



# V

ANNUAL REPORT 2002



# FINANCIAL STABILITY

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## 5 FINANCIAL STABILITY

In the field of financial stability, the BCL reinforced its framework in 2002. This pertains, on the one hand, to the analysis of the financial sector from a macro-prudential point of view and, on the other hand, in accordance with the law, to the oversight of payment and securities settlement systems in which the BCL participates. This reinforcement extends the efforts undertaken within the ESCB, where the links between monetary and financial stability are well established.

### 5.1 Macro-prudential surveillance

#### 5.1.1 Regular monitoring activities

The macro-prudential surveillance of the financial sector is based on the regular reporting of credit institutions as well as on specific information complemented by direct contacts with market players. More specifically, the surveillance relies on a follow-up of the activities and results of the financial sector as a whole and of systemically important credit institutions in particular.

In order to monitor the soundness of the Luxembourg banking sector and to detect its potential vulnerabilities, the BCL has set up a system of macro-prudential indicators. The BCL has thus reinforced its macro-prudential surveillance; its efforts are embedded in those carried out at the international and especially at the European level in the prevention of systemic risk.

The BCL indicators cover Luxembourg law credit institutions, including their foreign branches. The indicators basically follow the so-called CAMELS approach. They highlight developments in the banking sector in the fields of capital adequacy, asset quality, management soundness, earnings, liquidity and sensitivity to market risk, and are complemented by indicators pertaining to competitive conditions. The assessment generally takes into account the simple average, the weighted average and the standard deviation of the respective indicators.

Two publications were made in relation to the indicators in 2002. The first text, published in BCL Bulletin 2002/2, provides a description of the methodology and the results for the years 1999 to 2001. The second text, published in December 2002 in BCL Bulletin 2002/4, comments the evolution of a sample of the more important indicators until September 2002. Further publications are planned on a regular basis.

The unfavourable international economic and financial environment in 2002 has affected the Luxembourg financial sector. Because of its high economic opening degree, it has been confronted to pressures that have affected its financial results. Thus, both the return on assets and the return on equity have decreased; the return on assets has fallen back to its 1999 level. Large exposures as well as the volume of credit outstanding have declined, both in nominal and in real terms. Exposures towards related entities have intensified. Nevertheless, Luxembourg banks are well capitalised and their liquidity ratio stands comfortably above the prudential threshold. Credit risk remains limited. Although the results do not lead to the conclusion of an apparent systemic risk, the evolution of some ratios and the uncertain economic and financial context call for heightened vigilance of the authorities. Market players have initiated measures aimed at structural adjustment and cost reduction.

Institutionalising cooperation with the supervisory authority, following the example of the other Monetary Union members, could strengthen work in the fields of financial stability, systemic risk and crisis prevention.

#### 5.1.2 Specific analyses and studies

In 2002, the BCL analysed the cyclicity of the Luxembourg banking sector from 1993 to 2001. The study highlights the interaction between the real economy, measured by the GDP growth rate, and various activity and performance variables of the banking sector. The results show a cyclical pattern for a large number of banking variables, in particular for credit activity, securities, provisions and own funds. A distinct relationship with the business cycle, however, is less pronounced for most of the revenues variables. These variables generally show a higher correlation with the national rather than with the

European economy. The result underlines the importance of the banking industry for the national economy.

The BCL has also contributed to the elaboration of several specific studies, notably within the framework of the Banking Supervision Committee of the ESCB. The BCL has continued its work regarding the geographical distribution of the activities of the major European banking groups and markets as well as the instruments for credit risk transfer.

The first study shows strong differences in the degree of “Europeanisation” as well as in the configuration of assets and the relative importance of assets held abroad. The main activities developed abroad relate to commercial banking and retail banking, but regional specialisations do exist, as for example in Luxembourg. Nearly all large European banking groups are active in the United States and in the United Kingdom. Overall, the banking groups are fairly evenly split in their preference for developing activities through branches or subsidiaries.

The second study observes the rapid recent emergence of a global credit risk transfer market, not only between banks themselves, but also between banks and other financial institutions like insurance companies and investment funds. This phenomenon is accompanied by the emergence of new financial instruments such as asset backed securities, collateralised debt obligations or credit default swaps. In General, these instruments can be distinguished according to the structure of their underlying credit (simple or portfolio) and to their fungibility. Credit risk transfer activities can increase market efficiency and allow for a better diversification and improved risk management. They are thus beneficial from a systemic stability point of view. Additional work concerning data availability, the changing relationships between creditors and debtors, imperfect contracts and the influential role of rating agencies in the evaluation of credit risk transfer products is deemed necessary. In Luxembourg, interviews conducted with a limited number of banks have revealed that they are principally buyers of investment grade credit risk transfer products. In light of the continuous growth and evolution of the market, a follow-up of these activities seems appropriate.

### 5.1.3 European cooperation

At the European level, the BCL contributes to the macro-prudential and structural analyses of the financial sector of the Banking Supervision Committee (BSC) of the ESCB. This committee produces, among others, a semi-annual stability report and an annual structural developments report on the EU financial sector. A Memorandum of Understanding between banking supervisors and central banks on co-operation in crisis situation has been endorsed by the Governing Council of the ECB. This document aims at contributing to an enhanced cooperation between the authorities, without prejudice to their actual competences. The practical arrangements for implementation in Luxembourg are not yet specified.

The analysis at the European level shows that credit conditions have tightened and that profitability has fallen back to its average of the 1995-99 period. The banks have, however, been resilient and remain well capitalised. Potential risk sources for the sector are namely:

- geopolitical risk;
- further decline of the stock markets;
- increased vulnerability of firms in the present economic context; and
- the possibility of an emerging markets crisis.

The structural analysis reveals in particular that European banks have developed alternative investment strategies. The advanced consolidation has eliminated some of the less efficient actors. The biggest banks are in a wait and see position concerning further domestic or cross-border consolidation. They are making resolute efforts to cut costs, restructure their organisation, concentrate on their core businesses and develop a multi-channel distribution for their products. Work on a new Basle capital accord has spurred improvements in risk management techniques. Possible procyclicality effects of the new accord are being discussed.

The BCL hosted the 17th meeting of the BSC on 15 April 2002. This committee is composed of representatives of NCBs, of supervisory authorities and of the ECB.



#### 5.1.4 International cooperation

The IMF published its first report on the stability of the Luxembourg financial sector within the framework of its Financial Sector Assessment Program (FSAP) in June 2002. The BCL has contributed to this IMF mission. The IMF concluded that the Luxembourg financial sector is sound, efficient and well supervised. According to its assessment, the principal source of vulnerability of the Luxembourg financial place resides in its outward openness and its sensitiveness towards reputational risk. The sector could suffer from the impact of shocks arising from interbank activities. The BCL intends to deepen its analysis in this field in 2003.

The BCL contributes on a best effort basis to the necessary strengthening of the international financial architecture.

## 5.2 Oversight of payment and securities settlement systems

### 5.2.1 General activities

The operators of the payment and securities settlement systems that have been notified by the BCL to the European Commission on 12 February 2001 are subject to the BCL's oversight. These operators are the following: RTGS-L Gie (LIPS-Gross), SYPAL Gie (LIPS-Net) and Clearstream Banking Luxembourg. Moreover, the following technical agents are currently subject to oversight: the BCL for LIPS-Gross, CETREL for LIPS-Net and Clearstream Services for operational and IT services.

The oversight is based on a system of regular and *ad-hoc* reportings being for instance general information, business statistics, financial reporting, reportings from units in charge of compliance, internal audit and risk management, as well as direct contacts with the operators. In addition, operators have been invited, in the context of a self-assessment exercise requested by the BCL oversight policy and procedures, to give a detailed assessment of their compliance with criteria related to access to the system, governance, products and services, IT, risk analysis and risk mitigation techniques, business continuity solutions, relations between operators / technical agents / participants / suppliers, the use of contracts and by-laws, the legal framework and standards of the industry and of capital market bodies.

Moreover, the modification in the shareholder structure of Clearstream and the projects of integration of Deutsche Börse Group required a specific follow-up and an analysis of potential consequences, in particular as regards new risks for the operator, the smooth functioning of the system and the impact on the oversight mission of the BCL.

Finally, the BCL defined LIPS-Net, the national net interbank payment system, as systemically important notably because of its importance in the Luxembourg economy.

In accordance with a principle pointed out in the "Core principles for systemically important payment systems" and a recommendation of the IMF, the BCL has put in place a strict separation of oversight and operational activities.

### 5.2.2 Specific analysis and studies

The BCL Bulletin 2002/2 presents the role of the BCL in the field of oversight of systems. This analysis describes the objectives and the legal framework of the oversight mission, as well as its detailed practice. Other subjects presented in the analysis are: the potential risks within payment and securities settlement systems, the main studies under way as regards oversight and the relations with other authorities and with the operators.

In addition, the BCL made a specific analysis of the risks run by payment and securities settlement systems, (nature and probability of materialisation) and of the mitigation techniques. This analysis also measures the impact of these risks on the oversight mission of central banks. Subsequently, it describes an oversight framework suitable for both payment and securities settlement systems, including the development of tools for the evaluation and mitigation of risks. The aim is to allow for a comprehension of existing and future risks, an evaluation of the availability and efficiency of the mitigation techniques currently used by the market, as well as a prompt reaction of the overseers in case of crisis. This study has been published on February 2003.

### 5.2.3 Protection of payment and securities settlement systems against crime and terrorism

The prevention of systemic risk is notably based on the compliance with the rules applicable in the field of money laundering, of financial sanctions and of fight against terrorism. In this context, the BCL issued, on 28 June 2002, the circular BCL 2002/172 "Protection of payment and securities settlement systems against crime and terrorism". The operators are required to report to the BCL the procedures put in place in order to comply with the legal framework. This circular also requests from the addressees to keep track (traçabilité) of the transactions performed by the systems. This means that operators have to enable, if necessary, the identification of the participants who introduce an order into the system and the participants who benefit from this transfer. Moreover, the addressees are required to call their participants attention to the need to fill up the messages used for the transfer orders completely and correctly.

### 5.2.4 European cooperation

Following a decision made by the ECB Governing council and the CESR (Committee of European Securities Regulators) in 2001, a working group, in which the BCL is a participant, has been put in place. The working group's objective is the development of standards for the activities of securities clearing and settlement. The work is based on the CPSS/IOSCO (Committee on Payment and Settlement Systems/International Organization of Securities Commission) recommendations in this field.

In the field of oversight, the BCL is also represented in the ESCB's Payment and Settlement Systems Committee (PSSC) and its subgroups. The objective of this committee is to assist the ESCB in the promotion of the smooth operation of payment systems, in particular by advising on the operation and maintenance of TARGET and of the CCBM (Correspondent Central Banking Model), on the general payment systems policy and oversight issues and on issues of interest for central banks in the field of securities clearing and settlement systems.

The ECB Governing council approved a general framework for the oversight of TARGET to ensure, among others, the respect of the Core Principles for Systemically Important Payment Systems. The decision has been taken of a separation of the oversight and operational functions within the PSSC, entrusting the oversight function to the Payment Systems Policy Working Group subgroup and recommending a separation within the central banks. An assessment of a potential conflict of interests between the operational and oversight functions of payment systems, operated both at the PSSC level, will be done within the next two years.

### 5.2.5 International cooperation

In the context of the FSAP, mentioned above (5.1.4), the IMF has welcomed the Bank's implementation of its oversight mission concerning payment and securities settlement systems. Moreover, the IMF pointed out the observance of various standards and codes approved by international organisations and the payment systems' efficiency and soundness.