01 THE BCL'S ACTIVITIES

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1.1 MONETARY POLICY OPERATIONS

In Luxembourg, the BCL is responsible for conducting the monetary policy defined by the Eurosystem for the entire euro area.

Monetary policy operations have included conventional and non-conventional measures since 2007.

Open-market operations

The refinancing operations implemented by the BCL (open market operations) consist of funds allocated by the BCL guaranteed by eligible collateral submitted by its counterparties, the financial institutions of Luxembourg.

Open market operations include:
- Main refinancing operations (MRO) carried out through weekly tenders with a one-week maturity. These operations play a leading role in steering interest rates (thanks to the minimum bid rate or the fixed rate, since October 2008), in the management of banking liquidity and in signalling the trend of monetary policy.
- Long-term refinancing operations (LTROs), normally carried out through monthly tenders with a three-month maturity. These operations aim at providing additional long-term funding to the financial sector. They do not aim to give indications concerning the orientation of monetary policy.
- Fine-tuning operations, carried out 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 liquidity on a day-to-day basis.

There are two types of standing facilities:

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

Minimum reserves

Euro area financial institutions are subject to a system of mandatory minimum reserves to be held on accounts opened at their national central bank.

These 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 (swaps)

Besides its regular monetary policy operations, the Eurosystem extended the swap facility agreement established end-2007 with the US Federal Reserve. This agreement allows the Eurosystem to provide dollars to counterparties guaranteed by eligible collateral. Furthermore, the Eurosystem renewed the swap agreement established in December 2010 with the Bank of England. These two agreements have been renewed until at least August 2012.

In November 2011, the Eurosystem announced coordinated actions with the Bank of Canada, the Bank of England, the Bank of Japan, the Federal Reserve and the Swiss National Bank. In particular, these central banks agreed to establish temporary bilateral liquidity swap arrangements so that liquidity can be provided in each jurisdiction in any of their currencies should market conditions so warrant. These agreements remain valid until 1 February 2013.

Covered Bond Purchase Programme (CBPP)

Covered bonds are a key instrument for the credit institutions' funding. The CBPP is one of the non-conventional measures of the Eurosystem's Monetary Policy.

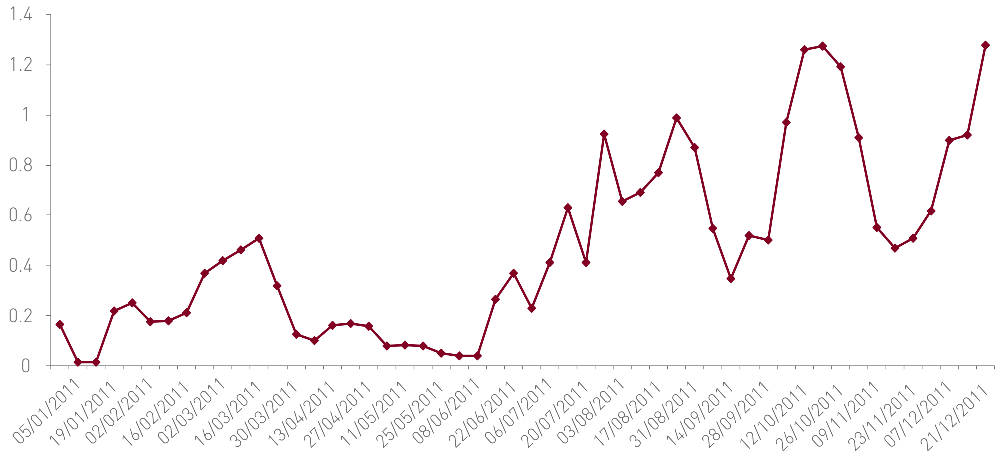
Securities Markets programme (SMP)

The SMP is a non-conventional purchase programme of both public and private bonds. The Eurosystem conducts specific operations in order to sterilise the impact of these bond purchases.

1.1.1 Open market operations

1.1.1.1 Main refinancing operations (MRO)

Chart 1:
MRO – Percentage of participation of LU compared to the euro area in 2011



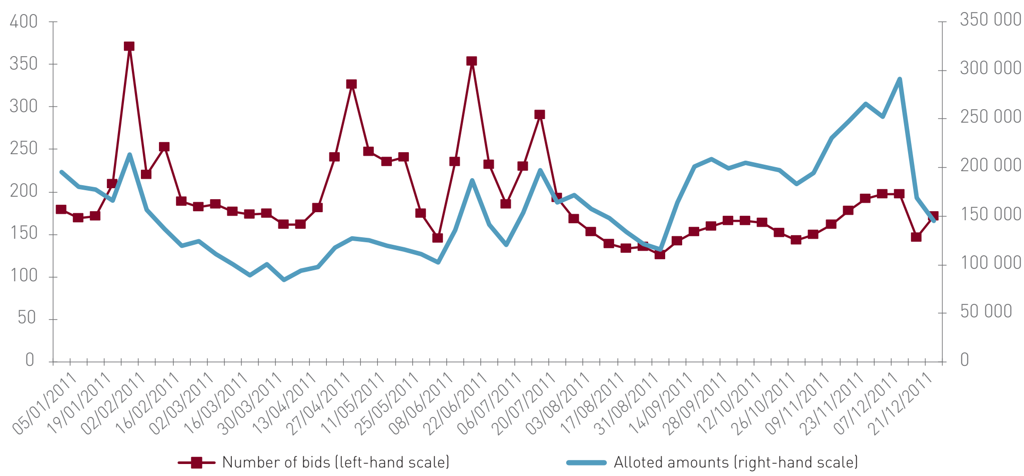
Source: BCL

Since October 2008, MROs have been conducted by the Eurosystem on a full allotment and fixed rate basis. This non-conventional measure was effective all through the year 2011. It is foreseen that this allotment method be maintained as long as necessary and at least until July 2012.

The percentage of participation of Luxembourg towards the MRO increased throughout 2011. Luxembourg currently ranks 11th in the euro area in terms of percentage of participation.

Volumes allocated through the MRO fell significantly due to the special 36-month operation launched mid-December.

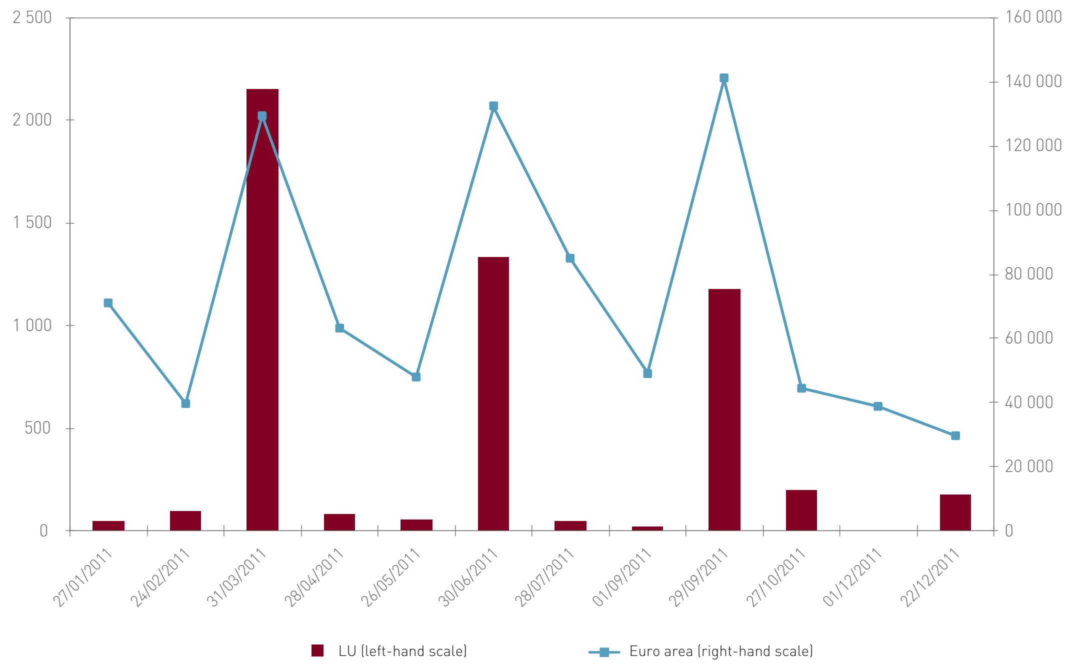
Chart 2:
MRO – Numbers of bids and allotted amounts in 2011 in euro area (in € million)



Source: BCL

1.1.1.2 Longer-term refinancing operations (LTRO)

Chart 3:
LTRO 3 months – LU and euro area – allotted amounts in 2011 (in € million)



Source: BCL

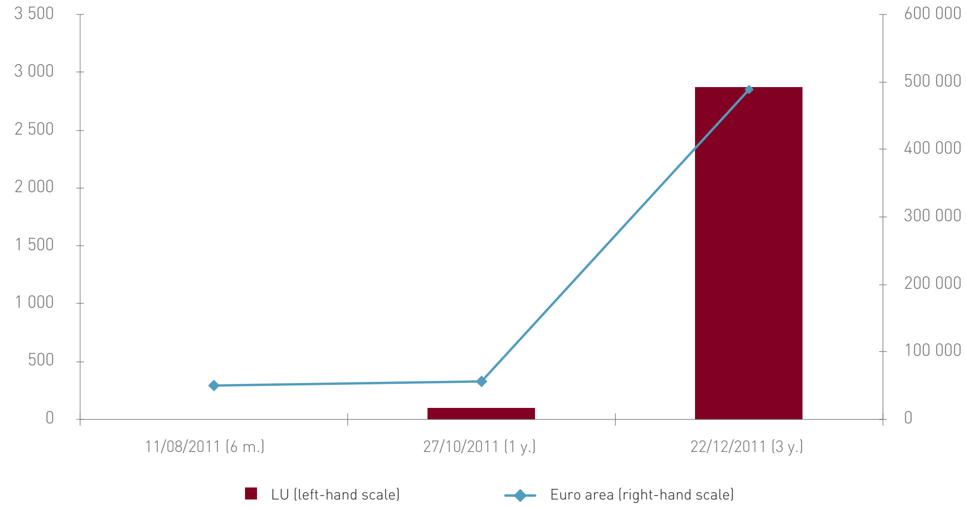
On top of the regular 3-month operations (12 over the year), one additional 6-month operation, two 12-month and one additional 36-month operation were conducted in 2011 in order to address monetary policy needs. These operations were fully allotted, at an adjustable rate that is computed at the maturity of the operation. This rate is fixed as being the average of the minimum bid rates of the MROs over the life of the operation.

Additional one-maintenance period operations were conducted throughout 2011. The Eurosystem announced that these operations would be maintained until at least mid-2012.

The 36-month operation conducted for the first time in 2011, had a remarkable success. An amount of € 489 billion was allocated to 523 counterparties in the euro area.

Luxemburgish counterparties did not participate in the supplementary 6-month operation, one counterparty took part in the one-maintenance period operation and another counterparty took part in the 12-month operation. Five Luxemburgish participants submitted bids for the 36-month operation.

Chart 4:
Additional operations – LU and euro area – allotted amounts in 2011 (in € million)



Source: BCL

1.1.1.3 Fine-tuning operations

Liquidity-absorbing operations

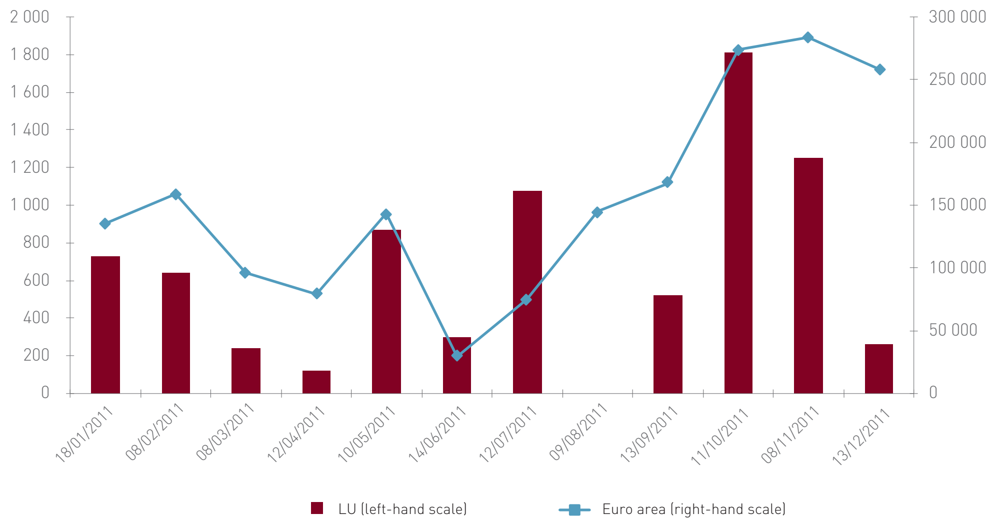
Since 2008, this type of operations has been open to all counterparties.

In 2011, fine-tuning operations were used exclusively on the last day of the maintenance period, in order to absorb excess liquidity.

Twelve operations of this type were conducted in 2011.

In December 2011, the Eurosystem announced that these operations would be discontinued in 2012.

Chart 5:
Fine tuning operations on the last day of the maintenance period – amounts absorbed – LU and euro area (in € million)



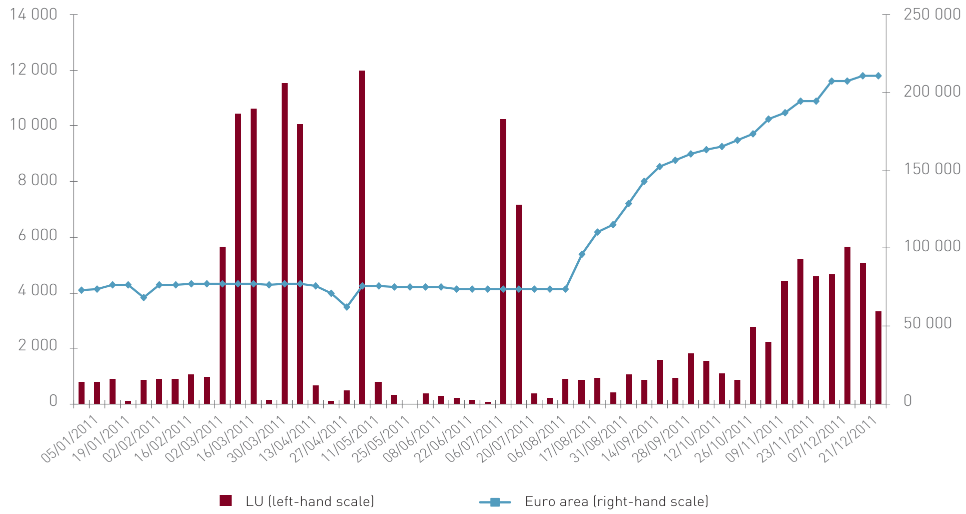
Source: BCL

From May 2010, one-week operations took place, aiming at absorbing the liquidity injected by the SMP. This is a non-conventional purchase programme targeting public and private sector bonds (see 1.1.6).

Counterparties in the euro area are allowed to submit up to four bids for this type of variable rate operation.

Overall, 52 operations of this type were conducted in 2011, absorbing on average € 2.7 billion in Luxembourg and € 110 billion in the euro area.

Chart 6:
One-week deposits in 2011 – LU and euro area (in € million)



Source: BCL

Liquidity providing operations

There was only one fine-tuning liquidity providing operation in 2011 which aimed to fill the one-day gap between the maturity of the MRO and the start value date of the 3-year supplementary operation. There was no participation in Luxembourg while an amount of € 141.9 billion was allotted in the euro area.

1.1.2 Standing facilities

Luxemburgish counterparties may resort to daily standing facilities with the BCL, i.e. deposit or marginal lending facilities, at a rate fixed beforehand.

These rates are determined each month by the Governing Council.

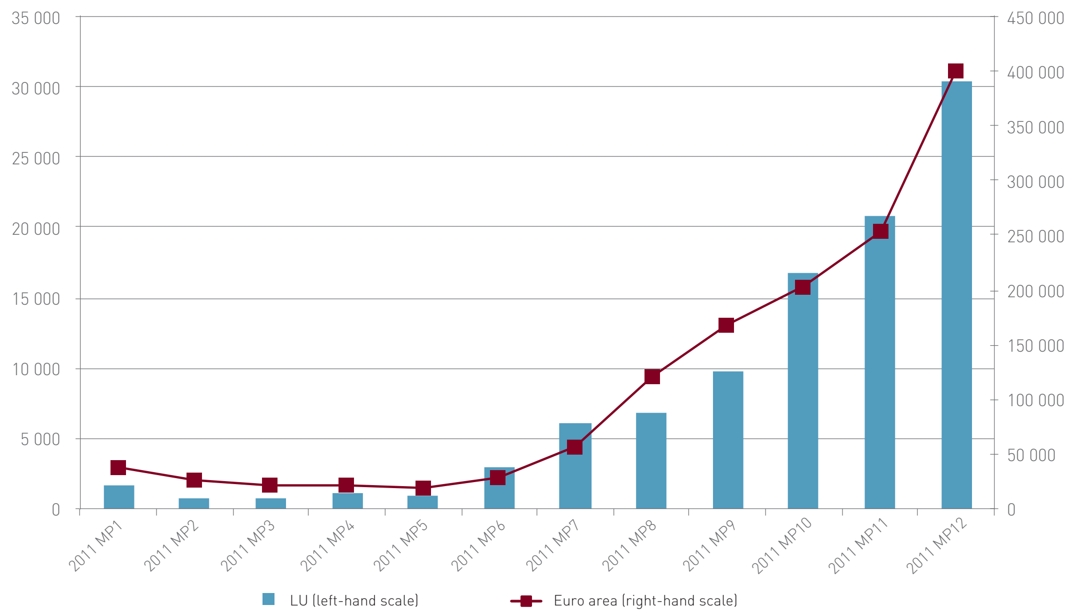
Marginal lending facility

The marginal lending facility was scarcely used in 2011 by the Luxemburgish counterparties, only on an *ad hoc* basis.

Deposit facility

After a stability phase during the first five months of the year, the amounts deposited in Luxembourg regularly increased until the end of the year.

Chart 7:
Development of the deposit facility in 2011 – LU and euro area (average daily amount in € millions)



Source: BCL

1.1.3 Minimum reserves

Euro area counterparties are required to maintain reserves at the national central bank of their country of residence. These reserves have to be kept on average over a fixed period of time. Counterparties can make free use of their liquidity throughout the maintenance period.

In 2011, in Luxembourg, the annual average amount of excess reserves was kept close to the one registered in 2010.

On 8 December, the Eurosystem announced that the minimum reserves rate would be reduced from 2 % to 1 % from 18 January 2012 onwards (start of the first reserve maintenance period in 2012).

1.1.4 Temporary currency auction facilities (swaps)

In 2011, the Eurosystem, in cooperation with the Federal Reserve System, carried on supplying dollar liquidity to the banks of the euro area. These operations were conducted as reverse transactions guaranteed by securities and had a maturity of 7 or 84 days (three 84-day operations took place in 2011).

In 2011, euro area and Luxemburgish counterparties initially displayed only a limited interest in these operations. On 30 November, the Eurosystem announced that the rate applied to these operations would be reduced by 0.5 percentage point. Consequently the number of participants and the amounts required increased significantly from December on. All bids received were set at pre-announced fixed rates.

1.1.5 Covered bonds purchase programme

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

In November 2011, the Eurosystem decided to initiate a second CBPP in the primary and secondary covered bond markets for an amount of € 40 billion. The programme expires in November 2012.

The Eurosystem intends to keep the purchased covered bonds until maturity.

1.1.6 Securities markets programme

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

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

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

As of 30 December 2011 the cumulative amount of purchases for the Securities Markets Programme reached € 211.9 billion.

1.2 FOREIGN EXCHANGE RESERVE 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 1 January 2011. As of 31 December 2011, the total market value of the ECB's reserves (including accrued interest) managed by the BCL corresponded to € 326 million. One goal of the foreign exchange reserve management of the ECB is to ensure that the ECB has sufficient available liquidity to intervene in the foreign exchange markets if need be. Security and liquidity are, therefore, basic requirements in managing reserves.

The tactical benchmark is established for each currency in line with the strategic benchmark.

This tactical benchmark reflects the ECB's risk/return medium-term preference in regards to 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 to maximise return. The amount of actively managed assets in gold is determined by the ECB, taking into account strategic considerations and market conditions. The BCL manages a USD portfolio on behalf of the ECB.

1.3 MANAGEMENT OF THE BCL'S ASSETS

1.3.1 Institutional structure

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

Level 1: The Council

The Council approves the guidelines of the asset management framework. Thus, the Council has allowed the BCL to provide asset management services to third parties and to hold their own funds asset portfolios in order to diversify the Bank's income. The guidelines also include a risk mitigation 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 regards to 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 short-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.

1.3.2 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 and independently from the Front Office. This monitoring structure has been given specific tasks at different levels of the organisation.

In addition, the Middle and Back Offices also take part in the monitoring process.

1.3.3 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 concerning matters 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 the following 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 geoChartical 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.

1.3.4 Structure of portfolios

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

This strategic orientation enables diversification in other asset categories.

The BCL manages seven kinds of portfolios.

Investment Portfolio

This portfolio consists of assets (equity and bonds), which can be deemed to represent its own funds (with a long-term investment profile). The main goal of the portfolio is to maximise return by taking the above-mentioned risk constraints into account (see section 1.3.2). As of 31 December 2011 the total market value (including accrued interest) amounted to € 2 072 million.

In 2011, the share of this portfolio invested in fixed income securities with a maturity above three years was lowered from 43 % to 29 %, whereas the percentage of bonds with a one to three-year maturity decreased from 44 % to 33 %. Moreover, by the end of 2011, variable rate and fixed rate bonds with a maturity of under one year represented 38 % of the investment portfolio.

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 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 2011, the total market value (including accrued interest) amounted to € 3 416 million.

Table 1: Breakdown of reserves as of 31 December 2011

Maturity	Portfolio 1	Portfolio 2
0-1 year	38 %	90 %
1-3 years	33 %	10 %
> 3 years	29 %	0 %

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 31 December 2011, the total market value (including accrued interest) of this portfolio in foreign currencies amounted to € 124.3 million.

The financial participation of the BCL in the capital of the BIS[1] and the IILM[2] reduced the amount of USD in the domestic reserves portfolio.

Pension Fund Portfolio

The management of this Fund is described further in section 2.2.2 of this report.

Foreign Reserves Portfolio of the European Central Bank

The management of this portfolio is described further in section 1.2 of this report.

Covered Bond Purchase Programme

After participating in the first CBPP, the BCL also takes part in the second programme. This € 40 billion programme expires in November 2012.

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 Eurosystems` 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, updated in 2009.

1.4 BANKNOTES AND COINS

1.4.1 Production of banknotes and coins

Within the Eurosystem, the euro banknote production is allocated according to a decentralised pooling scenario adopted in 2002, in which each NCB of the euro area is responsible for providing part of the total requirements. The euro banknote is produced in accordance with the requirements expressed by the participating NCBs and aggregated by the ECB. In this context, in 2011, the BCL organised the production of 7.7 million of € 20 banknotes and 8 million of € 5 banknotes for the Eurosystem's needs (compared to 17.8 million of € 20 banknotes in 2010). The BCL allocated the production of these banknotes via a tender. In addition, for its own needs, the BCL received 36.3 million banknotes from other NCBs (compared to 38.2 million in 2010).

Under an agreement with the State of Luxembourg, the BCL is also in charge of producing Luxembourg's euro coins and putting them into circulation. Following a tender, the BCL has commissioned the production of 38.6 million coins of the 2011 series to cover the needs of economic agents and numismatists.

1 Bank for International Settlements

2 International Islamic Liquidity Management Corporation (f. 1.11.2.1)

1.4.2 Circulation of banknotes and coins

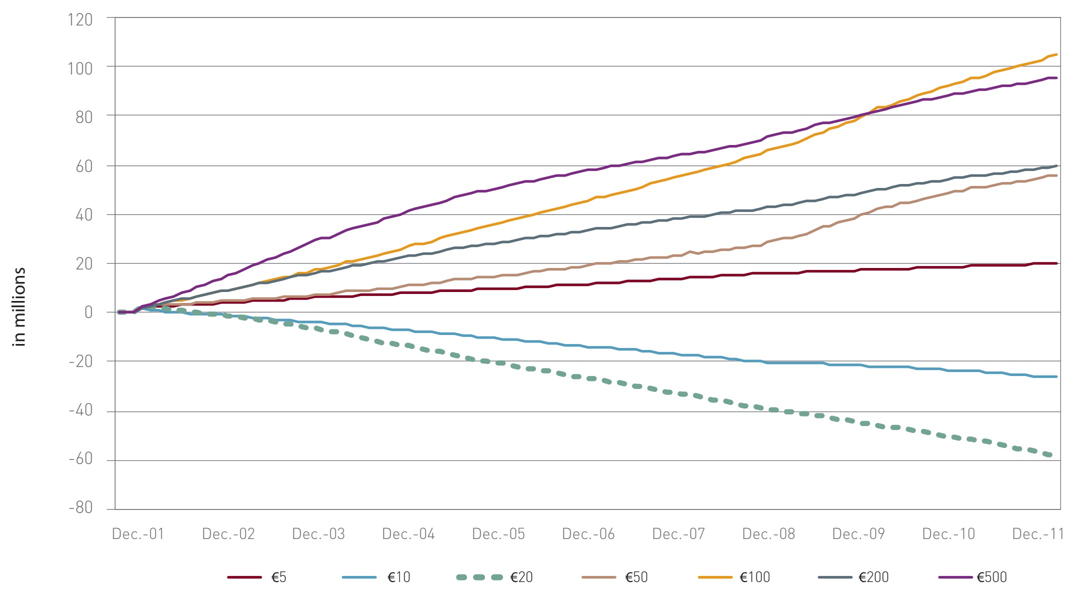
1.4.2.1 Euro banknotes and coins

The total net volume of banknotes issued by the BCL during the year 2011 amounts to 18.7 million banknotes, compared to 26.5 million in 2010, a decrease of 29.4 %. The BCL contributed for 2.4 % of the overall volume of banknotes put into circulation by the Eurosystem, compared to 5 % in 2010.

The distribution of banknotes by denomination reveals that the number of € 10 and € 20 banknotes lodged at the BCL exceeds the volume of banknotes issued. Financial institutions have indeed lodged more of these banknotes at the BCL than they withdrew, demonstrating the contribution to these denominations of tourists and especially cross-border workers from countries where they are more widely used. As to the denominations typically used for hoarding, i.e. banknotes of € 100, € 200 and € 500, the year 2011 was marked by a sustained demand, both in Luxembourg and in the euro area, in line with the tendency observed in 2010.

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

Chart 8:
Denominational breakdown of the number of euro banknotes put into circulation by the BCL

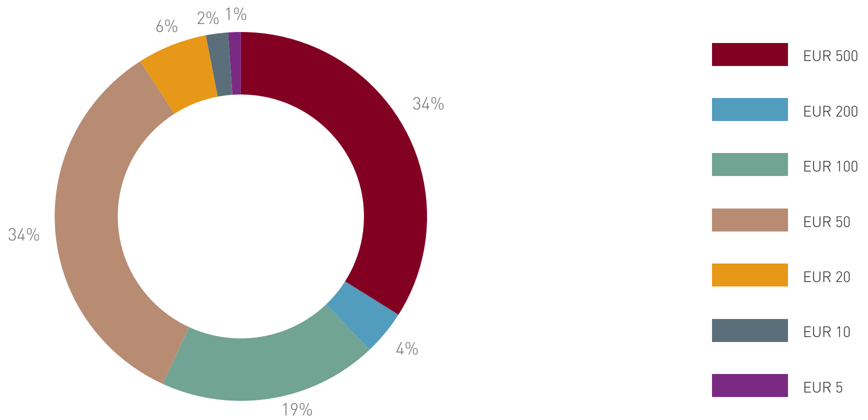


Source: BCL

In value terms, the net issuance of banknotes in Luxembourg grew at a less sustained pace in 2011 (+€ 5.1 billion, equal to an increase of 7.7 % in moving annual average) and reached € 72 billion by end December 2011. This increase is less strong than in 2010 (+10.5 %) and 2009 (+15.1 %).

Moreover, in terms of net issuance, Luxembourg ranked fourth in the Eurosystem in 2011, behind Germany (€ 391.8 billion), Italy (€ 153.6 billion) and France (€ 88.8 billion). In fact, the annual growth of net issuance in Luxembourg was higher than the one observed for the euro area as a whole (+5.8 % after +4.1 % in 2010), where it reached € 888.6 billion at the end of 2011 (compared to € 839.7 billion at end-December 2010), with the following breakdown by denomination:

Chart 9:
Distribution of the value of euro banknotes put into circulation by the Eurosystem by denomination



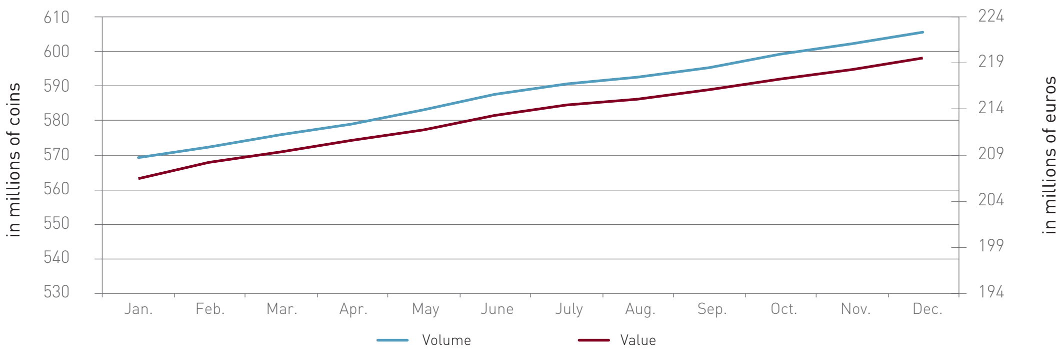
Source: ECB

Luxembourg euro coins continue to be the object of strong demand from the public. The total value of coins put into circulation increased by 6.7 % in 2011, marginally lower than in the previous year (+ 6.8 %), and rose from € 205.8 million to € 219.5 million.

The volume of coins put into circulation in the course of the year 2011 increased by 38.8 million units, equalling a growth of 6.8 %, and reaching a total of 605.7 million Luxembourg coins in circulation at the end of the year.

The chart below shows the development both in terms of volume and value of Luxembourg euro coins in circulation in 2011. The demand for Luxembourg coins grew steadily over the year.

Chart 10:
Volume and value of Luxembourg euro coins put into circulation in 2011

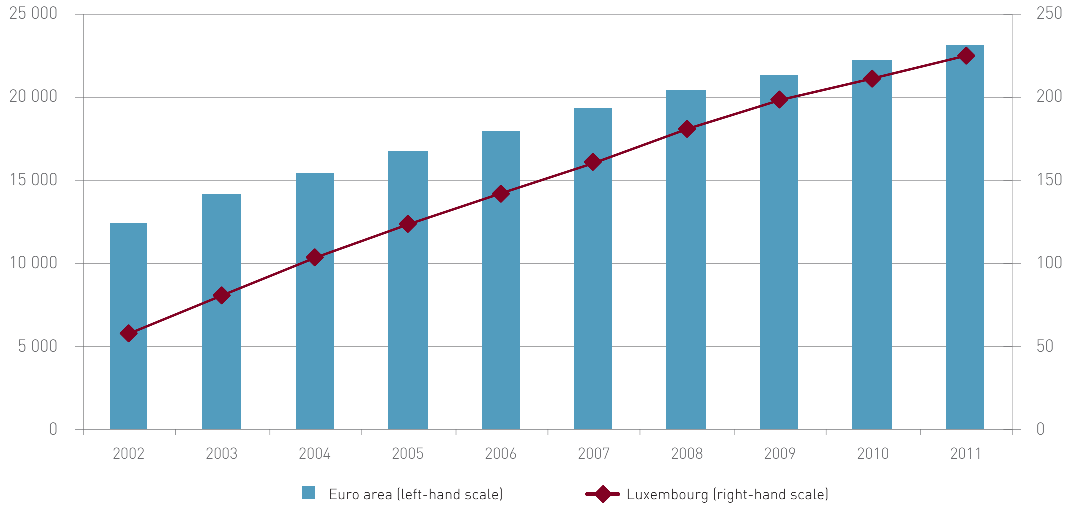


Source: BCL

Within the euro area, Luxembourg contributes nearly one percent (0.9 %) to the total value of all the issuing authorities and to 0.6 % of the total volume. The average value of Luxembourg coins in circulation remains unchanged compared to 2010: 36 cents compared to 24 cents on average in the euro area.

The following chart presents a visual comparison of the volume of coins put into circulation in Luxembourg with the corresponding volume of the euro area.

Chart 11:
Comparison of the euro coin circulation volume in Luxembourg and in the euro area

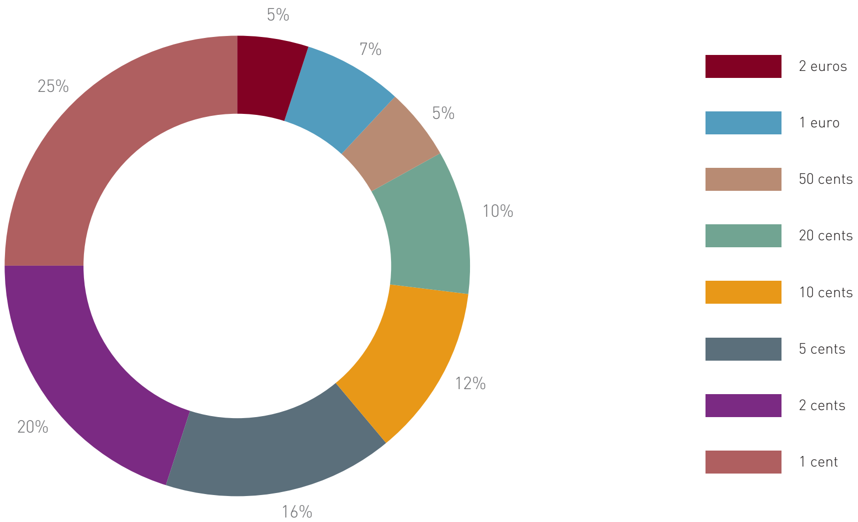


Source: ECB and BCL

The total value of euro coins put into circulation by the issuing authorities rose from € 22.3 billion in 2010 to € 24.2 billion in 2011, with their total number reaching 100.4 billion.

The following chart shows the breakdown by denomination of the volume of coins at the euro area level.

Chart 12:
Breakdown of the volume of coins of the euro area in circulation by denomination



Source: ECB

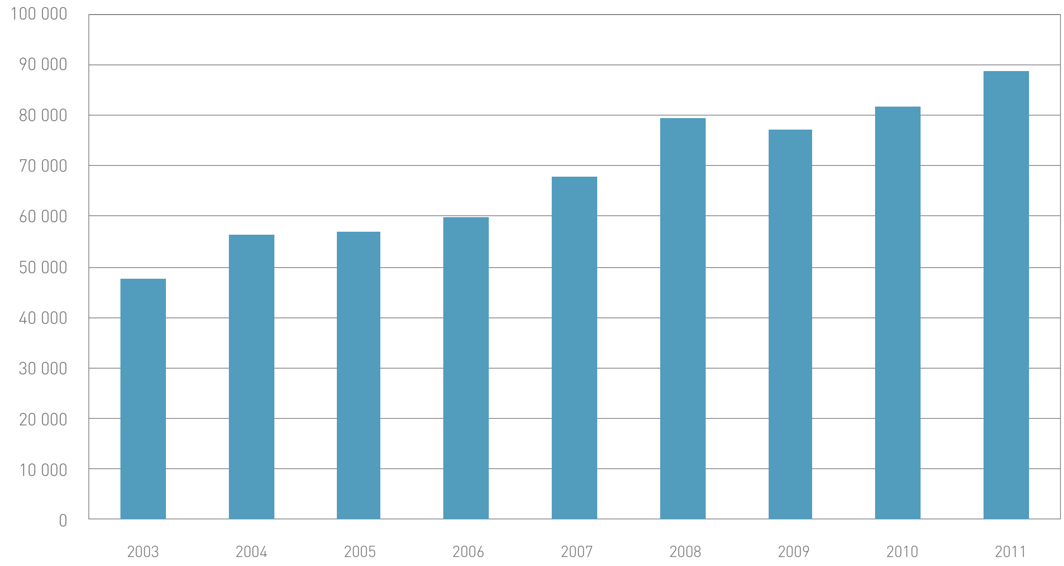
1.4.2.2 Luxembourg franc banknotes

During the year under review, the total value of Luxembourg franc banknotes issued by the *Institut Monétaire Luxembourgeois* and not yet presented for exchange, fell from LUF 208.3 million to LUF 206.9 million. This represents a decline of 0.7 % and is similar to the decline observed in 2010. In 2011, holdings of the 5 000 LUF banknote declined by 1.4 %, whilst those of 1 000 LUF banknotes decreased by 0.7 % and those of 100 LUF banknotes decreased by 0.1 %.

1.4.3 Handling of banknotes and coins

In the course of 2011 the volume of euro banknotes returned by financial institutions to the BCL increased by 8.7 % from 81.6 to 88.7 million banknotes. The chart below describes the evolution of these lodgments at the BCL since 2003.

Chart 13:
Lodgments of euro banknotes by financial institutions at the BCL (in millions of banknotes)



Source: BCL

The number of banknotes processed by sorting machines increased by 5.8 % from 77.5 million in 2010 to 82.1 million in 2011. The sorting machines check each banknote for authenticity and cleanliness. 7.9 million banknotes of all denominations had to be destroyed because they were unfit for circulation, which equals to a destruction rate of 9.6 %. This rate showed a wide variation between the denominations processed: it ranged from 6.6 % for the € 500 banknote to 25.6 % for the € 5 banknote.

1.4.4 National and international cooperation

In the fight against the counterfeiting of euro banknotes and coins, the BCL closely cooperated with the ECB and the national authorities in charge. For the analysis of counterfeit and unfit euro banknotes and coins, the BCL also collaborated with the Banque de France and the Deutsche Bundesbank since 2002 in accordance with a cooperation arrangement.

As in the past, with the support of the *Institut de formation bancaire Luxembourg* (IFBL) the BCL continues to train bank cashiers to authenticate euro banknotes and coins.

The BCL's Currency and Numismatics Department is participating in the preparation of a new euro banknote series. The design of this new series is based on the theme of "Ages and styles in Europe ". New security features will be incorporated, with the goal of providing maximum protection against counterfeiting thus allowing the public to easily distinguish a genuine banknote from a counterfeit. The introduction of this new series is foreseen for the coming years and will however be gradual. The timing and sequence of issuance of the second series and the exchange conditions of the first series will be announced in due time.

The BCL pools, with eight other central banks, its share of banknotes to be produced for the Eurosystem. This common European call for tender, whose purpose is to share resources and experience needed in monitoring the production of banknotes, foreshadows the future "Single European Tender Procedure".

The BCL also collaborates with seven other Eurosystem central banks in the management and maintenance of the CashSSP software. This software allows the Cash Department not only to manage its banknote and coin stocks and to monitor its sorting activity of fiduciary money but also to receive in a secured manner the reception of deposit and withdrawal announcements of commercial banks.

1.4.5 Numismatic issues

The BCL issues numismatic products on the theme of history and culture of the Grand Duchy. Through its numismatic premises, more than 4 400 sales transactions were completed in 2011. More than 7 000 parcels were sent out, corresponding to sales made through traditional mail or via the Internet shop of the BCL (https://eshop.bcl.lu).

In 2011, the BCL issued the following numismatic products:

- a € 2 commemorative coin, minted in 700 000 units, was put into circulation in February 2011. This coin, depicting the effigies of Their Royal Highnesses the Grand Duke Henri, Grand Duchess Charlotte and Grand Duke Jean, was also issued in BU quality as a coin card limited to 7 500 units;
- the 2011 BU set, issued in 7 500 units, comprises Luxembourg's euro coins of the 2011 series (including the € 2 commemorative coin);
- the 2011 BENELUX set, issued in an edition of 10 000 units, contains eight coins of the 2011 series of each of the three member countries;
- the 2011 PROOF set, limited to 1 500 units, is composed of nine coins;
- a silver-niobium coin, issued in July 2011 in an edition of 3 000 pieces, was dedicated to the Castle of Mersch and is the third element of the series devoted to the castles of Luxembourg;
- a gold coin, minted in 3 000 pieces, was dedicated to the «Rénert» (Reynard the Fox);
- a silver and Nordic gold coin, issued in December 2011 in an edition of 3 000 units, was dedicated to the «European Otter» and constituted the third element of the series devoted to the fauna and flora of Luxembourg.

1.5 STATISTICS

The BCL elaborates, collects, compiles and publishes a large set of statistical series. By doing so, it fulfils its commitments to the Eurosystem and the ESMA, as well as its commitments on a national level. These statistics are also used by other national institutions such as STATEC and CSSF in the framework of their own missions.

In 2011, significant efforts were made in order to improve the statistical collection of the BCL. The major challenge of the year 2011 consisted in the collection and compilation of new data related to financial stability.

1.5.1 New statistical regulations

In 2011, the BCL adopted and implemented two regulations defining new collections of source data for the compilation of external statistics for Luxembourg.

The BCL regulation BCL 2011/n°7 of 4 April 2011 is aimed at credit institutions and at the financial services of the *Entreprise des Postes et Télécommunications*. This regulation provides for the transmission of cross-border payments made on behalf of resident customers, as well as the transmission of the amount and economic nature of some cross-border own account operations, on a monthly basis.

The BCL regulation BCL 2011/n°8 of 29 April 2011 is aimed at companies taking out loans or issuing securities or derivatives on behalf of related entities. This regulation provides for the transmission, on a quarterly basis, of a balance sheet established according to accountancy standards in use. Moreover, this quarterly balance sheet is completed by data acquired monthly.

1.5.2 Publication of statistics

The BCL publishes a large array of statistics related to the financial sector on its website. In the course of 2011, several changes were implemented in order to improve the availability of statistical information for its users.

Thus, the BCL completed its publications by adding statistical tables which provide information on assets and liabilities for monetary and non-monetary UCITs detailed by main investment policies.

In the framework of the euro area debt crisis, the BCL proposed three new statistical tables providing an overview of the holding of securities issued by EU27 countries, as well as Switzerland, the United States and Japan. This information is broken down by the institutional sector of the issuer, namely banks, government and other sectors.

In 2011, the BCL also started to publish statistics on the annual stocks of assets and liabilities of insurance companies and pension funds; the data has been available since 2006 onwards.

Finally, the compilation of financial accounts for Luxembourg by the STATEC and the BCL allowed for the publication of several tables on quarterly financial accounts. These tables show the stocks and transactions occurring in the institutional sector from the first quarter of 2006 onwards.

1.6 PAYMENTS AND SECURITIES SETTLEMENT SYSTEMS

1.6.1 TARGET2-LU

Since 19 November 2007, the real-time gross settlement system TARGET2 has run on the new Single Shared Platform (SSP) operated in common by 24 central banks of the ESCB. In 2011, the National Bank of Romania joined the system.

With the Luxembourgish component TARGET2-LU, 30 direct participants (5 more than in 2007 and 2 more than in 2010), 44 indirect participants and three ancillary systems are registered.

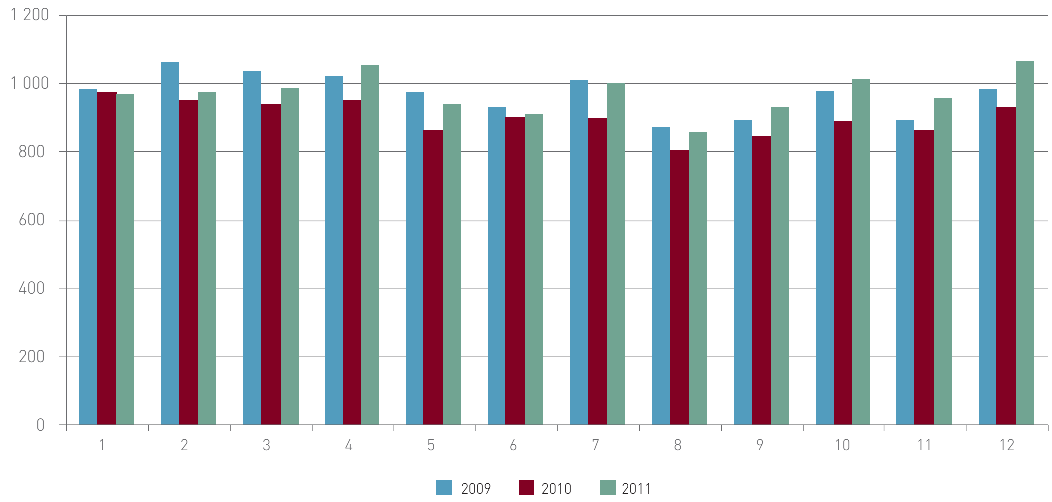
Domestic payments

In 2011, participants in TARGET2-LU exchanged a monthly average of 20 773 payments (compared to 19 379 in 2010) for a value of € 103.2 billion (compared to € 87.9 billion in 2010). 15 049 or 72.4 % of these payments were retail payments. Their value represented a monthly average of € 7.0 billion or 6.8 % of the domestic value exchanged.

The decreases in volume of TARGET2-LU triggered by the financial crisis of 2008 continued until 2010. In comparison to 2010, an increase in volume by 7.2 % occurred in 2011; this increase pushed volumes up to pre-crisis levels of 21 015 payments per month. The value exchanged increased by 17.4 %.

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

Chart 14:
Domestic payments: development of average daily volumes



Source: BCL

In 2011, participants in TARGET2-LU sent a monthly average of 47 820 payments towards other countries of the EU (45 774 payments in 2010) for an average value of € 808.4 billion (€ 570.6 billion in 2010). The volume of retail payments increased by 14.3 % to reach a monthly average of 25 631 payments representing 53.6 % of the total cross-border volume. Their relative part increased by 5 %. After their strong increase by 20 % in 2010, the volume of interbank payments decreased by 5 % to reach a monthly average of 22 189 transactions in 2011.

Customer payments amounted to a monthly average value of € 17.7 billion representing 2.2 % of the total cross-border value. The monthly value of interbank cross-border payments increased by 42.8 %, reaching € 790.7 billion. The increase was largely triggered by transfers related to overnight deposits with the BCL.

Cross-border payments increased by 4.5 % in volume and by 41.7 % in value within one year. The average value per transaction sent was € 16.9 million (compared to € 12.5 million in 2010). The average value of an interbank payment increased from € 23.7 million to € 35.6 million.

With a monthly average of 36 858 payments, participants in TARGET2-LU received 10 962 payments less than they sent. The value of the payments received exceeded that of the payments sent by 22 %.

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

Chart 15:
Cross-border payments sent: development of average daily values (million euros)

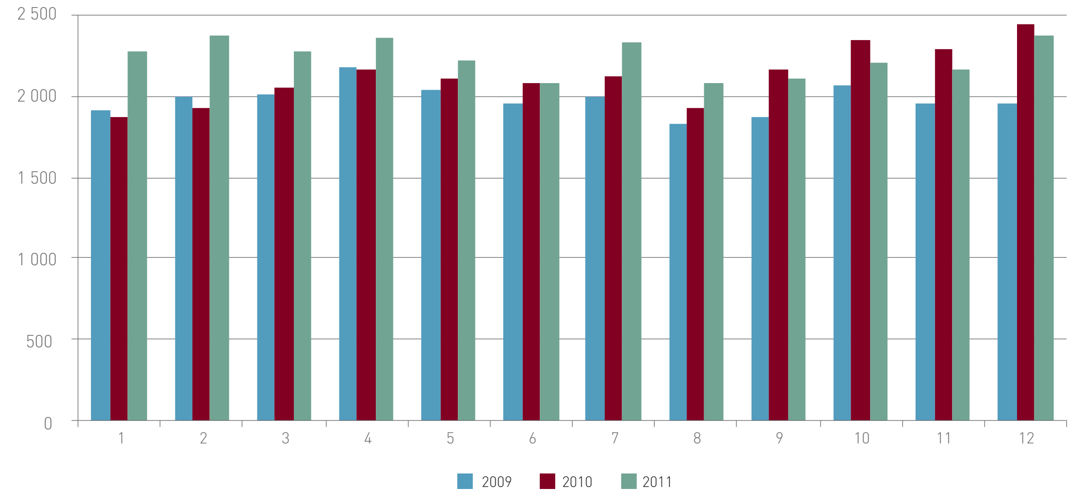
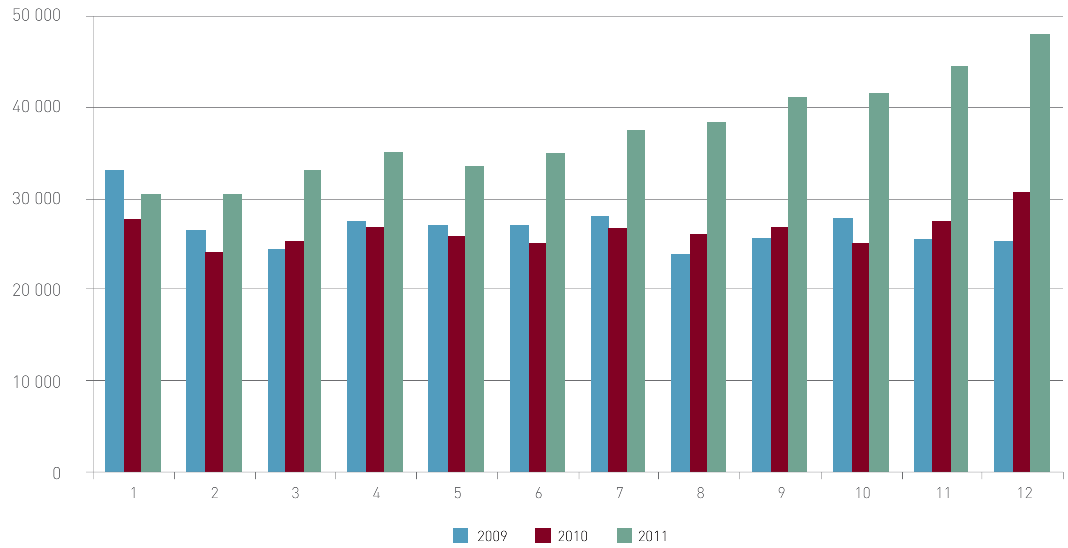


Chart 16:
Aggregated figures of domestic and cross-border payments



The total number of payments sent by participants in TARGET2-LU in 2011 amounted to 823 113 transactions (781 838 in 2010, an increase of 5.3 % in one year). 488 153 or 59.3 % of all payments were retail payments.

Table 2 provides a global overview of average daily volumes of payments per year since 2009. In 2011, all categories displayed increased figures in comparison to 2010.

Table 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)
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	36.2 %
2011	970	(30.3 %)	2 233	(69.1 %)	3 203	1 722	35.0 %
Variation 2010-2011	+8.6 %		+6.0 %		+6.8 %	+1.1 %	

Source: BCL

The average monthly value of all payments sent was € 911.6 billion of which € 24.7 billion (2.7 %) represented retail payments.

TARGET2-LU compared to other systems participating in TARGET2

Including transactions with ancillary systems, all national systems participating in TARGET2 transferred a monthly average of 7.35 million payments in 2011 representing a 1 % increase compared to 2010. Luxembourg accounted for 1 % of this volume. The average monthly value exchanged totalled € 69 421 billion, 2.6 % of which was yet again accounted for by Luxembourg.

In 2011, all national components of TARGET2 executed a monthly average of 4.87 million domestic transactions (4.98 million in 2010) for an average monthly value of € 34 427 billion. Luxembourg represented 0.9 % of this in volume and 2.4 % of this in value terms.

In addition, on a monthly average 2.59 million cross-border payments (2.40 million in 2010) for a value of € 16 651 billion (€ 15 226 billion in 2010) were executed. Luxembourg contributed 1.9 % to the volume and 5.9 % to the value.

The volume of retail payments in 2011 was 1.52 million transactions, about the same level as in 2010. By contrast, the volume of interbank payments increased by 0.5 % reaching 4.85 million transactions (4.83 million in 2010). Payments initiated within TARGET2-LU represented 1.5 % of all retail payments and 0.8 % of all interbank payments.

The average value of a TARGET2 payment was € 9.4 million (ancillary system transactions included). In TARGET2-LU, this value was € 25.5 million.

The daily maximum of payments sent in TARGET2 was 515 253 transactions (31 January 2011). In 2010, the maximum was reached in June with 496 079 payments. For Luxembourg, the daily maximum for 2011 was on 26 April with 4 722 payments. In 2010, the maximum was reached in April with 4 372 payments sent.

Availability and performance of TARGET2

In 2009 and 2010, the availability of the TARGET2 platform, and hence of TARGET2-LU, was 100 %. Following an incident at the opening of the day-trade phase on 25 July 2011, the SSP was unavailable for about three hours. The activation of the contingency module guaranteed the execution of all highly urgent payments during its unavailability time. In 2011, the availability of the TARGET2 platform was 99.89 %.

The SSP received a daily average of 346 328 payment instructions. 99.85 % were settled within five minutes (99.74 % in 2010) and 0.08 % within 15 minutes. For 0.07 %, the settlement took more than 15 minutes.

1.6.2 Retail payments in Luxembourg

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

The use of cheques has been decreasing for several years.

Credit transfers and standing orders

The settlement of credit transfers can be processed internally in banks, on a bilateral basis between the concerned banks or through a payment system (for instance TARGET2 or STEP2[3]). The bulk of Luxembourg credit transfers and standing orders are processed on the pan-European platform STEP2.

In 2011, Luxembourgish participants sent 78 820 transactions to STEP2 for a total value of € 229 million on a daily average. Domestic[4] transactions accounted for 65 % in volume (around 51 519 operations per day) and 59 % in value (€ 135 million).

The payments sent by the Luxembourgish community in STEP2 increased in 2011, respectively by 5 % in volume and by 16 % in value. The yearly growth of domestic activity reached 4 % in volume and 13 % in value.

Table 3: Annual variation of the activity in STEP2

Annual variation	2010/2011	2009/2010
Total volume	5 %	4 %
Total value	16 %	20 %
Domestic volume	4 %	0.1 %
Domestic value	13 %	17 %

Source: BCL

Direct debits

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

In 2011, the volume of direct debits amounted to 16.71 million for a value of € 7 656 million.

Payment cards in Luxembourg

There are two main categories of payment cards: debit cards and credit cards.

Bancomat, the domestic debit card scheme, ceased operations on 31 December 2011. Luxembourgish banks now issue debit cards in international schemes. The number of debit cards issued on 31 December 2011 reached 782 000 (compared to 600 000 in 2010). The strong increase is due to the concomitant use of Bancomat and newly issued cards during the changeover period at the end of 2011.

Credit cards issued in Luxembourg are mainly branded Visa and MasterCard. At the end of December 2011, the total volume of credit cards issued by banks in Luxembourg and managed by the Cetrel[5] was in excess of 533 000 units (505 000 in 2010).

3 STEP2 is managed by the Euro Banking Association (EBA)

4 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.

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

In 2011, the number of transactions[6] with Luxembourg-issued[7] debit cards totalled 44.92 million (42.92 in 2010) for a value of € 3.48 billion (3.36 in 2010). The number of credit card transactions amounted to 24.77 million (22.48 in 2010) worth € 2.66 billion (2.39 in 2010).

As for the transactions processed in Luxembourg on cards issued in Luxembourg or abroad, the volume on debit cards was 40.91 million (39.92 in 2010) for a value of € 2.91 billion (2.86 in 2010) and the volume on credit cards was 22.50 million (21.28 in 2010) worth € 2.01 billion (1.90 in 2010).

Until 31 October 2011, MiniCash served as the Luxembourgish e-money purse. It was built on a memory chip inserted in a Bancomat debit card on which the cardholder could transfer a certain amount of money immediately exchanged in e-money. In 2011, there were 0.60 million transactions for a total amount of € 1.13 million (compared to 1.71 million transactions for a value of € 3.90 million in 2010).

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

The SEPA (Single European Payments Area) project aims at achieving a single euro payment area in which all payments are considered as domestic, without any distinction between national and cross-border transactions.

With SEPA, a common set of payment instruments will be available and governed by a harmonised legal framework. The SEPA area encompasses 32 countries and territories, where users can make and receive payments in euro from a single account with the same ease and on the same conditions for domestic transactions.

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

The set of SEPA payment instruments are:

- the SEPA Credit Transfer (SCT), which was launched on 28 January 2008.
- the SEPA Direct Debit (SDD), which was launched on 1 November 2009.
- the payment cards: according to the SEPA Cards framework, every cardholder should be able to use their card in the SEPA area and every merchant should be able to accept all SEPA compliant cards, as far as it is economically justified. Common processing and security standards are being elaborated at the European level.

Banks in Luxembourg have already widely adopted the European credit transfer for retail operations. However, the European direct debits uptake remains low.

1.6.3 The general framework of eligible collateral in the Eurosystem credit operations

1.6.3.1 The list of eligible assets

All credit operations of the ECB and national central banks are based on "adequate collateral"[9]. 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).

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,

6 Payment transactions and cash withdrawals at ATMs. Data from the main cards processor.

7 Domestic (in Luxembourg) and international (abroad) transactions.

8 www.europeanpaymentscouncil.eu

9 Article 18 of the Statute of the ESCB and the ECB, article 22 of the founding law of the BCL.

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 the 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.

Following a Governing Council decision of 2010, the Eurosystem has applied a schedule of graduated valuation haircuts to assets rated in the BBB+ to BBB- range (or equivalent) since 1 January 2011. This new framework for graduated valuation haircuts takes into account the maturities of the marketable assets, their liquidity categories as well as the credit quality of the concerned assets as revised. More detailed information on this haircut schedule is published on the website of the ECB.

Concerning asset-backed securities (ABS), and according to a Governing Council decision of 2009, the rule of the "second best rating" has been applied to all ABS independently of their date of issuance since 1 March 2011. This rule implies that not only the best, but also the second best rating available must comply with the minimum threshold applicable to ABS.

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 purpose of the Eurosystem's credit operations. This decision arose from the positive evaluation made by the Governing Council concerning the economic and financial adjustment programme, which had been negotiated with the European Commission and the IMF, in collaboration with the ECB, and approved by the Irish government, and the strong commitment of the Irish government to fully implement the aforementioned programme.

On 29 April 2011, corresponding to the decision made on 16 December 2010 to gradually establish in the Eurosystem collateral framework loan-by-loan information requirements for asset backed securities, the Governing Council introduced specifications applicable to commercial mortgage-backed securities and small- and medium-size enterprise (SME) transactions. These specifications and their detailed contents to be used for residential mortgage-backed securities are available on the website of the ECB.

On 7 July 2011, the Governing Council suspended, until further notice, the application, in the case of marketable debt instruments issued or guaranteed by the Portuguese government, of the minimum credit rating threshold in the collateral eligibility requirements for the purpose of the Eurosystem's credit operations. This decision arose from the positive evaluation made by the Governing Council in response to the economic and financial adjustment programme, which had been negotiated with the European Commission and the IMF, in collaboration with the ECB, and approved by the Portuguese government, and the strong commitment of the Portuguese government to fully implement the concerned programme.

On 21 September 2011, the Eurosystem published an updated and consolidated version of its General Documentation applicable to monetary policy operations. The changes have been applied since 1 January 2012. This consolidation however does not concern non-conventional measures.

The eligibility criterion of the General Documentation (section 6.2.1.5 and 6.2.1.6), according to which debt instruments issued by credit institutions, other than covered bank bonds, are only eligible if they are admitted for trading on a regulated market, is not applicable to securities acquired in the framework of non-conventional measures. Moreover, the risk control measures for marketable assets (Section 6.4.2) have been amended. The Eurosystem has reduced the limit of the use of unsecured instruments issued by a credit institution or by any other entity with which the credit institution has close links. Such assets may only be used as collateral as long as their value does not exceed 5% of the total value of collateral submitted, instead of 10%.

On 8 December 2011, the Governing Council adopted a decision on additional temporary measures concerning the refinancing operations of the Eurosystem and collateral eligibility. In particular, in the field of collateral eligibility, the decision allows for the admission of certain other asset-backed securities and credit claims. The specific requirements pertaining to these measures are available on the website of the ECB.

1.6.3.2 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 different 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[10]; 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 securities issued in a system of another euro area country available, 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 collateralisation of central bank credit operations. In 2011, Luxembourg counterparties had the possibility to use the direct links between CBL and Clearstream Banking A.G. Frankfurt, Euroclear Bank, the SSS operated by the National Bank of Belgium, Monte Titoli (Italy), OeKB (Austria), Euroclear Netherlands, Euroclear France, KDD (Slovenia), and BOGS (Greece).

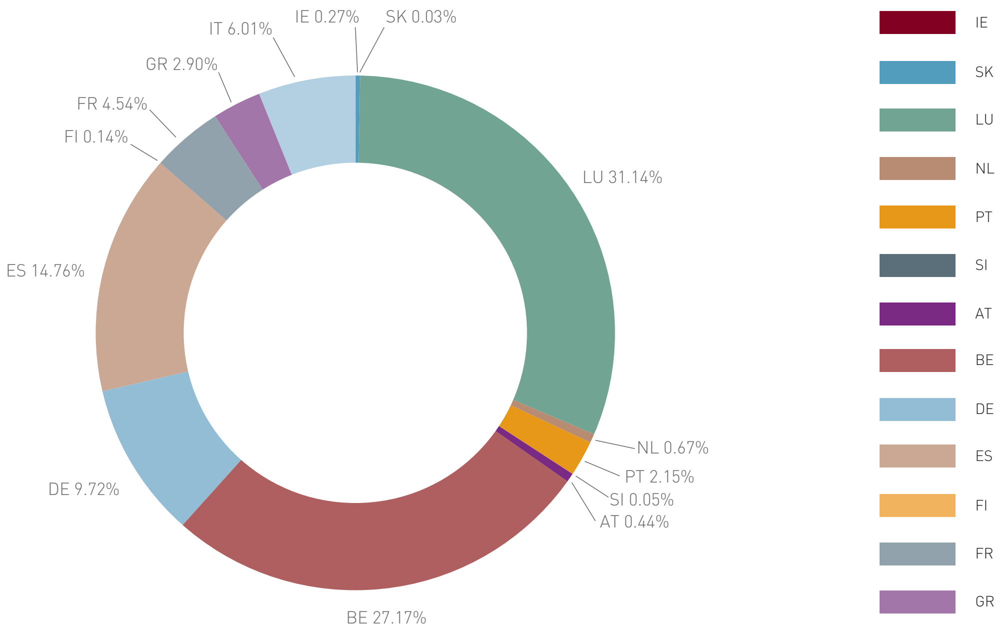
1.6.4 Correspondent Central Banking Model (CCBM)

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 based on the 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. In terms of value, the most active correspondent central banks in 2011 were those of Luxembourg (31.1 %), Belgium (27.2 %), Spain (14.8 %), and Germany (9.7 %). The most active home central banks were those of Germany (33.0 %), France (15.7 %), Greece (13.9 %), and Ireland (9.5 %).

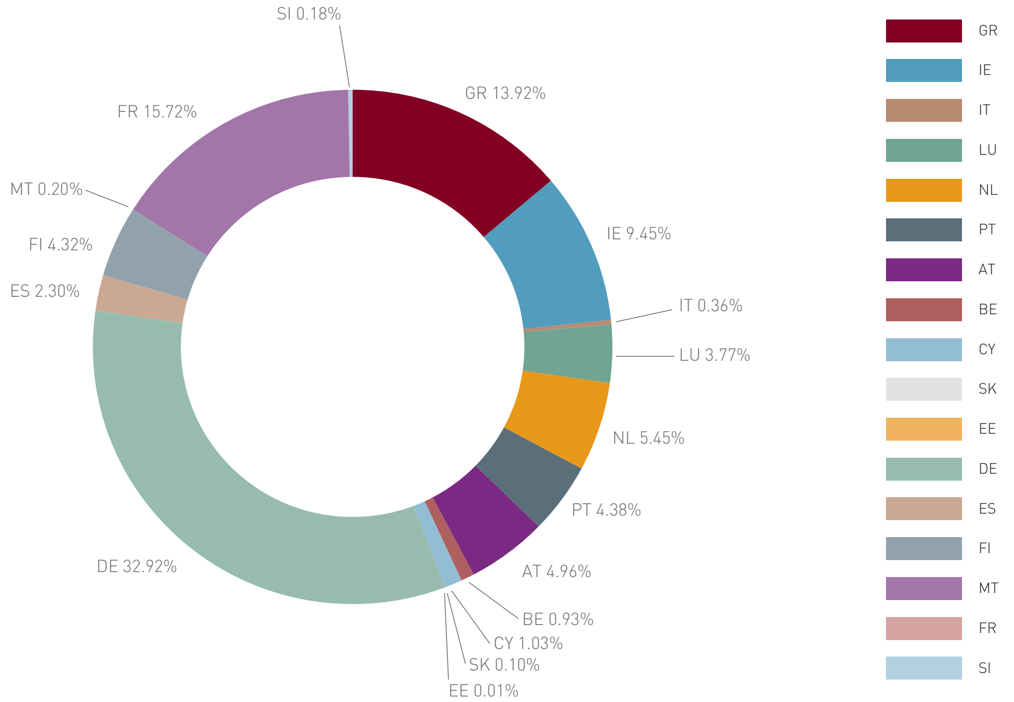
10 Correspondent Central Banking Model, see section 1.6.4.

Chart 17:
Correspondent Central Bank – 2011



Source: Eurosystem

Chart 18:
Home Central Bank – 2011



Source: Eurosystem

1.6.5 Future collateral management of the Eurosystem

The Eurosystem continued in 2011 its work aimed at enhancing collateral management, both for the Eurosystem and for counterparties. Besides the analysis of functional and technical specifications for a centralised platform in the future concerned with the management of collateral, the Eurosystem began the task of incorporating certain significant enhancements in the general collateral framework which had been requested by market participants. In particular, certain counterparties suggested to abandon the need to repatriate[11] eligible securities from the investor SSS to the issuer SSS in order to use them in the CCBM, as well as to allow the cross-border use of triparty services in the mobilisation of collateral. The incorporation of these two measures into the CCBM framework will require the ECB to define more harmonised operational procedures of the Eurosystem towards its counterparties.

1.6.6 TARGET2-Securities

TARGET2-Securities (T2S) is a Eurosystem project aimed at developing a single pan-European securities settlement platform in order to organise settlement operations in and between all participating Central Securities Depositories (CSDs) in a centralised and harmonised way. The platform will accomodate both the securities side as the cash side of transactions and provide DVP settlement in central bank money (CeBM) accordingly. This initiative is part of a more general process of financial markets integration in Europe, leading to a streamlining of procedures and to a substantial reduction of costs and risks.

2011 saw the conclusion of the negotiations concerning the Framework Agreement that applies to the development and migration of the platform and defines the rights, responsibilities and governance between all stakeholders taking part in the project (Eurosystem, central securities depositories and non euro area national central banks). The signature of the Framework Agreement by all these actors is expected to take place between April and June 2012. The ECB Governing Council confirmed that T2S is to become operational in June 2015.

In October 2011, the final T2S technical specifications were published. They will allow all actors to assess the feasibility and technical efforts needed for their organisation to participate in the initiative.

Under the lead of the T2S Advisory Group and National User Groups, efforts were pursued to clarify harmonisation initiatives needed in the participating countries in order to allow T2S to be used to its maximum potential. These initiatives could for example result in new market practices or regulatory changes.

2012 is expected to see the signature of the Framework Agreement by all interested stakeholders, the implementation of a new governance structure as well as clarifications in terms of implementation and migration procedures.

1.6.7 LuxCSD

LuxCSD, Luxembourg's central securities depository, was created jointly by the BCL and Clearstream International on the basis of an equal shareholding in 2010. It provides securities settlement services in central bank money. The Clearstream Group is the operator of LuxCSD, allowing it to benefit from operational synergies and a functional IT platform.

LuxCSD was technically established in 2011 and 2012 should be the first year of its commercial deployment. In that respect, LuxCSD will provide the following services:

- the settlement of securities transactions in central bank money;
- the settlement of free of payment transactions;
- securities issuance services with settlement in central bank money or free of payment;
- securities custody services;
- the routing of orders in investment funds shares;
- direct settlement against Clearstream Banking counterparties;
- upon its availability, a national access point to T2S.

11 In the terminology of the Eurosystem and its counterparties, this is the "removal of the repatriation requirement".

Securities eligible in LuxCSD will be debt securities, equities or investment funds shares, whether they are domiciled in Luxembourg or not.

In 2011, LuxCSD was designated by the BCL as a "securities settlement system" and notified to the European Commission as well as to the ESMA. LuxCSD is in the process of being assessed by the Eurosystem. The BCL will open an account in LuxCSD to collect collateral for monetary policy operations.

LuxCSD also formally confirmed to the ECB its interest in joining TARGET2-Securities. This interest will be reiterated in the first half of 2012 through the signature of the T2S Framework Agreement.

The LuxCSD Board is composed of three members, one of them mandated by BCL while the two others are mandated by Clearstream Banking.

1.7 FINANCIAL STABILITY AND PRUDENTIAL SUPERVISION

In addition to their main mission to maintain price stability, the Eurosystem and the BCL contribute to financial stability and prudential supervision. An unstable financial system hampers an efficient allocation of financial resources to the economy and affects the transmission of monetary policy.

According to the Eurosystems` definition, financial stability describes a situation in which the financial system, i.e. intermediaries, markets and infrastructures, are able to withstand shocks including sufficient buffers and are able to cope with their consequences. Ultimately, the aim is to reduce the occurrence of disturbances affecting the process of financial intermediation thereby fostering balanced and sustainable growth.

The financial stability mandate attributed to the BCL is based on the Treaty on the functioning of the European Union through its participation in the Eurosystem, and on national legislation. At the European level, article 127 of the Treaty on the functioning of the European Union entrusts the Eurosystem, in addition to its central task of conducting monetary policy, the responsibility of contributing to a well supervised and stable financial system. At the national level, article 2(6) of the organic law of the BCL stipulates the need for the BCL to cooperate with the government and the supervisory agencies in order to ensure financial stability. In addition, given its expertise in the matter, the legislator has entrusted the BCL with the supervision of payment and securities settlement operations.

1.7.1 Macro-prudential supervision

Macro-prudential supervision is designed to contribute to the efficient allocation of resources in the economy by minimising the build-up of vulnerabilities that could potentially destabilise the financial system. On the one hand the aim is to avoid the build-up of systemic risk while on the other hand it is intended to buttress the resilience of the system through the fine-tuning of buffers in the financial system.

This approach completes micro-prudential supervision by adding a macro-prudential perspective while taking into account the set of financial intermediaries and other components of the financial system and infrastructure. Macro-prudential supervision is based on the notion of systemic risk which is defined as "a risk of disturbances in the financial system which could have important consequences on the internal market and on the real economy."

With the tendency for systemic risk to behave in a cyclical manner, it is important to asses the evolution of risk at the level of the system. Consequently, macro-prudential analysis has to take the build-up of endogenous risk into account (i.e. resulting from the behaviour of financial intermediaries) as well as exogenous risk. By contrast, at the micro level, risk is considered as external (market risk, exchange rate risk, credit risk, …) and the extent of endogenous risk carried by an institution can be overseen. Among the tasks of macro-prudential supervision, is the need to recognise the degree of common exposures across institutions and their correlations as is the need to recognise the risks concerning employment and resources.

As a result, the relevant perimeter for macro-prudential supervision will be the entire set of financial intermediaries, markets and infrastructures that could represent a certain systemic importance.

Systemic risk has many dimensions which makes its analysis a complicated task. Furthermore, the dynamic developments in the financial sector allow for the potential of systemic risk to develop and change quickly. These principles demand the need for macro-prudential supervision to be comprehensive and continuous. This warrants for taking all risks into account including low-probability high-impact tail risks which by definition are difficult to predict.

Systemic risk is most commonly described in its cross-sectoral and temporal dimensions. As no single indicator can capture the multiple facets of risk, macro-prudential frameworks tend to use a series of risk indicators including early warning indicators (EWI) and financial soundness indicators (FSIs).

The cross-sectoral dimension requires the measurement of the correlation of exposures across financial institutions. This may give indications of the interconnectedness of the system and of common channels of contagion. While this analysis is limited by the amount of data available, a multitude of analytical tools exist to evaluate the links between financial institutions.

The temporal dimension focuses on the issue of pro-cyclicality in the financial system. Pro-cyclicality leads to an accumulation of risk over time due to the interaction of the financial and real sectors of the economy. Pro-cyclicality can be analysed using indicators on the credit cycle, asset prices, leverage and maturity mismatches.

1.7.1.1 Macro-prudential supervision in Luxembourg

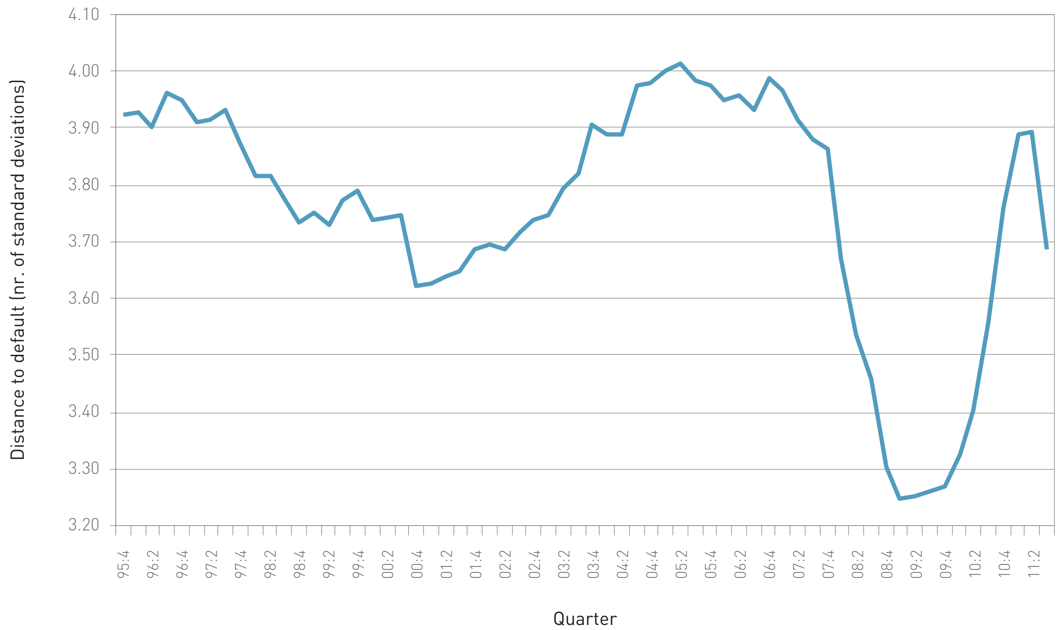
The BCL relies on multiple indicators to assess systemic risk. The BCL has developed indicators for probabilities of default of individual banks and their counterparties, aggregate z-scores, vulnerability indices and specific indicators to monitor liquidity.

Preliminary estimations of the probabilities of default of Luxembourgish banks exhibit a stabilisation of the dispersion as compared to 2010. This result applies to the median (0.01 %) and the maximum level which hovers inside a narrow band (10-12 %). This indicator points at a stabilisation in the financial sector in Luxembourg. Nevertheless, vulnerabilities remain for individual banks which, however, does not imply a systemic risk due to limited interconnectedness found on the national level. In aggregate these results are confirmed by calculations of the z-score and the BCL vulnerability index. The z-score increased between 2009Q4 and 2010Q4 after a decline between end-2007 and early 2009. A resurgence of vulnerability, nevertheless, occurred in 2011 when the trajectory of the z-score was reversed and its dispersion increased as well. This negative development mainly reflects the impact of distressed European sovereigns. In aggregate, the level of the indicator remains at a level which is compatible with the requirements for a stable financial system.

The BCL also engages in determining the link between finance and the real economy and in liquidity stress-testing. A number of indicators developed at the BCL take a forward-looking approach. In order to anticipate rising vulnerabilities in the banking sector, the BCL applies a special weight to its synthetic financial vulnerability indicator and to the macro-prudential stress tests.

The vulnerability indicator makes use of a host of variables from bank balance sheets, profit and loss accounts, macro-financial variables and the structure of the Luxembourgish banking sector. In order to keep track of medium term vulnerabilities in the Luxembourgish banking sector, the indicator is set for up to two years (while taking Eurosystem macro conditions into account). Predictions for 2012 and 2013 display a convergence of vulnerability in historic averages. In addition, over this time period, the index remains below a certain level thus, indicating a certain degree of vulnerability. In regard to the estimates, confidence intervals still remain thus also revealing an increased degree of uncertainty.

Chart 19:
The z-score index for Luxembourgish banks: 1995q1 - 2011q3



Source: BCL

The BCL also carries out regular top-down stress tests which attempt to quantify the impact of severe but plausible exogenous shocks on the stability of individual components of the financial system. Such stress tests can be followed up with the use of additional risk indicators to enrich the results. These indicators can subsequently help inform the prudential response of the outcome of the stress tests. In this context a new stress-testing framework[12] is being developed at the BCL which manages to accommodate better for tail events in credit risk distributions.

During the second half of 2011, the BCL analysed the impact of certain sovereign risks on the solvency ratios of Luxembourgish banks. This contributed in determining additional capital required in case of a further deterioration in European sovereign debt markets. The importance of these issues for the Luxembourgish fund industry was also analysed.

A number of specific studies were also carried out in the context of the changing regulatory environment. The impact of the new Basel III liquidity requirements on Luxembourgish credit institutions was analysed.[13] A paper was also produced on the leverage ratios of banks as an indicator for banks' external funding needs.[14] Furthermore, a common project between the BCL and the Luxembourg School of Finance (LSF) with financing from the *Fonds National de la Recherche* (FNR) focusing on stability in the Luxembourgish financial sector and on the construction of macro-prudential tools has been running since early 2011.[15]

The use of its security-by-security database permitted the BCL to continuously monitor the evolution of exposures of Luxembourgish banks and investment funds to distressed sovereigns. Network analysis are also carried out on interbank links making use of the available data like e.g. the risk concentration tables. Furthermore, the Basel Committee on Banking Supervision's (BCBS) framework was used to determine

12 Guarda, P., A. Rouabah et J. Theal. (Octobre 2011), "MVAR: A framework for capturing extreme events when conducting a macro-prudential stress test", Cahier d'études de la BCL n°63.

13 Giordana G., Schumacher I. (Juin 2011), "The Impact of the Basel III Liquidity regulations on the Bank Lending Channel: a Luxembourg Case Study", Cahier d'études de la BCL n°61.

14 Giordana G., Schumacher I. (Octobre 2011), "The leverage cycle in Luxembourg's banking sector", Cahier d'études de la BCL n°66.

15 X. Jin et F. Nadal de Simone, (Octobre 2011), "Market and book based models of probability of default for developing macro-prudential policy tools", Cahier d'études de la BCL n°65.

systemically important institutions in Luxembourg. The framework is based on a series of indicators including the size of an institution, its interconnectedness and its substitutability in case of default.

Regarding macro-prudential supervision, the BCL contributes to a number of committees and working groups at the level of the ESCB, inter alia the Financial Stability Committee (FSC) and its substructures. The BCL is also involved in a research network focusing on macro-prudential issues (Macro-prudential research network MaRs) which involves central banks of the EU. This initiative revolves around three main pillars including (i) the development of macro-financial models linking financial stability concerns to the performance of the economy, (ii) the evaluation of contagion risks and their transmission channels and (iii) the elaboration of a set of systemic risk indicators. The macro-prudential role of the BCL has evolved considerably since the inception of the ESRB and related structures, i.e. the Advisory Technical Committee (ATC).

1.7.1.2 The European Systemic Risk Board (ESRB)

The ESRB was created by the European regulation n°1092/2010, issued by the European Parliament and the Council on November 24, 2010, which deals with the macro-prudential surveillance of the financial system in the European Union.

The ESRB represents the macro-prudential pillar of the new European system of financial supervision. The ESRB's inaugural meeting was held on January 20, 2011. This new independent institution is responsible for the systemic risk surveillance at the EU level. Its mandate is the supervision and evaluation of systemic risk during normal times in order to mitigate the exposure of the system to the failure of systemic institutions as well as to increase the system's resilience to shocks. The ESRB can issue warnings on identified risks and relay recommendations aimed at tackling the risks if it is deemed necessary. In this regard, the scope of ESRB action covers the whole financial system and contributes to the mitigation of potential negative effects on the real economy.

The ESRB includes more than 70 institutions (central banks, national and European financial supervision authorities, the European Commission …) and consists of a General Board and a Steering Committee. The technical work is performed by an Advisory Technical Committee (ATC) implicating experts from the member institutions, and by an Advisory Scientific Committee involving experts from academia.

This new structure calls for new responsibilities, specifically for central banks, in regard to their expertise and responsibility in sustaining financial stability. Central banks thereby, play a major role in the European macro-prudential surveillance. The governor of the BCL is a voting member of the ESRB General Board, which is the unique decision body of the institution. The national micro-prudential supervisory authorities are part of the General Board, although as non-voting members. Given the BCL's responsibilities as a liquidity supervisor and according to a rotation principle agreed upon by the other national supervisory authorities, the BCL also finds itself represented on the General Board in matters concerning this issue. Furthermore, the BCL contributes to the technical and analytical works performed by the ESRB substructures, thereby providing its analytical expertise regarding macroeconomic, financial, monetary and statistical issues.

The inception of the ESRB should allow for the improvement of the ability to identify macro-prudential risks at the level of the whole financial system. Likewise, it provides a mechanism to issue clear warnings and recommendations which should trigger prompt action by the concerned national authorities (given the "comply-or-explain" principle).

After a short initial period aimed at implementing the institutional and organisational framework, the ESRB General Board started holding its plenary meetings at a minimum of four times per year. The ESRB has been mainly working on the following five subjects:

- the identification and assessment of general systemic risk, as well as the actions needed to deal with it;
- the analysis and study of macro-prudential actions towards specific risks which have triggered, for example, the issuing of recommendations regarding loans in foreign currencies (ESRB/2011/1) and the foreign currency funding of financial institutions in Europe (ESRB/2011/2);
- the analysis of macro-prudential aspects of ongoing European legislative developments, namely those regarding the transposition into European law of the Basel III rules within the Capital Requirements

Directive and the new Regulation for banks and other credit institutions (CRDIV/CRR), as well as the Central Counterparties legislation (EMIR);
- the identification of common principles for the implementation of macro-prudential national mandates and tools; the ESRB has issued a recommendation regarding national macro-prudential mandates (ESRB/2011/2);
- the identification of the analytical tools that the ESRB will develop further in the near future in order to study systemic risk.

1.7.2 Micro-prudential supervision

1.7.2.1 Liquidity supervision

The liquidity supervision of market operators was entrusted to the BCL by a modification of its organic law on 24 October 2008. The liquidity supervision of market operators principally aims at assessing the liquidity situation and the management of the liquidity risk of individual operators. The flaws in the liquidity risk management of certain operators having been one of the principal causes of the financial turbulences of 2008, management of liquidity and related risks were in the focus of attention of supervisory authorities at the international level over the last few years.

Regulation of liquidity is important for a central bank because, on the one hand, the central bank acts as a supplier of liquidity to the financial system in normal times-as in times of stress, and, on the other hand, it can detect or indeed prevent a failure chain on the markets, thus limiting systemic risk. This materialised again in 2011, marked by strong turbulences on financial markets that also affected the Luxembourg financial centre.

Liquidity supervision also constitutes an important support function for analyses conducted in the field of financial stability and in the analysis of systemic risks, by providing micro-prudential analysis as an input. In this context, the framework of supervision of the BCL is essentially based on two pillars, namely the permanent off-site monitoring carried out internally on the basis of data collected via the regular statistical and prudential reporting and on the on-site inspections of market operators.

After the issuance of the BCLs` Regulation of 2009/n°4 on 29 April 2009 defining basic principles for the supervision of liquidity, its scope of application, market operators' responsibilities and daily statements in the years 2009 and 2010, 2011 was marked by:
- the off-site monitoring of market operators;
- on-site visits, and
- the monitoring of work carried out on an international level, in relation to the definition and setting-up of new liquidity standards in the framework of Basel III as well as in the context of their transposition at the European level.

The off-site monitoring of market operators is based on a regular analysis of qualitative and quantitative information of an individual as well as on an aggregated level. In order to have a better monitoring of the liquidity position of the market operators, the BCL notably developed daily statements of the liquidity position of credit institutions. These reports apply to a sample of credit institutions and were introduced in May 2010. It allows the BCL to assess the liquidity position of these entities on a day-to-day basis.

In 2011, the BCL developed, based on historical data from these daily statements, a tool that allowed the assessment of the structural liquidity position of these credit institutions and the assessment of the individual evolution of their liquidity position over time..

It also pursued the development of the Liquidity Monitoring Framework (LMF) as a tool for liquidity supervision. This tool allows for the assessment of the vulnerability of individual credit institutions in terms of liquidity as well as for the identification of liquidity risks at an aggregated level. The LMF was thus subjected to methodological and technical improvements. These two tools add an additional dimension to the supervisory mission carried out by the BCL.

In 2011, the BCL also intensified the on-site visits with regard to liquidity supervision. These assessments are used in order to fully understand the framework and the procedures that individual operators have in place, in order to assess the appropriateness of the framework for the liquidity risk management of operators. The BCL mainly targets the credit institutions that are the most vulnerable to liquidity risk or that participate as a counterparty in monetary policy operations. The BCL carried out nine on-site visits in 2011. As a general rule, these on-site visits are coordinated and carried out in cooperation with the CSSF. The BCL is in regular contact with other institutions in the context of its surveillance mission.

The on-site visits revealed that the credit institutions are reinforcing their framework for liquidity risk management to align themselves with the recommendations in this regard, but some weaknesses remain, mostly at the level of performing stress tests.

These weak points also appear in the impact studies carried out in the context of the implementation of the new Basel III standards for liquidity. In the course of 2011, the BCL conducted, in cooperation with the CSSF, two impact studies on a representative sample of credit institutions for the financial centre, in order to determine the current positions of these banks with regard to the new liquidity standards.

The last study showed that, based on the figures of 30 June 2011, eight credit institutions out of 59 succeeded in respecting the two standards for funding liquidity, i.e. the LCR (Liquidity Coverage Ratio) and the NSFR (Net Stable Funding Ratio). Nevertheless these standards will only come into force from 2015 and 2018 onwards respectively. The monitoring of these liquidity ratios will continue in 2012.

As a supervisor in charge of liquidity, the BCL is also involved in the work of several supervisory colleges. With the majority of the credit institutions being affiliates of groups having their head office abroad, participation in these colleges allows for a better apprehension of the activity and risk profile of Luxembourgish entities in the context of their group. At the end of 2011, the BCL was a member of six supervisory colleges.

Since 2008, the BCL has also exercised the liquidity supervision of the European Investment Bank, the latter being admitted as an eligible counterparty for monetary policy operations of the Eurosystem. The contract governing the supervision was renewed in December 2011.

With regards to the monitoring of regulatory developments at the international level, the BCL is participating in the working groups dedicated to liquidity issues at the level of the Basel Committee and the European Banking Authority. Beyond the working groups dedicated to liquidity aspects, the BCL is also a member of the Board of Supervisors of the European Banking Authority as well as of other committees and subgroups that are of relevance in the context of its supervisory mission. As a general rule the implication in these committees and working groups is done jointly with the CSSF. As a supervisory authority, the BCL also participates in the work of the ESRB (European Systemic Risk Board).

1.7.2.2 Oversight

The oversight of payment and settlement infrastructures is an essential task for the central banks of the Eurosystem. The objective is to contribute to the security and efficiency of these infrastructures, especially in the light of the importance of a smooth functioning of the systems for the economy, the implementation of monetary policy, the preservation of financial stability and of public confidence in the currency.

According to the BCL's organic law, the BCL is in charge of promoting the security and the efficiency of payment and securities settlement systems, as well as the security of payment instruments. In this context, in conformity with BCL regulation 2010/n°6 of 8 September 2010 as amended by BCL regulation 2011/n°10 of 14 July 2011, the oversight of systems and instruments is applied to operators and issuers, participants, as well as services provided by technical agents or third party entities. The annex to the BCL regulation 2010/n°6 lists the principles and specific standards adopted by the Eurosystem, upon which the BCL bases its evaluation of the functioning of the systems and the instruments falling under its oversight. In this context, the operators and issuers shall follow the applicable principles and put in place an organisation, adequate rules and a risk management framework aimed at reducing the risks associated to the system.

The oversight and the assessments performed by the BCL are based on regular and ad hoc statements of qualitative and statistical information provided by relevant entities. This information, completed with regular contacts and specific on-site inspections, relates in particular to the development of the infrastructures' activities, their performance, their governance and the management of certain risks.

In regard to payment systems, the BCL, through its participation in certain working groups at the European level, contributed to discussions related to the cooperative oversight of TARGET2 (including its Luxembourg component TARGET2_LU), Euro1 and CLS. In 2011, these systems showed a stable and robust functioning. Moreover, the BCL performed an appreciation of the decentralised aspects of TARGET2, these aspects being mainly linked to the BCL's own connection to the system and to the ancillary services offered by the BCL to the Luxembourg participants.

In regard to securities settlement systems, the BCL pursued its oversight activities related to the systems operated by Clearstream Banking S.A. and by VP Lux S.à.r.l. Furthermore, the scope of the BCL's oversight of securities settlement systems was extended to the system operated by LuxCSD S.A. In application of articles 109 and 110 of the law of 10 November 2009, the BCL designated on 3 October 2011 the system operated by LuxCSD S.A. as a securities settlement system. In this regard, the BCL performed an assessment of the adequacy of the rules of the system, in line with legal requirements in this field.

In the course of 2011, the functioning of securities settlement systems was generally stable and resilient. Besides regular oversight activities, the BCL followed the implementation by Clearstream of certain recommendations issued in the context of the assessment of the system against the ESCB-CESR standards in 2010. Similar assessments of the systems operated by VP Lux S.à.r.l. and LuxCSD against the same ESCB-CESR standards are also being performed.

In addition, the compliance of the system operated by Clearstream with the principles issued by the CPSS-IOSCO Committee was assessed in 2011. This assessment, performed by the IMF in the context of the Financial sector assessment program (FSAP), in cooperation with the relevant national authorities, concluded to a high degree of compliance of the system with these principles.

In 2011, the BCL followed the development by the CPSS-IOSCO Committee of new principles to be applied to different types of financial market infrastructures of systemic relevance, e.g. central counterparties, payment systems, central securities depositories, securities settlement systems and trade repositories. Moreover, the work of the European Commission on the European Market Infrastructure Regulation (EMIR) and the discussions on a regulation relating to central securities depositories were paid particular attention.

Concerning payment instruments, the BCL contributed, at the Eurosystem level, to the definition of oversight standards for electronic money schemes. These standards, which are being finalised, follow a similar approach to the one adopted by the Eurosystem for payment cards, credit transfers and direct debit schemes. They target legal, financial, operational and reputational risks which these schemes are exposed to and shall be used as a basis for the assessments by central banks in this context.

Finally, the BCL actively contributed to the initiatives of the SecurePay forum established in 2011 which is composed of members of European central banks and banking supervisors. The ongoing work concerns the definition of security standards for Internet payments with payment cards and for electronic payments through web-banking applications.

1.8 REGULATORY AND LEGISLATIVE DEVELOPMENTS

1.8.1 European legislation

The BCL follows with a particular interest developments on economic governance and financial stability at the European and international level.

1.8.1.1 Economic governance

Primary law

Modification of Article 136 of the Treaty on the Functioning of the European Union (TFEU)

On the occasion of the European Council of 28 and 29 October 2010 the Heads of State or Government agreed on the need for Member states to establish a permanent crisis mechanism to safeguard the financial stability of the euro area as a whole.

In accordance with the simplified revision procedure under Article 48(6) of the Treaty on the European Union, the European Council adopted on 25 March 2011 the Decision n°2011/199/EU amending Article 136 TFUE on the establishment of a stability mechanism for Member states whose currency is the euro. Consequently, the following paragraph was added:

"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."

In accordance with the national procedures for approval this new provision is intended to enter into force on 1 January 2013.

In Luxembourg, a draft approving act was deposited by the Parliament on 27 September 2011.

International Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (fiscal compact)

Following the Statement by the Heads of State or Government of the euro area on 9 December 2011, an international treaty on Stability, Coordination and Governance in the Economic and Monetary Union was endorsed by 25 Member States of the EU on 30 January 2012. This treaty reinforces fiscal discipline, particularly through the introduction of a permanent binding balanced budget rule, preferably to be introduced at the constitutional level and ensuring enhanced surveillance of Member States that are subject to an excessive deficit procedure. This treaty was signed by the Heads of State or Government on 2 March 2012.

European Financial Stability Facility (EFSF) and European Stability Mechanism (ESM)

On 11 July 2011, the Finance Ministers of the 17 Member states of the euro area signed an intergovernmental treaty establishing a European Stability Mechanism that refers to a modification of Article 136 TFUE. This treaty was submitted to a ratification procedure by the signing Member states. Initially, it was foreseen that the European Stability Mechanism should be able to intervene as of July 2013, in view of replacing the European Financial Stability Facility[16].

Table 4: The European Stability Mechanism

Name	Legal basis	Duration	"Firepower" (origin and amount)
ESM European Stability Mechanism	International organisation established in Luxembourg on the basis of an intergovernmental treaty signed by the 17 Member States of the euro area. The treaty relies on the foreseen modification of Article 136(3) TFUE.	Same activities as the EFSF, starting operations in July 2012, then replaces the EFSF as from July 2013.	€ 500 billion (capital markets' funding with € 700 billion of subscribed share capital of which € 80 billion are paid-in from member states' budgets).

16 The EFSF has been incorporated as a joint-stock company (*société anonyme*) under Luxembourg law.

In addition, following the meeting of the euro area Finance ministers on 20 June 2011 and the Euro summit of 21 July 2011, the EFSF Framework Agreement was modified by a Supplemental Amendment Agreement to the EFSF Framework Agreement. Modifications aimed to increase the amount of guarantees given by shareholder Member states so as to bring them up to a total of € 780 billion, thus allowing the EFSF to have an effective lending capacity of € 440 billion. The modifications also aimed to allow Estonia, a new Member state of the euro area since 1 January 2011, to adhere to the intergovernmental treaty and, finally, to provide new intervention tools.

These additional tools enable the EFSF either to provide loans, to act on the basis of a precautionary programme, to finance the recapitalisation of financial institutions (by loans to governments of these member states, including non programme countries), to provide facilities for intervening in the secondary bond market, or to intervene in the debt primary market (all these tools are considered as a "financial assistance").

The amendments of the EFSF Framework Agreement entered into force on 18 October 2011. On 29 November 2011, the Eurogroup approved the modalities for the strengthening of the intervention framework of the EFSF with two approaches: first, with the creation of a special purpose entity aimed at enhancing primary sovereign bond issues with a partial coverage in case of the default of payment of a Member state (option 1) and, second, with the creation of a special purpose entity allowing a co-investment with external investors (option 2). These two special purpose entities were designed as companies governed by Luxembourg law, similarly to the EFSF. The BCL decided to support the EFSF by providing a registered office to the entity established under option 1.

During the summit held on 9 December 2011, the Heads of State and Government decided to increase the combined lending capacity of the EFSF and the ESM so as to reach € 500 billion. Finally, on 2 February 2012, Heads of State and Government signed the treaty bringing forward the ESM's starting of operations to 1 July 2012.

Table 5: The European Financial Stability Facility (EFSF)

Name	Legal basis	Duration	"Firepower" (origin and amount)
EFSF European Financial Stability Facility	A joint-stock company (*société anonyme*) under Luxembourg law whose capital share and scope of activities are defined in an intergovernmental treaty signed by the 17 Member States of the euro area titled "EFSF Framework Agreement", amended by a supplemental agreement that entered into force on 13 October 2011.	Activity foreseen to last until 2013. Survival of the legal entity until the maturity of securities issued.	€ 440 billion (capital markets' funding with € 780 billion of state guarantees taken from national budgets of Member states that are shareholders)
Optimisation of its firepower with:			
	"Option 1" Credit enhancement of new issuances of sovereign debt by a concomitant issuance of "Sovereign Bond Protection Certificates" by a special purpose vehicle incorporated in Luxembourg.		Coverage of 20 % to 30 % of the nominal value of new issuances guaranteed.
	"Option 2" Setting up of one or several co-investment funds (CIF) allowing a combination of public and private funding so as to increase the funding possibilities for the EFSF's financial instruments.		The funding capacity of the CIF is to be determined depending on who will be the external investors.

Secondary law

The six legislative proposals of the European Commission of 29 September 2010, concerning the reinforcement of economic governance in the EU and the euro area were adopted by the European Parliament on 28 September 2011 and by the Council on 8 November 2011 thus allowing for their entry into force on 13 December 2011.

The objective was to broaden and enhance the surveillance of fiscal policies, but also of macroeconomic policies and structural reforms in the light of the shortcomings of the existing legislation revealed on the occasion of the economic and financial crisis.

The adopted legislative package comprises six different legislative acts[17]: four legislative acts on fiscal aspects aiming notably at reinforcing the Stability and Growth Pact and the national fiscal frameworks of the Member States and two legislative acts aiming at detecting and correcting macroeconomic imbalances in the EU and the euro area. This implies a reform of the preventive and corrective part of the Stability and Growth Pact and the introduction of a new procedure on the prevention and correction of macroeconomic imbalances.

The "European semester", a new tool adopted by the European Council in 2010 and reflected in the amended Council Regulation (EC) n°1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, was applied for the first time in 2011. It enables an enhanced coordination of economic and fiscal policies according to a coordinated cycle.

The Eurosystem welcomed the agreement between the European Parliament and the Council, considering however that the agreed package fell short of the "quantum leap" in economic governance that the Eurosystem had long advocated for in the euro area.

In view of reinforcing the economic governance reform in the euro area beyond the aforementioned legislative package, 23 Member states, including Member states with a derogation (Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania) agreed on a "Euro Plus Pact" on the occasion of the informal meeting of the Heads of State or Government of the euro area of 11 March 2011 as endorsed by the European Council on 24 and 25 March 2011. In this context the signatories committed to even stronger economic coordination with annual assessments and monitoring by the Heads of State or Government.

On the basis of the aforementioned legislative package the Commission published two new proposals for Regulations[18] on 23 September 2011, whose adoption are pending. One of the proposals sets out provisions introducing a system of progressive surveillance, which complements the existing provisions of the Stability and Growth Pact and strengthens surveillance of fiscal discipline in the Member States whose currency is the euro. These provisions provide for the introduction of common fiscal rules in line with the budgetary objectives set at Union level as well as for enhanced monitoring of those Member States whose currency is the euro that are subjected to an excessive deficit procedure. The implementation of these rules should be done by the introduction of binding rules, preferably of a constitutional nature, in order to show the rigorous adhesion of national authorities to the Stability and Growth Pact. In addition, a common budgetary timeline is proposed in view of ensuring the efficiency of the European semester as well as independent fiscal councils in place at the national level who are to be in charge of monitoring the implementation of national fiscal rules.

1.8.1.2 Secondary legislation drafts

In 2011, several drafts for new regulations in the financial sector at the European level were proposed by the Commission. However, only few proposals were adopted as legislative acts.

The BCL followed with interest the developments related to the European proposal for the creation of a crisis management framework that should combine with its own proposal to set up a bank resolution fund in Luxembourg. Nevertheless, the Commission's proposal, initially expected to be presented at the beginning of the summer 2011, was not released during the year under review.

17 (i) Regulation (EU) n°1173/2011 of the European Parliament and of the Council of 16 November 2011 on the effective enforcement of budgetary surveillance in the euro area; (ii) Regulation (EU) n°1174/2011 of the European Parliament and of the Council of 16 November 2011 on enforcement measures to correct excessive macroeconomic imbalances in the euro area; (iii) Regulation (EU) n°1175/2011 of the European Parliament and of the Council of 16 November 2011 amending Council Regulation (EC) n°1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies; (iv) Regulation (EU) n°1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances; (v) Council Regulation (EU) n°1177/2011 of 8 November 2011 amending Regulation (EC) n°1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure; (vi) Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States.

18 Proposal for a Regulation of the European Parliament and of the Council on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area and Proposal for a Regulation of the European Parliament and of the Council on the strengthening of economic and budgetary surveillance of Member States experiencing or threatened with serious difficulties with respect to their financial stability in the euro area.

Furthermore, on 20 July 2011, the Commission presented proposals for a directive and for a regulation with the goal of strengthening the legislation on capital requirements for banks in accordance with the agreement of Basel III. These two texts aim at updating and replacing the current capital requirement directives (2006/48 and 2006/49). The proposal for a directive is related to the access and to the activity of collecting deposits in the public, while the proposal for a regulation is related to prudential requirements that institutions need to abide by in particular, as regards liquidity ratios. This package is also known as the "CRD IV" proposal.

Among legislative acts adopted in 2011, it is worth mentioning Regulation (EU) n°513/2011 of the European Parliament and of the Council of 11 May 2011 amending Regulation (EC) n°1060/2009 on credit rating agencies which specifies the role of the new European Supervisory Authority (European Securities and Markets Authority) over credit rating agencies registered in the Union. On 15 November 2011, the Commission presented a new proposal for a directive and for a regulation aiming at strengthening the latter regulation and at filling certain gaps.

1.8.2 National legislation

1.8.2.1 Draft law n°6327 on dematerialised securities

On 12 September 2011, the draft law on dematerialised securities[19] (the "draft law") was tabled with the Chamber of Deputies. It aims at governing the dematerialisation of securities, which Luxembourg law applies, whether they consist of capital, debt securities issued by companies incorporated under Luxembourg law, or debt securities issued under Luxembourg law by companies incorporated under foreign law. Dematerialised securities are designed as an additional category of securities, in addition to the possible issuance of such stock and debt securities in bearer or registered form. The draft law introduces a procedure governing the conversion of existing securities in bearer or registered form into dematerialised securities as well as the issuance of new securities in dematerialised form.

Securities listed on regulated markets may only be dematerialised by liquidation bodies. Securities settlement systems operating in Luxembourg and subject to the BCL's oversight, pursuant to the law of 10 November 2009 on payment services, are considered as such liquidation bodies. In consequence, no additional authorisation procedure shall apply to liquidation bodies, which as duly authorised securities settlement systems are automatically authorised as liquidation bodies. It may be recalled that the BCL intervenes alone in the designation process of the securities settlement system to the Ministry being in charge of the financial sector, which then notifies such a system to the European Commission.

Non-listed issues may be dematerialised, either within a liquidation body, or within a central account keeper having received a specific authorisation from the CSSF. Securities that have been dematerialised within a liquidation body or a central account keeper may circulate freely, including within the accounts maintained by account keepers; account keepers are defined as any person authorised under Luxembourg law to maintain securities accounts, including national or international bodies of a public nature established in Luxembourg and operating in the financial sector.

The draft law also modernises the framework in the law of 1 August 2001 on the circulation of securities and other fungible instruments (hereinafter the "law of 2001") that governs the holding and circulation of securities held in accounts located in Luxembourg, irrespective of their form and place of issuance. The draft law aligns the law of 2001 with the *Unidroit* Convention on substantive rules for intermediated securities of 9 October 2009, and with the expected Union harmonisation of securities law.

19 Draft law on dematerialised securities and amending:

- the law of 5 April 1993 on the financial sector, as modified;
- the law of 23 December 1998 creating a financial sector supervisory commission, as modified;
- the law of 10 August 1915 on commercial companies, as modified;
- the law of 3 September 1996 on the involuntary dispossession of bearer securities, as modified;
- the law of 1 August 2001 on the circulation of securities and other fungible instruments, as modified;
- the law of 20 December 2002 on collective placement bodies, as modified;
- the law of 17 December 2010 on collective placement bodies;
- the law of 13 February 2007 on specialized investment funds, as modified;
- the law of 22 March 2004 on securitisation, as modified.

Moreover, the draft law introduces three new provisions in order to strengthen the protection of the security holders' rights. First, it provides that, on bringing liquidation proceedings against an account keeper, the affected holders of the securities accounts immediately acquire the rights to the securities that have been credited to the securities account of the account keeper, without having to wait for the crediting of such securities to their own securities accounts. Second, without prejudice to the separately regulated irrevocability and finality rules, failure by one party to deliver or settle vis-à-vis its counterparty, confirmed on the date and under the terms and conditions applicable in the relevant market or fixed by an agreement between the parties or the rules of a securities settlement system, discharges the affected counterparty of its corresponding delivery or payment obligations, without prejudice to the liability of the defaulting party (Article 16 of the law of 2001). Third, if the relevant account keeper proceeds to deliver the securities or to pay the price in place of the defaulting account holder, such an account keeper acquires ownership by way of guarantee of the securities or funds received from the counterparty as compensation (Article 15 of the law of 2001).

In its opinion of 24 January 2012 concerning the draft law (CON/2012/3), the ECB welcomes the amendments to the law of 2001, which strengthen the protection and enforcement of the rights of the securities holders which maintain securities in a securities settlement system, a liquidation body, a central account keeper or an account keeper in Luxembourg. The ECB also welcomes the amendment of Article 16 concerning the law of 2001 which allows for the mitigation of the credit risk taken by the financial intermediary financing the acquisition of securities by its customers. The ECB considers that such an amendment is of particular relevance to the TARGET2-Securities (T2S), the Eurosystem's future settlement platform. Furthermore, the ECB understands that the amendment to Article 15 of the law of 2001 is supposed to address specific situations encountered in the present financial crisis where transfer orders duly entered into a system, in respect of a counterparty against which insolvency proceedings were subsequently brought, remained unsettled and suspended in the said system, as the insolvent counterparty did not discharge its obligations and the parties could not immediately agree on the bilateral cancellation of such a transfer order. In this respect, the ECB recommends, in its opinion, to clarify the impact of the newly introduced provision as well as its relationship with the settlement irrevocability granted by the Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems. The ECB also recommends that the draft law elaborate on how the proposed statutory discharge of obligations can be aligned with the rules of the operator of a securities settlement system.

Box 1

ADOPTION OF FISCAL RULES IN LUXEMBOURG

An international treaty on Stability, Coordination and Governance in the Economic and Monetary union was endorsed by 25 Member States of the EU on 30 January 2012. This treaty reinforces fiscal discipline, particularly through the introduction of a balanced budget rule to be of binding force and permanent character, preferably at the constitutional level, and ensures enhanced surveillance of Member States that are subject to an excessive deficit procedure. This treaty was signed by the Heads of State or Government on 2 March 2012.

Different Member states adopted or are about to adopt fiscal rules at a national level. Such a reform has currently not been carried out in Luxembourg.

The legislative framework in Luxembourg on public finance should be amended. It should be fully aligned with the Union's objectives of multilateral surveillance, in particular the European semester, in compliance with the aforementioned treaty and the recent reform of the Stability and Growth Pact (more specifically with Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States as well as with Regulation (EU) 1175/2011 of the European Parliament and of the Council of 16 November 2011 amending Council Regulation (EC) n°1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies).

Different options as mentioned hereinafter exist for achieving such a reform in Luxembourg.

Amendment of the law of 8 June 1999 on the budget, the accounting and treasury of the State

In compliance with Article 3(2) of the draft treaty on Stability, Coordination and Governance in the Economic and Monetary Union (and considering hereby Article 4 of the Commission proposal of 23 November 2011 for a Regulation of the European Parliament and of the Council on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficits of the Member States in the euro area) a fiscal rule should be foreseen in national legislation, more specifically in the law of 8 June 1999 on the budget, the accounting and treasury of the State.

Such an option would have the advantage of implementing the European requirements within a short time period. It would nonetheless imply the disadvantage that these provisions might subsequently be amended or annulled easily. A special legislation on public finance would also be needed to ensure a multiannual fiscal planning and compliance with the European rules and policies (with the introduction of a two-third majority vote by the members of Parliament (*Chambre des Députés*) as far as the rules on the establishment and implementation of public accounts and budgets are concerned).

In order to ensure that the fiscal rule is based, in accordance to European law, on a reliable and independent analysis and that it is in view of ensuring a proper and well-timed monitoring of compliance with the fiscal rules, an independent body such as a committee of experts should be put in place in Luxembourg. It would need to be endowed with at least functional autonomy vis-à-vis the minister having fiscal policy and legislation within its field of competence. It could be envisaged to have recourse to the different existing institutions having expertise in this domain.

Amendment of the Constitution

In compliance with Article 3(2) of the draft treaty on Stability, Coordination and Governance in the Economic and Monetary Union it could be envisaged to introduce a fiscal rule in the Constitution of the Grand-Duchy of Luxembourg, even though the draft treaty does not impose it formally[1]. Such provision would need to be accompanied by a special legislation on public finance ensuring the multiannual fiscal planning and compliance with the European rules and policies (with introduction of a two-third majority vote by the members of Parliament as far as the rules on the establishment and implementation of public accounts and budgets are concerned).

Such an option would have the advantage of stability by creating legal constraints ensuring that a subsequent amendment would only take place with the benefit of the required hindsight and reflection. Reference to an independent body could also be made in this context. Like in certain Member States (Austria, Germany, France) it could be envisaged to amend Article 95ter of the Constitution[2] in order to extend the competences of the Constitutional Court by enabling the latter to rule henceforth, in an abstract manner, on the compliance of laws with the fiscal rule. Such an amendment would however imply an innovation likely to deeply amend the legislative system of Luxembourg.

1 Reference is made to "binding rules, preferably of a constitutional nature".

2 Article 95ter stipulates:

(1) The Constitutional Court decides, by way of judgment, on the conformity of the laws with the Constitution.

(2) The Constitutional Court is seized, in a prejudicial manner, pursuant to the modalities to be determined by the law, by any court to decide on the conformity of the laws, save the laws approving treaties, to the Constitution.

(3) The Constitutional Court is composed of the President of the Superior Court of Justice, the President of the Administrative Court, two counselors of the "*Cour de Cassation*" and five magistrates nominated by the Grand Duke, upon the joint opinion of the Superior Court of Justice and Administrative Court. The provisions of Articles 91, 92, and 93 apply to them. The Constitutional Court comprises a chamber sitting with five magistrates.

(4) The organisation of the Constitutional Court and the manner in which it exercises its competences are regulated by the law."

1.8.3 BCL Regulations

In 2011, the BCL issued four regulations.

In regards to statistical data, the BCL issued the following regulations:

- Regulation BCL 2011/n°7 of 4 April 2011 in relation to the statistical data collection of the payment systems and financial services of the Post and Telecommunications company
- Regulation 2011/n°8 of 29 April 2011 concerning the statistical data collection of companies contracting loans or issuing debt or derivative products derived for the accounting of associated societies.

The Regulation BCL 2011/n°9 of 4 July 2011 aims to collect the statistics concerning the instruments and operations of payment systems.

Finally, the Regulation BCL 2011/n°10 of 4 July 2011 aims to renew certain dispositions of the BCL regulation 2010/n°6 of 8 September 2010 concerning the task of overseeing systems and payment instruments and securities settlement systems in Luxembourg.

1.8.4 Legal rate of interest

The rate was fixed at 3.50% for the year 2011 by a grand-ducal regulation issued on 1 February 2011 (published in the Mémorial A n°22 of 9 February 2011, page 174). For 2012, this rate remains unchanged following the grand-ducal regulation of 8 December 2011 (published in the Mémorial A n°255 of 16 December 2011, page 4305). It is observed that this rate does not correspond to a specific rate of reference of the money markets.

1.9 COMMUNICATION

1.9.1 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 2011 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. 21 working papers were published in 2011.

1.9.2 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 and law lectures at the University of Luxembourg and the Catholic University of Louvain as well as foreign exchange risk management lectures at the Strasbourg Institute of Political Studies, and econometrics and time series analysis lectures at the University of Metz.

The BCL also organised ad hoc presentations for various groups of students (Catholic University of Louvain, ULB-Solvay). In Berlin, on 13 April 2011, the BCL Governor gave a speech for students of the *Freie Universität Berlin* on the following subject: "*Europa nach der Krise – Balance zwischen Markt und Staat*". On 16 June 2011 he received a group of 40 students of the *Hochschule für Politik München*, for a discussion on "*Die Rolle des EU bei der Bewältigung der internationalen Finanz-, Wirtschafts- und Schuldenkrise*".

The BCL is a shareholder of the *Agence de Transfert de Technologie financière* (ATTF). This agency, established in 1999 at the initiative of the Luxembourg government, shares with mainly emerging countries, Luxembourg's know-how in financial matters. In May 2011, in the context of a BCL-ATTF joint seminar, the BCL held lectures for a delegation of the People's Bank of China. Presentations were organised in favour of a delegation of Uzbekistan and of a high-level delegation of the National Development and Reform Commission of the People's Republic of China.

The BCL organises presentations on the Eurosystem and the BCL for high-school students following economics classes (usually in the course of their last two years of studies). Students are received, 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.

1.9.3 The BCL's website

The BCL's website, www.bcl.lu, provides information about the Bank's activities and services, its internal organisation, as well as statistics concerning Luxembourg and the Eurosystem. It also contains links to the ECB's website and to websites of other central banks of the ESCB. Based on its search engine and its configurable mailing list, the site offers 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 media section. Hard copies are available at the BCL on request, as long as in stock.

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

Overall, 120 249 people visited the website in 2011 (154 346 in 2010), with more than 15 000 000 hits. The numismatic programme witnessed more than 25 000 downloads.

The numismatic products electronic shop (eshop.bcl.lu), directly accessible through the BCL website, attracted more than 54 000 visitors in 2011.

1.9.4 The library

The library, opened in 2005, uses the ALEPH library management system 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, and mainly tackle monetary, financial, economic and law issues concerning the euro area. Publications usually consist of regulations, statistics, reviews and surveys on the Luxembourg financial centre.

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.

1.9.5 Press relations

The Governor of the BCL gave 15 interviews to the international and national press. Six 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 and Financial Stability Review.

In total, 113 press releases were published.

1.9.6 The BCL research programme

BCL research activities are organised in six main research fields:

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

1.9.6.1 Research activities

BCL research output is regularly disseminated through its working paper series or the BCL Bulletin and the Financial Stability Review. Several studies were published in peer-reviewed scientific journals (Empirical Economics, Oxford Bulletin of Economics & Statistics, Journal of Economic Dynamics and Control, Journal of Housing Economics). The list of BCL research publications appears in an annex to this report.

BCL researchers also presented their work in seminars and workshops organised, among others, by the University of Luxembourg, the Eurosystem, the European University Institute, the International Finance & Banking Society, the European Workshop on Efficiency & Productivity Analysis, the German Economic Association and the Netspar Network for Studies on Pensions, Ageing & Retirement.

Since June 2010, the BCL has participated in the European central bank research network called MaRs (macro-prudential research network). In this context, BCL staff is involved in two work-streams: one on macro financial models, with a focus on the link between financial stability and economic performance, and the other focusing on early warning systems and systemic risk measures.

In March 2011, the BCL organised an international conference in Luxembourg to mark the end of the multi-year research project Perfilux (performance of financial services in Luxembourg), partly financed by the *Fonds National de la Recherche* (FNR). This project involved a collaboration between BCL researchers, the Luxembourg School of Finance (University of Luxembourg) and the STATEC. The BCL also collaborated with the Luxembourg School of Finance on a second FNR project named RISKADBS (Measuring financial stability in Luxembourg: risk adjusted balance sheets).

1.9.6.2 Fondation BCL

Incorporated in 2011, the *Fondation BCL* aims at promoting research and university education in the BCL's fields of activity. The *Fondation*'s byelaws were approved by a Grand-ducal regulation on 12 March 2011.

The Board of Directors of the *Fondation* is constituted of the following members:

Mr. Yves Mersch, President of the Council of the BCL – President

Mr. Serge Kolb, member of the Council of the BCL and Director at the BCL – Managing Director

Mr. Hans Helmut Kotz, Senior Fellow at the Center for Financial Studies, Goethe University, Frankfurt, Honorary Professor at the Fribourg University (D) and former member of the Deutsche Bundesbank's Board of Directors- Director

Mr. Jacques Poos, member of the Council of the BCL – Director

Mr. Patrice Pieretti, Professor at the Luxembourg University and former member of the Council of the BCL – Director

Mr. Romain Schintgen, member of the Council of the BCL – Director

Mr. Henri Sneessens, Professor at the Luxembourg University – Director

Mr. Christian Wolff, Professor at the Luxembourg University, Director of the Luxembourg School of Finance – Director

Mr. Jean-Pierre Zigrand, Professor at the London School of Economics – Director

The Board of Directors of the *Fondation* set as a priority for 2011-2012 research in the field of financial stability, a timely topic for researchers as well as for decision-makers in economic policy. The *Fondation* budgeted in 2011 € 5 000 for a scholarship for doctoral research in the area of financial stability and € 2 000 for the best doctoral thesis defended in 2011. With the collaboration of the CEPR/Euro Area Business cycle Network, the *Fondation BCL* prepares the organisation of an international conference in Luxembourg in 2012.

1.9.7 Conferences and events

The following conferences and events took place in 2011:

- Following the launch of the ECB charity initiative at the end of 2010, the BCL's Governor made a donation of € 6 250 to Mr. Michel Colin, President of the Luxemburg association of assistance to cardiac children, in the context of a ceremony organised at the BCL on February 18. This association, created in January 2002, aims at supporting children and their relatives with the help of cardiologists. The donation results from funds received over the last few years within the framework of the external activities of members of the ECB's Executive Board and of other members of staff of the ECB and are equally distributed in the national central banks of the Eurosystem.

- Conference entitled "Banking, Productivity and Growth" organised on March 28 and 29 at the Chamber of Commerce. This conference resulted from a 3 year research project, partially financed by the *Fonds National de la Recherche Luxembourg* and led by a consortium composed of the BCL, the Luxembourg

School of Finance (University of Luxembourg) and the STATEC. The conference ended with a round table chaired by Professor Paul Wachtel, professor of New York, and with the participation of the BCL's Governor as well as Mr. Serge Allegrezza, Director of the STATEC.

- Seminar and annual conference of the European Supervisor Education Initiative (ESE), which were both organised in Luxembourg. The seminar, from April 5 to April 7, dealt with the subject "Case studies on the development and review of Internal Rating Based models", whereas the annual conference, on September 28 and 29, addressed the following theme: "Financial Crises and the Challenge of Supervision". The European Supervisor Education Initiative association, which the BCL has been a member of since 2010, aims at training supervisors in Europe and at promoting the convergence of practices related to micro-prudential supervision in Europe.

- Organisation, by the association of The Bridge Forum Dialogue, of a round table on the theme "A world without oil?" on April 13 at the European Commission. Mr. Nobuo Tanaka, Executive director of the International Energy Agency, gave his institution's views on the subject. The conference was chaired by Mr. da Silva Caldeira, Vice-president of The Bridge Forum Dialogue.

- A Seminar was organised on the occasion of the presentation of the BCL's Financial Stability Review on April 28, in the presence of several central bank governors and high-level guests and representatives of the Luxembourg and European financial sectors as well as of the academic world. The press conference was followed by a presentation by the Governor of the Bank of Portugal, Mr Carlos da Silva Costa, on the economic and financial situation in Portugal. The seminar consisted of a session on liquidity and leverage and of a panel discussion about financial regulation.

- The 8th annual Summit of the Islamic Financial Services Board (IFSB) took place in Luxembourg from May 10 to May 13. Central bank governors participating in the Summit included the President of the IFSB, H.E. Faris A. Sharaf (Central Bank of Jordan), H.E. Rasheed Mohammed Al Maraj (Central Bank of Bahrain), H.E. Dr Zeti Aziz Akhtar (Bank Negara Malaysia), H.E. Dr Sanusi Lamido Sanusi Aminu (Central Bank of Nigeria) and H.E. Suwaidi Nasser bin sultan Al (Central Bank of United Arab Emirates).

- Contribution to the reflection works on the new financial regulation in Europe during the 6th European Lawyers' forum, which was held in Luxembourg from May 19 to May 21. The BCL's Governor was the Chairperson of the working session on "Crisis management and financial stability" within the topic: "Financial regulation: European law put to the test". Other panellists were: the Minister of Finances Luc Frieden, Professor Helmut Siekmann, from Frankfurt University, Klaus Regling, General Manager of the FESF, Diego Devos, General Counsel of the BIS, and Lars Heikensten, former Governor of the Swedish central bank and General Manager of the Nobel foundation.

- The Seventh Pierre Werner lecture organised by the BCL at the *Centre Culturel de Rencontre Abbaye de Neumünster* on 7July. Mr. Jaime Caruana, General Manager of the Bank for International Settlements, made a speech on the theme: "Regulatory reform: remaining challenges".

- The Bridge Forum Dialogue, organised a round table on the theme "Innovation and competitiveness in Europe" on 6 October at the European Commission. Chaired by Mr. Richard Pelly, Vice-president of the association "The Bridge Forum Dialogue", the conference gave the floor to Mrs Máire Geoghegan-Quinn, as European Commissioner for research, innovation and science.

1.10 EUROPEAN ACTIVITIES

1.10.1 Activities at the level of the ECB

In 2011, the Governor of the BCL participated in 22 meetings of the Governing Council and in the four meetings of the General Council. When making decisions, the members of the Governing Council do not act as national representatives but in their personal capacity, which is reflected in the principle "one member, one vote".

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. In 2011, more than 500 Executive Board's proposals were adopted by the Governing Council by written procedure; amongst these proposals were many opinions relating 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.

Committees assist the decision-making bodies of the ECB in the fulfilment 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.

1.10.2 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 up to 17.

1.10.3 Economic and financial committee (EFC)

A BCL representative participates in meetings of the Economic and Financial Committee (EFC). The EFC is composed of representatives of the finance ministries and central banks of EU Member sates, 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 from there onwards to the Council and to the Commission".

In 2011, the EFC continued to analyse the evolution of financial stability in the EU, including the recapitalisation of the banking sector under the aegis of the new EBA (European Banking Authority) - and the developments in the context of the sovereign debt crisis.

The EFC also handles cases relative to the economic policy discussed in the informal meetings of the ECOFIN Council, in which the BCL Governor participates.

1.10.4 The committee on monetary, financial and balance of payments statistics (CMFB)

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 actively contributed in 2011 to this framework. Progress was made in particular in terms of financial accounts, balance of payments, financial services and public finance statistics as well as national accounts.

1.10.5 Other activities at the European level

On February 11, Michel Barnier, European Commissioner in charge of the internal market and services, paid a working visit to the BCL. Discussions focused on ongoing reforms in financial regulations, the revival of the European market and the economic situation of Luxembourg.

1.11 NATIONAL AND EXTERNAL ACTIVITIES

1.11.1 National activities

1.11.1.1 Relations with the Parliament

On 8 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.

1.11.1.2 BCL Committees

The Statistics Committee

The Statistics Committee was set up by the BCL to ensure a constant dialogue between the actors of the financial centre of whom statistical statements are required and of the main users of the concerned data. The Statistics Committee is regularly consulted in the framework of the definition of the reports conducted on the different entities in the financial sector.

Banking and monetary statistics consultative commission (BMSCC)

The BMSCC, put in place by the BCL, aims to ensure an efficient collection of banking and monetary statistics on behalf of the BCL and to ensure dialogue with commercial banks. In 2011, the BMSCC was informed and consulted about conceptual issues related to the modification of the statistics collection, towards security by security statements and to the revision of the statistics collection towards the interest rates practiced by commercial banks.

Balance of payments statistics consultative commission (BPSCC)

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 positions. The Commission ensures an efficient organisation of data collection in order to avoid redundancies and to limit the workload for the entities requested to submit statistical data. In 2011, the BPSCC was informed and consulted about the principles to be applied in the field of the new balance of payments statistics. The aforementioned commission presented its opinion on the BCL 2011/n°7 regulation of 4 April 2011 concerning the collection of statistics with banking institutions and with the *Entreprise des Postes et Télécommunications*' finance department.

Economic and financial statistics consultative commission (EFSCC)

The EFSCC has been set up by the BCL to ensure an efficient collection of economic and financial statistics and to establish a dialogue between financial actors and the BCL. The commission was not consulted in 2011 due to the absence of new significant projects.

The Lawyers' committee (*Comité des Juristes*)

The Lawyers' Committee met six times during the year. The Committee provided assistance to the BCL on its examination of the draft law pertaining to dematerialised securities presented in this report, on a preliminary draft law amending the BCL's organic law, on a pre-draft law amending the law of 5 April 1993 relating to the financial sector with respect to its provisions on banks issuing mortgage bonds, on an internal working paper aiming at the creation of a resolution fund in Luxembourg, as well as general assistance on the draft regulations issued by the BCL. It examined the European Economic Governance rules and contributed to a proposal of the BCL for the implementation of the European budgetary rules at the national level.

1.11.1.3 External committees

The Economic Committee (*Comité de conjoncture*)

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

The BCL's contribution to the Economic Committee is two-fold: first, the BCL collects information on Luxembourg's cyclical position and secondly, it contributes to the Committee's work by monitoring and commenting on the latest developments in monetary areas 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 the 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 on the BCL's work in the area of consumer prices.

Banking accounting committee *(Comité "Comptabilité bancaire")*

This committee, set up by the *Commission de surveillance du secteur financier* (CSSF), aims to ensure an exchange of views between the supervisory authority, the BCL and the actors of the Luxembourg financial centre. The committee is consulted during the preparation by the CSSF of circulars concerning bank accounting issues.

Higher Council for Statistics of Luxembourg

The Higher Council for Statistics carries out advisory functions on behalf of the STATEC and is mandated to appraise the STATEC's annual programme.

The BCL's contribution to the work of the Higher Council for Statistics is two-fold: on the one hand, the BCL provides its opinion on the documents elaborated during meetings and submitted to it and, on the other hand, it also 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, whose main objective is to improve the correct character, transparency and efficiency of internal and external statements. 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 statements it collects from companies in the Luxembourg financial sector.

The Operational Crisis Prevention Group (OCPG)

The BCL established the Operational Crisis Prevention Group (OCPG) with the intention of enhancing the financial sector's preparation with regards to large-scale operational disruptions. Members include the ABBL, the CSSF and critical market participants. The group met twice in 2011.

1.11.2 External activities

1.11.2.1 The BCL's multilateral activities

Activities at the level of the IMF

The BCL handles Luxembourg's financial transactions with the IMF. It therefore 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 31 December 2011, Luxembourg's quota, recorded in full on the BCL's balance sheet, amounted to SDR 418.7 million, in comparison with SDR 279.1 million at the end of 2010. On 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 37.57 % of Luxembourg's quota.

The IMF's operational budget defines the currencies to be made available by its members on a quarterly basis and the distribution of reimbursements among its members. Thus, during 2011, the BCL granted credits amounting to SDR 71.6 million. At the end of the year, the credits granted by Luxembourg according to the New Arrangements to Borrow (NAB) reached SDR 66.8 million.

At the end of the year 2011, Luxembourg held SDR 243.83 million, that is, 98.87 % of its SDR allocation, in comparison to 98.67 % at the end of 2010. The BCL Governor, being also the Alternate Governor for Luxembourg at the IMF, attended the Annual Meeting of the IMF and the meetings of the International Monetary and Financial Committee (IMFC). A BCL member is on secondment with the IMF.

Activities at the level of the IILM

The International Islamic Liquidity Management Corporation (IILM) is an international institution created in October 2010 by twelve central banks and two multilateral organisations from Asia and Africa.

The BCL co-established this organisation in order to participate in the creation of short-term sharia-compliant financial securities, thus facilitating the cross-border management of liquid assets of institutions offering sharia-compliant financial services and, more generally, contributing to the strengthening of financial stability. The BCL Governor was appointed Vice-president of the IILM's Board of Directors, the IILM's main decision-making body consisting of the governors of the main founding members. The Board of Directors is responsible for defining the strategic vision and for the approval of the operational guidelines for the IILM's development.

In this context, the BCL Governor participated in the Board meetings and in the General Meeting that took place in the course of 2011.

The BCL's membership to the Bank for international settlements (BIS)

On the occasion of the Annual General Meeting of the Bank for International Settlements (BIS), the BCL was invited to become a member of the BIS, according to article 8.3 of the statutes of the BIS.

Established in 1930, the BIS, which has its headquarters in Basel, is the oldest international financial institution. It promotes the cooperation between central banks and contributes to the establishment of international standards in banking areas. The BIS has at present about sixty members from advanced and emerging countries.

This membership also allows the BCL to be more closely associated with the activities of the various committees and working groups of the BIS. Besides its participation in the Committee on the Global Financial System (CGFS) and in the Annual General Meeting of the BIS, the BCL was also represented by its Governor in the meeting on the world economy (Global economy meeting) and in the meeting of governors (Governors' meeting), which both take place once every two months in Basel.

Activities at the level of the Financial Stability Board (FSB)

The Financial Stability Board was established to coordinate the work of the national financial authorities and the organisations elaborating standards in the field of financial stability.

In 2011, the FSB established regional consultative groups thus bringing the authorities of the financial sector, who are members of FSB, and some non-member jurisdictions together, in order to exchange views on the vulnerabilities which may affect financial systems as well as on present and future initiatives to promote financial stability.

The regional consultative Group for Europe is co-chaired by the BCL Governor, who was elected by the non-members of the FSB, and by Mr. Tom Scholar, the Second Permanent Secretary of the UK Treasury, who was appointed by the members of the FSB. The regional consultative Group for Europe held its inaugural meeting on December 6 in Luxembourg. During this meeting, members discussed the work plan and the priority themes of the FSB, as well as the main reforms concerning financial supervision and their potential repercussions, financial vulnerabilities and financial stability at the regional level.

Participation in seminars or high-level conferences

- Participation in the *Official Monetary and Financial Institutions Forum* (OMFIF), organised at *De Nederlandsche Bank*, on March 24 and 25, on the theme: "Europe's place in the world economy". The BCL Governor gave a speech on the future of Europe.

- Participation of the BCL Governor in the "Conference on The State of the Union", organised on 9 and 10 May in Florence. At this two-day conference, organised in the context of Europe's day, participated, among others, José Manuel Barroso, President of the European Commission, Jerzy Buzek, President of the European Parliament, Franco Frattini, Italian Minister of Foreign Affairs and Lorenzo Bini Smaghi, member of the ECB Executive Board. During the session entitled "The Euro and Global Economic Governance", the BCL Governor gave a speech on the state of EMU.

- Speech of the BCL Governor during a conference organised in Zurich on May 23, under Gérard Philipps' patronage, Ambassador of Luxembourg in Switzerland, and introduced by Philipp Hildebrand, President of the Swiss National Bank, on the theme: "International Financial Centres after the Crises".

- Participation of the BCL Governor in the "Economic Ideas Forum" (EIF), in London, on May 26. The forum, organised by the *Center of European studies*, gathers high-level governmental representatives, managers of companies and other influential actors of Europe and of the United States together. The BCL Governor participated in this context in a panel of discussion chaired by Tom Spencer, Executive Director, European Center for Public Affairs, tackling the following theme: "Allies or Competitors? Cooperation across the Atlantic - Reforming Financial Services".

- Speech of the BCL Governor in the *Bankhaus Joh. Berenberg, Gossler and Co. KG*, in Hamburg, on June 16, on the theme: *Der Euro nach der Krise - geld-, währungs- und europapolitische Herausforderungen* (The euro after the crisis - challenges for monetary- and European policy).

- Participation of the BCL Governor in the symposium organised by the Federal Reserve of Kansas City, in Jackson Hole, on August 26 and 27. The discussions addressed, in particular, conditions for global economic growth.

Multilateral activities with the Government

The BCL Governor went to Washington from April 15 to April 17 and from September 22 to September 25 on the occasion of the Spring Meetings and the Annual Meetings of the IMF and the World Bank. He participated in theses meetings along with the Luxembourg Prime Minister and the Minister of Finance.

1.11.2.2 Bilateral relations

The BCL Governor accompanied the economic mission in Qatar, chaired by H.R.H. the Hereditary Grand Duke and led by the Minister of Economy and Foreign Trade, Jeannot Krecké, on November 23. On this occasion, the BCL Governor signed a Memorandum of Understanding with H.E. the Sheikh Abdullah Bin Saud Al Thani, Governor of the Central Bank of Qatar. The memorandum strengthens the cooperation between both central banks, in particular through exchanges of information in the fields of financial stability, payment systems and research.

The signing ceremony took place on the premises of the Central Bank of Qatar, in the presence of H.R.H. the Hereditary Grand Duke and the Minister of Economy and Foreign Trade. A working visit with the Minister of Finance of Qatar, Youssef Hussain Kamal, also took place.