July 2011
IMF Country Report No. 11/208

# Kingdom of the Netherlands-Netherlands: Publication of Financial Sector Assessment Program Documentation—Technical Note on Financial Sector Supervision: The Twin Peaks Model

This Technical Note on Kingdom of the Netherlands-Netherlands was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on June 27, 2011. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of Kingdom of the Netherlands-Netherlands or the Executive Board of the IMF.

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FINANCIAL SECTOR ASSESSMENT PROGRAM UPDATE

# KINGDOM OF THE NETHERLANDS-NETHERLANDS

FINANCIAL SECTOR SUPERVISION: THE TWIN PEAKS MODEL

# TECHNICAL NOTE

JUNE 2011

INTERNATIONAL MONETARY FUND
MONETARY AND CAPITAL MARKETS DEPARTMENT

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## GLOSSARY

| | |
|---|---|
| AFM | The Authority for Financial Markets (Autoriteit Financiële Markten) |
| AFS | Act for Financial Supervision (Wet op het Financieel Toezicht) |
| APRA | Australia Prudential Regulation Authority |
| DNB | Netherlands Central Bank (De Nederlandsche Bank) |
| ECB | European Central Bank |
| ELA | Emergency Liquidity Assistance |
| EU | European Union |
| FSB | Financial Stability Board |
| FSD | Financial Stability Division of DNB |
| LCFIs | Large Complex Financial Institutions |
| LFS | Law on Financial Supervision (Wet Financieel Toezicht) |
| LTV | Loan-to-value ratio |
| MoF | Ministry of Finance |
| PVK | Pensions and Insurance Supervisor |
| RFT | Council of Financial Supervisors |
| SVE | Securities Supervisor |

## Executive Summary[1]

**The Dutch "twin peaks" model of supervision, with the Netherlands Central Bank (DNB) as prudential supervisor of all financial institutions and the Authority for Financial Markets (AFM) responsible for conduct-of-business supervision, was introduced in 2002.** The full transition to the "twin peaks" was completed in 2007, with the introduction of the Act for Financial Supervision (AFS). The Dutch "twin peaks" model has been adopted for implementation, in whole or in part, in many countries, reflecting increasing dominance of large and complex financial institutions (LCFIs) and interconnectedness of their activities and the need to enhance macro-prudential supervision with its focus on systemic risks.

**Although the global financial crisis has seriously affected the Dutch financial sector, the case for the "twin peaks" model remains strong for the Netherlands.** The crisis has severely affected the Dutch financial institutions, resulting in extraordinary official support that was, as a share of GDP, among the highest in the world. Nonetheless, the crisis has demonstrated that with both micro and macro prudential supervision consolidated within DNB, it was able to take a systemic view across the financial sector and act quickly and decisively during the crisis.

**The integration of prudential supervision with the central bank enables the supervisory function to draw on the long standing credibility of the central bank as it ventures into new and highly challenging areas**, most particularly that of the identification, development, adoption and enforcement of macroprudential indicators. At a time when there needs to be public acceptance of good conduct-of-business practices, and a history of aberrations from such practices, the existence of an experienced and credible separate agency specifically for this purpose, can make an important contribution to restoring the credibility and standing of the financial institutions, enabling them once again to make their proper contribution to economic growth in the Netherlands.

[1] This Technical Note has been prepared by Jianping Zhou (Monetary and Capital Markets Department).

## I. BACKGROUND[2]

1. **In 2002 the Dutch authorities adopted an objective-based "twin peaks" supervisory model.** Under this model, DNB became a single prudential supervisor for all financial institutions (banks, insurance companies, investment firms, pension funds, and securities firms), and an AFM was created as supervisor responsible for conduct-of-business supervision including supervision of security market activities, with a strong focus on market behavior and consumer/investor protection.

2. **The "twin peaks" model replaced the sector-based supervision model with multiple supervisors,** which included a banking supervisor (DNB), a pension and insurance supervisor (PVK), and a securities supervisor (STE) carrying out conduct-of-business supervision related to security market activities. The coordination of micro-prudential and conduct-of-business supervision between the sector-based supervisory agencies was conducted by the Council of Financial Supervisors (RFT), which was set up in 1999 specifically for this purpose. With the introduction of "twin peaks," a "covenant" between DNB, PVK and the AFM was established to facilitate a smooth transition toward the objective-based supervisory framework. The full transition was completed in 2007—shortly before the country was hit by the global financial crisis—with the introduction of the AFS and the Pension Act.

3. **The design of the "twin peaks" model was based on several considerations.** In particular,[3]

- The preference for a unified prudential supervisor was driven by changes in the Dutch financial industry structure. Following the global trend, the Dutch financial system had become dominated by a few very large financial conglomerates operating across bank/insurance/pension lines, and offering increasingly complex financial products that blurred the conventional credit/insurance/securities boundaries (e.g., credit swaps and investment/linked insurance policies). The decision to bring the prudential supervision of banks, securities, pension funds, and insurance companies therefore responded to the regulatory challenge posed by large financial conglomerates. This approach also has the benefit of minimizing regulatory arbitrage. Even before the

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[2] Financial Sector Assessment Program Technical Note: The Netherlands Model of Financial sector Supervision.

[3] J. Kremers, D. Schoenmaker, and P. Wierts, 2003, Financial Supervision in Europe.

recent financial crisis, the number of unified supervisory agencies worldwide had increased rapidly (see Table 1).[4]

**Table 1. The Netherlands: Selected Examples of Objective-Based Supervisions**

| | Before Recent Crisis | After Recent Crisis |
|---|---|---|
| Integrated prudential and conduct-of-business supervision (One Peak) | Austria (2002), Belgium (2004), Germany (2002), Switzerland, Sweden, U.K. (FSA), Hungary (2000), Poland (2006), Japan, Korea, Singapore, Colombia, Nicaragua | Finland (2009), Germany, Switzerland, Sweden, Hungary, Poland, Japan, Korea, Singapore, Colombia, Nicaragua |
| Separated prudential and conduct-of-business supervision (Twin-Peaks) | Australia (1998),<br><br>Netherlands (2002) | Belgium (2011), Italy (planned), Spain (planned), France (planned), U.K. (planned), U.S.* (with multiple prudential supervisors), Australia (1998), Netherlands (2002) |
| Unified prudential supervision integrated with central bank | Netherlands, Hongkong, Singapore, Switzerland | Belgium (2011), Italy (planned), Spain (planned), France (planned), U.K. (planned), Netherlands, Hongkong, Singapore, Switzerland |
| Unified prudential supervision outside central bank | Australia, Belgium, U.K. (FSA), Japan, Hungary, Germany | Australia, Japan, Canada, Hungary |

- The preference for objective-based supervision led to the separation of prudential and conduct-of-business supervision under different agencies, or "twin peaks." Another approach to the challenges posed by financial conglomerates would have been the creation of a single regulator for both prudential and conduct-of-business supervision, justified by synergies between them.[5] The Financial Services Authority (FSA) in the

[4] See Donato Masciandaro and Marc Quintyn, 2010, "Regulating the Regulators: The Changing Face of Financial Supervision Architectures Before and After the Crisis," (Draft).

[5] See Clive Briault, "The Rationale for A Single National Financial Services Regulator," U.K. Financial Services Authority, Occasional Paper No. 2, 1999.

United Kingdom is one example, although it will soon be replaced by a "twin peaks" structure. But the view of the Dutch authorities (and supporters of "twin peaks") was that the objective of prudential supervision, which is safeguarding financial stability, is very different from that of conduct-of-business, which is protecting consumers. The arguments are (a) prudential and conduct-of-business supervisions simply do not mix, despite synergies between them, because they require different skill sets and different tools to achieve their individual objective; and (b) in normal times, consumer protection is likely to have more political attention than prudential supervision, possibly diverting resources away from prudential supervision.[6]

- The decision to locate the unified prudential supervisor within DNB was based on several factors. There are synergies between prudential and monetary policy aspects, and macroeconomic stability and financial stability are closely linked. It was expected that prudential supervisors could benefit from the central bank's macroeconomic analysis, as well as from the central bank's long standing credibility. The long standing independence of the central bank could also be an asset during times when difficult decisions would have to be made. DNB's role was enhanced with new responsibilities at the time when monetary policies became the responsibility of the European Central bank (ECB). This was expected to limit the potential conflict of interest between monetary policy and financial stability objectives.[7]

4. **The consolidation of macro- and micro prudential supervision within the central bank is another feature that distinguishes the Dutch model from other variations of "twin peaks,"** such as the Australian model.[8] With the consolidation, macro-prudential surveillance (to ensure financial stability) becomes closely linked to (micro-prudential surveillance (to ensure the financial soundness of individual financial institution). It has become evident during the recent crisis that, with all prudential oversight located in DNB, it is able to take a view of systemic issues across the financial sector as a whole, and react quickly and decisively in a crisis.

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[6] See Michael Taylor, "The Road from "Twin Peaks" and the Way Back" (mimeo), Central Bank of Bahrain, 2010.

[7] The concern was that central bank lending (as lender-of-last resort) to troubled banks would increase the net inflow of reserves to the banking system and thus undermine the monetary policy objective.

[8] Australia introduced what may be regarded as the first "twin peaks" model in 1998, when its central bank retained its longstanding mandate of maintaining financial stability, and the responsibility of micro-prudential supervision was transferred to an integrated supervisor, the Australian Prudential Regulation Authority (APRA), located outside the central bank. Close coordination between the central bank and the APRA is an important component of the "twin peaks" model of Australia.

## II. TWIN PEAKS MODEL IN PRACTICE

5. **The AFS, which came into force on January 1, 2007, provides the legal framework for the supervisory authorities under the twin peaks.** The AFS is supplemented by various Royal and Ministerial Decrees. Under this law, DNB is vested with the power to issue rules and policy guidelines that mainly concern the interpretation of the law. The structure introduced by the AFS does, however, provide for a larger role for the Ministry of Finance (MoF) than in most comparable systems. For example, both DNB and the AFM have relatively limited rule-making authority of their own, since most regulation is either directly contained in the AFS itself or in Decrees that are the responsibility of the MoF.

6. **The establishment of a "Covenant" between DNB and the AFM has facilitated the implementation of the AFS.** The "Covenant" set out a practical framework for division of responsibility and cooperation between them, which includes: (1) the designation of DNB as the lead agency with overall responsibilities for supervision (including licensing) for all financial institutions, and the designation of the AFM as the lead agency for securities firms; (2) an agreement that the lead supervisor would defer to the judgment of other supervisor; and (3) rules for consultation and information sharing.[9]

7. **Consequently, the clarity of mandates and objectives for the supervisory authorities has been improved substantially**. With an exception of a few isolated incidents, both DNB and the AFM appear to have a clear understanding of their respective roles and responsibilities under the "twin peaks" model, and in general cooperation and coordination between the two agencies seem to have functioned well in practice, including during the period of greatest financial stress during the crisis.

8. **The supervision of conduct-of-business, especially related to the securities markets, has been strengthened.** In recent years, the AFM has put considerable emphasis on improving the aspects of supervision related to consumer protection and transparency, using a risk-based approach for onsite supervision, complemented with institution-based on-site and off-site supervision for high-impact firms. The AFM's conduct-of-business supervision has been complemented by DNB's prudential supervision. For example, DNB has implemented a program for the supervision of investment firms in cooperation with the AFM, in which most supervisory resources are spent in the investment firms that conduct "risky activities," such as proprietary trading. Such firms are subject to on site inspections by DNB on an annual cycle, while the remaining firms are visited under a three year cycle.

[9] AFM and DNB Covenant , September 2010.

## III. Twin Peaks Model During the Crisis

9. **The "twin peaks" model worked well during the crisis, as decisions were able to be made in timely manner to contain the banking crisis, in part because of laws permitting information sharing.** The laws allowed for information sharing in the context of crisis management, both between DNB and the AFM, and between DNB and the MoF. The pre-crisis institutional setup also helped. The MoF and DNB have codified their roles regarding crisis management in a well-designed MoU, which gives the MoF the ultimate responsibility for financial stability and DNB the task to contribute to this objective, through actions falling under its jurisdiction. In addition, a coordination group on financial stability that used to meet 3–5 times a year began to meet weekly during the crisis, and it was quickly expanded to include representatives from DNB's markets, payments, and legal divisions. Based on this, a crisis management group was set up to include also representatives from the MoF and the AFM, and met daily. The coordination between DNB and the AFM also went smoothly based on specific arrangements under the AFS.

10. **Clear divisions of powers and responsibilities were instrumental in achieving effective coordination between key institutions during the crisis**:

- DNB was the lead authority for all bank resolution measures before any public solvency support was involved. It provided emergency liquidity assistance (ELA) to illiquid but solvent banks and imposed corrective measures to problematic banks. Moreover, DNB was responsible for changing the management of the failing banks and initiating bank restructuring.

- Whereas the AFM has no specific competences regarding crisis management and bank resolution, it contributes to the effectiveness of bank resolution by supporting discrete bank resolution measures while requiring transparency when and if necessary.

- The MoF (in charge of overall financial stability) was in the lead when it came to official solvency support for ABN-Amro, ING, and the other institutions.

11. **Nonetheless, the financial sector has been severely affected by the global financial crisis of 2007/08.** In addition, the credibility of DNB has been tested in view of some high profile bank failures. DSB Bank with a concentrated regional customer base, was closed in 2009. A government report looking into the failure of this bank criticized its handling by DNB. The failure of IceSave, an internet branch of an Icelandic bank with a substantial Dutch customer base led to difficult international negotiations. Conduct-of-business problems have negatively affected confidence in the integrity of the financial institutions, particularly in insurance. Extensive selling of products with high commission has reduced public confidence in insurance companies. With the settlement of the resulting claims likely to take many years, supervisors have taken proactive measures to ensure that financial institutions rebuild confidence in the industry, which remains an immediate priority.

12. **The crisis revealed certain areas within the "twin peaks" model that could be strengthened to realize the full benefits of the model going forward**. In part, these may have reflected a learning process as the transition to the model was completed only in 2007, but they also point to issues related to the supervisory approach, the scope of supervision, limited macro-prudential tools for reducing systemic risks, and weaknesses in supervision of financial institutions engaging in large cross-border businesses. More specifically,

- **Prior to the crisis, micro-supervision tended to rely on "moral suasion."** Although the AFS provides DNB with an extensive range of legal sanctions and powers to ensure compliance with laws and regulations, bank supervisors seem to have been reluctant to use enforcement powers to the full. This may reflect a traditional bank supervision culture as well as a learning process on the part of supervisors about the extent of their powers under the recently introduced AFS. As the crisis has shown, the supervision that has largely relied on moral suasion has become progressively less effective, as elsewhere, given the rapid changes in the Dutch banking system.

- **The crisis exposed areas for improvements in the prudential supervision for internationally active LCFIs,** such as Fortis and ING Group, especially with regard to their international business activities. Although the "twin peak" model was designed specifically in response to the emerging dominance of LCFIs, resources and supervisory instruments available for the supervision of LCFIs international activities are relatively limited, as is the case in many other countries.

- **DNB's legal authority over financial holding companies is constrained.** For mixed financial conglomerates, its power is limited to giving instructions, not imposing penalties, when the holding companies are judged as lacking inadequate risk management and internal control procedures. For insurance groups, there are explicit legal restrictions against DNB imposing broadly applicable limits on intra-group exposures. In addition, DNB has limited enforcement power against non-regulated holding companies. These problems prevail also in other European Union (EU) countries, and work is underway to issue new EU directives to deal with them.

## IV. Twin Peaks Model Going Forward

13. **DNB is taking decisive steps to achieve a more proactive and conclusive supervision.** These include the establishment of an enforcement department for corrective actions and sanctions and a major cultural change project ("VITA"), one component of which is to encourage supervisors to make more use of their formal powers and to bring supervisory tools more into line with supervisory best practice and ensure their more consistent application. Pension fund supervision appears to have been more pro-active in recent years; further integration of the staffs conducting supervision in the various sectors should enhance

the synergy potential of having a single prudential supervisor, and should help foster the incorporation of the new supervisory culture.

14. **The crisis underlines the importance of macro-prudential regulation and supervision.** The "twin peaks" model has the potential benefit of fully integrating macro- and micro-prudential supervisions. The AFS explicitly assigns to DNB the responsibility to safeguard the stability of the financial system. Within DNB, the Financial Stability Division (FSD) is primarily responsible for this task. However, macro-prudential analysis would need to be fully fed into policy changes and prudential surveillance. In the run up to the crisis, comprehensive analytical work conducted by the FSD was able to detect emerging systemic risks, but it had not been fully translated into surveillance work, in part because of the lack of sufficient macro-prudential tools.[10] In response, a separate Department for macro-prudential supervision was created within this Division in 2010 to further improve the monitoring of macro-prudential risks.

15. **For DNB to act more promptly to any emerging systemic risks and mitigate boom-and-bust cycles, it would need to expand its macro-prudential policy instruments**. In line with the Financial Stability Board (FSB) framework, the proposals under discussion include a resolution framework for going-concern banks, higher capital requirements, countercyclical buffers, and the use of contingent capital and bail-in instruments. In this context, there is a case for greater DNB involvement in the rule-making process, or at least to have discretion to adjust the levels of the designated instruments, so that these macro-prudential instruments can be more responsive to market developments. Under the AFS, DNB (and the AFM) has relatively limited rule-making authority of its own, since most regulatory requirements are either directly contained in the AFS itself or in Decrees that are the responsibility of the MoF. For example, currently the MoF is responsible for setting the limits for mortgage loan-to-value (LTV) ratios. Given the important link between housing sector health and financial stability, the supervisors could be allowed to change the LTV ratio within a range set by the MoF, or to require more capital to be held against high LTV loans.[11]

16. **To avoid regulatory arbitrage, the perimeter of regulation will need to be extended to enhance the surveillance of shadow banking activities**. Stricter capital requirements and regulations for banks could invite off-balance-sheet regulatory arbitrage (e.g., loan securitization). Therefore, rigorous regulation and supervision should also apply to the shadow banking system and to cover off-balance sheet entities. DNB, as the single regulator and supervisor, is well positioned to closely monitor the activities of non-banks such as hedge funds and insurance companies, apply uniform regulations to prevent

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[10] For example, DNB's "Financial Stability Overview," March 2007.

[11] For example, DBN could be allowed to change LTV ratio to help mitigate boom-and-bust cycles.

regulatory arbitrage between banks and non-banks, and to coordinate closely with other regulators to minimize cross-border regulatory arbitrage.

17. **In recognition of the problem related to cross-border supervision, DNB has recently taken measures to enhance the functioning of supervisory colleges in line with the recommendations of the FSB.** For the large banks operating on a cross-border basis, a multilateral written agreement is signed between members of the respective colleges to provide for further formal arrangements for home and host supervisors. In the context of securities market, the AFM has been actively participating in the college of supervisors for Euronext N.V., and engaging other EU supervisors through the European Securities Market Authority. The "twin peaks" model thus seems well suited to the international aspects of supervision, with the central bank able to bring its wider international experience to handling cross-border issues, and the AFM able to bribng specialized conduct-of-business expertise to bear in its international relations. However, greater international cooperation (e.g., ex-ante burden-sharing agreements), beyond the colleges of supervisors, may be necessary.

18. **The "twin peaks" model provides scope to redeploy resources to the part of the financial sector that is judged most susceptible to systemic risk.** In that regard, the resources devoted to banking supervision require further attention. The frequency of visits to individual banks has been determined according to available resources and risk analysis. The relatively fewer resources devoted to banking supervision seems to have had an influence on the extent of DNB's pre-crisis oversight of the activities of the overseas subsidiaries of some large Dutch banks. The extent of their activities would have justified a greater commitment of resources to their monitoring than was actually the case. The allocation of supervisory resources thus needs to be evaluated according to the potential systemic impact of regulated firms.

19. **Growing awareness that problems concerning conduct-of-business supervision can rapidly develop into a prudential problem highlights the importance of closer cooperation between DNB and the AFM.** The "Covenant" agreement (Article 1.5) set out general guidelines that the lead supervisor would defer to the opinions of other supervisor; but falls short in specifying a formal procedure for resolving differences in opinions. Such procedure should help avoid escalation of conflicts in public, which could harm the credibility of both institutions, as shown by a recent incident in which DNB and the AFM had opposite views concerning a fit-and-proper test result. In this case, the "Covenant" agreement should set out specific guidelines as whether such test should be passed by both DNB and the AFM.

## V. Conclusions and Recommendations

20. **The global financial crisis has tested the effectiveness of supervision under the "twin peaks" model.** The crisis has severely affected the Dutch financial institutions, resulting in extraordinary official support. The crisis revealed the strengths of the "twin

peaks" model, as decisions were able to be made in timely manner to contain the crisis and clear divisions of powers and responsibilities were instrumental in ensuring effective coordination between key agencies. However, the crisis also exposed certain areas where improvements could strengthen the "twin peaks" framework going forward.

21. **The supervisory authorities are making intensive and well-focused efforts to strengthen the supervisory framework.** More specifically, DNB has issued two comprehensive studies "DNB Supervisory Strategy 2010–2014" and "From Analysis to Action" that set out concrete steps which can lead to a more pro-active and conclusive financial supervision (Box 1).

**Box 1. The Netherlands: Strengthening Prudential Supervision Under the "Twin Peaks" Supervisory Framework: Reforms and Actions**

- Created an enforcement department for corrective actions and sanctions, to reduce reliance on moral suasion.
- Introduced a major cultural change project ("VITA"), one component of which is to encourage supervisors to make more use of their formal powers and to bring supervisory tools more into line with supervisory best practice and to ensure their more consistent applications.
- Expanded the department for macro-prudential supervision to further improve the monitoring of macro-prudential risks.
- Enhancing expertise in areas relating to investment and innovative financial products and specific knowledge in the fields of financial risks, fair value reporting, governance and strategy.
- Strengthening risk analysis and the current risk analysis tool (FIRM) to provide more scope for linking macro-prudential risks with the assessment of individual institutions.
- Promoting cooperation and knowledge sharing between different departments, by setting up knowledge networks.
- Intensifying group supervision for banks and insurance companies with large operations abroad, by establishing closer ties with host country supervisors. A day-to-day communication tool has been set up to enable to enable fast and safe sharing of supervisory information between supervisors.
- Supporting the move towards a consistent EU-wide supervisory framework.
- Strengthening quality of supervision through peer reviews and random auditing.

22. **Staff recommendations focus on measures to further strengthen the macro- and micro-prudential supervision and DNB/AFM coordination to reduce systemic risks**; the twin peaks model would look to be particularly suited to carry this agenda forward**:**

- Strengthening macro-prudential supervision, perhaps by introducing financial stability as an explicit mandate for DNB and by expanding the macro-prudential toolbox accordingly to enable DNB to take prompt actions against any emerging systemic risks without having to resort to legislative changes first.

- Intensifying supervision of LCFIs, with greater emphasis on group supervision and soundness of business models. Recent steps toward a more proactive and decisive approach—which includes timely on-site inspection and corrective actions that rely less on moral suasion—are welcome. Greater international cooperation, beyond the colleges of supervisors, to maintain sound institutions is also necessary.

- Further clarifying the division of responsibilities and cooperation between DNB and the AFM, through the enhancement of the existing "Covenant" and a formal procedure for resolving differences in views, thus avoiding escalation of conflicts which, as the shown by the recent experience, could harm the credibility of both institutions.