeared to transfer risks but were mainly intended to permit reduction of regulatory capital. While ostensibly these innovations lifted certain risks off firms' balance sheets, in practice they turned out to do so only insufficiently. The risk in such supervisory arbitrage – apart from that of direct losses in bad times – is that they undermine the effectivity of supervision. In 2011, DNB expects to acquire a better understanding of intragroup positions and transactions. Also, the results will be shared with the institutions concerned and where necessary, they will be asked to phase out certain positions and/or to make certain relationships more transparent.

6 Conclusion

The 2011 supervisory priorities as set out in this brochure were put together in December 2010. However, the financial sector continues to be characterised by considerable uncertainties. Especially in times like these, unforeseen developments cannot be ruled out. If the need arises, DNB will introduce new accents in its work programme in the course of 2011.

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