Banking Fundamentals

Textbook

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CHAPTER 1

Transformation Function of Banks

Introduction

Banks fulfil three core functions in the Dutch economy. This chapter deals with the function of bringing together money lenders and money borrowers. This is known as the transformation function of banks.

1.1 Transformation function

Transformation means conversion or changing the nature of something. In this case it concerns the transformation of money. On the financial markets, the lenders who have cash surpluses can trade with the borrowers who have cash deficits. The supply and demand sides, however, do not always match up perfectly with each other. That is why the banks have to fulfil a transformation function. The bank takes the cash savings and deposits of businesses, private individuals, and government organisations, and transforms them into credit facilities, which it provides to other companies, private individuals, and government organisations. This transformation proceeds via the capital market. The activities carried out by a bank in order to be able to fulfil the transformation function are also referred to as the 'interest margin business'.

The transformation function of a bank has to take into account the following aspects:

- size;
- term;
- risk.

Size

Ordinary savers offer relatively small amounts. The amount they keep in their savings accounts mostly ranges from a few thousand Euros to tens of thousands of Euros. Credit applicants generally need larger amounts of money. A loan for the purchase of a home might easily be as much as several hundred thousand Euros, and business loans can be even bigger.

The bank will provide a credit facility that offers the appropriate amount of money.

Term

Most consumers want to be able to access their money whenever they want. Money held in a payment account can therefore be withdrawn on demand, and that is also the case with most savings products. A deposit account, however, is a type of savings account where money cannot be withdrawn on demand, and instead the consumer might have to wait for a few months or years.
Credit facilities have a much longer term. A loan for the purchase of a car might have a term of 3 to 4 years. A mortgage usually has a term of around 30 years.

Risk

Both the money lender and the money borrower run a certain amount of risk. Although a money lender might be willing to lend a certain amount of (savings) money, he naturally does not want to lose it. And a money borrower might want to borrow some money, but they do not want the lender to be able to ask for it back whenever they want to.

The bank therefore takes on both of these risks. The high volume of loans handled by a bank mean it is able to accept a certain amount of risk. If there are 10,000 outstanding loans, and only a few of these are not paid back, then this will not have any major consequences for the bank. The bank will have already factored the risk of non-repayment into the charge for the credit facility. Similarly, if only a small number of people with savings accounts withdraw their money at the same time, then this will not affect the bank's ability to keep on providing the agreed credit.

The risk transformation performed by the bank means the money lender can lend money safely. The bank will make sure it is paid back on time. Likewise, the borrower can take out a loan safely. The bank will make sure the borrower will have access to the money for the entire term of the loan, although of course only if the borrower does not default on the loan in the meantime.

CHAPTER 2

Intermediary Function of Banks

Introduction

Banks fulfil three core functions in the Dutch economy. This chapter deals with the function of mediation and advising about financial products for money lenders and money borrowers. This is known as the intermediary function of banks.

2.1 Intermediary function

In order to be able to fulfil the intermediary function, the bank operates a mediation business. In the mediation business, the bank brings together money borrowers and lenders, and provides mediation between the two. However, it is not involved as a party in the transactions between them. The bank makes its market expertise, its network, and its administrative services available to the customers in exchange for a fee in the form of a commission. The money borrowers and lenders carry out the transactions for their own account and risk. Examples of banking activities associated with the intermediary function include: handling stock market flotations, trading in securities, and providing insurance.

2.2 Mediation and advice

In the mediation business, the bank is paid a fee to act as an intermediary (agent) for the products of third parties, such as:

- insurance;
- stock market flotations;
- trading in securities;
- investment advice and management services.

2.2.1 Insurance

The bank can act as an intermediary for insurance policies in a limited segment of the market. It includes, for example, insurance policies associated with a private home and the finance to buy a home.

Although a bank is able to act as an intermediary for insurance policies, a financial institution is not allowed to act as both a bank and an insurance company at the same time. The risks associated with banking activities might have negative consequences for the ability to pay out insurance claims, and vice versa. However, banks and insurance companies can exist as separate subsidiaries of the same parent company. There are no longer any true bank insurers left in the Netherlands any more. ING has sold Nationale Nederlanden, Reaal and Zwitserleven no longer have the Volksbank in their portfolio, and Achmea has sold Staalbankiers to Van Lanschot. Furthermore, ABN-AMRO insurance policies are actually products of Delta-Lloyd, and although Interpolis would appear to be part of the Rabobank, it is not. Interpolis is part of Achmea.

2.2.2 Stock market flotations

Large corporations, such as Unilever and Philips, raise finance directly on the capital market. They issue shares and bonds, and sell them to investors.

A share is a certificate of ownership. The shareholder is a co-owner of the company. A bond is a certificate of debt. The bond holder lends money to the company, and the bond gives him the right to repayment of the original amount plus interest. The collective term for shares and bonds is securities.

Stock exchange

Trading in securities, also known as stocks, is conducted in a stock exchange. The most famous stock exchange is the New York Stock Exchange, sometimes referred to as Wall Street. In the Netherlands, the trade in securities is handled by the Euronext exchange in Amsterdam. Trading on this stock exchange is not open to everyone. Only members of Euronext are allowed onto the trading floor. Most of the Dutch banks are members of Euronext.

Issue

An issue is when new securities are put on sale. The trade in these securities is called the new issue market or the primary capital market, because these are new securities that are being traded for the first time. The company itself is not a member of Euronext. It will therefore have to get a bank to organise the issue on its behalf.

The very first issue, the occasion when the company appears on the exchange for the first time, is called a stock market flotation. This flotation requires a lot of preparation: the company has to compile a prospectus with a detailed and precise description of the nature of the company, its financial position, and its prospects for the future.

The bank can act as an intermediary and provide support and assistance for both the initial flotation and for later issues.

2.2.3 Trading in securities

A consumer can sell his securities on to another party. This is called the secondary capital market. The company that has issued the securities is not a party to the transaction. It only gets money from the initial issue (primary capital market). If the value of the securities changes later on, then this only affects the buyers and sellers of the securities.

Selling of securities

A consumer can ask a bank to help with the buying and selling of securities. The bank will then only act as the service provider for the execution of the orders. The customer will trade in the securities for their own account. Any losses incurred due to a fall in prices can therefore not be recovered from the bank. The bank will charge a commission for the service, which will be a percentage of the value of the buy or sell transaction.

Safe custody of securities

The bank will keep the purchased securities in safe custody for the customer. The bank also charge a fee for this, the so-called "custody fee". Shares and bonds are no longer issued in the form of paper documents that actually have to be kept in a safe by the bank. The custody of book-entry securities is simply an administrative procedure.

The customer can place the securities in closed or open custody. With closed custody, the bank will keep any paper documents in a safe and keep administrative records for book-entry securities. With open custody, the bank also takes on the administrative management of the securities. In the case of shares, this means amongst other things that the bank settles the dividend payments, and in the case of bonds it handles the redemption of the bonds.

Banks do not include the positions of their customers in their own balance sheet. The securities, namely, are owned by the customers, and are therefore recognised on their own balance sheets. The situation is different for savings. Savings will be included in the bank balance sheet (liabilities side). This means the saver has a claim against the bank.

2.2.4 Investment advice and management services

The bank offers three types of services to consumers who (want to) invest:

- execution only;
- investment advice;
- asset management.

Execution Only

With the execution only service, the bank only handles the execution of the customer order. The bank carries out the investment transaction, for example the purchase of a particular share, without giving detailed advice to the customer beforehand. The bank is only liable for the proper execution of the order.

Investment Advice

The investment adviser will draw up a profile of the customer, whereby amongst other things he will take into account the objective of the investment, the investment horizon of the customer, and the risk that the customer is willing/able to take. The investment horizon is the length of the period over which the consumer wants to invest. The ultimate investment advice will of course also depend on the financial position and the knowledge/experience of the customer.

Example

Jelle wants to invest his savings over the next 10 years. His plan is to cash in his investments after 10 years, and then use the proceeds to finance his retirement. His investment horizon is therefore 10 years.

Based on the analysts' reports, the adviser can offer a selection of products that match the client profile.

Completely tailor-made, individual investment advice is not given very often. The compilation of this type of advice is very labour-intensive, and therefore expensive. The bank will only offer this type of service to wealthy clients.

In most cases, the investment adviser will limit the choice to a series of model portfolios compiled by the investment analyst. These model portfolios are classified according to their risk profile. The scale ranges from very defensive (risk-avoiding) to very offensive (risk-seeking). Based on the client profile, the adviser will try to find a suitable model portfolio.

If the investment capital is on the modest side, the bank will usually recommend the investment funds of the bank to the investor. These are off-the-shelf investment products that do not require any personal advice. The threshold amount that is applied in such cases differs from one bank to the other.

Asset Management

With the asset management service, a consumer asks the bank to manage his assets. This service is carried out on the basis of a management agreement. Under this agreement, the bank will be given certain authorities. For example, it will be able to independently carry out buying and selling orders for securities.

CHAPTER 3

Banks and the Payment System

Introduction

Banks fulfil three core functions in the Dutch economy. This chapter deals with the function of roviding a system fot the processign of national and international payment transactions. In order to fulfil these core functions, banks have to take certain risks.

3.1 Provision of payment services

Banks facilitate payment transactions by providing a system for the depositing, collection, and safe-keeping of cash currency and for the administrative processing of cashless payment orders from customers. By providing a system fot he handling of payment transactions, banks enhance the efficiency of the general economy. This is because it means consumers and businesses no longer have to exchange goods and services in kind. A well-organised payment system is therefore extremely important for the economy of a nation.

3.2 Banking services for the processing of payment transactions

Every consumer carries out numerous payment transactions every day. For example, they will buy bread rolls from the baker or pay for their lunch at the company canteen. Because the baker supplies the bread rolls, the consumer has to give something back in return. A sum of money is the generally accepted consideration. The consumer therefore has to have cash currency (coins, banknotes), electronic money (a VVV Gift Card), or cashless currency (a credit balance in a payment account), and be able to make payment in an efficient way. The bank plays an important role in this process.

3.2.1 Withdrawal and deposit of cash currency

The banks in the Netherlands do not play any role in cash currency transactions, but they do make it possible for consumers to withdraw cash from cashmachines or over-the-counter at a bank. This is called a cash withdrawal or a disposition. A cash withdrawal is a conversion of cashless currency into cash currency. The bank debits the amount withdrawn, namely, from the bank account of the customer, and pays the amount out in the form of banknotes. Banks also keep coins in stock, but these are mainly intended for businesses that need coins for change. These companies can withdraw coins over-the-counter or from a coin roll machine inside the bank.

The banks order coins from commercial coin suppliers and the banknotes from De Nederlandsche Bank (DNB). The supply of cash currency to banks and cash machines is outsourced to specialist security transport companies, such as Brinks and Group 4 Securicor (G4S). In order to provide their customers with an optimum service, the banks have to make sure they have enough cash currency in stock. However, they also have to make sure the amount of cash they keep on hand is not too great, because this would lead to

significant storage and security costs. Furthermore, cash currency does not generate any interest income for the bank.
Consumers can also deposit any surplus coins and banknotes they have with the bank. This is called a cash deposit. A cash deposit is a conversion of cash currency into cashless currency, because the deposited amount is credited to the bank account of the customer. Consumers can hand in their coins and banknotes over the counter or deposit them directly in a cash deposit machine. Cash deposits by consumers do not happen very often. Most deposits are made by shopkeepers who want to put their cash sales proceeds in the bank.

3.2.2 Organisation of cashless payment transactions

Banks manage the payment accounts of their customers. Furthermore, they also handle the settlement of cashless payment orders.

The payment account plays a pivotal role in the processing and settlement of cashless payment transactions. Consumers can use their payment account to make and receive cashless payments. The bank will send them a regular statement about the balance and about the outgoing and incoming payments in their account.
These are the three core functions associated with the payment account:

- making payments;
- receiving payments;
- bank statements.

Making payments

A consumer will usually send payment orders via the internet, for example using the online banking app of the bank. In exceptional cases, this can also be done via a paper payment order. The bank will then enter the orders it receives into its computer system. Any orders received on paper will be digitally scanned ('image processing' or 'imaging'). In the past, orders received by telephone were handled personally by a bank employee, but nowadays this can be done automatically by a bank computer using an option menu and by entering the order using a keypad or by voice. The orders are then entered directly into the computer system of the bank. The same applies for payment orders issued via internet banking using a computer or a smartphone.

When the bank receives the payment order, it will carry out an authenticity check and a bank balance check first. An authenticity check means the bank verifies the identity of the person issuing the order, and makes sure the person issuing the order is authorised to transfer money from the payment account. This is done by comparing the signature on written orders with a digital copy kept on file, or by making sure the order has the right code. A balance check means the bank will check to make sure the balance or credit limit of the account holder is sufficient to be able to carry out the order. The bank will only approve the order if both checks are successfully passed. It will debit the amount from the account (debit entry) and transfer the order.

Receiving payments

With incoming payment orders, the bank will credit the amount to the bank account (credit entry).

Bank statements

The bank of the payer and the bank of the receiver will inform their customers about the credit and debit entries that have taken place. An increasing number of account holders are also making use of the possibility to check their balance and account information using a computer or smartphone. In addition, it is still possible to get paper bank statements sent by post from most banks.

3.2.3 Settlement of payment orders

The exact procedure used to settle a payment order will depend on the banks involved with the order. There are separate categories for:

- intra-group transactions;
- interbank Euro payment transactions;
- interbank global payment transactions.

Intra-group transactions

With intra-group transactions, both the payer and the receiver have an account with the same bank. The bank can carry out the settlement of the payment, both the debiting from the one account and the crediting to the other account, internally. The money is therefore moved from one place to another within the bank. If an account holder has a payment account and a savings account with the same bank, any transfers between the payment account and the savings account are also classified as intra-group transactions.

Interbank Euro payment transactions

With interbank transactions, the payer and the receiver have an account with two different banks. Because millions of payment orders from consumers and businesses have to be settled between European banks every day, clearing institutions (automated payment processing exchanges) have been set up in all European countries, so-called Pan-European Clearing Houses, or PE-ACHs. These clearing institutions process the payment orders between the affiliated banks quickly and efficiently. In the past, clearing institutions only handled national payment orders, but nowadays clearing institutions within the Eurozone can also process payments from other Euro countries as well.

In the Netherlands, the interbank clearing institution EquensWorldline plays a major role in this process. The affiliated banks pass on payment orders from their account holders, for transactions to account holders with other banks, to EquensWorldline. EquensWorldline collects, sorts, and bundles the information about outgoing and incoming payment orders for each bank. This payment data processing is called clearing.

Once clearing has been completed, a settlement takes place between the banks. EquensWorldline uses the outgoing and incoming payment orders to calculate the net amounts the banks owe each other, and sends a file (batch) with details of the interbank payment obligations to TARGET2 roughly once every half hour. TARGET2 is a collective settlement system for Euro payments. All of the banks in the Euro countries plus a number of non-Euro countries are affiliated to this system. The Dutch banks have a special account with the DNB for settlement in TARGET2.
Within the European Union, there are 19 countries which have the Euro as the single currency. This means Dutch consumers can use the same Euro coins and banknotes to make payments in all of these countries as well as in the Netherlands.

Interbank global payment transactions

For payment transactions that are not in Euros, banks use their network of correspondent banks. For a payment in USD dollars (USD) from the Netherlands to the United States of America, for example, the bank of a Dutch customer will have to contact an American bank where it has a USD account. This American bank, also referred to as the correspondent bank, will in turn make sure that the payment reaches the bank of the beneficiary via the local clearing house. This is a time-consuming and expensive process.

The USD account is also referred to by the Dutch bank as the "nostro account" ('nostro' is Italian for 'our'). Conversely, an American bank can have a Euro account with a bank in the Netherlands. This is referred to by the Dutch bank as a "loro account" ('loro' is Italian for 'their'). A bank will handle the management of its nostro accounts itself, but the correspondent bank will carry out the actual transfers and provide the payment information.

CHAPTER 4

The Bank Balance Sheet

Introduction
The balance sheet of a bank is a statement of the assets and liabilities of the bank. This only concerns the transformation function. Payment transaction services and intermediary services are therefore not shown on the balance sheet.

4.1 The bank balance sheet

Financial reporting is an important subject for banks. In light of the enormous social responsibility that rests upon the shoulders of banks, accurate information about the financial position of a bank is indispensable for all the parties involved. Openness and transparency help foster long-term confidence in a bank. Moreover, complete, transparent, and clear financial information is also essential for the daily management and direction of a bank. One of the reporting tools used by banks is the balance sheet. The balance sheet of a bank is a statement that shows the value of all the assets (possessions) and liabilities (commitments), and the size of the equity at a particular point in time. The main liabilities are the funds, including savings, that have been entrusted to the bank by the public. The main assets are the credit portfolio and the investments.

The bank has temporarily borrowed the savings and will have to pay the savings back to the saver (on request). These savings are therefore recognised as a debt obligation on the liabilities side of the bank balance sheet.

Assets	Liabilities	
	Entrusted funds	
	Balance savings accounts	10,000
Total	Total	

Figure 1 The deposited savings and the bank balance sheet: the savings business (amounts in million Euros)

The activities on the liabilities side of the bank balance sheet are also collectively referred to as the liabilities business of the bank. In this context, the word 'business' means: all processes and operations carried out by all the different departments within the bank in connection with a certain function of the bank. Examples of the liabilities business include credit facilities and savings accounts.
The bank has to return the entrusted savings to the customer on request. From the bank's perspective, the saver is a creditor. That is why the bank refers to the interest it pays to the saver as the credit interest.

The money that has been lent out as credit belongs to the bank; the credit business is therefore recognised on the assets side of the bank balance sheet. The credit business is also referred to as the assets business.

Assets	Liabilities
Credit provided: Consumer credit 1,400 Mortgage credit 10,500 Total	 Total

Figure 2 Credit provision and the bank balance sheet: the credit business/assets business (amounts in million Euros)

The following table shows the four core activities of the bank as recognised in a complete bank balance sheet. This has been created by combining the two previous tables.

Assets		Liabilities	
Cash funds Credit provided: Consumer credit Mortgage credit	100 1,400 10,500	Entrusted funds: Balance payment accounts Balance saving accounts Equity	 1,000 10,000 1,000
Total	12,000		12,000

Figure 3 The four core activities and the bank balance sheet (amounts in million Euros)

The items Cash Funds and Balance Payment Accounts come from the payment transaction business. The item Credit Provided is from the credit business. The item Balance Savings Accounts is from the savings business.

The intermediary business is not recognised as a separate item on the bank balance sheet. Advisory and intermediary services do not have any consequences for the assets or liabilities of the bank. The concrete activities, such as the purchase or sale of shares, are only carried out on behalf of the customers. The actual share ownership is therefore recognised on the personal balance sheet of the customer and not on the balance sheet of the bank.

The above table shows that the bank has enough assets to cover its liabilities; the bank is thus in a position to fulfil its payment obligations (is 'solvent'). However, it also shows that the bank does not have sufficient cash funds at hand (is not 'liquid') Whereas the funds entrusted can mostly be withdrawn on demand, the assets of the bank can only be liquidated over a certain period of time. If the customers suddenly withdrew € 100 million in savings, which is less than 1% of the money that has been deposited, then there would be no cash funds left over. However, banks are obligated to take measures so they can survive a so-called "bank run".

The bank balance sheet in the following table is more detailed and therefore more realistic. The assets side has been expanded to include the items Securities and Real Estate. This means the assets now include investments that can be liquidated easily. The item Credit Provided has been reduced by the same amount. This bank can therefore cover withdrawals of up to € 1 billion in savings without too much difficulty.

Assets		**Liabilities**	
Cash funds Credit provided: Consumer credit Mortgage credit Securities Real estate	100 1,000 10,000 600 300	Entrusted funds: Balance payment accounts Balance saving accounts Equity	 1,000 10,000 1,000
Total	12,000	Total	12,000

Figure 4 Balance sheet of a solvent and liquid bank (amounts in million Euros)

CHAPTER 5

Mortgage Applications

Introduction

For many people, buying a home is one of the most important financial decisions of their life. After all, a home costs a lot of money. And the consumer usually does not have enough money of their own to buy a home outright. A mortgage loan can then provide a solution.

With a mortgage loan, the value of the property serves as collateral for the loan. A mortgage adviser can help consumers to choose the right mortgage product and to apply for the right mortgage loan. The adviser will assess the financial position of the applicant and make a suitable offer for a mortgage loan.

5.1 Mortgage loans

A mortgage loan is similar in many ways to a consumer loan. In most cases mortgage loans are for larger amounts and therefore have a longer term. The biggest difference with a consumer loan is the provision of collateral as security. Because the home serves as the collateral for the repayment of the mortgage loan, if the loan is not repaid the home can be sold and the proceeds used to cover the outstanding amount.

If a consumer wants to buy a home, they will usually need to take out a loan in order to finance the purchase. This is because most people do not have enough capital of their own to purchase a home outright. A mortgage loan can then provide a solution. The interest rates charged for a mortgage loan, namely, are usually lower than those charged for a consumer loan.

A mortgage adviser will ask the borrower to provide certain information when they apply for a mortgage. The approval of the mortgage application by the lender will in principle depend on two factors:
the value of the home;
the financial situation of the borrower.

5.1.1 Value of a home

The value of the property will serve as collateral for the loan. The credit provider (lender) will therefore want to know how much the property is worth. A valuation report drawn up by an estate agent and valuer provides a sound basis for this.

The valuation report will cover three value concepts:

- market value;
- foreclosure sale value;
- reinstatement value.

Market value

The private sale value (open market sale value or market value) is the value of the home under normal commercial trading conditions. In other words: in its current condition, vacant, and unlet. If the home was sold at the time when the valuation was carried out, then the purchase price would probably be more or less the same as this value.
The market value will be decisive for the maximum limit of the loan. Statutory regulations were introduced in 2013 whereby the maximum limit of the loan is linked to the market value of the property. In 2013, the maximum amount of a loan was limited to 105% of the market value. In 2014, this was reduced to 104%, in 2015 to 103%, and so on. The limit was reduced by 1% a year until it was finally fixed at 100% of the market value in 2018. This measure is intended to prevent borrowers from becoming overextended or overindebted. The ratio between the amount of the loan and the market value of the property is known as the mortgage-granting criterion.

Foreclosure sale value

The foreclosure sale value is an estimate of the proceeds resulting from the forced sale of the property in a public auction. This is the amount that the lender can expect to get if it enforces the security (sells the home). Because a forced sale will lower the purchase price, the foreclosure sale value will be lower than the private sale value. The foreclosure sale value is usually around 80% to 90% of the market value.

If the borrower fails to pay the interest and the agreed repayment instalments, as a last resort the credit provider can execute a forced sale (or foreclosure sale) of the property. This always takes place in an auction.

Reinstatement value

The reinstatement value is an estimate of the construction cost if the home has to be rebuilt after total destruction, for example as the result of a fire. The reinstatement value only concerns the home itself, and not the land it is built on, and it is important for the insurance of the building (buildings insurance).

5.1.2 Financial situation of the borrower

The credit provider will want to know more about the creditworthiness of the borrower. In this way it can make sure the borrower does not take on a bigger debt than he can afford to pay off. The credit provider will want to know how much the borrower earns, what assets the borrower already has, and if the borrower has any other ongoing commitments, such as spousal or child support or other loans. The income level of the borrower, and where relevant their partner, is an important factor. Furthermore, the stability of this income is also important. Does the borrower have a permanent job or a temporary job, or is he perhaps self-employed?

The borrower will have to provide documents to confirm his income level. A person who has a paid job will have to provide a statement from their employer and a recent payslip. A self-employed person can provide evidence for their income in the form of financial statements and tax returns.

Income

Is the income of the borrower high enough to be able to pay off the requested loan? This question is answered on the basis of the so-called “front-end ratio”, also referred to as the mortgage-to-gross-income ratio. With the front-end ratio system, the loan financing charges must not exceed a certain percentage of the gross income. This percentage (the front-end ratio) is calculated based on the income level and the applicable mortgage interest rate. The maximum amount that is available each year to pay off the loan is called the maximum financing charge. This is calculated by multiplying the income by the front-end ratio. The result is then divided by 12, and this is the maximum amount that is available each month to pay off the mortgage charges.

Ongoing financial obligations

The calculation of the front-end ratio has to take into account the average fixed living expenses. Extraordinary fixed expenses also have to be deducted from the available amount. If the fixed expenses include an ongoing loan, this will be deducted from the maximum financing charges. Any spousal support that is owed to an ex-partner will be deducted from the income before the front-end ratio is calculated. This does not apply in the case of child support. An existing loan will not be included in the calculation if it will be repaid with the new loan being taken out.

Example

The mortgage applicant has a gross annual income of € 40,000. For this income and at the applicable mortgage rate, the front-end ratio might be 30%. The fixed expenses associated with an ongoing consumer loan amount to € 2,400 per year. The maximum annual financing charges will therefore be € 9,600 (€ 40,000 x 0.30 = € 12,000 - € 2,400 = € 9,600), or € 800 per month.

The bank will check to see if a borrower has ongoing financing obligations amongst other things by consulting the registers of the Bureau for Credit Registration (BKR). A check with the BKR is part of the statutory obligation to collect sufficient information about the customer.

BKR registers a whole range of different types of credit provided to consumers. The information filed by lenders is also used to register any irregularities, such as payment arrears. This will give a potential credit provider insight into the payment history of the credit applicant. Borrowers who have had a poor payment history in the past will find it difficult to get new credit.

Mortgage loans for the purpose of buying a private home, however, are not automatically registered with the BKR. The loan will only be registered if there are payment arrears in excess of 120 days.

5.1.3 National Mortgage Guarantee

A consumer taking out a mortgage can apply for a national mortgage guarantee under the National Mortgage Guarantee Scheme (NHG). The NHG is operated by the Homeownership Guarantee Fund (WEW). If the borrower runs into financial difficulties and is unable to fulfil his payment obligations, the guarantee provided by the NHG means the credit provider will be guaranteed to get its money back. The WEW will pay the credit provider the residual debt that remains, where relevant after a forced sale of the home. This extra security for the lender means mortgage loans with an NHG guarantee have a lower interest rate. However, a one-off commission is charged for the NHG guarantee of 1.0% (2018) of the principal of the loan.

The NHG guarantee applies up to a certain maximum amount and is subject to certain conditions. Consumers who want to be eligible for an NHG guarantee are subject to a maximum financing charge percentage. This percentage will depend on the income level and the mortgage rate.

A mortgage with an NHG guarantee can be obtained for the purchase of existing homes and newbuild homes. In both cases, however, the cost of acquiring the ownership of the property must not exceed € 265,000 (2018). For homes where there will be investment in energy-saving measures, the NHG cost limit is € 280,900.

5.1.4 Credit offer

The lender or the adviser will draw up a credit offer on the basis of the information that has been provided, which will include the following details: the term of the loan, any additional costs, the interest rate, the interest term, and the method of repayment. The general loan conditions will usually be set out in an appendix to the credit offer

Since 2013, a ban on commission has been in effect. This means mortgage credit providers are not allowed to pay commissions to the mortgage advisers. The consumer has to pay the fee for the advice directly to the adviser. Before 2013, this fee was factored into the interest and the charges for the mortgage loan.

CHAPTER 6

Mortgage loans and repayment options

Introduction

Agreements are set out in the loan deed about the term of the loan, the amount of interest charged on the loan and the period it will be charged over, and the way in which the loan will be repaid.

The rules on the tax relief for interest on mortgage loans were changed at the start of 2013. For new mortgages taken out after this date, the mortgage interest relief can only be claimed if the loan is repaid on a straight-line or annuity basis during the term of the loan. The mortgage interest relief has thus been abolished for new interest-only mortgages and mortgages that are repaid on the basis of a life insurance policy, investments, or a savings account.

The mortgage interest relief can still be claimed for mortgage loans taken out before 1 January 2013. This also applies up to the original amount of loans that are remortgaged.

6.1 Deed of loan

The borrower can decide to accept the offer in the quotation. In the meantime, the lender will check the information that has been provided, and once it has been verified the loan can go ahead. A loan agreement will then be drawn up. The loan agreement (deed of loan) between the lender and the borrower will regulate the following issues:

- the amount and the term of the loan;
- the interest and fixed-interest period;
- the form of repayment.

6.2 The amount and the term of the loan

The amount is usually set in advance based on how much money is required and what the borrower can afford to lend. The usual term of a mortgage loan is 30 years. However, shorter and longer terms are also possible. With a shorter term, the borrower has to make the repayments over a shorter period, which means the average monthly charges are usually higher.

6.2.1 The interest and fixed-interest period

The borrower does not have to agree to a fixed interest rate for a period of 30 years. A fixed-interest period can be agreed of 1, 5, 10, 15, or 20 years. Generally speaking, the interest rate is higher for longer fixed-interest periods than for shorter periods. Some mortgage products have an interest rate reflection period. During this reflection period, the consumer can decide how long they want the fixed-interest period to be.

Borrowers can opt for variable interest if they want to, but this is not so common. The interest charged by the credit provider will then go up and down in line with the prevailing interest rate. This might be a sensible option if the interest rate is very high when the mortgage is taken out, especially if the interest rate is expected to go down in the future. If the market rate of interest falls, the consumer can then decide to fix the interest rate for a number of years.

The length of the fixed-interest period chosen by the borrower will not only depend on the prevailing interest rate at that time. The financial position and the profile of the consumer will also play an important role when it comes to making the right choice. If a consumer wants to have the security that his living expenses will remain at the same level over a long period, then a long fixed-interest period would be the most sensible option. If the size of the living expenses is not a major issue for the consumer, then he can opt for a shorter fixed-interest period.

At the end of the fixed-interest period, the borrower can agree a new fixed-interest period. If the interest rate has gone up by that time, then his mortgage charges will also go up. If the interest rate has gone down, then so will the mortgage charges.

6.2.2 Types of mortage repayment

Over the years, the providers of mortgage loans have introduced a whole range of different repayment types onto the market. The different forms of repayment can be categorised based on the moment when the repayment takes place:

- periodically during the term;
- in a lump sum at the end of the term;
- interest-only repayment.

Periodical repayment during the term

With some forms of repayment, the borrower pays the loan back in regular instalments, for example every month. This happens with straight-line mortgages and annuity mortgages.

- **Straight-line mortgages**

With a straight-line repayment mortgage, the borrower pays back the loan in the equal instalments. For a loan with a term of 30 years, for example, he will have to repay 1/360 of the loan each month. The outstanding debt will thus be reduced at a constant rate.

The borrower pays the outstanding interest on the residual debt. Because the residual debt will gradually get smaller, so will the interest charges. The straight-line the form of repayment has higher charges at the start of the term. But as time goes by, and more and more repayments have been made, the straight-line form of repayment will gradually get cheaper.

- **Annuity mortgages**

With annuity mortgages, the gross instalment amount will remain the same throughout the entire term, and so will the interest. The initial instalments will primarily consist of interest and only a small amount of loan repayment. As time goes by, the ratio between repayment/interest in the instalment amount will change. The borrower will gradually make higher repayments and pay less interest.

In the initial stages, an annuity mortgage is repaid at a slower rate than a straight-line mortgage. Compared to a similar straight-line mortgage, the borrower will pay interest for a longer period over a higher residual debt.

Lump sum repayment at the end of the term

With a lump sum repayment at the end of the term, the principal of the loan remains the same throughout the entire term. The borrower thus continues to pay interest on the total principal. As long as the interest rate does not change, the interest charges will also remain the same.

As time goes by, the borrower accumulates enough capital during the term in order to be able to make a lump sum repayment at the end of the term. In many cases, the tax department will grant a tax allowance for the accumulation of this capital. This means the borrower can accumulate this capital tax-free with a mortgage repayment endowment insurance policy (KEW), in a mortgage repayment savings account (SEW), or in a mortgage repayment investment account (BEW). The tax allowance is subject to certain conditions, and only applies up to a certain maximum limit.

Up until 2013, these products had certain tax benefits. The mortgage interest over the whole principal during the whole term was tax-deductible, and the accrual and pay out of the KEW, SEW or BEW was tax-exempt.

Although these tax benefits have been abolished for new loans, they still apply for loans taken out before 2013. The main conditions for the tax relief for this type of capital accrual are the blocking of access to the capital during the accrual, and that this capital must be exclusively used for the repayment of the home acquisition debt (mortgage debt).

There are three types of mortgages where the borrower repays the mortgage debt at the end of the term: the endowment mortgage, the savings-based mortgage, and the investment-based mortgage. With interest-only mortgages, a repayment will often also have to be made at the end of the term, but not always. This will depend on the agreements made between the lender and the borrower about this issue.

- **Endowment mortgages**

With a traditional endowment mortgage, the consumer accrues capital via a life insurance policy, which he can then use to pay off the loan at the maturity date. The life insurance is usually a so-called "combined endowment insurance policy". This means the insurance will be paid out both in the event of premature death and on the maturity date. This insured value of this insurance is calculated based on a notional interest rate.

However, a borrower will generally get a return that is much higher than this. The calculations are therefore based on a higher expected return, the prognosis return. Although the final capital can exceed the prognosis, it can also be less than expected. This is a risk the borrower will have to take.

Tax relief for an endowment mortgage was only granted up until 2013 if the mortgage was taken out with a mortgage repayment endowment insurance policy (KEW).

- **Savings-based mortgages**

A savings-based mortgage is similar to an endowment mortgage. The return on a savings-based mortgage (in this case the interest on savings) is equal to the mortgage interest rate. This means the borrower knows in advance exactly how much he needs to save in order to be able to repay the loan at the end of the term. If the mortgage rate is high, then he will have to pay relatively little at the end, because the interest on savings will also be high. If the mortgage rate is low, then the opposite will be the case: the interest on savings will be low, and the borrower will therefore have to save more to be able to pay the same final amount back at the end.

One advantage of a savings-based mortgage is that it limits the impact of any interim fluctuations in the interest rate. If the interest rate is high in a new fixed-interest period, this will be partly compensated for by the higher interest on savings, which means the savings contributions can be lower.
Tax relief can be granted for a savings-based mortgage taken out with a mortgage repayment endowment insurance policy (KEW) or with a mortgage repayment savings account (SEW). The KEW policy is a combined endowment insurance policy, which means the death risk is automatically insured as well. With the SEW savings account, separate life insurance can be taken out to cover the risk of death.

- **Investment-based mortgages**

The investment-based mortgage is also similar to the endowment mortgage. However, in this case the contributions of the borrower are not saved, but invested. There are various types of investment-based mortgages. In all cases, though, investment is carried out for the account and risk of the borrower, and the final capital will depend on the investment results achieved.

There are investment-based mortgages in the form of an endowment insurance policy, within which investment is carried out, or with an investment account where the borrower accrues capital in the form of securities. The latter type are usually referred to as securities-based mortgages.

Tax relief can be granted for an investment-based mortgage taken out with a mortgage repayment endowment insurance policy (KEW) or with a mortgage repayment savings account (BEW). The KEW policy is often a combined endowment insurance policy, which means the death risk is usually insured as well. With the BEW savings account, separate life insurance can be taken out to cover the risk of death.

- **Interest-only mortgage**

The term interest-only mortgage is strictly speaking not actually correct. The borrower also repays the loan at the end of the term as well with this type of mortgage. With this type of product, however, capital is not accrued for repayment during the term, as is the case with savings-based and endowment mortgages.

An interest-only mortgage will often only be repaid out of the proceeds from the sale of the home, for example in the event of the death of the borrower. The loan can also be repaid at the end of the term with a new (interest-only) loan.

CHAPTER 7

Mortgage Rights

Introduction

With a mortgage loan, the value of the property provides the lender with security for the repayment of the loan. This security is called a right of mortgage. If the borrower does not fulfil his financial obligations, the lender can sell the home. The right of mortgage is a real right that is registered with the land registry office.

7.1 Mortgage rights

The difference between a normal loan and a mortgage loan is the right of mortgage security that is provided. The provision of mortgage security means the following: the person who has been given the mortgage security, the mortgagee, has the priority to recover a claim from the proceeds of the sale of the registered property encumbered with the mortgage that belongs to the person who has given the mortgage security, the mortgager.

The terms used in this description can be defined as follows:

- Registered property is an object that is registered in a public register, such as a home.
- The claim is the outstanding debt of the mortgager (the borrower) to the mortgagee (the lender). The mortgager gives the right of mortgage to the mortgagee.
- The recovery of the claim from the proceeds of the sale of the registered property is also referred to as the enforcement of a right of mortgage.

The most important feature of mortgage security is the aspect of 'priority'. If the mortgager (the borrower) is in arrears with the payment of interest and repayment instalments, the mortgagee (the lender) can decide to foreclose on the loan, in other words demand the forced sale of the home. The mortgagee will have priority to the proceeds of the sale over any other creditors. This feature means the right of mortgage provides real security to the lender.

Before the credit provider can exercise the right of mortgage, it has to demonstrate that the lender is in arrears with the payment of interest and repayment instalments. If the borrower has fulfilled all the interest and repayment obligations, the credit provider will not be allowed to enforce the right of mortgage.

Lenders will often try to find other ways to persuade the borrower to make repayments first, because the forced sale of a home will have far-reaching consequences for the borrower. Furthermore, the proceeds of a forced sale might not be sufficient to cover the outstanding claim or debt.

7.1.1 Types of mortgage

There are three types of mortgage loans:

- fixed-rate mortgages;
- revolving mortgages;
- bank mortgages.

Fixed-rate mortgages

The consumer takes out a loan and gives the credit provider a right of mortgage as security for the loan. The value of a fixed-rate mortgage is always the same as the outstanding debt. The mortgage deed, the notarial agreement which establishes the right of mortgage, will contain a repayment schedule. With this type of mortgage, the loan agreement is included (integrated) in the mortgage deed. The value of the mortgage will consequently go down by the amount the consumer repays during the term of the agreement. At the end of the term, when the loan has been completely repaid, the right of mortgage will no longer have any value. However, in order to terminate the right mortgage, formal cancellation has to take place. The procedure for this is described hereafter. With this type of mortgage, the repayments that have already been made cannot be drawn again. The fixed-rate mortgage has gone out of fashion in recent years.

Revolving mortgages

With a revolving mortgage, the consumer can provide a right of mortgage on his home independently of any loan. This type of mortgage, also referred to as a current-account credit facility with mortgage security, is primarily used as security for current-account credit facilities. This is a credit facility that the consumer can draw on up to a predetermined maximum debit balance (limit).

The mortgage deed does not contain a repayment schedule in this case, and the right of mortgage will simply continue to exist until the credit facility has been completely repaid; it is also possible for a new credit facility to be secured by the same right mortgage. The interest rate, the repayment schedule, and the other conditions are set out in a separate loan agreement.

The borrower can continue to draw funds from the current account up to the limit. With a fixed-rate mortgage, once the loan has been repaid, the credit provider will have to establish a new right of mortgage. A revolving mortgage overcomes this problem.

Bank mortgages

The bank mortgage is a mortgage that is linked to all the claims that the credit provider has against the borrower, such as an overdraft on a payment account or a continuous credit facility. The bank mortgage therefore serves as security for the payment of all the claims that the credit provider has against the borrower. Nowadays, within the mortgage business credit providers primarily use bank mortgages.

7.1.2 Establishment of mortgage rights

A mortgage right is established through the registration of a notarial mortgage deed in the registers of the land registry office. A notarial deed has the advantage that this eliminates any uncertainty about what has been agreed between the parties, and makes it easy to prove the exact details of the agreement.

The mortgage deed describes the home or property (collateral), the claim (debt), and the conditions that are applicable. The loan agreement is the actual credit agreement. This details how much the buyer is borrowing, the interest rate, the fixed-interest period, and the repayment conditions. For a fixed-rate mortgage, the mortgage deed and the loan agreement are combined in a single document. The involvement of a civil-law notary is not required for the loan agreement.

The parties involved sign the mortgage deed and where relevant the separate loan agreement. The civil-law notary will send a copy of the mortgage deed to the mortgage register of the land registry office. The right of mortgage will be established as soon as it is registered. The civil-law notary will pay the principal sum of the loan provided by the lender, together with any money contributed personally by the buyer of the property, to the seller of the property.

The registration of the mortgage deed in the public registers has amongst other things the advantage that everyone can see whether a right of mortgage has been established on a property. That is crucial information for a credit provider who wants to be given security for a loan. It means a credit provider can check to see if a right of mortgage has already been established on the property.

If a mortgage right is established for the financing of a recently-purchase home, the civil-law notary will usually carry out two formal procedures: the transfer of title to the property and the establishment of the mortgage right. A mortgage can also be established for other purposes, for example to finance renovation or rebuilding work on a home. In that case, of course, no transfer of title will need to take place.
The sequence of the formal procedures described above is important, namely first the transfer of title or ownership and then the establishment of a mortgage right, because only the owner of a home can establish a mortgage right on his home. First of all the civil-law notary will execute the deed of transfer, which will transfer the ownership of the home from one person to the other. Then the civil-law notary will execute the mortgage deed, which will establish the right of mortgage.

Only after these deeds have been registered in the public registers will the borrower become the owner of the home and/or the mortgager. The involvement of the civil-law notary in both the transfer of ownership of a home and the establishment of a mortgage is moreover compulsory under the law.

Order of priority

If more than one mortgage has been taken out on a home, then the date of registration will determine the order of priority. The mortgage that was registered first is called the first mortgage, the second one is called the second mortgage, and so on. The order of registration will be decisive for the division of any proceeds from a foreclosure sale. The holder of the first mortgage will be able to recover its claim from these proceeds first. If there is still any money left over, then the holder of the second mortgage will be able to recover its claim from the remaining proceeds, and so on.

Cancellation

The right of mortgage vested on the property has to be 'released' as soon as the borrower has repaid the loan, or if the credit provider decides to terminate the right of mortgage for some other reason after consultation with the borrower. This formality is known as cancellation. The cancellation can only be effected with a notarial deed. The civil-law notary has to draw up a cancellation deed for this, which then has to be filed with the land registry office. The land registry office will then cancel the registration of the mortgage right.

CHAPTER 8

Taxation and Home Ownership

Introduction

Tax incentives are given to encourage home ownership. The value of the home is not included in "box 3" (income from savings and investments). Subject to certain conditions, the interest paid on the mortgage loan can be deducted from the income in "box 1". However, home ownership also has certain advantages (the owner does not have to pay any rent). Accordingly, this benefit of home ownership is taxed based on the notional rental value of the property.

8.1 Taxation aspects of home ownership

The Tax Department has a separate status for the ownership and financing of a private home. A private home is defined as an owner-occupied home that is the main residence of the taxpayer. The benefit derived from home ownership is treated as taxable income for the purposes of income tax. On the other hand, certain expenses associated with home ownership are tax-deductible for the home owner. This is also known as mortgage interest tax relief.

In addition to paying income tax, the owner of a home also has to pay property tax (OZB). This is a municipal tax levied on the ownership of real estate, such as a home. The value of the property, as defined in the Valuation of Immovable Property Act (WOZ), also referred to as the WOZ value, is set annually by the municipality, and this is used to calculate the amount of property tax. The WOZ tax rate varies from one municipality to the other.

The WOZ value will be the same as the market value of the home on the reference date. The reference date will be one year before the start of the year for which the value is set. This means that the WOZ value will in principle be the same as the market value on 1 January of the previous calendar year. The WOZ value for the year 2016 will therefore be the same as the market value on 1 January 2015.

8.1.1 Notional rental value

The Tax Department works on the assumption that a homeowner will derive certain financial benefits from their home ownership. For example, the homeowner does not have to pay any rent. A formula is used to calculate the financial benefit of the home ownership, and this is treated as taxable income which the homeowner has to pay income tax on. This additional taxable income is called the notional rental value. The amount of the taxable benefit will depend on the WOZ value. The higher the WOZ value, namely, the higher the percentage. In 2018, the lowest percentage was 0.25% and the highest percentage was 2.35%.

8.1.2 Tax-deductible expenses

The homeowner is allowed to deduct certain expenses from their taxable income that are associated with debts incurred in connection with the purchase, improvement, or maintenance of their private home. The money that has been borrowed must therefore have been spent on the private home. This is referred to by the tax department as home acquisition debt. In order for the expenses to be tax-deductible, the loan does not necessarily have to be a mortgage loan.

The following costs are tax-deductible:

- interest paid on the loan;
- signing fee paid for the loan;
- valuation costs in connection with the loan;
- costs of the National Mortgage Guarantee Scheme;
- civil-law notary fees for the mortgage deed;
- cost of registration of the mortgage deed with the land registry office;
- periodical leasehold charges (fee for the right to use the land which the home is built on); Penalty interest charged for transferring or switching a mortgage.

8.2 Repayment of home acquisition debt

Since 1 January 2013, any new loans deemed to be a home acquisition debt have to be repaid in full within a maximum of 30 years. The type of repayment must at least be on a decreasing term basis, but it may also take place on a straight-line basis. The amount that the homeowner has to repay each year has to be agreed when the loan is taken out. The Tax Department will check at the end of each year to make sure the repayments have reduced the loan to a certain amount. If this is not the case in any particular year, then the homeowner will be given one more year to make up the shortfall. If this does not happen, then the loan will be treated as income in “box 3” and the tax allowance will be withdrawn. However, an exception can be allowed if the homeowner has difficulty making the repayments.

CHAPTER 9

Credit Agreements

Introduction

A credit agreement between a consumer and a credit provider (lender) regulates all the arrangements that form the basis of a consumer credit facility.

This agreement regulates amongst other things the following subjects:

- credit sum and credit limit;
- contract amount;
- term;
- repayment instalment amount;
- rules for early repayment;
- default;
- credit charges;
- credit rates.

9.1 Credit sum and credit limit

The amount of the loan will be specified in the credit agreement. This credit sum is the amount that the consumer will borrow and have to pay back. The credit provider will not deduct any charges from the credit sum, such as a signing fee.

With some credit facilities, the consumer can make interim credit repayments or draw additional amounts. This means the credit sum is variable. In such cases, the credit limit will be specified in the credit agreement. This is the maximum amount that the consumer will be allowed to borrow.

The credit limit or the credit sum is also referred as the total credit amount.

9.2 Contract amount

The contract amount will be specified in the credit agreement (the total amount to be paid or the total credit amount). This amount includes both the credit sum and the credit fee. The credit fee is also referred as the 'total cost of the credit'. The consumer has to repay this total amount to the credit provider.

9.3 Term

The term of the loan will be specified in the credit agreement. The term is the period between the commencement date and the expiry date of the credit agreement. The term, usually expressed in whole months, is rarely longer than 72 months.

With some credit facilities, the consumer can make extra interim credit repayments or draw additional amounts. Nonetheless, a specific term always has to be agreed to start off with. This theoretical term and the repayment schedule, however, will change in practice when extra repayments and withdrawals are made.

9.4 Repayment instalment amount

The consumer will pay the credit back in regular instalments (often monthly). The monthly instalment specified in the credit agreement is the amount that the consumer will have to pay back to the credit provider each month.
The monthly instalment almost always consists of two components: the credit repayment and the credit charges. The instalment amounts can be calculated based on the credit limit or based on the outstanding debt. In the first case, the amount of the monthly instalments will remain constant, although the ratio between the two components will change over time. At the start of the term, the monthly instalment will mainly consist of the credit fee and only a small part will be repayments. This ratio will gradually change throughout the term, so that the credit fee component gets smaller and the repayment component gets larger. If the instalments are calculated based on the outstanding debt, the monthly instalments will be variable because the outstanding debt will change over time.

9.5 Rules for early repayment

The consumer has the right to repay the loan earlier than has been agreed in the credit agreement. One reason why this often happens is because the consumer can get a better rate from a different credit provider. A better rate will mean lower monthly instalments, which can act as an incentive for consumers to switch to a different credit provider. This is called transferring or switching.

If the loan is repaid earlier than agreed, then the original credit provider will not get all of the agreed credit fee. Credit providers will therefore charge a penalty fee in the event of early repayment for a non-revolving credit facility. However, on the other hand this is usually accompanied by a partial refund of the credit charges. This is also referred to as an interest refund.

9.6 Default

The legal concept of default means the consumer has failed to fulfil the conditions set out in the credit agreement. In the case of consumer credit, this usually means there are payment arrears. In other words, the consumer has not paid the monthly instalments on time, or not paid them at all. The credit agreement will describe what constitutes default, and what the credit provider will do in such cases. This subject will be discussed in more detail later on in this chapter.

9.7 Credit charges

The consumer has to pay a fee to the credit provider for the provision of the loan. The credit fee (interest) will be specified in the credit agreement. This charge is the nominal credit interest rate. The credit provider will usually charge this as a percentage per year, but monthly rates are also fairly common. If a consumer repays the loan in accordance with an agreed schedule (non-revolving credit), then the agreement will specify the amount of the fee in Euros for the entire term of the loan.

The credit provider will factor a number of components into the credit charges or the annual percentage rate of charge:

- interest costs incurred by the credit provider in order to raise the money;

- overheads of the credit provider, such as marketing, office expenses, and personnel;
- commission paid by the credit provider to an agent;
- surcharge for the credit risk;
- profit margin.

9.8 Credit rates

The credit rate specified in the loan agreement is the percentage of the limit, the credit sum, or the outstanding debt, that the customer pays as a fee to the credit provider. The cost of credit is therefore calculated based on the credit rate. This is usually a certain percentage per month.

The effective credit rate or debit interest rate is a figure that can be used to compare the credit offerings of the different credit providers. The effective credit rate is somewhat higher than the nominal interest rate. The effective credit rate takes into account, namely, the fact that the consumer is not going to pay the credit fee in one go, but at the end of each year, or per month. If the consumer pays the credit fee before the end of the term, then the credit provider will lose interest earnings on the outstanding amount. The credit fee for January would thus be paid 11 months too early, and the fee for February 10 months too early, and so on.

CHAPTER 10

Types of Consumer Credit

Introduction

A consumer can choose between various types of credit facilities. He can go to an adviser for advice, who will then recommend a suitable type of credit. If, for example, the consumer wants to have the certainty that the loan will be repaid within a certain timeframe, then a non-revolving credit facility would be most suitable. If, on the other hand, he wants to be able to draw and repay the credit flexibly, then a continuous credit facility might be more suitable.

The three most important types of consumer credit are:

- non-revolving credit;
- continuous credit;
- current-account credit.

10.1 Non-revolving credit

With a non-revolving credit facility, the consumer repays the loan within the term of the credit agreement in accordance with an agreed repayment schedule. Any amounts that are repaid cannot be drawn again.

There are two forms of non-revolving credit:

- non-revolving cash credit;
- non-revolving purchase financing.

10.1.1 Non-revolving cash credit

With non-revolving cash credit, the credit sum is paid into the bank account of the consumer. The consumer can then spend this money however they want to. An example of non-revolving cash credit is a personal loan.

In some cases the credit provider might want extra security. It can then impose the condition that the consumer has to give a so-called “non-possessory right of pledge” on the goods that are purchased with the credit.

Explanation

With ordinary or possessory pledge, the pledgor transfers an object as security to the pledgee. This means that the pledgee, in this case the credit provider, can sell the security object, and use the proceeds to repay the debt, if the pledgor (the borrower) defaults on the loan. With possessory pledge, the security object is thus beyond the control of the pledgor, and if the loan has been used to buy a car, for example, then the car will be taken away from him.
With non-possessory pledge, the security object remains under the control of the pledgor, but if the pledgor defaults on the loan, the pledgee can still seize the security object and sell it.

The credit provider consequently becomes the pledgee. This provides more security for the credit provider because it means the pledged object can always be seized and sold if the loan is not repaid. Even if the borrower goes bankrupt, the pledgee can still enforce its right to sell the pledged goods in the same way as if the borrower had defaulted on the loan.

10.1.2 Non-revolving purchase financing

With non-revolving purchase financing, an agreement is usually made between three parties: the consumer, the supplier of the goods, and the credit provider. The consumer (the borrower) purchases the goods from the supplier. The credit provider pays the credit sum to the supplier. The borrower then pays the loan repayments and the credit fee to the credit provider.

In other words, with purchase financing the consumer does not actually get their hands on the money. An example of non-revolving purchase financing is a loan to buy a new car.

When purchase financing agreements are drawn up, the following issues have to be regulated:
- retention of title;
- final instalment.

Retention of title

Under the law, a distinction is made between the person who owns a piece of property (the owner), and the person who has possession of the property (the possessor). The owner has legal ownership or title to the property. He has the right of disposal over the property. This means he can sell the property, give it away, or use it as security or collateral. The possessor has beneficial ownership of the property. This means he is able to use the property and has to take care of it, but he does not have the right of disposal over the property. In other words, for example, he is not allowed to sell the property.

If credit is provided subject to a retention of title, as in the case of a hire-purchase agreement, under the conditions of the credit agreement the credit provider will still have legal ownership, while the consumer will have beneficial ownership. Only when the consumer has paid the final repayment instalment will the legal ownership of the property be transferred from the credit provider to the consumer. This type of construction is common practice in the case of car loans.

The retention of title gives the credit provider more security in the event the consumer has problems repaying the loan. The credit provider can then seize the goods purchased with the loan, sell them, and use the proceeds to pay off the remaining debt.

Final instalment

The last repayment instalment of a non-revolving credit facility is often higher than the other monthly instalments. In that case, the last instalment is called the final instalment. The reason why it is higher is because a part of the credit is interest-only, and this has to be repaid in a lump sum at the end of the term. The interest-only part is linked to the residual value that the financed object has at the end of the term.

A final instalment is therefore often applied in the case of non-revolving purchase financing to buy a new car. At the end of the term, the car still has a certain residual value. This amount then has to be repaid as a single lump sum.

10.2 Continuous credit

With continuous or revolving credit, the borrower (consumer) and the credit provider agree that credit will be provided up to a certain credit limit. This credit limit is the maximum amount the consumer will be allowed to borrow. The consumer can decide when and how much they borrow, although of course only up to the maximum credit limit. Furthermore, the consumer can repay the borrowed amount earlier than agreed if they want to, without having to pay a penalty charge. Any money that has been repaid can also be borrowed or drawn again. The consumer has to repay the loan and the credit fee in monthly instalments. These instalments will be a percentage of the credit limit or the outstanding debt (outstanding balance).

The credit provider will specify the term of the continuous credit facility in the credit agreement (theoretical term). This term is calculated based on the assumption that the credit will be drawn up to the maximum limit at the start of the term, without any subsequent drawings, and with the same interest rate.

Three examples of continuous credit are:

- continuous or revolving cash credit;
- continuous or revolving purchase financing;
- credit cards.

10.2.1 Continuous or revolving cash credit

A continuous or revolving cash credit facility is agreed between two parties: the borrower (the consumer) and the credit provider. The credit sum is deposited in the bank account of the consumer, who can then spend this money how they want to.

10.2.2 Continuous or revolving purchase financing

A continuous or revolving purchase financing facility is agreed between three parties: the borrower (the consumer), the supplier, and the credit provider. The credit provider pays the supplier for the purchased goods (or services). In other words, the consumer does not actually get their hands on the money.

An example of continuous purchase financing is the credit facility provided by mail-order companies such as Wehkamp and Otto. A continuous credit account is opened when the first item is purchased. Monthly instalments and a (theoretical) term are calculated for the repayments. The consumer can still make new purchases while repaying the original credit, which is the equivalent of making new drawings on a cash facility.

10.2.3 Credit cards

A credit card can be used as a means of payment. The consumer can use a credit card to buy goods and services. The institution that has issued the card - a credit card company or a bank - acts as a guarantor for the payment of the purchase price to the supplier. With a charge card, the card issuer collects the amount that has been spent on the purchases directly from the holder of the credit card, usually on a monthly basis.

Payment is always deferred with a credit card. There is an interval between the date of purchase and the date when payment has to be made, which can be as much as several weeks. However, the cardholder does not have to pay a credit charge for this.

Instead of having to pay the total amount in one go, the consumer can often pay in monthly instalments. For the holder of the credit card, the credit card is equivalent to a form of continuous or revolving cash credit. Even though the first purchase has not been fully repaid, the consumer can still make new purchases with the credit card (equivalent to new drawings).

10.3 Current-account credit

Current-account credit is a credit facility that is often linked to a payment account.

The credit conditions are similar to those for continuous or revolving cash credit. There is a set credit limit, and the account holder can make repayments or withdrawals at any time. However, there are no monthly repayment instalments. The account holder and the bank will agree with each other how and when the credit will be repaid.

This usually involves salary credit in the case of consumers. This is a type of current-account credit with a short term of up to a maximum of three months. The account holder and the bank agree that the account must have a positive balance for at least one business day during the relevant period of three months.

CHAPTER 11

Providers of consumer credit

Introduction

The following organisations can act as providers of consumer credit in the Netherlands:

- finance companies;
- banks;
- mail-order companies;
- credit card organisations;
- municipal credit banks.

11.1 Finance companies

A finance company raises money on the capital market or from its parent company, and lends this out in the form of consumer credit. Finance companies offer cash credit and purchase financing, both and in revolving and non-revolving form.

Example

The concept of a finance company was created by the sewing machine manufacturer Singer. By introducing payment by instalments in 1850, Singer made it possible for ordinary consumers to buy very expensive sewing machines.

Brand-based purchase financing still exists to this day. Car manufacturers, for example, have set up their own finance companies that offer purchase financing for their own products. Paying by instalments is also frequently offered by manufacturers of furniture, domestic appliances, computers, and for mail-order purchases.

11.2 Banks

A bank provides credit in the form of consumer credit and mortgage credit. These credit facilities are financed with amongst other things the savings that have been deposited with the bank.

The bank can offer various forms of cash credit. Credit can be provided under a separate credit agreement (non-revolving and continuous credit), or under a credit agreement linked to the payment account of the customer (current-account credit, card credit).

11.3 Mail-order companies

A mail-order company supplies goods on the basis of both revolving and non-revolving purchase financing. This is also referred to as mail-order credit. The mail-order company itself is not licensed to operate as a bank, and therefore only acts as an intermediary for the credit facility. The actual provider of the credit is a finance institution, often a subsidiary of the parent company.

Example

Wehkamp is an example of a well-known mail-order company. Customers can make purchases from Wehkamp through a credit account. The actual credit is provided by a subsidiary, Wehkamp Finance BV.

11.4 Card-issuing institutions

With credit cards that are linked to a continuous credit facility, the cardholder is able to pay for purchases by instalments. A credit agreement has to be taken out with a credit card company for this. Companies that issue credit cards also offer credit cards that are not linked are to a continuous credit facility and only offer a deferral of payment, the so-called charge cards.

11.5 Municipal credit banks

There are 22 municipal credit banks (GKBs) in the Netherlands. The municipal council decides whether or not there will be a municipal credit bank in the municipality. The legal form of a GKB can differ from one bank to the other. Some GKBs are part of the official apparatus of a municipality or are formed through a partnership of municipalities. Other GKBs have the status of an independent foundation.

GKBs are often created to provide credit to low-income groups. They provide loans to people who are not able to get a loan elsewhere, for example because they are having financial difficulties.

In addition, GKBs also provide debt assistance and support. This means they help people who are experiencing financial difficulties or who are in danger of such. This help can include giving advice about money management or negotiating on behalf of the consumer with their creditors.

Sometimes a GKB can provide debt management credit. This is a loan that is provided under strict conditions, and may only be used to bundle existing debts so that they can be paid off as far as possibly in one go. When the loan has been repaid to the GKB, the borrower will be debt free and can make a new start.

CHAPTER 12

Applications for Consumer Credit

Introduction

The lender has to assess a credit application based on various criteria. The aim should be to make sure the consumer does not take on obligations they cannot fulfil. Ultimately, in such cases, the lender will then run the risk of the credit fee not being paid and/or the loan not being repaid.

An assessment of income and expenditure is a part of the procedure. In addition, the consumer can be asked to provide security. In the case of car finance, for example, it is standard practice for the lender to remain the legal owner of the car until the loan has been repaid (retention of title). Furthermore, the credit history of the applicant can be checked with the Bureau for Credit Registration (BKR).

The legislature protects consumers against irresponsible credit lending, amongst other things by setting a statutory maximum limit for the credit fee.

12.1 Applications for Consumer Credit

When a consumer makes an application for consumer credit, the credit provider tries to get background information during the application procedure to determine what the default risk or bad debt risk is. The consumer will have to provide information about their income and their cost of living expenses. Various factors will play a role in the assessment of the credit application, such as the creditworthiness of the applicant. For credit facilities of € 1,000 and over, the credit provider has a compulsory obligation under the law to obtain information about the financial position of the customer.

12.1.1 Income

The consumer has to provide evidence to show what their income level is and how stable their income is. This evidence can be provided, for example, in the form of salary statements, an employer's statement, bank statements, or income tax returns. Temporary income, for example from seasonal work, can often also be taken into consideration. However, the credit applicant will have to show that he has regularly carried out this seasonal work over many years.

There might also be extra income each year in connection with a job, for example an end-of-year bonus or a so-called "thirteenth month". The lender will include any guaranteed payments in the calculations.

The net income level might also be affected by:

- mortgage interest tax relief;
- rental housing tax allowance;
- healthcare insurance tax allowance;
- child benefits.

The net income earned over a single month or only a few months can sometimes make the financial situation look better than it really is. For example, in this period there might have been extra pay for working overtime, a supplement for working irregular shifts, or other temporary extra income. These types of income components are generally not included in the calculations. If the applicant becomes sick or loses their job, they will lose all of this extra income almost immediately anyway.

12.1.2 Expenses

The calculation of the cost of living and household expenses of the applicant is based on their regular or fixed expenses. These are expenses that will have to be paid even if the applicant suffers financial setbacks. This can include amongst other things:

- housing expenses;
- insurance premiums;
- repayment instalments for existing loans;
- spousal support obligations.

The variable expenditure for food, clothing, holidays, etc., can differ greatly from one household to the other. It would be very time-consuming to make a complete list of all these items, which moreover could be interpreted as an invasion of privacy. That is why these expenses are estimated using statistical data, such as a standard table for each income class. The methods can differ from one credit provider to the other.

The credit provider will also try to get information about any major changes that are likely to happen, or which perhaps are already known. For example, a move to a new home, new additions to the family, or the purchase of a new car will take up a great deal of the disposable family income. There might also be long-term factors, such as children leaving home to study.

12.1.3 Assessment of credit applications

Five factors a role play a role in the assessment of a credit application:

- creditworthiness;
- credit history;
- legal capacity;
- available security;
- personal impression.

Creditworthiness

The creditworthiness relates to the material risk of providing the credit. It is essential that the customer is able to fulfil the agreed repayment obligations.

Decisive for this assessment will be the amount of available income that the applicant has each month to pay for the loan interest (credit rate) and the loan repayments. The technical term for this is borrowing capacity. The monthly cost of the requested credit must not be higher than the available borrowing capacity.

The applicant must still have a minimum amount left over after they have paid the credit charges in order to cover their living expenses. This amount will depend on the income level and the family situation.

Standards have been set for this in the codes of conduct referred to below. If the applicant does not meet the applicable standard, then a loan must not be given to them.

With this in mind, many credit providers have chosen to adopt one of the following codes of conduct:
- VFN Code of Conduct, drawn up by the Dutch Finance Houses' Association (VFN);
- NVB Code of Conduct for Consumer Credit, drawn up by the Dutch Banking Association (NVB).

In addition to borrowing capacity, other factors can also play a role in the assessment of creditworthiness. For example, if the retirement date of the applicant is not far away the credit provider will have to take into account a possible drop in income.

Credit history
The credit history can be an indication of the moral risk of providing the credit. Credit providers therefore take a look at the morality of the customer. If the customer has had a problem repaying loans in the past, or defaulted on loans, this might be an indication of poor financial discipline. There is consequently a risk that they might have problems repaying the credit being applied for.

The credit history of the applicant will therefore be checked with the Bureau for Credit Registration (BKR).

Legal capacity
When assessing an application for consumer credit, the credit provider will always want to know if the applicant is actually capable of contracting, or in other words if they have legal capacity. A person who does not have legal capacity is not able to enter into legal contracts independently without the permission of a carer or guardian. For example, underage children and people placed under guardianship do not have independent legal capacity. If a credit application is made by an unmarried 17-year-old, the credit provider will therefore need the explicit permission of the parent or legal representative before approving the application.

Security
The provision of security by the applicant, such as a right of pledge or suretyship, will reduce the risk for the credit provider. If the customer does not fulfil the repayment obligations, the securities can then be converted into cash.

Personal impression
The credit provider will try to form a personal impression of the applicant during the assessment procedure. Does the customer have a short-term outlook on life, or are they planning for the future? Is customer fully aware of the obligations he is taking on, and what the consequences might be if he fails to fulfil these obligations?

If the credit provider or the adviser has only dealt with the applicant over the internet or telephone, then naturally the personal impression aspect will play a less important role. Furthermore, to make sure the assessment is as objective as possible, credit scoring is also used. By using an automated system of credit scoring, the assessment of the applicant will be less subjective.

Bureau for Credit Registration

The credit provider will check the applicant's credit history with the Bureau for Credit Registration (BKR). This check with the BKR is part of the legal obligation to collect sufficient information about the customer.

The BKR registers information amongst other things about the following types of credit:

- non-revolving credit with a term of 1 month or longer and a credit sum of € 250 or over;
- continuous credit with a credit limit of € 250 of higher;
- current-account credit of € 250 of higher;
- private home mortgages with payment arrears of three months or more;
- residual mortgage debts higher than € 250;
- mail-order credit higher than € 250;
- credit cards and charge cards with a continuous or revolving credit facility;
- operational lease (private lease) with a minimum contract value of € 250;
- telephone subscriptions with a loan for a telephone of € 250 or more.

The BKR also registers irregularities that are reported about consumers, such as payment arrears. This information comes from the credit providers. The BKR can use this information to give the credit provider insight into the current credit situation of the consumer. This will also reveal any information that the applicant has withheld.

The BKR keeps the data about credit problems for a period of five years after a case has been closed. In general, the credit provider will refuse the credit application if the information received from the BKR shows the consumer has had an irregular credit history in the past.

The credit provider has to carry out a check with the BKR for all applications where the credit sum is € 250 or more.

12.2 Consumer protection

The legislature considers the consumer to be a vulnerable party in the credit lending relationship, and has therefore taken a number of measures to protect the consumer against irresponsible credit lending.

This protection includes:

- a maximum credit rate;
- a duty to provide the consumer with product information;
- measures to prevent borrowers from becoming overextended or overindebted.

12.2.1 Maximum credit rate

A maximum limit has been set under the law for the credit rate (interest) that can be charged for consumer credit facilities. This is to make sure a consumer does not have to pay excessively high charges for a loan.

A credit provider will normally compensate for the risk of non-repayment by consumers with poor credit-worthiness by charging a higher credit rate. This could lead to disproportionately high charges for the consumer. The setting of a maximum legal limit for the credit rate is meant to stop this from happening.

Since 1 January 2015, the maximum permitted credit rate is 14%. This is based on a credit interest rate of 12% and the statutory interest rate of 2%

12.2.2 Duty to provide information to the consumer

The credit provider has to inform the consumer fully, accurately, and in plain language that they can understand. This obligation also applies for folders, advertisements, and other publicity material.

It has to be clear to the consumer how much the loan is going to cost. If the offerer makes reference to the cost of credit in the publicity material, then certain details also have to be included. The offerer will have to state how high the credit rate or the debit interest rate is, as well as the annual percentage rate of charge and the total credit amount.

Other requirements are:

- a statement of the credit conditions;
- at least four examples of typical credit sums/credit limits, and the associated (theoretical) terms;
- information about early repayment and any possible penalty charges;
- information about the consequences of payment arrears;
- a statement that the registers of the BKR will be consulted.

12.2.3 Measures to prevent borrowers from becoming overextended or overindebted

If a consumer becomes overextended or overindebted, it means they have taken on financial commitments that they cannot afford to pay. This can happen if:

- the amount they lend is too high;
- the credit provider or credit agent does not assess the credit application properly.

The credit provider has to have proper assessment procedures in place to make sure it never, or hardly ever, approves a loan that is too high. Practical experience shows that overindebtedness and problematic debts are often caused by a significant change in the family situation or work situation, for example due to a divorce, unemployment, or occupational disability.

The credit agent is paid a monthly commission by the credit provider. This should act as an incentive for the credit agent not to approve irresponsible loans. If a consumer falls behind on their payments by more than two months, then the credit provider will stop paying the monthly commission to the credit agent.

CHAPTER 13

Special Consumer Credit Management

Introduction

The consumer has to pay the loan repayments and the interest charges (credit fee), and must pay the full amount on time. If the borrower fails to do so, then the lender can take certain measures. These measures are known as special (credit) management.

13.1 Special credit management

If a consumer and a credit provider have concluded a credit agreement, both of the parties are bound by the conditions of that agreement. The credit provider has to make the credit amount available to the consumer, and it is not allowed to terminate the agreement unilaterally.

The consumer has to pay the loan repayments and the credit fee in full and on time. Special credit management comprises the measures that the credit provider can take if a consumer does not, or not fully, fulfil his obligations.

Special credit management consists of three phases:

- payment arrears;
- notice of default;
- recovery of the outstanding debt.

13.1.1 Payment arrears

If the consumer does not pay the monthly instalments on time, they will be behind on their payments or "in arrears".

The way in which payment arrears can arise differs from one type of credit facility to the other:

- With non-revolving credit, the consumer is in arrears as soon as he does not pay the monthly instalments on time.
- With continuous credit, the non-payment of an instalment is treated as a new credit drawing.
- The consumer will only be in arrears if the credit limit is exceeded.
- With current-account credit, the non-payment of an instalment is treated as a new credit drawing.
- The consumer will only be in arrears if the credit limit is exceeded, or if he exceeds the agreed maximum period for repayment.

The credit provider will usually wait one or two weeks to see if the consumer discovers that they are in arrears and then rectifies the situation. If that does not happen, a first written reminder will be issued. A reminder is a formal letter whereby the credit provider will set a period within which the consumer has to fulfil his payment obligations. If the arrears have not been paid off by the end of the set period, then the credit provider will issue a notice of default.

13.1.2 Notice of default

A notice of default is a formal letter from the credit provider to the consumer. The credit provider will inform the consumer that he is in arrears, and will once more demand payment of the outstanding instalments. It will also inform the borrower that if the arrears have not been paid off before the set deadline, then the entire credit sum plus interest will have to be paid back immediately. The consumer will then be given a fixed deadline by which the payment obligations have to be satisfied. If the borrower does not fulfil his obligations by that date, then he will be in default.
As of that date the credit provider can charge default interest on the outstanding amount. This will put more pressure on the consumer to pay off the arrears as soon as possible.

If the credit is being repaid normally, then the credit provider is not allowed to demand repayment of the entire credit sum before the end of the agreed term. Any clause in a credit agreement that gives the credit provider this right is also invalid (null and void). One of the legal exceptions to this rule is when the borrower is in default. However, this is only on the condition that there have been payment arrears for two months or longer.

13.1.3 Recovery of the outstanding debt

If the borrower has stopped making repayments, the credit provider can take the following steps to recover its claim from the borrower:
- the enforcement of securities (with a retention of title or right of pledge);
- imposing an attachment on the possessions of the consumer;
- applying for the bankruptcy of the consumer.

Enforcement of securities
With purchase financing, a retention of title is often established on the financed goods. This means the credit provider can seize the goods, sell them, and use the proceeds to pay off the outstanding debt.

With cash credit, the credit provider can take similar action if the consumer has granted a right of pledge on his possessions.

Attachment
Attachment plays a role when there is no retention of title or right of pledge. An attachment order will then allow the credit provider still to seize the possessions of the consumer, sell them, and use the proceeds to pay off the outstanding debt.

The credit provider will have to go to court to apply for an attachment order. Once the court order has been issued, a bailiff can impose the attachment on the possessions of the consumer. The attachment order means the consumer is not allowed to sell, give away, conceal, or keep these possessions beyond the reach of the credit provider in any other way. This measure is intended to coerce the consumer into then making payment. If he does not, then the bailiff will sell the goods at a public auction.
The credit provider can also impose an attachment on possessions that are being held by a third party. This is called a garnishment order. If the employer or benefits agency of the consumer is known, it is also possible to impose an attachment on a part of the salary or the benefits (attachment of earnings).

Applying for bankruptcy

A bankruptcy order is a court order. It means the consumer will lose the right of disposal over all his possessions. The court will appoint a receiver, who will take over the administration of, and sell (part of), the bankrupt's property. The receiver will then divide up the proceeds of the sale between the creditors.

Bankruptcy is not always a viable option. First of all, there have to be at least two or more creditors before a bankruptcy order can be applied for. Secondly, the proceeds of a bankruptcy are not always guaranteed. There might be other creditors who will be given priority when it comes to the division of the bankruptcy proceeds (preferential creditors). These can include, for example, the tax department and the receiver (costs of receivership) as well as pledge holders and mortgage holders.

CHAPTER 14

Choice of Payment Products

Introduction

When two parties do business with each other, money is usually involved. One party sells something to the other party, usually a product or a service. The other party pays a consideration for this, usually money. Hardly any trading takes place in the Netherlands that does not involve money.

The payer and the receiver can choose to have the payment made in cash currency (notes and coins) or with cashless currency (balance in a bank account). In addition, there is now digital money, whereby payments are made outside of the bank transfer system. An example of electronic money is the Bitcoin.

Banks offer various payment products that can be used for cashless bank transfer payments, each with their own characteristics. The features of these products depend amongst other things on the place where payment is made: at a physical location or from a distance. Furthermore, the choice of a suitable payment product will also depend on the moment of payment: in advance, directly, or in arrears.

14.1 Moment of payment

The bank will look at the moment when the money was debited from the account. This can coincide with the physical act of payment between the buyer and seller, but it can also lie before or after this moment. Banks call these different moments:

- direct payment;
- payment in advance;
- payment in arrears.

Formal and informal definitions

The buyer and seller might have a different understanding about the meaning of direct payment, advance payment, or payment in arrears than the formal definition used by the bank. To a seller, payment in advance means they get the money first and then they supply the goods or services. There are countless examples of this. Rental and insurance premiums have to be paid in advance at the start of the month. This also applies in the case of a down payment on an order placed in a shop. Furthermore, many purchases in a web store are also carried out on the basis of payment in advance (via iDEAL, credit card, etc.).

Direct payment
With direct payment, the relevant amount is debited from the account during the payment transaction. In other words, the payment order is carried out immediately by the bank. This happens when payment is made by debit card in a shop, when payment orders are sent via internet banking, and when purchases in a web store are paid for via iDEAL.

Payment in advance
With payment in advance, the money is already debited from the bank account before the actual payment transaction takes place. This is the case when payments are made using cash currency and electronic money. The account holder has withdrawn an amount in cash from his bank account beforehand, or transferred it onto a digital carrier. One example of a digital carrier is a VVV Gift Card, which is a virtual credit balance kept outside the banking system.

Payment In Arrears
With payment in arrears, the moment when the payment is debited from the account is after the moment when the actual payment transaction takes place. This happens with direct debit orders and payments made by credit card.

14.2 Payments on location or at a distance

Payment transactions can be divided into two types: payments on location (on-premises payments) or payments at a distance (off-premises payments). Specific payment products are used for each type of payment. Some payment products, such as the credit card, are suitable for both on-premises payments and off-premises payments.

With a payment on location, the buyer conducts the transaction at the physical point of sale. This can be a shop, a restaurant, a taxi, or a vending machine. This type of on-premises payment is also referred to as a retail transaction.

Payment by vending machine
The term retail transaction suggests the buyer and the seller have to be physically standing next to each other. But that does not always have to be the case. For example, buying a chocolate bar from a vending machine and paying for petrol using an unmanned payment terminal (point of sale terminal) are also considered to be retail transactions. This is because the buyer is physically at the point of sale.

With distance payments, the buyer is not physically at the point of sale. The payment order is issued from somewhere else, for example from home. Examples of this type of remote transaction include paying for a mobile telephone subscription and paying at the checkout of a web store.

There are different payment products for retail transactions and remote transactions. The following figure shows an overview of the different products. Buyer and seller conduct the transaction directly with each other using cash currency. With all other forms of payment, the transaction is carried out using some form of technology. This technology is necessary in order to notify the payment to the bank, and to receive confirmation that it has been carried out back from the bank. With credit card transactions, the payment also goes via a third party (Trusted Third Party or TTP): the credit card company.

14.2.1 Payment on location

A payment on location is also referred to as a retail transaction. The payment takes places at the point of sale. All types of money can be used for this. Suitable payment products for retail transactions are:

- cash currency;
- debit card;
- chip card;
- credit card.

Cash currency

Cash currency consists of banknotes and coins. With a cash currency payment, the payer hands over the money to the receiver. The receiver thus has immediate disposal over the paid amount.

A cash currency payment can be carried out quickly, anonymously, and without using technology. This has advantages, but also disadvantages. Cash currency can be lost, stolen, or destroyed by fire. Furthermore, it is difficult to carry around large amounts of cash currency because of its weight and size.

Cash currency is still used a great deal for smaller payments. Payment is quick, easy (without technical devices), and anonymous. There is no limit on the amount of banknotes a receiver has to accept. However, a payment using more than 50 coins can be refused. In the Netherlands, the 1 Eurocent coin and the 2 Eurocent coin are no longer in circulation, but in other Euro countries they are still being used.

Payments in cash currency are gradually becoming less common due to the rise in debit card payments (PIN transactions). That has been the case for larger amounts for many years. In the case of small payments, the debit card transaction charges used to be a major obstacle. However, nowadays PIN transactions are even used for smaller amounts of less than one Euro.

Cash currency payments are conducted without the direct involvement of the bank. However, the bank is still involved indirectly. Virtually all consumers receive their salary or other income through their bank account. They therefore have to be able to withdraw the cashless currency in the form of cash currency. The technical term for this is disposition (to dispose = make available).

For cash withdrawals up to approximately € 1,000 per time, or a total of € 2,500 per day (maximum limit differs per bank), the cash machine (ATM) plays the main role. At a cash machine, the account holder can access his account using a bank card and a PIN code. The cash machine will send the data to the bank for verification. The bank will check to make sure the card and the PIN code are valid, and that there are sufficient funds in the account to cover the requested amount. If everything is in order, the cash machine will issue the relevant amount.

For larger withdrawals, the account holder will have to go to the cash desk of his bank. A bank branch will only keep a limited amount of cash currency on hand. Larger withdrawals of more than a couple of thousand euros therefore often have to be notified in advance.

After receiving a cash currency payment, the receiver will have to be able to convert it back into cashless currency. This is because a shopkeeper or a restaurant owner will usually have to pay his suppliers by bank transfer using cashless currency. The technical term for the conversion of cash currency into cashless currency is deposition. Various (business) payment products can be used for this:

- seal bag: the business customer deposits the cash currency already counted in a special envelop. The bank will verify the amount, and credit the value to the payment account;
- deposit machine: the procedure is similar to a seal bag, but the deposit is made in a machine fitted on the outside wall of the bank. This method can therefore be used for cash deposits when the bank is closed;
- armoured car delivery: this is only used for very large amounts.

Debit card

Debit card is the official name for a bank card (also called a PIN card or a '*pinpas*' in the Netherlands). Payment with a bank card is more complicated than a cash currency payment. It requires a certain amount of technology, such as a payment terminal and a direct connection with the bank. There also has to be an underlying system that enables the payment to be transferred from one bank to the other.

Debit and credit

The name debit card is derived from the word 'debit'. A debit is a deduction from the balance of a bank account. This reduces the debt owed by the bank to the account holder. This will happen, for example, when a payment is debited from the account.

The exact opposite happens with a credit entry. In this case, the relevant amount will be added to the balance in the bank account. This will increase the debt owed by the bank to the account holder. This will happen, for example, when the salary of the account holder is deposited in his account.

A payment with a debit card is thus more complex, but the advantages far outweigh the disadvantages. The payer does not have to prepare the payment in advance (by making a withdrawal of cash currency). The receiver does not have to deposit the takings with a bank. There is no longer the 'hassle' of finding the right change. Furthermore, PIN transactions eliminate the risk of loss or theft of cash currency.

PIN transactions

PIN transactions can be carried out at most points of sale. Both fixed and mobile payment terminals are now used for this. However, a business still has to pay for the payment terminal and the connection with the bank. Consequently, this method of payment is less suitable for locations where there are only a few transactions each day.

The payment terminal (point-of-sale terminal) reads the information stored on the bank card, such as the account number. This information is stored on the chip in the bank card. The account details are also stored in the magnetic strip on the card. The magnetic strip is no longer necessary for payments inside of Europe. However, the magnetic strip is still used outside of Europe.

The payment terminal sends the account details on the bank card and the PIN code, via a clearing house such as EquensWorldline, to the bank of the payer. The bank will check to make sure the bank card and the PIN code are valid, and to make sure there are sufficient funds in the account to cover the payment. If everything is in order, the bank will send a confirmation of the payment to the payment terminal. The

buyer and the seller can then complete their transaction. If everything is not in order, the payment request will be denied.
For security reasons, most banks set a maximum limit for PIN transactions, for example € 1,000 per 24 hours. The maximum limit varies from one bank to the other. However, this maximum limit can also be inconvenient for customers who want to make large purchases. Some banks will deactivate the maximum limit temporarily on request. If that is not possible, the payment will have to be spread out over several days or several bank accounts.

The debit cards of Dutch account holders are suitable for use in all cash machines and payment terminals in Europe that have the Maestro logo. The account holder can thus also withdraw money from a cash machine of a different European bank. This guest usage is limited to one withdrawal per day. This service is provided free of charge within Europe. Under the European regulations, a payment transaction outside of the country of residence must not be more expensive than inside the country of residence. Because payment transactions in the Netherlands are free of charge, payment transactions anywhere else in Europe are also free of charge.

The Dutch debit card can also be used outside of Europe in cash machines and payment terminals with the Maestro logo.

Chip card

In the Netherlands, the public transport chip card ("*ov-chipkaart*"), an electronic payment card with an internal NFC chip, can be used to pay for public transport. The card can only be used for travel with the affiliated passenger transport companies, and the card has to be loaded with a balance or subscription beforehand.

Credit card

With credit card transactions, the credit card company takes care of the payment on behalf of the customer. The payer has to identify themselves using the 16-digit credit card number. The credit card company will transact the payment with the seller. This is a form of deferred payment. The credit card company will collect the relevant amount from the payer at some time in the future. It can do this in instalments, so that the payment is spread out (consumer credit).

With some products, the credit card company will collect the amount in one go, for example at the end of the month. Although this is a form of deferred payment, it is no longer spread out in instalments. This type of credit card is called a charge card.

The credit card will allow credit up to an agreed limit: the credit limit. For larger amounts, the collector (the receiver) will therefore ask the credit card for authorisation first before accepting the payment. The credit card company will then check to make sure the card is still valid and if there is sufficient credit left to cover the requested payment.

Credit cards are frequently used in hotels, restaurants, and car hire firms. Credit cards are less popular with retail store owners. This is because they have to pay a fee to the credit card company for each transaction. This fee is often relatively high in proportion to the sales price.

14.2.2 Payment at a distance

With payment at a distance (off-premises or remote payment), the payer and the receiver are physically at different locations. Examples include payments for rent, or for gas, water, and electricity. Purchases in web stores also fall within this category. Because the payer often receives an invoice with this type of transaction, these payments are also referred to as invoice payments.

The physical distance between the buyer and seller makes it difficult to use cash currency for the payment. Payments at a distance are therefore made using cashless money or electronic money. Products for payment at a distance are:

- European payment orders;
- iDEAL;
- urgent payment service;
- European direct debit orders;
- credit cards;
- electronic money.

European payment orders

With the European payment order, the account holder issues an order to the bank to transfer a sum of money to another account, either on a one-off basis or at regular intervals. The other account can be the account holder's own savings account or the account of a creditor for supplied goods or services. An example of a payment at regular intervals is a monthly standing order for the payment of rent.

Within the Single Euro Payment Area (SEPA), the European banks have drawn up common rules for bank transfers in Euros. A European bank transfer is also called a SEPA Credit Transfer.

The account holder can issue the transfer order to the bank in various ways. The traditional Dutch method, the transfer order form where the payer fills in all the payment details themselves, is not ideal for European bank transfers. This role is been taken over by payment orders issued via the internet.

The IBAN collection order form is still being used however. This is a standard form, where the receiver has already filled in certain details beforehand, such as the account number and the reference number. The receiver then sends this form to the payer. The payer sometimes has to fill in certain details (e.g., the amount), sign the collection order form, and then send it back to his bank. The advantage of the collection order form is that it reduces the risk of human error. The most important details have already been filled in.

The collection order form is often sent together with the article being supplied, for example by publishers and mail-order companies. Furthermore, many associations also use collection order forms to collect membership fees and donations. The handling fees charged by the bank, however, make this form of collection fairly expensive. For periodical payments, such as healthcare insurance premiums, a standing order is cheaper.

Payment via internet banking has become the new standard. The payer fills in all the details of the payment themselves. This also applies for payment using a collection order form. The details that have already been filled in by the receiver then have to be copied and entered by the payer into the form on the internet banking screen. There is more risk of a mistake being made during this process compared to signing and returning a pre-completed paper collection order form.

A payment app on a smartphone (mobile banking) generally offers all the same features as internet banking. There is no limit on the amount that can be transferred to the customer's own account. However, for security reasons a limit can be put on the amount that can be transferred to someone else's account, for example € 1,000 per day.

iDEAL

A large number of Dutch banks participate in the iDEAL system. This is a common standard for payment over the internet. The limitation of iDEAL is that it is only a national system. It can only be used for web stores that are based in the Netherlands. iDEAL is being modified in line with the SEPA standard for uniform Euro payment transactions so that foreign web stores will also be able to participate in the system.

When transactions are made via iDEAL, the web store connects the customer to his own bank. The web store fills in the most important details, such as the amount, the reference number, and the account number of the transferee. A payment via iDEAL is therefore very similar in some ways to the sending of a collection order form and direct payment via internet banking. The payment is guaranteed for the receiver. The paying account holder is therefore unable to reverse the transaction.

Urgent payment service

With the urgent payment service, the transfer is carried out with priority. If an urgent payment request is issued to the bank before a certain deadline (the cut-off time), then the transaction will be processed on the same day. Urgent payments are made via a separate payment circuit. The bank will charge a fee for this.

The urgent payment service is useful for consumers who have to make a payment before a set deadline. For example, when buying a home. The purchase price has to be deposited in the account of the civil-law notary before the civil-law notary can execute the deed of transfer. The urgent payment service can only be used for transactions within the Netherlands.

Urgent payment service or internet banking?

Payment via internet banking usually takes place very quickly. A payment to another account holder of the same bank will be completed in a matter of seconds. But internet banking cannot entirely replace the urgent payment service. The urgent payment service uses a separate payment circuit, which means the moment when the payment arrives at the receiver can be more closely controlled. With internet banking, on the other hand, there might be a delay with a transfer from one bank to another bank. In principle, interbank processing takes place once every half hour. But this system is not operational 24 hours per day. Furthermore, no transactions are processed in the weekend or on public holidays.

Various channels can be used to offer the urgent payment service: over the counter at a bank branch, by telephone, and via internet banking.

European direct debit orders

With a European direct debit order, an account holder gives authorisation to another party (a business account holder, such as a bank, a company, or a government organisation) to debit a one-off or regular, fixed or variable, amount from his bank account. The other party will present the order for one-off or regular direct debit payments to the bank of the account holder.

Within the Single Euro Payment Area (SEPA), uniform rules have been drawn up for debit orders in Euros. The European direct debit order is also referred to as SEPA Direct Debit.

There is a big difference with all other payment methods. The party given authorisation can decide for themselves, namely, when to initiate the payment. This has the advantage that the payer cannot forget to make the payment. On the other hand, the payer does lose control of his account to some extent. Different authorised parties might initiate direct debit payments at the same time. The balance of the account might then be lower than the payer intended.

Various problems can also occur with a direct debit order. For example, the wrong amount might be debited, debit orders might be carried out twice, and debit orders might continue even after authorisation has been withdrawn. In principle, the payer and the receiver will then have to resolve the situation between themselves. The payer has given authorisation to the receiver, not to the bank. The bank assumes that this has been arranged properly. The bank will therefore not check before making payment to see if the authorisation has been withdrawn. However, the bank will check afterwards to make sure the payment could be made. If the balance of the account is too low, or the available credit is insufficient, then the transaction will be reversed. This is also called a reverse entry.

Single order, single payment?

While checking her bank statement, Saskia sees a debit entry for a payment to a publisher. She recognises the payment. It is for a book that she bought a year ago. She paid for it at the time with a one-off direct debit order. When she checks her other bank statements, she finds out that this payment has indeed been made twice.

Is that possible? Yes. The publisher found the direct debit order when closing the books for the year. The order was not signed off as having been used, and thus the direct debit order was submitted once more. Luckily, Saskia can prove that she has already paid once before with the bank statements. If the publisher refuses to pay back the money, Saskia can start a procedure with her bank to reverse the unjustified collection.

With most direct debit orders and standing orders, the payer can reverse the payments afterwards. This is also called reverse entry. A period of 56 days applies for this, calculated as of the date of payment. Furthermore, the payer can also initiate the unjustified collection procedure, for example if he did not give any authorisation whatsoever, or if the amount was collected even though he had withdrawn his authorisation. A reverse entry of an unjustified collection can take place up to 13 months after the payment date.

In the Netherlands there is a special type of collection order known as the “games of chance standing order”, where the payer does not have any right of reversal. This form of collection is specifically intended for lottery participants. Because the consumers who have issued this type of collection order still have a right of reversal under the SEPA rules, De Nederlandsche Bank has granted a dispensation for this special form of collection.

Credit cards

A credit card is an ideal payment product for making reservations and bookings at a distance for amongst other things travel and hotels, and for payments in web stores. A big advantage is the international character of the credit card. National borders, different currencies, and different payment systems do not play a role. The credit card company handles all the international payments.

Example

Nico has ordered a couple of books from the English branch of Amazon. He will have to pay in pounds sterling (English pounds). But that will be taken care of by his credit card company. It will then charge Nico the relevant amount in Euros.

Electronic money

There are various products that can be used for remote payments with electronic money. The monetary value is stored on an electronic carrier outside the banking circuit.

CHAPTER 15

Safe Use of Payment Products

Introduction

Cash currency is not a very safe payment product. The risks include loss, theft, and destruction, for example during a fire. In practice, these risks are not that great. Nowadays consumers tend not to keep a great deal of cash currency on their person or in their home.

Cashless currency is safer than cash currency. The risk of theft and loss is very small. Nonetheless, if somebody else other than the account holder is able to get access to a payment account, then the losses can be enormous. Via the internet banking system, for example, all the available funds can be withdrawn from the payment account. Furthermore, this can also provide access to other accounts, such as savings accounts. That is why banks have various security measures in place.

15.1 Paper transaction orders

Payment order forms and other payment orders issued to banks have to be signed by the account holder. This signature is then compared with the signature kept on file by the bank when the payment account was opened. Sometimes a signature might change over time. If the difference becomes too great, the bank will ask for a new signature that it can keep on file.

15.2 Debit card

In the debit card (bank card or '*pinpas*') there is a chip that contains all the account details, including the account number. The cash machine or payment terminal reads the details stored on the chip. The account holder then has to confirm their identity with a personal identification code, the PIN code. This PIN code has to be entered correctly within 3 attempts. After 3 unsuccessful attempts, the card is automatically blocked. The bank will have to reactivate the card before it can be used again.

The chip is based on the EMV standard (EMV stands for Europay, MasterCard, Visa). This is a standard that has been agreed internationally for debit cards and credit cards. The use of a chip instead of a magnetic strip and the use of the PIN code (also for credit cards) have been incorporated within this standard.

If the account holder discovers that he has become the victim of fraud, he has to report this immediately to the bank. The bank can then block the card straightaway. Up until the abuse is reported, the account holder has to carry an insurance deductible of € 150. The bank will reimburse the rest of the stolen amount. The account holder will only be held liable for the entire amount if it can be proven that he acted carelessly. This will be the case, for example, if the account holder has written the PIN code on the card.

15.3 Credit card

Up until recently, it was fairly easy to commit credit card fraud. The card itself was easy to duplicate. With internet payments, you do not even need the physical card. All you need is the credit card number. That is why files with valid credit card numbers are sold on the internet. However, the credit card holder does not run any risk in the event of fraud. Any unauthorised or disputed payments can be reversed within a certain period. The seller therefore runs the risk of not receiving payment after supplying the goods.

Modern credit cards, however, have an EMV chip and a PIN code. This makes fraud with retail transactions virtually impossible. The PIN code system does not work for payments on the internet though. Instead, a special security code is used that is printed on the back of the credit card. This is the CCV code. This means the payer actually has to have a credit card in their hands. A (stolen) credit card number by itself is not enough.

Visa and MasterCard have each developed their own security system for credit card payments via internet: Visa uses Verified and MasterCard uses SecureCode. Both systems are based on a personal password or code, which the credit card holder has to enter when making a payment. This has two advantages:

- the credit card holder knows that he is the only person who can pay with his credit card;
- the web store knows it does not run the risk of having to pay back unauthorised credit card payments.

15.4 Internet banking

Internet banking not only makes it possible to access payment accounts, but also savings accounts and investment accounts. This means the losses in the event of abuse can be enormous.

A bank account therefore has to be properly protected against unauthorised access by third parties. There are two security systems:

1. Username and password. After three unsuccessful attempts, access is blocked. Each order has to be confirmed with a transaction code (TAN code). A different code has to be given for each order. The bank will send the TAN code by SMS text message to the account holder during the transaction.
2. Account number and temporary access code. This code is calculated using a special calculator. Both the bank card and the PIN code are needed for this. The payment order is approved using a second code, which is also calculated by the calculator based on the bank card and the PIN code. Some banks also make it possible to login using a self-chosen 5-digit PIN code. This means the security code calculator is no longer necessary. However, if the account holder wants to transfer a large amount to an unknown account, then the payment will have to be authorised using the security code calculator.

Both systems have advantages and disadvantages. The advantage of the first method is that the account can be accessed anywhere over the internet without needing any other device except a mobile telephone to receive the TAN code. Because the account number and PIN code are not used to get access, the loss or theft of the bank card together with the PIN code does not pose any direct threat. The disadvantage, though, is that the account holder has to enter his fixed user name and access code when logging on. That is risky if the internet connection is being ‘tapped’ using special software. That risk is even greater if a public Wi-Fi network is used, for example in a restaurant or a station.

With the second method, there is no risk of the username and access code being stolen. Although the account holder does have to enter his account number, this is only in combination with the temporary code or the 5-digit PIN code, and not his normal PIN code. On the other hand, the account holder has to have his bank card and the calculator with him when making the payment. The disadvantage of this is that if the card details and the PIN code are stolen ('skimming'), this will allow full access to the account.

The safety of internet banking (and mobile banking) is a joint responsibility of the banks and their customers. The bank has to provide a reliable and secure infrastructure. But banks also ask customers to follow the five 'Uniform Security Rules for Retail Customers' for electronic banking and payments.

The five rules are: keep your security codes secret; do not give your bank card to anybody else; protect your devices (with software); keep a check on your account; and report any incidents.

SSL and https
Normal internet traffic uses an unsecured link (http protocol). Banks use a secure link for internet banking. This protocol is called SSL. An SSL secure link can be identified by name of the website (which will start with https). A padlock pictogram will also be displayed next to the address.

15.5 Smartphone

The security system used for mobile banking (with a smartphone) is very similar to the system that was used for telephone banking (with a landline telephone or an ordinary mobile telephone). The login for the account is based on the user name or the account number. This is combined with a 5-digit PIN code. After three unsuccessful attempts, access is blocked.

There is no limit on the amount that can be transferred between the customer's own accounts. Transfers to other bank accounts are usually restricted to a certain limit, for example € 1,000 per payment or € 2,500 per 24 hours. The maximum limit varies from one bank to the other.

15.6 Authorisation

The authorisation for a European direct debit order has become much more secure. The account holder gives the supplier authorisation to debit a certain amount from his account. He is therefore giving somebody else permission to access his payment account. The bank will check to make sure authorisation has been given before carrying out the debit order.

The security procedure consists of three stages:

1. The receiver (the collector) has to conclude a direct debit collection agreement with his bank. This will lay down the rules for the collection procedure.
2. The account holder has to sign the direct debit order.
3. The payer can have any incorrect or unjustified payments reversed by his bank.

With the European direct debit order, the account holder can personally arrange for payments to be reversed. The bank will carry out a request for a payment to be reversed without making any further checks. The underlying assumption is that a debit order has been carried out unintentionally, for example on two occasions instead of only one, or the incorrect amount has been debited. The payer and the receiver have to sort out any disputes between themselves.

With other types of direct debit orders, in principle it is not possible for the payer to reverse the payment. However, this will depend on how the debit order was issued. If the order has not been issued on paper, then the payer will have a right to reverse the payment.

The unjustified collection procedure applies for all types of direct debit orders. The account holder can ask for an unjustified collection to be reversed up to 13 months after the payment date.

The bank will then check, amongst other things, the document that was used by the account holder to authorise the debit.

CHAPTER 16

The Payment Account

Introduction

The payer and the receiver can choose to have the payment made in cash currency (notes and coins) or with cashless currency (balance in a bank account). Banks offer various payment products that can be used for cashless bank transfer payments, each with their own characteristics.

A payment account is necessary for all the different types of cashless payments. The account holder and the bank have to enter into a current account agreement for this. The payment account is the gateway to the financial system and plays a pivotal role in the processing and settlement of payment transactions. That is why there are special rules for the opening and use of a payment account. The bank is not allowed to facilitate the laundering of money from criminal activities or the financing of terrorism.

16.1 Characteristics of the payment account

The characteristics of the payment account include:

- the balance is directly available for payment transactions;
- other people can deposit money in the account directly and without the permission of the account holder;
- the balance can be negative under certain conditions ('overdrawn');
- it has three basic functions: payments, receipts, statements.

Balance directly available

The money in a payment account can be spent immediately. It does not have to be released first. That is not the case with the money (balance) in a savings account. The savings nearly always have to be transferred to a payment account first. Because the money in a payment account can be spent at any time, the bank does not pay very high interest on the balance. Some banks do not pay any interest at all.

Third-party access

The account holder has complete control over the payment account. He can use his payment account to make payments, withdrawals, and deposits, for example from the savings account. Only the account holder is allowed to carry out these acts of management or disposition. Other people are only allowed to carry out transactions that increase the balance in the payment account. Such as a cash deposit or an incoming credit transfer. However, the account holder can authorise other people to debit payments from the account. For example, by issuing a one-off direct debit order or a standing order to a business.

Debit balance

In principle, the bank will only carry out a payment if there is a sufficient balance in the payment account. The account holder can increase the spending limit by making an overdraft agreement with the bank. In that case the balance will temporarily be allowed to be negative ('overdrawn').
The overdraft limit is the maximum negative balance (debit balance) that will be allowed for an account. In other words, the overdraft limit is the maximum amount the account holder is allowed to be overdrawn. No transactions will be allowed that exceed the overdraft limit. Payments or transfers that will lead to a higher debit balance will therefore not be carried out.

The overdraft limit will increase the spending limit for the account holder. The spending limit (or disposition limit) is the available balance that the account holder can spend. This will consist of both the available positive balance plus the overdraft limit. Or the overdraft limit minus the debit balance.

Debit interest is the interest that a bank will charge an account holder if his payment account has a debit balance ('overdrawn'). Interest can be expressed as an amount, but also as a percentage of the amount being borrowed (the interest rate). This is nearly always calculated per year or per annum.

Banks calculate the interest amount automatically. They use interest numbers for this.

Balance x number of days / 100 = the interest number.

1. Expressed as a formula: the interest number = S x d / 100; where S = balance; d = number of days.
   Interest rate per year/ number of days in a year (365 or sometimes 366) = the interest rate per day.
2. Expressed as a formula: the interest rate per day = r / 365; where r = interest rate per year.
   Interest (amount) = interest number x interest rate per day.
3. Expressed as a formula: the interest = S x d / 100 x r / 365.

Example

Bas has had a debit balance of € -1,000 for a whole year. He has therefore been overdrawn for 365 days (or 366 if it is a leap year).
The interest number is then: € -1,000 x 365 / 100 = -3,650.
The debit interest rate is 12.3%; the number of the days in the year is 365. The interest rate per day is therefore: 12.3 / 365 = 0.0337.
The interest is -3,650 x 0.0337 = € -123. For the overdraft of € 1,000 for one year, Bas therefore has to pay € 123 in interest to his bank.
If the balance stays the same for a whole year, the interest amount can be calculated as follows:
€ -1,000 x 12.3% = € -123.

Three basic functions

The payment account has three basic functions: payments, receipts, statements. The bank carries out the outgoing and incoming payments. The account holder can check the payment information at any time via the internet (internet banking, smartphone) or by telephone (telephone banking, "balance helpline" (*saldolijn*)). Customers who do not use internet banking will be sent a regular bank statement on paper by the bank.

16.2 Types of payment accounts

The ordinary payment account is intended for adult account holders. The payment account can be extended with a credit facility. This increases the spending limit. The bank can make this subject to the condition that regular payments are made into the account, for example salary payments.

For young people under the age of 18 there is a youth account. Some banks have different youth accounts for children up to the age of 12 year and for young people aged between 12 and 18. Youth accounts are often a combination of a payment account and a savings account. These accounts cannot be overdrawn.

The student account is intended for students in further education. This is an ordinary payment account with several additional features, such as a free bank card and cheap loans. However, this is subject to the condition that regular payments are made into the account, such as a student grant, study expenses allowance, or work experience training allowance.

16.3 Opening a payment account

A payment account for a new retail customer is opened by following a standard procedure. Although the sequence of the stages in the procedure might differ from one bank to the other, all of the following stages will be carried out:

- inventory procedure;
- identification and verification procedure;
- customer profile and risk profile;
- registered name of the account;
- current account agreement;
- General Banking Conditions;
- product conditions.

16.3.1 Inventory procedure

During the inventory procedure, the bank will identify the needs and wishes of the customer. This includes such subjects as:

- Will it be an individual or a joint account?
- Are there people with a power of attorney?
- Is there a need for a credit facility?
- What payment account options are required (with/without bank card, frequency of bank statements, etc.)?
- Is there a need for a credit card?
- Is there a payment account with another bank that has to be switched over (switching service)?

The switching service will allow credits and debits in the old account to be transferred to the new account over a period of 13 months. This will give the account holder enough time to inform everyone about the new account number. The switching service will also notify companies who use direct debit orders and standing orders about the change of account number.

16.3.2 Identification and verification procedure

If a new customer wants to open a payment account, under the Money Laundering and Terrorist Financing (Prevention) Act (Wwft) the bank has to ask for proof of identity and verify the identity of the new customer.

Identification

Identification involves confirming the identity of the customer. Who is he? If a new customer does not already have a Dutch payment account, the bank will have to ask for a valid identity document to confirm his identity. An identity document is valid if it has been issued by an official body (and is therefore not a forgery). And if the validity date has not expired.

Identification or legitimisation?

People often confuse the Dutch concepts of identification (*identificeren*) and legitimisation (*legitimeren*). Legitimate means that you are entitled or allowed to do something. A driving licence can be used as proof of identity (to prove who you are), and as a proof of entitlement (to prove that you are entitled to drive a car). So when people ask in Dutch for people to show their driving licence as "legitimisation" by using the Dutch word "*legitimeren*", that is not correct technically speaking.

In the Netherlands, the following identity documents may be used as proof of identity for financial transactions:

- a valid passport;
- a valid Dutch identity card (Model 2001 and Model 2006);
- a valid identity card issued in another EU member state with a photograph and the name of the holder;
- a valid Dutch driving licence;
- a valid driving licence issued in another EU member state with a photograph and the name of the holder;
- travel documents for refugees and foreign nationals;
- a valid residence permit (Dutch aliens' document issued under the Aliens Act 2000, which a foreign national can use to prove his identity and right of residence).

Verification

Verification of the identity of the customer means the bank employee has to check to make sure the details on the identity document that is shown match the actual identity of the person.

The verification of the identity of the customer has to be carried out meticulously. The bank employee has to check the signature and the person on the photo and compare it with the person who is in front of them. Furthermore, the identity document itself has to be checked for authenticity and validity. The purpose of these checks is to make sure the customer is who he says he is.

In order to form an objective opinion, the verification procedure has to answer the following questions:

- Is the identity document still valid or has it already expired?
- Do the physical features match those stated on the identity document (gender, age, height, colour of eyes)?
- Does the signature match?
- Does the stated nationality match?

In order to verify the reliability of the identity document shown by the customer, two extra checks have to be carried out during the verification phase:

- a check in the Verification of Information System (VIS), which registers stolen and lost Dutch and foreign identity documents;
- a check of the authentication and security features of the document. The details of the security features are provided by the issuing body (the government). Scanning equipment can also be used for this.

The bank has to keep the identity details in the customer file. This is usually done by making a copy or scan of the means of identification, and then keeping it on file. The identification procedure is carried out separately by each branch of the bank. If a customer wants to open an account with a different branch of the same bank, they will still have to go through the identification procedure again.

Secondary identification
With the normal identification procedure, the customer has to go to the bank branch in person. That can sometimes be very impractical, for example if the bank only has one branch in the Netherlands. It is also not possible when opening an internet account.

In such cases, the verification of identity carried out by another bank may be used. This is known as secondary identification for distance services. The conditions are:
- the customer provides the number of the identity document (or submits a copy of such);
- the first deposit in the account has to come from the bank account where the full identification procedure was carried out. This has to be a bank in the Netherlands or the European Union, or in a country outside of Europe that has been designated as approved by the Minister. These are countries that already have a duty to carry out the identification procedure;
- the services being supplied are not paid for in cash.

16.3.3 Customer profile and risk profile

The bank has to carefully check to make sure the relationship with the customer does not entail any risks for the bank. The bank might suffer significant damages if it becomes apparent later on that the customer has used the account for money laundering or for the financing of terrorism. These types of activities can severely compromise the integrity of the entire financial system. A bank is therefore not allowed to facilitate these activities in any way whatsoever.

Money laundering
With money laundering, somebody tries to circulate money in the financial system while concealing the origin of the money. They might want to conceal the source of the money, for example, because it comes from criminal activities (e.g., drug trafficking or tax evasion). By concealing the source, they can evade detection and prosecution by law enforcement agencies.

Cash currency can be laundered amongst other things by depositing it in a payment account. If this can be done without revealing the source, and then it will be impossible to distinguish it from normal cashless currency derived from legal activities. This sounds easier than it is in practice. It is difficult to do this anonymously because banks have to report cash deposits over a certain limit.

Under the Money Laundering and Terrorist Financing (Prevention) Act (Wwft), the bank has to draw up a customer profile and a risk profile. The customer profile is based on the following questions:

- What does the customer need a new payment account for?
- Who is going to use the account?
- What sort of payments will be transacted via the account?
- Who will the payments be made to?

The bank then has to draw up a risk profile for the new customer. This will focus on the issues of trustworthiness and creditworthiness. The bank can use various registration systems to investigate these issues:

- the bank's own internal registration of incidents with (former) customers;
- the External Reference Application (EVA), a common electronic registration system used by banks and finance companies in the Netherlands to register the names of all customers who have committed fraud with them, or who have committed, or tried to commit, some other type of criminal activity;
- the Bureau for Credit Registration (BKR), which provides information to affiliated banks and other credit institutions about credit facilities that consumers have taken out and about any payment arrears associated with such.

Client profile and risk profile as defined in the Financial Supervision Act (Wft)
The concepts of client profile and risk profile are also defined in the Financial Supervision Act (Wft). However, they are used in a different context in the Wft than in the Wwft. In the Wft, these concepts are associated with the obligation of due care that a financial adviser has towards the client. The adviser has to make a proper analysis of the customer's financial situation, his investment objectives, and the financial risks. This is to make sure the client is given proper advice that safeguards his interests.

16.3.4 Registered name of the account

An account can only be registered in one name, and only one person can have control over the account and the account balance. Only this person has the right to carry out acts of disposition. An act of disposition relates to the control of the account, such as closing the account, or changing the address.

If the account holder is unable to take care of his own bank affairs, for example due to illness or a stay in a foreign country, then someone else can be given a power of attorney to act on his behalf. The person who has been given the power of attorney (the authorised representative) has to go to the bank to provide proof of their identity and a specimen signature.

The authorised representative is only allowed to carry out acts of management. An act of management relates to the use of certain possessions. This means, for example, the authorised representative is allowed to make payments from the account. But he is not allowed to carry out acts of disposition. This means the authorised representative cannot close the account, put the account in a different name, or have it registered at a different address. He is also not allowed to give a power of attorney to anyone else.

By giving a power of attorney to somebody else, the account holder does not lose the right to use their own account. The account holder can withdraw the power of attorney at any time. He has to notify this to the bank in writing.

The bank will therefore freeze an account as soon as it is notified about the death of the account holder. All powers of attorneys will be immediately withdrawn, and the name of the account will be changed by putting the words 'heirs of' before the name of the deceased person.

The heirs will have to prove that they are entitled to receive the money in the bank account of the deceased person. They can do this, for example, by providing a so-called "certificate of inheritance". In this, a civil-law notary will name the heirs of the deceased person. In the past, a bank would make it compulsory for this type of certificate to be provided, but it no longer does that in most cases.

A certificate of inheritance is no longer compulsory if:
- the deceased was married or in a registered partnership;
- there is no last will and testament;
- there is not more than € 100,000 in the account.

To show the deceased was married or in a registered partnership, an extract of a marriage certificate or registered partnership certificate (obtained from the local council) will usually be enough. To prove that there is no last will and testament, the heirs have to obtain a so-called "no-will certificate" from the Central Register of Wills.

With a joint account, the account is held in the name of two or more persons. Each account holder has to go to the bank to provide proof of their identity. The account holders are jointly and severally liable for the account. Joint and several liability plays a role if the account has a negative balance. The bank can then hold each separate account holder liable for the entire deficit.

Example
The bank can decide for itself which account holder will be held liable first. If this person is not able to make up the entire deficit, then the bank will turn to the following account holder, and so on. The account holders will then have to decide amongst themselves how they will share the deficit.

There are two types of joint account:
- and/or account;
- and/and account.

And/or account
With an and/or account, also known as a *compte-joint* account, the account holders are allowed to use the account both jointly and individually. Under the account agreement, each account holder can carry out independent acts of management. This means each account holder can independently make payments from the account.

Example
The registered name of an and/or account might be for example: 'Mr W. Sluiter and/or Mrs Y. Sluiter-Bakker'.

At most banks, the acts of disposition have to be carried out jointly by both account holders. It is therefore not possible for one of the account holders to close the account or change the address without the express permission of the other account holder. However, this can be arranged if separate (notarial) letters of attorney can be provided.

Power of attorney clause in an account agreement
The Rabobank has opted for a different solution. The account agreement has a clause that provides a reciprocal and irrevocable power of attorney for all acts associated with the account. This makes it possible for individual account holders to carry out acts of disposition.

If one of the account holders dies, the and/or account will still be available for acts of management. The surviving account holder can thus continue to make payments. But authorised representatives with a power of attorney will no longer be able to do that. The powers of attorney granted by the account holder will become null and void, namely, as soon as his death is notified to the bank. The situation is different for acts of disposition. The heirs of the deceased will take the place of the account holder.

Example
The bank receives the death certificate for Mr Sluiter. It therefore changes the registered name of the account to 'Mrs Sluiter-Bakker and/or the heirs of Mr Sluiter'. Mrs Sluiter-Bakker will not be able to change the name of the account without the written permission of the heirs of Mr Sluiter.

And/and account
The and/and account is hardly offered at all any more. With this type of account, the account holders are only allowed to use the account jointly. In other words, they have to carry out all acts together. Because this can sometimes be very inconvenient, the account is combined with a reciprocal power of attorney. This means each of the account holders can then carry out acts of managements separately.

The reciprocal power of attorney creates a situation that is similar to the and/or account. However, the power of attorney is no longer valid after the death of one of the account holders. The bank will freeze the and/and account until the other account holder has obtained permission from the heirs of the deceased account holder for the account to be unfrozen.

Example
The registered name of an and/and account is: 'Mr K. Jansen and Mrs L. De Bruin'.

16.3.5 Current account agreement

After all the above procedures have been completed, the bank and the customer will sign a current account agreement. This agreement forms the legal basis for the relationship between the bank and the customer.

Example

For example, it will regulate the obligations of the bank and the customer in relation to outgoing and incoming payments. Technically speaking, an outgoing payment gives rise to a claim of the bank against the customer. Conversely, an incoming payment gives rise to a claim of the customer against the bank. The current account agreement will therefore include a clause that the bank and the client shall only owe each other the (positive or negative) end balance. The bank will carry out the incoming and outgoing payment transactions immediately in the order they are received.

16.3.6 General Banking Conditions

The current account agreement will also include a clause stipulating that the General Banking Conditions (ABV) are applicable to the agreement. The bank has to issue a copy of the ABV to the customer. The ABV sets out the rights and obligations of the bank and the account holder. Virtually all banks in the Netherlands use the ABV.

The ABV includes among other the following provisions:

- When providing its services, the bank must observe the necessary due care and show consideration for the interests of the customer. The bank therefore has an obligation of due care.
- The customer and his authorised representatives have to provide a specimen signature to the bank on request. This specimen will be kept on file by the bank as an authentic example of their written signature.
- If the customer is not satisfied with the service provided by the bank, it has to notify the bank about the complaint first. Every bank has a complaints procedure for this purpose. Disputes between the customer and the bank will be settled by the civil courts or by a dispute and complaints committee.
- In the Netherlands that is the Financial Services Complaints Tribunal (Kifid).
- Both the customer and the bank can close an account by written notice. If the bank closes an account, it will explain the reasons why the account was closed to the customer on request.

16.3.7 Product conditions

Product conditions are applicable for the specific (payment) products and services that the account holder purchases from the bank. There are product conditions for the savings account, the mortgage loan, the debit card (bank card), the credit card, and electronic banking. Product conditions form a supplement to the ABV.

16.3.8 Opening a savings account

The procedure for the opening of a savings account is very similar to the procedure for a payment account. The most important difference is that the customer has to nominate an existing payment account with a (different) bank, which will serve as the contra account for the savings account. Transfers to and from the savings account, namely, are only allowed to go via the nominated contra account(s). That is why secondary identification is often used with this procedure.

CHAPTER 17

European Payment Transactions

Introduction

The use of the Euro as the national currency in 19 European countries and the increased level of economic collaboration within Europe makes it necessary to have a common system for European payment transactions. The national payment systems and products, namely, are primarily designed for the internal, national markets. They are therefore less suitable for quick and cheap processing of cross-border Euro payments. Following the initiative of European politicians, the banks within Europe have developed the Single Euro Payment Area (SEPA).

17.1 Single Euro Payment Area (SEPA)

SEPA stands for Single Euro Payment Area. Within this payment area, which comprises 34 European countries, there should eventually be no difference between national and international Euro payments.

In connection with SEPA, the European banks have drawn up common rules and standards for the payment products and systems that make Euro payments possible. In the Netherlands, there has been a gradual migration of national products and systems to SEPA since 2008.

17.1.1 SEPA payments and participants in SEPA

SEPA applies for the following types of Euro payments:

- money transfers;
- direct debit payments;
- card payments made with a debit card or credit card.

SEPA was created at the initiative of the European Union (EU), which now consists of 28 countries. Six other countries have also affiliated to SEPA. The 34 SEPA countries are:

- 19 Eurozone countries: Belgium, Cyprus, Germany, Estonia, Finland, France, Greece, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Austria, Portugal, Slovenia, Slovakia, and Spain;
- 9 other EU member states: Bulgaria, Denmark, Hungary, Croatia, Poland, Romania, Czech Republic, United Kingdom, and Sweden;
- 6 other countries: Liechtenstein, Monaco, Norway, San Marino, Iceland, and Switzerland.

17.1.2 Transition to SEPA in the Netherlands

SEPA was introduced in two phases. In phase one, the Eurozone countries had to make sure all their products and systems were in compliance with SEPA by 1 August 2014. In phase two, the non-Eurozone countries had to introduce SEPA for their Euro payments by 31 October 2016. Payments in currencies other than the Euro do not fall under this obligation. Since 1 August 2014, therefore, the processing of payment transactions in the Netherlands has changed in various ways following the transition to SEPA.

The main changes for Dutch payment processing and settlement were:
- the introduction of new account numbers;
- the modification of products for payment orders and direct debit orders;
- the modification of products and systems for card payments.

Introduction of new account numbers
Following the introduction of SEPA, the International Bank Account Number (IBAN) is the new standard for account numbers. In addition, the Bank Identifier Code (BIC) of the affiliated banks is used for all payment orders. This is sometimes referred to as the SWIFT address.

In the past, IBAN and BIC numbers were only used for cross-border payments, but since 1 August 2014 they have to be used for inland payments as well. This meant every account number in the Netherlands had to be converted to the IBAN format. The IBAN numbers of both the payer and the receiver also have to be detailed in the payment order. And the BIC numbers of the both the sending and the receiving bank have to be used for every payment made to an account holder at a different bank. In other words, a payment cannot be carried out without the IBAN and BIC numbers.

A Dutch IBAN number consists of 18 characters, and is as made up as follows:
- the first two letters are the country code (NL for the Netherlands);
- the next two digits are a control number;
- the next four letters designate the bank (e.g., ABNA for ABN AMRO);
- and finally 10 digits: the ‘old’ account number preceded by one or more zeros.

Example
Most of the ‘old’ bank account numbers in the Netherlands had 9 digits. The account number 123456789, for example, has now become NL69 ABNA 0123 4567 89.

An ‘old’ account number of the Postbank (now ING) had a maximum of 7 digits. The account number 1234567 has thus now become NL83 INGB 0001 2345 67.

The BIC code is an international identification code for banks. The BIC code is used during transaction processing to make sure the payment gets to the right bank or branch of a bank. The BIC code is therefore only relevant for transactions between different banks.

In some countries, the BIC codes have 11 characters, but the BIC codes for banks in the Netherlands only have 8 characters:
- a bank code of 4 letters;
- a country code of 2 letters (NL for the Netherlands);
- a location code of 2 characters.

For example, the BIC code for the SNS Bank is: SNSB NL 2A.

Account holders can find their IBAN number and the BIC code of their bank on their bank statements and via internet banking.

The Dutch banks made a gradual transition to IBAN numbers. The banks set up the IBAN BIC Service to help their customers with the transition to IBAN numbers.

The modification of products for payment orders and direct debit orders

Within the framework of the SEPA, two European product standards have been introduced:

- SEPA Credit Transfer (European payment orders);
- SEPA Direct Debit (European direct debit orders).

The SEPA Credit Transfer, also referred to in the Netherlands as a European payment order, was introduced in January 2008. An important feature of the European payment order is that the IBAN numbers of both the payer and the receiver and the BIC code of the receiving bank are included in the payment order.

The European payment order has replaced the national credit transfer products, and has been used for ordinary payment orders and standing orders since 1 August 2014. The urgent payment service, the collection order form, iDEAL, and the digital invoice are still being used as national products for the time being, but eventually they will be integrated within SEPA.

The European payment order is currently only available for electronic transfers. Some banks will continue to provide European payment order forms on paper for certain target groups.

Since November 2010, the SEPA Direct Debit order, also known as the European direct debit order, has been available for both payers and collectors. With a European direct debit order, the payer and the collector have to include their IBAN number and the BIC code of their bank in the order.

There are two standard variants for one-off direct debit orders and standing orders, which replaced the national payment collection variants on 1 August 2014:

- the ordinary European direct debit order for the collection of one-off and periodical payments from retail customers and business account holders;
- the business European direct debit order for the collection of payments from business account holders.

Modification of products and systems for card payments

All Dutch debit cards and credit cards are fitted with an EMV chip. In addition, cash machines and payment terminals have been modified so that they can read the information stored on that chip. This makes point-on-sale transactions safer, because unlike the magnetic strip, the EMV chip is not easy to duplicate. To make sure debit cards can be used throughout Europe in the future as well, the debit cards are marked with the logo of an international brand, such as Maestro of MasterCard or V PAY of Visa.

17.2 Payment transaction legislation

The system for the processing and settlement of payment transactions is regulated by national laws and European regulations. European regulations have to be implemented in national legislation.

17.2.1 Legal currency

Legal currency, or legal tender, is a means of making payment that is allowed under the law. All types of money - cash currency, cashless currency, and electronic money - are legal currency in the Netherlands. The Euro is legal currency throughout the entire Eurozone. This is the group of 19 EU countries that have introduced the Euro as their national currency.

Under the law, nobody is obligated to accept all types of legal currency. The European Regulation on payment transactions states that a payment in Euros using more than 50 coins may be refused. In principle, a shopkeeper will always accept cash currency. However, if 1 eurocent and 2 eurocent coins cause too much inconvenience, a shop may refuse to take them. Most shops will also refuse to take banknotes of € 100 or more. The losses that will be incurred if counterfeit money is accidentally accepted are too high, and finding enough change for these banknotes can also be inconvenient.

Furthermore, there are many parties that only accept payment in cashless currency. They do not accept any cash currency at all. Examples of such are health insurers, publishers of weekly magazines, and professional associations.

What currency is accepted?

In general, it is very clear what currency will be accepted in a certain situation. Nobody would try to pay for their health insurance with cash currency at the reception desk of a health insurance company. A payment with cashless currency (collection form or direct debit order) is more appropriate in such situations.

Some situations are less straightforward, and the receiver has to make it clear what means of payment will be accepted. If a shop only accepts debit card payments, then a notice about this has to be clearly displayed in the shop. A shop can also accept different forms of payment at different checkouts. In Ikea, for example, some of the checkouts only accept debit card payments.

17.2.2 Payment Services Directive (PSD)

The European Commission introduced the Payment Services Directive (PSD) in order to harmonise the national rules governing the payment system. This Directive was implemented in the national legislation of all the EU member states. In the Netherlands, this led to an amendment of the Financial Supervision Act (Wft) and the Dutch Civil Code (BW).

As well as the 28 EU member states, Liechtenstein, Norway, and Iceland have also implemented the European Directive in their national legislation. This means 31 European countries now have the same legal rules for payment transactions.

The main legal rules concerning for payment services are:

- Not only banks, but also so-called “payment institutions” are also allowed to offer payment services. In principle, any non-banking businesses can be registered as a payment institution. However, in the Netherlands they have to apply to the DNB for a licence, and they are not allowed to carry out any other banking activities, such as credit lending.
- The Financial Markets Authority (AFM) is responsible for the market conduct supervision of all providers of payment services, both banks and payment institutions.

- All offered payment services, with the exception of one-off transactions and the changing of cash currency, have to be covered by a framework contract.
- The offerer of the payment services has to provide the customer with detailed information about such subjects as the conditions and the charges for those services, and the time it will take to carry out payment orders.
- Payment orders issued electronically have to be carried out within one business day. An additional business day is allowed for payment orders issued on paper.
- Value dating - stopping earlier or starting later with the calculation of interest on the transferred amounts - is prohibited. The payer will continue to earn interest on the amount of the payment up until the moment when the payment order is transacted. The receiver will start earning interest on the amount of the payment no later than the first business day after the receipt of the payment.
- The offerer of payment services is liable for the reversal of unjustified payment transactions and for the payment of any compensation, except in cases of fraud or gross negligence on the part of the payer.
- The payer will have to pay an insurance deductible of € 150 in the event of the loss or theft of a payment instrument, such as a debit card.

The PSD has since been followed up with the PDS 2. The most important additions compared to the PSD 1 are:
- The maximum amount of interbank fees, the so-called “Multilateral Interchange Fees” (MIFs), has now been fixed at 0.2% for a debit card transaction and 0.3% for a credit card transaction.
- Third party account information service providers (AISPs) will be given access to account information if the account holder has given their consent for this. For example, if an AISP is offering an innovative service which the account holder wants to use. Banks then have to share that account information with the AISPs.
- Third party payment initiation service provider (PISPs) are allowed to carry out payment transactions via their internet applications if an account holder issues an order and gives their consent for the service. Banks are then obligated to facilitate this service.

CHAPTER 18

Motives for Saving

Introduction

Consumers have various reasons for wanting to save. There are three main motives for saving: the precautionary motive in order to have money in times of adversity; the special-purpose motive in order to have money for a specific item of expenditure; and the capital accumulation motive in order to guarantee a certain standard of living in the future.

The amount a consumer can save depends on their personal financial situation. If they have more income than expenditure, then they will have surplus income. This surplus can then be saved.

18.1 Savings

The economic definition of saving is the deferral of consumption until a later date. In other words, the person does not spend (consume) their entire income straightaway.

Some consumers save without meaning to, because they structurally spend less than they have coming in. Other savers deliberately put money aside for later on; they do this with a specific motive in mind.

There are three main reasons (savings motives) why consumers save:

- precautionary motive;
- special-purpose motive;
- capital accumulation motive.

18.1.1 Precautionary motive

A customer who saves for a precautionary motive wants to build up a reserve for unforeseen or unpredictable future expenditure. Examples of unforeseen expenditure are the cost of repairing a car, a television, or a washing machine.

The characteristics of saving for a precautionary motive are:

- there is not a clearly-defined spending purpose;
- the spending moment is not known;
- the amount of the future spending is not known.

A person saving for a precautionary motive will have a preference for saving products that allow the deposits (balance) to be withdrawn immediately and free of charge. They want a low-risk option. However, the interest earned on the savings will also be relatively low.

18.1.2 Precautionary motive

A customer who saves for a special-purpose motive puts money aside for planned expenditure in the future, such as the purchase of a boat or a trip around the world. The characteristics of saving for a special-purpose motive are:

- there is a generally-defined consumer spending purpose;
- the spending moment is generally known;
- the amount of the future spending is generally known.

A person saving for a special-purpose motive will prefer a savings product where the savings balance will become available or be released at the desired time. The saver can thus opt for a savings product where the balance cannot be withdrawn on demand. The amount that is deposited in the savings account will depend on the amount the saver thinks he will need at the relevant spending moment. The interest rate offered will normally be higher the longer the term is.

A special form of saving for a special-purpose motive is saving to provide financial support for a partner, children, and grandchildren, for example to pay for the cost of further education.

18.1.3 Capital accumulation motive

A customer who saves for a capital accumulation motive wants to build up capital to have money available at a later stage in life for living expenses and other expenditure. One example is saving to top-up a pension.

The characteristics of saving for a capital accumulation motive are:

- the spending purpose is centred around providing financial security;
- the start of the spending period is known and usually lies a long way ahead in the future;
- the duration of the spending period is usually not known;
- the amount of the future spending is usually not known.

A person saving for a capital accumulation motive will above all want to get a high return (interest rate) over a long period. He might therefore choose to have the interest on the savings fixed for a long period. However, he will then run the risk of the interest rate going up during that period. On the other hand, a higher rate of interest is usually offered for long-term savings accounts than for short-term savings accounts.

18.2 Financial situation

The consumer has to have sufficient income to be able to put savings aside. He will therefore need to take into account his ongoing living expenses. Any surplus money that is left over can be used for savings.

18.2.1 Income

Income can be both regular and incidental in nature.

Regular income

Regular income is received on a regular, re-occurring basis. This is often received on a monthly basis, but sometimes on an annual basis as well.

The main types of regular income are:

- wages or salary;

- benefits and grants paid to students, people who are unemployed or occupationally disabled, and pensioners;
- income from other activities, such as freelance work or activities during time off;
- profits from business activities (for independent contractors);
- spousal support;
- payments under an annuity policy.

The total income has to be calculated based on the net income, in other words after the deduction of income tax and national insurance contributions. People in paid employment receive net wages or salary. Income from other sources is often paid gross, and therefore the income tax and national insurance contributions will still have to be paid to the tax department.

Incidental income

Incidental income is not received on a regular or re-occurring basis. The main types of incidental income are:
- inheritance or bequest;
- capital gains, for example on the sale of a house;
- bonus or golden handshake;
- lottery winnings.

18.2.2 Expenses

Consumers have both ongoing expenses (re-occurring on a regular basis) and incidental expenses (occasionally on an incidental basis).

Ongoing expenses

Ongoing expenses can be fixed or variable in nature. The main types of ongoing expenses for consumers are:
- fixed expenses, such as rent, utility supplies, local and provincial government taxes, insurance premiums, study expenses, contributions, subscriptions, and the repayments and interest on mortgages and other loans;
- household (variable) expenses, such as food, clothing, and personal care;
- other ongoing (variable) expenses, such as transport, leisure, and minor repairs.

The fixed expenses are paid on a contractual basis, which the consumer has little or no control over. Variable expenditure is usually linked to the lifestyle of the consumer, and is therefore also predictable to a large extent.

Incidental expenses

Incidental expenses of consumers are:
- larger amounts required to buy durable consumer goods, such as a house, computer, car, boat, or caravan.

Due to the high purchase price of these goods, it will often be necessary to save up for these items.

18.2.3 Calculating the surplus or deficit

The surplus income of a consumer is the amount that is left over after all the ongoing expenses have been paid out of the regular and incidental income. He can then use this surplus for savings if he wants to. The choice of savings product will depend on the savings motive. This will be decisive for the amount that needs be saved (spending amount), the amount that will need to be saved in a specific period (savings amount), and the total period over which money will be saved (savings term).

If there is a negative difference between the amount of the regular and incidental income and the amount of all the ongoing expenses, then this is referred to as an income deficit. The consumer will therefore not have enough income to put savings aside.

Example

Ayse receives income from her work (salary) and spousal support. She also inherited some money from a great aunt this month as well. Her expenses consist of rent, insurance premiums, etc. (€ 1,000). She spends approximately € 500 on food and clothing each month. When she has worked out all her income and expenses, she can draw up a budget. Ayse's budget for this month's income and expenditure is as follows.

Regular income		
(Net) salary	€	1,250
(Net) spousal support	€	400
Incidental income (inheritance)	€	3,500
Ongoing expenses (fixed + variable) -	€	1,500
Surplus	€	3,650

This month Ayse had more income than expenditure. She has € 3,650 left over. In other words, she has a budget surplus. She can therefore save up to € 3,650.
If her expenditure is bigger than her income, then she will have a budget deficit.

CHAPTER 19

Types of Savings and Savings Products

Introduction

Having a savings account with a bank is better for a consumer than keeping the money in a jar at home or in a safe deposit box with a bank. This is because the bank pays (credit) interest over the amount of the savings, and sometimes on any credit balance of a payment account. For payment accounts and savings accounts with withdrawal on demand, the interest rate is usually fairly low. Savings accounts with banks that have withdrawal restrictions usually have more favourable interest rate conditions. In other words, the easier it is for a saver to get access to the money in the account, the lower the interest rate will be. One disadvantage of keeping money in a jar or in a savings account is that it will lose its value over time due to inflation.

19.1 Types of savings

Savings are a form of investment. Generally speaking, however, people often do not think of savings in this way. Nonetheless, finding the right balance between risk and return is also important when it comes to savings. Consumers can save (invest) their money in two ways: cash currency and cashless currency.

19.1.1 Cash currency savings

Cash currency saving is the oldest form of saving. The saver keeps his own stash of coins and banknotes.

Cash currency saving still exists. Some people do not trust the banking system. Another reason for not putting money in the bank is that cash savings can be concealed from government agencies, such as the Tax Department or Social Services.

Note

Hiding savings from the Tax Department is a criminal offence. This also applies even if the money comes from a totally legal source, for example wages, and income tax has already been paid on this money. This is because tax also has to be paid on savings over a certain threshold amount (tax-free allowance threshold). Anybody who hides money from the Tax Department will therefore be guilty of tax evasion.

There are various disadvantages with cash currency savings. The money can easily be stolen or destroyed in a fire. It is also a relatively expensive form of saving. Because prices go up, the value of the savings will go down a few per cent every year. Furthermore, no interest is being received from the bank. The increase in the price of goods and services (general price level) is called inflation. Because of inflation, consumers will be able to buy less goods and services with the same amount of money; their purchasing power will decrease. Purchasing power is how much a consumer can actually buy with their money (disposable income).

19.1.2 Cashless currency savings

Most savers put their savings in a bank account. Money held in a bank account is cashless currency. That is why savings with a bank are called cashless currency savings. Only banks are allowed to hold money from consumers in safekeeping.

Cashless currency savings have three characteristics:
- security;
- demandability;
- interest earnings.

Security

The saver has a claim against the bank for the full amount of the balance being held with the bank. This is one of the two main differences between savings and investments. With savings, the entrusted funds are guaranteed. The value of investments, on the other hand, can go up or down depending on the market value (price). The second difference between savings and investments is that savings are not converted into a different type of asset value, such as property or shares.

The saver has to have the reassurance that the bank will actually be able to repay the amount of savings deposited. This is guaranteed in two ways.

The first form of security is that a bank is regulated by the central bank. Banks with a head office in the Netherlands fall under the supervision of De Nederlandsche Bank (DNB). The DNB checks to make sure banks are financially and economically sound. Banks with a head office in another member state of the European Economic Area (EEA) are regulated by the relevant central bank in each country.

The second form of security is the bank balance guarantee scheme. This guarantee scheme has been agreed EEA-wide. In the Netherlands, this scheme is known as the deposit guarantee scheme. If a bank with a Dutch licence goes bankrupt despite the market regulation, then retail customers and small business customers will be covered by this deposit guarantee scheme. This scheme guarantees all balances up to € 100,000. This guarantee applies per account holder per bank.

Demandability

The bank has to pay out the balance held in a savings account to the saver on demand. That is the case with ordinary savings accounts. With other savings products, however, the bank can set supplementary conditions that limit or discourage the demandability of savings. For example, by charging a withdrawal fee or by requiring a minimum balance to be held in the account throughout the entire term. Withdrawal fees are often calculated as a percentage of the withdrawn amount multiplied by the number of remaining years until the end of the agreed term. On the other hand, the bank will pay a higher interest rate on these accounts.

Interest earnings

The bank will pay interest (credit interest) on the deposited savings. The amount that is saved will thus get gradually bigger. The actual interest rate will depend on the flexibility and the term of the savings product. In principle, the more flexible the withdrawal options are, the less time the bank will have the savings, and thus the lower the interest rate will be. Conversely, the greater the withdrawal restrictions are, and the longer the savings are entrusted with the bank, the higher the interest rate will be.
Credit interest is the interest that a bank pays to an account holder on the money that is held in the account. Interest can be expressed as an amount, but also as a percentage of the amount being invested (the interest rate). This amount or rate is nearly always calculated per year or per annum.

This 1% is also referred to as the nominal interest rate. Nominal means ‘theoretical’. The nominal interest rate is the percentage that the bank will theoretically pay on an annual basis.

Example

Celeste has € 1,000 in her savings account. Her bank pays credit interest of 2.3% once per year (on 31 December). Literally speaking, 2.3% means 2.3 per 100. For each € 100, the bank therefore pays € 2.30. For each € 1000, the bank pays Celeste € 23 on 31 December of each year.
Expressed as a formula: € 1,000 x 2.3% = € 1,000 x 2.3 / 100 = € 1,000 x 0.023 = € 23.

After 1 year her balance has increased by 2.3% or € 23 to € 1,023.
Expressed as a formula: € 1,000 + 2.3% x € 1,000 = € 1,000 x (1 + 0.023) = € 1,023.

This is a calculation of the so-called “simple interest”. It is called simple interest because the bank only pays this interest once per year.

The general formula is: S1 = S0 x (1 + r) or closing balance = opening balance x (1 + r); where r = decimal interest rate per year (the decimal interest rate is the percentage divided by 100; for example 2.3% becomes 0.023).

The nominal interest rate (here: 2.3%) is not always the same as what the customer actually receives.

Example

After 2 years the balance of Celeste’s savings account has gone up again: € 1,023 x 1.023% = € 1,046.53 (€ 1,000 x (1 + 0.023)2). This is a little bit more (€ 0.53) than 2 x € 23. This is because of the interest on interest (compound interest).
In 2 years has Celeste effectively earned € 46.53 / 2 = € 23.26 per year. That is 2.3265%. This effective interest rate is the average interest rate per year that she will receive from the bank if she saves for longer than one year.
The difference will be even greater after 10 years: € 1,000 x (1 + 0.023)10 = € 1,255.33. Instead of € 230 (10 x € 23), Celeste has received € 255.33 in compound interest. That is € 255.33 / 10 = € 25.53 per year. She has effectively received 2.55% interest per year, instead of the original 2.3% nominal interest rate.

The general formula is: $St = S0 \times (1 + r)^t$ or closing balance after t periods = opening balance x $(1 + r)^t$; where r = decimal interest rate per year; t = number of periods.

The value of the balance held in a bank account or savings account will also go down due to inflation.

Example
Celeste receives 2.3% credit interest on her savings account. Her balance on 1 January is € 1,000. She will therefore have more money at the end of the year (€ 1,023) than at the start of the year (€ 1,000). But with that € 1,023 she will still only be able to buy roughly the same as she could at the start of the year. The interest gains will be counteracted by the effect of inflation.

If the inflation rate is 2%, then her balance also has to grow by 2% if she wants to have the same spending power that she had at the start of the year. Due to inflation, the value of her savings will go down by 2% x € 1,000 = € 20 each year. Her spending power will therefore have only gone up by € 23 - € 20 = € 3. She will therefore be able to buy € 3 more than she could at the start of the year.

19.2 Savings products

The consumer can use the savings product of a bank to save in a certain way. The consumer has to sign an agreement with the bank for each savings product. The conditions will be different for each savings product, but a general feature of all savings products is that the deposits and withdrawals have to go through a payment account. It is therefore not possible to make payments to a third party from a savings account. However, it is sometimes possible to make withdrawals from a cash machine.

There are four main types of savings products:
- payment account;
- savings account with immediately available balance;
- savings account with non-immediately available balance;
- savings products for specific target groups.

19.2.1 The Payment Account

More or less everyone saves in their payment account to some extent. This is the account where they receive their salary. Part of this is spent almost immediately on fixed expenses, such as rent, utilities, and insurance. The remainder is only spent during the course of the month on food, drink, clothing, and other variable expenses.

This type of saving does not give much of a return. The interest paid on the balance of a payment account is low, and at some banks even zero.

Payment accounts and savings accounts
Payment accounts and savings accounts differ from each other in the following ways:
- The bank charges the account holder a fee for the use of the payment account; the savings account is free of charge.

- The account holder of a payment account can transfer money to third parties, and receive money from third parties; that is not possible with a savings account. Savings accounts can only be used in combination with a contra account, which has to be designated by the account holder in advance.
- The payment account can have a negative balance (it can be 'overdrawn') if the account holder has a current-account credit facility; that is not possible with a savings account.

19.2.2 Savings account with withdrawal on demand

With a savings account with withdrawal on demand, the saver can withdraw his savings at any time. This means he can transfer (a part of) his savings to his payment account whenever he wants.

The following types of saving accounts have an immediately available balance:

- ordinary savings account;
- savings account with a minimum deposit and/or withdrawal restriction;
- savings account with a tiered interest rate;
- savings account in foreign currency.

Ordinary savings account

An ordinary savings account is the most flexible type of savings account. The saver can make deposits and withdrawals at any time. There is no minimum deposit requirement, and the bank does not charge any withdrawal fees. The interest rate is variable and follows the current interest rate.

The bank always has to keep enough cash at hand because the savings can be withdrawn at any time. Cash at hand does not generate any income for the bank. That is why the interest rate for a savings account with an immediately available balance is so low.

Savings account with a minimum deposit and/or withdrawal restriction

With a savings account with a minimum deposit and/or withdrawal restriction, withdrawals and deposits are subject to certain restrictions. The interest rate is directly linked to the extent of these restrictions, because on average the bank will have greater use of larger amounts that are held for longer periods in a savings account.

Examples of restrictive conditions (with hypothetical limits) are:

- The balance must be at least € 1,000.
- A deposit or withdrawal may not be smaller than € 100.
- A withdrawal up to € 1,000 per time will be free of charge. The customer will have to pay a charge for withdrawals over this amount.
- The customer can withdraw € 5,000 free of charge per month. A fee will be charged for withdrawals of larger amounts, unless the withdrawal has been notified at least 30 days in advance (period of notice).
- Bonus interest on the lowest balance in the quarter.
- Bonus interest if the balance has risen by at least 10% during a year.

Some conditions are primarily aimed at discouraging withdrawals of savings. With a quarterly bonus savings account, the saver will lose the bonus for the whole quarter. A withdrawal made later on in the quarter will therefore lead to a greater loss of interest. That is because he was almost eligible to receive the full bonus.

Savings account with a tiered interest rate

With a savings account with a tiered interest rate, the interest rate is linked to the size of the balance. This type of savings account is therefore ideal for large deposits. Up to a deposit limit of € 5,000, for example, this product will be similar to an ordinary savings account, with a similar interest rate. Above this threshold limit of € 5,000, the bank will pay a higher interest rate.

There are two variants of this type of savings account. In the first variant, the higher interest rate only applies for the amount over the threshold limit. In the second, the higher interest rate will apply for the entire balance as soon as the customer goes over the threshold limit.

Savings account in foreign currency

A savings account in foreign currency can have advantages under certain conditions. For example, the saver can benefit from a higher interest rate that is offered for balances in foreign currency. They can also benefit from a rise in the exchange rate of this currency against the Euro. However, they also run the risk of the exchange rate of this currency going down against the Euro.

19.2.3 Savings product with non-immediately available balance

With a savings product with non-immediately available balance, the saver and the bank will sign an agreement about the amount that has to be deposited, the duration of the restriction on availability, and the interest rate.

Examples of these products include:

- fixed-term savings account;
- climbing interest rate savings account;
- savings certificate;
- climbing interest rate savings certificate;
- deposit account.

Fixed-term savings account

With a fixed-term savings account, the bank and the saver will sign an agreement about how long the money has to stay in the savings account. This term can vary from 1 to 10 years. A fixed interest rate will be offered, which will be higher the longer the term is. Depending on the conditions agreed, the bank will pay the interest per month, per quarter, or per year.

It is also possible to make extra deposits (follow-up deposits). The new deposit date and the original term will apply for the follow-up deposits. However, the interest rate will be based on the current interest rate. The interest rate for the first deposit might therefore be different than the interest rate for the follow-up deposits. Some banks set minimum limits for the first deposit and the follow-up deposits.

It is usually possible to withdraw the balance prematurely, or to end to the savings agreement prematurely.

If the saver wants to withdraw his savings before the end of the term, then he will have to pay a penalty charge. The penalty will be a percentage (for example 1.5%) of the amount he withdraws multiplied by the remaining number of years of the fixed term. But the penalty will never be more than, for example, 10% of the withdrawn amount.

Example
A saver withdraws € 10,000 with 4 years of the term remaining. He will then have to pay the following penalty: 1.5% of € 10,000 = € 150 x 4 = € 600.

Climbing interest rate savings account

A climbing interest rate savings account (climbing interest rate deposit account) is a variant of the savings account with a fixed term. The term of the savings agreement will usually be 5 or 10 years, and the interest rate will gradually increase over this period. This interest rate is agreed in advance. A minimum deposit limit will usually apply of several thousand Euros. The initial interest rate in the first year will be similar to the interest rate for an ordinary savings account. Thereafter the interest rate will increase each year, for example in increments of 0.25%.

At the end of the term, the balance can be withdrawn free of charge. However, it is often possible to make interim withdrawals or to terminate the savings agreement prematurely. Although the saver will then lose out on the higher interest rate (and sometimes also an extra bonus) in the final years of the term. Interim withdrawals or premature termination will therefore mean a loss of potential earnings.

Savings certificate

Saving certificates are type of valuable paper or equity instrument with a term that can vary from 1 to 15 years. They have a fixed interest rate over this term. Banks offer savings certificates in registered and bearer form. Registered savings certificates cannot be sold or traded. The registered owner can only cash them in at the issuing bank, either prematurely or at the end of the term. Bearer savings certificates can be traded on the stock exchange or on the open market (privately).

The value of a savings certificate can range from € 500 to € 5,000. The value of a savings certificate is referred to as the denomination. The issuing bank will not pay out the savings interest in the interim period, but credit it to the balance of the savings account instead. This produces a favourable interest-on-interest effect.

Some savings certificates specify the initial deposit, the agreed interest rate, and the term. The end value (the deposit plus the credited interest) will be paid out in a lump sum at the end of the term. Other savings certificates do not specify the initial deposit, but only the end value. The bank then sells the savings certificates at a price that is below the end value. The difference between the end value and the sales price is the fixed interest that the bank credits during the term.

Climbing interest rate savings certificate

Climbing interest rate savings certificates are registered savings certificates with a fixed denomination. They have a maximum term of 5 years. The registered owner can cash them in at the issuing bank at set moments during the term. The amount that will be paid out by the bank for each interim period, and the amount on the end date, when the certificate is cashed in, will be specified on the certificate. The longer the customer holds on to the climbing interest rate savings certificate, the higher the amount of compound interest they will receive.

Deposit account
The deposit account is intended for savings that can be left untouched for a certain period. The term can range from 1 month to 20 years. The deposit interest rate is fixed for the entire term. The bank will set the deposit interest rate based on the current interest rates on the financial markets.

These interest rates will also depend on the length of the term. The minimum deposit can range from € 500 to € 25,000. The bank will charge a penalty for early withdrawals.

19.2.4 Savings products for specific target groups
Savings products for specific target groups include:
- young person's savings accounts;
- ethical savings schemes;
- green savings schemes.

Young person's savings account
The young person's savings account makes it possible for parents and grandparents to open a savings account for a child or grandchild. For the bank, it is a useful product for developing customer loyalty at an early age.

The young person's savings account is very similar to an ordinary savings account. Some banks pay a slightly higher interest rate and/or pay a bonus if the savings have been in the account for a certain period of time.

Ethical savings schemes
The bank converts the funds entrusted to it into credit facilities. A bank does not usually have to explain to the savers what the credit facilities are being used for. With ethical savings schemes, that does happen. The bank can then only provide credit facilities for projects that fall within the ethical selection criteria. These criteria vary from one bank to the other. Generally speaking though, these criteria will usually include the development of renewable energy sources, environmentally-friendly enterprise, and providing microcredit to small businesses in developing countries. Generally excluded are the weapons industry, businesses with a high environmental impact, and businesses that use child labour.

Green savings schemes
Savings that are deposited in a green savings account are used to finance projects that contribute to a sustainable society, such as wind energy and organic farming. A green savings scheme is a type of ethical savings scheme, but with more tax advantages. If the green projects are approved by the government, then there is a higher tax-free limit for income tax on income in "box 3". In addition to the tax-free allowance, the rate of income tax on this income is also lower.

CHAPTER 20

Bank Savings

Introduction

Savers can keep their money in a jar or in a savings account with a bank. However, they can only earn interest on their money if they put it in a savings account with a bank.

There are also tax incentives to encourage people to save capital in a savings account or an investment account. This is also referred to as 'bank savings'. The consumer can then use the capital saved to pay off a loan for a private home or for income after retirement.

The government wants to stimulate more competition in this area. The monopoly that life insurance companies previously had for products for capital accumulation with tax benefits has been abolished, and they can now be offered by other parties. This has resulted in lower costs for the consumer.

20.1 Home acquisition debt

Tax incentives are given for two types of savings for the repayment of home acquisition debt: the mortage repayment savings account (SEW) and the private home blocked investment account (BEW). The SEW can only be offered by banks and the BEW can only be offered by investment institutions.

These types of finance have tax advantages because the value of the accrued capital is not taxed in "box 3". Instead, these products fall within "box 1", and subject to certain conditions the earnings on these savings are exempt from tax. In order to qualify for this tax allowance, the products have to satisfy a number of requirements.

For many years, a tax allowance has been given for the accrual of capital in the form of endowment insurance in order to pay off a home acquisition debt. This type of insurance is currently known as mortgage-linked endowment insurance (KEW). The tax allowance rules for the KEW are virtually the same as for the SEW and the BEW. Only life insurance companies are allowed to offer the KEW product.

In 2013, the tax allowances for these types of savings were abolished for new loans. However, existing loans (arranged before 1 April 2013) still qualify for the tax allowance.

20.2 Home acquisition debt

Tax allowances are available for two types of savings products for a retirement provision: the annuity savings account and the tax-efficient blocked annuity investment account. The annuity savings account can only be offered by banks and the blocked annuity investment account can only be offered by investment institutions. Under the tax relief rules, subject to certain conditions the amount that is saved can be deducted from the income in “box 1”. At the end of the period agreed between the parties, the balance of the account has to be paid out in instalments. Income tax is then levied on these payments.

It has been possible for many years to save capital for a retirement provision via an annuity insurance policy. The tax allowance for the accrual of the retirement provision is given in the same way as for the annuity savings account and the tax-efficient blocked annuity investment account. Only life insurance companies are allowed to offer annuity insurance policies.

CHAPTER 21

Investment Categories

Introduction

An investor keeps his financial surpluses in a different form than cash currency (notes and coins) or cashless currency (deposit in a bank account). The investor buys an investment, owns it for a certain amount of time (sometimes for decades), and then ultimately sells it again. The basic assumption is that the investment will be worth more as time goes on. However, this is not always guaranteed. The price of an investment can go up or down depending on the supply and demand. Investments therefore always involve a certain amount of risk.

The investment categories (also called asset classes) are:

- liquidities;
- real estate;
- bonds;
- shares;
- derivatives;
- investment objects.

The return for the investor can consist of direct returns and indirect returns. Direct returns are the earnings derived by the investor from the ownership of the investment, less the cost of ownership. Indirect returns are the change in value of the investment between the time of purchase and the time of sale, expressed as a percentage of the original value.

Both the direct returns and indirect returns can be affected by investment risks. In the case of indirect returns, there is a risk that the value could go down and not up. With most investments, the investor has no guarantee that he will be able to sell the investment for more than he paid for it.

Example

Each investment category has its own general ratio between risk and return. Investments in liquidities are comparatively risk-free; consequently the expected return is also relatively low. Investors who are willing to take more risks can invest in derivatives: the expected return is therefore also higher.

21.1 Liquidities

Liquidities are investments that can be converted into cash at short notice and without additional costs. This category includes deposit accounts. The market for these investments is the money market.

A deposit account is a bank product: the investor and the bank sign an agreement about the amount the investor will deposit in the deposit account, the term of this deposit, and the interest rate the bank will pay on the deposit. Only deposits with a term of two years or less fall within the category of liquidity investments. The deposits with a longer term are treated as fixed-interest investments, the same category as bonds.

Risk and return on liquidities

If an investor entrusts money to a bank, which is used for investment in liquidities, the investor will be entitled to receive interest. Furthermore, he will also be entitled to repayment of the amount entrusted to the bank. The money can be invested amongst other things in deposits and in loans to businesses, government organisations, and other banks.

The interest rate is the direct return on an investment in liquidities. The indirect return over the entire term is usually zero: the investor will get back the exact same amount that was invested.

The value appreciation of the investment will depend on any interest rate adjustments during the term of the investment. Because interest rates go up and down, the actual end value of an investment in liquidities subject to interim interest rate adjustments is difficult to predict.

21.2 Real estate

Real estate is a collective term for buildings, such as homes, offices, industrial units, retail units, and shopping centres. Most real estate is put on the property market via property developers. They build a building for their own account and risk, or for the account and risk of a client.

Direct investment in real estate is not an obvious choice for the average consumer because the unit price for this type of property is relatively high. They therefore usually do not have enough capital of their own for this type of investment, and will not find it easy to get a loan for it either. Furthermore, the management of real estate is a complex business: collection of rental, looking for new tenants, maintenance, improvements, usage permits, etc. However, consumers can invest indirectly in real estate via real estate investment funds.

Risk and return on real estate

The direct return on real estate investment is determined by the difference between the rental income and the operating costs. These costs are fairly high because a building needs continuous maintenance and improvements in order to make it lettable. Furthermore, there are also costs associated with building ownership, such as municipal property tax and buildings insurance. The risks include the inability of the lessor (the investor) to find a new tenant if a sitting tenant leaves. This will lead to a loss of rental income while the costs stay the same, which reduces the ultimate return. The direct return will be paid out to the investors in a real estate investment fund in the form of a dividend.

If the annual rental increases are calculated on the basis of a fixed ratio between the rental and the costs, then this will have a stabilising effect on the direct return in the long term. An investment in real estate is relatively low-risk.

The indirect return is the difference between the purchase price and the sales price. Certain costs associated with the buying and selling will have to be deducted from this, such as the fees of the real estate agent and the civil-law notary.

Generally speaking, real estate investment has fewer risks than investment in shares but more risks than investment in bonds. However, the risks are different for each particular category of real estate: the risk with residential housing is relatively low, while commercial real estate has higher risks.

The balance of supply and demand for commercial real estate changes all the time, which means both rental prices and purchase and sales prices can fluctuate considerably. The real estate market has a notorious cycle: if there is a shortage on the supply side, returns shoot up, which attracts new suppliers, which leads to overproduction. However, this overproduction only becomes apparent after a couple of years because of the long construction period. This overproduction ultimately leads to empty buildings, which pushes rental prices down. When contract revision takes place, the (direct) return on the real estate investment will go down.

Example
An investor has purchased a retail unit for € 300,000. After 10 years, the building is sold for € 450,000. If no interim dividend payments have taken place, and there has been no additional investment, after these 10 years the investor will receive an indirect return on his investment of:

€ 450,000 – € 300,000 x 100% = 50%

€ 300,000.

21.3 Bonds

A bond is a certificate of debt. The owner of the bond, the bond holder, has lent money to an institution. This can be a business or a government body. The bond holder will therefore have a claim against this institution. A bond must have a term of at least two years when it is issued.

Example
A bond usually has a nominal value of € 1,000. An institution that wants to raise € 20 million will therefore have to issue 20,000 bonds with a nominal value of € 1,000.

An institution will issue bonds if it wants to raise long-term loan capital. The issue (or issuance) will take place on the primary market. The bank acts as an intermediary in this process. The bond holders can then trade their bonds on the secondary market. The price that bonds are traded at will depend on the coupon rate on the bond, and the current interest rate on the capital market. If the current interest rate goes down, then the return on an investment in liquidities will go down. This will make investment in bonds and shares a more attractive prospect. It will also make bond and share prices go up. Conversely, the demand for and price of bonds will go down if the interest rate on the capital market goes up. Investors will then be able to achieve a similar return on an investment in liquidities, but at a lower risk.

The issuing institution will have a debt with the bond holder. The institution has an obligation to repay this debt at the end of the term. A bond holder is entitled to receive a fee for the provision of the capital. This fee is known as the coupon rate, or coupon for short. The coupon is a percentage per year of the nominal value. The nominal value is the amount that the investor has leant to the institution, which they will be repaid at the end of the term.

Risk and return on bonds

With bonds, the direct return consists of the coupon. The bond holder therefore runs virtually no risk at all: he has a right to receive the agreed coupon. However, there is a default risk. This is the risk that the issuing institution will not be able to meet its financial obligations (payment of the coupon and redemption of the bond). The indirect return consists of any change in the market price of the bond. The change in the market price can therefore also be negative. The combined direct and indirect return is also referred to as the effective return or redemption yield.

An investor who holds on to a bond throughout the entire term will not get any indirect return. The bond holder will then be repaid the nominal value of the bond at the end of the term. This will be the exact same amount that he lent to the institution in the first place.

In practice, bondholders do not always hold on to their bonds for the entire term. If a bond is traded before the end of the term, the price will depend on the supply and demand for bonds, which in turn will depend on the current trend in interest rates. This means the price of a bond can be both higher and lower than the normal value.

Example

A stock exchange will show the prices for bonds as a percentage of the nominal value. A listed price of 105 means a bond with a nominal value of € 1,000 is being traded for € 1,050.

Bonds are considered to be a relatively safe investment category. The bonds issued by the Dutch government (government bonds) are very low-risk. The Dutch State is considered to be a reliable debtor. The risk that the bond will not be redeemed on the maturity date is therefore very low. Less stable countries, however, have a higher default risk. This also applies in the case of corporate bonds. A company can have cash flow problems or even go bankrupt. Bonds with a high default risk are nonetheless attractive for certain investors, because the effective return will also be high.

21.4 Shares

A share is a certificate of ownership. The owner of a share, the shareholder, is a co-owner of the equity of a company.

A company will issue new shares if it wants to raise equity capital. In theory, the company could try to find the potential buyers itself, but this is highly unusual. Normally, a bank will handle the issue on behalf of a company. A share issue is sometimes referred to as an equity issue.

Shares are traded on a stock exchange, also known as the stock market. The market is divided up into the primary capital market and the secondary capital market. New shares are issued on the primary capital market, and previously issued shares are traded between shareholders on the secondary capital market.

When shares are issued on the primary market, the issuing institution receives the sales proceeds. The price of a share when it is first put into circulation is called the issue price. The issuing institution has no involvement in trading on the secondary market. The price of a share, the listed price, will depend on the supply and demand for the share.

The supply and demand for a share will depend on a large number of factors, such as the current interest rate. The higher the interest rate, the more attractive an investment in liquidities will become. Liquidities will then offer a similar return on investment, but at a lower risk. This will reduce the demand for shares, which will cause of share prices to go down.

A share has a nominal value, which is specified on the share. The nominal value is the amount by which the shareholder has participated in the equity of the company. A share with a nominal value of € 50 therefore means the value of the shareholder's participations in the equity of that company is € 50. This nominal value only has a symbolic meaning for most investors. Much more important is the listed price of the share.

The shareholder will have a say in the running of the company. By purchasing the share, namely, shareholder has become a co-owner of the company. He is therefore entitled to attend the shareholders meetings, where he will have the right to vote on motions put forward by the executive board.

The shareholder is entitled to receive earnings on the share in the form of a dividend distribution (the dividend). The dividend distribution is usually calculated based on the profits achieved by the company. The executive board will put a proposal to the shareholders meeting about the dividend that will be distributed. The shareholders meeting will then have to vote on this proposal.

Risk and return on shares

Shares offer a direct return in the form of the dividend distribution, which can be in cash or shares, or a combination of both. In terms of the direct return, the investor only runs a minor risk. In the worst case, the company will not pay out any dividend and the direct return will be zero.

The indirect return consists of the difference between the buy price and the sell price of a share. In terms of the indirect return, therefore, the investor runs a considerable risk. Share prices fluctuate considerably, and sometimes by a huge percentage in a very short time. An investor who buys and sells at the wrong moments can therefore suffer significant losses.

Example

On average, the market value (listed price) of shares goes up by approximately 8% per year. However, this is the average over a long period, for example 20 years. The change in market value year-on-year is very unpredictable. Shares have been known to go both up and down by more than 40% in value in a single year.

21.5 Derivatives

Derivatives are financial products that are derived from other, traditional financial products. The most well-known type of derivative is the "option". The value of the option is derived from the development in the listed price of the underlying product.

Example

Blankenstein shares have a listed price of € 20.50. An investor wants the right to buy this share no later than 6 months later at a price of € 18 and will pay a premium of € 2.50 for this.

There are two main types of options:

- Call option: this option gives the option holder the right to buy a share at a predetermined price during a set period.
- Put option: this option gives the option holder the right to sell a share at a predetermined price during a set period.

The option holder therefore has the right to buy or sell shares under terms and conditions that are set in advance. The counterparty is the writer of the option. They are obligated to cooperate with the exercising of the option. If the buyer of a put option exercises his right and offers the shares for sale, the writer has to buy the shares under the agreed conditions. The buyer of the option pays the option premium; the writer receives this amount.

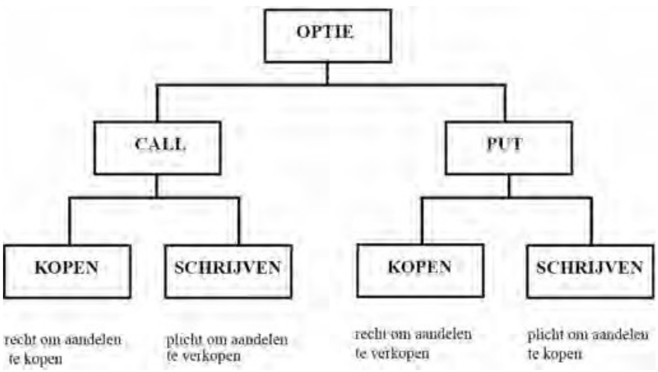

Figure 5 Overview of the possibilities with options

Risk and return on derivatives

The option holder can decide to exercise his right. They will then buy (with a call option) or sell (with a put option) the shares at the agreed exercise price. This is the price agreed between the parties beforehand. The best time to exercise a call option is when the exercise price of the option is lower than the listed price of the share. This means the shares are relatively cheap to buy, and can then be sold on the stock market straightaway at a higher price. The best time to exercise a put option is when the exercise price of the option is higher than the listed price of the share. The option holder will then be able to sell his shares at a higher price than the listed share price.

The option holder will not exercise a call option if the listed price of the share is lower than exercise price of the option. He has nothing to gain by exercising an option to buy shares for a price that is higher than the listed price. Similarly, it is not always a good idea to exercise a put option. If the exercise price of the option is lower than the listed price of the shares, then it will be more profitable to sell the shares on the open stock market.

An option is a negotiable or tradable right. In the Netherlands, most of the trading in options takes place on the options exchange (Euronext Amsterdam Derivatives Markets). The listed price of an option will depend on two factors: the extent to which the option is so-called “in the money”, and the time and expectation value or time value premium. The longer the term of an option, the greater the uncertainty will be about the expected change in price. This is compensated for by a higher option premium.

21.6 Investment objects

In the Financial Supervision Act (Wft), there is a separate definition for investment objects.

An investment object is defined as: ‘an object, a right on an object, or a right on the whole or partial return in money, or a part of the revenues, from an object, …, which is acquired otherwise than for no consideration, by which acquisition the acquirer is given the prospect of a return in money, and whereby the management of the object is primarily carried out by somebody else other than the acquirer… or any other right that is accorded under an order in council’.

Investment in investment objects has the typical characteristics of investment in general, which is apparent from the following:

- It is difficult to predict the value appreciation of the object during the term of the investment.
- Both the interim return on investment and the final return are uncertain, because they depend on the commercial success of the object.
- As a general rule, it is very difficult or impossible to sell the investment in an investment object prematurely.

Investment in investment objects is sometimes carried out on an individual basis. In such cases, the return on investment will depend on the value of the part of the object that has been assigned to the investor.

Example

An investment in a plantation of teak trees with a term of 6 years is an investment object, whereby the investor will only get the principal sum back after 6 years, and the return will depend on the revenues from specific trees or lumber. It might be the case that the trees assigned to a particular investor might grow slower than the trees assigned to other investors. His return on investment might therefore be lower than the returns of the other investors.

In principle, under the Financial Supervision Act (Wft), providers of, intermediaries in, and advisers on investment objects have to have a licence from the AFM. However, they do not under the prudential supervision of the DNB.

Risk and return on investment objects

Investment objects offer a direct return in the form of interim dividend payments. In terms of the direct return, the investor only runs a minor risk. In the worst case, no interim dividend payments will be made on the investment object and the direct return will be zero.

It is not possible to predict the indirect return on investment objects in advance, because this will depend on the object specifications.

CHAPTER 22

Direct and Indirect Investments

Introduction

Shares, bonds and other securities are traded on a stock exchange. Consumers are not able to trade directly on a stock exchange. A consumer therefore has to give buying and selling instructions to an intermediary. This is known as indirect distribution.

Direct distribution does occur, however, in the case of investment funds. The consumer is able to buy participations directly with the fund manager. With most funds, the investor is also able to sell his participations back to the fund manager as well. What can be confusing is the way investors are able to invest in shares and other securities via an investment institution. This is known as indirect investment (which is not the same as indirect distribution).

22.1 Direct investment

With direct investment, the investor buys financial instruments in his own name. The financial instruments are then owned by the investor. This would be the case, for example, when an investor buys shares in Unilever. In this way the investor can build up his own investment portfolio.

This type of investment is beyond the reach of most consumers. An investment portfolio should be built up on a diversified basis. In other words, shares in different sectors, supplemented with bonds and perhaps real estate. This broad composition will help to reduce the risk of losses. However, it is also less likely to make huge profits. However, a lower profit is not as bad as suffering losses. The psychological blow of investment losses is much greater than the disappointment of lower returns.

It is only possible to create a diversified portfolio if sufficient funds are available. Buying and selling instructions can easily cost € 10 each (transaction charges). It is therefore hardly worth it if you are going to buy € 200 worth of shares in Philips. The transaction charges alone would represent a loss of 10% on the buying and selling of the shares (two times € 10 on a value of € 200). The minimum investment requirement is therefore usually set at tens of thousands of Euros. Because the situation on the financial market fluctuates continuously, good portfolio management moreover requires a great deal of attention from the investor.

Indirect distribution

Private investors are not allowed to trade on the stock exchange. The stock exchange is a trading facility for professional traders, such as financial institutions. The investor can therefore only make investments on the stock exchange via an intermediary. The intermediary can be a bank or a stockbroker. This form of investment is therefore a type of indirect distribution.

22.2 Indirect Investments

Indirect investment is usually carried out via an investment institution. The private investor buys units or certificates of participation (participating interests) from the investment institution. The investment institution invests the money contributed by the private investor in shares, bonds etc., depending on the investment policy laid down in the articles of association. The private investor can buy units of participation for a relatively small amount. The spreading of the investment is also guaranteed.

There are four basic types of investment funds:
- liquidity funds;
- bond funds;
- property funds;
- equity funds.

These exist in many different variants. Examples include (but are not limited to):
- Mixed funds: combination of two or more investment categories, for example shares and bonds;
- Country funds and regional funds: investments in a certain country or region, such as Asia;
- Sector funds: investments in a certain sector, for example ICT;
- Theme funds: investments based around a certain theme, such as sustainable energy or water companies;
- Index funds: funds that follow a stock market composite index, such as the AEX index or the Dow-Jones index.

Direct and indirect distribution

With many investment funds, the investor can buy (and sell) the units of participation directly with the manager of the fund. This is referred to as direct distribution.

Investment funds can also be listed on the stock exchange as well. As with shares and bonds, the units can only be bought or sold on the stock exchange via an intermediary. This is referred to as indirect distribution.

Example

One of the subsidiaries of ING is an investment institution, which offers various investment funds. One of these is the ING Global Fund, a global equity fund. The investor can buy the units of participation from ING (= direct distribution). The fund is also listed on the Amsterdam stock exchange. The units can therefore be purchased from other offerors.

Negotiability or tradability of units of participation

The way in which a fund will issue and redeem units of participation will be laid down in the articles of association of the investment fund. There are two main types of investment fund:

Open-end investment funds listed on the stock exchange. The units of participation in this type of fund are sold by the fund itself and on the stock market. An investor can therefore buy them directly from the fund or indirectly on the stock market.

Closed-end investment funds are not listed on the stock exchange. The investor can only buy and sell units of participation directly with the fund itself.

Variable or fixed capital

Many investment funds are funds with variable capital. In other words, the investor can buy and sell units of participation with the fund at any time. This type of fund is called an open-end investment fund.

The opposite of this is the closed-end investment fund. This is an investment fund with fixed capital. The fund will issue one or more series of units of participation. These units can only be purchased at the time of issue. The fund will not buy the units back from the investor. The investor has to find a buyer for the units on their own. This is easier to do with investment funds listed on the stock exchange than with closed-end funds.

CHAPTER 23

Investment Advice

Introduction

If an investor needs investment advice, they can go to an investment advisor. The adviser is responsible for the substantive quality of all the advice that they give. Furthermore, they have a statutory obligation of due care with respect to the client. One tool that helps in this respect is the client profile. The ultimate choice of product has to be such that the characteristics of the investment portfolio are compatible with the identified client profile.

Accordingly, the investment adviser has to make suitable asset allocation proposals to the client. In addition, the invested capital has to be spread over various investment categories. To help clients make decisions about complex financial products, the offerers of investment products have to provide a financial information leaflet that contains all the relevant product information. Since 1 July 2012, all product information leaflets have to comply with the European directives.

The investor compensation system, which was introduced under the Financial Supervision Act, provides compensation to investors for losses that are suffered due to the malpractice of an investment institution.

23.1 Value development of investments

The investor is faced with a dilemma. If they minimise the risks, then they can only expect a low return on the investment. An investment in liquidities might yield a return of 3% per year. It will therefore take 24 years before the value of the start capital has doubled. As a general rule, the time it takes for the value of an investment to double can be calculated by dividing 72 by the return percentage.

Example

An investor who is willing to take risks might be able to achieve high returns (but this is not guaranteed!). The value of the investment will then grow quickly. For an average return on investment of 9% per year, the value of the investment will double every 8 years. After 24 years, the start capital will be worth 8 times more (namely 23). On the other hand, there is also the risk that some or all of the start capital might be lost.

With the current interest rate of around 1%, it would actually take 72 years before the value of the investment is doubled. Standard scenarios can be used in order to get an impression of the value appreciation of an investment.

23.1.1 Scenarios

Scenarios that try to forecast the value appreciation of an investment are based on data about past performance. This might be, for example, the trend over the last 10 years. The primary statistic is the average return per year, the so-called “historical return”. The second statistic is the deviation of the return in a year compared to the average over the whole period.
These statistics can be used to work out three scenarios:

- a neutral scenario: the assumption is that the historical return will also apply in the future;
- an optimistic scenario: this scenario is based on the assumption there will be above-average investment years;
- a pessimistic scenario: this scenario is based on the assumption there will be below-average investment years.

Example
An investment has a current value of € 100,000. How much will this investment be worth in 10 years?

Over the past 10 years, the value of the investment has appreciated by an average of 10% per year. However, there were also years where the return was -10% and +30% compared to the average.

With the neutral scenario, the investment will appreciate over the coming years in accordance with the historical return, thus by 10% per year. The end value after 10 years will be approximately € 260,000.

The optimistic scenario results in an end value of € 450,000. The pessimistic scenario only results in € 145,000.

23.2 Investment Advice

Investment advice means the customer is given advice about the composition of the investment portfolio. This includes advice about which investments to buy and which to sell. The investment adviser is responsible for the quality of all the specific advice they give. The adviser moreover has a statutory obligation of due care with respect to his client. One tool that helps in this respect is the client profile. This provides an analysis of the investment objectives, financial position, risk tolerance, and risk perception of the client. Furthermore, the knowledge and experience of the customer also plays a role. The ultimate choice of product has to be such that the characteristics of the investment portfolio are compatible with the identified client profile.

This means the investment adviser has to make suitable asset allocation proposals to the client. In addition, the invested capital has to be spread over various investment categories. The adviser also has to provide a financial information leaflet for a model portfolio, which has a mix of these categories. Although an information leaflet was compulsory for all so-called complex financial products, it did not fully explain the situation in relation to international products. That is why the European Union decided that providers of investment products had to modify or replace the existing national financial information leaflets to comply with the European Directive after 1 July 2012 (see the previous section).

23.2.1 Suitable advice

A party providing investment services has a statutory obligation of due care with respect to the customer. The provider or adviser has to make sure the advice is suitable for the customer. He therefore has to give the client proper information about the risks associated with a product, and make sure the customer fully understands the consequences.

The profile of the customer, the advice, and the agreements made about the service provision are laid down in a customer file.

23.2.2 Investment goals of the customer

The investment adviser has to make a careful assessment first to make sure the customer does not take any irresponsible investment risks. He has to carry out a thorough analysis of the investment goals of the customer, his financial scope (risk tolerance level), the emotional characteristics (risk perception), and the knowledge and experience of the customer. The client profile will be drawn up at the initial consultation. This will have to be reviewed at regular intervals to make sure the customer's situation has not changed.

The goals of the customer are divided into objective and subjective goals. With an objective goal, it will be necessary for the customer to accumulate the target capital. The goal can only be modified or deferred slightly, or not at all. Examples of an objective goal include the repayment of a mortgage or a pension provision.

With a subjective purpose, although the customer might still want to accumulate the target capital, there are alternative options if that does not happen. Examples of a subjective goal include the purchase of a bigger house or early retirement. These goals are not absolutely essential for the customer.

Risk tolerance

The risk tolerance of a customer depends on their financial scope. This is determined amongst other things by how severe the consequences will be if the target capital is not achieved. With a specific objective, the available scope is rather small. If the investment return does not meet expectations, for example, this could mean the mortgage cannot be repaid on time.

Another consideration is whether or not the customer also has alternative sources of income in addition to his investments. A person who only has their invested capital to pay for their living expenses after retirement is in a much more vulnerable position than a person who receives a regular pension as well.

Risk perception

The risk perception of a customer depends on their emotional characteristics. How much investment experience does the customer actually have? How will he respond if he loses money? If the customer is not able to deal with financial uncertainty, then certain types of investment should be excluded. They will find it difficult to cope with the fluctuations in the prices of shares and real estate. It will cause them too much emotional stress.

Example
The adviser can ask the customer the following question: “How would you feel if your investment lost 25% of its value in one year?”

An experienced investor might not be too concerned about this. It would only mean that the price of shares has gone down. It would therefore be a good time to buy more shares while the price is low. An inexperienced, nervous investor might be inclined to then quickly sell off the whole investment. Even though selling shares after a big drop in prices means the losses could be very high.

Types of investor
In terms of risk perception, customers are assessed as either defensive, neutral, or offensive. Defensive means the customer wants to avoid risks. Offensive means the customer is willing to take risks.

23.2.3 Product choice and asset allocation

The adviser has to recommend a product that is suitable for the customer. The characteristics of the investment portfolio have to match the client profile. The customer must not be persuaded into taking excessive risks.

An investor will often spread the invested capital over various investment categories. With this type of asset allocation, for example, he might invest 40% in shares, 10% in real estate, 40% in bonds, and the rest in liquidities.

The reason for this asset allocation is that the investment categories respond in different ways to different economic developments. By mixing the investment categories, the aim is to achieve the highest possible return while keeping the risk of value depreciation to a minimum.

Example
Investment categories do not all react the same way to changes in the economy. For example, if the interest rate on the capital market goes down, the price of bonds will go up. Liquidities will also be less attractive. Share prices might either go down (poor economic outlook) or go up (low interest rates make it cheaper for businesses to borrow money).

If a company announces a setback (failed merger, disappointing profits), share prices will often fall sharply. Bonds are less sensitive to this type of news.

Model portfolio
Providers of investment products offer so-called “model portfolios”. A model portfolio is a particular fixed mix of investment categories. It is possible to calculate the expected risk and return for each model portfolio. A model portfolio is often described as defensive, neutral, or offensive.

A defensive model portfolio primarily consists of liquidities and bonds. It will have a fairly predictable value appreciation. In terms van scenarios, the pessimistic, neutral, and optimistic scenarios will not differ that much from each other.

An offensive model portfolio primarily consists of shares and real estate. The value appreciation is less easy to predict. The pessimistic, neutral, and optimistic scenarios will then have completely different outcomes.

Example
A customer wants to buy a house. He will need to take out a mortgage loan for this of € 350,000. The customer profile shows he is an average investor with a neutral profile. The suitable, neutral model portfolio will yield an end value of € 275,000 after 30 years. That will not be enough to repay the mortgage debt.

With an offensive model portfolio, on the other hand, the necessary € 350,000 could be achieved. However, according to the pessimistic scenario the end value might be no more than € 200,000.

An offensive investment portfolio would therefore not be compatible with the customer profile. The adviser therefore advises against this. The customer is disappointed. He asks if it would be possible to change the customer profile. If the adviser agrees to this, he will be in breach of his obligation of due care. This is because his advice always has to be in the best interests of the customer.

The possible liability of the adviser if he agrees to change the customer profile in such a situation cannot be fully determined at this point in time. The case law concerning the obligation of due care is still at an early stage. Nonetheless, it is very likely that the customer would be able to successfully sue the adviser for any adverse consequences. That might even be the case if the adviser had carefully informed the customer about the potential risks, and the customer had agreed to accept the consequences.

23.2.4 Essential Information Document (EID)

Since 2018, an Essential Information Document (EID) has to be issued for investment products. The EID is an updated version of the financial information leaflet.
The EID contains, amongst other things, information about the type of investment and information about the risks, the costs and the return on the investment product.

Investor compensation scheme
The investor compensation scheme was set up as part of the Financial Supervision Act. The name ‘investor compensation scheme’ gives the impression that investors will be compensated for any investment losses. But that is not the case. A person who decides to make an investment has to accept the risk that the value of the investment can go either up or down.

The investor compensation scheme only comes into effect if the investor suffers losses because the investment institution has not complied with the rules for asset separation. Asset separation means the institution has to keep the investment portfolio of the customer separate from its own equity. This is to make sure the assets of the customer are not lost if the investment institution runs into financial difficulties. If the investment institution goes bankrupt, the separation of assets will also prevent these investments from being treated as liquidation assets.

The investor will receive compensation up to a maximum of € 20,000 if he suffers losses because the investment institution has not complied with the rules on asset separation.

Example

Gert saw the value of his investment portfolio fall in just 6 months from € 35,000 to € 25,000. The share prices continued to go down. When the investment institution suddenly went bankrupt, he found out the losses were even greater. The investment institution had used the shares of its clients for its own investment activities. This meant Gert had lost an additional € 5,000.

The investor compensation scheme subsequently compensated Gert for the losses that he suffered due to the malpractice of the investment institution (€ 5,000).

The losses on the investment portfolio (€ 10,000) were entirely for the account of Gert.

CHAPTER 24

Liquidity surplus

Introduction

A business can, deliberately or accidentally, retain liquidity surpluses for shorter or longer periods. If these liquidity surpluses are held in a bank account, the bank will see these amounts as entrusted funds.

Banks can offer various products for liquidity surpluses. These products can be divided into products for small and medium-sized enterprises (SME) on the one hand, and large enterprises and corporate clients on the other.

24.1 Funds entrusted

Every company has to make sure that it has enough liquid funds to support the operational processes. Liquid assets are all the funds that are immediately available in order to make payments. Examples include cash in hand and bank account deposits. The part of the liquid assets that a company has in a bank account with a bank is referred to by the bank as funds entrusted.

A business therefore has to make sure that it does not have a shortfall of liquid funds at any point in time, and it might therefore decide to retain extra liquid funds in reserve. These extra liquid funds are known as a liquidity surplus. The size of the liquidity surplus or shortfall can be used to calculate the liquidity position of a company.

A surplus (or shortfall) of liquid funds can arise because income and expenditure transactions do not take place at the same time. Furthermore, the size of the income and expenditure amounts are also not identical to each other. A liquidity surplus can therefore arise without a business making a conscious decision for this to happen. A business can draw up a liquidity forecast in order to estimate the probable size and duration of a surplus or shortfall. This will provide an overview of the expected future income and expenditure over a certain period. For example, per week or per month over a period of one year.

Businesses can make a conscious decision to retain liquidity surpluses, and there are three main reasons for doing this:

- transaction motive;
- precautionary motive;
- speculation motive.

Transaction motive

The transaction motive means a business wants to maintain a certain liquid reserve in order to be able to cover the expenditure necessary to guarantee the continuity of the operational processes, for example the payment of wages and the purchase of raw materials. Because the exact time and size of the daily income and expenditure cannot be predetermined, a liquidity surplus will give the business the certainty that it will be able to cover all the necessary expenditure.

Precautionary motive

The precautionary motive means a business wants to have an extra liquid reserve to make sure it can cover any sudden unforeseen expenditure.

Speculation motive

The speculation motive means a business wants to have an extra liquid reserve to be able to benefit from any price changes in production resources.

CHAPTER 25

Bank Products for the SME Sector

Introduction

If a business has a liquidity surplus in a bank account, the bank will see this as funds entrusted.

Banks can offer various products for liquidity surpluses. These products can be divided into products for small and medium-sized enterprises (SME) on the one hand, and large enterprises and corporate clients on the other.

For the SME sector, banks have current accounts, savings accounts, and deposit accounts.

25.1 Small and medium-size enterprises

The customers of the bank within the small and medium-sized enterprise sector (SME sector) are the smallest businesses. The majority of these businesses are sole traders and independent contractors. Businesses in this segment usually supply goods and services to the local market, and primarily have a need for standardised bank products and services. There are three types of standard products for liquidity surpluses for this client group.

These products are:

- the current account;
- the business savings account;
- the deposit account.

25.2 The current account

A payment account or current account is a bank account held by a retail customer or a business, which is used to make payments to other parties and to receive payments from other parties.

A business current account is a payment account for business customers. All the income and expenditure of the business goes through this account. The balance of the payment account will fluctuate considerably. The balance will go up when the company receives payments from its customers. And it will go down when the company makes payments to its suppliers.

The interest rate on the positive balance of a current account is usually variable and often not more than 0.5%. This is because the funds in a current account can be withdrawn at any time, and therefore the bank always has to have enough cash at hand to cover this eventuality. Consequently, the bank is not able to use the balance of current accounts for credit lending, which would generate extra revenue. Similarly, the lower interest rate on a current account means a company does not want to leave any liquidity surpluses in a current account longer than it has to.

25.3 The business savings account

The easiest product a company can use to get a higher return on temporary surpluses is the business savings account. This is a bank account where the company can put liquidity surpluses and get a higher interest rate than it gets on the current account. The company will not be able to make direct payments to third parties from the savings account, but will have to transfer money from the savings account to the current account first. The interest rate will depend on the withdrawal conditions and the size of the balance. A sliding scale is often used to calculate the interest rate for business savings accounts, with different interest rates for different balances.

Balance (in Euros)	Interest
up to 10,000	0.50%
10,000 to 50,000	0.40%
50,000 to 200,000	0.35%
200,000 to 500,000	0.30%
500,000 to 1,000,000	0.25%

Figure 6 Example sliding scale of interest rates for business savings accounts

The biggest advantages of a business savings account are that the customer can get a return on a liquidity surplus and yet still easily withdraw it again whenever necessary. The biggest advantage for the bank is that it can achieve a higher return with the deposited savings. This is because on average savings are held longer in a savings account than a current account has a credit balance, and the bank can use this money for credit lending.

A business savings account can often be opened and managed via the internet. Different banks give business savings accounts different names, such as: SME Extra Account, Business Plus Account, Entrepreneurs Internet Savings Account, or Business Return Account.

25.4 Deposit account

The most well-known product on the money market is the deposit account or deposit for short. A deposit is a contract whereby a company entrusts money to the bank, which only becomes available to the company again at the end of the agreed term. In principle, therefore, the amount in the deposit account cannot be withdrawn early.

A balance in a deposit offers the bank more security than a balance in a current account or in most business saving accounts. With a deposit account, the bank only has to have the required liquidity at the end of the term, which means the balance can be used in the meantime for interest-bearing loans. The fixed rate of interest agreed for the deposit also offers the bank more security. That is why a bank usually pays a higher interest rate for a deposit account than for a current account or a savings account.

The minimum deposit for a deposit account is usually around € 10,000 to € 12,500. A term of up to 10 years can be agreed, but this is usually too long for a business. A liquidity surplus generally only has to be deployed for a few weeks or months.

In principle, the shortest term for a business deposit account is only two weeks, but a bank may allow shorter terms if the amount is big enough.

In that case, the company will go to various banks to try and get the best rates for the deposit, which is known as "shopping around". By shopping around, the company forces the banks to compete each against each other by offering a better rate.

Generally speaking, deposits are a safe form of investment for a company. However, despite the high rates offered by many banks, the returns are still relatively low compared to other types of investment, such as bonds. Companies that are trying to achieve a maximum return will therefore not opt for a deposit account.

A deposit account is also not suitable if a company still wants flexible access to its liquidity surplus. It is usually quite difficult to prematurely close or renegotiate a deposit account. This problem can be (partly) resolved by taking out short-term deposits, or by spreading out the maturity dates of several deposits over a longer period of time.

Example

The Den Beste market gardening company grows tomatoes in a glasshouse, which are harvested in April. After deduction of costs, the revenue is € 100,000. Some of this will be needed in May to pay the holiday allowance of the employees. In June, the tomato glasshouse is prepared for the following growing season. The soil is disinfected and replanted. A large number of seasonal workers are used for this.
Den Beste decides to put the revenues into two deposit accounts in the meantime. The first account will be released at the end of May (payment of holiday allowance). The second will be released at the end of June (payment of seasonal workers).

Commercial enterprises hardly ever use deposits with a term of longer than a couple of months. They prefer to use any long-term liquidity surplus for investment in their own business. This is the core activity of the company, and where it expects to achieve the highest return.

A non-profit organisation, such as an association without commercial activities, does not have to pay corporation tax, and therefore the cost of raising loan capital (interest charges) cannot be treated as a tax-deductible business expense. Borrowing money is therefore expensive and unattractive for a non-profit organisation. It has no way of earning back the cost of the loan charges by making a profit on the sale of products and services. A non-profit organisation will therefore prefer to finance any investment using its own equity. By holding on to a liquidity surplus, the organisation can use it as a financial buffer to absorb any financial setbacks or uncertainties, or to finance future investment. It will therefore prefer to put it into a deposit account because the deposit and the interest will be guaranteed.

Example

The NTKC is an association that runs more than 20 camping sites in the Netherlands. Only members of the association can camp on these sites. The membership fees are collected in October. After deduction of direct expenses, such as ground lease, site hire, and maintenance costs, some of the liquidity surplus is placed in two deposit accounts.

A part of the surplus serves as a general reserve, and is fixed in a deposit account with a term of 8 years. A second deposit account has a term of 3 years. This is a special-purpose reserve that will be used to modernise the administration system. A part of the surplus will be needed to cover ongoing expenses, and will therefore be kept in the current account.

25.4.1 Types of deposit accounts

There are different types of deposit accounts, with different terms, interest rates, and withdrawal conditions. The possibilities include:

Fixed-term deposit account

With a fixed-term deposit account, a single lump-sum amount is deposited. Both the amount and the interest rate will be fixed for an agreed term. Early withdrawal might be possible, but this will be discouraged with very high withdrawal charges.

Flexible deposit account

With a flexible deposit account, interim withdrawals and deposits are also possible. The price for this flexibility is a lower interest rate. Furthermore, a minimum balance often has to be kept in the account in order to receive a certain interest rate. If the amount held in the deposit account falls below this minimum level, then a lower interest rate will be paid on the entire balance.

Special-purpose deposit account

A special-purpose deposit account is a deposit with a short term (up to 6 months), which is earmarked for a special purpose, for example the purchase of real estate. If the customer uses the deposit for this purpose, then no costs will be charged when the deposit is withdrawn.

CHAPTER 26

Bank products and services for large enterprises and corporations

Introduction

If a business has a liquidity surplus in a bank account, the bank will see this as funds entrusted.

Banks can offer various products for liquidity surpluses. These products can be divided into products for small and medium-sized enterprises (SME) on the one hand, and large enterprises and corporate clients on the other.

Large enterprises and corporations make use of the same products as the SME sector, but are also offered several other products as well: cash management advisory services, call money, money market paper, and money market funds.

26.1 Large enterprises and corporations

The large enterprise sector serves the medium to large business sector. These businesses have a lot of employees (in any case more than 100), often supply products and services both inside and outside the local market, and usually have more complicated payment transactions. Large enterprise customers often need more specialised services than SME customers.

Corporates are the biggest customers, and are often listed on the stock exchange or part of multinational corporations. The business operations of these enterprises are naturally more complicated than those of other business customers. Furthermore, they often have branches in several countries.

The banks offer these businesses the same standard products that are offered to the SME sector. However, in most cases they are offered a certain degree of customisation in the form of non-standard rates, terms, and withdrawal options. In addition, the bank often provides consultancy services in the form of cash management advice.

The most common types of products and services offered to large enterprises and corporates are cash management advice, call money and call deposits, money market paper, and money market funds.

26.2 Cash management

The planning and the management of cash flows and current account balances by a company is called cash management. In order to help companies with this issue, most banks also have a Cash Management department. The services provided by the Cash Management department of a bank are aimed at organising the cash flows of a business in the most efficient and profitable way.
The cash management of a company will cover several issues:

- balance management;
- liquidity management;
- cash flow management.

26.2.1 Balance management

Balance management is the day-to-day management of the current account balances of a business. All incoming and outgoing payments will change the balance on a daily basis. The company will then have surpluses or deficits in the accounts every day. The aim of the company is to control the balances on a regular basis (daily) so that the maximum amount of interest is earned on these balances.

For example, the balances of different accounts can be compensated with each other. For example, if one account has a debit balance (in the red), and another account has a credit balance (in the black), then this could result in higher charges. The debit interest that has to be paid, namely, is always much higher than the credit interest that is received. It is therefore a good idea to transfer funds from the account with the credit balance to the account with the debit balance, and in that way reduce the amount of debit interest that has to be paid.

If there is still a cash surplus afterwards, then this can be temporarily deployed elsewhere to generate income.

26.2.2 Liquidity management

Liquidity management is the management of liquidity positions of the business that exist for longer than a few days (i.e., more than one week) but less than one year. The aim of the company is to generate maximum returns from these surpluses.

If it knows how long the surpluses will last, the company can then deploy these surpluses to generate the highest possible returns, while at the same time clearing any deficits in the cheapest possible way.

Temporary surpluses or deficits in liquidity positions can be caused for various reasons. However, because they last for less than one year, they generally do not appear in the balance sheet of the company.

Example

A utility company receives monthly payments in advance from 100,000 private households for the supply of gas, electricity, and cable television. On average a household pays € 100 per month. The utility company therefore receives € 10 million at the beginning of each month. It only needs some of this at the end of the month (to pay wages).

26.2.3 Cash flow management

Cash flow management is the totality of activities carried out to manage payment transactions both within the company and between the company and third parties. The aim of cash flow management is to keep costs to a minimum by reducing the number of payments, reducing the costs per payment, delaying outgoing payments, and speeding up incoming payments.

Managing the various payment dates is an important aspect of cash flow management. The company will try to delay outgoing payments to its suppliers (accounts payable) as long as it can without harming its business. On the other hand, it will also try to speed up incoming payments from its customers (accounts receivable).

26.3 Call money and call deposits

Call money is a loan which is agreed for an indefinite period, and which can be cancelled by either of the parties, both the lender and borrower, on a daily basis. The bank will either provide these loans or mediate for parties who want to lend call money.

Call deposits are deposits with a term of just one day. A call deposit is settled the following day. Some businesses are not only able to place call deposits with their bank, they can also borrow money from their bank for just one day. This type of deposit is only used for very large amounts, because then the difference in interest rates over just a single day will still outweigh the cost of the transaction.

26.4 Money market paper

Banks act as an intermediary when large companies want to buy money market paper with large amounts of surplus funds. Money market paper is a tradable acknowledgement of debt with a maximum term of two years (a short-term bond). In return, the holder of the bond will receive a predetermined rate of interest during the term of the bond. When the term of the bond expires, the borrowed amount has to be repaid.

There are different types of money market paper, depending on who the issuer is. In Europe, the following categories are used:

Commercial paper
With commercial paper, the issuer of the acknowledgement of debt is usually a commercial enterprise. Commercial paper can also be issued by an institution (e.g., the European Investment Bank) or a local government body (e.g., the municipality of Amsterdam).

Certificates of deposit
If the issuer is a commercial bank, the acknowledgement of debt is called a certificate or deposit.

European Bank Certificates
The European Central Bank also issues money market paper. These are called European Bank Certificates.

Dutch Treasury Certificates
The short-term debt instruments (less than one year) issued by the Dutch state are called Dutch Treasury Certificates.

26.4.1 Issue of money market paper

A company that wants to issue commercial paper will need the help of a bank. The issuing company will have to specify the required amount, the desired term, and the interest it is willing is to pay.

The bank will then set up a commercial paper programme together with the company. Important aspects of a commercial paper programme are:

- the total size of the programme, in other words: the maximum amount of money the company wants to raise from the money market under the programme;
- the different currencies the money market paper can be issued in;
- the size of the denominations;
- a guarantee from a parent company, where relevant;
- a creditworthiness (rating) of a rating agency, where relevant.

The bank will thus act as the arranger of the commercial paper programme and draw up a prospectus which sets out the conditions for the commercial paper. The bank will also report the programme to the central bank. Furthermore, the bank the will also act as the broker. This means the bank will go on the market to find counterparties with liquidity surpluses who are willing to invest in the relevant money market paper. However, the bank will not run any default risk itself in that capacity. The default risk is the risk that the issuer of the commercial paper does not repay the loan. This risk lies with the buyer of the commercial paper.

26.4.2 Negotiability or tradability of money market paper

Money market paper can be traded during the term. The advantage of this is that the investor can sell the money market paper again if it suddenly needs more liquidity. However, there is not a very lively secondary market for money market paper, because it is not traded on an exchange.

In practice, when this happens the bank that has sold the money market paper to the investor will usually buy the paper back from him again. Although the banks are not obligated to buy back the paper, they nearly always do. This is because they like to point out that tradability is one of the biggest advantages of money market paper.

26.5 Money market funds

Money market funds are investment funds that invest in money market paper and deposits. Similar to other investment funds, a participant can sell their participation at any time. An investment fund is capital that has been brought together by different participants, which is then invested in different types of securities by a fund manager. For the investing company, the advantage of investing in this type of fund is that the money can be withdrawn immediately at any time. It will then be paid the return or yield over the relevant period plus the original contribution.

A money market fund will spread the investments across several parties. That is a major advantage compared to investing in money market paper, for example. The likelihood of a money market fund collapsing (going bankrupt) is many times smaller than a single counterparty not being able to make repayment. One last advantage is the convenience. The company can agree with the bank, namely, that the available balances in its current accounts are automatically diverted to the money market fund of the relevant bank.

CHAPTER 27

Capital Requirement

Introduction

A company needs to have a certain amount of capital at its disposal in order to be able to run its business. The capital requirement of a business is equal to the total value of all the production resources that a company owns at a particular point in time: in other words, the total value of all the property, plant, and equipment.

27.1 Capital Requirement

The capital requirement of a company is the amount of capital that is required to maintain the necessary property, plant, and equipment (the production resources) over a certain period. The capital requirement is therefore equal to the total value of the property, plant, and equipment as stated on the balance sheet. A balance sheet provides a statement on the one hand of the assets and receivables of a company, and on the other hand the liabilities of a company at a particular point in time (the balance sheet date).

The capital requirement of a company is thus the value of all its assets and receivables at a particular point in time: this is the capital requirement that has already been covered by the company. Every business needs to have capital assets in order to be able to run its business processes. On the one hand, this can consist of tangible capital goods or non-current assets, such as property, plant, and equipment. On the other hand, it can also consist of intangible capital goods or current assets, such as stocks, receivables, and liquid funds. All of these tangible and intangible goods are recognised on the asset side of the balance sheet. That is why they are collectively referred to as assets.

These are capital goods that the company has already acquired. In order to acquire these goods, the company had to call on certain sources of capital, which can be divided into internal capital (equity) or external capital (loan capital). This capital is therefore recognised on the liabilities side of the balance sheet.

Assets	**Liabilities**
capital goods	sources of capital
- non-current assets	- equity
- current assets	- loan capital

Figure 7 Capital goods and sources of capital

27.1.1 Non-current assets

Non-current assets, often referred to as fixed assets, are assets that are at the company's disposal for longer than one year. This includes land, buildings, and machinery and means of transportation.

Money that is invested in the acquisition of real estate, such as land and buildings, cannot be released without this having consequences for the company's business operations. The capital requirement for these types of assets is thus permanent in nature (permanent capital requirement).
Machines, inventory, and vehicles have a long economic life, but are still less durable than real estate. These goods can also be sold and replaced without this harming the business operations. The capital requirement associated with these goods is long-term in nature, but not permanent.

27.1.2 Current assets

Current assets are assets and receivables of the company where the invested capital will become available within one year. Current assets have a changeable character: stocks of raw materials, semifinished products and finished products, accounts receivable, and liquid funds (including the balance in the current account).

The value tied up in the current assets will therefore change rapidly. A production cycle starts with the purchase of raw materials and consumables. The capital used for this will become available again when the produced goods are sold. The capital requirement for these types of assets is thus relatively short-term in nature.

Example

A building contractor installs custom-made kitchens for retail customers. The initial start-up costs consist of arranging a meeting with the client and the designer, working out the details of the design, and after the order has been confirmed, the pre-finance for the ordered materials. In general, the installation work starts within three months after the first contact with the client. This contractor has a relatively short project cycle. The capital invested in the project is therefore quickly released again, which means the capital requirement is only short-term in nature.

A contractor who is building homes has a much longer turnaround time, and uses much larger quantities of materials. In that case, the capital tied up in current assets will be much larger and for considerably longer.

27.1.3 Business processes

In addition to the capital requirement for operating resources, there is also the capital requirement associated with the production process itself. The materials will need to be processed, and that requires capital (personnel costs, machine costs). This capital requirement will increase gradually during the production process and then decline abruptly when the customer pays.

Example

The actual installation of the kitchen takes four weeks. During the first two weeks, the kitchen units are assembled in the workshop. This work is carried out by two full-time furniture makers. Afterwards, the kitchen is installed in the client's home. This work is also carried out full-time by two men over a period of two weeks. The personnel costs therefore go up from 0 to 40 man-days in this period of four weeks.

The elements of this capital requirement include:
- wages for the employees who work on the product;
- expenditure on water and energy;
- cost of raw materials;
- storage costs for raw materials and finished products.

27.1.4 Continuity

The final aspect of the capital requirement concerns the survival of the organisation is a whole. The company can only make use of a product for a limited period. The useful economic life of a product can be extended by improving the product, but eventually it will come to an end.
A company therefore needs to invest in innovation. The capital requirement associated with this can be short-term in nature, such as a computer supplier who launches a new model on the market. The development of a fundamentally new product, on the other hand, such as a flatscreen TV or a new drug, can take years.

CHAPTER 28

Sources of Capital and Borrowing Requirement

Introduction

Every company has to have a certain amount of internal capital or equity. When a company is founded, the owner or owners have to provide this capital themselves. When the company starts to make a profit, some of the profit will revert to the owners as a consideration for making this capital available. Another part of the profits will revert back to the company, which will lead to an increase in equity. The equity can also be increased by finding more owners or by increasing the amount of the participation of the existing owners.

Property, plant, and equipment are items that cause a permanent and long-term capital requirement. It is possible to finance the acquisition of these non-current assets using internal capital or equity. Furthermore, new products and services have to be developed (innovation), and a buffer will have to be retained in order to cover any risks. Internal capital or equity is the preferable way of financing this.

Financing for current assets (stock and work in progress etc.) and receivables (accounts receivable), on the other hand, is generally raised in the form of short, medium, or long-term loans.

28.1 Sources of capital

The sources of capital of a company can be divided into internal capital (equity) and external capital (loans).

28.1.1 Equity

The owners of a company will need to have internal capital, or equity, when it is founded (start-up capital). In the simplest form, there is one owner who raises the start-up capital for the business out of his own money. With a one-man business, or sole trader, there is no distinction between the assets of the company and the private assets of the owner (natural person). A company can also be owned by several natural persons, for example in the form of a professional partnership, a general partnership, or a limited partnership.

If a company has legal personality, the personal assets of the owners (shareholders) are kept separate from the company assets. Examples in the Netherlands include the private company (BV) and the public limited company (NV). The shares of a private company are registered and are not freely marketable. This means the owner of a share cannot sell the share to anybody he wants to, or at any price. He will need to have the permission of the other shareholders of the private company first. The shares of a public limited company, on the other hand, are bearer shares and are therefore freely marketable. With bearer shares, the person who has the shares in their possession (the bearer) is deemed to be the owner of the shares.

With freely marketable shares, the holder of a share is free to sell the shares to anybody they want to, and at any price. Some public limited companies are listed on the stock exchange.
The equity of a company will go up or down if the company makes a profit or a loss, if private withdrawals or deposits are made, or if shares are issued or purchased.

The equity has a number of functions, including the absorption of poor operating results and the safeguarding of the continuity of the company. This means the owners run the risk of losing the capital they have contributed. Equity is therefore also referred to as risk-bearing capital or venture capital.

Banks and other credit providers are not easily persuaded to provide risk-bearing capital. A company will often have to raise the equity itself. This can be done, for example, by contributing more capital per owner or shareholder, by attracting more owners or shareholders, or by issuing participating interests.

A company that is listed on the stock exchange can issue freely marketable shares via a share issue. With a share issue, the shares are put up for subscription in batches, and through the mediation of the bank these are then subscribed to by new and existing shareholders.

The company therefore puts new shares in circulation with a share issue. This happens on what is known as the primary capital market. A company uses this market to raise money from the buyers of its shares. The first (primary) holder of the shares can sell these shares on if they want. This takes place on the secondary capital market.

On the secondary capital market, the ownership of the shares changes without the company having any involvement. The price (the listed price or market price) of the shares will depend on the supply and demand for the shares. Any change in the price of a share will not directly affect the company. The price of a share is, however, an indication of the confidence that investors have in the company. A sharp drop in the price of a share is an indication that investors think the company is not functioning properly. And that will make it difficult to raise new equity with a (following) share issue.

Most companies are not listed on the stock exchange. Shares in these companies therefore have to be placed privately, with the bank playing an intermediary role. Very small businesses usually have to raise capital from family and friends.

Banks sometimes buy blocks of shares in ordinary companies. They will set up a separate subsidiary for this. The blocks of shares are called participating interests, and the subsidiaries are called private equity companies or venture capital companies.

With high-risk but promising businesses, banks will often prefer to take a participating interest rather than provide a bank loan. If a bank gives a normal bank loan to this type of company, although it runs the risk of losing the loan, it will not share in the profits if the company is a success. The interest and the amount to be repaid are fixed in advance. With a participating interest, on the other hand, the bank will profit from any success the company has. This is because the value of the shares will go up.

If the company is a success, there will be more income than expenditure. This surplus, the profit, can be added to the equity. In general, the owners/shareholders will want to receive a part of the profits in the form of a cash dividend. This is a consideration for the capital they have contributed and the associated risk they run. This profit distribution (in the case of legal persons, known as a dividend) is taken out of the equity of the company.

28.1.2 Loan capital

Loan capital does not come from the owners or shareholders, but from an external party, for example a bank or a creditor. Loan capital is only provided for a certain amount of time. Sooner or later, it has to be paid back to the lender or loan provider again. The repayment to the loan provider is usually not linked to the results of the company, and is therefore referred to as low-risk capital or borrowed funds.

A distinction is made between long-term loan capital and short-term loan capital. This distinction is based on the way a company has to recognise the loan capital in its annual accounts according to the regulations.

Loan capital which the company does not have to repay for at least one financial year will be treated as long-term loan capital. The final repayments on long-term loan capital that have to be made in the next financial year will no longer be treated as long-term loan capital.

Example

A company has taken out a loan with a bank in 2014. The loan runs until July 2024. In the annual reports for the years 2014 to 2022, the loan will be recognised as long-term loan capital. In the annual report for 2023, however, it will be treated as short-term loan capital. The loan has to be repaid by July 2024, and it is therefore no longer available to the company for a full financial year.

A company can raise long-term loan capital in the form of long-term bank loans. The bank will then refinance these loans via the capital market. The government and some big businesses also raise long-term loan capital directly on the capital market. This takes place via bond loans. In exchange for the loan, the lender will receive a certificate of debt, the bond, which gives the lender the right to repayment of the loan and the payment of annual interest (coupon rate or coupon). This certificate of debt can be traded on the capital market.

Loan capital that is available for less than one financial year is treated as short-term loan capital. Interest might also have to be paid on this loan capital in the new financial year, but more importantly the money will leave the company during the course of that year. The amount of the loan has to be repaid to the lender, and that is only possible if there are sufficient cash reserves (or assets that can be liquidated quickly).

Loan capital that is needed quickly can be raised in various ways, for example:

- by taking out a bank loan;
- by taking out a loan with a non-banking institution;
- by postponing the payment of invoices of suppliers (supplier credit);
- by asking for advance payments from customers (buyer credit).

28.2 Use of sources of capital

Equity is mainly used to finance the permanent capital requirement associated with real estate. The company will not earn any interest on the capital that is tied up in land and buildings, but on the other hand, generally speaking, the value of the real estate will increase each year.

Innovation can be a high-risk undertaking. It is a long road from initial concept to finished product, and success is not always guaranteed. The product might not even make it to the market, or even worse, somebody else might get there first. When that happens, the investment is lost. Lenders are reluctant to provide loan capital for this type of high-risk activity. Innovation therefore usually has to be financed with internal capital or equity.

The ratios between equity and debt capital and/or total assets are important indicators for loan providers and trade creditors. They show how solid the financial position of a company is (solvency position), or whether it will go bankrupt at the first sign of adversity.

Long-term loan capital is suitable for the financing of machines, inventory, and transportation. It is also used to finance a part of the current assets. Some of these assets are more permanent than the name suggests. An individual outstanding account might be paid off within a reasonable period, but out of all the outstanding invoices there is usually a fixed or permanent core of unpaid accounts. The same applies for stocks and liquid funds.

A short-term capital requirement is variable in terms of size and duration. The capital requirement will grow steadily during the production process, and then suddenly disappear when the customer pays. A company can also cover a short-term capital requirement with a flexible source of finance. Short-term loan capital is the best way to do this.

28.3 Borrowing Requirement

A company considering an investment needs to work out its capital requirement first. Then the company needs to decide how to finance this capital requirement.

Most businesses do not have enough equity to finance their entire capital requirement. The extra amount of loan capital a company needs to raise is called the borrowing requirement.

CHAPTER 29

Rights of Creditors

Introduction

When a company goes bankrupt, some creditors of the bankrupt company have priority over other creditors. The preferential creditors have first priority, then the ordinary creditors, and finally the subordinated creditors.

29.1 Rights of Creditors

Under the law, both natural persons and legal persons, with their entire assets, can be held liable for all their debts. If a company fails to fulfil its payment obligations, the creditors are therefore able to recover their claims against all the assets of the company. In the case of companies without legal personality, the claims can be recovered against the private assets of the business owners as well.

The question is, how can the creditors enforce their claims and recover their money? It is often the case, namely, that debtors refuse to cooperate or simply do not have enough money to pay the debts. Under the law, however, creditors are afforded a number of legal remedies that enable them to sell off the assets of the debtor and then use the proceeds to pay off the debts. A so-called "foreclosure sale", for example, usually takes place after the debtor has been declared bankrupt. When a bankruptcy order is issued by the courts, the entire assets and all the revenues of the defaulting debtor are seized.

A debtor can be declared bankrupt by the courts at the request of two or more creditors. All the assets and liabilities of the debtor are covered by the bankruptcy. The receiver will arrange a foreclosure sale of all the assets, and the foreclosure proceeds will then be divided up amongst the creditors. However, some creditors might not get any of their money back at all, especially if there are one or more preferential creditors. Preferential creditors are accorded priority under the law, and are given preference over the ordinary or unsecured creditors.

29.1.1 Preferential creditors

Preferential creditors have priority over the ordinary and unsecured creditors because they have a preferential claim. This means the claim is attached to a right of pledge or right of mortgage. By virtue of that right of pledge or mortgage, the creditor can enforce the sale of the attached assets either with or without a bankruptcy order. Unlike the ordinary creditors, the preferential creditors do not need to get a court order first. A preferential creditor can also use all of the foreclosure proceeds to settle their claim only; they do not have to share the proceeds with the other creditors.

29.1.2 Ordinary creditors

Ordinary creditors have an equal right to a share of the foreclosure proceeds in the event of bankruptcy. The receiver will therefore have to divide up the proceeds in proportion to the size of each creditor's claim. In most cases, the proceeds are not enough to pay for 100% of every claim. The receiver will then give each creditor the same percentage for their claim.

29.1.3 Subordinated creditors

Subordinated creditors only receive proceeds after all the claims of the other creditors have been paid.

CHAPTER 30

Security

Introduction

Before approving a loan, a bank will look at the security that is being offered. Real security, or collateral, will put the bank in the strongest position. If the company is liquidated, the pledgees and mortgage holders will have priority over the other preferential creditors and the ordinary creditors. Personal security, such as suretyships and joint and several debt obligations, provide less of a guarantee for recovery. Quasi-security, such as subordination and repurchase commitments, do not offer any means of recovery whatsoever.

30.1 Real security

The borrower can provide one or more of his assets (goods) as underlying security for a loan. The lender can then sell these assets if the borrower fails to fulfil his repayment obligations.

Assets are divided into real rights and property rights. Real rights relate to material or tangible assets, such as a buildings or stocks of goods. Property rights relate to immaterial or intangible assets, such as a right of egress, the right to an insurance payment, or the future income from accounts receivable.

The ownership of some assets has to be registered in a special register. These assets are referred to as property subject to registration, or registered property for short. This category includes land, buildings, ships, and aeroplanes.

The owner of an asset has the right to sell his property and to keep the proceeds. This right can be assigned to another party, such as the credit provider, as security for the provided credit.

Real securities are:
- rights of mortgage;
- rights of pledge.

30.1.1 Right of mortgage

The owner of a piece of registered property can assign a right of mortgage to the lender. Registered property is an item of property that is registered in a public register. The lender thus becomes the holder of the right of mortgage. If the debtor defaults on the loan, the lender can sell the security, usually by public auction, and use the proceeds to recover the outstanding debt.

The mortgage holder has a right of summary foreclosure, which means he can sell the security or collateral at a public auction without having to get a court order first. The right of mortgage is assigned by

way of a notarial deed, and is registered in the mortgage register of the land registry office. The right of mortgage itself is therefore considered to be an item of registered property.
The right of mortgage is attached to the registered property. It will not be cancelled if the underlying registered property is sold, but will still be attached to it as a right that can be enforced against the new owner. That is why people buying real estate usually insist that it is 'transferred unencumbered by mortgage'. The previous owner therefore has to repay the loan first, after which the right of mortgage can be cancelled. Alternatively, the previous owner can have the right of mortgage transferred to a different item of registered property.

30.1.2 Right of pledge

A right of pledge is similar in many ways to a right of mortgage, but relates to non-registered property. The right of pledge itself is therefore not registered in a register. If the pledgor does not fulfil his obligations, the credit provider can sell the pledged property and use the proceeds to recover the claim. The pledgee has a right of summary foreclosure.

In principle, any item of non-registered property can be pledged. The only condition set under the law is that the pledge can actually be assigned in practice.

Example
A car or a bearer savings certificate are tradable goods. They can be pledged.

Property rights, such as a registered debt or the proceeds of a life insurance policy, are non-tradable. However, these rights can still be assigned, and therefore also pledged.

A car purchased under a hire-purchase agreement (financial lease) cannot be transferred during the lease period (it is subject to a retention of title of the lease company). Only after the final lease instalment has been paid can the borrower transfer the car to somebody else.

There are various types of pledge rights:
- undisclosed pledge;
- disclosed pledge;
- possessory pledge;
- non-possessory pledge.

Undisclosed pledge
An undisclosed pledge can be used in connection with property rights. Only the pledgor and the pledgee know about the pledging. The debtor does not make it publicly known that he has pledged the right. One example would be the pledging of accounts receivable.

Example
A publisher sells magazines through retail outlets and via subscriptions. The revenue from retail sales is unpredictable. The subscription revenue, on the other hand, is very predictable. The vast majority of the

subscribers will renew their subscription. The expected subscription revenue can therefore be pledged. The publisher will not disclose this pledge to the subscribers.

An undisclosed pledge can be established by way of a notarial deed. A private deed can also be used, as long as it is registered with the tax department.

Disclosed pledge

A disclosed pledge can also be established on property rights. In this case, in addition to the pledgor and the pledgee, everyone else will also know about the pledging.

An undisclosed pledge will only have to be disclosed if the pledgee decides to foreclose and sell the underlying security. When this happens, the debtor will have to be told that all of his payments will have to be made to the pledgee in the future. Only payments made to the pledgee will be recognised as a 'discharge' of the payment obligations. A disclosed pledge can sometimes be the preferred option straightaway.

Example

Henk runs a copywriting agency. He is a sole trader. He applies for credit to expand the agency. As security, Henk provides a life insurance policy with a pay-out in cash when he reaches the age of 60.

The bank accepts the pledging and asks the life insurance company to make a record of the pledging on the policy itself.

Possessory pledge

A possessory pledge can be established on goods that are tradable, such as a bicycle or a car. With a possessory pledge, the relevant object is handed over to the pledgee. The pledgor no longer has the right of disposal over these goods. A private deed is sufficient.

A particular kind of possessory pledge is the bank pledge. Under article 18 of the General Banking Conditions, a bank will automatically pledge all the assets of a customer that it has in its possession to itself. This includes the balances held in the accounts, book-entry share deposits, and valuable papers held in safekeeping by the bank for the customer. Because of this automatic pledging, the bank can recover any claims it has against the customer (such as a debit balance of a current account) from the other assets of the customer it might have in its possession.

Example

Otto Bartoli runs a wholesale business for machine oil, and has a current account with the Eurobank. He has a special-purpose reserve to finance any expansion or innovation. This special-purpose reserve is kept in a deposit account, also with the Eurobank. The Eurobank will automatically become the pledgee of the deposit, which will then serve as security for current and future claims.

Non-possessory pledge

With a non-possessory pledge, the goods are not handed over to the pledgee. The pledgor therefore still has possession of the goods. This type of pledge is therefore suitable for the pledging of machinery and inventory.
A non-possessory pledge can be established by way of a notarial deed or with a private deed that is registered with the tax department.

30.1.3 Protection of other creditors

The holders of a right of mortgage and a right of pledge have a very strong position. This can seriously disadvantage the other creditors. Especially if an object has been given in possessory pledge, which puts it beyond the reach of the other creditors.

That is why business owners sometimes use this type of pledge to deliberately put assets out of the reach of creditors. The assets are then pledged to friendly third parties so they cannot be touched if the company goes bankrupt.

If a creditor thinks they have been disadvantaged by a right of pledge that is not related to the normal business operations of a company (undue pledging), it can apply for a so-called '*actio Pauliana*' to have the right of pledge annulled on the grounds that it is fraudulent. If this application is upheld, the right of pledge will be annulled and the assets will revert back to the bankrupt estate.

30.1.4 Enforcement of security

In addition to the right of summary foreclosure, under the law the mortgage holder and the pledgee also have various other rights, such as:

- right of priority in the recovery of claims;
- the position of preferential or secured creditor in the event of bankruptcy.

The right of priority in the recovery of claims means the mortgage holder or pledge holder will be able to recover their claims first out of the proceeds of any foreclosure sale of the security or collateral.

The right of priority in the recovery of claims and the right of summary foreclosure mean these creditors are already in a strong position. The status of preferential or secured creditor makes that position even stronger. The mortgage holder or pledge holder does not have to take any other creditors into consideration. He can enforce the recovery of his claims as if the other creditors do not exist, and moreover does not have to contribute towards the costs of bankruptcy proceedings.

In some situations, the proceeds of the foreclosure sale of the security will not be enough to recover the secured claims. In that case, the mortgage holder or pledge holder will be treated as (ordinary) creditors with respect to their residual claims.

30.2 Personal security

Personal security can be provided if a company does not have enough real security for the credit it needs. Personal security is security provided by a third person. This person can in turn offer both real security and personal security.

There are various types of personal security, including:

- a contract of suretyship;
- a guarantee;
- a joint and several debt obligation.

30.2.1 Contract of suretyship

A surety takes on an obligation towards to the creditor that he will pay all the debts of the borrower if he is unable to pay them himself. The surety can only be held liable if the borrower defaults on the loan.

The spouse or registered partner of the surety is not a co-surety, but they do have to give their permission for the suretyship. Without this permission, the suretyship can be nullified (a court order can be obtained for the annulment of the suretyship).

A contract of suretyship is a so-called “accessory obligation” or dependent obligation. The contract will only exist as long as the debt still exists. The contract of suretyship will therefore be extinguished as soon as the debt has been extinguished. The surety can also dissolve the contract. But the surety can still be held liable for any obligations that were taken on before the contract was dissolved.

A contract of suretyship can be attached to a specific debt. A credit suretyship can be attached to all the existing and future credit facilities provided by a bank. A bank suretyship goes even further, and can be attached to all current and future claims.

A surety is liable up to the full extent of his assets. There is no guarantee, however, that the financial position of the surety will always stay the same. The bank can therefore cover itself against the possible bankruptcy of the surety by taking out a right of mortgage or pledge on the assets of the surety. This is called “secured suretyship”.

In a private company or a public limited company, the company’s assets are kept separate from the personal assets of the owners. In theory, the owners of the company can take company assets out of the business and keep them as personal assets so they cannot be foreclosed on. A bank can overcome this by getting the owners to provide a personal suretyship for the debts of the company.

30.2.2 Guarantee

A guarantee is very similar to a suretyship. The guarantor (the person who provides the guarantee) guarantees that the debtor will fulfil his obligations to the creditor. The main difference compared to a suretyship is that a guarantee is not a dependent obligation. In other words, the guarantee will not be extinguished as soon as the debt is extinguished, but has to be cancelled by the guarantor himself.

30.2.3 Joint and several debt obligation

With a joint and several debt obligation (also called a declaration of joint and several liability), one or more third parties obligate themselves to pay a debt. Joint and several means that each of the parties can be held individually liable for the full debt. The creditor can therefore choose which party to recover the debt from.

With a general partnership, by law all of the partners are jointly and severally liable. With other forms of partnership, a separate agreement has to be made about this (in the partners’ liability declaration).

Partners who are married will usually try to protect their private assets with a marriage contract. The bank can overcome this by getting the spouse to sign a declaration of joint and several liability.

30.3 Quasi-security

Quasi-security, or intangible security, is a promise by the borrower or a third party to do something, or not to do something, for the benefit of the bank. However, the bank has no guarantee that the promise will actually be fulfilled when invoked. It is therefore not guaranteed security.

Common types of quasi-security or intangible security include:

- subordinations;
- repurchase commitments;
- *pari passu* statements;
- pledge;
- mortgage declarations.

30.3.1 Subordination

If one or more creditors of a company make a promise to only recover their claim after the company has paid all its debts to the bank, this is called a subordinated debt. In the event of bankruptcy, these creditors will then become subordinated creditors.

A subordinated loan is a loan that, in the event of bankruptcy, only has to be repaid after all the other creditors (or one particular creditor) have been paid. In the banking business, subordinated loans are often found to exist alongside bank loans. The provider of the subordinated loan will therefore be one of the other creditors. The bank will agree with this creditor that its loan will only be paid off after the debtor has paid off all his debts to the bank. The other creditor therefore runs the risk that there will be nothing left to pay off his debt. Because of this risk, the interest charges on a subordinated loan are often much higher than for a non-subordinated loan.

Frits has a courier business with a weak solvency position. The bank is still willing to provide credit, but only if the existing loan provided by Henk, the brother of Frits, is subordinated. If Frits goes bankrupt, then Henk will be last in line, after the mortgage and pledge holders, the tax department, and the ordinary creditors.

30.3.2 Repurchase commitments

A company can finance the purchase of current assets with supplier credit, for example by delaying payments to suppliers. Naturally, suppliers would rather their customers financed this type of purchasing with bank credit. The bank is more likely to provide this credit if the suppliers promise that, if necessary, they will buy back the goods they have supplied. The declaration whereby a supplier makes this promise is called a repurchase commitment.

30.3.3 Pari passu statement

In a *pari passu* statement, the borrower promises that he has not provided any real security to other credit providers, nor will he do so in the future without allowing the bank to share in such.

Example

Jitske wants to start an environmental consultancy firm. She has found suitable office space, but she will need to pay a deposit. She goes to the bank to ask for a loan. However, she cannot provide any real security. She lives in rented accommodation, and the office equipment of the company, such as the computer and the copying machine, have been purchased with credit finance.
This means she cannot pledge this equipment as security. She therefore signs a *pari passu* statement, in which she promises that the bank will be able to share in any future real security.

30.3.4 Pledge

The borrower promises that he will not offer current assets as security to third parties. He also promises that he will not sell these assets except during the course of his normal business activities. This is called a negative pledge because the borrower promises not to undertake certain action.

It is usually combined with a positive pledge. In this the borrower promises to offer certain assets to the bank as security if the bank requests such.

30.3.5 Mortgage declarations

A mortgage declaration is a type of pledge. In this the borrower promises not to sell certain real estate, or to encumber it (further) with a right of mortgage for a third party (negative mortgage declaration).

The opposite of this is a positive mortgage declaration, where the borrower promises to provide the real estate as security to the bank on request.

CHAPTER 31

Credit Applications

Introduction

A credit application can be divided into three stages. In the first stage, the bank makes an assessment of the business owner, the business, and the security being offered. In the second stage, a credit proposal is drawn up internally. This will be then be assessed by the authorising officer. If the authorising officer approves the proposal, then the third stage will follow: the proposal presentation phase.

31.1 Credit Applications

A credit application is dealt with in three stages:

- the credit assessment interview;
- the credit proposal formulation;
- the credit offer.

31.1.1 Credit assessment interview

During the credit assessment interview, the bank will try to form an impression about the credit applicant. The interview will deal with various subjects, such as:

- Who is the credit applicant?
- What do they do, and what is their position within their sector?
- Do they do business with any other banks?
- How much credit are they asking for, and why?
- What is the financial position of the company?
- How is the company run?
- What security, if any, can be provided?
- What commercial interest does the bank have in the company?

All this information will be collected and registered properly. This will prevents any misunderstanding with the customer, make it possible to handover the file to other bank employees, and it can also be used as evidence in legal proceedings.

31.1.2 Credit proposal

The collected information will be assessed and an internal credit proposal will be formulated. This proposal will include:

- general information about the company, the sector, and the business owner;
- financial information, not only the figures, but also the accounting principles used to calculate them;
- details of the credit requirement, such as the purpose, type, and credit limit;
- available security;
- the credit advice.

The advice will be then be assessed by the authorising officer. The authorising officer can either reject or approve the application or ask for additional information.

31.1.3 Credit offer

If the internal credit proposal is approved, the customer will then be made a credit offer. This credit offer is also known as a credit arrangement letter. The credit offer will state:

- the legal form of the company and the liability of the owners;
- the nature and amount of the credit;
- the security that has to be provided;
- the credit conditions;
- the periodical financial reports that have to be provided (balance sheet, profit and loss account);
- general and specific conditions;
- the availability period (validity period of the offer).

CHAPTER 32

Credit Administration

Introduction

The bank will carefully monitor the status of all the credit agreements that have been concluded. All the agreements that have been made, and any amendments made at a later date, will be kept on file in the credit administration system.

Furthermore, any developments in the credit situation will also be monitored. This credit management process will involve monitoring the credit situation (credit monitoring), adjusting the level of credit if necessary (credit review), and intervention if the credit situation takes a turn for the worse (special credit management).

32.1 Credit Administration

The credit administration department will systematically record all the details about the credit that has been provided. This concerns the individual credit facilities that have been provided to businesses, the credit portfolio of each separate branch of the bank, and the credit portfolio of the bank organisation as a whole.

The credit administration system has to fulfil a number of functions:

- administrative records and documentary evidence;
- monitoring the credit position of the customer;
- financial accounting and external auditing;
- policy management information.

A credit file is kept for each customer. All the documents associated with the credit facility will be kept in this file, such as:

- records of meetings;
- correspondence;
- credit analyses;
- information about the company;
- copies of documents relating to the requested security (security registration);
- the credit proposal;
- copy of the credit arrangement letter signed by the customer;
- approved change proposals;
- review proposals.

Only copies of these documents will be kept in this file. The original security documents and the signed credit arrangement letter will be kept in the security dossier. This will be kept in a separate secure and fireproof location.

In many cases the authorising officer will also keep a copy of the credit file (the shadow file).
In addition to the details of the agreement, the credit file will also contain information about the history of the credit facility (repayment, early repayment, arrears).

32.2 Credit management

The credit analysis is based on the current situation plus information about the preceding period. Although projections can be made on this basis, the outcome is by no means certain. The bank will therefore continue to monitor developments within the company after the credit agreement has been signed. This type of credit administration is primarily about internal procedures, and does not really involve the customer. The administration is divided into three areas:

- credit monitoring;
- credit review;
- special credit management.

32.2.1 Credit monitoring

With credit monitoring, the bank monitors the credit risk. It makes sure the borrower is able to meet the credit conditions, both now and in future, such as the payment of interest and repayments. The credit history can also provide an indication of a growing credit risk.

The warning signs for this are:

- the debit balance of the current account is continually near the credit limit. Under normal circumstances, the incoming payments will turn the debit balance into a credit balance on a regular basis. The continuous use of the full limit can therefore be an indication that the credit facility is not being used in the proper way or that there are problems in receiving payments from customers;
- the limit is exceeded repeatedly in quick succession;
- payments to creditors are deferred, often in combination with an increase in the number of queries about the account holder and/or problems with the collection of bills of exchange. This might be an indication that the company is having difficulty meeting its payment obligations;
- the turnover is low compared to the credit limit. This can be an indication that turnover is going down.

Furthermore, the bank will also monitor other indicators, such as:

- a worsening of the general economic climate;
- the developments in the relevant sector;
- the trend in the turnover of a certain shopping area. A particular shopping mall, for example, can become less popular with shoppers over time;
- the quality of the management (takeover, change of owner).

32.2.2 Credit review

Businesses can develop in both a positive and a negative way. The bank therefore has to check once a year to make sure the credit conditions are still appropriate for the company. An ideal moment for this review is shortly after the annual figures have been announced. In the case of large or poorly-performing businesses, the bank will carry out this review twice a year.

If the business is running as expected, then in general the customer will not be affected by the credit review. There will not be any reason to impose additional conditions for the credit facility, and thus the credit facility can continue as normal.

32.2.3 Special credit management

If the credit monitoring or the credit review procedures identify problems with the credit relationship, then measures will have to be taken. The credit administration will then be transferred to a special department.

The activities of this department, usually called the special credit management department, are primarily aimed at safeguarding the interests of the bank. Various measures can be taken in this respect. It might be possible to save the business with targeted restructuring measures. The business might also still have disposable assets that can be used to provide security. On the other hand, the bank might decide that it needs to foreclose on the existing security.

CHAPTER 33

Short-Term Credit Products

Introduction

A business generally raises financing for current assets (stock and work in progress etc.) and receivables (accounts receivable) in the form of short-, medium-, or long-term loans.

Examples of short-term credit products include the current-account overdraft facility, loans secured by promissory notes, and factoring. With these credit products, the bank has an important role to play as a money lender.

33.1 Business credit products

Business credit products are products where the lender provides the borrower with a sum of money, a business resource, or a service. The borrower makes a commitment to pay back the credit, usually with the addition of interest charges.

Business credit products are intended to provide finance for investment in a business. These products are used by small and medium-size enterprises (SME sector), large enterprises, and corporations.

Business credit products can be divided up into short-, medium-, and long-term credit products, and credit substitute facilities.

33.2 Short-Term Credit Products

Short-term credit products are credit products with a term of up to a maximum of two years.

The main types of short-term credit products are:

- business current-account credit facilities;
- acceptance credit and promissory credit;
- factoring.

33.2.1 Business current-account credit facilities

A business current account is a current account for a company, government organisation, or a self-employed person that can be used to make and receive cashless currency payments. A business current account is a so-called "non-borrowing account", and therefore technically speaking it is a "credit account".

This means the account holder always has to maintain a positive (credit) balance in the account. A credit facility can be attached to the business current account, known as the business current-account credit facility. In that case, the bank and the account holder (borrower) will agree the maximum debit balance ('overdraft') that the account holder will be allowed for the business current account: the credit limit. The account holder will then be able to make payments and cash withdrawals up to the credit limit. Of course, the account holder does not have to spend all of the credit.

The sales proceeds of the company will be deposited in this current account. This means that the balance of the account will fluctuate considerably over time, with both credit balances and debit balances. This means that if business is going well, the borrower does not have to worry about being overdrawn. As soon as the sales revenues are deposited in the account, the amount that has been drawn will automatically be repaid. This means the credit has, in industry jargon, a self-liquidating character.

A current-account credit facility can be cancelled by either party at a day's notice. It does not matter if the account has a credit balance or a debit balance. However, banks are reluctant to cancel the credit facility if the account is overdrawn. This is because it could interfere with the business operations of the customer and make it more difficult for them to pay back the loan. The customer would also have to find alternative financing to pay back the overdraft (the debit balance) at very short notice. The customer might then be unable to pay its suppliers and the continuity of the business could be put at risk. The bank would thus run the risk of the customer not being able to repay the overdraft. If a bank decides to cancel a current-account credit facility, this virtually always happens after extensive correspondence about the situation with the customer.

Interest

A current-account credit facility has two types of interest: debit interest on the negative balance (debit balance) and credit interest on the positive balance (credit balance). Debit interest is the charge paid by the customer for the use of a credit facility. Debit interest is only owed on the days that the account actually had a debit balance. Credit interest is the charge paid by the bank to the customer on the credit balance held in the account with the bank.

The debit interest rate for current-account credit is directly linked to the refinancing interest rate of the European Central Bank (ECB). If the ECB changes the refinancing interest rate, this will automatically also change the interest rate that the borrower has to pay.

The refinancing interest rate will be increased by a certain percentage. This mark-up is the same for all banks. The refinancing interest rate plus the mark-up is known as the basic interest rate.

The bank will use the basic interest rate as the starting point for the debit interest rate. Banks also apply an additional surcharge on top of the basic interest rate. This surcharge will depend on the quality of the borrower, the credit amount, and the income that the bank can expect to receive from the customer for some other reason.

refinancing interest rate of the ECB + mark-up (same for all banks)
basic interest rate + mark-up (varies per credit facility)
debit interest rate

Figure 8 Calculation of debit interest rate

If the current account has a credit balance, the customer will receive credit interest. The interest on a positive balance in a current account (credit interest) is usually fairly low. The credit interest paid by the bank is low because the company can withdraw the balance in the current account at any time, and therefore the bank has to keep cash on hand to cover this eventuality.

Commissions and charges

The bank will usually charge a one-off signing fee. In addition, the borrower will often have to pay credit commission. This commission is a fee charged by the bank during the period that the account does not have, or only just has, a debit balance. Although the bank does have disposal over the amount of the credit during this period, it cannot use this amount freely because the credit might be withdrawn at any time. Both commissions are calculated as a percentage of the credit limit.

Transaction handling fees will also be charged for a business current account. These fees will be linked to the use of the payment services of the bank. Whether the account has a debit balance or a credit balance does not make any difference for these transaction charges.

Special types of credit

Seasonal influences often have an effect on business performance. For a manufacturer of cleaning products, the seasonal factors will be hardly noticeable. For a manufacturer of ice cream, on the other hand, seasonal trends will play a major role. This manufacturer will build up stocks of ice cream during the off-season. In the summer (the high season), the company will concentrate more on selling the products and less on production. During the off-season, therefore, very little cash will be coming into the company, and the manufacturer will need to have a credit facility for the current account. In the high season, so much money will be coming in that eventually the current account will have a credit balance.

A seasonal credit facility has therefore been developed for businesses that are affected by seasonal trends. With this type of credit facility, the account can have an even greater debit balance, within the agreed limit, over an extended period. The bank will not see this as a sign that the company is having financial difficulties. For the repayment of this facility, the bank and the company will usually make a reduction arrangement (also called a discount scheme) about when the credit has to be repaid.

The current-account credit facility can also be combined with advance receivables financing. This means the company will give its outstanding claims, or receivables, to the bank as security. A list of receivables (pledged to the bank) will be drawn up for this. The bank will then have the right to receive the incoming payments from the company's customers. The bank will then be willing to advance a certain percentage (usually between 70% and 90%) of the outstanding claims on top of the basic credit (the normal credit limit).

The stand-by credit facility has been developed for companies that need extra credit at short notice, for example for the takeover of another company or for other special investments. In these situations, a company might miss out on commercial opportunities if lengthy credit negotiations have to be held first. The bank will therefore agree in advance that it will be willing to provide credit in such situations, and reserve the agreed amount. If the credit is not drawn, then the company will not have to pay any credit charges for the facility. In order to compensate for this lost income, the bank will usually charge a commitment fee or stand-by commission.

33.2.2 Acceptance credit and promissory credit

With certain commercial transactions, the buyer can fulfil his payment obligation by issuing a so-called "acknowledgement of debt". If the debtor (the buyer) draws up this document himself, it is known as a promissory note (i.e., the making of a promise). If the creditor (the seller) draws up this document, it is known as a bill of exchange (i.e., the acceptance of a promise). The bill of exchange is sent to the buyer. The buyer has to sign the document and send it back to the seller.

The seller can then take the bill of exchange or the promissory note to his bank. The bank buys the document and pays the amount agreed in the document to the seller. The bank will then collect this amount from the bank of the buyer later on. By accepting the bill of exchange or the promissory note, the bank is effectively providing short-term credit to the seller. This credit is therefore known as acceptance credit or promissory credit. It is sometimes also referred to as discount credit (the acceptance of the bill of exchange by the bank is called 'discounting').

The bill of exchange or the promissory note will have a specified nominal value, which is the amount owed by the buyer. The bank will pay this nominal amount to the seller after deduction of the interest owed on such. This means that interest is paid before the credit is provided, while with most business credit facilities it is paid afterwards.

There is no guarantee that the amount of the bill of exchange can actually be collected from the buyer. In most cases, bank will discount the bill of exchange or promissory note subject to a reservation of rights (under usual reserve). That means the bank will have a right of recourse against the person it has accepted the negotiable instrument (i.e., the bill of exchange or promissory note) from. If the bank is unable to collect the debt from the buyer, then the bank can still go back and recover the unpaid amount from the seller.

In some cases the bank might be willing to waive its right of recourse. It will then discount 'without recourse' (*à forfait*). This might happen, for example, if the bank of the buyer guarantees the payment of the bill of exchange or promissory note.

33.2.3 Factoring

Factoring is a very specific form of financial service that goes beyond credit lending. With factoring, a company hands over it its trade receivables (the payments it is owed from its customers) to a specialised institution, which is called a factoring company or factor for short.

In its most extensive form, factoring is a combination of several services:
- complete acceptance of the risk that the customers will not pay their debts (the default risk);
- advance finance (advance funding) for 70% - 90% of the outstanding invoices;

- takeover of the accounts receivable administration;
- collection of the outstanding receivables and credit monitoring.

Banks often set up special subsidiaries to handle their factoring activities. In order to be eligible for factoring, a business will have to satisfy a number of conditions.

The most important conditions are:
- The average invoice value must be at least € 500 to € 1,000.
- The payment term for the claims must be no more than 90 to 120 days.
- The factoring company will set limits for each customer.

Example
Dentist Hendriksen makes use of the services of Famed, a factoring company. One of his patients, Gerard, has been to see him for treatment. Hendriksen sends the claim against Gerard to Famed, which then takes over the collection of the claim. Famed pays the amount of the claim to Hendriksen and sends an invoice to Gerard. If Gerard does not pay the invoice, then Famed will take further steps to recover the claim. However, Hendriksen will no longer have any involvement in the process.

CHAPTER 34

Medium-Term and Long-Term Loan Capital

Introduction

A business generally raises financing for current assets (stock and work in progress etc.) and receivables (accounts receivable) in the form of short-, medium-, or long-term loans.

A company can raise medium-term and long-term loan capital on the capital market. The capital market consists of a public capital market and a private capital market. The public capital market is where such products as bonds are traded. The bank plays a key role as a broker in the issuing of bonds.

34.1 Medium-Term and Long-Term Loan Capital

In order to raise long-term and medium-term loan capital, a company can turn to the capital market, the market where such products as debt securities are traded. The capital market consists of:

- the public capital market;
- the private capital market.

34.1.1 Public capital market

The public capital market is open to anyone who wants to buy or sell debt instruments. In the public capital market, all the traders know what the situation is with regard to supply and demand. In practice, debt instruments are issued on the public capital market by national governments, local or regional governments, semi-public institutions, and large corporations. Banks handle the issue of bearer debt instruments on behalf of the issuers of the debt instruments or debt certificates. With bearer debt instruments, the person who has the debt instrument in their possession (the bearer) will be deemed to have the rights on that debt instrument, as long as there is no proof to the contrary. These debt instruments are therefore not registered.

Types of debt instruments

The debt instruments or certificates to be placed on the market can be divided into:

- instruments with a fixed interest rate (bonds);
- instruments with a variable interest rate ('floating-rate notes').

Bonds

Bonds are usually bearer bonds, and are an acknowledgement of debt with a fixed interest rate, often in nominal denominations of € 1,000. The term of bonds can vary between 5 and 15 years. The method of repayment or redemption is laid down in the loan conditions. If the repayment is made in a lump sum at the end of the term, this is referred to as a bullet loan.

Two types of bonds deserve special attention:
- convertible bonds;
- subordinated bond loans.

A convertible bond, or convertible for short, is a certificate of debt with a right of exchange for the buyer of the bond (the holder). Under certain conditions (the conversion conditions) the holder will have the right to exchange his convertibles for shares (this is a right, and thus not an obligation). On account of this extra right, the interest rate will usually be very low. For the company issuing the convertible bonds, this means the coupon rate will also be very low. It is therefore a very cheap way for a company to raise finance. If the bond holder decides to exercise the right of conversion, then the loan capital will be converted into equity by the issuing party. Loan capital, or external capital, does not come from the owners of a company, but from an external party, for example a bank. Equity, or internal capital, is capital that has been contributed by the owners of a company.

With a subordinated bond loan, the holder (the lender) agrees to accept certain restrictive conditions. In the event of bankruptcy, the holder will be subordinated to other creditors. This means his loan will only be repaid after all the other creditors have been paid. He will usually receive a higher interest rate for this subordination. From the perspective of the other creditors, the subordinated loan can be seen as an increase of the equity, as a result of which the solvency position of the company will improve. The solvency position of a company is an indication of its ability to absorb any losses. The solvency position is the ratio of equity to total assets, also known as the capital asset ratio, and is expressed as a percentage.

34.1.2 Private capital market

On the private capital market, debt instruments are traded between two parties outside of the stock exchanges. The parties negotiate directly with each other about prices and conditions. Most businesses have to turn to the private capital market if they want to raise medium-term or long-term loan capital.

The private capital market for medium-term and long-term loans also includes trade in leasing finance and guaranteed SME credits.

CHAPTER 35

Medium-Term and Long-Term Credit Products

Introduction

A business generally raises financing for current assets (stock and work in progress etc.) and receivables (accounts receivable) in the form of short-, medium-, or long-term loans.

Various products are offered on the private capital market, such as medium-term loans, leasing, and guaranteed SME credits. The bank acts as both a money lender and an intermediary for these products.

35.1 Business credit products

Business credit products are products where the lender provides the borrower with a sum of money, a business resource, or a service. The borrower makes a commitment to pay back the credit, usually with the addition of interest charges.

Business credit products are intended to provide finance for investment in a business. These products are used by small and medium-size enterprises (SME sector), large enterprises, and corporations.

Business credit products can be divided up into short-, medium-, and long-term credit products, and credit substitute facilities.

35.2 Medium-Term and Long-Term Credit Products

Credit products that have a term of longer than two years are called medium-term and long-term credit products.

The main types of short-term credit products are:

- medium-term loans;
- leasing;
- guaranteed SME credits.

35.2.1 Medium-term loans

A medium-term loan is a loan with a fixed term and often also a fixed interest rate. In the past, the term of medium-term loans was two to five years. Nowadays, it is not unusual for credit facilities to have a term of 8 to 10 years, and in some cases even as high as 25 years.

A bank cannot provide medium-term and long-term loans entirely for its own account and risk. This is because of the difficulty in matching the terms of the loans it provides with the terms of the funds that are entrusted to the bank. The funds held in payment accounts and in many savings accounts can be withdrawn at any time, while medium-term and long-term loans have to be provided over many years. Although savings certificates and deposits do have a slightly longer term, it is usually not much more than one year.

The mismatch between the terms of the available funds and the issued loans is known as the matching problem. Normally this does not cause any difficulties, but it would if large numbers of savers decided to withdraw their money all at the same time. The bank would not be able to liquidate its assets - the long-term loans - fast enough and it would have liquidity problems. In a worst-case scenario, this could lead to panic amongst savers and mass withdrawals (a bank run).

The regulatory authority therefore monitors the liquidity position of banks closely. A bank has to maintain a certain ratio of liquid funds to outstanding loans. In other words, the amount of loans a bank can provide will depend on the amount of liquid funds it has at its disposal.

A bank can place some of the loans with institutional investors (pension funds, insurers). The bank will effectively be acting as an intermediary in such cases.

A medium-term loan is ideal for the financing of machinery, transportation, and inventory. The term of a loan is then often geared to the expected economic life of these production resources. The amount of the loan can be made available in a lump sum or in instalments, and will often be repaid on a straight-line basis (in equal instalments).

Interest and commission

The interest rate for medium-term loans is based on the current market interest rate on the capital market when the loan is taken out. Banks also apply an additional surcharge on top of the market interest rate. This surcharge will depend on the quality of the borrower, the credit amount, and the income that the bank can expect to receive from the customer on other grounds. The fixed-rate period will depend on the term of the loan, but it can be fixed for the entire term.

When the loan is taken out, the bank will usually charge a one-off signing fee. This fee is calculated based on the amount of the loan.

CHAPTER 36

Leasing and Guaranteed SME Credits

Introduction

A business generally raises financing for current assets (stock and work in progress etc.) and receivables (accounts receivable) in the form of short-, medium-, or long-term loans.

Various products are offered on the private capital market, such as medium-term loans, leasing, and guaranteed SME credits. The bank acts as both a money lender and an intermediary for these products.

36.1 Leasing

Leasing is a medium-term credit product that is intended for the financing of a concrete object, such as a welding robot or a heavy goods vehicle (object financing). Other common leasing objects are aeroplanes, computers, and copying machines.

The lease company (the lessor) makes the object available to the user (the lessee) for a predetermined period. In return, the user has to pay a fee for this.

There are two forms of leasing:
- financial lease;
- operational lease.

Financial lease

Financial lease is the business variant of 'buying in instalments'. The lease company pays the supplier the full amount for the object. The lessee can then use the object as they see fit during the lease period. The lessee will also have to pay the costs associated with the usage, such as maintenance, repairs, insurance, and so on. The lessee has to recognise the object under the assets on the balance sheet, and recognise the outstanding debt to the lease company under the liabilities.

The lease contract will include a retention of title clause. The user will only acquire full ownership of the object when the final instalment has been paid. The lessee is therefore not allowed to sell the object during the lease period. If the instalments are not paid, or not paid on time, the lease company can repossess the object.

Example

Dentist Hendriksen makes use of the services of Famed, a factoring company. One of his patients, Gerard, has been to see him for treatment. Hendriksen sends the claim against Gerard to Famed, which then takes over the collection of the claim. Famed pays the amount of the claim to Hendriksen and sends an invoice to Gerard. If Gerard does not pay the invoice, then Famed will take further steps to recover the claim. However, Hendriksen will no longer have any involvement in the process.

Operational lease

Operational lease is basically the hiring of an object from a lease company. The lease company remains the full owner of the object. That means that all the associated costs, such as maintenance, insurance, and value depreciation will be the account of the lease company. At the end of the lease period the lease company will take back the car.

Because the object is not owned by the lessee, it does not have to be recognised on the balance sheet. This leads to an 'abridgement' or reduction of the balance sheet total. A balance sheet reduction means the balance sheet total is lower because the object and the loan (the lease) are not recognised on the balance sheet. This type of finance is therefore also referred to as off-balance sheet finance. The lease contract, however, still involves certain payment obligations (the periodical lease payments). The lease finance obligations therefore have to be disclosed in the explanatory notes to the annual report.

Example

The Van Lunteren bakery has decided to lease a vehicle on the basis of operational lease. In that case, the vehicle will still be registered in the name of the lease company. The cost of petrol, insurance, and maintenance will be for the account of the lease company, as will the risk of loss (total write-off after an accident).

36.1.1 Interest and commission

The interest rate of a lease contract is based on the current market interest rate when the loan is taken out, and is fixed for the entire contract term. With operational lease, if necessary the costs for maintenance, insurance, etc., can also be included in the lease instalments.

The lessor will charge a one-off signing fee when the lease contract is signed. This fee is calculated based on the amount being financed.

36.2 Guaranteed SME credits

If a small business is not able to provide sufficient security when trying to get a loan from a bank, then under the terms of the SME Credit Guarantee Scheme the bank can ask the government to provide a credit gaurentee. Under certain conditions, the government can provide a guarantee to the bank in the form of a suretyship for a part of the credit amount. This guarantee or surety means that if the small business does not pay the money back to the bank, then the bank can turn to the government and it will pay the money to the bank. The government will then have a claim against the small business, and thus the small business will still have a debt to pay off. The guarantee will reduce the risk for the bank because it will improve the creditworthiness of the small business.

There are two types of credit guarantee (surety) agreements:

- business credit guarantee agreements intended for general credit and loans;
- soil decontamination credit guarantee agreements intended for finance for soil remediation.

This credit facility is intended for businesses in the small or medium-sized enterprise sector with less than 250 employees and a turnover of less than € 50 million. Businesses in farming and horticulture, cattle farming and fishing, the financial sector and real estate, and independent professionals are excluded from the scheme. Small businesses that want to get support under the scheme have to satisfy a number of conditions.

36.3 Interest

Interest rate for a loan with a credit guarantee is based on the current market interest rate when the loan is taken out. The interest rate is fixed for the entire term.
The bank will have to pay a so-called “underwriting commission” to the government within 35 days after the credit agreement has been signed. The underwriting commission will be a percentage of the guaranteed loan, and will depend on the term of the loan agreement. The bank will charge the underwriting commission on to the customer.

CHAPTER 37

Credit Substitute Facilities

Introduction

A company generally raises financing for current assets (stock and work in progress etc.) and receivables (accounts receivable) in the form of short-, medium-, or long-term loans from a bank.

The bank can also act as a guarantor for the payment obligations of a customer by offering credit substitute facilities. The bank guarantee and the bill guarantee are two common types of credit substitute facilities.

37.1 Credit Substitute Facilities

With credit substitute facilities, the bank acts as a guarantor for the payment obligations of a customer. Two common types of credit substitute facilities are:

- bank guarantee;
- bill guarantee.

37.1.1 Bank guarantee

The bank can provide a bank guarantee to a creditor as security for the fulfilment of a payment obligation by its customer (the debtor). This means the creditor is sure to get their money back, either from the debtor or from the bank that has issued the guarantee. The bank has a unilateral obligation with respect to the creditor. If the creditor can provide evidence to show the debtor has not fulfilled its payment obligation, and the conditions for the calling in of the guarantee have been satisfied, then the bank has to pay the guaranteed amount to the creditor. The debtor has no say whatsoever in the matter.

Example

The Kromkamp car dealership sells and customises Landcruisers. A regular customer, Helmut, sees a special Landcruiser at Kromkamp he really wants to buy. Helmut also wants Kromkamp to convert the car into a camper, but he only wants to pay for the work after it has been completed. Kromkamp agrees to defer payment, but only on the condition a bank guarantee is provided. The guarantee can be called in as soon as the work has been completed in accordance with the agreed specifications and the car is ready for delivery.

When the work on the car has been completed, Kromkamp notifies Helmut that he can come and collect the car. Even if Helmut refuses to pay for the work, or decides not to buy the car at all, Kromkamp will still get its money because it can call in the guarantee.

It is up to the creditor to initiate the calling in of the guarantee. It has to inform the bank in writing that the debtor has failed to fulfil his payment obligations, and that therefore it is calling in the guarantee. Technically speaking, bank guarantees are payable on demand and this only requires a written notification from the creditor that the debtor has not fulfilled the specified payment obligation. That is why a bank guarantee has to include a precise description of the conditions under which the bank will be required to make payment. The bank, namely, has to be able to objectively verify that the creditor is invoking the guarantee on justifiable grounds.

The bank will ask its customer (the debtor) to provide a counter-guarantee. The conditions of the bank for the provision of the guarantee, and the security that has been offered, will be laid down in this counter-guarantee. This security might be, for example, the pledging of money in a savings account or deposit to the bank or a reduction of a credit facility.

Guarantees for rental payment obligations

Bank guarantees are also used when commercial rental contracts are entered into. Lessors of homes and office buildings, etc., run the risk that the lessee will default on the rental payments or cause damage to the rented or leased object. In general, it is difficult to recover the associated financial losses from the lessee. The lessee might not have any money, they might contest the claim, or they might simply disappear without a trace.

The lessor will therefore usually ask the lessee to pay a deposit when the rental or lease agreement is signed. The lessee can also provide a bank guarantee instead of a deposit as security for the payment of the rental and any damage that is caused. The amount of this type of guarantee will usually be equivalent to three months' rent or lease.

Other guarantees

There are also other types of guarantees that are used in specific situations, such as:

- a customs guarantee;
- a guarantee for payment of tax;
- a bid bond;
- a maintenance bond;
- a performance bond.

• Customs guarantee

Import duties often have to be paid on imported goods. In principle, these duties have to be paid in cash. The customs service will only release the goods after the duties have been paid.

Example

A ship arrives at the port of Rotterdam with 20 containers of electronic equipment. € 100,000 in import duties has to be paid on these imported goods. The importer will only be allowed to take the goods away after the duties have been paid.

Importers who have to pay import duties on a regular basis can ask for the payment of these duties to be deferred. In effect, the tax collector will then be providing a form of credit. The tax department will therefore run the risk of this credit not being repaid by the importer (non-payment). The bank of the importer will therefore have to provide a guarantee to the tax department.

- **Guarantee for payment of tax**

A guarantee for payment of tax is used in connection with income tax and corporation tax. When the tax department imposes a tax assessment, then in principle the tax owed will have to be paid soon thereafter. In some cases the tax department will be willing to allow payment to be deferred on the condition the company provides a bank guarantee.

- **Bid bond or tender bond**

A bid bond can be requested from a contractor (exporter or building company) who responds to an invitation to tender or who submits a bid as part of a public tendering procedure. That is why a bid bond is also called a tender bond.

The bid bond prevents contractors submitting bids they cannot honour in practice. There will usually be a stipulation in the tender conditions that a bid bond has to be provided equal to a certain percentage (2% to 5%) of the bid amount.

- **Maintenance bond**

A maintenance bond will become effective on the date of completion and acceptance of certain work or the delivery of machinery; it serves as security for the fulfilment of the contracted maintenance and guarantee obligations of the contractor or supplier.

- **Performance bond**

A performance bond can be useful when supplies or work are being carried out under a contract. The beneficiary (the buyer or client) can enforce the guarantee if the contracted supply of goods or agreed work has not been carried out or is not carried out satisfactorily. The guarantee is usually 5% to 10% of the transaction amount.

37.1.2 Bill guarantee

A contract of suretyship is a type a guarantee whereby a third party (the surety) obligates themselves towards the creditor to pay the debt if the debtor defaults on the debt.

A contract of suretyship is therefore similar in many ways to a bank guarantee. The main difference, however, is that the contract of suretyship does not exist as an independent agreement. The suretyship is linked to a primary obligation. It is therefore also known as a dependent or accessory obligation. If the primary obligation is extinguished, the accessory obligation will also become extinct.

The most well-known example of a contract of suretyship in the banking industry is when bills of exchange are endorsed or guaranteed (bill guarantee). The debtor promises to make payment by way of a bill of exchange (a type of acknowledgement of debt). The creditor might then stipulate that the bank of the debtor stands surety for the payment (guarantees the payment). If the debtor does not pay, the creditor can recover the debt from the bank that has given the surety.

With a bill guarantee, it is clear that this is an accessory obligation. The bank will only stand surety as long as the payment obligation exists. As soon as the payment has been settled, the payment obligation will expire, and thus also the suretyship.

CHAPTER 38

Core Functions of the Business Payment Account

Introduction

Banks make a distinction between retail payment accounts and business payments accounts. The payments and transactions of retail account holders (consumers), namely, are different than those of business account holders (businesses and institutions).

Businesses and institutions mainly make payments by bank transfer or electronically. They receive payments both in cash currency and by bank transfer or electronically. That is why banks offer their business account holders different types of payment accounts, which provide services that meet their specific needs.

Banks charge their business account holders a fee for these services. Banks also have special solutions to handle the communication with business account holders.

38.1 Core Functions of the Business Payment Account

A business payment account is an account that is used by a business account holder: a company, government organisation, institution, or partnership. This type of payment account forms the basis for the business relationship between the bank and the business account holder. Only the account holders are able to make use of the bank products for payment transactions, savings, investment, and credit. In turn, this makes it possible for them to buy (i.e., pay for) products and services of other manufacturers and service providers.

The business payment account differs from a retail current account in several ways. The main differences are summarised below.

- The business payment account offers more possibilities, for example the ability to have payments deposited in the account by direct debit or collection order forms.
- The business payment account and the payment transaction services for the account are not provided free of charge.
- The account can be included in an offsetable system ('cashpool').
- A cashpool is a group of accounts, where different agreements are made about interest and other charges and the settlement of such. The consolidation of bank balances allows for more efficient cash management.

Business account holders use these accounts amongst other things for:
- incoming payments;
- outgoing payments;
- to bridge temporary deficits;
- cash management.

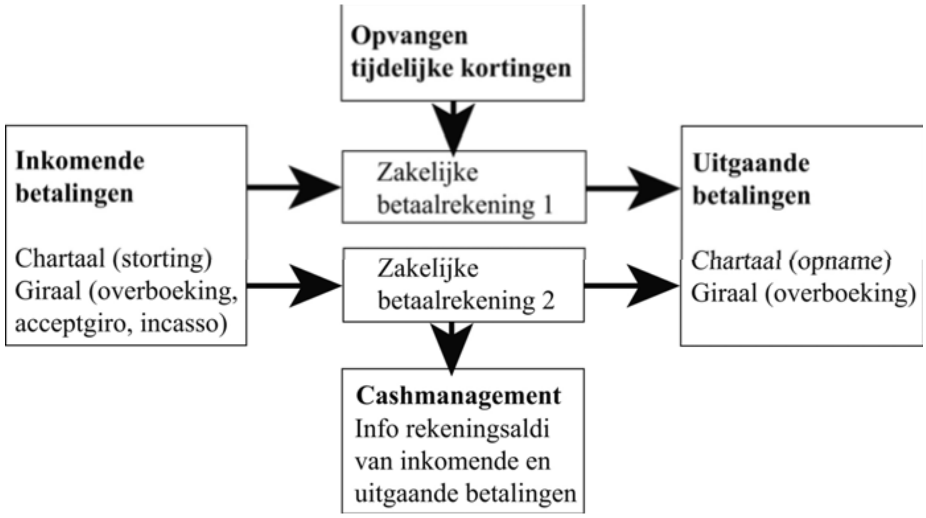

Figure 9 Functions of the business payment account

Incoming payments

Business account holders often have to deal with a large number of different types of payment transactions. For business account holders, it is also vitally important that they receive their payments on time in order to avoid any undesirable balance deficits. Businesses therefore need to have their incoming payment transactions handled with speed, efficiency and security.

Banks offer business account holders various products that enhance the speed, efficiency, and security of incoming payments. Examples are:
- the seal bag for the depositing of received cash currency payments;
- the payment terminal for debit card and credit card payments with a PIN code;
- the collection form and the direct debit form used to receive distance payments;
- the internet checkout desk for all types of payments in web stores.

Outgoing payments

Business account holders generally have a higher volume and much larger outgoing payments than retail account holders. Amongst other things, they can use banking products for the processing of batch orders to pay suppliers and wages, such as the Business Payments (*Zakelijke Betalingen*) service of EquensWorldline.

Bridging temporary deficits

Business account holders often use a credit facility that is linked to the payment account. A credit limit will be set for the credit facility. This limit can be a fixed amount or depend on the 'throughput' of the account, such as the amount that is paid into the account each month.

The credit limit plus the balance in the account is known as the spending limit of the account. The bank will carry out payment orders of the account holder as long as the spending limit will not be exceeded. If the account holder has a debit balance for a certain amount of time, the bank will charge the account holder debit interest for this. The account holder will therefore only pay debit interest if it uses the credit facility.

Cash management

Cash management is the internal management of account balances and cash flows by medium-sized and large businesses, and by (government) institutions. Banks offer fast and specific account information and specialised services in the field of cash management. This means businesses with several payment accounts, which might sometimes be in different countries and in different currencies, are able to manage their account balances better and transfer amounts more easily.

In practice, cash management is essentially about maximising the interest earnings and minimising the debit balances. Amongst other things, this means businesses want to concentrate their credit or debit balances in the different accounts as much as possible in order to maximise interest earnings and/or minimise interest charges. More and more businesses are therefore also using cash pooling, whereby the balances in different accounts are regularly “pooled” (virtually) in a single central account.

38.2 Types of business payment accounts

Banks have three main types of business payment accounts:
- the current account;
- the foreign currency account;
- the foreign country account.

The current account

A current account is a general account for business payment transactions and the handling of other banking affairs, such as cash management. Various payment products can be linked to the account, such as an (extra) debit card, a credit card, or business internet banking.

A current account can be opened by the bank for both residents and non-residents of a country. A company will be considered a resident of the Netherlands if it is incorporated under Dutch law, and will be considered a non-resident if it is incorporated under foreign law. In both cases, the company has to be registered with the Chamber of Commerce.

The current account can be used amongst other things for:
- withdrawals and deposits of cash currency;
- national payment orders, standing orders, and urgent payments;
- European and global payment orders;
- receiving payments with national collection forms;
- receiving payments with national and European direct debit orders;
- to bridge temporary deficits;
- to receive debit card and/or credit card payments;
- to receive internet payments.

The foreign currency account

A foreign currency account is a payment account in foreign currency, for example US dollars, which is held with a bank in the country of incorporation of the business customer, for example in the Netherlands.

A foreign currency account can have advantages for companies who do a lot of international business, and where payments are made in a specific foreign currency. This account enables the company to make and receive payments in this foreign currency. As a result, the company will pay no, or very little, currency exchange costs. Currency exchange costs are only charged for transfers to and from a Euro currency account.

Foreign country accounts

A foreign country account (also known as an offshore account) is an account held by a company in a foreign country, which is usually in the currency of that country. Foreign country accounts are often opened by businesses that do not have a branch of their own in a country where they do a lot of business. If a company does have a branch in the relevant country, this branch will usually open its own payment account (with a local bank).
A collection account is a foreign country account that is used mainly for incoming payments from local customers.

Important reasons for opening a foreign country account are:
- access to the local clearing system;
- access to local banking expertise and support;
- payments for local products.

38.2.1 Charges and earnings on a business payment account

Many banks charge a fee for the opening of an account. It is generally more expensive to open a non-resident account than it is to open a resident account. This is partly because a non-resident account involves more administrative work for a bank.

Furthermore, banks often charge a fee for a current account or foreign country account. This fee can cover the following charges and/or costs:
- maintenance fee (monthly or quarterly);
- transaction charges;
- compulsory non-interest-bearing or low interest-bearing minimum balance;
- any costs in connection with reports to the central bank.

Banks usually do not pay credit interest on the credit balance in a business payment account. However, they do charge debit interest on the debit balance of an account.

CHAPTER 39

Customer Screening for a New Business Account Holder

Introduction

When a customer wants to open a business bank account, the bank has to verify the legal status of the customer. This is because the person whose identity has to be verified, and the name under which the account can be registered, will partly depend on what the legal status of the customer is. The legal status will also be decisive when it comes to defining the customer profile and the risk profile of the customer. This customer screening phase is a key component of the Money Laundering and Terrorist Financing (Prevention) Act (Wwft). Banks have to draw up their own screening procedures in order to satisfy the requirements of the Wwft.

Before a business payment account can be opened for a new customer, the bank will have to carry out a (standard or in-depth) customer screening procedure, during which the bank will confirm the identity of the new customer and check to make sure the new customer is not involved in criminal activities.

39.1 Mandatory customer screening

The bank has a mandatory obligation to carry out customer screening under the law. This duty of investigation is laid down in the Money Laundering and Terrorist Financing (Prevention) Act (Wwft). The mandatory customer screening means amongst other things that the bank has to confirm the identity of the customer, verify the legal form of the customer, verify the objective of the organisation as described in its articles of association, and the identities of the people who are authorised to represent the new customer (' know your customer' or KYC for short).

The bank can only take on a new customer if they have successfully passed the customer screening procedure.

39.1.1 Passing customer screening

The customer screening process will only have been successfully passed if the bank is able to gain insight into the risks that it will run with the new account holder, and the measures it will need to take in order to control these risks.

This means the bank has to successfully complete the following steps of the process:

- the identity of the business customer has been confirmed and the proof of identity has been verified (step 1);
- a customer profile has been drawn up by establishing why the customer wants to open the account and what the intended nature of the relationship between the customer and the bank will be (step 2);

- the risk profile of the customer has been determined by establishing what risks the bank will run if it enters into a new business relationship with the customer (step 3);
- After these three steps have been successfully completed, the bank can open the payment account. However, the bank still has a mandatory obligation to monitor the customer and the transactions carried out by it (step 4).

Simplified customer screening

A simplified customer screening procedure can be carried out for Dutch government bodies and companies listed on the stock exchange. This is because there is a very low risk of these organisations being involved in money laundering or the financing of terrorism. With the simplified customer screening procedure, the bank does not have to go through the time-consuming identification and verification stages.

39.1.2 Identification and verification (step 1)

Identification involves confirming the identity of the customer, and verification involves verifying the validity of the proof of identity. The procedure is different for customers with legal personality and for customers without legal personality.

Identification and verification for organizations without legal personality

For organisations without legal personality, the bank not only has to identify and verify the organisational form, but also the natural persons who will represent the organisation, such as the owner of a one-man business or the individual partners of a professional partnership.

After an organisation without legal personality has been identified, this information is then verified on the basis of documents, data, or background information from a reliable source. For the verification of the organisational form of the company, for example, the bank has to ask the customer for a notarial deed of formation or an extract from the commercial register of the Chamber of Commerce. This extract can be either in the form of an extract obtained electronically or a document certified by the Chamber of Commerce. In the case of an electronic extract, the bank will then have to consult the register itself in order to prevent any deception.

The identification and verification procedure for the representatives of an organisation is the same as the identification and verification procedure for a retail customer who wants to open a payment account. The bank will usually ask for an identity document to be provided for each of the natural persons involved, and then check the authenticity and validity of the identity documents.

When entering into a business relationship with a legal person, banks have a legal obligation to establish the identity of the ultimate beneficial owner (or UBO for short). This legal obligation does not apply when a bank enters into a business relationship with a business customer who does not have legal personality. However, on account of its risk policy, a bank might nonetheless decide to identify the UBO in this case as well.

Identity documents

In the Netherlands, the following identity documents may be used as proof of identity:

- a valid passport;
- a valid Dutch identity card (Model 2001 and Model 2006);

- a valid identity card issued in another EU member state with a photograph and the name of the holder;
- a valid Dutch driving licence;
- a valid driving licence issued in another EU member state with a photograph and the name of the holder;
- travel documents for refugees and foreign nationals;
- valid residence permit (Dutch aliens' document issued under the Aliens Act 2000, which a foreign national can use to prove his identity and right of residence).

In order to form an objective opinion, the verification procedure has to answer such questions as:
- Is the identity document still valid or has it already expired?
- Do the physical features match those stated on the identity document (gender, age, height, colour of eyes)?
- Does the signature match?
- Does the stated nationality match?

In order to verify the reliability of the identity document shown by the customer, two extra checks have to be carried out during the verification phase, namely:
- A check in the Verification of Information System (VIS), which registers stolen and lost Dutch and foreign identity documents.
- A check of the authentication and security features of the document. The details of the security features are provided by the issuing body (the government). Scanning equipment can also be used for this.

After the identification of the customer and the verification of his identity, the bank has to keep the information it has collected about the customer in a customer file for five years after the end of the relationship with the customer. The bank may also keep a copy of the identity document of the customer on file, but that is not obligatory.

Identification and verification of legal persons
The identification and verification procedure for legal entities is more detailed and more complicated. The bank will go through the following steps:
- identification and verification of the legal entity itself;
- identification and verification of the ultimate beneficial owner of the legal entity;
- identification and verification of the representatives of the legal entity.

Identification and verification of the legal entity itself
For the identification and verification of the legal entity itself, the bank has to record the following details about the legal person:
- registration number with the Chamber of Commerce;
- name and address laid down in the articles of association and the business name and address;
- legal form, and the place and country where the organisation has its registered office according to its articles of association;
- ownership and control structure (directors or representatives and their authorities);
- objective of the organisation according to its articles of association (sector or industry, activities, and business relations).

The identity of a legal entity established in the Netherlands can be verified based on a hardcopy or electronic extract from the commercial register of the Chamber of Commerce. In the case of an electronic extract, the bank will then have to consult the register itself in order to prevent any deception. For the verification of foreign legal entities, the following will also apply:

- The identity of a foreign legal entity established in the Netherlands, which is registered as such in the commercial register of the Dutch Chamber of Commerce, can be verified based on an extract from the commercial register, or on the basis of 'documents, data, or background information from a reliable and independent source'.
- The identity of a legal entity established in a foreign country, without a branch in the Netherlands, has to be confirmed by the bank 'based on reliable and internationally recognised documents, details, or information, or based on documents, details, or information which are recognised as a valid means of identification under the law of the country of origin of the customer'.

Example
An example of a 'document from a reliable and independent source' is a deed or declaration drawn up or issued by a lawyer, (junior) civil-law notary, or an independent practitioner of a legal profession equivalent to such, who is practising in the Netherlands or in another country that is part of the European Economic Area (EEA).

The means of verification referred to are only examples. The bank can decide for itself which documents, details, or information it needs in order to establish the risk associated with the customer, as long as this information comes from a 'reliable and independent source'. For the verification of documents that are recognised as a valid means of identification under the law of the country of origin of the customer, however, it is necessary to have knowledge of the laws in the relevant country.

In some cases, the country where the parent company is incorporated will have an official commercial register that can be consulted electronically. The bank will then have to consult the commercial register itself in order to prevent deception.

Identification and verification of the ultimate beneficial owner of the legal entity

The ultimate beneficial owner (UBO) of a legal entity is a natural person who owns more than 25% of the shares in that legal entity, or who exercises de facto control over the legal entity by some other means, for example by having shares or voting rights placed in the name of a front man. Shareholders of companies listed on the stock exchange will not be treated as UBOs.

The bank has a legal obligation to establish the identity of the ultimate beneficial owner (or UBO) of the legal entity. The method of verification used will depend on the risk associated with the nature of the activities of the legal entity, or the background of the customers in the specific case. Identification and verification of the UBO is necessary to prevent persons from using a legal entity to conceal their identity.

Identification and verification of the representatives of the legal entity

For the identification of the representatives of the legal entity, the bank has to record and confirm a number of details, such as the surname, the first names, and the date of birth of the person or persons who are representing the legal entity. The general starting point is that the bank must be able to confirm whether or not a person who claims to have representative authority, actually does have this authority. However, the law gives the bank the freedom to confirm the representative authority based on the deed of formation or articles of association and/or the registration in the commercial register. For legal entities established in a foreign country, this will have to be confirmed on the basis of documents, details, or information from a reliable and independent source (e.g., a notarial deed).

If there are two or more authorised representatives of a legal entity, the bank will also have to confirm and verify the identity of each authorised representative.

The confirmation and verification of the identity of an authorised representative is usually carried out on the basis of a valid identity document. The same rules will apply for this as for the identification of retail customers and organisations without legal personality.

Example
Eklinek is a multinational corporation trading in domestic appliances. This US company also has a subsidiary in the Netherlands. Eklinek Netherlands has its registered office in a major Dutch city, and has found a Dutch bank with a good international reputation to handle its payment transactions. When the representative of Eklinek makes an appointment to meet with the bank, the bank asks him to bring the following information with him to the meeting:

- registration with the Chamber of Commerce;
- articles of association of Eklinek Netherlands;
- proof of identity of the person or persons who will be authorised to represent Eklinek at the bank;
- organisational diagram of Eklinek;
- completed and signed UBO declaration (which can be downloaded from the website);
- In this declaration, the customer has to name the ultimate beneficial owner.

The bank will then go through the entire identification and verification procedure, and carry out the necessary checks. The identity of the person or persons authorised to represent Eklinek will be confirmed based on an extract of the registration with the Chamber of Commerce. The person who is authorised to sign for the account must be clearly identified. If it states in the extract that the representative at the meeting is independently authorised, then this person can sign. If not, then the identity of the person who is authorised to sign must be determined based on the articles of association. Employees of the company can also represent the company at the bank even if they are not named in the extract. However, they must have a power of attorney signed by the customer for this purpose. For low-risk customers, the UBO can be confirmed by way of a signed declaration.

39.2 Drawing up the customer profile (step 2)

Under the Money Laundering and Terrorist Financing (Prevention) Act (Wwft), the bank has to draw up a customer profile to establish why the customer wants to open a new payment account, and what the intended nature of the relationship will be. This should establish whether or not the applicant will be a reliable customer for the bank.

This means amongst other things that the bank employee has to find out:

- what the customer needs a new current account for;

- who will make use of it;
- what sort of payments will be transacted via the account;
- who will receive the payments from the account.

Where relevant, the bank employee will have to identify the sources of the payments into the new account.

39.2.1 Establishing the risk profile (step 3)

In this step the bank will assess the risk profile of the company and its representatives. The bank will determine which risk category the customer falls into, and record this risk category in the customer file. This is done so the bank can decide which risk management measures it needs to take.

If the bank decides there is an increased risk of money laundering and the financing of terrorism, it has a legal obligation to carry out an in-depth customer screening procedure. The bank can decide for itself how to carry out this in-depth customer screening procedure because the Dutch legislature has not laid down any detailed criteria or guidelines for this.

39.2.2 Monitoring the customer and transactions (step four)

After a bank enters into a business relationship with a customer, it has a legal obligation to continuously monitor the customer. In other words, even after the agreement has been concluded, the bank still has a legal obligation to keep checking whether the customer and its transactions continue to match the established customer profile and risk profile. If discrepancies are identified, the bank has to investigate them and change the customer profile and risk profile as necessary.

CHAPTER 40

Types of Risks Faced by Banks

Introduction

Risks and risk management play an important role in any business, but in the case of banks they are critical issues. Banks have to look after the money of their customers, and they always have to be in a position to pay this money back again. More importantly, they have to look after the money that has been entrusted to them carefully while they have it. Banks are therefore faced with a wide range of risks. The dividing line between the different categories of banking risks is not always easy to define. This is because certain risks hardly ever occur in isolation, so that one risk will tend to trigger another risk.

40.1 Types of Risks Faced by Banks

Banks are faced with a wide range of risks. These risks can be divided into the following risk categories:

- solvency risks;
- liquidity risks;
- market risks;
- credit risks;
- counterparty risks;
- systemic risks;
- interest rate risks;
- legal risks;
- operational risks;
- reputation risks;
- strategic risks.

40.1.1 Solvency risks

A solvency risk is the risk that a bank does not have enough funds:

- to satisfy the minimum solvency requirements in the different countries where it is active. The entitlement to operate as a bank is contingent on the availability of sufficient capital;
- to support its credit rating;
- to achieve the projected growth and its strategic objectives.

Regulators assess the capital position and the target percentages used to measure the solvency position on a continuous basis. The guidelines can be tightened up from time to time, as a result of which banks might be restricted in the implementation of the planned strategy and the achievement of the envisaged profit levels.

If the climate on the financial markets is not conducive to raising capital, then this might only be possible at a much higher cost.

40.1.2 Liquidity risk

A liquidity risk is the risk that the bank will not be able to fulfil its contractual obligations on time, such as withdrawals from current accounts, repayments of deposits, bonds, and banking credit, payment of undrawn credit lines of customers, or the settlement of obligations that the bank has on account of derivative transactions. In extreme circumstances, a shortage of liquidity can force a bank to sell assets even if the market does not offer any favourable opportunities for this. For example, after the collapse of Lehman Brothers in October 2008, the confidence of banks in the financial sector rapidly plunged to such a low point that they were no longer willing to issue any deposits to each other, not even for a single day. That meant concessions on prices were unavoidable. That is why banks are now obligated to keep a significant part of their assets in the form of liquid investments. Liquidity risks can be caused by a large number factors and events both inside and/or outside the bank.

A bank run is an acute and very serious form of liquidity risk, and occurs when customers suddenly lose confidence in a particular bank and want to withdraw all of their money at the same time. Due to the transformation function of liquidity, in general banks do not have sufficient cash reserves to actually pay back all the money that can be withdrawn at any particular time. Once it becomes known that all the customers of a particular bank have taken out their money and want to put it somewhere else, then other banks will also lose confidence in this bank. They will also want to get their money back from the bank before it is too late. If the bank reaches a point where it is unable to cover the withdrawals, it will try to raise extra liquidity from other banks, but by that time it is usually too late. In this way, a bank run will often lead to bankruptcy, as it did in the case of Icesave and DSB.

40.1.3 Market risk

A part of the assets of a bank will be valued at market value on the balance sheet, amongst other things to give regulatory authorities and other parties insight into the value appreciation of the bank.

A market risk is the risk that the income or the capital of the bank, or its capacity to carry out transactions, will be negatively influenced by changes in the level or movement of market prices, such as interest rates, credit spreads, share prices, commodity prices, or currency exchange rates. The future results of the bank might therefore turn out lower than previously expected if the market conditions worsen. For many banks, a part of the profits come from the trade in financial instruments. Traders of a bank buy financial products with the intention of selling them at a higher price later on, or vice versa. However, they can also make a loss on these transactions.

Financial markets can moreover fall victim to stress conditions, where market prices suddenly fall to extreme lows, as they did in the period 2007-2010. As well as having a direct impact on the value of the trading portfolio, these stress conditions can also indirectly affect a bank if the value of less-liquid investments of the bank have to be adjusted downward, such as CDOs and US subprime mortgages. These types of adverse market conditions are often difficult to predict, and can cause banks to accumulate significant losses. In stress conditions, it is virtually impossible to make a realistic estimate about the value of many financial instruments. The downward value adjustment of less-liquid investments will therefore usually take place in several stages. A decline in value can be caused by a drop in market prices, but also by defaulting counterparties and ineffective risk cover.

An unpleasant consequence of price volatility and reduced liquidity on the financial markets is that it is precisely in periods of stress that banks are usually forced to improve their liquidity and balance sheet ratios, including their solvency position. Essentially, that means they have to sell a part of their portfolio in difficult economic conditions, while at the same time other banks are also being forced to sell their portfolios. The downward pressure on prices and market volatility resulting from these portfolio sales will then make the balance sheet ratios of the banks even worse, which in turn will force them to undertake another round of selling. Towards the end of 2008, therefore, the regulatory authorities decided to ease the criteria for the valuation of assets at market value. They gave banks the opportunity to classify a part of the assets valued at market value, namely the least liquid instruments, as assets for which the market was temporarily inactive.

40.1.4 Credit risk

A credit risk is the risk that a customer, a client, or a counterparty of a bank does not fulfil its contractual obligations, or the risk that the value of the security provided by a counterparty will go down. The main credit risk of a bank is associated with the loans and credit provided to businesses and retail customers. This is mainly a default risk. However, a credit risk can also arise if an entity the bank has invested in is downgraded, and this leads to a decline in the market value of the investments of the bank. In times of economic recession, as was the case for several years after 2008, the credit risk will increase.

A credit risk can also take the form of a country risk, for example if difficulties arise in a country where a credit interest has been established, and this means the expected realisable value of this interest has to be adjusted downward, or if the country itself is the borrower. Another form of credit risk is settlement risk, which is the risk that the bank makes a payment to a counterparty in connection with a particular transaction, but the corresponding consideration is never received.

40.1.5 Counterparty risk

In its normal daily business operations, the bank is dependent on many different industry sectors and counterparties, but the size of the counterparty risk associated with the parties in the financial sector is the most significant. This exposure can be caused amongst other things by activities in the trading portfolio, credit lending, the raising of deposits, and the settlement of transactions. Banks also use a lot of derivatives to cover or "hedge" these risks, whereby transactions are concluded with other parties in the financial sector. If this type of counterparty defaults on a transaction, then the risk that the bank had intended to hedge with this transaction will not be covered properly. For example, bank A has an interest in Greek government bonds, which it has hedged with a credit default swap with bank B. If bank B is then not able to fulfil its obligations, the risk that Greece will default on the bonds will then become a direct risk for bank A, whereas previously it would have been absorbed by bank B. The counterparties in the financial sector can include brokers, commercial banks, investment banks, investment funds and investment companies, and institutional clients.

40.1.6 Systemic risk

Because a systemic crisis can have major consequences for the economy, one of the main reasons why banks are regulated is to stop this from happening. If people start to lose confidence in one bank, there is a risk they might start to lose confidence in all the other banks. In addition, banks do a lot of trading with each other, which means they have reciprocal obligations towards each other. If one bank gets into financial difficulties, this can cause problems for many other banks. One bank after the other could then have liquidity problems. This type of domino effect occurred after the collapse of Lehman Brothers in 2008, which dragged numerous other banks down with it when it crashed.

Examples of previous systemic crises include the Great Depression of 1929 and the Herstatt crisis of 1974, when the German bank Herstatt was unable to fulfil its dollar obligations and its counterparties lost all their money. Since then, this type of systemic risk has been referred to as an 'Herstatt risk'.

Example
There are numerous examples of banks that were severely damaged by the credit crisis of 2007/2008. The systemic risk became a very real threat for European banks following the sudden of bankruptcy of Lehman Brothers in the US in 2008. For a while, banks stopped borrowing from each other altogether.
The systemic crisis was eventually averted in 2009 after an international emergency fund of trillions of Euros was set up to temporarily cover the risks of banks.

40.1.7 Interest rate risks

An interest rate risk is the risk that the net interest result of the bank or its equity will be adversely affected by changes in the interest rates.

40.1.8 Legal risks

A legal risk is the risk that a bank will not be able to legally enforce a claim against a counterparty. This can happen, for example, if there are errors in a contract.

40.1.9 Operational risks

An operational risk is not specifically a banking risk. This is a risk faced by every enterprise that has commercial operations. The causes of operational risks can be divided into four categories: inadequate organisation, human error, faulty systems, and external events.

40.1.10 Reputation risks

A reputation risk is the risk that the reputation of bank will be damaged by a certain event. A reputation risk is usually caused when a bank suffers significant losses on account of other risks. For example, if a major borrower of a bank goes bankrupt, or the bank becomes the victim of major fraud. Customers of this bank will then lose confidence in the bank. A damaged reputation can then in turn lead to the account holders of a bank suddenly wanting to withdraw all their money, which will create liquidity problems for the bank.

40.1.11 Strategic risks

A strategic risk is the risk that the wrong strategic decisions will be taken. An example of a strategic risk is if a bank makes a loss on a strategic takeover or if a strategy aimed at penetrating new markets proves not to be profitable.

Other strategic risks include lower-than-expected demand for new products, which happened at the beginning of this century when there was a sharp decline in investment by retail customers, or if competition from other banks gets more intense. The fluctuations in the annual profit figures of a bank can be an indication of the size of a strategic risk.

40.2 The risk management process

Banks are paying more and more attention to the risk management process. Not only is effective risk management in the interests of the bank itself, it is also a compulsory requirement imposed by the regulatory authorities.

The risk management process is divided into several phases:
- the identification of risks;
- the formulation of the policy on risks;
- the translation of the policy into concrete operational procedures;
- the measurement of risks.

40.2.1 Identification of risks

The most important aspect of risk management is the identification of the risks faced by a bank. The executive board of Barings, for example, had no idea whatsoever of the risk they were running because of the organisational chaos at their branch in Singapore in the 1990s. Nick Leeson was able to continue his rogue trading for years without the bank taking any action to stop him.

40.2.2 Formulation of policy on risks

The second step is to formulate a policy to deal with the risks that have been identified. The elements of the risk policy are:
- defining the risk appetite: what risks is the bank willing to take, and to what extent;
- establishing a risk management structure within the organisation;
- selecting the systems that will be used to measure the risks;
- selecting the instruments that will be used to manage the risks.

40.2.3 Translation of the policy into operational procedures

The third phase of the risk management process is the translation of the risk policy into concrete operational procedures. This can include, for example, the setting of operational limits. This means maximum limits will be set for the size of the risk the bank is willing to take for specific activities.

Banks will set counterparty limits, for example. These limits will set a maximum financial value for the obligations of a certain counterparty towards the bank. A bank will set counterparty limits for both its credit lending and its trading for its own account and risk.

When the bank is trading for own account and risk, it will also set so-called “trading limits”. These trading limits are the maximum size of the positions that the traders or departments are allowed to take when they are trading in shares or currency, for example.

40.2.4 The measurement of risks

The measurement of risks is aimed at determining the exact size of the risks being run by the bank. If the bank is able to determine the exact size of the risks associated with a certain activity, it can make an informed decision about whether or not it wants to run these risks. Furthermore, the bank will use the information about the size of certain risks to plan the allocation of it capital assets. It will then be able to reserve equity as a buffer for the risks involved. The risks of a particular activity will then be weighed up against the return on this activity; in other words, the RORAC will be calculated. The bank can then make a decision about whether to downsize or upsize its activities in this area.

Measurability of risks

Banks will measure their risks in order to calculate the financial value of the risks they are running. These calculations will be carried out using both historical data and statistical models. This approach works well with market risks and credit risks.

Nowadays, some banks also try to estimate the size of their operational risks using historical data. The number of incidents that have fatal consequences for banks, such as Barings and Allied Irish Bank, are nonetheless rare. The value of this historical data when it comes to predicting the future is therefore questionable.

Banks are also unable to calculate the financial value of their reputation risks, liquidity risks, legal risks, and strategic risks. That is unfortunate, because it is precisely the financial consequences of these risks that can be the most damaging.

Expected and unexpected losses

For the measurement of market risks and credit risks, banks make a distinction between expected losses and unexpected losses. Expected losses are the losses that are most likely to be incurred based on a probability analysis of historical data.

However, the theory does not always work out as expected in practice. It is very unlikely that the actual credit losses suffered over the coming year will be exactly the same as the expected losses calculated by the bank. In other words, there will also be unexpected losses. Banks use computer models to estimate the size of these unexpected losses.

CHAPTER 41

The Central Risk Committees of the Bank

Introduction

The internal auditor and the central risk committees play an important role in the risk management process. The internal auditor carries out its work in line with the principles of the Banking Code. The most common risk committees are: the Asset & Liability Committee, the Group Credit Committee, the Market Risk Committee, and the Operational Risk Committee.

41.1 The central risk committees of the bank

Banks have set up various committees at group level, which monitor the risks and take the necessary measures when the risks become too great. These include such committees as:

- the Group Credit Committee;
- the Asset & Liability Committee;
- the Market Risk Committee;
- the Operational Risk Committee.

The members of these committees are often a managing director, division head, or a member of the board of directors.

41.1.1 Group credit committee

The Group Credit Committee is the committee that focuses on credit risks. This committee analyses the credit risks at portfolio level. It looks at such issues as country limits, limits for each business sector, developments in the quality of the credit portfolio, and the credit margin on the total credit portfolio. Furthermore, it also has to approve any major individual credit facilities.

41.1.2 Asset & Liability Committee

The Asset & Liability Committee manages the risks associated with the composition of the bank balance sheet. The main tasks of the Asset & Liability Committee are:

- supervising the treasury activities;
- ensuring the efficient coordination of assets, liabilities, and cash flows, which are the traditional elements of balance sheet management;
- determining the composition of the bank's own funding.

41.1.3 Market Risk Committee

The Market Risk Committee focuses on new products on the financial markets and takes decisions about the systems and models to be used to determine the value and the risks of these products. The Market Risk Committee also monitors the overall market risks of the trading portfolios at a corporate level.

41.1.4 Operational risk committee

The Operational Risk Committee formulates the general policy and procedures for the management of operational risks. Because the measurement of operational risks is still a relatively new concept, this committee spends a large amount of its time on developing ways to measure operational risks. This is basically done in two ways. The first way is qualitative, for example by asking all the separate business units to identify their risks and then to rank them in order of ascending priority.

The second way is quantitative, for example by setting up a database in which the details are entered of all the losses that are suffered as a result of operational errors. The next step is the development of a programme that can predict future expected losses based on the data in this database.

CHAPTER 42

Supervision in the Netherlands

Introduction

Banks play a crucial role in the economy of a nation. Amongst other things, they make sure there is a proper alignment between the supply and demand for money, that businesses are able to make the necessary investment, and that payment transactions are carried out smoothly and efficiently. In other words, the activities carried out by banks involve major public interests. In order to protect these interests, it is necessary for supervision of the banking sector to be carried out. The credit crisis in 2008 underlined once more how important it is to have proper supervision of banks.

This chapter describes how the supervision of the banking industry is organised in the Netherlands. The powers and authorities of the regulatory authorities in the Netherlands - De Nederlandsche Bank and the Financial Markets Authority - will also be discussed in this chapter.

42.1 Supervision in the Netherlands

There are basically two models of financial supervision: a sectoral supervision model, and a functional supervision model.

With the sectoral supervision model, the supervision is organised per sector. This means separate regulatory authorities are established for each sector. In the past, only the sectoral supervision model was applied in the Netherlands. De Nederlandsche Bank (DNB) was responsible for carrying out the supervision of banks. The Pensions and Insurance Supervisory Authority of the Netherlands (the predecessor of the Financial Markets Authority (AFM)) was responsible for the supervision of insurance companies and pension funds.

With the functional supervision model, the supervision is organised based on different functions. A functional supervision model has also been introduced in the Netherlands (also referred to as the 'twin peaks model'), which is based on two main functions. These two functions are prudential supervision and market conduct supervision. Banks incorporated in the Netherlands are now supervised by two separate regulatory authorities in the Netherlands, one for each of the two separate functions: De Nederlandsche Bank (DNB) is the Dutch central bank and it carries out the prudential supervision, and the Financial Markets Authority (AFM) carries out the market conduct supervision.

42.1.1 Prudential supervision by the DNB

The DNB is responsible for the prudential supervision of the non-system banks. The Dutch system banks fall under the direct supervision of the ECB. The system banks are ING, ABN-AMRO, Rabobank, the

Volksbank, and BNG. The definition of prudential supervision is set out in the Financial Supervision Act (Wft).

Legislative text
"Prudential supervision focuses on the solidity of financial enterprises and contributes to the stability of the financial sector."

The prudential supervision carried out by the DNB consists of three core tasks:
- ensuring low inflation (monetary depreciation);
- making sure the system for the processing and settlement of payments is safe and secure;
- regulating the solidity and integrity of financial institutions.

This chapter only deals with the third core task.
The DNB regulates the solidity and integrity of financial institutions in four ways:
- systemic supervision;
- solvency and liquidity monitoring;
- granting licences;
- supervision of takeovers and acquisitions.

Systemic supervision
Systemic supervision is the supervision of the system of financial institutions, which was assigned to the DNB under the Bank Act 1998, and which is aimed at ensuring the stability of the financial system as a whole. Systemic supervision is also referred to as macro-prudential supervision. This supervision focuses on the stability of the macro-environment of banks, the sector as a whole, and is closely related to the prudential supervision carried out for individual financial institutions. That is why both forms of supervision have been assigned to the same regulatory authority.

Systemic supervision is the supervision carried out by the DNB to prevent the occurrence of systemic risks. This is the risk that (liquidity) problems in one financial institution will spread to other institutions. This is also known as the domino effect: when one company goes bankrupt it will drag the other market parties down with it. This type of domino effect can destabilise an entire economy.

Solvency and liquidity monitoring
The DNB has to make sure the solvency position and the liquidity of banks is solid enough to guarantee the stability of the sector.

In order to meet the solvency requirements, a bank must have enough equity to be able to absorb unexpected losses. The equity has to provide a buffer.

In order to meet the liquidity requirements, a bank must have enough liquid funds to be able to cover all the potential withdrawals of money by customers. Supervision of the solvency position of banks is necessary because from a business economic point of view, banks prefer not to have too much money in a liquid form. The bank will earn higher interest on an illiquid credit loan (e.g., a mortgage loan), namely, than it will on a liquid placement of funds (e.g., a deposit with another bank).

If customers suspect a bank is having liquidity problems, this can cause a bank run. If a bank run happens, large numbers of customers will try to take all of their money out of the bank at the same time.

Example
In 2008 there was a run on the Icesave bank in the Netherlands, which was a subsidiary of the Icelandic bank Landsbanki. Landsbanki was unable to fulfil its obligations, which meant the Icelandic deposit guarantee scheme came into effect. The Icelandic government, however, was unable to fulfil its obligations under the deposit guarantee scheme. This situation ultimately led to the Dutch government having to lend money to the Icelandic government so the guarantee scheme could be carried out.

Granting licences

The DNB plays an important role in the granting of licences to banks in the Netherlands.

Market access for banks in the Netherlands is regulated under the Financial Supervision Act (Wft). In order to be allowed to operate as a bank in the Netherlands, a bank has to have a banking licence. Since the introduction of the Single Supervisory Mechanism (SSM) on 4 November 2014, banking licences have been granted by the European Central Bank (ECB).

However, an application for a banking licence in the Netherlands has to be submitted to the DNB. The DNB will handle the licence application in close collaboration with the ECB. If the DNB is of the opinion that the statutory licensing requirements have not been satisfied, it can independently decide to refuse the licence application. On the other hand, if the DNB is of the opinion that the statutory licensing requirements have been satisfied, it will draw up a provisional decision for the granting of a licence and send this to the ECB. As soon as a definitive decision has been taken, the DNB will notify the applicant about such.

The DNB will attach certain conditions to the granting of a banking licence. A financial undertaking applying for a banking licence has to satisfy, amongst other things, the following conditions:

- expertise and trustworthiness of the executive management;
- ethical business practices;
- control structure;
- adequate operational management procedures;
- minimum number of members of a supervisory board;
- minimum equity;
- solvency and liquidity.

The DNB keeps a public register where all the financial undertakings that have been granted a banking licence are registered.

Supervision of takeovers and acquisitions

Together with the ECB, the DNB is responsible for carrying out the supervision of takeovers in the banking sector. Technically speaking, these takeovers are called 'proposed acquisitions of qualified holdings'. A party that wants to take over another bank in the Netherlands will only be allowed to do this if it has obtained a certificate of no objection.

A notification about a proposed acquisition of a qualified holding in the Netherlands has to be submitted to the DNB. The DNB will send a provisional decision to the ECB, in which it will state whether or not it has an objection to the acquisition. As soon as a definitive decision has been taken, the ECB will notify the proposer about such.

42.1.2 Market conduct supervision by the AFM

The AFM is responsible for the market conduct supervision of the banking sector. A definition for the meaning of market conduct supervision is set out in the Financial Supervision Act (Wft).

Legislative text

"Market conduct supervision is aimed at ensuring orderly and transparent financial market processes, fair competition between market parties, and the careful handling of customers' interests."

The AFM is active in two areas:

- financial services;
- capital markets.

Financial services

The AFM aims to make sure financial services are provided in a way that gives due care and consideration to the interests of consumers. Banks that provide financial services have to have the necessary expertise, and be reliable and ethical. The information given by banks to consumers must be factually correct and comprehensible, and must not be misleading. Finally, banks have to act in the interests of their customers (obligation of due care).

Capital markets

The AFM aims to make sure the capital markets are operated in a fair and efficient way. This will increase the confidence of investors in these markets. It carries out supervision in relation to the prohibition on market abuse (such as inside information, manipulation, and misleading conduct). Furthermore, it makes sure that banks disclose price-sensitive information in a timely and accurate way. Finally, the AFM enforces the rules for the issuing of securities and public takeover bids, for financial reporting, and for accountants who audit financial accounts.

The following areas of market conduct supervision will be looked at in more detail:

- information provision;
- obligation of due care;
- prohibition on insider trading;
- prohibition on market manipulation;
- obligation to report.

Information provision

The AFM makes sure the information provided by banks to their customers is accurate, clear, and not misleading. Under the Wft, a bank that wants to offer a complex financial product has a compulsory obligation to draw up a key investor information document. This must contain all the information about this product that is relevant for investors so they have a proper understanding of the way the product works, both in terms of the expected return and in terms of the degree of risk.

Obligation of due care

The Wft assumes that there is inequality in the relationship between financial undertakings and their customers. If a customer enters into an agreement with a bank, the consumer will have to be protected as the 'weaker party'. As the 'stronger party', the bank has an obligation of due care with respect to the interests of the customer. In this way, the legislature aims to prevent banks from abusing the information advantage that they have over the customer.

This obligation of due care essentially means that before the bank gives any advice to a customer, it has to find out about the personal situation of the customer, and then base the advice that it gives as far as possible on the information that it has obtained.

The Wft stipulates that a bank has to get information from the customer about his:
- financial position;
- knowledge and experience;
- investment objectives;
- risk appetite.

The advice the bank gives to the customer has to be based on the information that it has collected.

Prohibition on insider trading

The Wft contains a prohibition on insider trading. The AFM is responsible for enforcing this prohibition. There are two parts to the prohibition: trading on the basis of insider information is prohibited, and the disclosure of this insider information to a third party is also prohibited.

The Wft follows the assumption that a certain group of people will have inside information because of the position they have. Directors of banks, for example, fall within this category. These people are not allowed to use this inside information (for their own benefit, or for the benefit of a third party).

Furthermore, anybody else who knows, or who reasonably ought to know, that they have inside information, is not allowed to use this inside information (for their own benefit, or for the benefit of a third party).

Prohibition on market manipulation

The AFM is responsible for enforcing the prohibition on market manipulation. This prohibition means, in short, that it is prohibited:
- to carry out a transaction which sends out an inaccurate or misleading signal about the price of a financial instrument ('price manipulation');
- to carry out a transaction whereby the price of a financial instrument (e.g., shares) is kept at an artificially high level;
- to carry out a transaction on the basis of deception or deceit;
- to spread information which sends out an inaccurate or misleading signal about the price of a financial instrument, while the person spreading the information knows or reasonably ought to know that this information is inaccurate or misleading.

The law does allow for some exceptions in relation to these prohibitions. For example, transactions that fall in categories a and b are allowed if the motives of the person who carried out the transaction are 'justified' and the transaction was carried out in accordance with 'accepted market practice'.

Obligation to report

Banks have a legal obligation to report a reasonable suspicion of insider trading or market manipulation as quickly as possible to the AFM. This obligation is referred to as the obligation to report.

The AFM expects the employees of banks (e.g., investment advisers) to have sufficient professional knowledge and experience to be able to determine when there is a 'reasonable suspicion'. Only in these cases does the bank have an obligation to report to the AFM.

Any employee of a bank can report a reasonable suspicion of insider trading or market manipulation to the AFM. These reports can also go through a compliance officer. The person who makes the report will be designated as the contact person by the AFM.

42.1.3 Regulatory law in the Netherlands

The regulatory authorities DNB and AFM have been given their regulatory powers by law. The most important law in this respect is the Financial Supervision Act (Wft).

The Wft consists of the following sections:

- The General Section.
- The section on Market Access for Financial Undertakings.
- The section on Prudential Supervision of Financial Undertakings.
- The section on Market Conduct Supervision of Financial Undertakings.
- The section on Market Conduct Supervision of Financial Markets.

The Wft is at the top the pyramid of financial laws and regulations in the Netherlands. In the Wft, there are often references to the secondary or subordinate legislation that 'hangs' under the Wft.

Example

Article 1:80 Wft gives the regulatory authorities (DNB and AFM) the power to impose an administrative fine on an offender who has violated certain articles of the Wft.

In this article it also says that "further rules can be introduced by ministerial order in relation to the exercising of this power". The fines that can be imposed for a breach of the relevant articles are worked out in more detail in the 'ministerial order'. These detailed provisions are not included in the Wft itself.

42.1.4 Powers of regulatory authorities

In order to carry out effective supervision, it is important for the regulatory authorities to have certain powers. On the other hand, it is also important for the parties subject to supervision (the financial undertakings) to be given legal protection against any undue exercising of these powers.

The General Section of the Wft gives the regulatory authorities various powers which they can use to enforce the Wft:

- the giving of instructions about prescribed courses of action;
- the appointment of a receiver;
- the imposition an order subject to a penalty;
- the imposition of an administrative fine.

Some examples of the fines that have been imposed by the AFM are given below.

Example

The Financial Markets Authority (AFM) imposed an administrative fine on 5 June 2015 of € 750,000 on Delta Lloyd Asset Management N.V. (DLAM). In the period investigated by the AFM from 1 April 2012 to 26 November 2014, DLAM had not organised its operational management procedures in a way that assured a controlled running of its business operations.

The regulatory authorities act as an independent administrative body when they exercise their powers. This means they are bound by the provisions of the General Administrative Law Act (Awb). Under the Wft, a financial undertaking that has been fined has the right to lodge an objection against this with the regulatory authority. If this objection is dismissed, the financial undertaking can appeal to the administrative courts.

CHAPTER 43

European Supervision

Introduction

Banks play a crucial role in the economy of a nation. Amongst other things, they make sure there is a proper alignment between the supply and demand for money, that businesses are able to make the necessary investment, and that payment transactions are carried out smoothly and efficiently. In other words, the activities carried out by banks involve major public interests. In order to protect these interests, it is necessary for supervision of the banking sector to be carried out. The credit crisis in 2008 underlined once more how important it is to have proper supervision of banks.

This chapter describes how the supervision of the banking industry at a European level is organised in the Netherlands. The powers and authorities of the European regulatory authorities within the Single Supervisory Mechanism will also be discussed in this chapter.

43.1 European Supervision

The Single Supervisory Mechanism (SSM) is the new system of financial supervision that has been operated by the European Central Bank (ECB) and the national authorities in the Eurozone countries since 4 November 2014. De Nederlandsche Bank (DNB) is the designated national authority in the Netherlands.

The SSM works together with the European Banking Authority (EBA), the European Parliament, the Eurogroup, the European Commission, and the European Systemic Risk Board (ESRB).

The European Systemic Risk Board (ESRB) is responsible for the systemic supervision of the financial system in the EU. It monitors the overall risks for the economy and the stability of the total financial system.

The European Banking Authority (EBA) organises the supervision of banks. The EBA has the task of improving the operation of the internal market by introducing suitable, efficient, and harmonised European supervision and regulations.

The ESRB and the EBA work together in the European System of Financial Supervision (ESFS).

The European System of Financial Supervision (ESFS) consists of:

- The three European regulatory authorities, one for the banking sector (the EBA), one for the securities sector, and one for the sector of insurance and industry pensions;
- The European Systemic Risk Board (ESRB), which is responsible for the systemic supervision of the financial system in the EU. It monitors the overall risks for the economy and the stability of the total financial system;

- The Joint Committee, a network of the three sectoral regulatory authorities, which has the task of ensuring cross-sector consistency in European supervision regulations;
- The national regulatory authorities. These authorities are responsible for the supervision in the individual member states. In the Netherlands, the regulatory authorities are the DNB and the AFM.

Furthermore, Colleges of Supervisors have been set up for all cross-border financial institutions.

43.1.1 Division of tasks between the ECB and DNB

The SSM consists of the ECB and the NBAs of the participating member states, and thus combines the strengths, experience, and expertise of all these institutions. The ECB is responsible for the effective and consistent operation of the SSM. The ECB carries out the supervision of the operation of the system based on the division of responsibilities between the ECB and the NBAs. In order to ensure effective supervision, the credit institutions are divided into two categories: 'important' and 'less important'. Roughly speaking, a large bank will be designated as important if: the value of its assets is greater than € 30 billion; or if it is one of the three most important banks in a country. The ECB carries out direct supervision of important banks, while the NBAs are responsible for the supervision of the less important banks.

Within the Single Supervisory Mechanism (SSM), the European Central Bank (ECB) is responsible for granting banking licences.

However, an application for a banking licence in the Netherlands has to be submitted to the DNB. The DNB will handle the licence application in close collaboration with the ECB. If the DNB is of the opinion that the statutory licensing requirements have not been satisfied, it can independently decide to refuse the licence application. On the other hand, if the DNB is of the opinion that the statutory licensing requirements have been satisfied, it will draw up a provisional decision for the granting of a licence and send this to the ECB. As soon as a definitive decision has been taken, the DNB will notify the applicant about such.

Together with the ECB, the DNB is also responsible for carrying out the supervision of takeovers in the banking sector. Technically speaking, these takeovers are called 'proposed acquisitions of qualified holdings'. A party that wants to take over another bank in the Netherlands will only be allowed to do this if it has obtained a certificate of no objection. A notification about a proposed acquisition of a qualified holding in the Netherlands has to be submitted to the DNB. The DNB will send a provisional decision to the ECB, in which it will state whether or not it has an objection to the acquisition. As soon as a definitive decision has been taken, the ECB will notify the proposer about such.

43.1.2 Convergence of national supervisory regimes

Some banks are affected by several national legal systems, especially if their organisation has branches in more than one country. The advantage for Dutch banks is that supervision in the Netherlands is very thorough. Generally speaking, if a Dutch bank satisfies the Dutch requirements, then it will usually satisfy the requirements of other countries as well. However, it is always better to make sure. Especially if the bank has branches in the US. This is because the US has a very detailed and complex regulatory system. Organisations in the US are subjected to stringent requirements in relation to both the business units inside the US and the business units outside the US.

It is clear that (Western) national supervisory bodies are willing to share and learn from each other's experiences in relation to supervisory law. One example of this can be seen in the field of credit lending to businesses and consumers. At one time, these services were not regulated very strictly in the US or the UK. Following the credit crisis in 2008, however, both countries decided to introduce additional rules for credit lending, and therefore they looked at the way credit lending to businesses and consumers was regulated strictly in other countries.

If a bank is affected by two or more supervisory regimes, it has to comply with all the separate national requirements in each country. It is not automatically the case that if the national requirements have been satisfied in the country where the parent company is based, then the bank will be exempt from compliance with the supervisory regulations in the other countries where its subsidiaries are based. Banks might therefore have to comply with several systems, which occasionally might have contradictory requirements, and thus a bank can find itself in a no-win situation.

CHAPTER 44

European Laws and Regulations, Implementation in National Legislation

Introduction

This chapter describes the system of European laws and regulations, and the way in which European laws and regulations have an impact on supervision in the Netherlands.

44.1 European laws and regulations

Dutch banks have to comply with an increasing number of binding European and international (supervision) laws and regulations. These (supervision) laws and regulations are not always (directly) imposed by the Dutch legislature, and therefore there is not always a regulatory authority with direct responsibility in the Netherlands.

Under Article 249 of the EC Treaty, the Treaty establishing the European Community, there are four types of decisions under European or Community law:

- Regulations;
- Directives;
- Decisions;
- Recommendations and Opinions.

The EC Treaty (Article 249) also accords legal force to these different types of decisions:

Legislative text

"For the fulfilment of their tasks, and under the conditions comprised within this Treaty, the European Parliament and the Council jointly, the Council and the Commission can lay down Regulations and Directives, issue Decisions, and issue Recommendations or Opinions.

- An EU Regulation is applicable everywhere. All its sections are binding, and are directly applicable in each member state.
- An EU Directive is binding with respect to the result that has to be achieved in each member state where it is applicable, but the national bodies are given the power to decide the form and methods for themselves.
- An EU Decision is binding in all its sections for the parties it is specifically aimed at.
- Recommendations and Opinions are not binding.

European regulations

An EU Regulation can impose rights and obligations directly without any national laws having to be introduced. A Regulation is always a Community law, which the member states are not allowed to deviate from. Because a Regulation is generally applicable, this means its scope and operation is applicable for an indefinite series of persons or situations. A Regulation is also directly applicable. In other words, no further implementation regulations are required. The European Court of Justice of the EU has even gone so far as to rule that a Regulation precludes the introduction of national implementation regulations.

Example

"EC Regulation 1754/2002 of 1 October 2002 for the fourth Amendment of EC Regulation 881/2002 of the Council for the imposition of certain specific restrictive measures against some persons and entities who have ties with Osama bin Laden, the Al Qaida network and the Taliban, and for the withdrawal of Regulation (EC) No. 467/2001 of the Council."

This EC Regulation replaced 'Sanctions Order IV', which directly imposed the same obligations on all member states. All of the Dutch sanctions orders were withdrawn shortly after they were introduced and replaced by an EC Regulation with the exact same scope as the withdrawn sanctions orders, but with the difference that the Regulation imposed identical obligations on all member states.

European Directives

A European Directive is also a binding piece of legislation. However, unlike with a Regulation, only the outcome is obligatory under a Directive. The member states have an obligation to achieve the result prescribed in the Directive within the period set in the Directive. However, each member state can decide for itself the form and methods it thinks will be most suitable to achieve this result.

Example

European Directive 91/308 on the prevention of the use of the financial system for the laundering of money led to the introduction of two anti-money laundering laws in the Netherlands: the Disclosure of Unusual Transactions (Financial Services) Act (MOT) and the Provision of Services (Identification) Act (WID). The third anti-money laundering Directive was implemented by the EU member states in their national legislation in 2007. This led to the merging of both of the Dutch laws to form the Money Laundering and Terrorist Financing (Prevention) Act (Wwft) on 1 August 2008. Since then, a fourth anti-money laundering Directive has been introduced. The Wwft was amended in line with this new Directive on 1 January 2013.

European Decisions

EU Decisions are only binding for the parties they are aimed at. This means EU Decisions are an effective way for the European Commission to directly impose rights or obligations on specific groups of natural persons or legal entities.

Recommendations and Opinions

Recommendations and Opinions are not legally binding. In that way they are different to Regulations, Directives, and Decisions. However, Recommendations and Opinions can still have far-reaching political implications. Recommendations and Opinions can have a considerable indirect effect because they are often used as the basis for the preparation of binding legislation in the member states.

44.2 Implementation of European Directives in national legislation

Within the European Union, the legislative authority is vested in the European Council, which passes the European Directives. The member states of the European Union are obligated to implement these Directives in their national legislation.

The European Commission takes always the initiative for the drawing up of Directives, while the European Council (in which the member states of the EU are represented) passes them.

A brief description is given below of the implications that two Directives have had for national legislation.

Second Coordination Directive on Banking Supervision

The European Commission adopted the guidelines on the coordination of banking supervision of the Basel Committee in the Second Coordination Directive on Banking Supervision.

The two most important elements of this European Directive were:

- the European passport;
- the country of residence principle.

- **European passport**

The European passport means that on the basis of a single banking licence, banks can offer their services in other member states, both via cross-border service provision and via branches established in other countries. The introduction of this passport is a major breakthrough because it means the different member states will now have to explicitly recognise each other's supervisory regime.

- **Country of residence principle**

The country of residence principle means the responsibility for the supervision of satellite branches of a bank established within the EU now lies with the regulatory authority in the member state where the bank has its registered head office. Under the Second Coordination Directive, the country of residence principle applies for virtually every aspect of supervision, with the only major exception being liquidity monitoring.

In the Netherlands, the European passport and the country of residence principle were implemented in the Wft.

Basel Committee, CRD and CAD

One of the most important bodies in the field of international supervision of the banking industry is the Basel Committee. The Basel Committee was founded in 1975. The secretariat of the Basel Committee is based in the Bank for International Settlements. The committee was initially set up following the systemic crisis in the banking sector in 1974 caused by the bankruptcy of the German Herstatt Bank.

The Basel Committee consists of the presidents of the central banks of Belgium, Canada, Germany, France, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, and the United States of America. The countries are represented by their central bank and by the regulatory authority that is responsible for prudential supervision (if that is not the central bank itself). The Basel Committee has two objectives:

- coordination of national supervision;
- implementation of uniform supervisory legislation.

The Basel Committee regularly makes proposals about the way central banks should coordinate their supervisory tasks with each other, and in relation to new supervisory legislation. The committee has no formal supranational powers, but its recommendations are generally applied worldwide because so many countries have already implemented these recommendations in their national legislation. This has helped to create a level playing field for banks in different countries.

In 1988, the Basel Committee set solvency requirements for credit risks, which were expanded in 1996 with solvency requirements for market risks, and in 2007 with solvency requirements for operational risks in what is known as Basel II. Basel II went much further, however, than the expansion of solvency requirements: it also introduced a system whereby regulation is organised into three pillars. Pillar 1 comprises the solvency requirements, while pillar 2 regulates the way banks have to carry out permanent analysis of their risks, and pillar 3 comprises the requirements set for more extensive public information provision about the size of the risks a bank is exposed to.

The G20 summit ratified Basel III in November 2010 in Seoul. The aim of Basel III was to improve the quality and size of capital reserves held by banks. Basel III was also aimed at making sure banks create extra capital buffers during periods of economic growth. This puts them in a better position to absorb losses during periods of economic recession. Banks that do not, or not fully, comply with extra buffer requirements can have restrictions imposed on them with respect to the dividends and performance-related bonuses that can be paid out. The recommendations of Basel III had to be implemented by January 2019.

The requirements of Basel III in relation to credit risks were tightened up even further in late 2017. For example, banks are only allowed to make very limited use of their own risk models and calculations. The standard models are leading, and the banks' own models can only deviate from the standard models to a limited extent.

Although the extra requirements in relation to credit risks were only a minor addition to the Basel III accord, it is now referred to as Basel IV.

The recommendations drawn up by the Basel Committee were laid down in a largely unchanged form in two European Directives: the Capital Requirements Directive (CRD) and the Capital Adequacy Directive (CAD). Every member state of the European Union then had to implement these Directives in their national legislation. In the Netherlands, that was the Financial Supervision Act (Wft).

The diagram below shows the way the international proposals of the Basel Committee are integrated into the supervision of Dutch banks by the DNB.

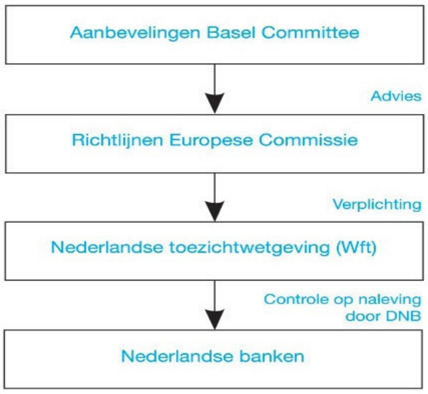

Figure 10 International rules and national legislation

Example

In 2011, the Basel Committee was asked to draw up a new set of recommendations known as Basel III, which were to be introduced throughout Europe under the Capital Requirements Directive (CRD) IV and implemented in the Wft in the Netherlands.
