Dear Mr Bos,

With regard to the intention of The Royal Bank of Scotland Group Plc (RBS), Banco Santander Central Hispano S.A. (Santander) and Fortis N.V./Fortis S.A: (Fortis) – hereafter jointly referred to as the Consortium – to take over and, subsequently, split up ABN AMRO Group, DNB has investigated the possible effects thereof on financial stability. The envisaged transactions could jeopardize the financial stability, which would be an undesirable development for the financial sector. The fact is that by the envisaged transactions two undertakings are involved which because of their size, the nature of their activities and their roles in the interbank market and payments are of vital importance for the Netherlands and the Dutch financial sector. Problems at either or both institutions might generate system-wide effects.

Before discussing our investigation, we refer to the current situation on the international financial markets. Presently, signs increasingly point to a serious disruption of the global financial system, as internationally operating banks have substantially increased liquidity needs and therefore hoard liquidity. As a consequence, the international money market for maturities from one week onward is not functioning well at the moment. Banks’ uncertainty about their future liquidity needs arises from the deteriorated market climate for credit products. As a result, banks feel increasingly compelled to provide funding again to special vehicles related to them (‘conduits’). The liquidity need potentially ensuing from this development is vast. The deficient functioning of the money market may have negative effects for all banks directly or otherwise involved in the envisaged acquisition. Therefore, there is a risk that the takeover process will become disorderly, which would harm the financial stability in the Netherlands.

We also note that the intended split-up, given its unique nature and complexity, calls for great care and enough time from the acquiring parties. At the same time, it is in the interest of the financial stability in the Netherlands that the duration of the period of uncertainty about the future of ABN AMRO Group be kept to a minimum.

From our analysis it emerges that there is an increase in financial stability risks. In the transition phase, in which ABN Amro Group is split up and the various business units of this institution are transferred to the Consortium partners, additional operational risks will arise as a result of the duration and complexity of the process indicated above. This underscores the importance of a careful and controlled disintegration and integration, also where the payments systems are concerned. The conditions and restrictions attached to the declaration of no objection applied for by the Consortium partners, as we advised in our letter pursuant to section 3:95 (3) of Wet Financieel Toezicht¹, seek to control these operational risks as much as possible.

Even if the Consortium partners comply with these instructions and restrictions, in the transition phase conflicts of interest may occur between the parties concerned or between business units of ABN AMRO Group and one or several of the new owners. If any such conflict occurs, the

¹ Netherlands Financial Services Act
interests of ABN AMRO Group may be impaired and the care required for the disintegration process may be jeopardised, which could adversely affect the financial system. The risk of conflicts of interests is inherent to the approach opted for by the Consortium partners. While the conditions and restrictions to be met by the Consortium regarding the steering of the ABN AMRO Group aim to remove this risk, nonetheless a residual risk remains.

In the final phase, Fortis and business units of ABN AMRO Group will combine to form an institution which – in the event that it runs into acute (solvency) problems – will expose the Dutch financial system and the real economy to greater negative spillovers than in the original situation. The concentration of these risks with a single party once more underscores the importance of continued safeguarding of the solidity of this new systemically relevant undertaking.

The tense situation on the international financial markets calls for vigilance, also as regards the intended takeover. The operational risks in the transition phase can be largely overcome with conditions and restrictions. Since conflicts of interest between the Consortium partners or with business units of ABN AMRO Group cannot be fully taken away by these conditions and restrictions, there is a residual risk. The financial stability risks entailed by the intended take-over and split-up seen in isolation, however, present no ground for a negative opinion. For further details, we refer to the Annex to this letter.

In view of the risks in the transition phase and the control thereof, DNB is compelled to monitor the envisaged disintegration of ABN AMRO Group closely, within the scope of both its regular supervisory activities and subsequent applications by the Consortium partners for declarations of no objection.

With kind regards,
ANNEX

This Annex starts by briefly explaining the terms financial stability and systemic risk and how they apply to ABN AMRO Group (hereinafter: ABN Amro) and then proceeds to interpret the present situation on the financial market. This is followed by a discussion of the main risks entailed by the split-up by the Consortium and the merging of ABN Amro’s Dutch retail branch with Fortis. The risks identified in this Annex are complementary to those identified in the prudential test performed within the scope of the application for a declaration of no objection, and primarily relate to contagion to the rest of the financial system and the real economy.

An analytical framework
Financial stability refers to a situation in which the financial system is capable of allocating liquidity so efficiently and absorbing shocks so adequately that they have no distorting effect on the real economy or on other financial systems.\(^2\) Closely related to financial stability is systemic risk. This is the possibility of developments occurring that may seriously impede the functioning of the financial system and eventually cause severe damage to the real economy. Systemic risk becomes manifest once problems spread to other institutions as a result of contagion, but also if a number of institutions are simultaneously hit by the same shock. Systemic relevance refers to the measure of the potential systemic risk inherent to a segment of the financial system.

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Application to ABN Amro

The systemic relevance of ABN Amro for the Netherlands in the original situation can be illustrated on the basis of the following three factors:

- Potential contagion channels to the rest of the financial system. In this regard, reference can be made to ABN Amro’s strong interrelatedness with other banks through the interbank money market and because of several important cross-participations.\(^3\) Also, ABN Amro is, as a major player, linked to the main payments and securities systems, it is the largest correspondent bank of the Netherlands and an important counterparty on the financial markets. Another contagion channel – in the (unlikely) event that ABN AMRO should go

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\(^2\) See DNB’s Quarterly Bulletin of December 2000, p. 6. Although various definitions of financial stability circulate, there is by and large consensus about this term.

\(^3\) About 5% of ABN Amro’s share capital was (in any case until quite recently) held by ING and Fortis.
bankrupt – is the Dutch deposit guarantee system, which provides that part of the losses are attributed to the rest of the banking system.

- **Potential contagion channels to the real economy.** Risks may manifest themselves by way of negative wealth effects, including deposits which in case of a bankruptcy are not protected by the deposit guarantee scheme. In addition, the real economy may be hit by a failure of the new undertaking’s financial services. Finally, unfavourable developments at ABN Amro may indirectly affect the real economy by undermining the confidence in the financial system.

- **Shock resistance.** This is the capacity to accommodate less-than-expected developments of various natures in an orderly manner, so that the consequences need not be transferred to other segments of the financial system or the real economy. Within this context, reference can be made to the sound solvency position of ABN AMRO Group, as well as the strong diversification across other market segments and geographic regions.

The systemic relevance of ABN Amro in the original situation implies that major changes regarding this undertaking may have substantial consequences for the financial stability in the Netherlands.

Before discussing our investigation, we refer to the current situation on the international financial markets. Signs increasingly point to a serious disruption of today’s global financial system currently, because internationally operating banks have substantially increased liquidity needs and therefore hoard liquidity. As a consequence, the international money market for maturities from one week and upwards is not functioning well at the moment. Banks’ uncertainty about their future liquidity needs arises from the deteriorated market climate for credit products. As a result, banks feel increasingly compelled to fund special funding vehicles related to them (‘conduits’) themselves again. The liquidity need potentially ensuing from this development is vast. The deficient functioning of the money market may have negative effects for all banks directly or otherwise involved in the envisaged acquisition. Therefore, there is a risk that the takeover process will become disorderly, which would harm the financial stability in the Netherlands.

We also note that the intended split-up of ABN AMRO Group, given its unique nature and complexity, calls for great care and enough time from the acquiring parties. At the same time, it is in the interest of the financial stability in the Netherlands that the duration of the period of uncertainty about the future of ABN AMRO Group is kept to a minimum.

The analysis below discusses a number of potential risks in the transition phase, the period during the split-up and integration processes, and the final phase, when the integration will have been completed.

**Transition phase: implications of split-up and integration of ABN Amro by the Consortium**

The disintegration of an internationally active major bank the size of ABN Amro and the subsequent division of the business units across the three Consortium partners will be a complicated operation without precedent. The parties have announced that this process is estimated to last two to three years. During the transition phase, the undertaking will be directed by a common structure, while also service platforms will be shared.

Due to its duration and complexity, the transition phase will be characterised by extra operational risks. Within this scope the following aspects are particularly important:

- As long as the payments operations of the new combinations (Consortium + ABN Amro) are run separately from the respective existing administrative systems, the transition phase will have no consequences for payments. This changes once ABN Amro’s administrative systems will be disintegrated and integrated with the Consortium partners’ systems. This consolidation process may take several years. It should be expected that, in anticipation of the full integration of the systems, the new combination will be striving to minimise the **intraday** liquidity costs. If it seeks to do so by rushing into consolidating the liquidity management and channelling the corresponding payment flows around the systems, significant risks may arise, especially in stress situations.
• Furthermore, dismantling of ABN Amro’s Transaction Banking system will be a complex and time-consuming operation. Much time is expected to go into realising a division according to the lines along which the Consortium intends to split up the Group and its customer base. A hasty split-up may lead to extra operational risks, whereas a careful transition plan might mitigate such risks to a considerable extent. A plan to be approved by DNB should therefore be among the conditions and restrictions to be attached to the declaration of no objection applied for by the Consortium partners. A specific point of attention for the Consortium partners is the circumstance that during the transition period it will be difficult to realise synergy gains from their systems, both as regards the servicing of customers and the reduction of operational costs.

• Special attention will be required for the critical payments, in particular those run through the various Real Time Gross Settlement (RTGS) systems of central banks and Continuous Linked Settlement (CLS), which handles the FX transactions. Too brash an integration may yield risks for liquidity management, in particular during emergency situations. In view of this aspect, too, a transition plan to be approved by DNB should be a condition. This plan should ensure that the integration of processes and procedures for liquidity management will not take place before the (supporting) administrative systems have been integrated.

• Besides the disintegration of ABN Amro, the integration of specific business units with Fortis into a new undertaking is of relevance to the Netherlands. The integration process will probably not be completed when ABN Amro has been dismantled. The consolidation process may carry extra risks related to the migration of staff, systems and customers. The consolidation of administrative systems linked to payments will therefore continue to be an important point of attention in this phase.

Although these risks may be largely contained, the possibility cannot be precluded that in the transition phase conflicts of interests emerge between the Consortium partners or between individual business units of ABN Amro and one or several new owners. In such a case, the interests of ABN AMRO Group may be impaired and the care required for the disintegration process is liable to be pushed aside, which could adversely affect the financial system. The risk of conflicts of interests is inherent to the approach opted for by the Consortium partners. While the conditions and restrictions to be met by the Consortium regarding the governance of the ABN AMRO Group aim to remove this risk, a residual risk remains all the same.

Final phase: implications of ABN Amro’s Dutch retail branch merging with Fortis
The situation after the ABN Amro’s foreign business units and wholesale activities have been hived off and after completion of the integration of its domestic retail operations with Fortis, may be summarized as follows:

• Compared to the original ABN Amro, the new undertaking will lack geographic diversification advantages (as a result of foreign business units being hived off), which is partly compensated for, however, by the addition of the insurance activities of Fortis. On balance, the Dutch financial system as a whole will become less diversified. This implies a certain loss of shock resistance, since geographic diversification advantages will disappear without this being offset by extra sectoral diversification.

• Furthermore, combining the Dutch retail activities of Fortis and ABN Amro will result in a concentration of a number of risks with one party. This applies to the deposit guarantee scheme, among others. If this scheme is called on for the new combination, higher costs would have to be borne by a smaller group of banks. A similar concentration will occur in the provision of financial services. In the event of a failure of the new combination, the negative real-economy effects will probably be more serious than in the original situation. The fact that these risks will be concentrated with one party, once more underscores the importance of continued safeguarding of the solidity of this new systemically relevant undertaking.

This new combination will call for intensive cooperation with the Belgian authorities as regards the regular supervision, payments and crisis management. The existing forms of cooperation may serve as a basis for this, however. Furthermore, any measures of the new undertaking which may have consequences for special credit measures (ELA), burden sharing or the scope of the deposit guarantee scheme will need to be submitted for approval to DNB.