CPB Netherlands Bureau for Economic Policy Analysis

CPB Communication | 2012, May 30

# CPB Financial Stability Report

## *Risk report for the House of Representatives*

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# CPB Communication

**To:** The House of Representatives

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**Re:** Risk report for the House of Representatives

# CPB Financial Stability Report

Following the recommendations of the De Wit Committee, the House of Representatives has requested CPB *(Netherlands Bureau for Economic Policy Analysis)* and DNB (*the Dutch Central Bank*) to prepare a joint report on international and national macro-economic developments and their relation to the developments in the financial sector, to be issued at least annually.[1] The findings relating to developments in the financial markets as indicated in the 2012 Central Economic Plan (CEP) are used as the basis of this report with respect to the CPB section. As CPB has limited capacity for preparing such reports in terms of staffing levels, the analysis is limited to a description of the main risks. The fact that no other risks are mentioned does not necessarily mean that these do not exist.[2]

[1] House of Representatives Records II 2009-2010, 31 980 Nr. 4, Recommendation 1.
[2] For example tax problems in the USA, political unrest in the Middle-East or social unrest in China.

**Key issues**

The main risk to the Dutch economy is currently the European sovereign debt crisis. After the failed formation following the elections of 6 May, the Greek will vote again on 17 June. The new government to be formed will decide whether or not to comply with the memorandum of understanding agreed with the Troika (the European Central Bank (ECB), the European Commission (EC) and the International Monetary Fund (IMF)). A stalemate could lead to Greece's bankruptcy and eventually even to its exit from the EMU. The exact consequences to the Dutch economy are difficult to estimate. Direct exposure of the Netherlands to a Greek exit is limited. However, Greece exiting the EMU could lead to further escalation of the European debt crisis. Investors would wonder whether countries such as Portugal and Ireland will follow suit. This process could create its own dynamics and as a result, financial markets could start a run on the financial sector in weaker countries.

In particular the current situation in Spain is precarious. If Greece should exit, this would require an immediate, incisive and credible change of course of European politicians in order to prevent further loss of confidence in financial markets. The current step-by-step approach will prove insufficient in preventing contagion from a Greek exit to other countries. Possible measures include extending the ESM emergency fund and the introduction of a bank union enabling recapitalisation funded by ESM of the European banking sector. Another contribution to a solution is the introduction of Euro-bonds; however, this concept currently has little political support. A repetition of the LTRO operation does not seem prudent, as this would postpone hard measures against 'sick' banks.

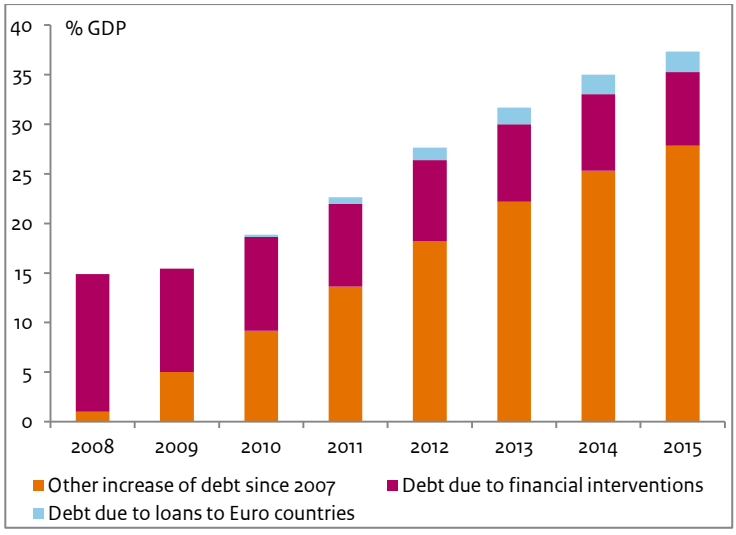
The central issue is whether Spain, and in the longer run Italy, can reform their economies and introduce the necessary spending cuts. Recovery of economic growth is of great importance in preventing Italian or Spanish debt restructuring. The scale of the current emergency fund, the European Financial Stability Fund (EFSF) and in the near future the European Stability Mechanism (ESM), is insufficiently large to support these countries. Supporting Spain alone will already stretch the emergency fund to its limits. Furthermore, the Northern European economies and financial sectors are far more interconnected with Spain and Italy than with countries such as Portugal, Ireland and Greece.

The second major risk are the growth forecasts for Europe. The CEP 2012 forecasts modest recovery of the Eurozone economy from the second half of 2012 onwards. This is based, among others, on the highly lenient monetary policy of ECB, the slight improvement of the situation in the financial markets and limited recovery of confidence. Regarding the Euro crisis, the assumption is that no major incidents will happen but that confidence will not be restored in the short term. If growth fails to materialise or if the forecasts are adjusted downwards, the 3% EMU balance limit will not be achieved. Excessive austerity may have a negative effect by impeding economic growth.

The third key risk is the financial sector. The CEP is based on the assumption that no major new problems will arise within the Dutch financial sector. Banks will continue to reduce their balance sheets, and as a result, investments may lag; however, the assumption is that in the Netherlands, banks will not do so on a major scale, as the Dutch banks are relatively sound. However, an uncontrolled Greek exit with contagion of other Euro countries can and will affect the Dutch banking sector. Furthermore, there are risks due to the Dutch banks' relatively large need of market financing and the continuing problems in the Dutch housing market. At a European level, the feedback mechanisms that interconnect banks' and countries' health form an important risk. The problems in the banking sector amplify the debt crisis while the debt crisis increases the problems in the banking sector. A European safety net and a European resolution framework for banks may contribute to breaking this vicious circle.

As shown by figure 1 below, rescuing financial institutions does not constitute the main cost of the financial crisis. The cost of the recession following the crisis is far more extensive. This figure specifies the increase of Dutch sovereign debt into various sources. Policy - in the form of monetary policy, incentives, spending cuts and reforms - plays an important role in limiting these costs. The increased sensitivity of the Dutch economy for financial shocks requires a more systematic analysis, both at a national and European level.

**Figure 1 Increased debt as a percentage of GDP by source**




Source: *CEP 2012*

The following issues are discussed in the next sections of this report: Chapter 1 discusses the risks ensuing from the European debt crisis; Chapter 2 reviews the Dutch financial sector and Chapter 3 analyses the property market.

# 1 The European debt crisis

## 1.1 Greece, Ireland, Portugal

Greece currently forms the most acute risk from the perspective of the European debt crisis. The country has entered into an economic and political crisis situation.[3] Capital is fleeing the country on a massive scale. It is impossible to predict where this will end. All options are possible, ranging from continuing the chosen path to renewal of the Troika accord and even to exiting the Euro. After the failed formation following the elections of 6 May, the Greek will vote again on 17 June. Subsequently, the new government to be formed will review whether or not to comply with the agreements concluded with the Troika. A stalemate could lead to Greece's bankruptcy and eventually even to its exit from the EMU.

However, even if Greece would have continued access to emergency support, further write-downs of Greek sovereign debt cannot be excluded. In a recent analysis assessing the sustainability of Greek debt, the IMF concludes that significant downward risks have developed.[4] The main risks are: a drop in demand due to continued problems within the Euro zone; fiscal multipliers with a higher impact than expected that cause cuts to impede growth more than forecast; and lagging political implementation of measures. The affordability of sovereign debt is highly sensitive to this type of changes. In June, the eligibility of Greece for further payment under its financial assistance programme will be assessed. This depends on the willingness of the new Greek government to comply with the terms and conditions imposed.[5]

As a minor success, the restructuring of Greek government bonds in the hands of private investors has had a positive effect on the tenability of Greek sovereign debt.[6] Because the Greek government activated the so-called Collective Action Clauses (CACs), ISDA (the International Swaps and Derivatives Association) classed the restructuring of Greek sovereign debt as a credit event. For this

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[3] The Greek GDP (*Gross Domestic Product*) decreased by a year-based percentage of 6.2 during the first quarter of 2012 after having decreased by 7.5% (year-based) during the last quarter of 2011. The European Commission forecasts a 4.7% shrink in the Greek economy during 2012, see http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:113:0008:0010:EN:PDF

[4] IMF Country Report No. 12.57

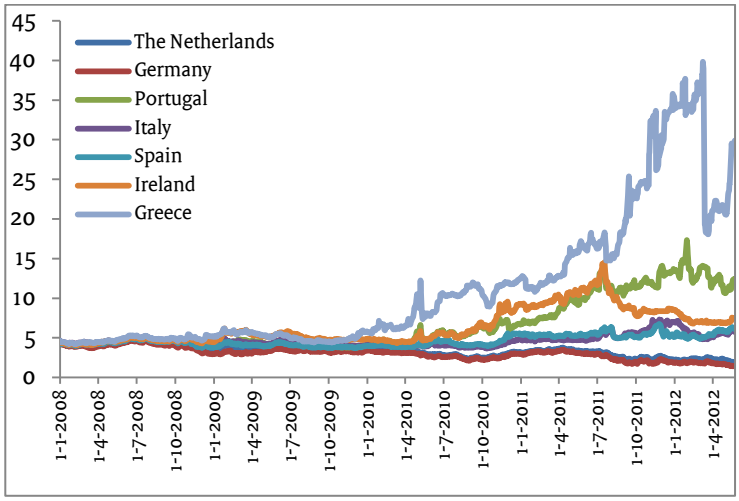
[5] In March this year, the Board of the European emergency fund EFSF disbursed 1.65 billion Euros of the total loan package made available amounting to 28 billion. The following tranche, amounting to 5.2 billion Euros has been disbursed on 10 May. An amount of 4.2 billion Euros was disbursed directly; the remaining amount is not required immediately for debt repayment, and will be paid out at a later stage, depending on the funding needs. The reason for this disbursement was prevention of acute lack of cash, which would probably have led to not being able to pay the wages of civil servants and the state loan repayments. For the ESFS's statement, please refer to http://www.efsf.europa.eu/mediacentre/news/2012/2012-16-statement-from-efsf-regarding-next-disbursement-to-greece.htm.

[6] In exchange for new Greek government bonds with a value of 31.5% of the principal of exchanged debt and EFSF bonds maturing within 24 months, 85.8% of Greek debt holders have initially cooperated; see http://www.minfin.gr/portal/en/resource/contentObject/id/7ad6442f-1777-4d02-80fb-91191c606664. Furthermore, the Greek authorities used the collective action clauses to coerce the majority of the other holders to cooperate.

reason, CDS contracts (Credit Default Swaps - insurance contracts on Greek sovereign debt) had to be paid out. Previously, this gave rise to fear of contamination of the sovereign debt of other Euro-zone countries and banks, but this did not materialise.

Greek developments are crucial to both Portugal and Ireland. New support measures will probably prove necessary for Portugal. Ireland seems to do slightly better. The interest rate on Irish government bonds has decreased since June last year, as shown in the graphic below. However, if Greece should fail and exit the Euro, both Portugal and Ireland will be in the limelight of the financial markets again.

**Figure 2 Interest rate on government bonds in various EMU countries**




Source: Datastream

Direct exposure of the Dutch financial sector to problems in Portugal, Ireland and Greece is relatively small. The stress tests of EBA (the European Banking Authority) indicate that the Dutch banks' exposure to government debt of the above-mentioned countries was as follows during October 2011: Greece (1.18 billion Euros), Ireland (0.44 billion Euros) and Portugal (0.77 billion Euros). According to DNB, the Dutch banks' receivables on Greece, Ireland and Portugal amounted to 3.2 billion Euros, 43.7 billion Euros and 2.0 billion Euros respectively during the first quarter of 2012.[7] These may seem significant sums of money; however, these do not constitute a serious threat to the financial sector.

[7]See DNB, Foreign Debt Proportions of MFIs, Table t5.8nk. This concerns receivables of monetary and financial institutions.

However, this does not imply that the consequences of a further crisis in these countries would also be minor. If Greece would exit the Euro, this would lead to immediate speculation in the financial markets that Portugal and/or Ireland will follow. This will lead to a bank run in those countries. If in such a situation Spain and Italy would come under fire as well, the consequences would be dire. At the moment the situation in Spain in particular is precarious. As set out in the next paragraph, the EMU's current emergency resources are inadequate for supporting both countries. This is why, in the event of a Greek exit, it is important for European leaders to deliver a credible message that the exit of any other countries will be prevented.

## 1.2 Spain and Italy

Whereas the Netherlands's exposure to sovereign debt of Greece, Portugal and Ireland is limited, this is not the case for Spain and Italy.[8] The maximum extent of any new loans to be provided via the ESM and EFSF emergency funds of 750 billion Euros will not be sufficient to provide liquidity support to these countries.[9] Both Spain and Italy must renew large quantities of government debt in the near future (i.e. refinance). The graphic below shows the percentage of debt to be rolled over. The two countries' total debt amounts to about 2,220 billion Euros, 30% of which will have to be revolved within two years. For comparison, we also included the maturities of Dutch sovereign debt. Quick recapitalisation of the Spanish banking sector is inevitable.[10]

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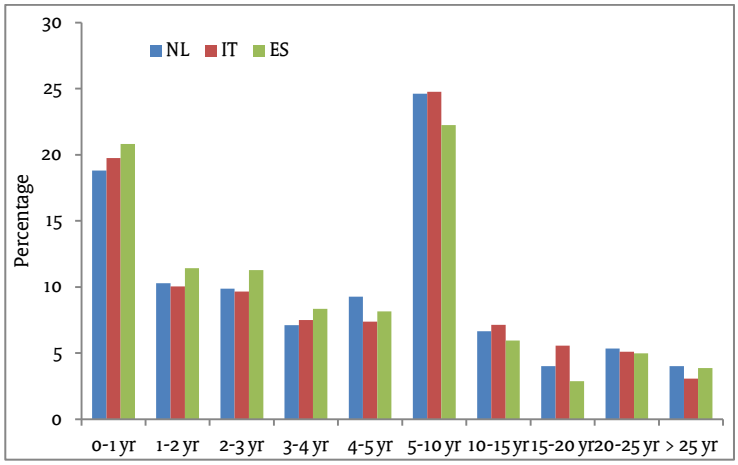
[8]The Netherlands is directly exposed to problems in Spain and Italy in various manners; in the first place via loans to Spanish and Italian companies. Dutch investments in both Spain and Italy consist of various components. The figures published by DNB indicate that during the fourth quarter of 2011, Spain and Italy owed Dutch banks a total of 32.4 billion and 15 billion respectively (DNB, Foreign Debt Proportions of MFIs, table t5.8nk). According to the figures of the Spanish central bank, the total foreign direct investments of the Netherlands in Spain during 2010 amounted to 109 billion Euros, with portfolio investment amounting to 49.3 billion Euros. The figures in data published by EBA show that during October 2011, Dutch banks were exposed to Italian government debt to an amount of 8.14 billion Euros and to Spanish government debt to an amount of 2.06 billion Euros. Regarding Italy and Spain, DNB states that the 2010 direct foreign investment amounted to 22.3 billion Euros and 20.6 billion Euros respectively. In the second place, the Netherlands is exposed to risk via a possible call on EFSF or ESM via guarantees (EFSF) and capital deposits and guarantees (ESM). In the third place, via ECB profit distributions that may be lower if loans issued by ECB are not repaid. Finally, the Netherlands has indirect exposure if the financial markets should lose their confidence in Dutch financial institutions that have incurred major exposure towards these countries.
[9]ESM's capacity of issuing new loans amounts to 500 billion Euros, to be accrued between 2012 and the first half of 2014; see the statement of the Euro group. IMF added 50% in previous programmes. This would take the total lending capacity to 750 billion Euros. Up to July 2013, EFSF may supplement ESM's capacity to issue new loans, implying that the total lending capacity immediately exceeds 500 billion Euros. The ceiling for loans issued by ESM and EFSF combined was increased to 700 billion Euros, i.e. if EFSF issued loans to an amount of 200 billion Euros, ESM will be allowed to lend an amount of 500 billion Euros.
[10] According to ECB data, the scale of the Spanish financial sector as at January 2012 amounted to 3,637 billion Euros, with capital and reserves amounting to 379 billion Euros. In Italy, the amounts were 4,117 and 390 billion Euros respectively.

**Figure 3 Current remaining maturity of government debt as a percentage of total debt**




Source: Spanish central bank, Italian central bank, Agency Ministry of Finance

Italy currently has inspired some confidence in the markets. However, the Italian government will have to prove its worth by actually implementing the proposed measures. By contrast in Spain, the new government seems unable to convince the markets of its credit-worthiness. The problems in Spain therefore form the highest risk at this moment. The interest rates on Spanish government bonds are increasing again, in spite of the 27 billion Euros in 2012 spending cuts that Spain committed to. The main spending cuts concern education and healthcare. Other measures are also part of the austerity packages, such as freezing the civil servant payroll and increased income tax. As in the Netherlands, a number of key changes are implemented in the Spanish pension system. This includes raising the retirement age from 65 to 67, to be phased in gradually between 2013 and 2027. Furthermore, the number of years worked that are eligible for full pension accrual is raised from 35 to 37. The early retirement age is increased from 61 to 63 years old; part-time retirement will remain possible from age 61.

In order to restore the banks to health, a fund for restructuring banks was created in June 2009. The number of so-called 'Cajas' was reduced from 45 to 17; capital requirements are raised from 8% to 10%; and since February 2012, supplementary capital requirements and property-related provisions apply. Furthermore, some banks were recapitalised and the government issued guarantees on bank bonds.

In spite of these measures, the Spanish banking sector cannot be classified as healthy. The deficits of Spain in respect of the Target 2 payment system, an indicator of the amount of private capital taken out of Spain, rose by 65 billion Euros between February and March 2012. Since July 2011, this amount increased by 219 billion Euros. The bad debt percentage in the Spanish banks' balance sheets has reached approximately 8.2% of all loans, an absolute amount of 144 billion Euros. The bad debt percentage is likely to further increase. Even based on conservative assumptions

regarding losses incurred on such loans, the Spanish banks are likely to be confronted with extensive losses covered only partially by the current reserves.[11] The banks have created reserves for such losses; however, whether or not these will prove adequate for all banks is very much the question. Spain took control of Bankia in May 2012, the country's largest property bank, and effected a capital injection of 4.47 billion Euros by converting government loans into share capital. Furthermore, Spanish banks are being forced to increase their reserves and holding part of their property portfolio separate.

More in general, Spain is confronted with problems via four channels. In the first place, the recession necessitates spending cuts in Spain, depressing the country's growth and deepening the recession as a result. During the first quarter of 2012, no less than 24.4% of the Spanish labour population was unemployed. The largest loss of jobs was incurred in the construction and industrial sectors. From the biannual EC growth forecasts of 11 May 2012, it is apparent that the Commission estimates the 2012 budget deficit at 6.4% during 2012 and 6.3% in 2013.[12] Furthermore, the Spanish economy is expected to shrink by 1.8% during 2012 - more than the 1.0% forecast by the Commission in February this year.[13] Further spending cuts will cost growth in Spain. It is therefore unclear whether this will actually decrease the debt quote.

In the second place, a nominal adjustment is necessary; in other words, wages and prices must decrease in order to make Spain more competitive, thereby decreasing the nominal Gross Domestic Product (GDP). At the same time, inflation remains low because Spain is in a monetary union. To countries in a monetary union, a nominal adjustment is more costly. If a country has its own currency, nominal adjustment can be realised by devaluation. Insofar as government debt is a factor in a country's own currency (as is the case in the UK, for example), a nominal adjustment through devaluation simultaneously reduces the country's debt expressed in foreign currencies. This cannot be instigated within a monetary union, which implies that government debt is not relieved.

In the third place, the interest rate further increases as market confidence dissipates. The banking sector needs recapitalisation, which will increase the country's debt quote. There is a risk that investors will avoid investing in the Spanish economy for fear of being confronted with having to pay for redemption of that debt. This will set off a self-reinforcing cycle, further shrinking the economy and further impeding repayment of debt. Just such a so-called hold-up problem or debt

[11] Citibank, Focus on Spain, 3 April 2012
[12] The forecasts are not based on all measures announced because some measures are insufficiently specified.
[13] Spain intends to reduce its budget deficit from 8.5% GDP during 2011 to 3% during 2013. The Spanish government indicated holding on to its 2012 budget deficit target of 5.3%.

overhang problem occurred in Greece previously.[14] European support will then improve the repayment outlook. Such support should mainly be focused on the third and fourth channels.[15] It is difficult to see how escalating problems can be successfully confronted without extending the current arsenal of emergency mechanisms, incisive ECB interventions or establishing mutual insurance mechanisms between the Euro-zone members. It is important in this respect to cut the link between a country and the local banking sector. This is set out in the next paragraph.

## 1.3 The negative feedback loop between banks and governments

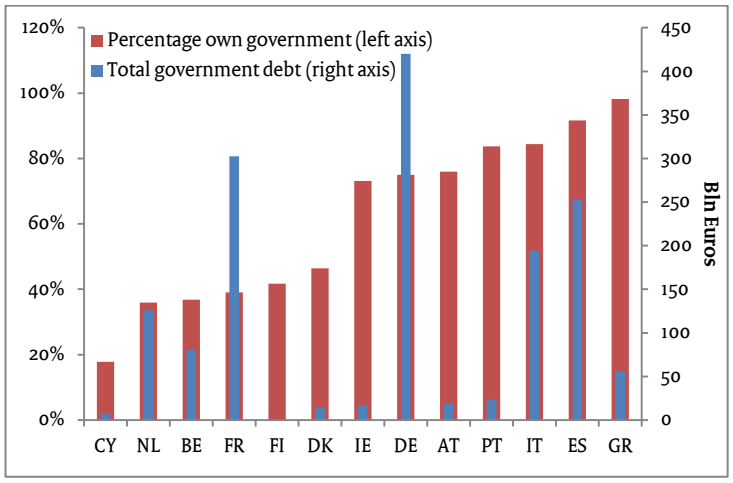
In addition to possible problems within EMU countries, the European banking sector also forms a direct risk in the development of the European debt crisis. This was already mentioned above in the section on the Spanish situation. According to EBA, 31 European banks must collectively increase their tier 1 capital by 115 billion Euros in order to ensure compliance with EBA requirements (Core Tier 1 capital ratio of 9% as per late June 2012). In spite of the stricter requirements and recapitalisation plans submitted, markets are still showing little confidence in the condition of European banks however. Banks are still hardly lending to each other and CDS spreads remain high. The decrease of these spreads after the recent liquidity support by ECB, the so-called LTRO (Long-Term Refinancing Operation) has turned out to be temporary. Furthermore, there is a risk that banks issue fewer loans in order to strengthen their capital structure. This pressurises credit issues to households and companies, deepening the recession as a result.

The banking sector also plays a central role in reinforcing the crisis due to the 'double feedback loop' between banking crises and sovereign crises. This works as follows. If the credit-worthiness of countries decreases, banks are affected (1) because they hold a relatively large proportion of bonds of their own government, and also because (2) the implicit guarantees of governments are devalued. This increases the banks' financing costs. Figure 4 below shows that a relatively large amount of government debt on banks' balance sheets consists of their own sovereign's debt. This is in particular the case in Southern European countries. If the credit-worthiness of banks decreases, on the other hand, governments are affected because (1) this leads to decreased economic growth and therefore lower tax revenues, and (2) this increases the probability that the government will have to provide emergency support to banks.

[14] See The Netherlands and the European debt crisis, CPB Policy Brief 2011 / 03.
[15] Similar dynamics occurred in Greece. See The Netherlands and the European debt crisis, CPB Policy Brief 2011 / 03.

Taking the safety net and restructuring mechanisms for banks to a European level will help to cut these negative feedback mechanisms, t.[16] The Greek elections on 17 June form an important calibration point in this respect. The introduction of a banking union in the heat of financial crisis is difficult, as this would compare to insuring a burning house. However, the fire is threatening to spread, which is why it would be better to insure the burning house after all. The Euro-zone countries cannot afford to come up with vague plans. In the past, some unspecified intentions were presented. The plans lost credibility due to disputes on specific details. The crisis is now so serious that the Euro-zone countries can no longer afford to allow this to happen again.

**Figure 4** **Bonds of own government as a percentage of total government bonds on the banks' balance sheets**




Source: 2011 EBA stress test

Thanks to the ECB's unconventional monetary policy, commercial banks were allowed to secure liquid resources against collateral at very low interest rates. During the first three-year LTRO in December 2011, banks withdrew a gross amount of 489 billion Euros from ECB, and 530 billion Euros during the second three-year LTRO of 1 March this year. This was designed to encourage banks to lend more money to both consumers and companies. It is unclear to what extent this aim is actually achieved. For the time being, the ECB statistics are showing a decrease in credit volume. Banks may also use the loans to buy government bonds. This has boosted the demand for government bonds, resulting in a temporary decrease in interest rates. A drawback is that this has probably reinforced the feedback loop between governments and banks, in particular in the southern countries. Spain and Italy could have been supported via EFSF, via ECB or via a route

[16] Also refer to C. Teulings, M. Bijlsma, G. Gelauff, A. Lejour and M. Roscam Abbing, 2011, Europe in crisis.

where ECB lends money to local banks. Due to lack of agreement between politicians, the latter, least direct option was chosen.

## The financial sector and the real economy

Four mechanisms can cause a crisis in the real economy to spread to the financial sector and vice versa - see for example Antony, Broer and Teulings (2011). The financial accelerator works because the amount of capital that a company can borrow is determined by its collateral. If a shock reduces the value of its collateral, a company can invest less. If this affects the economic growth outlook, the value of collateral decreases even further. As a result, companies can borrow even less, resulting in a feedback loop.

The bank capital channel arises if the equity falls below the minimum capital requirements. If a bank is unable to acquire equity, it must reduce its lending activities as well as its balance sheet. This is referred to as the leverage effect. If the entire banking sector is affected by this problem, the real sector is confronted with a credit crunch. Companies get into trouble, the growth rate decreases and the credit-worthiness of the banks' lending portfolio comes under pressure. This is how another feedback loop arises.

The bank lending channel starts with deterioration in the banks' refinancing options. Banks must attract new loans in a short period of time. As reduced credit provision in the short term does not offer a solution, they are forced to sell assets. In extreme cases, this may lead to so-called 'fire sales', where banks are forced to sell their assets below market value (Wagner, 2010). A fire sale negatively affects the value of other banks' assets however, again resulting in a feedback loop.

The risk channel starts with an increase in the volatility of prices of financial assets. Risk-adverse investors therefore demand a higher risk premium. This implies that the demand side of the market is confronted with an increase in the price-cost margin. Additionally, increased insecurity may also cause demand for credit to decrease, as companies and families reduce their investments and acquisition of sustainable consumption goods. This mechanism instigates a one-off drop in economic activities. The table below provides an overview of the above mechanisms.

| Name | Mechanisms | Transmission |
|---|---|---|
| | | |
| Financial accelerator | Company collateral | Feedback |
| Bank capital channel | Bank equity | Feedback |
| Bank lending channel | Liquidity | Feedback |
| Risk channel | Risk / volatility | One-off |

Macroprudential analysis of the relationship between the real economy and the financial sector requires an integrated approach. A quantitative estimate of the general influence of a financial crisis on an economy can only be assessed based on a derived form analysis containing all relevant channels. There are only a few models including more than one channel. Exceptions include, for example: Gerali et al. (2010), Meh and Moran (2010) and Gertler and Kiyotaki (2011).

Antony, J., Peter Broer P.D., Teulings C. N. (2011), What lessons can we learn from the Great Recession regarding our macro models?, KVS pre-advice 2011.
Gerali, A., S. Neri, L. Sessa and F.M. Signoretti (2010): Credit and banking in a DSGE model of the Euro area. *Journal of Money, Credit and Banking*, 42, 107-141.
Gertler, M. and N. Kiyotaki (2011): Financial intermediation and credit policy in business cycle analysis, In B.M. Friedman and M. Woodford (eds.): *Handbook of Monetary Economics*, Chapter. 11, 547-599, vol. 3, Elsevier.
Meh, C.A. and K. Moran (2010): The role of bank capital in the propagation of shocks, *Journal of Economic Dynamics and Control*, 34, 555-576.

The 2012 CEP concluded that the debt crisis calmed down during the first few months of 2012 due to having supplementary liquid resources available in the form of the ECB's three-year loans (LTROs), government changes and announced reform plans in both Italy and Spain. The interest gap with German government bonds decreased, share prices were higher and the share price volatility decreased. This has changed dramatically. The debt crisis surged again due to the deteriorating positions of the Spanish banks and the political problems in Greece. Furthermore, the LTRO has reinforced the negative feedback loop between countries and banks. A cause for concern is also that it was predominantly the Southern European banks making use of the LTRO, supporting weak banks without any conditionality.

The extensive liquidity support to European banks raises two key questions. In the first place: how to prevent banks from using the temporary break to postpone the desperately needed recapitalisation? There is a risk that the ECB infusion will allow insolvent banks, similar to the Japanese zombie banks in the nineties, to scramble on for years, resulting in misallocations of credit.[17] Furthermore, there is the problem of credibility. Suspending liquidity support if banks are not sufficiently healthy will result in lack of credibility. ECB and the European government leaders must therefore work on a strategy to reduce the LTRO as quickly as possible. An important element could be further institutional renovation enabling countries such as Italy and Spain to be granted liquidity support.

This is why it is important for banks to acknowledge losses on their assets and bring their equity to a sound level as quickly as possible. In order to accelerate recapitalisation, the option of limiting dividend payments for banks using LTRO may be considered. Due to the various mechanisms connecting the real economy and the financial sector (see the text box 'The financial sector and the real economy' for an overview of such mechanisms), a well-capitalised financial system is of prime importance to a healthy economy.

The second equally important key question concerns phasing out the liquidity support granted by ECB. ECB has proved more agile in its interventions than the Japanese central bank during the 1990s. One of the lessons of the lingering Japanese crisis was that quick intervention is key. However, this also involves risks. If the European banks do not succeed in returning to health within three years, there is no credible way for ECB to demand repayment of the loans.

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[17] The Japanese central bank provided insolvent Japanese banks with cheap loans, hoping that this would help them get out of trouble eventually. These so-called zombie banks continued their bad loans this way, supported by the central bank, in hopes that the relevant zombie companies would overcome their problems in due time. The inevitable restructuring of insolvent companies and banks was delayed for years in this manner. The banks lent money to companies that hardly made a profit or turned a loss, in hopes that these zombie companies would overcome their problems in due time. As a consequence, healthy start-ups were unable to raise credit and restructuring of Japanese banks was delayed by many years. The resultant misallocation of credit certainly contributed to what was later known as 'the lost decade' of the Japanese economy, the long period of low economic growth rates in Japan during the nineties.

## 1.4 Guarantees, loans and other risks

If the European sovereign debt crisis deepens, the Dutch government is affected through the impact on economic growth and also directly or indirectly through guarantees and support measures. Direct exposure concerns the guarantees ensuing from the emergency mechanisms set up in the context of the European debt crisis, in particular EFSF and ESM. Indirectly, the guarantees to the financial and non-financial sector also play a role, just as guarantees relating to the housing market. Table 1 provides an overview of guarantees and loans, specified into their relation with the European debt crisis.

**Table 1 Guarantees en Loans**

| **Guarantees** | | Amount (bln Euros) |
|---|---|---|
| *Crisis-related* | Guarantees on credit (Guarantees interbank loans, Credit EU payment balance support to member states, EFSF and EFSM) | 136.14 |
| | Guarantee on participations (DNB - participation in IMF) | 47.31 |
| | Guarantees on risks that are uninsurable or hard to insure (participation ABN AMRO) | 0.95 |
| | Secondary guarantees (NHG) | 136.21 |
| | | |
| *Non-crisis-related* | Guarantee on credit | 7.64 |
| | Guarantee on participations | 16.45 |
| | Guarantees on risks that are uninsurable or hard to insure | 29.14 |
| | Other guarantees | 0.29 |
| | Secondary guarantees | 99.47 |
| | | |
| **Loans and other payments** | | |
| | ABN AMRO | 0 |
| | ING non-liquid assets reserve provision | 12.79 |
| | Fortis/ABN AMRO | 31.72 |
| | Capital provision reserve | 3.57 |
| | Deposit Iceland guarantees | 1.42 |

Source: 2012 National Budget tables 1, 7.1 and 7.2, and 2012 Annual Financial Statement table 6.1

In addition to these guarantees, deposit guarantees amounted to approximately 390 billion Euros in 2010.[18] These are officially chargeable to the financial sector. In a situation where problems are relatively limited, this is indeed possible; however, eventually it is the government that pays the bill if one of the three largest banks in the Netherlands gets into trouble, as the Dutch banking sector is too small to bear the cost.

Furthermore, ECB granted a large amount of support in the context of the crisis in the form of its Securities Market Programme (SMP), with ECB buying government bonds on the secondary market, the LTRO operations and Target 2, with ECB granting loans to banks against collateral.[19] If ECB should incur losses on these loans, the Dutch government is exposed to this indirectly, as ECB may decide to ask the member states to make supplementary deposits. Furthermore, ECB may limit its profit distribution to the central banks. The central banks share the profit distribution with the government and this revenue may therefore decrease. Additionally, implicit guarantees were granted, including the guarantees activated in the ABN AMRO rescue operation. These are not included in the table below. If the European debt crisis deepens, these guarantees may be invoked and this is therefore another risk to government finance.

# 2 The Dutch financial sector

The financial sector in the Netherlands forms an important link between on the one hand savers and investors, and on the other hand investors and the companies they want to invest in. A shock affecting the financial sector also affects the real economy (see the text box 'The financial sector and the real economy'). The Dutch financial sector is relatively healthy, but has a number of weaknesses.

## 2.1 The financing deficit of Dutch banks

A bank must finance the gap between the assets on its balance sheet and the sum of consumer deposits and equity via the financial markets. For example by issuing bonds or entering into interbank loans or repo transactions.[20] DNB defined the Dutch banking sector's financing deficit as the difference between loans and deposits and disclosed it in various publications (see 2011 Annual

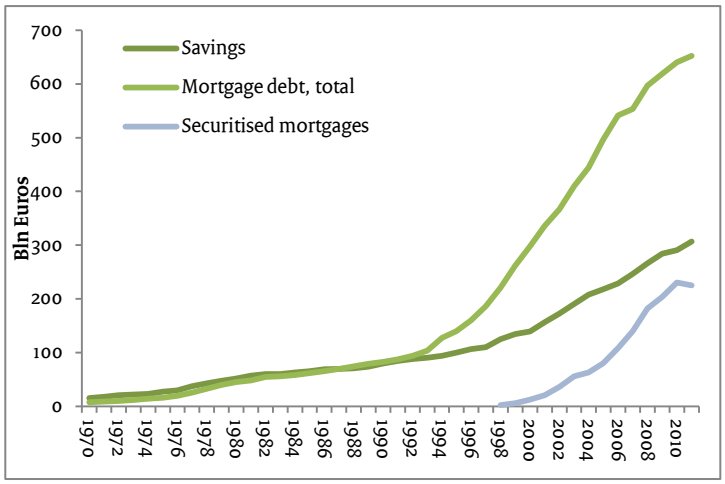
[18] Refer to the letter sent by the Minister of Finance on 2 May 2011, reference FM/2011/ 8672 U.
[19] This comprises a Target 2 imbalance amounting to a total of 892.1 billion Euros (Institute for Empirical Economic Research at Osnabrück University (Germany); data based on observations of 12/11 and 03/12). SMP, CBPP1, CBPP2 jointly 279.4 (ECB open market transactions from 29.3.12). MRO and longer-term refinancing transactions, jointly 1,155.0 billion Euros (ECB week statement 27.03.12).

[20] In repo transactions, one party sells assets to another party, simultaneously committing to buying the assets back later at a price agreed in advance. The difference between the selling price and the purchase price serves as the interest fee.

Report DNB).[21] This shows that Dutch banks are more dependent on financing through financial markets than banks in other European countries.

This does not imply that Dutch consumers hold insufficient deposit savings. Dutch consumer savings deposits in banks are around the European average.[22] According to Eurostat data[23], the savings deposits of Dutch consumers in banks during 2007 amounted to 61% of GDP, compared with 67% in Germany, 56% in France and 64% in Italy.[24] However, Dutch banks do lend more than banks in other countries. This is mainly due to above-average high mortgage loans. Figure 5 shows mortgage funding in Dutch banks. The total mortgage debt of Dutch households is very high. As a percentage of the national income, it increased from 43% in 1995 to 105% during 2011. The financing deficit is therefore also due to the ratio between average savings balances and high mortgage loans.

**Figure 5 Savings, mortgage debt and securitisation of mortgages since 1970**




Source: National accounts, De Nederlandsche Bank, CPB

[21] The financing deficit can be used to measure the quantity of mobile financing that a bank holds, i.e. financing that can flow out quickly. DNB defines the financing deficit as the difference between domestic loans and domestic savings deposits. An alternative measure is the difference between the assets of banks and immobile financing (equity, consumer savings and long-term debt). The financing deficit will then increase.
[22] The total savings balances of Dutch consumers, however, are far above the EU average due to high pension savings in the Netherlands.
[23] Please refer to http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/Household_financial_assets_and_liabilities
[24] For other years we could not find any European Data.

Mortgage financing is generally issued with a long maturity. If financing via the financial markets is based on short maturities, banks are exposed to refinancing risks, as parties lending money to Dutch banks will charge a higher interest fee from the banks when perceiving increased risk. Due to short-term financing, the interest charges incurred by banks can run up quickly and this confronts the banks with problems. In the event of problems in the financial markets, the financing options may even drop off completely. This forms a risk to the Dutch government, which eventually is the guarantor of Dutch banks.[25]

Due to the relatively larger financing deficit (in combination with a relatively large financial sector in the Netherlands), the Dutch banks can therefore be considered vulnerable to problems in the capital markets. This vulnerability to external shocks would be reduced if Dutch banks would have a higher capitalisation level. There are various options to ensure higher capitalisation levels. The first option is for banks to reduce their balance sheets by selling mortgage loans, which means that they will need lower amounts of market financing. In order to take mortgages off the balance sheet, banks make us of securitisation. Securitisation growth since 1998 is shown in figure 5. However, the financial crisis made clear that securitised mortgages sometimes return to the banks' balance sheets.[26] The market for securitisation has, moreover, become less accessible due to the crisis.

The second option for more extensive capitalisation is for banks to attract long-term loans in order to limit the refinancing risk. However, long-term financing is more expensive than short-term financing. This implies that long-term financing comes at a cost. From a social perspective, however, such costs may be justified as these would reduce the risk of a system crisis.[27] The proposal for a banking tax that was recently adopted aims, among others, to encourage the banks to enter into more long-term financing contracts by taxing long-term loans at a lower rate than short-term loans.[28]

The third solution is to limit the volume of residential mortgages or increase consumer deposits in banks. Dutch consumers have relatively high mortgage loans. However, the impact of changes to the maximum mortgage amount consumers can borrow on the level of mortgage debt in the Netherlands is visible only with a significant delay. Moreover, changing consumer savings habits is not an easy task, also because banks have limited access to savings, as pension capital is not accrued in banks but in pension funds. Furthermore, the Dutch housing market is vulnerable. The

[25] For example, the central bank in the USA bought a total of 850 billion dollars in securitised mortgages.
[26] For example because banks guarantee the financing of special purpose vehicles or to keep the bank's reputation intact.
[27] See Perotti and Suarez, 2011.
[28] House of Representatives Records II 2011-2012, 33 121 Nr. 2.

prices of existing homes sold during April of this year were lower than in April 2011 by 5.2%. Further decreases in the housing prices may lower consumer confidence and therefore consumption.

The structure of the deposit guarantee system is also an important factor in limiting risks. DSB's subordinated deposits outstanding were subject to legal ambiguity on which contracts were guaranteed or not.[29] Ambiguity on which loans are subordinated and which are not in the event of a bank's bankruptcy creates room for strategic manipulation and may increase uncertainty among the bank's creditors. The impression that the rules regarding access to the deposit guarantee system are slackened retrospectively must be avoided. A banking intervention framework must therefore contain a clear classification of claim priority.[30] This sets high requirements to the legal framework and the quality of court decisions.

## 2.2 The leverage of Dutch banks

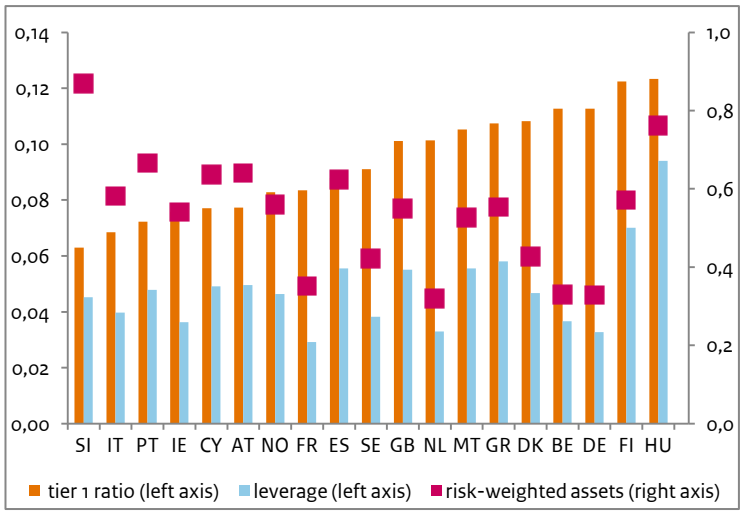
After its stress test of October 2011, EBA (the European Banking Authority) concluded that 31 European banks must increase their tier 1 capital by in aggregate 115 billion Euros in order to ensure compliance with EBA requirements, i.e. a Core Tier 1 capital ratio of 9% as per late June 2012.[31] Dutch banks had a relatively positive score in this stress test. The figure below shows three averages for banks per country: the first average is the core tier 1 ratio, the second the ratio between core tier 1 capital and total assets, and the third the risk-weighted assets as a percentage of the unweighted assets. The first two are on the left axis, the latter on the right. The ratio between core tier 1 assets and total assets is related to the banks' leverage: the lower the ratio, the higher the leverage.

Figure 6 shows that while Dutch banks have a relatively high core tier 1 ratio; at the same time, the average leverage of Dutch banks is high compared with those of banks in other countries. This is caused by the low amount of core tier 1 capital in Dutch banks compared with their total assets, and therefore they are relatively sensitive to unexpected losses. The high scores of Dutch banks in the EBA stress tests are therefore due to the favourable weighting of risk-weighted assets. A significant of these assets consists of mortgage loans, which have a low risk weighting. If any long-

[29] In an appeal, the Board of Appeal in the private sector judged that the subordinated deposits at DSB do fall within the scope of the deposit guarantee system because these are not part of the capital base, as DNB previously argued. Whether or not subordinated deposits fall within the definition of equity does not depend on the information provided.
[30] Among others, such an intervention framework will have to dictate which measures the supervisor must implement during various phases of intervention in a bank confronted with problems. Please refer to Bijlsma, Elsenburg and Zwart, A binding intervention framework for supervision of banks, CPB Policy Brief 2011/04.
[31] Core tier 1 equity is equal to the existing EU definition of tier 1 equity, minus participations in financial institutions and minus hybrid financing instruments; please refer to EBA FAQ.

term economic downturn would severely affect the credit-worthiness of mortgage portfolios, the Dutch banks may incur heavy blows in spite of the low risk weighting.

**Figure 6** **Tier 1 ratio, leverage and risk-weighted assets of European banks**

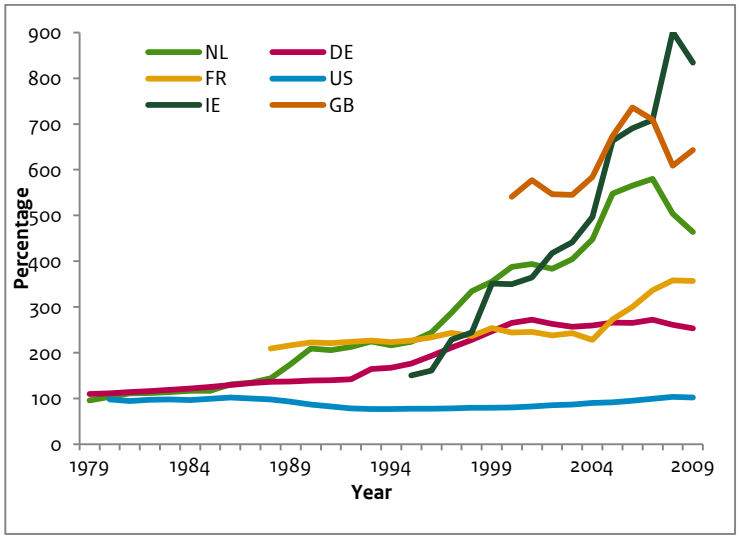



Source: EBA, CPB

## 2.3 The scale of Dutch banks

Compared with other European countries and the USA, the Dutch banking sector is relatively large, as is shown in figure 7. The total value of the bank balance sheets of Dutch banks as a percentage of GDP rose from 95% to almost 500% during the past three decades. In France and Germany, the pace of the increase in this percentage was much slower, rising to 350% and 250% respectively. The banking sectors in both the United Kingdom and Ireland are far larger still than in the Netherlands, with the Irish banking sector increasing up to over 900% in 2008. The total value of the American banks' balance sheets as a percentage of GDP has remained virtually stable during the period 1980 - 2010.

**Figure 7 Total bank balance sheets as a percentage of GDP**

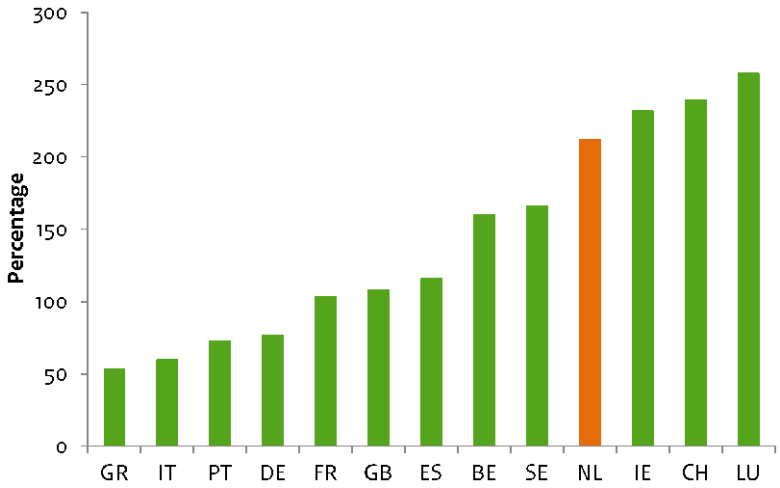



Source: OECD, ECB

Figure 8 shows that the Netherlands not only has a large banking sector, but also that the largest bank in the Netherlands (ING) is also very large in comparison with banks in other European countries. The second bank in the Netherlands (Rabobank) is larger than the largest German bank relative to GDP, which indicates a high level of concentration within the Dutch banking sector.

The size and concentration of the Dutch banking sector constitute a risk to the government. The deposit guarantee system guarantees part of the account holders' balances if a bank is unable to comply with its obligations. Although the associated cost is in the first instance charged to the banks, it would be plausible for the government to lend emergency support if it concerns a major bank. In addition, recent history has shown that the Dutch government deems some banks too important to let go (too big to fail). This effect is reinforced if more than one of such 'system banks' (SIBs - Systemically Important Banks) would be confronted with problems during the same period.

**Figure 8 Balance sheet amount of the largest bank as a percentage of GDP (2010)**




Source: OECD, ECB

Under the new framework for capital regulation (Basel III), system banks must hold larger capital buffers. These are minimum requirements; individual countries may impose stricter national requirements above the basic level, subject to certain basic requirements.[32] In its annual report, DNB indicates that SIBs, depending on their relevance to the system, should hold an additional core capital of 1 to 3 percent of the risk-weighted assets. Core capital includes paid-up share capital and retained profits. This requirement is supplementary to the regular 7% capital requirement set by Basel III.[33] This means that the SIBs' total core capital should be 8 to 10 percent. In times of increased credit growth, this requirement may be raised to 12.5% due to the so-called contra-cyclical Basel III capital buffer. Additionally, Basel III requires convertible capital of at least 3.5%. The Minister of Finance indicated that he wishes to impose supplementary requirements to convertible capital. Depending on the level of these requirements, the Netherlands, in this respect, is aligned with the UK and Switzerland.[34]

[32] See the report of the Ecofin Council of 2 May in Brussels

[33] The minimum requirement for core capital was increased from 2% to 4.5% of the total risk-weighted assets of a bank. A core capital buffer requirement of 2.5% is phased in, encouraging banks to a capital ratio target value of 7%. Capital requirements are introduced in phases; the SIBs are to gradually build up the buffer between 2016 and 2019.

[34] Please refer to Appendix 1 to the follow-up memorandum on public utilities and commercial activities.

The vulnerability of the Dutch economy due to its large banking sector can be addressed in various ways. As noted above, the capital requirements for Dutch banks could be further increased. A higher equity ratio will protect the Dutch tax payer against the cost of a crisis, simultaneously forming an incentive for banks to further limit risks. The long-term cost of such an increase is probably relatively low, whereas the benefit in terms of lower risk of a system crisis is significant.[35] Please note in this respect that Dutch banks have proven highly capable of reaching higher capital levels. It is therefore more or less safe to conclude that further accrual of equity is relatively easy to accomplish.

In the second place, smaller banks should be favoured in order to prevent banks from being too big to fail. This may come at a cost, as smaller banks lose the benefit of economy of scale. However, economic studies, in particular regarding US banks, show that economy of scale in banks may be important, but the curve flattens at a far lower level than the current scale of banks with hundreds of billions.[36] As smaller banks benefit less from implicit government guarantees (i.e. they are not too big to fail), they pay a higher interest rate when attracting financing.

Also, social risks decrease with a financial sector smaller as a whole. Of course, this also comes at a cost. According to CBS (Statistics Netherlands) statistics, the added value of the Dutch financial sector amounts to approximately 7.0% of GDP. However, this figure is distorted upwards by several effects. In the first place, the recent increase is driven by a lower interbank interest rate. This raises the added value of the financial sector as defined by CBS, but this is set off by a lower added value of companies obtaining loans from banks.[37] In the second place, the government's implicit guarantees for the largest Dutch banks are not considered. In the third place, the current calculation method does not factor in risk corrections and in particular does not factor in the negative external effect of system risk.[38] On the other hand, a large financial sector may also generate positive external effects. Research into the optimal size of the financial sector is still in a premature stage.

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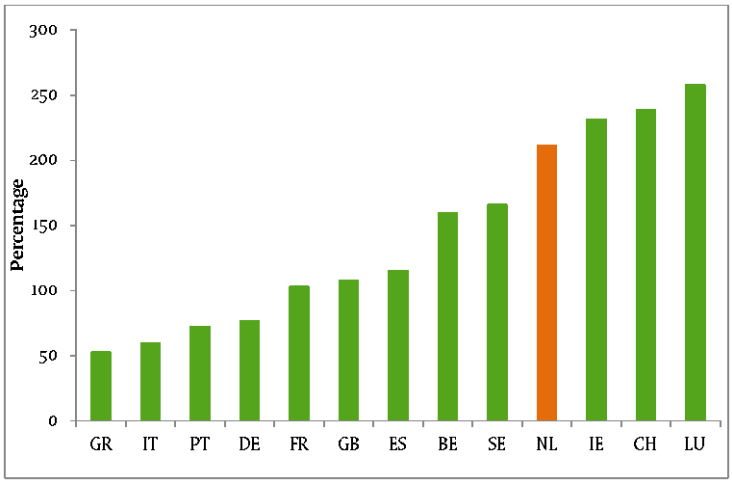
[35]Naturally, short-term costs may be incurred as banks may increase their prices or issue fewer loans. Policy can play an active role in reducing these transition costs, by affording banks a longer term to adjust while limiting dividend payments, or by imposing mandatory issues of new share capital on banks. Please refer to Bijlsma and Zwart, Are stricter capital requirements costly?, CPB document 215.

[36] Refer, for example, to Berger, Allen N. and Loretta J. Mester, 1997, Inside the box: What explains differences in the efficiencies of financial institutions?, Journal of Banking and Finance 21, 895-947. They find that the optimal scale of a bank is around 25 billion dollars. Amel, Dean, Colleen Barnes, Fabio Panetta, and Carmelo Salleo, 2004, Consolidation and efficiency in the financial sector: A review of the international evidence, *Journal of Banking and Finance* 28, 2493-2519 find that the operating costs of commercial North-American banks increase in banks larger than 50 billion dollars.

[37]After all, the interest surcharge on such loans has increased.

[38]See, for example Haldane (2012)

**Figure 9** **Balance sheet amount of the largest bank as a percentage of GDP for American states**




Finally, it would also be helpful if supervision and a safety net, such as the deposit guarantee system, would take place at a European level rather than at national level; see also the previous discussion on recapitalisation of the Spanish banking sector. Ensuring that support operations for banks are not implemented through individual member states will allow for decreasing the feedback between bank crises and government debt crises. The option of supporting banks in a certain country via ESM would be a first step in this direction.[39] Figure 9 shows that the various states of the USA also differ enormously in terms of the size of their banks. However, these banks do not need to contend with high interest levels of individual states. The main reason for this difference is that the regulatory body and safety net for the banks are organised at a federal level.

[39]ESM may provide support to the banking sectors in countries that are unable to borrow money on the capital market. The EC, ECB and IMF will impose requirements on countries applying for loans.

# 3 The Dutch property market

## 3.1 The Dutch mortgage market

Banks are sensitive to losses on their mortgage portfolio. Mortgage debt has further increased during the past few years (see figure 5), amounting to 644 billion Euros according to DNB's calculations of mid-2011. In combination with falling prices for residential homes and increasing unemployment, this constitutes a high risk to banks.

Losses for banks arise if home owners are no longer able to pay their mortgage interest and if the value of a home upon sale is lower than the mortgage provided. The debt of Dutch households amounts to approximately 250% of gross debt-to-income. This gives the Netherlands the highest rate within the European Union after Denmark.[40] The total household debt mainly consists of mortgage debt, but also of consumptive credit.[41] During 2009, 15% of all home owners had accrued a negative surplus value, i.e. the mortgage debt exceeded the WOZ value (municipal estimate).[42] In particular relatively young households with an average to high income have accrued negative surplus value and low savings, resulting in negative equity. After a sudden income shock, for example due to unemployment, disease, divorce or an interest rate shock, they are at risk of being confronted with payment problems. They would subsequently be indebted after sale under duress. In contrast, the surplus value of the over-65 population is an average of 70% according to DNB.[43]

A scenario with increasing unemployment and increasing mortgage interest could materialise upon further escalation of the European debt crisis. Additionally, the decreasing prices of residential homes, combined with the economic downturn and higher unemployment constitute an increasing risk to Dutch banks. The value of homes will be pressurised due to the adverse economic climate. This negatively affects demand for homes. As supply has not dropped, the number of homes for sale is increasing. The risks on the housing market are reinforced if politicians give insufficient clarity on the policy that will be implemented regarding the housing market, causing reticence in potential buyers and sellers.

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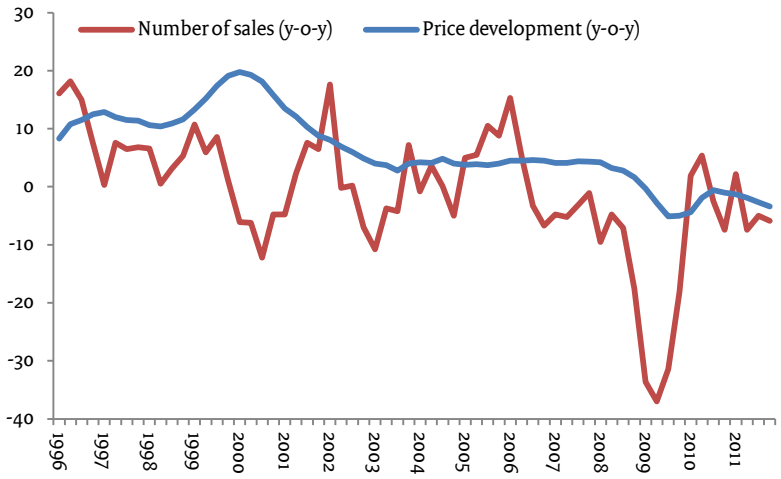
[40] Eurostat gross debt-to-income ratio of households
[41] In March 2012, the temporary and permanent credit facilities amounted to 15.9 billion Euros, whereas credit limits on accounts were used to an amount of 9.8 billion Euros (Source: CBS).
[42] http://www.cbs.nl/nl-NL/menu/themas/bouwen-wonen/publicaties/artikelen/archief/2010/2010-020-pb.htm
[43] Risks Dutch mortgage debt highly concentrated, DNB Bulletin, December 2011

**Figure 10** **Year-on-year movements in housing prices and number of homes sold (as a percentage)**




Source: CBS

Part of this risk is hedged by the government's NHG (National Mortgage Guarantee). During the first quarter of 2012, 28,200 new loans with NHG protection were issued. This is a decrease compared with the same quarter last year (37,800). The number of active guarantees as at 31 March 2012 was 949,000. This concerns over 80% of homes within the NHG limit of 350,000 Euros.[44] The NGH's equity amounts to 740 million Euros. If this buffer should prove insufficient to comply with payment obligations, the government will act as the guarantor. Regarding NHG's provided before 1 January 2011, the foundation can invoke subordinated interest-free loans of the national government and municipal governments (at 50% each). Loans concluded after this date are protected by a 100% safety net function of the national government. During 2009, CPB estimated the risks as limited.[45] However, the scenarios used in the analyses seem to have become obsolete and the risk has increased therefore.

Although the number of sales under duress of homes within the scope of the Guarantee in the Netherlands is still at a relatively low level, an increase has become visible: from 491 during the first quarter of 2011 to 765 in the same period this year.

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[44] As per 1 July 2012, the NHG limit will be lowered to 320,000 Euros and will be decreased further in phases until 1 July 2014 to the original amount of 265,000 Euros. In order to hedge the slightly higher risk to the government's safety net due to decreasing the limit, the insurance premium for home buyers was increased from 0.55% to 0.7% of the mortgage amount. Please refer to the quarterly statement of the Foundation Guarantee Fund Owned Homes, of 2 April 2012.

[45] Also see http://www.cpb.nl/publicatie/verhoging-nationale-hypotheekgarantie

Various measures can help limit the sensitivity of banks to losses on the Dutch housing market. In the first place, incentives for repayment of mortgage debt can be implemented. Due to years of fiscal incentives, obtaining high mortgages was attractive to consumers. With the current tax regulations, it is at this moment more attractive to accrue savings than to repay mortgage debt. This does not automatically imply that the equity position of households would improve. Where the debt position would be lowered, the consumers' savings deposits would decrease - the money can be spent only once. Therefore, this would also not automatically decrease the financing gap in Dutch banks; the mortgage debt outstanding will decrease along with a decrease in the consumer savings accounts.

A second option is further lowering the maximum loan-to-value ratio (LTV) of a mortgage loan. The government's Spring Accord limits in due course the maximum mortgage value eligible for tax deduction for new mortgages to the market value of the property. Exceptions are allowed for value-adding (and/or sustainable) investments in owned property.

Another option is gradually limiting the mortgage interest tax deduction. This would remove the incentive for home owners to sustain a large mortgage debt, which will then decrease quicker during the maturity of the mortgage. The Spring Accord includes some measures regarding tax-deductible mortgage interest. Regarding new mortgages as from 2013, the interest paid will be deductible only concerning loans that will be redeemed fully and at least on an annual basis during its maturity. Tax deduction of mortgage interest for existing mortgages will remain unchanged. The redemption period eligible for mortgage interest deduction will remain 30 years for everyone. One of the complications of these options is the inherent tension between decreasing mortgage debt and setting the housing market in motion. Further decrease of the housing prices will affect consumer spending while increasing the risk to banks.

In the short term, the amounts outstanding may be lowered by selling mortgage portfolios on the financial markets (securitisation). Banks have already securitised a limited part of their mortgage portfolios; however, the low risk weight associated with residential mortgages according to the Basel standards is an incentive to keep mortgages on their balance sheets. However, the supervisor has some room to manoeuvre in this respect, and under the second pillar of the Basel Accord, may increase the risk weighting, leading to a greater incentive for securitisation. Banks do depend on sufficient liquidity in this market, which has been severely affected by the crisis.

## 3.2 The market for commercial properties

The value of commercial properties (offices, shops, business estates) shows a decrease across the board. This affects financial institutions investing in property or lending to property developers. The banks' amount outstanding in property loans in the Netherlands is approximately 80 billion Euros. This mainly concerns loans to property companies, investors and property developers. The

risk to banks is that these loans may not be repaid if the property designated as collateral decreases in value. One quarter of the Dutch property portfolio of banks is currently worth less than the associated collateral. This may confront the banks with problems in the near future. According to DNB, approximately 30% of the banks' property loans will mature either this year or during 2013, whereas approximately half the loans will mature in 2015 or after.[46]

Any ambiguity regarding the extent to which various banks are affected by the problems in the property sector may affect the position of all banks on the capital markets. Economic literature based on experiences during the current financial crisis showed that banks may tend to polish up their balance sheets by not or not sufficiently impairing assets that have decreased in value.[47] It is also unclear to what extent the banks have impaired their property portfolios. Furthermore, there are various ways of recognising offices at too high carrying amounts. Examples include rent-free periods, rebates on the lease price or investment contributions of the owner, decreasing the actual lease revenue, whereas the carrying amount is based on undiscounted lease prices.[48] The failed sale of Uni-Invest late last year of a property portfolio offered at 40% below the value on the balance sheet illustrates the inclination of slow impairment.[49]

Furthermore, accurate valuation is impeded by a division in both the market for office buildings and the market for shop premises. The value of quality properties in the right locations decreases far less than premises in peripheral locations. Approximately 13.9% of office buildings are vacant.[50] The possibility that some of the vacant buildings cannot be used as such anymore cannot be excluded. The division in the office buildings market is also apparent from the large spread of impairments between the various components of the IPD/ROZ-index. Impairments on offices ranged between 18% and 31% during the period 2008 - 2011.[51] The duality in shops is mainly expressed in vacancies in B and C locations. The Association of Institutional Property Investors is advocating demolition of some of such premises.[52]

Dutch financial stability would benefit from banks taking their losses on their property portfolios, and if necessary acquiring extra capital to cover these losses. Furthermore, the underlying reasons of excess supply in the office market may be studied. Naturally, decreased demand due to the economic crisis is one of the underlying causes of vacancies in the office buildings market. A

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[46] Please refer to Overview Financial Stability, DNB, spring 2012
[47] See, for example, Huizinga en Laeven (2009).
[48] According to property agents DTZ Zadelhoff ('The candidates in the market', January 2012). The value of a property is a function of the lease revenues. Basing valuations on a lease price without considering discounts granted will result in overvaluation.
[49] Het Financieel Dagblad. 'DNB: property will become the third crisis in the financial sector', 3 February 2012.
[50] DTZ Zadelhof, The market for Dutch commercial property, January 2011.
[51] IPD press release, 2 March 2012.
[52] IVBN 2012.

secondary possible cause may be competition between municipal governments in attracting new businesses. This may lead to a further increase in the supply of office buildings. Other factors may also play a role; these may include structural deceleration in the growth rate of demand for office space, and a slow response of developers to increased vacancy rates.

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