



# 02

## THE BCL'S ACTIVITIES



## 2 THE BCL'S ACTIVITIES

### 2.1 MONETARY POLICY OPERATIONS

In the Grand-Duchy of Luxembourg, BCL is responsible for conducting the monetary policy as defined by the ECB, for the entire euro area.

The objective of monetary policy is to steer interest rates and to control the liquidity in the money markets. To achieve these goals, the Eurosystem uses instruments from three different categories:

#### *Open-market operations*

The refinancing operations conducted by the BCL (open market operations), consist of funds granted by the BCL against eligible collateral submitted by its counterparties, the financial institutions in Luxembourg.

Open market operations are split into:

- Main refinancing operations (MRO), carried out by the Eurosystem on a regular basis. MRO are realised through weekly tenders with a one-week maturity. Those operations play a leading role in steering interest rates (thanks to the minimum bid rate), in the management of banking liquidity and in signalling the trend of monetary policy.
- Longer-term refinancing operations (LTRO), carried out by the Eurosystem on a regular basis. LTRO are normally conducted through monthly tenders with a three-month maturity. Those operations aim at providing additional longer-term funding to the financial sector. They do not aim at giving signals about the orientation of the monetary policy.
- Fine tuning operations, executed by the Eurosystem on an *ad hoc* basis in order to counter temporary imbalances.

#### *Standing Facilities*

This instrument allows for the injection and withdrawal of liquidities on a day-to-day basis.

There are two types of standing facilities:

- The marginal lending facility: the counterparties benefit from a marginal lending facility at BCL, which they can use in the form of a current account overdraft (against a guarantee) until the following working day.
- The deposit facility: the counterparties benefit from the possibility to make overnight deposits with BCL at the end of the day.

### **Minimum reserves**

The financial institutions of the euro area are subject to a system of mandatory minimum reserves to be held on accounts opened at their national central bank (NCB).

Those reserves aim at stabilising money market interest rates, and at creating a structural liquidity deficit.

The amount of reserves to be held is determined according to the balance sheet of the financial institution.

### **Temporary currency auction facilities**

Besides the regular monetary policy operations, the Eurosystem added temporary currency tender operations. Since the end of 2007, financial institutions of the euro area have been experiencing a shortage of liquidities in dollars. To address this issue, the ECB set up a swap agreement with the Federal Reserve (US dollar term facility), through which the ECB, via the NCBs, provides dollars to counterparties through tender operations against eligible collateral. These agreements have been renewed in December 2010 at least until August 2011.

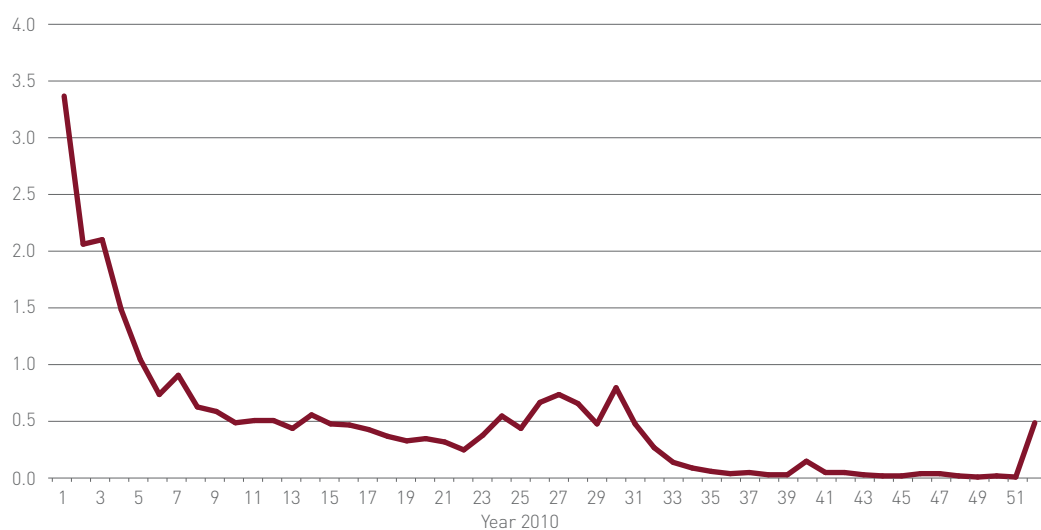
Similar operations set up with the Swiss National Bank in order to provide Swiss francs liquidities to financial institutions were suspended in January 2010.

## **2.1.1 Open market operations**

### **2.1.1.1 Main refinancing operations (MRO) in 2010**

Chart 2.1:

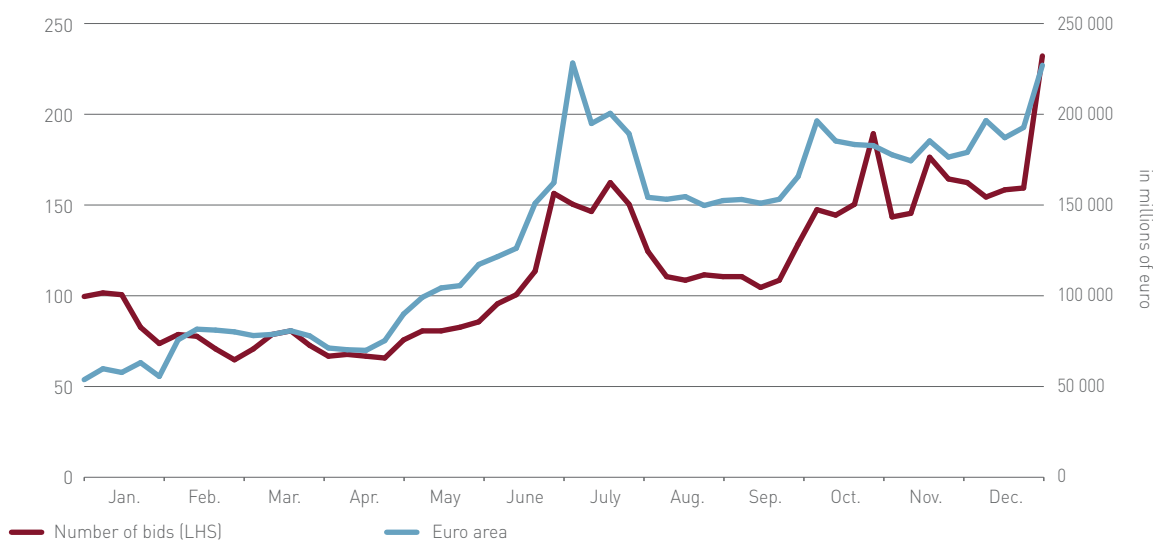
MRO 2010: % of allotted amounts LU / euro area



Since October 2008, the MRO have been conducted on a full allotment and fixed rate basis. This non-conventional measure was effective all through the year 2010. It is foreseen that this allotment method be maintained as long as necessary and at least until 12 July 2011, which corresponds to the end of the sixth maintenance period for the minimum reserves.

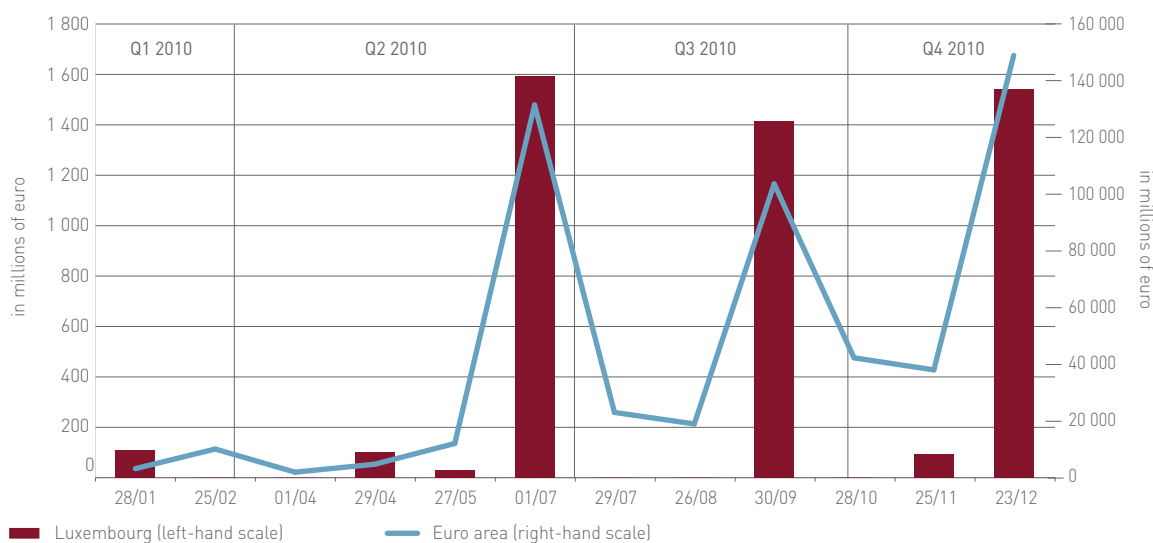
The percentage of participation of Luxembourg compared to the euro area remained at a level situated below 1% during the main part of 2010.

Chart 2.2:  
MRO - Number of bids and volume allotted in the euro area



### 2.1.1.2 Longer-term refinancing operations (LTRO) in 2010

Chart 2.3:  
LTRO 3 months - Allotments in LU and the euro area in 2010



On top of the regular 3-month operations (12 over the year), two additional 6-month operations were conducted in 2010. These operations were allotted at 100%, at an adjustable rate that is computed at the maturity of the operation. This rate is fixed as being the average of the minimum bid rates of the main refinancing operations during the life of the operation.

The Eurosystem announced that one maintenance period operations would be continued and allotted at 100% and at a fixed rate at least until the second quarter of 2011.

Luxembourgish counterparties did not participate in the supplementary 6-month operations, neither to one maintenance period operations.

2009 one-year operations coming to maturity did not have a significant impact in Luxembourg. Amounts that came to maturity were only partly renewed through the regular 3-month operations.

### 2.1.1.3 Fine tuning operations in 2010

#### Liquidity absorbing operations

Since 2008, this type of operations is open to all counterparties. In 2010, fine tuning operations were used exclusively on the last day of the maintenance period, in order to absorb excess liquidities.

Twelve operations of this type were conducted in 2010.

Both volumes and numbers of participating banks have decreased for Luxembourg and euro area over the year.

Chart 2.4:

Fine tuning operations on the last day of the maintenance period – amount absorbed – LU and euro area

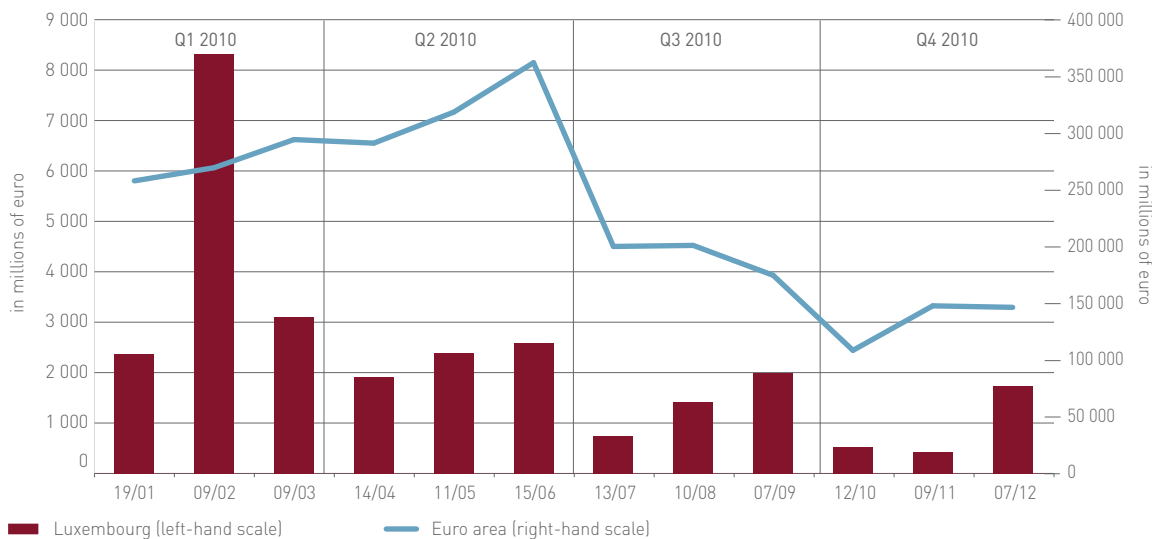
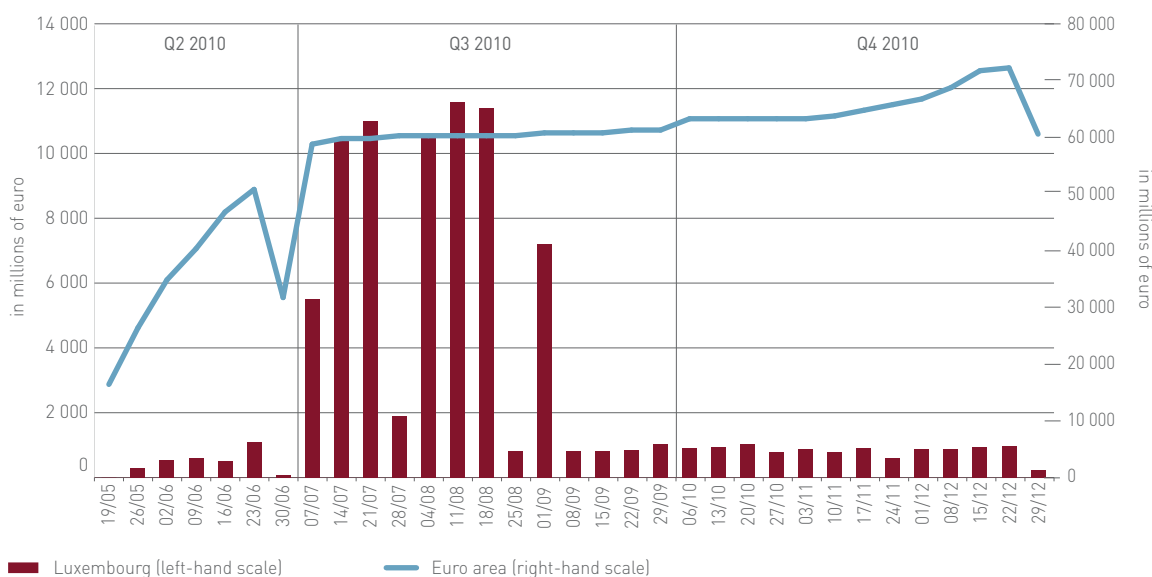


Chart 2.5:

Liquidity – providing operations – LU and euro area



From May 2010, one-week operations took place aiming at absorbing liquidity injected through the Securities Markets Programme (see point 2.1.5 below). In all, 33 operations of this type have been conducted in 2010, absorbing on average EUR 2.7 billion in Luxembourg (with a minimum of EUR 71 million and a maximum of EUR 11.6 billion) and EUR 57.2 billion in the euro area.

#### ***Liquidity providing operations***

Exceptionally, at maturity of one-year and six-month operations, 6-day and 13-day operations were conducted to enable counterparties to receive liquidity until the next main refinancing operation. There have been 4 operations of this type in 2010 without any Luxembourgish participation for the 2 last operations.

### **2.1.2 Standing facilities**

Luxembourgish counterparties may resort to daily standing facilities with the BCL, i.e. deposit or marginal lending facilities, at a rate fixed beforehand. Those rates are related to the reference rate of the ECB.

#### ***Marginal lending facility***

In 2010 the marginal lending facility was only used on ad hoc basis by the Luxembourgish counterparties.

#### ***Deposit facility***

After a stability phase during the first quarter, the use of the deposit facility in Luxembourg has regularly increased until the end of the one-year operation (beginning of July 2010) before declining slowly.

### **2.1.3 Minimum reserves**

The euro area counterparties are required to build reserves at the NCB of their country of residence. Those obligations have to be kept on an average over a fixed period. The counterparties can make free use of their liquidities over the period, which helps stabilising the market.

In 2010, for Luxembourg, the amount of excess reserves were kept close to those registered in 2009.

### **2.1.4 Temporary currency auction facilities**

#### ***USD operations***

In May 2010, the Eurosystem, in cooperation with the Federal Reserve System, resumed to supply dollar liquidities against eligible collateral used for regular operations. These operations were conducted as reverse transactions with a maturity of 7 or 84 days (only one 84-day operation took place in 2010).

In 2010, euro area and Luxembourgish counterparties did not take great interest in those operations. All bids received have been satisfied at pre-announced fixed rates.

In December 2010, the Eurosystem announced the extension of these operations until August 2011.

#### ***CHF operations***

CHF liquidity providing operations introduced in 2008, in cooperation with the Swiss National Bank, were discontinued in January 2010.

A press release published on 18 January 2010 announced the expiration of those operations given decreasing demand and the improvement in the functioning of this market segment.

## 2.1.5 Covered bond purchase programme and Securities markets programme

### *Covered bond purchase programme*

The covered bond market is a key instrument for the credit institutions' funding. This market segment was particularly affected by the financial crisis.

In May 2009, the Eurosystem decided to step in the primary and secondary covered bond markets for an amount of EUR 60 billion.

This objective has been achieved in June 2010. The Eurosystem intends to keep the purchased covered bonds until maturity.

### *Securities markets programme*

In May 2010, the Eurosystem decided to conduct an exceptional securities markets programme.

The objective of this programme is to address the malfunctioning of securities markets and restore an appropriate monetary policy transmission mechanism.

In order to sterilise the impact of the interventions, the Eurosystem conducts specific operations to re-absorb the liquidity injected through the Programme.

## 2.2 FOREIGN EXCHANGE RESERVES MANAGEMENT BY THE BCL

In accordance with the Statutes of the Eurosystem and in line with its share in the ECB's capital key, the BCL transferred €74.6 million in foreign exchange assets to the ECB. The ECB's foreign exchange reserves have been managed in a decentralised way by the NCBs since January 1999. As a result of the EU's enlargement and the relative growth of GDP and population in Luxembourg, the BCL's share in the ECB's capital key has been 0.1747% since 1st January 2010. As of the 31st of December 2010, the total market value of the ECB's reserves (including accrued interest) managed by the BCL corresponded to €303.1 million. One goal of the foreign exchange reserves management of the ECB is to ensure that the ECB has sufficient available liquidity to intervene in the foreign exchange markets if needed. Security and liquidity are, therefore, basic requirements in managing reserves. This tactical benchmark reflects the ECB's risk/return medium-term preference as regards market conditions.

A change in the tactical benchmark may affect different risk categories (for example, modified duration or liquidity risk). The Value at Risk of the tactical benchmark may differ from that of the strategic benchmark in the context of fluctuation margins announced, in advance, by the ECB.

Regarding the management of this portfolio, the prime task of the BCL is to invest foreign exchange reserves on behalf of the ECB within the prescribed fluctuation bands and fixed risk limits, the objective being return maximisation. The amount of actively managed assets in gold is specified by the ECB, taking into account strategic considerations and market conditions. The BCL manages a USD portfolio on behalf of the ECB.

## 2.3 MANAGEMENT OF THE BCL'S ASSETS

### 2.3.1 Institutional structure

Asset management is based on a five-level intervention structure, in addition to risk control:

- The Council (level 1),
- The Executive Board (level 2),
- The Asset and Liability Management Committee (ALCO) (level 3),
- The tactical committees (level 4),
- The portfolio managers (level 5).



### ***Level 1: The Council***

The Council approves the guidelines of the asset management framework. Thus, the Council has granted the BCL the possibility to provide asset management services to third parties and to hold own funds asset portfolios in order to diversify the Bank's income. The guidelines also include mitigation of the risk framework applied to asset management.

### ***Level 2: The Executive Board***

The Executive Board defines the risk management framework. Thus, it determines the maximum risk allowance (MRA) in the management of the Bank's own assets. It also specifies the risk management measures, like the Value-at-Risk (VaR) method and the application of stress-testing scenarios. The Executive Board also sets warning thresholds, which can lead to the calling of emergency meetings for assessment and arbitrage purposes. The Executive Board sets the limits of the framework annually.

### ***Level 3: The Asset and Liability Management Committee ALCO***

ALCO determines the strategic benchmark according to the framework fixed annually by the Executive Board by examining the impact of each risk profile (market, credit and liquidity risk) which would result from the proposed investment policies, in respect of both the overall balance sheet and the profit and loss account of the BCL. During the year, ALCO regularly assesses the results of the investment policy.

### ***Level 4: The tactical committees***

The tactical committees monitor the evolution of the portfolios on a shorter-term basis and work out proposals for tactical benchmarks that comply with the limits laid down by the strategic benchmark.

The tactical committees consist of the following:

- The *Comité de gestion*, for the BCL's own funds,
- The *Comité réserves de change* for the pooled reserves of the ECB,
- The *Comité tactical benchmark* for the pension fund of the BCL.

### ***Level 5: The portfolio managers***

The transactions are executed by the portfolio managers, in strict compliance with the limits set, covering both the overall and specific investment limits.

## **2.3.2 Risk control**

The Risk Management unit monitors the positions of all the portfolios in order to assess risks and to verify compliance with the pre-defined limits. This monitoring is carried out daily, independently from the Front Office. This monitoring structure has been completed with specific missions at different levels of the organisation. In addition, the Middle and Back Offices also take part in the monitoring process.

## **2.3.3 Conceptual framework**

### ***The investment policy objectives***

The main objectives are to generate a high income on a regular basis and to ensure a total return over the long term by taking into account considerations such as capital safety, stability of securities and liquidity. In order to achieve these goals and in accordance with the principle of risk diversification, the BCL implements a coordinated, progressive and pro-active investment policy based on modern portfolio theory.

The investment approach takes into account:

- the analysis of economies and international financial markets;
- the asset allocation decisions by assessing the returns on different international markets;
- the drawing-up of a clearly defined strategy;
- the capital value preservation of the assets under management by a policy of risk diversification and the application of specific qualitative requirements with regard to investments;
- the application of strict risk control measures.

Investment decisions are based on:

- market risks (interest rates, exchange rates, equity prices, commodity prices);
- credit risks (minimum credit ratings criteria by international rating agencies);
- liquidity risks (concentration limits by sector, by issuer, by issue and by geographical diversification)

### ***Performance measurement***

The quality of the investment decisions is measured by comparing the performance with the external benchmarks of leading investment banks. This allows a given performance to be assigned to a decision level (strategic, tactical) as well as to daily management.

### **2.3.4 Structure of portfolios**

The bulk of the BCL's own funds are invested in fixed income securities denominated in euro.

The strategic orientation allows a diversification into other asset categories.

The BCL manages five kinds of portfolios: the Investment Portfolio, the Liquidity Portfolio, the Domestic Reserves Portfolio, the Pension Fund Portfolio and Portfolios from third parties.

#### ***Investment Portfolio***

This portfolio consists of assets (equity and bonds), which can be deemed to represent its own funds (with a longer-term investment profile). The main goal of the portfolio is to maximise the return by taking into account the above-mentioned risk constraints (see section 2.3.2). As of the 31st of December 2010 the total market value (including accrued interest) amounted to 2 040.7 million euro.

In 2010, the share of this portfolio invested in fixed income securities with a maturity above three years was raised from 32% to 43%, whereas the percentage of bonds with a one to three-year maturity increased from 31% to 44%. Moreover, by the end of 2010, variable rate and fixed rate bonds with maturity under one year represented 13% of Portfolio 1.

The securities included in this portfolio are widely diversified, not only geographically but also in terms of sectors and issuers.

#### ***Liquidity Portfolio***

This portfolio comprises the other assets that are largely attributable to a Eurosystem arrangement (Agreement on Net Financial Assets) and mirrors TARGET accounts and other liabilities.

This portfolio, whose liability profile covers certain liquidity needs, also aims at maximising income. The instruments used are mainly fixed-income short-term bonds, variable rate bonds and certificates of deposits (ECP), provided that they comply with strict and predefined rating criteria. As of 31 December 2010, the total market value (including accrued interest) amounted to 4 372.5 million euro.

Table 2.1: Breakdown of reserves as of the 31st of December 2010

Maturity	Portfolio 1	Portfolio 2
0-1 year	13%	55%
1-3 years	44%	35%
3-10 years	43%	10%

### ***Domestic Reserves Portfolio***

This portfolio aims to maintain an intervention portfolio in addition to the pooled foreign exchange reserves transferred to the ECB. Thus, the main requirements for this portfolio are security and liquidity. As of the 31st of December 2010, the total market value (including accrued interest) of this portfolio in foreign currencies amounted to 200.6 million euro.

### ***Pension Fund Portfolio***

The management of this Fund is described further in section 4.4.3 of this report.

### ***Third Party Portfolios***

The BCL provides non-standardised discretionary management services to institutional clients (central banks and international organisations). Furthermore, the Bank acts as one of the Eurosystem service providers (ESP). Six central banks within the Eurosystem offer institutional clients (central banks, public authorities and international organisations) a comprehensive range of services for managing Euro-denominated reserve assets under a framework of harmonised services defined by the ECB.

## **2.4 BANKNOTES AND COINS**

### **2.4.1 Production of banknotes and coins**

In the Eurosystem the euro banknote production is allocated according to a decentralised pooling scenario adopted in 2002 according to which each NCB of the euro area is responsible for the supply of one part of the total requirements. The euro banknotes are produced in accordance with the requirements expressed by the participating NCBs and aggregated by the ECB. In 2010, the BCL was in charge of the production of 17.8 million €20 banknotes for the Eurosystem's needs (26.4 million in 2009). The BCL has supplied these banknotes via a tender. Besides the BCL received 38.2 million banknotes from other NCBs for its own purposes (74.2 million in 2009).

According to an agreement with the State of Luxembourg, the BCL is also responsible for the production of Luxembourg's euro coins and puts them into circulation. Following an invitation to tender, the BCL commissioned the production of 42.2 million coins of the 2010 series to cover the needs of economic actors and numismatists.

### **2.4.2 Circulation of banknotes and coins**

#### **2.4.2.1 Euro banknotes and coins**

##### **2.4.2.1.1 Banknotes**

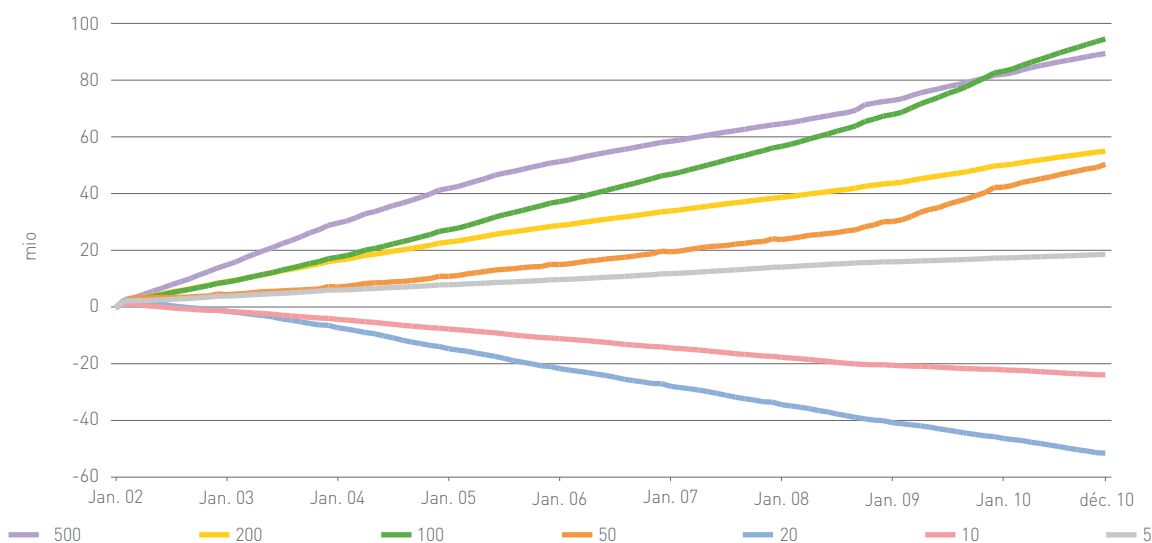
The total net volume of banknotes issued by the BCL in the course of 2010 amounts to 26.5 million banknotes compared to 37.1 million banknotes in 2009, representing a decline of 29%. This is partly due to the reversal of the strong increase in the demand for banknotes which occurred at the height of the financial crisis of 2008. Despite this evolution, the BCL contributed even so with some 5.0% to the total volume of banknotes put into circulation by the Eurosystem, compared with 2.6% in 2009.

Furthermore, the number of €10 and €20 banknotes lodged at the BCL exceeds the volume of banknotes issued. This can be explained by the fact that financial institutions lodged more of these banknotes at the BCL than they withdrew, demonstrating the contribution of tourists and cross-border workers<sup>1</sup>, where these denominations are more widely used.

Looking at the high denominations (€100, €200 and €500), the demand in Luxembourg and in the euro area remained buoyant in 2010.

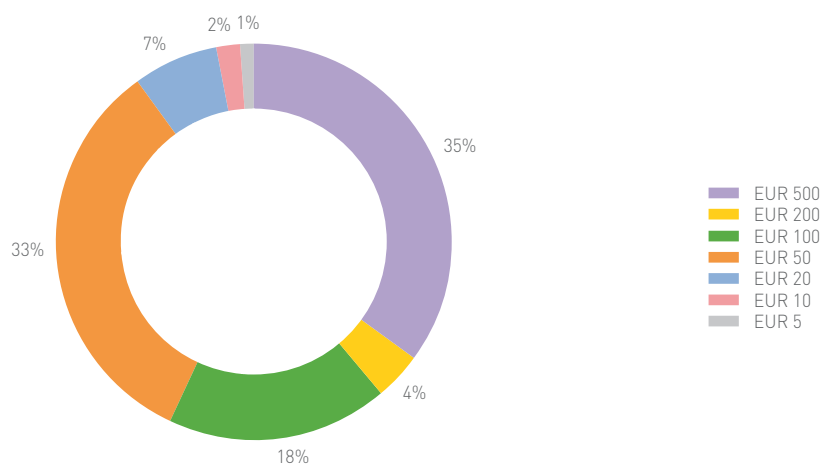
The chart below illustrates the different trends in the development of the circulation of the different denominations.

Chart 2.6:  
Denominational breakdown of the number of euro banknotes put into circulation by the BCL



Source: BCL

Chart 2.7:  
Value of euro banknotes put into circulation by the Eurosystem by denomination



Source: BCE

1 Cross-border workers represented around 40% of total employment in Luxembourg in 2010.

The net issuance of banknotes in Luxembourg grew at a moderate pace in 2010: It rose by €6.4 billion, i.e. +10.5% on a yearly basis, to reach 66.9 billion at end-December 2010. This increase was less pronounced than in 2009 (+15.1%) and 2008 (+13.9%). The latter year was characterised by a strong rise in the demand for banknotes in September and October.

Moreover in terms of net issuance, Luxembourg remained in fifth position in the Eurosystem, behind Germany (€366.7 billion), Italy (€145.4 billion), France (€81.1 billion) and Spain (€76.6 billion). In fact, the annual increase of net issuance in Luxembourg was also higher than that noticed in the euro area as a whole (+4.1%, after +5.7% in 2009), where net issuance reached €839.7 billion at end-December 2010 (€806.4 billion at end-December 2009).

#### 2.4.2.1.2 Coins

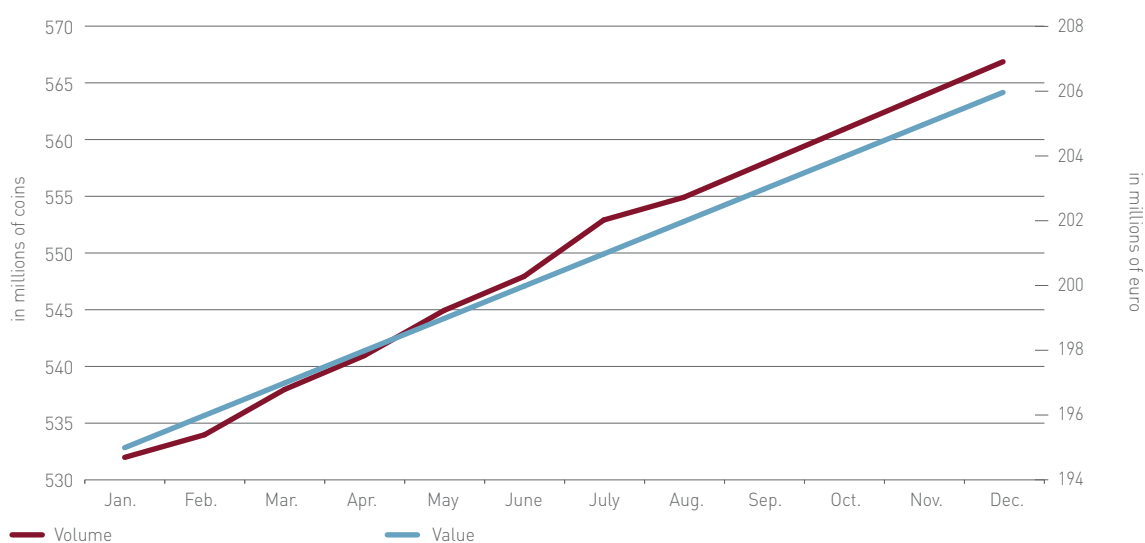
Luxembourg euro coins continued to be strongly demanded by the public. Although a slight deceleration can be noticed, the total value of coins put into circulation increased by 6.8% in 2010 compared to 9.6% in 2009. It rose from €192.7 million to €205.8 million.

The number of coins issued in the course of 2010 increased by 38.4 million coins, equalling a growth of 7.3%, and reaching a total of 566.9 million Luxembourg coins at the end of 2010.

The following chart shows the development both in terms of volume and value of Luxembourg euro coins in circulation throughout 2010. The demand for Luxembourg coins grew steadily in the course of the year.

Chart 2.8:

Volume and value of Luxembourg euro coins put in circulation in 2010



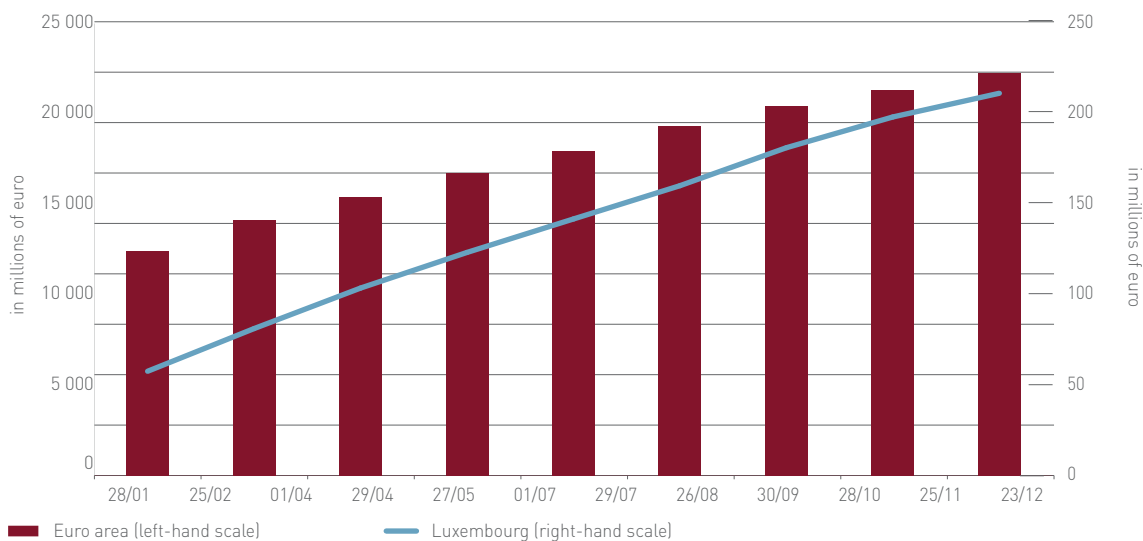
Source: BCL

Within the euro area, Luxembourg contributes to 0.9% of the total value issued by all the issuing authorities and to 0.6% of the total volume. The average value of the Luxembourg euro coins in circulation amounts to 36 cents, in comparison with an average of 24 cents in the euro area.

The following chart compares the volume of the different coin denominations put into circulation by Luxembourg with the volume corresponding to the rest of the euro area.

Chart 2.9:

Comparison of the circulation volume of the different euro coin denominations in Luxembourg and the euro area

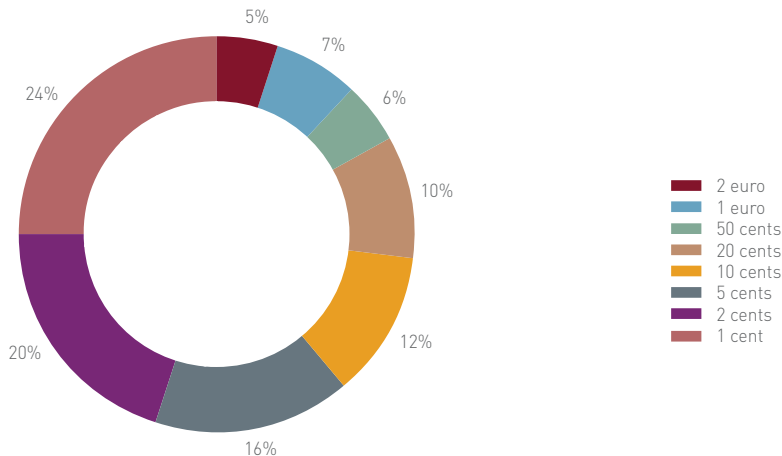


Sources: ECB and BCL

The total value of euro coins put into circulation by the Eurosystem increased from €21.3 billion in 2009 to €22.3 billion in 2010, whereas the total volume of coins reached €92.9 billion. The following chart shows the denominational breakdown of this volume at the euro area level:

Chart 2.10:

Breakdown by denomination of the volume of coins of the euro area in circulation



Source: ECB

#### 2.4.2.2 Luxembourg franc banknotes and coins

In 2010, the total value of Luxembourg franc banknotes issued by the *Institut Monétaire Luxembourgeois* not yet exchanged fell from LUF 209.8 million to LUF 208.3 million, which equals a decline of 0.7% (nearly the same as last year). In this period, the volume of 5 000 LUF banknotes not yet returned underwent the most pronounced decline (1.3%), while that of 1 000 LUF and the 100 LUF banknotes fell both by 0.5%.

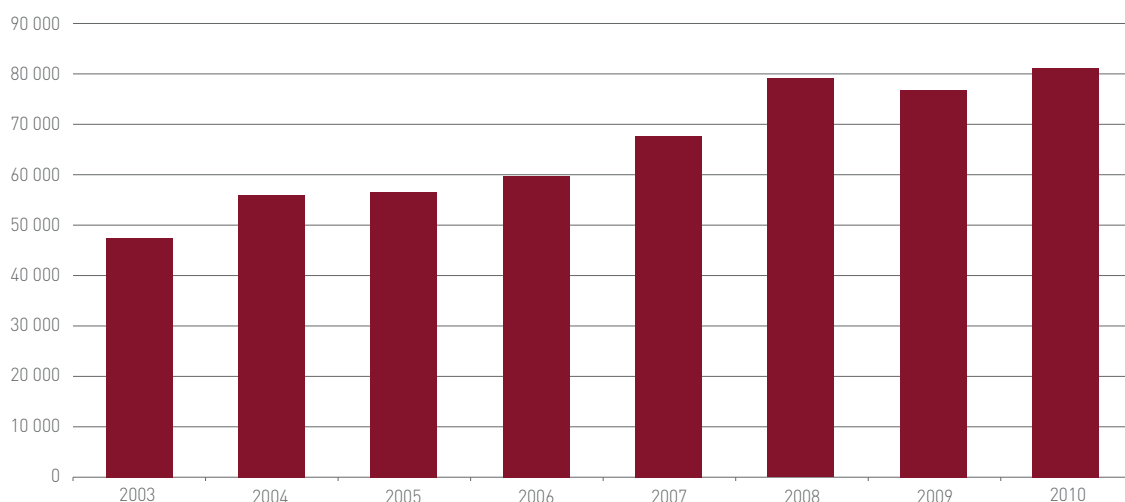
#### 2.4.3 Handling of banknotes and coins

The number of euro banknotes returned by financial institutions to the BCL has increased by 5.8% from 77.1 million in 2008 to 81.6 million in 2009.

The chart below describes the evolution of the number of euro banknotes lodged by financial institutions to the BCL.

Chart 2.11:

Lodgments of euro banknotes by financial institutions at the BCL (thousands of banknotes)



Source: BCL

The number of euro banknotes processed by sorting machines increased by some 1.6% from 76.2 million in 2009 to 77.5 million in 2010. These sorting machines carry out authenticity tests as well as soiling tests. Nearly 15 million notes of all denominations had to be destroyed as they were unfit for circulation, which equals to a destruction rate of 19.3%. This percentage varied strongly between the denominations processed and ranged from 7% for the €500 banknote to 53% for the €5.

#### 2.4.4 National and international cooperation

In the field of the fight against counterfeiting of euro banknotes and coins, the BCL continues to cooperate closely with the ECB and the competent national authorities. For the analysis of counterfeit and unfit euro banknotes and coins, the BCL has collaborated since 2002 under the terms of an agreement with the Banque de France and the Deutsche Bundesbank.

As in the past, the BCL continues the training of bank cashiers with the support of the *Institut de Formation Bancaire Luxembourg*.

The BCL participates in the preparation of a new euro banknote series. The design of this new series, based as well on the theme "Ages and styles in Europe" will be slightly adapted. New security features are being incorporated in order to ensure a maximum protection against counterfeiting and an easy identification of counterfeits by the public. The new euro banknote series' introduction is expected in the coming years and will be gradual. The release calendar, the issuance sequence and the exchange conditions of the new series will be announced in due time.

For a number of years now, the BCL participated in a pooling process with seven other central banks in order to produce its share of banknotes for the Eurosystem. This European call for tender, which aims at sharing resources and experience needed for monitoring the production of banknotes, paves the way for the future single Eurosystem tender procedure.

The BCL collaborates also with five other Eurosystem central banks on the management and maintenance of the Cash SSP software. This software allows the Cash Department not only the management of its banknotes and coins stocks, the monitoring of its sorting activity of fiduciary money but also the secure reception of deposits and withdrawals announcements by commercial banks.

### 2.4.5 Numismatic issues

The BCL continues to offer numismatic products through several distribution channels in order to meet the collectors' interest and inform them about Luxembourg's history and culture. The public has access to the BCL's numismatic premises, where more than 4 200 sales operations were carried out in 2010. The BCL has sent nearly 5 000 parcels to its numismatic clientele, which had made use of the mail order facility or the Internet shop of the BCL (<https://eshop.bcl.lu>).

In the course of 2010, the BCL issued the following numismatic products:

- A €2 commemorative coin, minted in 500 000 units was put in circulation in January 2010. This coin, depicting the effigy of the Grand-Duke Henri and his coat of arms, was issued in BU quality as a coin card limited to 7 500 units.
- The 2010 BU set, comprising Luxembourg's euro coins of the 2010 series (including the €2 commemorative coin) (7 500 units).
- The 2010 BENELUX set offering 8 coins of the 2010 series of each of the three-member countries (10 000 units).
- The 2010 Proof set features 9 coins (1 500 sets).
- A silver-niobium coin dedicated to the castle of Esch-sur-Sûre, issued in June 2010 in an edition of 3 000 pieces, constitutes the second element of the series dedicated to the Castles of Luxembourg.
- A silver-titanium coin dedicated to the 25th anniversary of the signature of the Treaty of Schengen, was issued in June 2010 in an edition of 3 000 pieces.
- A silver coin issued in September 2010 in an edition of 3 000 pieces was dedicated to the 700<sup>th</sup> anniversary of the wedding of John of Luxembourg with Elisabeth of Bohemia.
- A silver and nordic gold coin issued in October 2010 in an edition of 3 000 units, was dedicated to the "Arnica Montana", constituting the second element of the series devoted to the fauna and flora of Luxembourg.

## 2.5 DEVELOPMENTS IN THE FIELD OF STATISTICS

During 2010, the ongoing assessment of statistical data collection, compilation and dissemination has still been heavily influenced by the recent financial crisis. Therefore, particular attention has been dedicated to the preparation of statistical information needed in the area of financial stability analysis as well as in the framework of the European Systemic Risk Board (ERSB) that was established at the end of 2010.

In this area several regulations and guidelines of the European Central Bank that relate to monetary, banking and financial statistics have come into force; therefore, in order to draw a more complete picture of the financial sector, the ESCB has developed statistics on insurance corporations and pension funds.

Finally, the BCL publishes on its website a vast set of statistical series covering the financial sector. During 2010 several updates, prepared in 2009, were uploaded in order to broaden the statistical information put at the public's disposal.

### 2.5.1 Money and banking statistics

The past year has been marked by the introduction of new layouts of the main statistical reports that have to be submitted by monetary financial institutions, i.e. credit institutions and money market funds. The aim of this revision of the data collection system was to increase the quality as well as the coverage of statistical information concerning the balance sheet while increasing efficiency by integrating the security-by-security and the balance sheet data collection. The information provided by the statistical data collection in the monetary financial institutions sector is an essential component for the conduct of monetary policy in the euro area as well as for the mission of the BCL in the areas of financial stability and liquidity surveillance.

The BCL also participates in the production of Short Term European Paper statistics that are published daily by the ECB.

The BCL also participates in the statistical work of the Bank for International Settlements (BIS) and contributes to the international banking statistics collected and published by the BIS.



Furthermore, the BCL provides information on the Luxembourg financial system to the International Monetary Fund (IMF) in order to publish them in the monthly International Financial Statistics review of the IMF as well as in the framework of the Special Data Dissemination Standard (SDDS).

### **2.5.2 External statistics**

The BCL publishes on its website quarterly statistics of the Luxembourg balance of payments as well as International investment position, External debt and Reserve assets statistics. The BCL and the STATEC disseminate, after availability of a new dataset, on a quarterly basis, a joint press statement informs the public of the major evolutions touching the balance of payments.

The BCL participates in the annual Coordinated Portfolio Investment Survey of the IMF (the so-called CPIS). The results of this survey are available on the BCL website.

In the course of the year under review, the BCL, jointly with the STATEC, continued to progress in the development of a new balance of payments collection system. BCL has in particular discussed the future reporting requirements with the reporting agents.

### **2.5.3 Economic and financial statistics**

In January 2010, the BCL started to collect statistical data from securitisation vehicles. The objective of this data collection is to provide the users with quarterly statistical information on assets and liabilities of resident securitisation vehicles. In this context, it is important to mention that the BCL has the ECB in establishing the list of euro area securitisation vehicles that is updated on a regular basis.

In addition, the BCL has updated the statistical data collection for money market funds in order to ease the reporting burden. As a consequence of this update the layout of the statistical data collection for money market funds and non monetary investments funds is now strictly identical although the frequency is higher for money market funds.

Finally, according to the cooperation agreement signed with the National Statistical Institute (STATEC) relating to the development of financial accounts, the BCL participates in the compilation of the latter.

### **2.5.4 Other statistics**

For some fifteen years, central banks of the ESCB have collected in their respective jurisdictions statistics for the use of different means of payments and on the activity of payment systems and securities settlement. These statistics, that are largely harmonised, are published on an annual basis in the so-called "Blue Book".

## **2.6 PAYMENTS AND SECURITY SETTLEMENT SYSTEMS**

### **2.6.1 TARGET2-LU**

Since the 19th of November 2007, the real time gross settlement system TARGET2 has run on the new Single Shared Platform (SSP) operated in common by the central banks of the Eurosystem. 28 direct participants (25 in 2007), 44 indirect participants and two ancillary systems are registered with the Luxembourgish component TARGET2-LU.

#### ***Domestic payments***

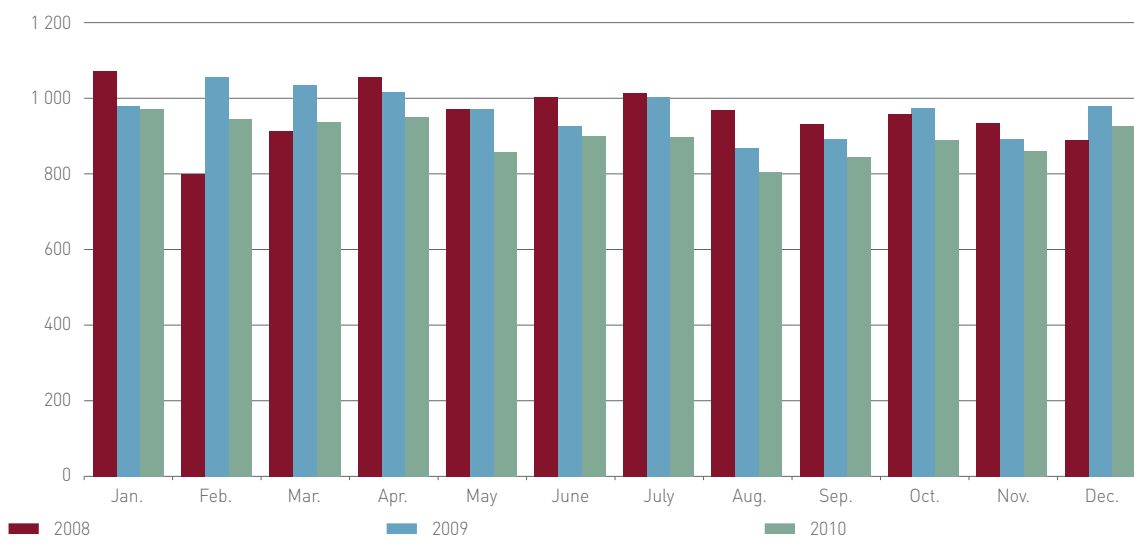
In 2010, participants of TARGET2-LU exchanged a monthly average of 19 379 payments (against 20 684 in 2009) for a value of 87.9 billion euro (against 267.8 billion euro in 2009). 12 588 or 65.0% of these payments were retail payments. Their value represented a monthly average of 5.6 billion euro or 6.4% of the domestic value exchanged.

The decrease of volumes triggered by the financial crisis of 2008 have continued in TARGET2-LU in 2010. In comparison to 2009, the reduction in 2010 was 6.3%. The decrease in values exchanged was attributable for over 80% of BCL's own transfers. It relied for a major part on a changed methodology that for the year 2010 eliminated start-of-day transfers of participants' balances from the statistics. A minor part was triggered by a decrease in the use of different monetary policy instruments.

The following chart illustrates the development of average daily volumes in domestic payments.

Chart 2.12:

Domestic payments: evolution of average daily volumes



### Cross-border payments

In 2010, participants in TARGET2-LU sent a monthly average of 45 774 payments towards other countries of the EU (42 232 payments in 2009) for an average value of 570.6 billion euro (573.3 billion euro in 2009). The figures include 22 408 retail payments representing 48.9% of the total. Their relative part is decreasing by 5% following the strong increase of interbank payments from 19 419 transactions in 2009 to 23 363 transactions in 2010 (+20%). Customer payments amounted to a monthly average value of 16.8 billion euro representing 2.9% of the total cross-border value.

The volume of cross-border payments saw a global increase of 8.4% whereas the value exchanged decreased by 0.5% in comparison to 2009. The average value per transaction sent was 12.5 million euro (against 13.6 million euro in 2009). The average value of an interbank payment decreased from 28.7 million euro to 23.7 million euro.

With a monthly average of 36 431 payments, participants in TARGET2-LU received less payments than they sent.

The following charts display the development of average daily volumes and values in cross-border payments sent by Luxembourgish participants.

Chart 2.13:

Cross-border payments sent: evolution of average daily volumes

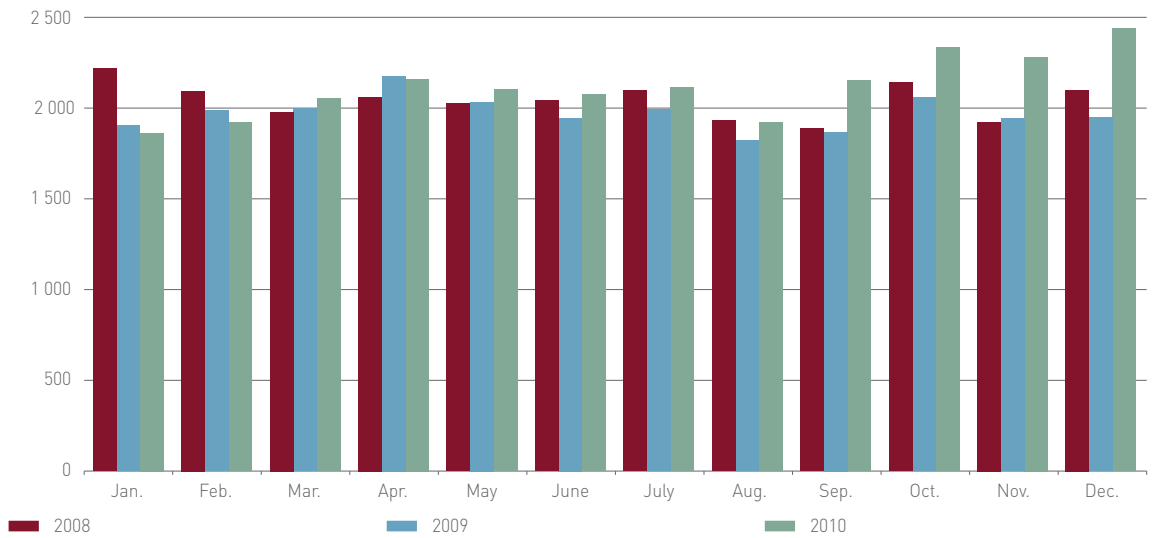
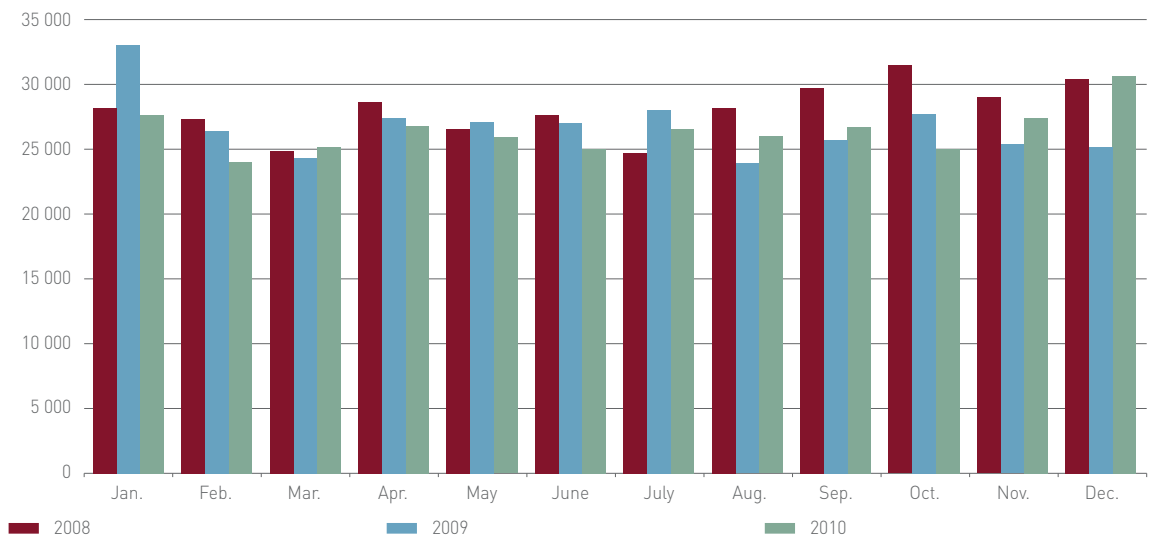


Chart 2.14:

Cross-border payments sent: evolution of average daily volumes (million euro)



### ***Aggregated figures of domestic and cross-border payments***

The total number of payments sent by participants in TARGET2-LU in 2010 amounted to 781 838 transactions (754 980 in 2009, increase of 3.5% in one year). 419 950 or 55.6% of all payments were retail payments.

The following table provides a global overview of average daily volumes of payments per year. The total volumes exchanged in 2010 have slightly increased in comparison to 2009, and the increase was exclusively attributable to cross-border transfers.

The average monthly value of all payments sent was 658.5 billion euro of which 22.4 billion euro (3.4%) for retail payments.

Table 2.2: Volumes of payments in daily averages

	Domestic		Cross-border sent		Total sent	Cross-border received	
	Volume	(% volume sent)	Volume	(% volume sent)	Volume	Volume	(% volume sent and received)
2008	963	(32%)	2 049	(68%)	3 012	1 687	35.9%
2009	970	(32.9%)	1 981	(67.1%)	2 951	1 616	35.4%
2010	893	(29.8%)	2 107	(70.2%)	3 000	1 704	36.22%
Variation 2009-2010	-7.9%		+6.4%		+1.7%	+5.4%	

### TARGET2-LU compared to other systems participating in TARGET2

In 2010, all national systems participating in TARGET2 transferred a monthly average of 4.98 million domestic payments (5.07 million in 2009) for a value of 34.2 billion euro. The part of Luxembourg represented 0.4% of this volume and 0.6% of this value.

In addition, 2.40 million cross-border payments (2.15 million in 2009) for a value of 15 226 billion euro (11 593 billion euro in 2009) were carried out as a monthly average. Luxembourg contributed for 1.9% to the volume and for 43% to the value exchanged cross-border.

### Availability and performance of TARGET2

As in 2009, the availability of the TARGET2 platform, and hence of TARGET2-LU, was 100% in 2010. In 2008, it was 99.96%.

The SSP received a daily average of 341 226 payment instructions. 99.74% were settled within 5 minutes (99.96% in 2009) and 0.08% within 15 minutes. For 0.18%, the settlement took more than 15 minutes.

### 2.6.2 Retail payments in Luxembourg

Next to notes and coins, the most used payment instruments in Luxembourg are payment cards, credit transfers and direct debits.

The volume of cheque transactions has continued to strongly decrease over the past years. Since July 1st, 2006<sup>2</sup> banks in Luxembourg only settle cheques on a bilateral basis.

#### Credit transfers:

The settlement of credit transfers can be processed in the banks internally, on a bilateral basis between the concerned banks or through a payment system (for instance Target2 or Step2<sup>3</sup>). The bulk of Luxembourg credit transfers and standing orders are however processed on the pan-European platform STEP2.

In 2010, Luxembourgish participants sent 75 149 transactions for a total value of €197 million on a daily average through the STEP2 system. Domestic<sup>4</sup> transactions accounted for 66% in volume (close to 49 672 operations a day) and 60% in value (€119 million). The remaining volume is cross-border.

The payments sent by the Luxembourgish community in STEP2 strongly increased in 2010 with a relative growth of respectively 4% in volume and 20% in value as compared to 2009. The yearly growth of the domestic activity was almost nil in volume and 17% in value terms.

<sup>2</sup> Date when the Luxembourgish cheque settlement system was discontinued.

<sup>3</sup> The Step2 system is managed by the Euro Banking Association (EBA)

<sup>4</sup> A credit transfer or a direct debit is considered as domestic when both the payer and the payee have their payment account with a Luxembourgish institution.

Table 2.3: Annual variation of the activity in Step2:

Annual variation	2010/2009	2009/2008
Total volume	4%	10%
Total value	20%	25%
Domestic volume	0.1%	2%
Domestic value	17%	19%

### **Direct debits:**

Until the European direct debit (Sepa Direct Debit) takes off, direct debits are domestic payments that are cleared either via the DOM-Electronique system or bilaterally by banks.

In 2010, the volume of direct debits amounted to 15.72 million for a value of €7 016 million.

### **Payment cards in Luxembourg:**

Two different types of payment cards are to be distinguished, debit cards and credit cards. The national debit card system is called Bancomat. The majority of debit cards is co-branded with the international system Maestro. Credit cards issued in Luxembourg are mainly branded Visa and Mastercard. At the end of December 2010, the total volume of debit cards issued by banks in Luxembourg and managed by the Cetrel<sup>5</sup> was near to 600 000 (576 000 in 2009). The number of credit cards issued by Luxembourg banks in 2010 was over 505 000 (484 000 in 2009).

In 2010, the number of transactions<sup>6</sup> processed with debit cards issued in Luxembourg<sup>7</sup> totalled 49.92 million (40.59 in 2009) for a value of €3.36 billion (3.19 in 2009). The number of transactions processed with credit cards amounted to 22.48 million transactions (21.89 in 2009) for an amount of €2.39 billion (2.27 in 2009).

Regarding transactions processed on the Luxembourgish territory with cards issued in Luxembourg or outside the country, the volume of transactions with debit cards amounted to 39.31 million (38.21 in 2009) for a value of €2.79 billion (2.72 in 2009) and to 21.28 million (21.39 in 2009) equivalent to €1.90 billion (1.87 in 2009) for transactions processed with credit cards.

MiniCash is the Luxembourgish e-money purse. It consists in a memory chip set up on a Bancomat debit card on which the cardholder can transfer an amount of money exchanged in e-money. In 2010, 1.71 million transactions were realised for a total amount of €3.90 million (compared to 2.10 million transactions for a value of €5.49 million in 2009). MiniCash will be discontinued on 31 October 2011.

### **The implementation of the SEPA project for non-cash payments:**

The SEPA (Single European Payments Area) project is consistent with the setting up of the euro as a single currency. It foresees the creation of a single euro payments area in which all payments are considered as domestic, without any distinction between national and cross-border payments.

The SEPA project is being implemented by the European banking industry through the European Payments Council (EPC)<sup>8</sup>. The Eurosystem and the European Commission are the catalysts of this project.

SEPA aims at providing common payment instruments, which are ruled by a harmonised legal framework.

<sup>5</sup> Centre de Transferts Electroniques; <http://www.cetrel.lu>

<sup>6</sup> Payment transactions and cash withdrawals at ATMs. Data from the main cards processor,

<sup>7</sup> Transactions in Luxembourg and abroad.

<sup>8</sup> For more information regarding the EPC: [www.europeanpaymentscouncil.eu](http://www.europeanpaymentscouncil.eu)

The single set of payment instruments will enable payments in euro to be realised as easily and under the same conditions as domestic payments, independently of the country of destination within the SEPA area which encompasses 32 countries:

- the *SEPA Credit Transfer (SCT)* was launched on 28 January 2008.
- the *SEPA Direct Debit (SDD)* was launched on 1 November 2009.
- the *SEPA Cards framework*: SEPA for payment cards foresees that a cardholder is able to use its card in the SEPA area and that all merchants are able to accept all SEPA compliant cards, as far as it is economically justified. Common processing standards are being elaborated at the European level; their implementation is foreseen for 2010-2012.

In Luxembourg, the SEPA project is being implemented by the Association des Banques et Banquiers Luxembourgeois (ABBBL) through a committee regrouping the representatives of the main credit institutions active in retail banking as well as representatives of the national supervisory authorities.

The Luxembourgish banks have already widely adopted the European credit transfer for retail operations. The adoption of the European direct debit is effective since end 2010; however, its use by creditors remains quite low.

The law of the 10 November 2009, that transposes in particular the directive 2007/64/EC of 13 November 2007 regarding payment services in the internal market, brings significant changes in the field of payments in Luxembourg. A more detailed description is provided in the legal part of this annual report, more precisely in paragraph 3.3.1.2.

### **2.6.3 The general framework of eligible collateral in the Eurosystem credit operations**

#### **2.6.3.1 The list of eligible assets**

All credit operations of the ECB and national central banks are based on "adequate collateral". Consequently, each counterparty of the Eurosystem guarantees the credit received from a Eurosystem central bank by providing assets as collateral. These assets have to fulfil specific eligibility criteria specified by the Eurosystem in the General Documentation on Eurosystem monetary policy instruments and procedures. The list of eligible assets is published on the website of the ECB. This single list for Eurosystem credit operations comprises two different asset classes, marketable assets (securities) and non-marketable assets (in particular credit claims).

In April 2010, the Governing Council confirmed that the following instruments will no longer be eligible as from 1 January 2011:

- Marketable debt instruments denominated in US dollar, pound sterling and Japanese yen, and issued in the euro area.
- Debt instruments issued by credit institutions and traded on certain non-regulated markets accepted by the Eurosystem.
- Subordinated debt instruments when they are protected by an acceptable guarantee.

The Governing Council also decided to keep the minimum credit threshold for marketable and non-marketable assets in the Eurosystem collateral framework at investment-grade level (i.e. BBB-/Baa3) beyond the end of 2010, except in the case of asset-backed securities (ABS). In addition, the Governing Council decided to apply, as of 1 January 2011, a schedule of graduated valuation haircuts to the assets rated in the BBB+ to BBB- range (or equivalent). More detailed information on this haircut schedule is published on the website of the ECB.

On 3 May 2010, the Governing Council suspended, until further notice, the application, in the case of marketable debt instruments issued or guaranteed by the Greek government, of the minimum credit rating threshold in the collateral eligibility requirements for the purposes of the Eurosystem's credit operations. This suspension results, also from a risk management point of view, from the positive evaluation by the Governing Council of the economic and financial adjustment programme, which had been negotiated with the European Commission and the IMF, in liaison with the ECB, and approved by the Greek government, and the strong commitment of the Greek government to fully implement that programme.

In December 2010, the Governing Council decided to add fixed-term deposits to the list of assets eligible as collateral for Eurosystem credit operations.

On 31 March 2011, the Governing Council suspended, until further notice, the application, in the case of marketable debt instruments issued or guaranteed by the Irish government, of the minimum credit rating threshold in the collateral eligibility requirements for the purposes of the Eurosystem's credit operations. This suspension results, also from a risk management point of view, from the positive evaluation by the Governing Council of the economic and financial adjustment programme, which had been negotiated with the European Commission and the IMF, in liaison with the ECB, and approved by the Irish government, and the strong commitment of the Irish government to fully implement that programme.

Concerning asset-backed securities (ABS), the Governing Council had decided in November 2009 to require at least two ratings from an accepted external credit assessment institution for all ABS issued as of 1 March 2010. The eligibility of these assets will be determined according to the "second-best" rule meaning that not only the best but also the second best available rating must comply with the minimum threshold applicable to ABS. As of 1 March 2011, the second-best rule and the requirement to have at least two ratings will be applied to all ABS.

Eligible assets can be used throughout the whole euro area in order to collateralise credit operations with the Eurosystem. According to the nature of the assets and to the country in which they are settled, counterparties use different channels and procedures to mobilise collateral. Non-marketable assets are either mobilised via appropriate handling procedures developed by each NCB (domestic mobilisation) or via intermediation of a correspondent central bank (cross-border mobilisation). The mobilisation of marketable assets requires the involvement of one or of several securities settlement systems.

### **2.6.3.2 The Eurosystem as a user of securities settlement systems**

#### ***Selection of central securities depositories at the domestic level***

For the mobilisation of securities by its counterparties, the Eurosystem has selected securities settlement systems operated by central securities depositories. A securities settlement system of a national CSD is eligible if it obtains, after verification of its compliance with the evaluation criteria established by the Eurosystem (the User Standards), the formal approval of the Governing Council. In this context, the Eurosystem assesses securities settlement systems and links between securities settlement systems. In Luxembourg, the systems operated by Clearstream Banking S.A. (CBL) and by VP Lux S.à r.l. are eligible for the mobilisation of securities by the Eurosystem's counterparties.

#### ***Cross-border use of collateral***

Besides using eligible domestic securities settled via the national depository, counterparties can receive credit from their national central bank by using collateral issued in a depository located elsewhere in the euro area. The Eurosystem sets two procedures for such cross-border use of collateral. Counterparties may use

- the CCBM<sup>9</sup>; and
- links established between securities settlement systems of CSDs.

Currently two types of links are eligible: direct links and relayed links:

- In a given securities settlement system located in a country of the euro area, direct links make available securities issued in a system of another euro area country, thanks to bilateral accounts that the two systems maintain with each other.
- Relayed links enable the transfer of securities between two systems without bilateral accounts by using a third intermediary system.

Links have to be approved by the Governing Council before being used for the collateralisation of central bank credit operations. In 2010, Luxembourg counterparties had the possibility to use the direct links between CBL

---

<sup>9</sup> Correspondent Central Banking Model, see section 2.6.4.

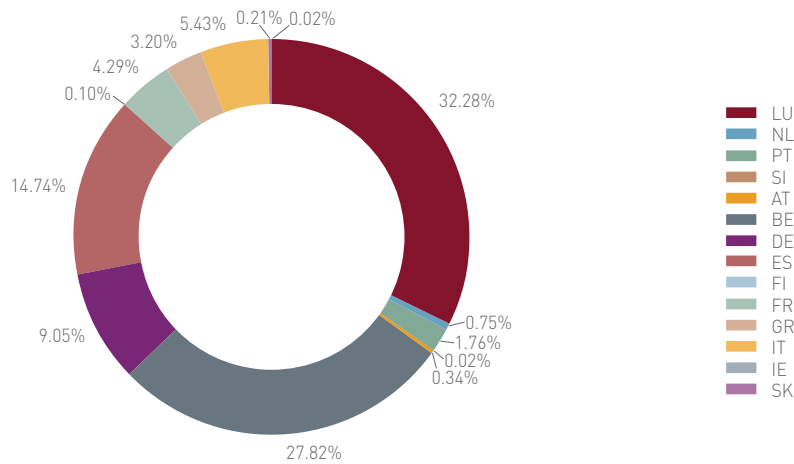
and Clearstream Banking A.G. Frankfurt, Euroclear Bank, the SSS operated by National Bank of Belgium, Monte Titoli (Italy), OeKB (Austria), Euroclear Netherlands, Euroclear France, and KDD (Slovenia).

### 2.6.4 Correspondent Central Banking Model (CCBM)

The main objective of the CCBM is to enable counterparties of the Eurosystem to use securities on a cross-border basis even if there is no eligible link between the national depository and the foreign depository in which the counterparty holds securities. For this purpose, in the CCBM each national central bank acts on behalf of the other central banks as a custodian for securities held at the national depository. This procedure involves first of all a central bank called a correspondent central bank (CCB), which differs from the central bank granting the credit to the counterparty. The CCB holds the account at the CSD in which the deposited securities are registered. The home central bank (HCB) grants the credit to its counterparty on the basis of confirmations it receives from the CCB.

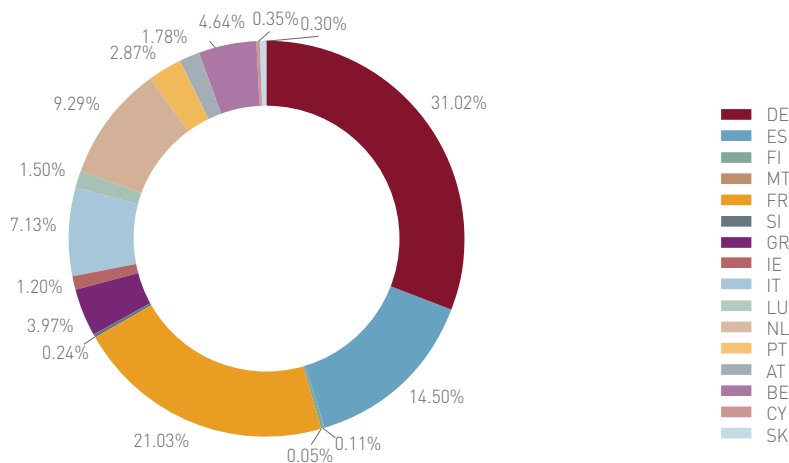
The CCBM remains the main channel for the cross-border mobilisation of collateral used in the Eurosystem's credit operations.

Chart 2.15:  
Correspondent central bank in 2010



In terms of value, the most active correspondent central banks in 2010 were those of Luxembourg (32.28%), Belgium (27.82%), Spain (14.74%), and Germany (9.05%). The most active home central banks were those of Germany (31.02%), France (21.03%), Spain (14.50%), and the Netherlands (9.29%).

Chart 2.16:  
Home central banks in 2010





Box 2.1:

### THE TARGET2-SECURITIES PROJECT

In light of a very fragmented market with a multitude of securities settlement systems calling for the set-up of a pan-European infrastructure, the Eurosystem has pursued its endeavour to develop the Target2-Securities system (T2S). The T2S project consists more specifically in the setting up of a centralised platform providing harmonised delivery versus payment settlement services, in central bank money, across all participating central securities depositories. This project is a part of a more general endeavour, at European level, aiming at integrating financial markets, standardising existing processes and reducing substantially costs and risks.

Following the "Specification" phase, the Target2-Securities has entered its "development" phase in 2010. Beyond the announcement of its launch date, foreseen in September 2014, a number of developments have materialised this year, the most important of these being the following:

- The Users Specifications, which had been finalised and submitted for consultation in 2009 were officially frozen in February 2010 as a stable base upon which to start the development of the first version of the platform;
- Intense negotiations have started between the Programme Board, a body created by the Governing Council, and those Central Securities Depositories having signed the T2S Memorandum of Understanding, in order to define the legal framework which will organ-

ise their relationships upon the launch of T2S. The discussions on this important contractual framework were nearly finalised at the end of the year, in order to allow for the signature of the Framework Agreement in the course of 2011;

- The Target2-Securities project was presented for the first time at SIBOS (Swift International Banking Operations Seminar) in October 2010 in Amsterdam;
- During SIBOS, the Target2-Securities pricing was presented with the reference price of a standard delivery versus payment instruction being set at 15 cents. This price will be valid for intra-CSD as for cross-border transactions;
- The T2S Project team was very active, and collaborating with key market players, in specifying the way T2S functionalities will be implemented and how this will trigger a number of changes to local market practices in those countries which will adopt the platform. All these exchanges took place through a number of working sessions.

2011 will be a crucial year for Target2-Securities with the signature of the Framework Agreement between the Eurosystem and the Central Securities Depositories as well as the communication by those CSDs of their plans on how they will adapt and integrate their activities with T2S and the impact this will have on their business models as well as those of their customers.

Box 2.2:

### THE CCBM2 SYSTEM PROJECT

In July 2008 the Governing Council decided to develop and to implement the single platform CCBM2 (Collateral Central Bank Management). This platform will offer central banks the necessary functionalities for the management of securities and credit claims received from counterparties, both for domestic and for cross-border collateral. The development and the operation of CCBM2 on behalf of the Eurosystem was assigned to the National Bank of Belgium and to De Nederlandsche Bank. It is envisaged that the operations of the platform will start before or at the same time as T2S.

CCBM2 will closely interact with the two other infrastructures operated by the Eurosystem in the area of liquidity, TARGET2 and T2S. The three systems will provide complementary services. For instance, on the basis of securities settled in T2S, CCBM2 will instruct TARGET2 to update a counterparty's credit line in TARGET2. Given the complementarities and the enhanced efficiency, the CCBM2 platform constitutes an additional initiative of the Eurosystem that reinforces market integration.

CCBM2 will process instructions in a Straight-Through Processing manner. This will permit the Eurosystem's counterparties to mobilise their col-

lateral in a quick and safe way in order to generate in real time corresponding credit in TARGET2. For counterparties, CCBM2 will hence facilitate the realisation of benefits from TARGET2 and T2S. Moreover, CCBM2 will entail a standardisation of communication and of collateral mobilisation procedures. Finally, CCBM2 will permit banks operating in multiple countries of the euro area to optimise their use of collateral, and thereby to enhance their liquidity management.

CCBM2 will be a modular system, consisting of a message router, and of modules for the management of securities and of non-marketable assets. Only the participation in the message router is mandatory for the national central banks (NCBs). This will ensure a standardised interaction between the Eurosystem and counterparties, and will permit NCBs to choose the modules of CCBM2 according to their own needs. In 2010, the NCBs of the Eurosystem confirmed their participation in the different modules of CCBM2. The big majority of Eurosystem NCBs will participate in all modules of CCBM2.

In 2010, the Eurosystem has also finalised the elaboration of the Business Requirements Document, which defines the functionalities as well as the

non-functional requirements of the CCBM2 platform. The functionalities describe the tasks to be performed by CCBM2, while the non-functional requirements define the service level of the platform. On the basis of the Business Requirements Document, the Eurosystem has subsequently started to work out the detailed functionalities, which enable the development of the CCBM2 software. Moreover, the Eurosystem has started to draft an Interface Guide, which will indicate the communication channels as well as the messages used by central securities depositories and the counterparties in order to communicate with CCBM2. CCBM2 will permit the use of SWIFT and of the Internet as communication network.

Although CCBM2 pursues the objective of a technically consolidated management of collateral, the NCBs stay responsible for the relations with their counterparties. In line with the availability of technical documentation, the BCL will reinforce its preparatory work with its counterparties and with central securities depositories in 2011. This work will comprise on the one side continued information on the planning of the project, and on the other side the preparations in view of counterparty certification, testing, migration, and the operational phase of CCBM2.

### 2.6.5 The creation of LuxCSD

In relation to the development of Target2Securities (T2S), a Central Securities Depository (CSD) providing settlement services in central bank money had to be created in Luxembourg. LuxCSD, the new central securities depository in Luxembourg, aims at providing a local access to the T2S infrastructure when this one will be launched, in 2014.

The LuxCSD S.A. Company was incorporated in July 2010, jointly by the BCL and Clearstream International in an equal partnership. Going forward, Clearstream will be the operator of LuxCSD in providing the following services:

- Securities settlement in central bank money;
- Securities settlement free of payment;
- Securities issuance with central bank money settlement or free of payment;
- Securities safe keeping;
- Order routing for investment funds;
- Direct settlement against counterparties in Clearstream Banking;
- In due time, a national access to Target2Securities.

LuxCSD will support the issuance and the holding of debt securities, equities or investment funds shares, domiciled in or outside Luxembourg. A specific focus will be granted to providing specific services related to investment funds in light of Luxembourg leadership in that area.

LuxCSD will be live in the second half of 2011 and will be assessed according to the procedures of the Eurosystem. The BCL will open an account in LuxCSD to collect collateral needed to support monetary policy operations.

LuxCSD has a Board of Directors composed of one member issued from the BCL and two members issued from Clearstream Banking. The Board of Directors is supported by a General Manager in charge of daily operations and a User Commission.

## **2.7 FINANCIAL STABILITY AND PRUDENTIAL SUPERVISION**

### **2.7.1 Macro-prudential supervision**

#### **2.7.1.1 Macro-prudential supervision in Luxembourg**

Given the high degree of interconnectedness between the different financial actors, the identification and analysis of potential systemic risks necessitates the adoption of a holistic approach to the financial system. In fact, any component of the financial system may generate vulnerabilities which can have important repercussions on the financial sector and on the real economy. Accordingly, macro-prudential analysis must be based on a large range of appropriate data not only at the aggregated level but also at the individual level with specific emphasis placed on systemically important financial institutions.

In order to assess the robustness of the financial system as a whole and the importance of the systemic risks which could affect the equilibrium of the financial system in Luxembourg, the BCL bases its macro-prudential approach on multiple methodologies and indicators. Nevertheless, considering the importance of the banking sector in Luxembourg and its interconnectedness with other segments of the financial system, from a macro-prudential perspective the BCL assigns particular importance to the analysis of the sector. Currently, the BCL gives priority to the time dimension of macro-prudential supervision, which is directly linked to procyclicality issues.

Tools used for the time analysis, include notably the modeling of the links between the financial and the real economies, the construction of a model dedicated to the analysis of liquidity in the banking sector in the event of shocks, the development of a vulnerability index of the financial system providing projections up to two years and the estimation of the default probability of banks and their counterparties. These analyses tend to show that the Luxembourg banking sector is sufficiently robust to absorb severe financial shocks. It has to be highlighted that some indicators developed by the BCL follow a prospective approach.

Indeed, in order to be able to anticipate the emergence of weaknesses in the banking sector, the BCL assigns significant importance to the evolution of its synthetic indicator of financial vulnerability as well as to the results of its macro-prudential stress-tests. The vulnerability index is composed of a large range of variables based on banks' balance sheet and profit and loss account data (checking and interbank deposits, profitability, variability of common equity and provisions), on macro-financial data (yields of stock markets) and variables which reflect the competitive structure of the banking sector (variation in the number of banks).

Considering the available data and macro-economic forecasts of the Eurosystem, projections of this indicator up to a horizon of two years are performed in order to assess the medium-term evolution of the vulnerability of the banking sector in Luxembourg. As an illustration, projections obtained for 2011-2012 show that the level of this indicator remains very close to the average historical risk level. In other words, it is in line with financial stability requirements. As regards stress-tests, the BCL conducted two stress-tests on the Luxembourgish banking sector in 2010 (see box 2.3 and 2.4). The first one has been run within the context of the framework of the assessment of the Luxembourg financial system conducted by the IMF; whereas the second one was specifically tailored towards the analysis of credit risk. The results of these analyses were published in the BCL's Financial Stability Review at the end of April 2011.

Several *ad hoc* analyses have been conducted in order to assess the repercussions of the emergence of new risks. In this context, two studies have been recently conducted in order to quantify the impact of the new Basel III regulation on the Luxembourgish credit institutions. In addition, a common project has been conducted by the BCL and the Luxembourg school for finance during the first quarter of 2011, backed by the

financial support of the national research fund. This study is dedicated to the analysis of issues related to the stability of the financial system in Luxembourg. Indeed, these research efforts have provided encouraging preliminary results regarding the estimation of probabilities of defaults for Luxembourgish banks based on the Merton model.

In this context, the BCL gives particular attention to the impact of the implementation of the new Basel III regulation on liquidity and deleveraging. It seems necessary that these rules should take into account the business models of banks. It is of great importance that the cumulative impact of these regulations on the banking sector is analysed through a segregated approach.

Concerning the cross-sectional dimension, the analysis is constrained by the limited data that are available for the evaluation of common exposures. Despite this constraint, the use of the "security-by-security" database permits the BCL to analyze, on an ongoing basis, the important sovereign exposures to credit institutions and investment funds. In order to increase our understanding not only of the interconnectedness of Luxembourg banks, but also of their exposures to common counterparties, the BCL, as the macro-prudential supervisory authority, actively participates in a research network organised by the ESCB. This network has the specific objective of analyzing contagion channels using Target II data.

In performing its duties with respect to macro-prudential supervision, the BCL contributes actively to the different committees and working groups of the ESCB. These include the Financial Stability Committee (FSC), which was set up in 2011 as a replacement for the former BSC. Finally, it has to be highlighted that the BCL's involvement in macro-prudential supervision increased following the establishment of the European Systemic Risk Board (ESRB) and its related bodies, such as in particular the Advisory Technical Committee and its two sub-structures related to macro-prudential tools and macro-prudential analysis, respectively.

Box 2.3:

### THE IMF FSAP MISSION

The IMF mission was present in Luxembourg throughout November 2010 in order to conduct a Financial Sector Assessment Program (FSAP). The evaluation carried out under this framework, to which the BCL has participated, assessed the robustness of the Luxembourg financial sector. In this respect, the discussions were focused primarily on the analysis of the robustness of banks, insurance companies and investment funds as well as on the structure of the Luxembourgish financial sector. Moreover, the quality of the legal framework and of financial infrastructures, such as payments and securities settlements systems, as well as the capacity for the competent authority to handle a systemic crisis, were also analysed. At the institutional level, the BCL was involved in the assessment of central counterparties in Luxembourg and also in the conduct of the macro and the liquidity stress-tests.

Moreover, three self-assessment exercises were conducted by the competent authorities in order to assess the quality of the financial system over-

sight and its compliance with international standards. These were related to the assessment of the fundamental principles of the Basel Committee, the assessment of the migration level of principles of financial regulation to the International Organisations of Securities Commissions (OICV or IOSCO) and the assessment of the fundamental principles regarding the payments and security settlements (CPSS/IOSCO).

In addition, the BCL has participated in a stress-test within the context of the FSAP in order to analyse the capacity of the Luxembourgish banking sector, as a whole, to resist the emergence of macro-economic shocks. The IMF approach for simulation of the scenarios was based on a "top down" approach. This consisted of a sensitivity analysis to measure the effects of shocks on a sample of banks in terms of the impact on their Tier 1 solvability ratios. This exercise demonstrated that profits are the first means of absorbing losses following an economic shock. However, it appears that during a period of stress, profits generated may not always be at a level that is sufficient to cover losses. In this case, recourse to common equity may be required.

Box 2.4:

#### **EU-WIDE STRESS TESTING EXERCISE**

In 2010, a stress test was conducted at the European level, under the aegis of the EU Finance Ministers (ECOFIN Council) and coordinated by the Committee of European Banking Supervisors (CEBS) with the close cooperation of the European Central Bank (ECB). As of January 2011, CEBS has been replaced by the European Banking Authority (EBA). The objective of this exercise was to assess the resilience of the European banking system in the event of severe and strong economic shocks over the 2010 and 2011 horizon.

This exercise was based on a sample of 91 European banks and banking groups, including large banks with cross border activities, but also some local banks with significant activities within EU Member States. Regarding Luxembourg, two banks were

included in the sample given their predominant role in the Luxembourg financial sector. The ECB has been actively involved in the development of the macro-economic scenarios for 2010 and 2011, not only with respect to the baseline scenario but also with respect to the adverse one. In the context of the most severe scenario, banks that were unable to maintain a *Tier 1* equity ratio superior to 6%, at the end of 2011, were deemed to have failed the test.

Based on its own internal stress-test models, the BCL reached a similar conclusion for the solvability ratios as published by the two Luxembourgish banks. Under the most severe adverse scenario, these ratios remained above 6%, thereby demonstrating the robustness of the Luxembourg banks. This exercise has been repeated during the first quarter of 2011 and has been based on even more severe macro-economic scenarios. The 2011 exercise will be further reinforced by a peer review process.

#### **2.7.1.2 The establishment of the European System of Financial Supervisors (ESFS)**

Further to the recommendations for reinforcing the European system of financial supervision that were issued by the High level group chaired by Jacques de Larosiere, the European Commission issued, at the end of 2009, five legislative proposals aimed at establishing a new European financial supervisory architecture. In this respect, 2010 has been characterised by the examination and the adoption of those legislative texts by the European Parliament and the Council, in order to put in place a new European System of Financial Supervisors (ESFS). This system relies on the two complementary pillars of supervision, namely the micro- and macro-dimensions. The ESFS is composed of an integrated network of European and national supervisory authorities while the day-to-day supervisory responsibilities remain at national level. More precisely, the ESFS is composed of:

- i) the **European Systemic Risk Board (ESRB)**, a new independent body, is responsible for the oversight of risks at the European level. According to the legislation, the ESRB, which formally came into existence on 16 December 2010, shall assess the systemic risks in order to mitigate the exposure of the system to the risk of failure of systemic institutions and to enhance the financial system's resilience to shocks. The ESRB is in charge of issuing warnings and recommendations where such systemic risks are deemed to be significant. In this respect, the ESRB covers all financial sectors and contributes to mitigating any potential negative impact on the real economy. All ESRB bodies namely- the General Board, the Steering Committee, the Secretariat, the Advisory Scientific Committee, and the Advisory Technical Committee- are now operational. The ECB is in charge of the Secretariat of the ESRB.
- ii) three **European Supervisory Authorities (ESA's)**, established on 1 January 2011, are responsible for the micro prudential oversight of the European financial system, namely, the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA), and the European Securities and Markets Authority (ESMA). The ESA's shall contribute to the set-up of common regulations and technical standards in terms of supervision, and to the harmonised implementation of legal EU binding decisions, to stimulate and foster delegations of tasks and responsibilities between competent authorities, to cooperate closely with the ESRB, to analyse the evolution of the markets in their respective competence fields and to foster the protection of depositors and investors.

- iii) the **Joint committee** of the European supervisory authorities will ensure the consistency of activities between the three ESA's, in cooperation with the ESRB. Through this Joint Committee, those authorities shall closely coordinate their activities and elaborate common positions regarding, for instance, financial conglomerates.
- iv) The **competent or supervisory authorities** in the Members States.

The establishment of a body dedicated to macro-prudential supervision constitutes a step forward in strengthening European financial supervision, thus contributing to safeguarding financial stability. This new architecture, which was instituted at the beginning of 2011, contributes to addressing the weaknesses related to the fragmentation of the responsibilities associated with financial supervision and the analysis of systemic risks, as demonstrated by the recent crisis. The establishment of the ESRB should allow for a better identification and assessment of macro-prudential risks as well as the issuance of specific warnings and recommendations to be implemented by the relevant authorities and operators. The cooperation between the micro- and macro dimensions is essential, firstly in order to ensure the smooth functioning of the new architecture, especially regarding the access and exchange of all necessary data, and secondly, regarding the follow-up of warnings and recommendations issued by the ESRB. This is important given that it lacks both a legal mandate and a set of legally binding powers. Finally, at least annually and more frequently in the event of widespread distress, the ESRB will be invited to an annual hearing in the European Parliament and the Council.

This new architecture calls for new responsibilities for central banks which play an important role in European macro-prudential supervision. Indeed, the President of the BCL is a voting member of the General Board, the only decision-making body of the ESRB. The ordinary plenary meetings of the General Board are scheduled to take place at least four times a year. The inaugural meeting was held on 20 January 2011. In addition, the national supervisory authorities are also members of the General Board and can contribute through their specific knowledge and experience. In this respect, the BCL, as the authority in charge of markets' and operators' liquidity surveillance, is also represented at the General Board level but as a non-voting member that follows a rotation mechanism with the other national supervisory authorities. As such, the BCL is also represented at the European Banking Authority. Finally, the BCL makes its expertise available in terms of macro-prudential, financial, monetary and statistical analyses, by participating in the studies and technical work conducted by the various ESRB bodies. In this context, the BCL participates in the work done by the Advisory Technical Committee and its two sub-structures.

## **2.7.2 Micro-prudential supervision**

### **2.7.2.1 Liquidity supervision**

Following an amendment to its organic law dated 24 October 2008, the Banque centrale du Luxembourg was entrusted with the task to supervise the liquidity situation of market operators. As opposed to macro-prudential supervision, which aims at analysing the systemic risk and possible contagion effects within the financial system, liquidity supervision intends here to assess the liquidity situation of individual operators as well as their liquidity risk management framework. The 2008 market turbulences being largely due to shortcomings in the liquidity risk management framework of financial market operators, the management of liquidity and its related risk has become one of the major topics on the agenda of supervisory authorities throughout the last two years, and this both at national and international level. This momentum has been reflected in Luxembourg by entrusting the Banque centrale with the liquidity supervision of market operators. Liquidity regulations are in fact particularly important for a central bank for two reasons: On the one hand, central banks act as liquidity providers to the financial system in normal as well as in stressed times. On the other hand, central banks can detect and help prevent potential series of bank failures and thereby limit systemic risk.

While the year 2009 has been mostly dedicated to the definition and the set-up of an appropriate framework pertaining to the performance of this new mission, in particular with the publication of a regulation (BCL regulation 2009/N°4 dated 29 April 2009) defining the rules and responsibilities of market operators in the field of liquidity risk management, the year 2010 was marked by the implementation and actual application of this new supervisory framework on a national level as well as by the follow-up of international workstreams in relation with the definition and the development of the new liquidity standards in the context of Basel III.

The supervisory framework of the BCL relies essentially on two pillars: On the one hand the ongoing off-site monitoring of market operators and on the other hand on-site inspections with market operators.

The ongoing off-site monitoring is based on the regular analysis of both qualitative and quantitative information at the level of individual market operators as well as at an aggregated level. In order to streamline and enhance the efficiency of its monitoring of the liquidity situation of market operators, the Banque centrale has put in place a Daily Liquidity Reporting (DLR). This reporting, which is required from a selected sample of credit institutions, has been introduced in May 2010 and allows assessing the liquidity situation of credit institutions. Furthermore, the Banque centrale has initiated the analysis of the liquidity risk of investment funds, with a specific focus on monetary funds, and insurance companies.

In the context of the development of the new Basel III liquidity standards, the Banque centrale has carried out a first impact study among 29 credit institutions in May 2010. This study was repeated in early 2011. The studies showed that a majority of local banks do not yet comply with the new liquidity standards. It has to be noted that these standards will become legally binding from 2015 respectively 2018 onwards.

On-site inspections of market operators allow the Banque centrale du Luxembourg to assess the existing framework and procedures established by individual market operators with regards to their liquidity risk management framework (compliance with best practice). Mainly targeted are those credit institutions that are the most exposed to liquidity risks due to the nature of their businesses. Also targeted are those institutions which are particularly linked through their participation in monetary policy operations. During the course of 2010, the Banque centrale du Luxembourg conducted seven on-site inspections and twelve short-term visits in coordination with the *Commission de surveillance du secteur financier*. The visits showed that credit institutions are reinforcing their liquidity risk management frameworks in order to comply with existing rules and standards, but they also showed that there are still weaknesses, in particular when it comes to conducting stress tests.

As a supervisor in charge of liquidity supervision, the Banque centrale currently participates in six colleges of supervisors, which allows for a better evaluation of the activities and risk profiles of important local subsidiaries of cross-border banking groups.

Furthermore, as supervisor of liquidity the Banque centrale is a member of the "European Systemic Risk Board (ESRB)" and participates in the "Board of Supervisors" of the "European Banking Authority" (EBA), formerly CEBS. Moreover, it participates in specific working groups on liquidity at the level of the Basel Committee on Banking Supervision (BCBS), which issued in December 2010 the final version of its liquidity standards planned to be implemented progressively over the following years.

### 2.7.2.2 Oversight

The payment and settlement infrastructures constitute indispensable elements for the development of market economies. Indeed, these infrastructures permit the settlement of payment flows related to products, services and financial assets. Their smooth functioning is therefore essential for the implementation of monetary policy, the safeguarding of financial stability and of the public confidence in the currency.

The BCL, as a member of the Eurosystem, has as mission to promote the smooth functioning of payment and settlement infrastructures. This mission focuses, in particular, on overseeing the security and the efficiency of payment and securities settlement systems, as well as the security of payment instruments.

The BCL adopted on 8 November 2010 a regulation which specifies the scope of its oversight mission, the general framework and the means by which it performs this activity. This regulation is published in the Mémorial and on BCL's website. According to this regulation, the BCL's oversight includes the system or the instrument, itself comprising the operators or the issuers, the participants, the services (in particular of operational and technical nature) provided by technical agents or third party entities. The oversight applies also to the operating rules and contracts related to the systems or instruments.

Moreover, the operators of systems and the issuers of payment instruments shall put in place a risk management framework adapted to the size and complexity of their activity. This framework shall be based on an

organisation, procedures and internal rules enabling an efficient management, monitoring and control of the security and/or efficiency of the system or instrument, of the associated risks as well as of the applicable legal and operational environments.

The oversight performed by the BCL is based on regular reportings from relevant actors comprising quantitative and qualitative information, completed by regular contacts and specific on site inspections. The actors are required to conduct regular self assessments of the degree of compliance of their infrastructure against applicable recommendations, standards or principles. The BCL applies the recommendations, standards and principles defined by the Eurosystem for the different types of systems and payment instruments and which have been adopted by the Governing Council of the ECB.

BCL's oversight consists of two fields of activity. On the one hand, the oversight activities concern the systems which it designates and operates in Luxembourg and the payment instruments made available to the public in Luxembourg. On the other hand, the BCL contributes to the oversight activities which are performed in a coordinated way at the Eurosystem level and are partly focused on infrastructures without clear domestic anchorage.

Overall, the operations and the services provided by the overseen payment and settlement infrastructures showed a stable and resilient functioning in 2010.

### **Securities settlement systems**

In 2010, the BCL pursued its oversight activities related to the systems operated by Clearstream Banking SA and by VP Lux. The BCL proceeded to the analysis of regular and *ad hoc* information received in relation with the system's activities, incidents, monitoring and management of certain risks, governance, rules and internal procedures, as well as financial data related to the systems.

The system operated by Clearstream was assessed against the 19 recommendations jointly issued by the ESCB and the Committee of European Securities Regulators (CESR), which became ESMA in 2011. The system shows a high degree of compliance regarding most of the ESCB-CESR recommendations. Nevertheless, some specific action points have been addressed to the operator and a follow-up of the implementation of these actions will be conducted in 2011. A similar assessment of the system operated by VP Lux against the same ESCB-CESR recommendations was launched end of 2010 and will be finalised during 2011.

The BCL has also cooperated and exchanged information with foreign competent authorities for the oversight of certain entities or technical agents which are supplying IT and/or operational services to operators of the settlement systems in Luxembourg.

Concerning the future securities settlement system operated by LuxCSD SA, the BCL has started its analysis of the preliminary documentation sent by the operator. This analysis will be finalised in 2011.

Finally, the BCL contributed to the coordinated oversight activities related to Target2 Securities (T2S), the securities settlement single platform which is currently being developed at Eurosystem level. Given the international nature of the settlement services which will be proposed by T2S to infrastructures based in and outside the euro area, a cooperative oversight framework will be put in place regrouping the prudential supervisors and the central banks which are competent in this field. A preliminary assessment of the design of the T2S platform was launched in 2010 by the concerned authorities.

### **Payment systems**

In the field of payment systems, the BCL contributed to the joint oversight of the Target2 payment system, the single platform put in place by the Eurosystem. In this context, an assessment of the system against "Business continuity oversight expectations" was finalised in 2010. Globally, this assessment concluded on a well defined framework for business continuity, as well as a high degree of resilience. Certain recommendations were nevertheless issued by the Eurosystem on specific points.



Concerning the Target2 payment system, the BCL is also in charge of overseeing some decentralised aspects located in Luxembourg. These aspects include among others the contractual relationship and the support function towards the Luxembourg participants, as well as the IT infrastructure for the connection of the BCL to the Target2 system. In this regard, the BCL defined specific principles.

Finally, the BCL took an interest in the activities of the payment systems operated by EBA Clearing and more specifically, the systems Euro 1 and Step 2. The oversight of these systems is performed by the ECB and is subject to an information exchange and discussions within the Eurosystem.

### ***Payment instruments***

The payment instruments which fall under the scope of BCL's oversight comprise among others the credit transfer, the direct debit, the payment cards and the e-money schemes which are offered to the public in Luxembourg.

In 2010, the BCL extended the reporting scheme related to certain payment instruments, in particular the payment cards and the e-money schemes. This information, concerning among others, activity, fraud and incidents, is collected on a regular basis and subject to BCL's follow-up.

Furthermore, in 2010 the BCL contributed to the coordinated assessment exercise of all payment card schemes operating in the euro area, and more particularly to the peer review of assessments of certain card schemes conducted by other central banks. This review confirmed that the different central banks have implemented the oversight standards for payment cards in a consistent manner. The conclusions of this assessment by the Eurosystem will be finalised and published in 2011.

Finally, specific oversight frameworks were defined in 2010 at the Eurosystem level for the SEPA credit transfer and direct debit schemes. In 2011, the BCL will participate in a coordinated assessment exercise of these instruments, based on these frameworks.

## **2.8 LEGISLATIVE ACTIVITY**

### **2.8.1 European legislation**

#### **2.8.1.1 Treaty change**

The provisions of the Treaty of Lisbon which entered into force on 1st December 2009 established the Eurosystem<sup>10</sup> and set up the new European legal framework as well as the legal basis of new pieces of legislation adopted since then.

In connection with the management of the Greek and Irish crises, the European Council of 28-29 October 2010 adopted the final report of the task force set up in March 2010 and chaired by Mr Van Rompuy, President of the European Council. The Heads of State or Government of the European Union have agreed on the need to adopt a permanent mechanism so as to manage the crisis and preserve the financial stability of the euro area.

On 16 December 2010, the European Council agreed that the Treaty should be amended in order for a permanent mechanism to be established by the Member States of the euro area to safeguard the financial stability of the euro area as a whole (the European Stability Mechanism). This mechanism will replace the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM), which will remain in force until June 2013. It approved the following paragraph to be added to Article 136 of the Treaty on the Functioning of the European Union (TFEU):

“The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality.”

---

<sup>10</sup> Article 282 of the TFEU.

In order to conduct this amendment, the European Council decided to launch the simplified revision procedure provided for in Article 48(6) of the Treaty on the European Union with a view of having national approval procedures completed by the end of 2012 and entry into force on 1st January 2013.

### 2.8.1.2 Economic governance

On 29 September 2010, the European Commission adopted a legislative package containing a reinforcement of the economic governance in the European Union.

The existing legislation has proven to have shortcomings. A broader and enhanced surveillance of fiscal policies is foreseen and macroeconomic policies and structural reforms are sought. New enforcement mechanisms are foreseen for non-compliant Member States. The recently agreed "European semester" will integrate all revised and new surveillance processes into a comprehensive and effective economic policy framework<sup>11</sup>.

The legislative package is made up of six pieces of legislation: four proposals deal with fiscal issues, including a wide-ranging reform of the Stability and Growth Pact, while two new regulations aim at detecting and addressing effectively emerging macroeconomic imbalances within the European Union and the euro area.

This package of new measures is intended to be adopted by June 2011.

### 2.8.1.3 Financial supervision

At the end of 2010, the European Union lawmaker adopted a new financial stability scheme in the Union which entered into force on 1st January 2011 and which is based on macroprudential supervision. This scheme hinges on a European System of Financial Supervision (ESFS) that comprises in particular the new European Systemic Risk Board (ESRB), based in Frankfurt, and three new European Supervisory Authorities: the European Banking Authority (EBA), in London, the European Insurance and Occupational Pensions Authority, in Frankfurt, and the European Securities and Markets Authority (ESMA), in Paris.

Regulations establishing the European System of Financial Supervision provide that the Governor of the BCL participates in meetings of the General Board of the ESRB with a voting right.

## 2.8.2 National legislation

At the end of 2010, the BCL presented a pre-draft-bill (*avant-projet de loi*) to the Government with the aim of adapting and recasting the law of 23 December 1998 concerning the monetary status and the BCL (the Organic Law).

The pre-draft-bill was presented to the Government before being subject to the consultation of the ECB. It may be recalled that, in accordance with Article 127(4) of the TFEU<sup>12</sup>, any amendment of the Organic Law must be submitted to the ECB before their adoption.

This pre-draft-bill includes provisions clarifying the missions of the BCL, its organisation, as well as its independence that are made necessary to adapt it to the change of the legal framework.

### 2.8.2.1 Provisions dealing with the missions of the BCL

Without prejudice to the missions deriving from its participation in the ESCB, it is important to clarify the missions of the BCL, in particular taking into account the new European framework of financial supervision.

The BCL's main task remains the participation in the execution of the tasks of the Eurosystem and of the ESCB. Then, in accordance with EU law, the pre-draft-bill provides that the BCL plays a role in financial stability with the prevention of systemic risk and macroprudential supervision, as well as with the supervision of

<sup>11</sup> Pres release IP/10/99 of 29 September 2010.

<sup>12</sup> Article 127 of the TFEU replaces ex-Article 105 of the Treaty establishing the European Community since the entry into force of the Treaty of Lisbon.

market participants. The new provisions foresee to ensure an efficient coordination between the supervision authorities that are involved, in compliance with European obligations. It is essential to coordinate the activities of the supervision authorities in Luxembourg to the benefit of participants so as to limit the administrative burden and to give foreign supervision authorities one well-identified contact point. It is important to clarify that within the relationship with foreign authorities, European authorities or international bodies, the BCL is performing responsibilities that are assigned by domestic law. These developments are small in comparison with the legal regimes that are applied in other Member States and on which Luxembourg could build further reforms on.

Since the beginning, the Council of the BCL has discussed about the economic and financial evolution of Luxembourg, based on the works of the BCL. This activity is growing and the requirement emerges to clarify its legal basis.

Moreover, the statistical tasks of the BCL are rapidly developing and require new legal provisions. Thus, it seemed necessary to review the outdated framework set forth by Grand-Ducal decree of 10 November 1944, as modified, that deals with the foreign exchange control. It is also an opportunity to include in the organic law some provisions that are spread in different pieces of legislation as well as clarifying the statistical tasks of the BCL with respect to the balance of payments, financial accounts and public finance fields.

The pre-draft-bill also foresees confirming the research activity of the BCL in the monetary and financial fields, as it is carried out by the whole Eurosystem.

Further, it is important that the BCL could benefit from the payment of fees by entities under its supervision to perform its tasks as an authority, such as other supervision authorities and in compliance with the principles of financial independence and of monetary financing prohibition set in the Treaty on the Functioning of the European Union (TFEU) according to which the national lawmaker cannot oblige the BCL to perform new tasks without the related financial compensation.

Finally, in view of the new tasks of the BCL, particularly in the field of supervision, it is appropriate to adapt its civil liability regime like it is applied to other authorities in Luxembourg.

### **2.8.2.2 Provisions dealing with the BCL's organisation and its independence**

Many provisions of the pre-draft-bill are intended to clarify the independence regime of the BCL and thus address comments raised by ECB opinions.

The BCL, as a member of the Eurosystem and of the ESCB, is a "sui generis" public institution established under national law in compliance with the Treaties that impose to set it free from any governmental supervision over the conduct of its basic tasks. It must act independently. The recent opinion of the ECB of 17 June 2010 (CON/2010/48) holds that the principle of central bank independence requires "that no third party [i.e. including a Government or a national lawmaker] should be able to exercise direct or indirect influence [over the performance of the NCB's tasks, or over its ability, both operationally in terms of manpower, and financially in terms of appropriate financial resources, to fulfil its mandate [...] and to properly cover its administrative and operational expenses]"<sup>13</sup>.

This BCL's independence is counterbalanced by a judicial control of its legal acts (which is reinforced by the pre-draft-bill) and a direct relationship with the Parliament (which is also reinforced) in order to ensure that the BCL, through the intervention of its Governor, reports on its activities and on its situation, particularly from an assets and an organisational perspective. Thus, it is proposed that the Governor of the BCL could be invited by the Parliament to present the reports and stances of the BCL and have an exchange of views.

The pre-draft-bill aims at precisating the rules of governance and identifies the provisions applicable to the Council of the BCL, the Executive Board and the Governor respectively.

<sup>13</sup> Opinion of the ECB of 17 June 2010 on a draft law relating to the restructuring of the Central Bank and Financial Services Authority of Ireland (CON/2010/48), section 3.1.14, p. 9.

With respect to the Council of the BCL, it is foreseen to slightly modify the scope of its powers so as to take into account current practice. As the Executive Board is being confirmed in the superior executive role of the BCL, it seemed worth defining that members of the Council will not take on a personal civil liability.

The pre-draft-bill makes clear that the Executive Board adopts the regulations as well as other legal acts of the BCL.

In addition, considering the evolution of the activities of the BCL, the need to adapt the current composition of the Executive Board has been addressed by providing for the possibility to appoint from three to five directors (instead of two as of today) besides the Governor.

As regards the Governor, one may note that the BCL is the only NCB of the Eurosystem whose organic law does not define its status. It is proposed to remedy to this gap. In particular, the Governor exercises himself the missions allocated to him at European level.

It is also important for the BCL to dispose of an appropriate financial basis, in line with the material increase of its commitments and of risks exposed to conduct its activities. To achieve that, a capital set at least at one billion euro appears to be necessary. Some reserves were already incorporated to the capital in 2009, in accordance with the law of 24 October 2008, setting the original amount of the capital of 25 million euro at 175 million euro today. However, the equity of the BCL is still largely insufficient when considering the amount of its operations and its risks. The pre-draft-bill contains a proposal of setting the capital at one billion euro subscribed by the State and payable progressively.

The gradual increase of the equity would allow the BCL to face its different tasks, among which the task of lender of last resort; it would allow the BCL to pay-in the doubling of the capital of the ECB, decided on 13 December 2010<sup>14</sup>, of which the BCL is a shareholder and, in the end, would allow the State to receive a dividend.

The pre-draft-bill also defines the regime of the legal acts of the BCL, based on the ECB's and other NCBs' in particular after the modification of the Constitution pursuant to the law of 19 November 2004 that introduced the new Article 108bis on the regulatory powers of public institutions and the modification introduced by the law of 24 October 2008, granting the power to adopt regulations to the BCL. It is essential for the BCL to have an appropriate legal basis to enforce its regulations and decisions. Thus, it would be authorised to take the necessary steps, of administrative nature, whether with financial obligations or not, in compliance with the principles applicable to legal proceedings under administrative law, so as to oblige market participants who do not comply with them. There is an opportunity to make clear the rules of adoption, implementation and control of legal acts of the BCL.

Finally, with respect to the social matters of the BCL, even if there is a requirement of adopting a specific regime for the staff of the BCL, in accordance with the principle of independence, it is nevertheless not an appropriate moment, from a political point of view, to amend a regime inherited from specific circumstances related to the establishment of the BCL by way of an act of the Parliament. Therefore, the change of the regime is postponed. There are only editorial modifications which have been submitted to the Government in order to update some legal references.

### **2.8.3 BCL Regulations**

In 2010, the BCL issued a regulation reinforcing the implementation of one of its core tasks – the promotion of the smooth operation of payment systems and securities settlement systems – in accordance with articles 2 (5) and 27-3 of the organic law dated 23 December 1998, as amended.

Regulation BCL 2010/No.6 dated 8 September 2010 aims at clarifying the BCL's task in the area of oversight of payment systems, securities payment systems and payment instruments in Luxembourg, in accordance with the law of 23 December 1998, as amended and the law of 10 November 2009.

---

14 Decision of the ECB of 13 December 2010 (ECB/2010/26) on the increase of the European Central Bank's capital [OJ L 11, 15.01.2011, p. 53]

Regulation BCL 2010/No.6 defines the scope of the oversight, provides for a general framework for the exercise of the oversight of systems and payment instruments and defines the general duties of the system operators, payment instrument issuers and governance authorities. Regulation 2010/No.6 abrogates and replaces the provisions included in circulars BCL 2001/163 and 2001/168.

## **2.8.4 BCL's opinions**

The BCL issued three opinions in 2010 relating to different draft laws.

### **2.8.4.1 Opinion relating to draft law n°6164 implementing the Directives EC/2009/110 and EC/2009/44**

The draft law n°6164, deposited with the Chamber of Deputies on 30 July 2010, implements into Luxembourgish law the Directives CE/2009/110 and CE/2009/44 and amends several laws in force, notably the law of 05 August 2005 on financial collateral arrangements.

The observations and amendments proposed by the BCL in its opinion of 10 November 2010 have mainly as purpose to associate the BCL with the authorisation procedure of the electronic money institutions and the withdrawal of their authorisation. The BCL reiterates its competences in the field of supervision of liquidity, payment systems and payment instruments issued by electronic money institutions notably and confirms that the BCL should act as sole correspondent towards the ECB and the central banks of the ESCB. The BCL reformulates some comments raised by the ECB on the occasion of the elaboration of the Directive on electronic money institutions.

The BCL's opinion follows the ECB's opinion of 5 November 2010<sup>15,16</sup>. To the extent that the ECB has already been consulted on the relevant directives, the latter limits its observations to the amendments to be introduced into the law of 05 August 2005 on financial collateral arrangements. The new paragraph (5) of Article 2 of the law of 05 August 2005 introduces simplified rules for the creation of collateral arrangements over credit claims. Besides, this paragraph (5) introduces the principle according to which the debtor of a claim subjected to a financial collateral arrangement may waive, in writing or by any other lawful means, its right of set-off. In its opinion, the ECB recommends that the Luxembourg legislator addresses the interaction between the proposed new regime and the regime governing currently the creation of pledges over credit claims in favour of the BCL based on the understanding that the two regimes will co-exist. Furthermore, the ECB recommends clarifying the rights of the Eurosystem as collateral taker in comparison with the rights conferred to depositors by the new law.

### **2.8.4.2 Opinion relating to draft law n°6165 implementing the Directives EC/2009/111, EC/2009/49 and EC/2009/14**

The draft law n°6165, deposited with the Chamber of Deputies on the 30 July 2010, implements into Luxembourgish law the Directives EC/2009/111, EC/2009/14 and EC/2009/49 and amends several laws in force, notably the law of 05 April 1993 on the financial sector as amended.

The draft law has effects on the BCL's competence in the field of supervision of the general liquidity situation following the law of 24 October 2008 improving the legislative framework of the Luxembourg financial centre. In view of the above, the BCL issued an opinion on its own initiative, dated 09 November 2010, to the attention of the Chamber of Deputies.

In its opinion, the BCL stresses the need to update the draft law based on the present and forthcoming amendments at European level, notably since the entry into force of the Lisbon Treaty. The draft law is indeed outdated in some respects, notably as regards its terminology.

Most of the proposed amendments highlight the BCL's wish, on the one hand, to act as the sole intermediary between the CSSF and the other central banks of the ESCB when it comes to exchanges of information and,

<sup>15</sup> Opinion of the European Central Bank of 5 November 2010 on amendments to the legislation on financial collateral arrangements as regards credit claims (CON/2010/78)

<sup>16</sup> The ECB and BCL were both consulted for an opinion by the Ministry of Finance.

on the other hand, to be invited, as competent authority in the field of liquidity, by the CSSF to participate in the colleges of supervisory authorities in matters relating to liquidity supervision and to set up a cooperation.

Finally, the BCL invites the Chamber of Deputies to insert a new provision into the draft law stating that the “stress tests” are conducted and carried out by the BCL to the extent that these tests cover, in total or in part, the liquidity of operators or the financial sector.

### 2.8.4.3 Opinion relating to the draft law concerning the budget of the State for the year 2010

The BCL has issued, as each year, an opinion relating to the draft law concerning the budget of the State. The BCL’s opinion is commented in another Section of the Annual Report.

### 2.8.5 Legal rate of interest

The rate was fixed at 3.50 per cent for the year 2010 by a grand-ducal regulation of 5 February 2010 (published in the Mémorial A no. 24 of 23 February 2010, page 480). For 2011, this rate remains unchanged following the grand-ducal regulation of 1 February 2011 (published in the Mémorial A no. 22 of 9 February 2011, page 174). It is observed that this rate does not correspond to a specific rate of reference of the money markets.

Box 2.5:

#### **BCL COMMITTEES AND EXTERNAL COMMITTEES**

##### ***The Economic Committee***

The Economic Committee acts on the basis of the legislation which authorises the government to take measures to stabilise employment. Thus, the Committee provides a framework for examining business cycle fluctuations in the country’s economy and for monitoring economic policy issues as they arise.

The BCL belongs to the Economic Committee for two reasons: it collects information on Luxembourg’s cyclical position and it contributes to the Committee’s work by monitoring and commenting on the latest developments in the monetary domain and in the financial sector.

##### ***The Consumer Price Index Commission***

The BCL has an observer status at the meetings of the Consumer Price Index Commission (CPIC), which is in charge of advising and assisting STATEC in the preparation of consumer price indices. This Commission also issues technical opinions on the design of the monthly consumer price index and supervises the compliance of this index with national and European regulations. The BCL presents its inflation projections for Luxembourg to the CPIC and provides explanations related to BCL work in the area of consumer prices.

##### ***Committee “Comptabilité bancaire”***

The committee “*Comptabilité Bancaire*” set up by the Commission de surveillance du secteur financier (CSSF), aims at ensuring an exchange of views between the supervisory authority, the BCL and players of the Luxembourg financial centre. The committee is consulted during the preparation CSSF circulars concerning bank accounting issues.

The committee met several times in 2010 to discuss the implementation of the accounting standards IAS/IFRS, the new regulatory capital adequacy, financial reporting (FINREP) and the common reporting (COREP) defined by the Committee of European Banking Supervisors. In this framework the committee discussed the IFRS consolidation versus the CRD (capital requirements directive), the link between the FINREP taxonomy and the IFRS taxonomy and the definition of “retail banking”.

##### ***Higher Council for Statistics of Luxembourg***

The Higher Council for Statistics carries out advisory functions on behalf of the national statistical institute of Luxembourg (STATEC) and is mandated to provide appraisal on the STATEC’s annual programme. The BCL contributes in two ways to the work of the Higher Council for Statistics: on the one hand, it provides its opinion on the documents elaborated during meetings and submitted to it and, secondly, it provides the STATEC with data collected on the financial centre to enable the latter to achieve its work Programme.

### ***XBRL Luxembourg asbl***

XBRL (eXtensible Business Reporting Language) is a financial reporting standard based on XML, which main objective is to improve the correct character, transparency and efficiency of internal and external reporting. The non-profit association XBRL Luxembourg asbl includes some twenty organisations using XBRL and/or providing services related to XBRL technology. The role of the association is to promote the XBRL standard within Luxembourg's economy.

The BCL, as a founding member of XBRL Luxembourg, will analyse the potential to adopt the XBRL standard in the context of the statistical reporting it collects from companies of the Luxembourg financial sector.

### ***The Statistics Committee***

The Statistics Committee has been set up by the BCL to ensure a constant dialogue between the actors of the financial centre that are subject to statistical reporting requirements and the main users of this data. The Statistics Committee is regularly consulted in the framework of the definition of the reporting for the different entities of the financial sector.

### ***The Monetary and banking statistics consultative commission***

The Monetary and banking statistics consultative commission has been set up by the BCL to enhance the dialogue between reporting agents and the central bank. The Commission also ensures the efficiency of the reporting procedures in the area of monetary and banking statistics. During 2010, the Commission has been informed and consulted on various conceptual issues in relation with the revision of statistical data collection for credit institutions, the security by security reporting for credit institutions as well as the revision of the statistical data collection on interest rates applied by credit institutions.

### ***The Balance of payments statistics consultative commission***

The Balance of payments statistics consultative commission acts as an advisory group and assists

the BCL in its mission to collect data in the areas of balance of payments and international investment position. The Commission ensures an efficient organisation of data collection in order to avoid redundancies and to limit the collection charge for the entities requested to submit statistical data.

### ***The Economic and financial statistics consultative commission***

The Economic and financial statistics consultative commission has been set up by the BCL in order to ensure an efficient organisation of the data collection in the area of economic and financial statistics as well as to enhance the dialogue between financial intermediaries and the central bank. During 2010, in the absence of new projects, the Commission was not consulted.

### ***The Fiduciary Money Committee***

During 2010, the main retail commercial banks gathered together within the BCL's Fiduciary Money Committee in order to discuss, inter alia, the constitution of one or several deposit facilities for coins within banks or fund security firms.

### ***The Lawyers' committee (Comité des Juristes)***

The Lawyers' Committee provided assistance to BCL on its examination of the draft Securities Law Directive, on its opinions relating to the draft laws no. 6164 and 6165 described in the report as well as on a preliminary draft law amending the organic law.

### ***The Market operations commission***

The Market operations commission focused its discussions on the impact of the financial market crisis on the monetary policy operational framework.

### ***The High-Level committee for the financial centre***

In 2010, the Government set up the High Level committee for the financial centre which aims at developing and strengthening the Luxembourg financial centre in close cooperation with the private sector. The BCL's Governor is a member of the High committee and members of the BCL's staff participate in different working groups.

## 2.9 COMMUNICATION

### 2.9.1 Publications

As required by its statutes, the BCL publishes each year a report on its activities. This annual report is published in French and in English. In 2010 the BCL also published three bulletins and one financial stability review.

In its working papers the BCL publishes the results of research conducted by its staff. Each working paper contains a non-technical summary. In 2010, six working papers were published.

### 2.9.2 Training at the BCL

The BCL furthered its cooperation with the University of Luxembourg, where a staff member gave lectures on institutional aspects of the Eurosystem. Other staff members gave economics lectures at the Catholic University of Louvain.

The BCL also organised ad hoc presentations for various groups of students from the following universities: Catholic University of Louvain, Maastricht School of Management ASCI (administrative staff college of India), and Maastricht University.

The BCL is shareholder of the *Agence de Transfert de Technologie financière* (ATTF). This agency, established in 1999 at the initiative of the Luxembourg government, shares with mostly emerging countries Luxembourg's know-how in financial matters. In March and July 2010, in the context of study visits, the BCL held lectures for delegations from the People's Bank of China and the Banking and Finance Academy of Uzbekistan.

The BCL organises presentations on the Eurosystem and the BCL for high school students (usually in the course of their last two years) following economics classes. Classes are greeted, along with their economics teachers, at the auditorium of the Monterey building, for an educational and interactive presentation of the organisation and the missions of the BCL and the Eurosystem. Other topics can also be tackled according to teachers' requests and students' questions.

### 2.9.3 BCL's website

The BCL's website, [www.bcl.lu](http://www.bcl.lu), provides information about the Bank's activities and services, its internal organisation, as well as statistics about Luxembourg and the Eurosystem. It also contains links to the ECB's website and to other central banks of the ESCB. Based on its search engine and its configurable mailing list, the site offers to each visitor a clearly structured information package, suitable for professionals as well as private individuals.

All BCL publications can be viewed and downloaded from the Publications and the media section. Hard copies are available from the BCL on request, as long as stocks last.

The website exists in English and French. Publications are displayed in their original language (English, French and German).

Overall, 154 346 people visited the website in 2010 (136 464 in 2009), with 17 186 809 hits. The numismatic programme witnessed more than 27 348 downloads (20 600 in 2009).

The numismatic products electronic shop ([eshop.bcl.lu](http://eshop.bcl.lu)), directly accessible through the BCL website, has attracted more than 83 200 visitors in 2010 (53 500 in 2009).

### 2.9.4 The library

The library, opened in 2005, uses the ALEPH library management systems as do a number of other central banks. The system is electronically linked with the other public libraries in Luxembourg.



The library's publications mainly deal with economics and law. Publications stem from international organisations (World Bank, IMF, OECD, BIS, European Commission), but also from national central banks.

The library is open to the public upon request, either by fax (+352 4774 4910) or by e-mail (bibliotheque@bcl.lu).

The library is open on Monday, Wednesday and Friday from 9am to 12pm and from 3pm to 5pm.

### **2.9.5 Press relations**

The Governor of the BCL gave 12 interviews to the international and national press. Seven press conferences were held, on the occasion of the presentation of the BCL's financial accounts, of the Annual Report and of the BCL's Bulletins, the Financial Stability Review and the numismatic programme. Two journalists from national press participated in seminars organised by the ECB in Frankfurt. In total, 93 press releases were published.

### **2.9.6 The BCL's Research Programme**

The BCL's research programme is organised around five main domains:

- Business cycles and long-term trends;
- Competitiveness and productivity;
- Labour markets;
- Monetary analysis, credit and financial markets;
- Other subjects.

Research results are regularly disseminated through BCL publications (as working papers or through the BCL bulletin or Financial Stability Review). Results are also published in peer-reviewed scientific journals (Economic Journal, Journal of Financial Stability, Managerial and Decision Economics).

In addition, BCL researchers also presented their work in seminars or workshops organised by the University of Luxembourg, STATEC, the Ministry of the Economy, the Eurosystem, the National Bank of Poland, EFFAS-European Bond Commission, Dynare, EcoMod, PricewaterhouseCoopers, CEPR and others.

Since June 2010, the BCL has been a member of MaRs (the ESCB Macro-prudential research network). In particular, BCL researchers are active in workstreams on (i) macro-financial models linking financial stability and economic performance; (ii) early-warning systems and systemic risk indicators.

In October 2010, the BCL organised an international conference in Luxembourg on Household Finance and Consumption, in collaboration with the ECB and with the financial support of the "Fonds National de la Recherche" (FNR). The FNR also contributed to financing the multi-year Perfilux project analysing the performance of the financial sector in Luxembourg. This project involved a collaboration between researchers at the BCL and the Luxembourg School of Finance (University of Luxembourg) and STATEC.

### **2.9.7 Conferences and events**

The following conferences and events took place in 2010

- Presentation of the financial stability review in 2010. The presentation to the press, attended by guests from Luxembourg's financial sector, academics and European central bankers, was followed by a seminar entitled "Some factors underlying the current crisis and stress-testing" in which the authors of specific studies presented their research work to agents from the financial sector and international experts.
- From April 20 to May 28, hosting of the travelling ECB exhibition on the euro. This exhibition, aiming at increasing the public's knowledge of the single currency and the euro's security features, attracted more than 1300 visitors. The exhibition's inauguration by the BCL's Governor and Mrs Gertrude Tumpell-Gugerel, member of the ECB's Executive Board, coincided with the finals of the "Euro Rallye" competition organised for children from the Great region by the BCL and the ECB.
- On the occasion of the 40th anniversary of the "Werner report", organisation of a conference by the association *The Bridge Forum Dialogue* and the Pierre Werner Institute, on October 8 at the European Investment bank. After an introduction by the BCL's Governor, Jean-Claude Juncker, Prime minister and Eurogroup's President and Philippe Maystadt, Vice-President of the association *The bridge Forum*

*Dialogue* and President of the European Investment bank, shared their views on the topic. This conference attracted a large audience, amounting to around 700 people.

- Hosting of a joint ECB-BCL conference on household finance and consumption behaviour, on October 25 and 26 at Neumünster Abbey. This conference aimed at presenting best practices in empirical and theoretical research as regards households' behaviour in financial assets accumulation, debt and consumption in the course of a lifecycle. The conference's speakers included representatives from the BCL, the ECB, the Federal Reserve System and academics.
- BCL participated in the "*Foire de l'étudiant*" (student's fair) on November 11 and 12. Employment and career opportunities as well as training and traineeship opportunities were presented. The Deutsche Bundesbank was present on the BCL's stall and provided information on training opportunities at the *Fachhochschule der Deutschen Bundesbank* to learn about central banking affairs.
- Organisation of a conference entitled "*Towards a safer global financial system*" on November 11. After an introduction by the BCL's Governor, Mr. José Viñals, former Governor of the Banco de España, Counsellor and Director Monetary and Capital market department at the IMF, presented his views on the topic.

## **2.10 EXTERNAL ACTIVITIES**

### **2.10.1 Relations with the Parliament**

#### **2.10.1.1 Financial Stability Fund: Project presentation**

During the financial crisis of 2008, substantial amounts of public funds were used by governments in order to support the financial sector and to protect depositors. At the September 2009 G-20 Summit in Pittsburgh a clear political message, adopted in turn by the European Union, was formulated, according to which taxpayer money should in the future not be used anymore to cover the losses of the banking sector.

In this context, the BCL submitted in September 2010 a proposal for the establishment of a Financial Stability Fund in Luxembourg, financed by contributions from credit institutions, to the Luxembourg Parliament and Government. This Financial Stability Fund would include both a Deposit Guarantee Scheme as well as a Resolution Fund for failing banks in order to restore confidence in the financial sector, to guarantee the safety of deposits, to contribute to avoiding contagion effects and to minimise, or even eliminate, the need to revert to public funds in order to save banks.

The first objective of such a Financial Stability Fund, namely ensuring the reimbursement of depositors, could be achieved through instituting a resolution fund, whose objective is to ensure the orderly resolution of a bank, avoiding thus that, in the event of an emergency, assets would be sold at fire-sale prices and contagion effects towards other credit institutions would materialise. In other words, the intention is to minimise the impact of a bank failure through maximising the value of the remaining assets and through facilitating, as far as possible, the return towards a "normal" use of the bank's assets and liabilities, while simultaneously ensuring its deposits stay guaranteed.

In this context, it has however to be ensured that the resolution fund for banking failures part of the Financial Stability Fund does neither provide an insurance against bank failure, nor that it would be used to bail out a failing bank. The assets of the resolution fund can only be used for actual resolutions (i.e. to resolve the bank in an orderly fashion), while respecting rules on state aid measures.

In order to ensure the financing of such a Financial Stability Fund, credit institutions would have to contribute to both parts of the Fund proportionally to the size of their balance sheet as well as to their risk profile. The Financial Stability Fund would be built-up progressively by these contributions.

The BCL thus put forward two options to finance the Financial Stability Fund in Luxembourg. The Financial Stability Fund would manage the assets of the two underlying funds independently within their respective specific investment constraints which could, if necessary, be defined by the legislator. The management of the assets should generate revenues in order to cover the Fund's running costs and could, if necessary, be used to contribute complementary funding to the Fund itself.

In order to determine the target size of the Fund and its calculation methodology, several factors have to be considered:

- The resolution costs of the past crisis and the size of similar funds proposed in other jurisdictions;
- The weight of the Luxembourg financial sector;
- The expected resolution costs for a predetermined number of banks, while accounting for the relative concentrations of systemic activities in those banks, and
- The ease of application of the calculation methodology, its transparency as well as the ease with which it can be communicated.

On an operational level, the Fund should be able to draw either on dedicated human resources, or resources made available by means of outsourcing. Furthermore, the Fund should intervene in the management of a failing bank through replacing the current governance organs and by reverting to experienced persons.

Meanwhile, the European Commission has submitted a document for public consultation to create a European network of resolution funds for failing banks. The Eurosystem has participated in this consultation. The European Commission is expected to introduce a legislative proposal on this subject soon.

#### **2.10.1.2 Presentation of the BCL's opinion on the state budget motion**

On 12 November, the Governor of the BCL presented the opinion of the Bank on the state budget motion to the Financial and Budget Commission of the Luxembourg Parliament.

### **2.10.2 Activities at the European level**

#### **2.10.2.1 Activities at the level of the ECB**

During 2010, the Governor of the BCL participated in 20 meetings of the Governing Council and in the four meetings of the General Council.

The Governing Council meetings are held twice a month at the ECB's headquarters in Frankfurt. While the first meeting is exclusively devoted to the analysis of economic and monetary evolutions and to monetary policy decisions, the second meeting deals with issues related to the other missions of the Eurosystem. Besides these meetings, the Governing Council also takes decisions via written procedures. In 2010, more than 500 Executive Board's proposals were adopted by the Governing Council following this procedure; among these proposals, many were opinions related to draft laws at the European or national level, according to article 127 paragraph 4 of the Lisbon Treaty.

The General Council meetings, that gather the ECB President, the ECB Vice-President, and the ESCB Governors together, are also held in Frankfurt, four times a year.

When making decisions, the members of the Governing Council do not act as national representatives but in their personal capacity, which is reflected by the principle "one member, one vote".

Committees assist the decision-making bodies of the ECB in the fulfillment of their tasks. The Governing Council or the Executive Board can ask Committees to carry out analyses on precise topics. The Committees report to the Governing Council through the ECB Executive Board.

Committees were created by the enforcement of article 9.1 of the ECB's rules of procedure. There are currently 17 committees, which are essentially composed of members of the Eurosystem, but can also include, for some issues, ESCB members. Each member is appointed by the Governor of his/her national central bank or, in special cases, by the ECB's Executive Board. Under the aegis of Committees, working groups or task forces are established, with specific objectives, but in conformity with their Committee's mandate. The Governing Council also created High Level Groups to help solve particular issues.

The BCL contributes to the Eurosystem's and the ESCB's work at this level through the participation in the meetings of committees, working groups and task forces of members of its staff.

### 2.10.2.2 Relations with the European Parliament

On January 15, 2010, at the invitation of the BCL's President, Luxembourg's members of the European Parliament participated in a work visit at the BCL. Issues discussed included the economic situation of the euro area, institutional questions such as the economic and monetary governance and relations between the European Parliament and the Eurosystem.

### 2.10.2.3 Enlargement of the euro area

On January 1, 2011, exactly two years after Slovakia, Estonia introduced the euro, bringing the number of member states having adopted the single currency to 17.

### 2.10.2.4 Economic and financial committee (EFC)

A BCL representative participates in meetings of the Economic and Financial Committee (EFC). The EFC is composed of representatives from the finance ministries and central banks of EU Member states, the European Commission and the ECB. According to the treaty, one of the tasks of the EFC is to "review the economic and financial situation of the Member states and of the Community and to report regularly thereon to the Council and to the Commission".

In 2010, the EFC continued to analyse the evolution of financial stability in the EU and the risks weighing on this stability. It followed reforms envisaged in the aftermath of the financial crisis.

The EFC also works on economic policy issues discussed at informal ECOFIN meetings, which are attended by the BCL's President and which were strongly marked, in 2010, by the economic impact of the financial crisis, especially on public finance, as well as by the proposal for reforming European financial supervision and economic governance. In the context of signs of a gradual economic recovery, these discussions also dealt with the designing of appropriate exit strategies, notably vis-à-vis extraordinary fiscal measures adopted by public authorities in order to face the crisis.

### 2.10.2.5 The committee on monetary, financial and balance of payments statistics

In the context of the mission of the Statistical Office of the European Communities (Eurostat), the Committee of Monetary, Finance and Balance of Payments Statistics (CMFB) works on the development and coordination of statistical categories that are required under the policy implemented by the Council, the Commission and various committees assisting them. Central Banks, National Statistics Institutes as well as the Commission and the ECB are represented in the CMFB. Under the leadership of this Committee, different "task forces" operate with specific duties assigned to them. The BCL has contributed actively to this framework. Progress has been made particularly in terms of financial accounts, balance of payments, financial services and public finance statistics as well as national accounts.

## 2.10.3 Multilateral activities

### 2.10.3.1 BCL's multilateral activities

#### *Activities at the level of the international monetary fund and other international organisations*

The BCL handles Luxembourg's financial transactions with the IMF. For this purpose, it manages Luxembourg's assets and liabilities vis-à-vis the IMF in both the general account and the Special Drawing Rights (SDR) account. As of the 31st of December 2010, Luxembourg's quota, recorded in full on the BCL's balance sheet, amounted to SDR 243.23 million, that is, 98.67% of its SDR allocation vs. 98.6% end 2009. At this same date, the reserve position (the difference between Luxembourg's total quota at the IMF and the euro-denominated assets held by the IMF at the BCL) represented 23.68% of Luxembourg's quota.

The IMF's operational budget defines the currencies to be made available to its members on a quarterly basis and the distribution of reimbursements among its members. During 2010, the BCL granted credits amounting to SDR 16.2 million.

The BCL President, being also Alternate Governor of the IMF, attended the Annual Meeting of the IMF and the meetings of the International Monetary and Financial Committee. A BCL member is on secondment to the IMF.

The BCL also attended the meetings of several working groups at the Organisation for Economic cooperation and Development (OECD) and at the Bank of International Settlements (BIS), contributing, in particular, to the work of the OECD's Financial Markets committee (FMC) and that of the BIS' Committee on the Global Financial System (CGFS). As every year, the BCL's Governor attended the BIS' Annual General Meeting.

#### ***BCL's adherence to the International Islamic liquidity corporation***

On October 8, IFSB members, including the BCL, represented by its governor, signed a Memorandum of participation aiming at the establishment of an International Islamic Liquidity corporation (IILM). The BCL's President then participated in the IILM's constitutive ceremony on October 25th in Kuala Lumpur (Malaysia). On December 13th, the BCL's Governor participated in the IILM's second meeting in Jeddah (Saudi Arabia).

#### ***Participation in high level seminars or conferences***

- 5th High-level Seminar of Central Banks in the East Asia-Pacific Region and the euro area co-organised by the Reserve Bank of Australia and the ECB, on February 10, during which the BCL's Governor made a speech entitled "Review of the Framework for Liquidity Provision".
- 7th Islamic financial services board (IFSB) Summit on May 4 and 5 in Bahrain, dealing with the global financial architecture and challenges for Islamic finance. The BCL's Governor chaired a session on balanced growth for Islamic finance. Representatives from the Luxembourg financial centre, including Mr. Claude Zimmer, member of the BCL's Council, presented at a showcase Luxembourg's assets for Islamic finance.
- "Symposium on Islamic Finance and Takaful at the Crossroads of Change" organised on May 7 by the FWU Group, a group of financial services present in Munich, Luxembourg, Kuala Lumpur and Dubai. The GCL's Governor made a speech entitled "Islamic Finance and Takaful: The European Perspectives".
- High level Eurosystem seminar jointly organised by the ECB and the central banks and monetary authorities of the Gulf cooperation Council on June 30th in Rome.
- High level conference organised in Tallinn on September 20th to prepare the introduction of the euro in Estonia, and in which the governors of the central banks of the euro area participated.
- Conference *The EMU Werner plan lecture*, organised in London on October 14 by the Official Monetary and Financial Institutions Forum (OMFIF) and the Lafferty Group to commemorate the fortieth anniversary of the publication of the Werner report. The BCL's Governor made a speech entitled "Lessons from the EMU Rescue – Which Way now for Europe?".
- 54th Congress of the International lawyers' association in Istanbul on October 29, when the BCL's Governor made a speech on the topic "European Lessons to be drawn from the Crisis to improve Global Financial Stability".
- High Level Meeting for the Middle East & North Africa Region on the Emerging Framework to Strengthen Banking Regulation and Financial Stability" on November 8 in Abu Dhabi, where the BCL's Governor made the keynote speech entitled "Shaping a New Regulatory Framework: International Banking at the Crossroads".

#### **2.10.3.2 Multilateral activities with the Government**

The Prime Minister, the Finance Minister and the BCL's Governor attended the IMF and World Bank spring and annual meetings in Washington from April 24 to 26 and from October 7 and 10.

## 2.10.4 Bilateral relations

### 2.10.4.1 BCL's bilateral relations

#### *Signature of Memorandums of Understandings with central banks*

On May 19th, the BCL's Governor and the Central Bank of Iceland's Governor signed an agreement on assets which underlying assets are labeled in Icelandic crowns in the context of the liquidation of an Icelandic bank in Luxembourg.

In the framework of the visit of a Luxembourg delegation in Shanghai on September 28th, the BCL's Governor signed a Memorandum of Understanding with Mr. Yi Gang, Vice Governor of the People's Bank of China. This Memorandum of Understanding establishes the bases of cooperation between both central banks, notably in the fields of training and information exchanges.

#### *Working visits in central banks*

- Visit of the BCL's Governor in Moscow for the 150th anniversary of the Bank of Russia on June 18th.
- Third annual meeting between the BCL and the Bank of Slovenia in Schengen on July 23rd. This annual meeting allows both central banks to take stock of their mutual activities and to enhance their cooperation in certain areas.
- Mutual visits of the BCL's Governor and of the Governor of the Czech Central bank, Miroslav Singer, on September 1st and 17th in Prague and Luxembourg, on the occasion of the joint issuance of a numismatic coin commemorating the wedding of John of Luxembourg, also called "John the blind", with Elizabeth of Bohemia.
- Participation of the BCL's Governor in the conference organised for the 35th anniversary of the Bank of Cape Verde on September 24th in Praia. The BCL's Governor made a speech entitled "How the Luxembourg Experience can help reduce Lending Rates in Cape Verde".

### 2.10.4.2 Bilateral relations in cooperation with the Government

On September 28th, a Luxembourg delegation, chaired by the BCL's Governor and by Mr. Ernst-Wilhelm Contzen, President of the Association for Banks and Bankers in Luxembourg (ABBL) and Mr. Fernand Grulms, Chief Executive Officer of Luxembourg for Finance (LFF), and composed of bankers and representatives of the financial centre, went to Shanghai for a mission aiming at reinforcing mutual links between the financial centres of Luxembourg and Shanghai. On this occasion, a conference on the Luxembourg financial centre, under the patronage of the BCL, was organised for representatives of the Chinese financial sector. The BCL's Governor made a speech entitled: "*The Euro: a Credible Currency?*"