ANNUAL REPORT 2014

BANQUE CENTRALE DU LUXEMBOURG

EUROSYSTEM

MISSION STATEMENT OF THE BCL

The *Banque centrale du Luxembourg* (BCL) is a public institution created by Luxembourg law. The BCL's independance is based on its organic law, the Treaty on the European Union and the Treaty on the Functioning of the European Union. The BCL is a member of the European System of Central Banks (ESCB) composed of the National Central Banks of all 28 EU Member States and the European Central Bank (ECB).

THE MISSION

The Bank is a member of the Eurosystem that consists of the European Central Bank and the National Central Banks of the Member States that have adopted the euro. It takes part in the Single Supervisory Mechanism (SSM). It is in charge of managing the monetary and financial responsibilities granted to it as one of the National Central Banks of the ESCB.

At the national level, the central bank has to carry out the tasks conferred on it by the national laws and conventions.

It is developing the following fields of competence:

- Research and studies and their communication thereof, which aim to prepare, on the one hand, monetary policy decisions and, on the other hand, the development of wider knowledge concerning monetary, financial and economic issues;
- Collection and analysis of statistics in the monetary, financial and balance of payments fields;
- Implementation of monetary policy;
- Organisation and supervision of payment and securities settlement systems;
- Issuance and circulation of banknotes and coins;
- Financial asset management, both on own account and for third parties;
- Participation in the prudential supervision of the financial system and the exercise of the oversight of payment and securities settlement systems, in order to ensure the stability of the financial system in Luxembourg;
- Advisory services to legislative and regulatory authorities in financial and monetary areas.

THE VISION

The BCL intends to become a centre of competence, excellence even, whose performance will generate public confidence in the Central Bank.

Among Luxembourg institutions, the BCL takes every care that it is capable of fulfilling all its national, European and international obligations.

In view of the wide variety of its duties and activities, both in the public sector and in a competitive environment, the BCL must generate an income guaranteeing its institutional, functional and financial independence.

CORPORATE VALUES

Consequently, the values associated with its action are:

- Professionalism, guaranteed by highly specialised employees, high-performance tools and a high-level infrastructure;

- Quality in all its services;

- Stability provided by its long term vision of all its activities;

- Objectivity resulting from the establishment of precise rules that are equally applied;

- Integrity, guaranteed by the transparency of its internal operations and with respect to professional ethics;

- A good governance, within and through the governing bodies concerned with the use of the highest standards in governance.

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THE GOVERNOR'S MESSAGE[1]

1 Finalised mid-June 2015.

The year 2014 has witnessed an economic recovery in the euro area. However, this recovery has remained fragile and uneven. Inflation has hovered at low levels and has even entered into negative territory.

Against this backdrop of very low inflation, the Governing Council maintained an accommodating monetary policy stance and introduced a series of new unconventional monetary policy measures to fulfil its mandate, namely ensuring price stability. Thus, the Governing Council reduced the rate on the main refinancing operations twice to a record low of 0.05%. On 5 June 2014, the Governing Council also decided to reduce the rate on the deposit facility, which allows commercial banks to make overnight deposits with the Eurosystem, to -0.1%. This rate was reduced further to -0.2% on 4 September 2014. The Eurosystem also introduced Targeted Longer-Term Refinancing Operations (TLTROs) that allow credit institutions to have access to additional liquidity at longer maturities provided it is accompanied by loans to corporates and households, excluding real estate-related loans. These operations will come to maturity in September 2018.

In order to reinforce the monetary policy's accommodative stance, to improve its transmission mechanism and to support the provision of credit to the real economy, the Governing Council introduced an Asset-Backed Securities Purchase Programme (ABSPP) and a third Covered Bonds Purchase Programme (CBPP3) during the last quarter of 2014. These two programmes were complemented in March 2015 by the Public Sector Purchase Programme (PSPP) through which securities issued by central governments of the euro area, by certain agencies located in the euro area or by international or supranational institutions located in the euro area are purchased under certain conditions. Under these three programmes, which jointly are known as the Expanded Asset Purchase Programme (EAPP), combined asset purchases amount to 60 billion euro per month. These purchases are intended to be made at least until end-September 2016 and will be conducted until a sustained adjustment in the path of inflation that is consistent with the Eurosystem's definition of price stability - namely inflation rates below, but close to, 2% over the medium term- is achieved.

The Eurosystem's most recent macroeconomic projections, which were published in early June 2015, have confirmed a certain recovery in the euro area and slightly revised upward the inflation projections for the year 2015.

The year 2014 also saw the inception of the Single Supervisory Mechanism (SSM), the first pillar of the Banking Union. This mechanism, which became operational on 4 November 2014, has marked the beginning of the new banking supervision architecture in the euro area, placing the supervision of all credit institutions located in the euro area under the responsibility of the European Central Bank. While the European Central Bank is directly responsible for the supervision of about 120 credit institutions that are qualified as "significant" from a systemic point of view, the National Competent Authorities remain responsible for the direct supervision of the remaining credit institutions. Nonetheless, the European Central Bank can decide to take over the supervision of these entities if it considers such measure to be necessary. Although the Governing Council makes decisions pertaining to the supervision of banks and is ultimately responsible for such decisions, decisions are proposed by the Supervisory Board, in which the BCL is represented. The EU Members States that are not part of the euro area choose to join the Single Supervisory Mechanism on a voluntary basis.

Before taking over its responsibility as banking supervisor, the European Central Bank coordinated a comprehensive assessment of the balance sheets of 130 credit institutions located in the euro area that were considered the most relevant in terms of systemic risk. The results of this exercise, which was launched in November 2013, were published by the European Central Bank on 26 October 2014. In Luxembourg, the six banking groups that were subjected to this evaluation passed the test successfully.

The rules pertaining to the functioning of the Single Resolution Mechanism, the second pillar of the Banking Union, also have been laid out in an EU Regulation. This mechanism will serve as a centralised resolution framework for all the credit institutions that are part of the Single Supervisory Mechanism. The conditions for the establishment of a resolution fund have also been determined. Initially, this fund, which will provide financial resources in case a bank is restructured, will be financed by banks at the national level. However, the intergovernmental agreement, which aims to merge the national funds into a single fund as of 2016, is currently under ratification. As for the third pillar, the deposit guarantee scheme, an EU Directive aiming to reinforce the protection of depositors has been published in June 2014.

It is also worth noting that, in the continuity of the launch of the new "Europa" series, the Eurosystem issued the new 10 euro banknote on 23 September 2014. The new 20 euro banknote of the same series, which was presented last February, will enter into circulation on 25 November 2015.

In Luxembourg, the law of 12 July 2014 on the coordination and the governance of public finances led to the inception of the National Council on Public Finances (*Conseil national des finances publiques*). The Council was set up in the context of the implementation of the "Fiscal Pact", which was supposed to be transposed into national law on 1 January 2013. The BCL welcomes the fact that the proposal included in the initial draft law, which foresaw that the BCL would bear this responsibility, was discarded. Such a role would have obliged the BCL to become part of the budget process, which is of a political nature. Such an approach would not have been in line with the need for a reciprocal independence between a government and a central bank. Although the establishment of an organ that needs to be independent is a step in the right direction, as it contributes to a better governance in public finances in Luxembourg, the BCL still does not have an unconditional, timely and automatic access to all public finance-related statistics, as advocated by the European Central Bank in its opinion on the draft law. Even though access to these statistics has improved, it remains incomplete. This situation constrains the BCL's analytical capacity. It is in the interest of the country, and of the country's good governance, to foster transparency in this area in order to allow the involved institutions, including the BCL, to conduct independent analyses that are based on all existing data.

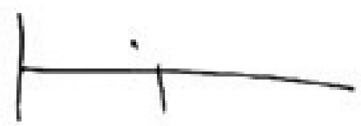
The BCL also welcomes the creation, in April 2015, of the Systemic Risk Committee (*Comité du risque systémique*). This committee, whose establishment follows a recommendation by the European Systemic Risk Board to set up such a body by 1 July 2013 at the latest, is composed of the Minister of Finance, the Director General of the *Commission de Surveillance du Secteur Financier* (CSSF), the Director of the *Commissariat aux Assurances* and the Governor of the BCL. The BCL is in charge of the Secretariat, under the direct supervision of its Governor. It is imperative for this committee to be able to rely on adequate instruments and governance in order to make effective decisions when financial stability is at risk. The near future will tell us whether the rules embedded in the law of 1 April 2015 respond to this requirement.

For the BCL, the year 2014 has underscored more than ever the need to buttress the Bank's financial capacity. In this context, it is important to recall that the BCL is bound by its organic law to fund the entirety of the current and future pensions of its staff. The dynamics of these pensions are linked to the growth of the institution, the latter being an inevitable consequence of the increase in and the deepening of the BCL's tasks. This situation required the Bank to make a first significant increase in provisions in its 2014 financial accounts in order to cover its future obligations in this area. The amount of the provision was based on new computations carried out by an independent external actuary.

The BCL's weak capital base, which has been referred to several times over recent years, continues to be a growing threat to the Bank, risking putting in jeopardy its financial and operational independence. Hence, I welcome the Prime Minister's commitment, expressed on 13 March 2015, to find a progressive and sustainable solution to endow the BCL with adequate capital.

To conclude, my two colleagues of the Executive Board and I would like to thank the BCL staff. Without their commitment, the BCL could not achieve the objective of excellence it has set for itself.

On behalf of the BCL's decision-making bodies and staff, I would also like to pay a last tribute to Mr Pierre Jaans, former Director General of the Luxembourg Monetary Institute, who passed away at the beginning of this year. His sharp analyses and strong opinions have deeply enriched the monetary, economic and financial debates, both at the national and the European levels.



Gaston Reinesch

(at the right) Mr Mario Draghi, President of the ECB and (at the left) Mr Gaston Reinesch, member of the Governing Council of the European Central Bank.